

**REVENUE RULING 2003-56:
PARTNERSHIP DEBT IN A TAX-DEFERRED EXCHANGE**

Background: IRC Section 752 provides that any decrease in a partner's share of the liabilities of a partnership (or any decrease in an individual's liabilities due the partnership's assumption of the individual's liabilities) will be considered a distribution of money by the partnership to the partner. This provision creates a problem for partners when a partnership enters into an IRC Section 1031 exchange for encumbered property that crosses the taxable year of the partnership.

Example: On October 1, 2003, Partnership P, a calendar year Taxpayer, sells property A for \$500,000 subject to a mortgage of \$300,000. P's basis in the relinquished property is \$100,000. On January 20, 2004, P acquires replacement property B for \$450,000.

In this example, P has realized gain of \$400 and recognized gain of \$50. The liability offsetting rules under 1.1031(b)-1(c) allow the netting of the debt relief on the transfer of the relinquished property against the debt assumed on the acquisition of replacement property.

Under the provisions of IRC 752(b), do the partners of P need to report the "distribution of money" from the partnership by virtue of the relief of the liability at the end of their taxable year? What happens if the exchange is not completed? At what point is the net difference in liabilities (increase or decrease) reportable for purposes of Section 752?

Revenue Ruling 2003-56 provides that the liability offsetting rules under the 1031 Regulations are also taken into account in determining the amount of any decrease in a partner's share of partnership liability under Section 752(b). If a partnership enters into an exchange that straddles two taxable years of the partnership, each partner's share of the relinquished property liability is offset with each partner's share of the replacement property liability for purposes of computing any decrease in a partner's share of partnership liability (and deemed distribution of money). If, as a result of the exchange, there is an overall decrease in the partner's share of the partnership liability (as demonstrated above), the decrease is reportable in the first taxable year of the partnership – since the decrease is attributable to the transfer of the relinquished property. If, as a result of the exchange, there is a net increase in the partner's share of the partnership liability, resulting in a deemed contribution of money by the partner to the partnership, the increase will be reported in the second taxable year of the partnership.

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