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November 11, 2015

LEGEND

X =

Y =

P =

O =

a =

b =

Dear :

This responds to a letter dated June 25, 2015, and subsequent correspondence, submitted on behalf of X, requesting a ruling that its receipt of Notice to Proceed payments under certain long-term construction contracts give rise to liabilities for purposes of section 752.

FACTS

Two construction companies, X and Y, formed a partnership P to enter into long-term construction contracts to engineer, design, and construct certain industrial facilities for the owner, O. Under the contracts, P is obligated to perform all work, meaning all obligations, duties, and responsibilities required, including fabrication, construction, commissioning, performance testing, and any other services or work required to be furnished under the contracts. Further, the contracts spell out P's obligations to achieve substantial completion and final completion within specific timeframes. Each contract provides that P will follow a construction schedule and achieve substantial completion in approximately a years.

As compensation for P's full and complete performance of the work, O is to pay P $b under each contract. During the period that the work is being performed, O is required to make interim, or progress, payments to P in accordance with a payment milestone schedule, provided that P is otherwise in material compliance with its contractual obligations. Generally, under the payment milestone schedules, P is entitled to progress payments for the portion of work relating to completion of each payment milestone. Accordingly, over the term of the construction period, progress payments, generally, are tied to the completion of certain work. However, there are certain payments (the "Notice to Proceed payments") to be made to P before the completion of the work and before incurring costs in performing the work, at the time O issues P certain notices to proceed with the next phase of construction.

Before P is entitled to receive payments under the contracts and, explicitly, to receive the Notice to Proceed payments, P is required to provide certain guarantees and also to deliver to O irrevocable standby letters of credit. The letters of credit secure P's obligations to perform under the contracts and cover O's damages in the event of non-performance or default by P. The amount of the letters of credit securing P's obligations roughly corresponds to the amount of the Notice to Proceed payments.

The contracts provide that if P fails to prosecute the work in a diligent and efficient manner, or if P abandons the project or repudiates any of its obligations, a default occurs. In that event, O is entitled to several remedies, including seeking specific performance (that is, obtaining judicial enforcement requiring P to make good on its obligation to perform the work) and recovery from P of costs, damages, losses, and expenses (that is, requiring P to make good on its obligation to cover O's damages in the event of nonperformance). Specifically, the contracts allow O to draw-down directly against the letters of credit in the event of a default by P.

P reports income using the percentage of completion method under § 460. Therefore, P reports income based on a comparison of contract costs incurred to estimated total contract costs. Because most progress payments are linked to work performed, and, correspondingly, to costs incurred, there generally is a correlation between the year in which payments are received and the year in which income is reported. However, the Notice to Proceed payments are different—they are not linked to contract performance and precede P's reporting of the related income.

LAW AND ANALYSIS

Section 722 provides that a partner's basis is increased by the amount of money the partner contributes to the partnership.

Section 752(a) provides that any increase in a partner's share of the liabilities of a partnership shall be considered as a contribution of money by such partner to the partnership.

Section 1.752-1(a)(4)(i) defines liability as follows:

> An obligation is a liability for purposes of section 752 and the regulations thereunder (§ 1.752–1 liability), only if, when, and to the extent that incurring the obligation—
> (A) Creates or increases the basis of any of the obligor's assets (including cash);
> (B) Gives rise to an immediate deduction to the obligor; or
> (C) Gives rise to an expense that is not deductible in computing the obligor's taxable income and is not properly chargeable to capital.

Section 1.752-1(a)(4)(ii) defines obligation as follows:

> For purposes of this paragraph and § 1.752–7, an obligation is any fixed or contingent obligation to make payment without regard to whether the obligation is otherwise taken into account for purposes of the Internal Revenue Code. Obligations include, but are not limited to, debt obligations, environmental obligations, tort obligations, contract obligations, pension obligations, obligations under a short sale, and obligations under derivative financial instruments such as options, forward contracts, futures contracts, and swaps.

Revenue Ruling 95-26, 1995–1 C.B. 131, concludes that a partnership's obligation to deliver securities in a short sale transaction constitutes a section 752 liability under a definition of partnership liability similar to the definition quoted above. The Revenue Ruling reasons that a short sale creates such a liability inasmuch as: (1) a short sale creates an obligation to return the borrowed securities, citing Deputy v. Du Pont, 308 U.S. 488, 497-98 (1940), 1940-1 C.B. 118; and (2) the partnership's basis in its assets is increased by the amount of cash received on the sale of the borrowed securities. Therefore, the Revenue Ruling concludes that the partners' bases in their partnership interests are increased under section 722 to reflect their shares of the partnership's liability under section 752. In Salina Partnership LP v. Commissioner, T.C. Memo 2000-352, the Tax Court examined the policy underlying section 752 and the analysis of Revenue Ruling 95-26 and held that a partnership's obligation to close its short sale by replacing borrowed securities represented a partnership liability within the meaning of section 752.

CONCLUSION

Based solely on the facts submitted and the representations made, we conclude that P's obligations under the contracts to proceed with performing work and to incur costs in performing the work, and the corresponding obligations to satisfy O's remedies in the event P were to default or suspend work, constitute liabilities under section 752 upon and to the extent P receives the Notice to Proceed payments but has not yet reported the related income.

Except as specifically set forth above, we express no opinion concerning the federal tax consequences of the facts described above under any other provision of the Internal Revenue Code.

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

In accordance with the Power of Attorney on file with this office, a copy of this letter is being sent to X's authorized representative.

Sincerely,

David R. Haglund
David R. Haglund
Chief, Branch 1
Office of Associate Chief Counsel
(Passthroughs & Special Industries)

Enclosures (2)

Copy of this letter
Copy of this letter for section 6110 purposes

cc: