Internal Revenue Service

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Department of the Treasury

Washington, DC 20224

Person to Contact:

Telephone Number:

Refer Reply To:
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Date: June 10, 2003

LEGEND:

Taxpayer =

B = .

C =

D =

E =

F =

date 1 =

date 2 =

date 3 =

date 4 =

w =

x =

y =

z =

Dear

This is in reply to your August 13, 2002, request for a ruling that the discharge of indebtedness described below will not result in income under § 61(a)(12) of the Internal Revenue Code because it will be treated as a purchase price adjustment under Rev. Proc. 92-92, I992-2 C.B. 505.

FACTS:

Taxpayer purchased C, D, and E on date 1 from B . As part of the purchase price, Taxpayer gave B a promissory note (the "Note") totaling $w. Taxpayer also gave B cash in the amount of $x that Taxpayer borrowed from F, a third party lender. In exchange for the loan, Taxpayer gave F three promissory notes (collectively, the "Third Party Note") . Because F was the primary lender, Taxpayer, B, and F entered into a Debt Subordination Agreement (the "Agreement").

In supplemental information dated March 14, 2003, you stated that B entered into the Agreement in order to induce F to loan the amount of $x to Taxpayer, so that Taxpayer could complete the purchase of C, D, and E from B. Under the Agreement, B agreed not to require current payments with respect to the Note until Taxpayer's current liabilities to F under the Third Party Note are paid in full. However, F and B are not joint creditors with respect to the Note. F has no right to force B to cancel the Note. F does have the right under Section 2 of the Agreement to request that Taxpayer stop making current payments on the Note, but F has no right to demand that B cease enforcing its right to all payments on the Note. Under the terms of the Note, Taxpayer, as the buyer, is indebted solely to B, the seller, with respect to the balance of the Note. An affidavit submitted by the President and General Manager of Taxpayer represents that, "[T]here were direct negotiations between [Taxpayer] ... and [B] ... to forgive the [N]ote." Finally, each of the partners of Taxpayer represents that for federal tax purposes they "will report the discharge of the Note in a manner that is consistent with [Taxpayer's] ... federal income tax treatment of the discharge."

During B's third quarter ended date 2, Taxpayer's operating performance declined, and Taxpayer was delinquent in payments on the Note to B. For the year ended date 3, Taxpayer was also in default on the Third Party Note to F. Consequently, under the Agreement F instructed Taxpayer on date 4 to cease all payments to B. As a result, B plans to discharge Taxpayer's Note. As of the date of the discharge of the Note, Taxpayer will be insolvent; Taxpayer's liabilities will exceed the fair market value of its assets by approximately $y. Taxpayer's adjusted tax basis in the assets purchased from B will be approximately $z on the date of discharge.

LAW AND ANALYSIS:

Section 61(a)(12) provides that gross income includes income from discharge of indebtedness.

Section 108(e)(5) provides that if (A) the debt of a purchaser of property to the seller arising out of such purchase is reduced, (B) the debt reduction does not occur in a title

11 bankruptcy case or when the purchaser is insolvent, and (C) the reduction would be treated as income to the purchaser from the discharge of indebtedness but for this paragraph (e)(5), then such reduction will be treated as a purchase price adjustment. This purchase price adjustment treatment will result in a reduction in the basis of the property securing the debt rather than in discharge of indebtedness income.

Section 3.01 of Rev. Proc. 92-92 provides that the Internal Revenue Service will not challenge a bankrupt or insolvent partnership's treatment of a reduction (in whole or in part) of an indebtedness owed by such partnership as a purchase price adjustment, provided that the transaction would otherwise qualify as a purchase price adjustment. However, section 3.02 of the revenue procedure provides that the treatment in section 3.01 will not apply if any partner in the partnership adopts a federal income tax reporting position with respect to the debt discharge that is not consistent with the partnership's federal income tax treatment of that discharge.

Under the facts presented, the seller of the property, B, agreed to discharge the debt that was part of the purchase price owed by the Taxpayer, who was insolvent at the time. F's assertion of its rights under the Agreement did not effectively force B to discharge the Note. Taxpayer is not directly or indirectly indebted to F with respect to the Note; B currently retains all rights as creditor with respect to the Note. The debt being discharged is owed by Taxpayer to B, and B is discharging Taxpayer's debt.

CONCLUSION:

Based solely on the information provided and the representations made, we conclude that under Rev. Proc. 92-92 Taxpayer may treat B's discharge of Taxpayer's Note as a purchase price adjustment. This treatment will not apply if any partner in Taxpayer adopts a federal income tax reporting position inconsistent with Taxpayer's treatment.

CAVEATS:

A copy of this letter must be attached to any income tax return to which it is relevant. We enclose a copy of the letter for this purpose.

Also enclosed is a copy of the letter ruling showing the deletions proposed to be made in the letter when it is disclosed under § 6110.

Except as expressly provided herein, no opinion is expressed or implied concerning the tax consequences of any aspect of any item discussed or referenced in this letter.

This ruling is directed only to the taxpayer(s) requesting it. Section 6110(k)(3) provides that it may not be used or cited as precedent.

Sincerely,

Robert A. Berkovsky
Branch Chief
Office of Associate Chief Counsel
(Income Tax & Accounting)

Enclosures (2)