

**INTERNAL REVENUE SERVICE
NATIONAL OFFICE TECHNICAL ADVICE MEMORANDUM**

December 13, 1999

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Index (UIL) No.: 108.00-00
CASE MIS No.: TAM-110367-99/CC:DOM:IT&A:B3

District Director

Taxpayer's Name:
Taxpayer's Address:

Taxpayer's Identification No:
Years Involved:
Date of Conference:

LEGEND:

Partnership =

Lender =

Year 1 =

Year 2 =

\$A =

\$B =

ISSUE:

Was a pre-1993 debt of the Partnership that was secured at the time incurred by real property used in the Partnership's trade or business debt incurred "in connection with" real property used in the Partnership's trade or business within the meaning of § 108(c)(3)(A) of the Internal Revenue Code?

CONCLUSION:

The pre-1993 debt of the Partnership was incurred "in connection with" real

property used in the Partnership's trade or business within the meaning of § 108(c)(3)(A) because, at the time incurred, the debt was secured by real property used in the Partnership's trade or business.

FACTS:

Prior to Year 1, the Partnership acquired land and constructed improvements thereon (the Real Property). In order to finance these activities, the Partnership incurred the Original Loan. From the time of its acquisition of the Real Property, and at least until the cancellation in Year 2 of a portion of the Partnership's obligations under the New Loan, described below, the Partnership used the Real Property in its trade or business. The Original Loan was debt "incurred" by the Partnership "in connection with" real property used in the partnership's trade or business within the meaning of § 108(c)(3)(A).

In Year 1, prior to 1993, the Partnership borrowed funds from the Lender pursuant to the New Loan. The amount of the New Loan exceeded the Partnership's then existing obligations with respect to the Original Loan. Concurrent with the borrowing, the Partnership used a portion of the proceeds of the New Loan to repay its then existing obligations with respect to the Original Loan, pay transaction costs and fees incurred in connection with the New Loan, and establish certain reserves required by the Lender. The Partnership used the remaining \$A of the proceeds of the New Loan (the Overborrowing) to make distributions to its partners. At the time it was incurred, the New Loan was secured by the Real Property.¹

Several years later, in Year 2, (after January 1, 1993) the Lender canceled a \$B portion of the Partnership's obligation to the Lender then owed in connection with the New Loan. (\$B is a smaller amount than \$A.) On its partnership income tax return for the tax year ending in Year 2, the Partnership reported that it had \$B of cancellation of indebtedness (COD) income attributable to "qualified real property indebtedness." The Partnership allocated this amount among its partners, and certain of its eligible partners elected under § 108 to exclude their allocable shares of this amount from income.

¹ The memorandum of the examining officer states that the debt on the Partnership property was refinanced and these properties were cross-collateralized. The memorandum also quotes from a letter from the general partner to a limited partner seeking its agreement to the refinancing and stating that the amount of the New Loan would be approximately, but no more than, 90% of the fair market value of the Real Property. If the fair market value of the Real Property was substantially less than the amount of the New Loan when incurred, it may be possible that an issue is raised as to whether New Loan was in substance secured by the Real Property. Since this has not been raised as a legal issue, nor do the facts presented raise it, it has not been addressed in this memorandum.

LAW AND ANALYSIS:

The issue under consideration in this technical advice memorandum is whether the New Loan from the Lender to the Partnership was incurred “in connection with” the Partnership’s business real property within the meaning of §108(c)(3). If the New Loan was incurred “in connection with” the Partnership’s business real property, then even the \$A Overborrowing portion used to fund distributions to the Partnership’s partners, could, assuming all other requirements were satisfied, qualify as qualified real property business indebtedness (QRPBI) as defined in §108(c)(3), the cancellation of which could give rise to COD income excludible under § 108(a)(1)(D) to the extent of the applicable limitations.

The Revenue Reconciliation Act of 1993 amended § 108(a)(1) to provide that, in certain instances, the gross income of a taxpayer does not include COD income from the discharge of QRPBI. Section 108(c)(3) sets forth the criteria that must be satisfied in order for a debt to be QRPBI. First, the debt must have been incurred or assumed “in connection with” real property used in a trade or business. Whether the “in connection with” requirement is satisfied is determined as of the time the debt was incurred or assumed. Second, at the time the debt is forgiven, it must be secured by real property used in the trade or business. Third, the debt must have been incurred or assumed prior to 1993, or, if incurred or assumed after 1992, the debt must be qualified acquisition indebtedness (QAI) as defined in § 108(c)(4). QAI is indebtedness “incurred or assumed to acquire, construct, reconstruct or substantially improve” business real property. Finally, the taxpayer must elect to exclude the COD income.

Sections 108(c)(3) and 108(c)(4) must be interpreted so that it is possible for a pre-1993 debt (such as the Partnership’s New Loan from the Lender) to satisfy the “in connection with” requirement of § 108(c)(3)(A) without also satisfying the QAI standard of § 108(c)(4) applicable to post-1992 debt. A contrary interpretation must be rejected because it would eliminate any effective distinction between pre-1993 and post-1992 debt and therefore render § 108(c)(4)’s QAI concept superfluous. In Ginsberg & Sons v. Popkin, 285 U.S. 204, 208 (1932) the Supreme Court stated, as a fundamental rule of statutory construction, that “effect shall be given to every clause and part of a statute”. See also, Thoburn v. Commissioner, 95 T.C. 132, 149 (1990). Therefore, the term “in connection with” cannot simply mean QAI. However, QAI will meet the “in connection with” requirement. Presumably, therefore, Congress, in grandfathering pre-1993 debt from the QAI requirement, intended to make it easier for such debt to satisfy the QRPBI definition. Thus, the question becomes what less restrictive relationship than incurred “to acquire, construct, reconstruct, or substantially improve” such real property (the relationship required in order for a debt to be QAI), satisfies § 108(c)(3)(A)’s “in connection with” requirement applicable to pre-1993 debt?

Cases that have construed the term “in connection with” as used in other tax statutes suggest that the term should be construed broadly. See Snow v. Commissioner, 416 U.S. 500 (1974) (holding experimental expenditures to be

deductible under § 174 as incurred “in connection with” the taxpayer’s trade or business even though, at the time incurred, the activities did not constitute a trade or business for purposes of § 162); Huntsman v. Commissioner, 905 F.2d 1182 (8th Cir. 1990) (holding that a debt incurred three years after the taxpayer purchased his residence was incurred “in connection with” the purchase of the residence as required by § 461(g)(2) when the debt replaced three-year balloon debt incurred at the time the residence was purchased); Alves v. Commissioner, 734 F.2d 478, 481-82 (9th Cir. 1984) (stock purchased by an employee was in connection with the performance of services under § 83 even though purchased at full market value and not considered compensation). When Congress used “in connection with” in § 108(c)(3)(A) it was aware of the Supreme Court’s interpretation of this same language in Snow. Therefore, it is reasonable to assume that it intended the same broad interpretation be given to the language in § 108(c)(3)(A). See Miller v. Commissioner, 836 F.2d 1274, 1282 (10th Cir. 1988).

The language of § 108(c)(3)(A) requires that the debt be incurred or assumed in connection with qualified real property. Therefore, the nexus of the debt is to the qualified real property, not necessarily to the trade or business. This connection between the debt and the qualified real property must exist when the debt is incurred or assumed. It is the real property and not the debt that must satisfy the used in a trade or business requirement.

Since the statutorily required connection is between the debt and the qualified real property, it is reasonable to find that pledging the qualified real property as security for the debt when the debt is incurred or assumed constitutes a meaningful connection between the debt and the real property. This interpretation fulfills the statutory requirement. In addition, it preserves a separate meaning for § 108(c)(4), construes “in connection with” broadly, as case law requires, and provides for a less rigorous standard for pre-1993 debt than that which must be met by post-1992 debt. Therefore, regardless of the fact that the proceeds of the New Loan were used both to refinance the Original Loan and for other purposes bearing a less direct relationship to the Real Property, the fact that the New Loan was secured by the Real Property satisfies the statutory requirement of § 108(c)(3)(A).

For the above reasons, we conclude that § 108(c)(3)(A)’s “in connection with” requirement is satisfied if the debt is secured by real property used in a trade or business at the time the debt is incurred or assumed, and, accordingly, that the New Loan from the Lender to the Partnership was incurred “in connection with” the Partnership’s business real property. Since we have determined that the statutory requirement is satisfied in this instance because the New Loan was secured by the Real Property at the time it was incurred, there is no need to address the secondary argument presented by the taxpayer that depended on tracing the use of the loan proceeds to determine if the debt was incurred in connection with real property used in a trade or business.

This conclusion that § 108(c)(3)(A)'s "in connection with" requirement is satisfied if, at the time the debt is incurred, it is secured by business real property is not inconsistent with the regulations under §§ 108 and 1017 finalized in 1998. The preamble to these regulations (see T.D. 8787, 1998-46 I.R.B. 5, 6) addressed a comment suggesting that § 108(c)(3)(A)'s "in connection with" requirement be deemed satisfied with respect to pre-1993 debt if, on January 1, 1993 (the effective date of the 1993 Act's amendments to § 108) the debt was secured by business real property. The preamble rejected this comment, stating that the "in connection with" requirement "should [not] be interpreted to mean only that the debt must be secured by" business real property as of January 1, 1993. The preamble did not suggest that the requirement would not be satisfied if a pre-1993 debt was secured by business real property at the time the debt was incurred or assumed.

CAVEAT(S):

A copy of this technical advice memorandum is to be given to the taxpayer(s). Section 6110(j)(3) of the Code provides that it may not be used or cited as precedent. Except as expressly provided herein, no opinion is expressed or implied concerning the federal tax consequences of any aspect of any transaction or item discussed or referenced in this memorandum under any provision of the Code other than § 108 and no opinion is expressed or implied herein as to whether all or a portion of the Partnership's Year 2 COD income related to the New Loan was excludible under § 108 by the partners.