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# IRS Clarifies Cancellation Of Partnership Indebtedness

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In today's economic climate, more and more taxpayers are struggling to repay loans, and must negotiate with lenders for alternatives. The Internal Revenue Service has issued proposed regulations that provide guidance on (1) the determination of cancellation of indebtedness income of a partnership that issues a partnership interest to its lender in satisfaction of the partnership's debt, and (2) the tax consequences to the lender.

**Background**

When a lender cancels all or a portion of a borrower's indebtedness, the borrower generally will have taxable income equal to the amount of the discharge (cancellation of indebtedness income, or "COD" income). This is generally true whether the borrower satisfies the reduced amount of debt with cash, or with property. However, there had been a question prior to 2004 as to whether a borrower partnership's issuance of an interest in the partnership in exchange for satisfaction of its debt was tax free to the partnership where the partnership interest was worth less than the face amount of the debt.

Case law in existence prior to 1980 held that a corporation had no COD income when it transferred stock to a lender in exchange for its debt, no matter what the value of the stock transferred (the "debt-for-equity exception"). Many believed that the debt-for-equity exception also applied to partnerships.

A 1984 amendment to Section 108 of the Internal Revenue Code changed this result for corporations (other than those that were insolvent or bankrupt), providing that, in a debt-for-equity exchange, a debtor corporation had to recognize COD income in the amount that the debt exchanged by the lender exceeded the value of the stock transferred to the lender. Since this statutory change dealt only with corporate borrowers, many continued to believe that this debt-for-equity exception continued to apply to partnerships.

In 2004, Congress ended the uncertainty, and amended Section 108 to state that discharges of indebtedness of a partnership, in exchange for a capital or profits interest in the partnership, result in COD income, in the amount that the debt exceeds the fair market value of the partnership interest. Any such COD income of the partnership will be included in the distributive shares of the taxpayers that were partners in the partnership immediately before the discharge. The amended statute does not provide any guidance on how to determine the fair market value of the partnership interest issued.

**Proposed Regulations**

Four years later, but just in time for the current economic crisis, on October 30, 2008, the IRS issued proposed regulations, which provide a safe harbor for valuing a partnership interest issued by a partnership to a lender in a debt-for-equity exchange, for purposes of determining COD income. As long as certain requirements are met, taxpayers can use the "liquidation value" of the partnership interest as its fair market value, and do not have to take into account valuation factors such as illiquidity or minority discounts, which could lower the value. The proposed regulations define "liquidation value" as the amount of cash that the lender would receive with respect to the interest if, immediately after the transfer, the partnership sold all of its assets (including good will, going concern value, and any other intangibles associated with the partnership's operations) for cash equal to their fair market value, and liquidated.

Under the proposed regulations, this definition of "fair market value" can be used only if four requirements are met: (i) the partnership maintains capital accounts in accordance with accounting rules set out in Treasury Regulations; (ii) the lender, partnership, and its partners treat the fair market value of the indebtedness as being equal to the liquidation value of the partnership interest (i.e., the parties report consistently for tax purposes); (iii) the debt-for-equity exchange is an arm's-length transaction; and (iv) subsequent to the

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exchange, neither the partnership redeems, nor any person related to the partnership purchases, the lender's interest as part of a plan at the time of the exchange which has as a principal purpose the avoidance of COD income by the partnership.

The regulations provide that if the safe harbor requirements are not met, all facts and circumstances will be considered in determining the fair market value of the partnership interest. This raises the specter of IRS auditors applying steep discounts to value (for illiquidity and/or lack of control), resulting in larger amounts of COD income for partnerships that do not meet the safe harbor.

One oddity in the safe harbor is that the first requirement technically requires only that capital accounts be "determined and maintained" in accordance with the Treasury Regulations. On its face, this requirement seems to dictate how the partnership keeps it books, but does not require that those books have any impact on the partners' economic entitlements, that is, the regulation seems to contain no requirement that the partnership make liquidating distributions in accordance with the partners' capital account balances. Yet, without requiring liquidation in accordance with capital account balances, the requirement to maintain capital accounts would seem pointless. Many partnership agreements direct that the partnership liquidate in accordance with stated percentages or a "waterfall," rather than in accordance with the partners' capital account balances. If there is an implicit requirement in the regulation to liquidate in accordance with capital accounts, partnerships may need to amend their agreements to comply with this requirement.

**Example**

Partnership P has $1,000 of outstanding indebtedness owed to creditor C. In an arm's-length transaction, C agrees to contribute the debt to P, in exchange for an interest in P. If P sold all of its assets for cash equal to fair market value, and liquidated, the amount of cash C would receive with respect to the partnership interest issued to C is $700.

Assuming all of the safe harbor requirements are met, P can value the interest issued to C at its liquidation value. Thus, the fair market value of the partnership interest issued to C is deemed to be $700. P is treated as satisfying the $1,000 indebtedness with $700, and P will have $300 of COD income. The $300 of COD income must be included in the distributive shares of the persons who were partners in P immediately before the exchange.

**Lender's Tax Consequences**

The proposed regulations issued on October 30, 2008 also amend the regulations under Section 721, generally resulting in unfavorable tax consequences to a lender in a debt-for-equity exchange with a partnership borrower.

**Background**

Section 721 of the Code provides generally that a person who contributes property to a partnership, in exchange for a partnership interest, recognizes no gain or loss on the contribution. Under the proposed regulations, a contribution of debt by a lender to a partnership, in exchange for a capital or profits interest in the partnership, will generally be treated as tax free to the lender under Section 721. The lender's basis in its partnership interest will be equal to the lender's adjusted basis in the debt contributed. No loss will be recognized by the lender at the time of the contribution of the debt, even if the partnership recognizes COD income.

In the above Example, Section 721 would preclude C from recognizing a loss on its contribution. However, since C's basis in its partnership interest will be equal to C's adjusted basis in the contributed debt, C may recognize its loss either when it sells its partnership interest or when its interest is liquidated.

**Accrued Interest Obligations**

The proposed regulations also state that in the case of a contribution of indebtedness for unpaid rent, royalties, or interest on indebtedness (including accrued original issue discount (OID)), to the partnership debtor, Section 721 tax-free treatment is not available. In other words, a lender may have to recognize ordinary income to the extent that part of the debt contributed relates to accrued interest.

Prior to 1980, if a lender contributed a corporation's accrued interest obligation to the corporation, in exchange for stock of the corporation, the lender was potentially eligible for tax-free treatment under Section 351 with respect to stock received in satisfaction of its claim for any accrued interest (if all the other requirements of Section 351 were met), even if the lender had not yet reported the accrued interest income. In 1980, Congress amended Section 351 so that tax-free treatment was no longer available in such a case. Thus, a cash-basis lender must recognize gain upon a contribution of an interest obligation to a debtor corporation. No parallel change was made in 1980 to the rules governing tax-free contributions to partnerships, with the result that a lender's contribution of a partnership's accrued interest obligation to the partnership, in exchange for a partnership interest, was believed by some to be tax free under Section 721. The October 30, 2008 regulations propose to resolve this issue; under these regulations a cash-basis lender must recognize taxable income on such a contribution to a partnership.

The proposed regulations to Section 721 also provide that, for purposes of determining the respective portions of a partnership interest issued to a lender that are considered to be in exchange for principal indebtedness, interest, or OID, very specific ordering rules apply, under which payments of indebtedness are generally allocated first to accrued interest, and then to principal. For example, assume that creditor C, a cash-basis taxpayer, contributes indebtedness with (a) a principal amount of $1,000 (and an adjusted basis of $1,000), and (b) an accrued interest obligation of $200, to partnership P, in exchange for a partnership interest in P with a fair market value of $250. Under the ordering rules, the partnership interest would be applied first to

the accrued interest obligation, and then to the principal obligation. Section 721 would then apply only to C's exchange of the principal indebtedness for a partnership interest; it would not apply to C's exchange of the interest obligation for a partnership interest. Therefore, C would have to report $200 of interest income, as a result of the satisfaction of the interest obligation with a partnership interest with a value of $200. The remaining partnership interest issued by P, valued at $50, would be transferred by P to C in exchange for the $1,000 principal obligation, resulting in no loss recognized by C, and a high carryover basis to C in its low-value partnership interest, equal to C's adjusted basis of $1,000 in the principal amount of debt contributed. These ordering rules clearly produce unfavorable results to C. Additionally, although the proposed regulations do not make it clear, there is no obvious reason why these ordering rules would not also apply also to the determination of COD income to P, resulting in COD income to P of $950 (principal indebtedness of $1,000 less partnership interest issued worth $50).

The proposed regulations would apply to exchanges occurring on or after the date the regulations are finalized.

**Conclusion**

Fortunately, the proposed regulations are short and fairly straightforward. Unfortunately, the proposed regulations do not address other unresolved COD issues that are becoming increasingly relevant in the current economic climate. In addition, the proposed regulations introduce the inequity of COD income to a borrower but no current loss available to the lender. We hope that this issue and other issues will be addressed in time to aid the growing number of troubled borrowers and lenders facing these questions.