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**TEACHING OLD DOGS NEW TRICKS –
EMERGING TAX ISSUES FOR DISTRESSED
REAL ESTATE ASSETS AND PARTNERSHIPS***

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TEACHING OLD DOGS NEW TRICKS – EMERGING TAX ISSUES FOR DISTRESSED REAL ESTATE ASSETS AND PARTNERSHIPS

In the late 1980s and early 1990s, primarily as a result of the savings and loan crisis and the absence of equity capital, tax advisors worked on thousands of workout transactions. In the process, tax practitioners acquired extensive knowledge of the various issues that can arise in connection with transactions ranging from (i) debt modifications to (ii) foreclosure (or deed in lieu of foreclosure) transactions to (iii) partnership transactions that included exchanges of partnership debt for newly issued equity interests in such partnerships or the contribution of fresh capital to the troubled partnerships to facilitate restructurings of such partnerships' balance sheets and capital structures. The tax advisor became intimately familiar with the concept of cancellation of indebtedness income ("**COD Income**"); the intricate rules of sections 108 and 1017 of the Internal Revenue Code of 1986, as amended (the "**Code**" or "**IRC**"); the devastation to cash-strapped clients forced to recognize phantom income or gain as a result of a workout; the sometimes fatal interaction of IRC sections 108, 704(b), 752 and 1274; and a bevy of other potential traps.

Between 1991 and 1999, the Internal Revenue Service (the "**IRS**" or "**Service**"), in response to conditions on the ground and the extensive participation of the American Bar Association Section of Taxation¹ and the AICPA, promulgated numerous Revenue Procedures and Revenue Rulings (i) to clear up certain matters (e.g., Rev. Rul. 91-31² served to clarify that, notwithstanding the holding in *Fulton Gold*,³ the cancellation of a nonrecourse liability triggers COD Income and a taxpayer cannot merely reduce his tax basis in the asset(s) secured by such nonrecourse debt) and (ii) to provide relief and clarity in a number of other instances where the statutory language of IRC section 108 or certain provisions of Subchapter K did not (and still do not) provide clear rules and there were no regulations providing any meaningful guidance regarding the proper interpretation of various statutory provisions. In addition, significant legislative changes were made to IRC section 108 and new regulations were promulgated to deal with the fact patterns and issues that had emerged, especially where the distressed taxpayer was a partnership or a partner in a partnership. Appendices I, II and III hereto briefly summarize the most important IRS pronouncements, legislative changes and regulations that were issued or enacted to address many of these problem areas. Appendix IV hereto briefly summarizes IRC section 108(i) that was recently enacted to allow taxpayers, under certain circumstances, to defer COD Income recognized by them during 2009 or 2010 until 2014 and to then recognize such COD Income (without the benefit of utilizing the exclusions contained in IRC section 108(a)) over the ensuing five year period.

In retrospect, it was a wild, crazy and fun time to be a tax advisor and when we all emerged from the darkness of workouts to the light of economic recovery, many of us thought we had mastered this complex area of the tax law because we had "seen it all." Boy were we wrong.

The balance of this outline will not concentrate on the basics of workout transactions and IRC section 108 planning as there are scores of articles that have been written and speakers

¹ For an extensive discussion of the most salient workout tax issues that were focused upon by tax advisors during this period, see "Report of the Section 108 Real Estate and Partnership Task Force," 46 *Tax Law* 209, 216 (1992-1993).

² 1991-1 C.B. 19.

³ 31 BTA 519 (1934).

who have addressed the literally hundreds of rules that so many of us grappled with two decades ago. Instead, this outline will focus on certain new issues and problems that have arisen during the past few years as new transactions and fact patterns have emerged. In some cases, the new issues can be attributed to the expanded use of limited liability companies (“**LLCs**”) that were not prevalent until the promulgation of the Check-the-Box (“**CTB**”) regulations.⁴ In other cases, today’s owners of troubled assets (REITs, private equity funds, non-U.S. investors) differ from the typical owners of yesteryear (insolvent individuals who developed and owned real estate projects directly or through syndicated partnerships).

The remainder of this outline will focus on the following broad categories of transactions and issues that currently are in play:

1. Transactions where the current owners cease to own the assets that are subject to indebtedness that exceeds the fair market value (“**FMV**”) of such assets (often referred to herein as “**underwater assets**”).

2. Characterizing a liability as a recourse or nonrecourse debt for purposes of IRC section 1001.

3. Transactions where the taxpayer recognizes that it will not recoup its equity investment with respect to the underwater asset and seeks to recognize its inherent loss in the most tax efficient manner.

4. Finally, the last section of this outline contains a discussion of the key rules of Subchapter K that can apply to partnerships that own underwater assets (including the manner in which COD Income recognized by such a partnership may be allocated among its partners), transactions pursuant to which creditors become partners in troubled partnerships, and certain collateral consequences that should be taken into account in structuring transactions on behalf of underwater partnerships and their partners.

⁴ Treas. Reg. § 301.7701-3.

WHAT HAPPENS IF A DEBT CANNOT BE WORKED OUT – VOLUNTARY AND INVOLUNTARY FORECLOSURES AND OTHER DISPOSITIONS OF PROPERTY

A. Introduction. If a debtor and creditor are unable to reach an agreement to modify or otherwise restructure a troubled loan, typically one of two scenarios will unfold: (1) if the debtor wishes to retain the troubled asset it may seek bankruptcy protection and hope that a satisfactory plan can be formulated that will leave it with possession and control over its property, or (2) if the debtor is not willing (or able) to affirmatively utilize the bankruptcy laws, the property will be acquired by the creditor pursuant to a consensual agreement, a foreclosure sale or a bankruptcy filing. This section will focus on the general tax rules that are applicable to voluntary and involuntary dispositions of real property and offer several planning suggestions. The tax consequences of these transactions will depend on how the transaction and the debt are **characterized** for federal income tax purposes because the characterization accorded to the transaction will affect the **character** of the income **and/or** loss that must be recognized by the debtor (and its partners) in connection with the disposition. To the extent that COD Income arises as a result of a workout transaction, such income will be taxed as ordinary income (at the highest marginal rates) except to the extent that (i) such income can be excluded under IRC section 108 (most typically under IRC section 108(a)(1)(A) (the bankruptcy exclusion), 108(a)(1)(B) (the insolvency exclusion) or 108(a)(1)(D) and 108(c) (the qualified real property indebtedness exclusion for solvent individuals and S corporations)), or (ii) such income can be offset with (A) losses of the taxpayer from the current taxable year (or net operating losses from past years that have been carried forward), (B) suspended passive activity losses, or (C) other tax attributes of the taxpayer. On the other hand, if the taxpayer is an individual and recognizes a capital loss¹ in connection with the transaction, such loss may prove to be of only limited value since it cannot be carried back and can be used only if the taxpayer recognizes capital gains during the current year or a future year. **Characterization** and **character** will also be crucial with respect to the other matters discussed in the succeeding sections of this outline.

B. Sale or Exchange Treatment.

1. General Overview. Voluntary and involuntary dispositions of property, including dispositions occurring pursuant to foreclosure proceedings and deeds in lieu of foreclosure, constitute sales or exchanges for federal income tax purposes.² Any such disposition, therefore, will likely result in the recognition of gain or loss by the debtor. The amount of such gain or loss will be determined by comparing the proceeds realized by the debtor with the debtor's adjusted tax basis in the property "sold."³ The key determination, therefore, is the amount of proceeds that will be deemed realized by the debtor as a result of the disposition. The answer will depend on several factors, the most important of which are (1) whether the debt that encumbers the property constitutes recourse or nonrecourse debt for purposes of IRC section 1001, and (2) the FMV of the property at the time of the disposition.

¹ Losses may be ordinary under IRC section 1231. Ordinary losses claimed under IRC section 1231 may be recaptured as ordinary income in later years under IRC section 1231 (c).

² See *Helvering v. Hammel*, 41-1 U.S.T.C. ¶ 9169 (S.Ct. 1941); *2925 Briarpark, Ltd., v. Commissioner*, 163 F.3d 313 (5th Cir. 1999); Rev. Rul. 73-36, 1973-1 C.B. 372; Treas. Reg. § 1.1001-2(a)(1); see generally Witt & Lyons, "An Examination of the Tax Consequences of Discharge of Indebtedness," 10 *Va. Tax Rev.* 1, 4 (1990), at 57-63; Kalteyer, "Real Estate Workouts - Original Issue Discount Implications of Troubled Debt Restructurings," 43 *Tax Law.* 579 (Spring 1990), at 579; Lipton, "Briarpark and the Unexpected Limits to Careful Tax Planning," 90 *J. Tax'n* 198 (April 1999).

³ IRC section 1001(a). If the mortgagor has a right of redemption, the gain or loss realized on the foreclosure will not be recognized until the right of redemption period expires. See Rev. Rul. 70-63, 1970-1 C.B. 36.

2. Dispositions of Property Subject to Nonrecourse Debt.

a. **General.** Following the Supreme Court's decision in *Tufts*, it is well settled that the amount realized upon the disposition of a property subject to a nonrecourse liability will always be at least equal to the amount of such liability.⁴ Thus, if property subject to a nonrecourse liability is foreclosed upon or voluntarily conveyed by the debtor, such debtor will recognize gain or loss⁵ equal to the difference between (1) the amount of the liability (plus the amount of cash and the FMV of any other property paid to the debtor) and (2) the debtor's adjusted tax basis in the property immediately before the disposition. No portion of the debtor's gain will constitute COD Income under these circumstances and, therefore, IRC section 108 and the potential for relief provided thereunder will be totally unavailable.⁶ It has been suggested that, where the debtor who owns an underwater property is insolvent and wishes to avail himself of the benefits of IRC section 108, a taxpayer might (1) convert the debt into recourse debt prior to the disposition (presumably with an understanding that any deficiency amount will be forgiven by the creditor),⁷ (2) sell the collateral to a third party with the consent of the creditor, with the debtor paying the sales proceeds to the creditor in exchange for a full release of the debt, or (3) obtain a discharge of a portion of the debt in exchange for a cash payment to the creditor and then transferring the property to the creditor in satisfaction of the debt.⁸ Each of these suggestions appears to be susceptible of being attacked on a number of grounds, including step transaction principles.⁹ Scenario (2) is addressed immediately below.

b. **Functional equivalent of foreclosure – *Briarpark*.** In 2925 *Briarpark, Ltd. v. Commissioner*,¹⁰ the taxpayer, a limited partnership, acquired land and constructed an office building thereon. The land and building were encumbered by a nonrecourse loan made by a bank, a portion of the loan being personally guaranteed by the taxpayer's general partner.

In 1989, when the amount owing in respect of the debt substantially exceeded the FMV of the land and building, the taxpayer, at the request of the bank, offered the assets for sale. Several months later, when the loan was in default, the taxpayer sold the property to a third party, which third party conditioned its purchase on the removal of all encumbrances on the property (particularly the liens held by the bank). The bank agreed to release its liens with three provisos: (i) that the net sales proceeds be paid to the bank; (ii) that the general partner make a cash payment to the bank in respect of his partial guarantee of the loan (such cash payment

⁴ See also IRC section 7701(g); Treas. Reg. §§ 1.1001-2(a)(1), 1.1001-2(c) Examples (6) and (7); *Estate of Delman v. Commissioner*, 73 T.C. 15 (1979).

⁵ Such gain or loss may be ordinary income or loss, capital gain or loss or IRC section 1231 gain or loss depending on the facts.

⁶ The taxpayer's gain (if any) may constitute gain from a passive activity, however, which can be offset if the taxpayer has otherwise suspended passive activity losses. It has been suggested that foreclosures and other dispositions of property encumbered by nonrecourse debt should be analyzed in the same manner as similar transactions where the debt is recourse to the owner, as discussed, *infra*. Under this analysis, the sales proceeds would be limited to the actual FMV of the property and the debt in excess of such value would be treated as COD Income. See Blanchard, "Discharge of Nonrecourse Debt: A Reexamination of the Distinction Between Recourse and Nonrecourse Debt and Related Issues," 50 *Tax Notes* 773 (Feb. 18, 1991); Blanchard, 51 *Tax Notes* 1461 (June 17, 1991). It is unlikely that many taxpayers have taken this position.

⁷ The conversion of a liability from nonrecourse to recourse should not cause the taxpayer to be deemed to have sold the underwater asset provided that there is no agreement that the creditor will forgive the deficiency amount. This begs the question, of course, why the taxpayer would agree to undertake personal liability with regard to an undersecured loan.

⁸ See Witt & Lyons, *supra* footnote 2, at 61.

⁹ But see *Danenberg v. Commissioner*, 73 T.C. 370 (1979), *acq.*, 1980-2 C.B. 1; T.A.M. 8005002 (Oct. 11, 1979).

¹⁰ 163 F.3d 313 (5th Cir. 1990), *aff'g.*, 73 T.C.M. (CCH) 3218 (1997).

being less than five percent of the portion of the loan guaranteed by him); and (iii) that the partnership's cash reserves be paid to the bank.

The taxpayer took the position on its tax return that the transaction resulted in approximately \$14.5 million of COD Income and a net loss of \$61,245 whereas the Service took the position that the transaction resulted merely in gain to the taxpayer and that the taxpayer did not realize any COD Income.

The resolution of the issue presented to the court essentially came down to how the transaction should be characterized for tax purposes. The Tax Court noted that the sale of the property, with the proceeds being paid to the bank, had the "same practical effect as several other transactions which have been held to be a 'sale or exchange'." These transactions included an involuntary foreclosure sale;¹¹ a reconveyance of property subject to a nonrecourse loan;¹² an abandonment of property subject to a nonrecourse loan;¹³ and a deed in lieu of foreclosure.¹⁴ The Tax Court then held (and the Fifth Circuit concurred) that the Briarpark partnership transaction was the functional equivalent of the foregoing transactions and that the fact that the bank did not acquire title to the property was immaterial.¹⁵ In so holding, the court distinguished *Gershkowitz v. Commissioner*,¹⁶ which held that the settlement of a nonrecourse loan at a discount resulted in COD Income to the borrower where the borrower sold the property three months later. The key difference between *Gershkowitz* and *Briarpark* is that in *Briarpark* the Tax Court and the Fifth Circuit found a single transaction whereby the property was deemed sold subject to the entire debt secured thereby, whereas in *Gershkowitz* the sale occurred at a later date in an independent transaction (with the taxpayer retaining title to the property in question **after** the debt in question had been discharged).

There are a few other interesting aspects of the Tax Court's holding in *Briarpark*. First, two years prior to the sale transaction, the bank agreed to convert the loan from a recourse to a nonrecourse obligation. At such time, it appears that the existing loan balance exceeded the FMV of the property. The taxpayer argued that the conversion of the loan from a recourse to a nonrecourse obligation resulted in COD Income to the taxpayer at such time. The court rejected this alternative argument, chiefly on the ground that the bank, which also advanced new funds to the taxpayer to fund tenant improvements, intended to enforce all of its rights under the loan following the conversion. Second, the court observed, without analysis, that there was not any identifiable event indicating the taxpayer had abandoned the property on or before the conversion of the loan from a recourse to a nonrecourse loan. It would appear that, while neither the court nor the taxpayer was directly asking the question of whether the bank had become the owner of the property for tax purposes, implicitly the court was holding that neither the conversion of the loan from recourse to nonrecourse nor the fact that the loan balance significantly exceeded the FMV of the property caused the taxpayer to cease to be the owner of the property for tax purposes. This theme will be further explored in several other contexts in the discussion that follows.¹⁷

¹¹ *Helvering v. Hammel*, 311 U.S. 504 (1941).

¹² *Allen v. Commissioner*, 856 F.2d 1169 (8th Cir. 1986).

¹³ *Yarbro v. Commissioner*, 739 F.2d 479 (5th Cir. 1984).

¹⁴ *Laport v. Commissioner*, 671 F.2d 1028 (7th Cir. 1982); *Freeland v. Commissioner*, 74 T.C. 970 (1980).

¹⁵ *Sands v. Commissioner*, T.C.M. 1997-146.

¹⁶ 88 T.C. 984 (1987).

¹⁷ For a further discussion of *Briarpark*, see Lipton, "Briarpark and the Unexpected Limits to Careful Tax Planning," 90 *J. Tax'n* 198 (April 1999).

c. Other Thoughts Regarding Constructive Foreclosure. One of the issues that permeates real estate workout and distress situations is at what point in time the tax owner of an underwater asset should be deemed to cease to own such asset in the absence of an actual conveyance of title to the asset to the lender, a designee of the lender or a third party purchaser or transferee of the asset. Set forth below are several questions and observations related to this issue:

1. A mere decline in the value of the collateral without more does not cause a realization event to occur.¹⁸

2. Can the substantial modification of an undersecured debt cause the asset to be deemed transferred to the creditor?¹⁹

3. Are there circumstances where a substantial change in the value of the collateral, in combination with other events (modification of the debt that includes a substantial increase in the “economic rights” of the lender and/or additional involvement of the lender in the monitoring or operation of the asset), are sufficient to create a realization event?²⁰

4. Do actions taken by the debtor or its partners (e.g., claiming worthlessness deductions) impact the realization question?

d. Nonrecourse Debt Guaranteed by a Partner. If the property foreclosed upon is subject to debt that is nonrecourse to the partnership but guaranteed by a partner, it is not clear that the debt will be treated as nonrecourse debt for purposes of IRC section 1001. At least two commentators have expressed the view that, based upon *Tufts*, the partnership should recognize gain measured by the full amount of the debt (*i.e.*, that the debt should be treated as nonrecourse for purposes of IRC section 1001), and the release of the guarantor-partner(s) should be ignored.²¹

3. Dispositions of Property Subject to Recourse Debt. In the event a property subject to a recourse debt is foreclosed upon by, or voluntarily conveyed to, a creditor, the transaction must be carefully scrutinized to determine the ***amount and character*** of the taxpayer's income or loss. As noted above, in these situations there are two transactions taking

¹⁸ See *Proesel v. Commissioner*, 77 T.C. 992 (1981).

¹⁹ Prop. Reg. § 1.1001-3(f)(7)(ii) is intended to answer this question in the negative. For a discussion of this proposed regulation, including whether the proposed regulation in fact ensures that the substantial modification of an underwater loan will not be treated as transferring tax ownership of the troubled asset to the creditor, see Lipton, “Proposed Regulations Address Impact of a Decline in Debt Issuer's Financial Status under Debt Modification Regulations – or Do They?”, Vol. 13, No. 4 *J. Passthrough Entities* 7 (July-August 2010). For further discussion on this question, see Sugin, “Nonrecourse Debt Revisited, Restructured and Redefined,” 51 *Tax L. Rev.* 115, 142-145 (1995).

²⁰ *L&C Springs Associates v. Commissioner*, 74 T.C.M. 928 (1997), *aff'd*, 188 F.3d 866 (7th Cir. 1999); *Carlins v. Commissioner*, 55 T.C.M. 228 (1988); *Cozzi v. Commissioner*, 88 T.C. 435 (1987); *Brountas v. Commissioner*, 74 T.C. 1062 (1980), *vacated and remanded on other grounds*, 692 F.2d 152 (1st Cir. 1982); *aff'd in part, rev'd in part on other grounds sub. nom., CRC Corp. v. Commissioner*, 693 F.2d 281 (3d Cir. 1982), *cert. denied*, 462 U.S. 1106 (1983). For a more thorough analysis of these issues, see Sowell, “Worthless Partnership Interests,” 44 *Tax Mgmt. Memo.* 480 (Nov. 17, 2003).

²¹ See Reeves and Shapleigh, “Effect of Discharge of Indebtedness Income on Partnerships and Partners,” 8 *J. Partnership Tax.* 18, 26-27 (Spring 1991). The authors question this conclusion since the debt is not pure nonrecourse debt and the issue has not been fully addressed by the Service or resolved by the courts. Consequently, in these scenarios, it is conceivable that taxpayers may characterize the debt (as recourse or nonrecourse) depending upon a variety of factors, including the solvency of the partners, the amount of the debt and the partnership's adjusted tax basis in its assets.

place: (i) a taxable disposition of the property, and (ii) to the extent the FMV of the property is less than the outstanding balance of the recourse debt, either the taxpayer continues to be liable to the creditor (in the amount of the deficiency), or the remainder of the liability that was not satisfied by the conveyance of the property is discharged by the creditor. Under this approach, the taxpayer must recognize gain or loss equal to the difference between the FMV of the property and the taxpayer's adjusted tax basis therein immediately prior to the disposition. If the remainder of the debt is forgiven as part of the transaction, the amount forgiven will constitute COD Income that, unless one of the exclusions provided by IRC section 108 is applicable, will be included in the taxpayer's gross income. The transaction thus must be bifurcated to analyze these two distinct transactions.

a. Case Law. The case law regarding whether foreclosures or other dispositions of property subject to recourse debt should be bifurcated in the manner described above is divided. In *Chilingirian v. Commissioner*,²² the debtor was held to have realized sales proceeds that included the full amount of certain first lien recourse debt secured by his property upon the foreclosure of such property by the second lienholder. Significantly, it is unclear from the facts reported in *Chilingirian* whether the FMV of the property was greater or less than the debt secured thereby. In addition, it appears that neither the Service nor the taxpayer argued, nor did the court consider, whether the foreclosure transaction should be bifurcated to determine the true nature of the taxpayer's income. In *Aizawa v. Commissioner*,²³ the Tax Court held that the amount realized by the taxpayer on a foreclosure sale of real property subject to a recourse liability was limited to the proceeds of the foreclosure sale, where the taxpayer remained liable for the balance of the debt. *Aizawa* left unanswered whether the Tax Court might apply *Tufts* where the taxpayer conveys his property to a recourse lender in full satisfaction of the debt. The Tax Court subsequently addressed this question in *Frazier v. Commissioner*.²⁴ In *Frazier*, the court applied the reasoning in *Tufts* and determined that the true FMV of property subject to a recourse liability and transferred in foreclosure should be treated as the amount realized and that the excess should be treated as COD Income.²⁵

b. Rev. Rul. 90-16. As a result of this division, certain regional offices of the Service took the position that a foreclosure or voluntary conveyance of property in full satisfaction of recourse debt was governed by *Tufts*, with the amount realized being equal to the full amount of the recourse debt. The Service responded to these wayward agents by issuing Rev. Rul. 90-16,²⁶ which makes it clear that a disposition of property secured by a recourse liability must be analyzed in accordance with the bifurcation method set forth in Treas. Reg. § 1.1001-2(a)(2) regardless of whether the recourse liability is fully satisfied as an integral part of the conveyance.

c. Partially Recourse Debt. If the secured debt is partially recourse, the Service takes the position that a transfer of cash or the collateral to the creditor in satisfaction of the debt will be allocated first to the nonrecourse portion of the debt in the absence of an agreement to the contrary.²⁷ As a result, if the FMV of the property transferred to the creditor is less than the nonrecourse portion of the debt, the sales proceeds realized by the

²² T.C.M. 1986-463, *aff'd*, 918 F.2d 1251 (6th Cir. 1990).

²³ 99 T.C. 197 (1992), *aff'd*, 29 F.3d 630 (9th Cir. 1994).

²⁴ 111 T.C. 243 (1998).

²⁵ See Lupi Sher, "Frazier: Revenue Rulings Should Have Some Fair Market Value," 81 *Tax Notes* 687 (November 9, 1998).

²⁶ 1990-1 C.B. 12.

²⁷ See T.A.M. 8348001.

debtor will equal the nonrecourse portion of the debt, and the recourse portion of the debt will be deemed forgiven and will constitute COD Income.

d. Conversion of Recourse Debt to Nonrecourse Debt. In some cases, a loan workout will result in the conversion of a recourse debt into a nonrecourse debt. Under Treas. Reg. § 1.1001-3(e)(5)(ii), such a conversion typically will result in a substantial modification of the debt and the deemed issuance of a new debt instrument in exchange for the old debt instrument. In general, such a deemed exchange should not result in COD Income provided the instruments are not publicly-traded and the issue price of the new note is at least equal to the adjusted issue price of the original note. This assumes, of course, that following the modification, the debt is still treated as debt for tax purposes, and there has not been a constructive foreclosure or other deemed transfer of the asset to the creditor. In *Briarpark, supra*, as noted above, the conversion of debt from recourse to nonrecourse did not trigger either COD Income to the borrower or a constructive abandonment of the assets, even though the FMV of the assets was less than the outstanding loan balance, because the creditor continued to view itself as a creditor following the conversion.

4. Characterizing Debt as Recourse or Nonrecourse for Purposes of IRC section 1001.

a. General Rule – State Law Controls the Determination. As explained further below, the classification of a debt as recourse or nonrecourse will have significant implications in connection with a foreclosure sale or other disposition of an underwater property. While IRC section 1001 does not provide any guidance regarding when a debt should be characterized as recourse or nonrecourse, the prevailing view of tax advisors is that the determination of whether a liability is recourse or nonrecourse for purposes of IRC section 1001 generally turns on how the liability is characterized under the controlling state law.²⁸ One commentator recently noted, however, that the Service apparently believes that the characterization of a liability for purposes of IRC section 1001 should be based on IRC section 752 principles.²⁹ If the proper standard for making the recourse/nonrecourse determination is the characterization of the debt under state law, then the recourse/nonrecourse determination should not be difficult where the debtor is a general partnership, limited partnership or LLC that is treated as a partnership for federal income tax purposes because the recourse/nonrecourse determination will turn solely on whether, under the terms of the loan documents, the creditor's rights are limited to specified assets that secure the debt (nonrecourse liability for IRC section 1001 purposes) or whether the creditor can pursue all of the debtor's assets in the event the loan is not repaid (recourse liability for IRC section 1001 purposes). Put another way, under the terms of the controlling loan documents and state law, may the creditor reach all of the assets owned by the borrower and may the creditor use the bankruptcy laws to enforce its rights against the borrower?

b. The Plot Thickens – Single Member LLCs. If the LLC has only one owner/member and does not file a CTB election, such LLC ("**SMLLC**") will be disregarded

²⁸ See Rubin, Whiteway and Finkelstein, "Treatment of Liabilities as Recourse or Nonrecourse in a Complex Financial World," 13 *J. Passthrough Entities* 29 (July-August 2010); see also Burke, "Exculpatory Liabilities and Partnership Nonrecourse Allocations," 57 *Tax Law.* 33, at 37 (Fall 2003); Starr, Case, Garre-Lohnes, Rosenberg, Schmalz and Crnkovich, "Limited Liability Companies," 752-2nd *Tax Management Portfolio* (BNA) A-45 (2010).

²⁹ 2010 TNT 186-22 (Sept. 17, 2010), citing two non-binding IRS pronouncements, FSA 200028019 (July 14, 2000) and NSAR 020142 (Feb. 26, 2002). This issue will be focused upon in detail below in connection with the discussion of the Tax Court's decision in *Great Plains Gasification*, 92 T.C.M. 534 (2006).

for federal income tax purposes and its assets and liabilities will be treated as owned/owing by the sole member. The sole member, however, generally will not be liable for such debt (absent a guarantee or similar contractual undertaking). In these instances, special analysis is needed to determine if the debt of the SMLLC is to be treated as recourse or nonrecourse debt for purposes of IRC sections 1001 and 7701(g).³⁰ Unfortunately, neither of these sections nor the regulations thereunder provide any definition or guidance regarding when debt owing by a state law partnership or an LLC should be treated as recourse or nonrecourse debt for purposes of these sections. While the regulations issued pursuant to IRC sections 704(b) and 752 define recourse, nonrecourse and partner nonrecourse liabilities for purposes of allocating a partnership's income, loss and debt among its partners, such regulations would appear to be irrelevant for purposes of characterizing debt as recourse or nonrecourse for purposes of IRC sections 1001 and 7701(g).³¹ As noted above, while there is some commentary addressing this issue (with conclusions drawn in relatively straightforward fact patterns),³² there is no helpful authority addressing the more complex fact patterns that are illustrated below.

c. Illustrative LLC Fact Patterns.³³

(1) Nonrecourse Loan to SMLLC. SMLLC borrows money from Bank on a fully nonrecourse basis. The loan is secured by one or more assets owned by SMLLC. Bank's sole recourse is against the asset(s) owned by SMLLC and Bank cannot reach other assets owned by the taxpayer (the owner of SMLLC). This loan should be characterized as nonrecourse debt for purposes of IRC section 1001.

(2) Nonrecourse Loan to SMLLC Guaranteed by Owner of SMLLC. Same facts as above but the owner of SMLLC personally guarantees the nonrecourse loan. Because Bank can pursue the owner and enforce its rights against owner's other assets, such loan should be characterized as a recourse debt for purposes of IRC section 1001.

(3) Recourse Loan to SMLLC. SMLLC borrows money from Bank and is personally liable to repay the loan. SMLLC owns a single real estate asset. Under state law, SMLLC can be sued by Bank if it defaults under the loan and Bank can pursue all remedies available to it under the applicable state law, including the filing of a bankruptcy petition against SMLLC. Bank cannot sue the owner of SMLLC nor may Bank reach any of such owner's other assets to satisfy Bank's claims against SMLLC. This is a more difficult fact pattern. Some tax advisors are of the view that the loan should be viewed as nonrecourse for purposes of IRC section 1001 on the theory that the SMLLC is a disregarded entity and the lender cannot seek to enforce its rights against the taxpayer (the owner of SMLLC) pursuant to a bankruptcy proceeding. Other advisors are of the view that the answer may depend on whether the owner of SMLLC owns other assets or has the right to acquire other assets under the operative documents and agreements. If the owner of SMLLC is precluded from acquiring

³⁰ IRC section 7701(g) codifies the Supreme Court's decision in *Commissioner v. Tufts*, 83-1 U.S.T.C. ¶ 9328 (S.Ct. 1983) and provides that in determining the gain or loss with respect to an asset, the FMV of the asset is not less than the amount of any nonrecourse debt to which the asset is subject.

³¹ *But see Great Plains Gasification Associates v. Commissioner*, discussed *infra*; see also footnote 5, *supra*, and the accompanying text suggesting that the Service may believe that the rules of IRC sections 704(b) and 752 are relevant in characterizing debt as recourse or nonrecourse debt for purposes of IRC section 1001.

³² See Rubin, *supra*, at 34-36.

³³ These examples are merely illustrative of the problem as there are countless other fact patterns that pose similar difficulties of analysis. The conclusions expressed herein assume that state law governs the recourse/nonrecourse determination.

additional assets, these advisors believe that the loan may be viewed as recourse to the taxpayer on the theory that Bank has the right and ability to reach **all** of the assets of the **taxpayer** (the owner of SMLLC) even though Bank cannot actually sue the taxpayer or file a bankruptcy petition against the taxpayer. On the other hand, if the owner of SMLLC has other assets that cannot be reached by Bank, the consensus view appears to be that the recourse loan to SMLLC should be treated as a nonrecourse liability for purposes of IRC section 1001.

(4) Recourse Loan to Regarded LLC that Owns Single Asset and is Prohibited from Owning Other Assets. LLC (taxed as a partnership) borrows money from Bank and acquires a real estate asset. LLC (but not its members) has full personal liability to repay the loan. Under the LLC agreement and the controlling loan documents, LLC is prohibited from acquiring any other assets. If LLC defaults on the loan, Bank can pursue all remedies available to it under state law, including the filing of a bankruptcy petition against LLC. Bank cannot sue the members of LLC nor may Bank reach any of the members' other assets to satisfy its claims against LLC.

Once again, there is not unanimity among tax advisors as to whether the loan is recourse or nonrecourse for purposes of IRC section 1001. Some advisors are of the view that, because Bank can sue LLC (the taxpayer) and pursue relief under the bankruptcy laws, the loan should be treated as recourse for purposes of IRC section 1001, while other advisors believe that the loan should be considered nonrecourse for such purposes because **in substance** Bank can only reach the single real estate asset owned by LLC.

This fact pattern is similar to the fact pattern considered by the Tax Court in *Great Plains Gasification*, a controversial and perplexing decision that is discussed immediately below.

d. Great Plains Gasification. In *Great Plains Gasification*, the Tax Court considered whether debt owing by a partnership that was discharged as part of a foreclosure proceeding was recourse or nonrecourse debt. *Great Plains Gasification* has created a great deal of consternation among tax professionals³⁴ because of the reasoning employed by the Tax Court in concluding that the debt in question was nonrecourse debt.

In *Great Plains Gasification*, the partnership incurred approximately \$1.5 billion of debt to build a coal gasification plant. Such loan was secured by a mortgage on the partnership's assets and was guaranteed by the Department of Energy ("**DOE**"). The parent corporation of one of the partnership's general partners pledged shares of stock of one of its subsidiaries ("**Pledged Shares**") to secure the DOE guaranty. The partnership defaulted on the loan, the DOE paid off the loan and the DOE eventually foreclosed on the plant, bidding in \$1.0 billion for the partnership's pledged assets. The DOE released the partnership from the remaining debt when it acquired title to the Pledged Shares.

In holding that the entire debt was discharged as a result of the foreclosure, the Tax Court stated that "the debt was in substance nonrecourse against the partnership and the partners," and, therefore, the sales proceeds received by the partnership on the foreclosure included the entire debt.

In *Great Plains Gasification*, the Tax Court addressed other issues that have not garnered as much attention as its analysis of the recourse v. nonrecourse question. One of

³⁴ See Rubin, *supra*.

these issues was whether the partnership abandoned the project prior to the foreclosure sale. In finding that the facts did not support the Service's argument that an abandonment had occurred, the court observed that the question of abandonment is "inherently a factual matter" (citing *L&C Springs*), and noted that while a determination of abandonment typically requires both an intent to abandon the asset and an "affirmative act" of abandonment, the overt act of abandonment is not needed when the abandonment would result in the taxpayer recognizing income if "it is clear for all practical purposes that the taxpayer will not retain the property" (again citing *L&C Springs*).³⁵

In *L&C Springs*, the Seventh Circuit considered the point at which the taxpayer should be deemed to have abandoned property and recognized COD Income under IRC section 1001. The taxpayer argued the abandonment took place in 1991 when the property was sold pursuant to a foreclosure proceeding while the Service argued that the abandonment occurred in 1990 when the lender acquired effective control over the property but had not yet acquired legal title thereto. The Seventh Circuit affirmed the Tax Court's decision that the abandonment occurred in the earlier year, such decision being based on the default by the taxpayer on the debt, the taxpayer's failure to pay property taxes, and the lender taking over control and management of the property. The subsequent passage of legal title to the lender was deemed a "mere formality.

The Tax Court then turned to the recourse/nonrecourse issue and stated that such determination is made at the partnership level and that debt is generally treated as nonrecourse if the creditor's remedies are limited to specifically pledged assets and as recourse if the creditor may reach all of the debtor's assets (citing *Raphan v. U.S.*³⁶). Interestingly, *Raphan* addressed the allocation of debt among partners under IRC section 752, and the *Raphan* decision led to the amendment of the IRC section 752 regulations in 1988. Importantly, *Raphan* did not address, and would appear to have no relevance in characterizing, debt for purposes of IRC section 1001 (which, as noted above, governs sales of assets, including sales pursuant to foreclosure proceedings).

After opening the door by referring to *Raphan*, the Tax Court in *Great Plains Gasification* proceeded to rely on Treas. Reg. § 1.752-1(e) (which was in effect when the transactions at issue occurred) to define a partnership liability as nonrecourse where "none of the partners have any personal liability." The court then noted that the partnership in question had no significant assets other than the coal plant and that under the controlling documents it was not authorized to acquire other assets or engage in any other business. The court then concluded that the liability was in substance nonrecourse (under the prior version of Treas. Reg. § 1.752-1(e)) because the partnership's liability was effectively limited to the project assets and the partners' liability was limited to their partnership interests. Perhaps more importantly, the court also noted in a footnote that the taxpayer did not argue that the debt should be considered recourse by virtue of the pledge of the Pledged Shares.

It appears that the taxpayer did not seek to characterize the debt as recourse because its tax objectives did not relate to the **character** of income recognized as a result of the foreclosure and pledge transactions, but rather related to the timing of such income recognition (the taxpayer sought to defer recognizing a substantial portion of its gain until the following year when it formally transferred the Pledged Shares in respect of its guaranty).

³⁵ Issues related to abandonment and worthlessness are discussed *infra*.

³⁶ 759 F.2d 879 (Fed. Cir. 1985).

The question that must be asked following the Tax Court's decision in *Great Plains Gasification* is what relevance does this decision have going forward for purposes of characterizing debt as recourse or nonrecourse for purposes of IRC section 1001. Is the holding simply wrong because the debt was recourse to all of the assets of the partnership under state law (an argument that was not advanced by the parties)?³⁷ Was the decision wrong because the lender could also reach the Pledged Shares? Is the decision irrelevant because it relied on IRC section 752 principles that appear to be irrelevant for purposes of IRC section 1001? Or is *Great Plains Gasification* important because it suggests that, in substance, the loan in question was nonrecourse because the partnership had "no significant assets apart from the project" and "the partnership was not authorized to acquire nonproject assets or to engage in any business other than the project."³⁸ While it is impossible to answer these questions at this time, it appears that, following *Great Plains Gasification*, the questions of whether other assets can be reached by a creditor, and whether a borrower has the right to acquire other non-pledged assets, may need to be asked and answered.

5. Determining FMV. In the absence of clear and convincing proof to the contrary, the FMV of property that is foreclosed upon will be the amount bid in for such property at the foreclosure proceeding.³⁹ On the other hand, if the debtor voluntarily transfers the property to the creditor, it will be more difficult to establish the FMV of the property. In the latter case, to establish the FMV of the property, the debtor should enter into an agreement with the creditor that sets forth the agreed upon FMV of the property. Such agreements, of course, are not binding on the Service. Moreover, in many instances the creditor will not agree to enter into an agreement specifying the FMV of the collateral. To avoid these potential problems, the debtor should obtain an appraisal of the property, and report the transaction in a manner that is consistent with such appraisal.

³⁷ See Rubin, *supra*, at 35.

³⁸ *Great Plains Gasification*, *supra*, at 28.

³⁹ Treas. Reg. § 1.166-6(b)(2); see *Community Bank v. Commissioner*, 62 T.C. 503 (1974), *acq. in result*, 1975-1 C.B. 1.

LIKE-KIND EXCHANGE ON THE EVE OF FORECLOSURE

In a bit of *déjà vue*, the question has recently been raised whether a taxpayer who owns an asset that is encumbered by a nonrecourse liability that exceeds the FMV of the asset may transfer such asset as part of a like-kind exchange transaction. Transactions of this nature were effected in the early 1990s and the Service, at least informally at such time, questioned whether an asset with “negative equity” could in fact be a relinquished property for purposes of IRC section 1031.

It is understood that these transactions have reemerged and, thus, the question has arisen once again as to whether such an asset may be disposed of through a qualified intermediary (“**QI**”) with a view to effect a like-kind exchange transaction and avoid the recognition of taxable gain inherent in the underwater asset. Such taxable gain would be equal to the excess of (i) the nonrecourse liability owing by the taxpayer with respect to the asset over (ii) the taxpayer’s adjusted tax basis in such asset. In these cases, the taxpayer, prior to the foreclosure or deed in lieu of foreclosure event, transfers the asset to QI subject to the debt, QI acquires replacement property designated by the taxpayer, the replacement property is direct deeded to the taxpayer, and subsequently the relinquished property is foreclosed upon or otherwise transferred to the nonrecourse lender. It is critical to note that, to permit QI to acquire the replacement property, the taxpayer will likely have to transfer to QI the cash needed by QI to acquire the replacement property (the balance of the purchase price for the replacement property being funded with debt encumbering such property, either newly issued debt or existing debt that would continue to be secured by the replacement property). Such cash would be furnished by the taxpayer in the manner contemplated by Treas. Reg. § 1.1031(d)-2.

The key question, of course, is whether transactions of this type will be respected according to their form. Set forth below is a brief summary of the key issues and arguments that bear upon these transactions.

1. Is the Underwater Asset Property for Purposes of IRC section 1031? Does the relinquished property constitute “property” for purposes of IRC section 1031? This question squarely asks whether an asset in which the taxpayer has “negative equity” can be treated as property for purposes of IRC section 1031. It does not appear that there is any authority that has directly considered this issue. Neither the language of IRC section 1031 nor its legislative history appears to limit its application to exchanges involving non-troubled properties. In the early 1990s, IRS representatives made public statements that a like-kind exchange on the eve of a foreclosure appeared to be an abusive transaction and that regulations might be promulgated to deny such exchanges tax-free treatment under IRC section 1031. While the Service never issued any such regulations under IRC section 1031, the Service did propose regulations under IRC sections 332, 351 and 368 regarding the treatment of transactions under those sections where the property being transferred is subject to liabilities in excess of the FMV of such property.¹ In general, the proposed regulations provide that a transfer of such property is not entitled to nonrecognition treatment. The Service has indicated that it recognizes the principles set forth in the proposed regulations could be applied to other provisions of the Code. Accordingly, it is possible that the Service ultimately may extend this approach to IRC section 1031. While there are not many authorities addressing transfers of underwater assets or

¹ 70 Fed. Reg. 11903 (March 10, 2005). For a thorough discussion of these proposed regulations, see Blanchard, Hooker and Vogel, “Underwater Assets and Insolvent Corporations: Reflections on Treasury’s Recently Proposed Regulations and Related Matters,” 59 *Tax Law.* 107 (Fall 2005).

insolvent businesses, IRC section 351 implicitly has been held to apply to the incorporation of an insolvent sole proprietorship where the business was continued following the incorporation.²

In the IRC section 1031 context, the following arguments might be advanced to support like-kind treatment where the relinquished property has “negative equity”: (i) the asset is not worthless – it is merely subject to debt in excess of the gross FMV of such asset; (ii) the purpose of IRC section 1031 is to permit taxpayers to roll their built-in gain into a like-kind replacement property whereas IRC sections 351 and 721 appear to require the taxpayer-transferor to receive stock or a partnership interest that represents a continuing interest in the asset(s) contributed to the corporation or partnership; and (iii) Treas. Reg. § 1.1031(d)-2 provides a mechanism for a taxpayer to furnish cash to a QI to fund the acquisition of designated replacement property where the QI does not have sufficient cash from the sale of the relinquished property to otherwise do so.

2. Should the Form of the Transaction be Respected? Are there other facts present that are inconsistent with the purported transfer to QI?³ The primary factual/legal questions that must be examined are (a) under the controlling loan documents, may the taxpayer transfer title to QI, and (b) has title for tax purposes already shifted from the taxpayer to the lender? It seems advisable to examine the loan documentation to ascertain whether the transfer to QI may be void as a matter of law and also whether the transfer causes the nonrecourse loan to become immediately due and payable. If these circumstances exist, the Service may argue that there has been no transfer. One can imagine the Service making a similar argument if the loan is already in default. Ultimately, however, it appears that the taxpayer’s position may hinge on the second question, to wit: who is the owner of the underwater asset as of the date of the purported transfer to QI – the taxpayer or the lender? It seems clear that one of the parties must be treated as the owner for tax purposes, and this raises the question of what events must have occurred in order for a nonrecourse lender with respect to an underwater asset to become the owner of such asset for federal income tax purposes (*i.e.*, has there been a constructive foreclosure). As noted above, the mere diminution in the value of an asset (even if below the debt) does not constitute a realization event as to the current owner. The question, therefore, should turn on whether other events have occurred that would support a conclusion that tax ownership of the asset should be viewed as having moved to the lender prior to the conveyance of the asset to QI.

Based upon the foregoing, it seems advisable that, if a like-kind exchange involving an underwater asset is to be pursued, the controlling loan documents must be carefully reviewed and the totality of the facts related to the communications, understandings and dealings between the taxpayer and the lender must be fully probed and understood. Even with “good” facts, extreme caution is suggested due to the nature of the issue and the absence of any direct authority addressing these transactions.

² *Rosen v. Commissioner*, 62 T.C. 11 (1974), *aff'd*, 515 F.2d 507 (3d Cir. 1975) (the taxpayer realized gain under section 357(c) to the extent the liabilities assumed exceeded the adjusted basis of the assets transferred).

³ An interesting, and unresolved, question is whether the taxpayer can enter into a deed-in-lieu agreement with the lender and seek to assign such deed-in-lieu contract to QI in an attempt to satisfy the formalistic requirements of the QI regulations.

ABANDONMENT AND WORTHLESSNESS OF PARTNERSHIP INTERESTS: A DISTINCTION WITH A DIFFERENCE

1. **Overview.** In recent years, taxpayers have devoted a substantial amount of time determining alternative courses of action available to them with respect to their interests in troubled partnerships. In some cases, an individual may own an interest in a partnership whose assets (or sole asset) is subject to debt substantially in excess of the FMV of such asset(s). In other cases, a partnership may own multiple assets, one or more of which may be owned by a lower tier partnership in which the taxpayer-partnership (the upper-tier partnership) owns an interest. In these instances, the taxpayer that owns the interest in the troubled partnership increasingly is evaluating whether he should abandon his partnership interest and claim a loss with respect to such interest, while in other cases partners are evaluating whether such interests have become worthless for purposes of IRC section 165(a).

It is impossible to address all possible scenarios in this outline. Taxpayers owning interests in troubled partnerships, however, generally will fall into one of two categories. Certain taxpayers will have a loss inherent in their partnership interest (*i.e.*, their adjusted tax basis in their partnership interest will exceed their share of partnership debt) whereas others will have a gain inherent in their partnership interest (*i.e.*, their adjusted tax basis in their partnership interests will be less than their share of partnership debt). In the former case, the taxpayer has a positive tax capital account while in the latter case the taxpayer's tax capital account will have a negative balance. It is important to keep in mind that if the partner does nothing, he or she may end up recognizing both ordinary COD Income and a capital loss, which loss may not be carried back and can only be used in the future if the taxpayer thereafter recognizes capital gains. Needless to say, taxpayers who find themselves in this situation, having suffered a real economic loss and then owing tax on COD Income (and possibly at higher rates beginning in 2011), will not be happy campers (or happy, continuing clients). The balance of this section of the outline will focus on the circumstances under which a partner with a tax loss inherent in its partnership interest may claim a deduction with respect to its partnership interest under IRC section 165(a), will analyze the differences between abandonment and worthlessness deductions and will then synthesize the intersection of analysis between foreclosure events and claims of abandonment and worthlessness.¹

The discussion that follows focuses primarily on the ability of a partner to claim a loss on the ground that its interest in a partnership is worthless as well as the character of any such loss. In recent years, there has been an increased focus on whether partnership interests should be abandoned, particularly where a partner determines that, on a net tax basis, it is to the partner's advantage to walk away from its partnership interest, particularly where the partner would recognize COD Income (and possibly an offsetting or corresponding capital loss) if the partner does not abandon its interest and the partnership eventually loses its assets pursuant to a foreclosure (or similar event). It is for this reason that partners increasingly are "running the numbers" to ascertain whether they should stay the course or take proactive steps to minimize the tax burden they will ultimately suffer when the underwater asset is completely submerged and lost.

2. **IRC section 165(a).** IRC section 165(a) provides that a taxpayer may claim as a deduction "any loss sustained during the taxable year and not compensated for by insurance or otherwise." Treas. Reg. § 1.165-1(b) provides that, in order to claim a loss under IRC section

¹ Sowell, *supra*.

165(a), the loss must be (1) evidenced by a closed and completed transaction, (2) fixed by identifiable events, and (3) actually sustained during the year for which the deduction is claimed. As explained more fully below, the loss will be an ordinary loss so long as there is neither an actual nor a deemed distribution of cash (pursuant to IRC section 752(b)) to the taxpayer and so long as the transaction is not otherwise in substance a sale or an exchange.

The following discussion concentrates on several key court decisions that focus on the circumstances under which a partner may claim a worthlessness deduction with respect to its partnership interest under IRC section 165(a) as well as the stance that the Service has taken with respect to the availability and character of deductions claimed under IRC section 165(a) with respect to abandoned or worthless partnership interests. It appears that the Service does not fully appreciate the difference between abandonment and worthlessness (or that the Service believes that the facts that must be present to sustain a deduction are the same for both concepts). As noted below, the Service's position on the question of worthlessness of partnership interests has not been sustained by the courts that have considered this issue.

3. Echols and Tejon Ranch. In 1993, the Service issued Rev. Rul. 93-80² seemingly in response to the Fifth Circuit's decision in *Echols v. Commissioner*³ (seemingly because the Service in Rev. Rul. 93-80 did not mention *Echols* or the Fifth Circuit's analysis therein). The following discussion will analyze *Echols* and other authorities (particularly *Tejon Ranch Co. v. Commissioner*⁴ the reasoning of which was heavily relied upon by the Fifth Circuit in *Echols*), together with several other court decisions that discuss the abandonment and worthlessness of partnership interests, and will provide commentary regarding this emerging and confusing area of the tax law affecting troubled partnerships and partners who own interests therein.

The taxpayers in *Echols* owned an interest in a limited partnership that owned land. Following a series of unfortunate events, including the default of a developer who owned a portion of the land, the taxpayers called a partners' meeting during May 1976 and announced they would no longer contribute to the partnership their 75 percent share of the funds needed to make mortgage and ad valorem tax payments owing with respect to the land, the FMV of which was then less than the principal balance of the outstanding nonrecourse loan secured thereby. The partnership had unsuccessfully attempted to restructure the loan and had ceased its attempts to sell the land. In February 1977, the lender foreclosed on, and acquired title to, the land. At the May 1976 meeting, the taxpayers offered to convey their partnership interest to the other partner or to anyone else who wished to assume their obligations. The other partner also averred he would not furnish any further funds to the partnership. The partnership also ceased making ad valorem tax payments and mortgage payments during 1976.

The taxpayers claimed a deduction with respect to their partnership interest under IRC section 165(a) on the ground they had abandoned such interest. Alternatively, the taxpayers claimed a deduction on the ground the partnership interest was worthless. While *Echols* is frequently cited with respect to the Fifth Circuit's reversal of the Tax Court's decision that the taxpayers had not abandoned their partnership interest in 1976,⁵ by far the more interesting

² 1993-2 C.B. 239.

³ 935 F.2d 703 (5th Cir. 1991) ("*Echols I*"), rehearing denied, 950 F.2d 209 (5th Cir. 1991) ("*Echols II*").

⁴ 49 T.C.M. 1357 (1985).

⁵ The law is settled that a partner who abandons his interest in a partnership may deduct his loss related thereto under IRC section 165(a). See Rev. Rul. 93-80, *supra*; 1997 FSA Lexis 190 (July 7, 1997); *Citron v. Commissioner*, 97 T.C. 200 (1991).

aspect of *Echols* is the Fifth Circuit's excruciatingly detailed discussion of the circumstances under which a partner may claim a loss for worthlessness under IRC section 165(a).

a. ***Echols I.*** In *Echols I*, the Fifth Circuit began its opinion by noting that two important distinctions must be kept in mind at all times: (1) the case at hand involved the partners, not the partnership, and (2) the abandonment and worthlessness of a partnership interest are distinct concepts and that "either concept can, under proper circumstances," give rise to a deduction under IRC section 165(a). The Fifth Circuit then noted that both the Tax Court (93 T.C. 553 (1989)) and the Service failed to remain cognizant of these distinctions and such failures led to an incorrect decision by the Tax Court. As we shall see, this is another instance where the proper characterization of a transaction or fact pattern is critical in determining the tax consequences to be accorded thereto.

In holding that the taxpayers were also entitled to a deduction in 1976 on the basis that their partnership interest was worthless during that year, the court noted that while the test for abandonment is objective, the test for worthlessness is both subjective and objective. The subjective part of the test, according to the court, seems to require nothing more than the taxpayer himself deem his asset to be worthless. The taxpayer's subjective desire and opinion, however, are not enough to sustain the deduction (or satisfy the requirements of IRC section 165(a) and Treas. Reg. § 1.165-1(b)). Rather, as more fully articulated in the Fifth Circuit's second opinion (*Echols II*, discussed below) when it denied the Service's motion for rehearing, the taxpayer-partner must still show "closed and completed transactions ... fixed by identifiable events" in the year for which the loss is claimed. The Fifth Circuit went to great lengths to make clear its view that such identifiable events need not be property level events such as the sale or other disposition of the property or the abandonment of the partnership interest itself. This is a critical point because it appears that the Service believes that aggregate principles of partnership taxation are to be applied in the worthlessness context⁶ while the Fifth Circuit treated the partnership as an entity and felt that the partners' interest in the partnership should be looked at on a standalone basis in making the worthlessness determination.

The Fifth Circuit then considered whether the taxpayers had abandoned their partnership interest and noted that although the Tax Court, the Service and the taxpayers unanimously agreed that a taxpayer need not relinquish title to a partnership interest to establish an abandonment loss, the Tax Court nevertheless analyzed the abandonment question by reference to previous cases where there had been an actual disposition of property **by the partnership** rather than an abandonment **by the partner** of its partnership interest. The Fifth Circuit concluded that the taxpayers had in fact abandoned their partnership interest in 1976 by virtue of their affirmative actions that evidenced that they were walking away from their ownership interest (a combination of their declarations and their overt acts).

The Fifth Circuit next addressed the taxpayers' alternative argument supporting their claimed loss under IRC section 165(a) – that their partnership interest had become worthless in 1976. The Fifth Circuit ruled that the facts, as found by the Tax Court, supported a worthlessness deduction, noting that while the test for finding abandonment was a purely objective test, worthlessness requires both objective and subjective testing. The subjective test requires a finding that the taxpayer **subjectively** believes his partnership interest is worthless and then the taxpayer must **objectively** prove that the interest was in fact valueless at such time. In *Echols I*, the Fifth Circuit found that the taxpayers manifest their subjective

⁶ See 1997 FSA Lexis 190, *supra*.

determination by (1) claiming the loss deduction in 1976 and (2) having made it clear during such year that they would no longer fund the expenses or debt service owing by the partnership. The court further observed that there is not a specific date on which a partnership interest becomes worthless but rather each partner may reach its own conclusions regarding the worthlessness of its particular interest. The court also stated that the taxpayer need not show that the FMV of its partnership interest “fell to or below zero” during the year in question, nor must the taxpayer show that its interest is “absolutely, positively without any value whatsoever.” As noted below in the detailed discussion of Rev. Rul. 93-80, the Service does not share this view.

In rendering its opinion and conclusions regarding worthlessness, the Fifth Circuit relied heavily on the Tax Court’s opinion in *Tejon Ranch*, where the partnership in question had become “insolvent beyond any hope of rehabilitation” and such insolvency constituted the “closed and completed event” that warranted the worthlessness deduction.

b. Tejon Ranch. The facts of *Tejon Ranch* were as follows: A public corporation (through its subsidiary acting as a general partner) contributed land to a newly-formed limited partnership for the purpose of developing such land for agricultural purposes. The partnership raised cash from the public and, together with debt financing, commenced the agricultural business. Subsequently, the partnership suffered severe economic distress and defaulted on loans owing by it to both third party lenders and its general partner. The senior lender considered foreclosing on its lien but opted not to because it feared the partnership would file for bankruptcy and such filing would result in further costs and losses to the lender. Instead, the lender advanced additional operating funds to preserve its collateral, took over the partnership’s operations and sought to restructure the partnership’s debt. The third party loans were in fact restructured and the senior lender agreed to fund the partnership’s operations for one additional month.

The Tax Court considered whether the taxpayer was entitled to a loss deduction (1) under IRC section 166 for certain loans (“**Partner Loans**”) made by it to the partnership, and (2) under IRC section 165 for capital contributions made by it to the partnership. With respect to the deduction claimed with respect to the partnership interest, the court noted that, to be deductible under IRC section 165(a), the “loss must be evidenced by closed and completed transactions, fixed by identifiable events, which show the year in which such a loss was sustained.”

The taxpayer argued that its loans and partnership interest became worthless during 1977. The Tax Court concluded that, although the partnership was in financial difficulty by the end of 1977, the loans had not yet become worthless. In so holding, the court noted that the partnership had not defaulted on its loans (there were two other senior loans made to the partnership by unrelated lenders) and there was “some possibility that [the partnership] could secure additional financing” to cover its working capital needs. In addition, the partnership was selling off assets to raise cash and, in the court’s view, there had not been an identifiable event to “justify abandonment of any hope of recovery.”

The court held that the loans became worthless in 1978 when the partnership ran out of operating funds and the primary unrelated lender (1) was considering foreclosing on the partnership’s assets (which foreclosure was not pursued because the lender was concerned about the costs associated therewith) and (2) took over operating control of the partnership and restructured the partnership’s debt. The foregoing occurrences were ruled to be identifiable events that demonstrated the worthlessness of the Partner Loans. The court emphasized that

the lender was effectively in control of the partnership at such time, but the court did not hold or consider whether the assets of the partnership should be deemed owned by the lender at such time.

With regard to the taxpayer's interest in the partnership, the Service argued that a deduction under IRC section 165 was not available because no closed or completed transaction had occurred (such as a dissolution or liquidation). The court dismissed the Service's argument and ruled that the taxpayer was entitled to claim a worthlessness deduction in respect of its partnership interest in 1978 because the partnership was "insolvent beyond any hope of rehabilitation by the end of 1978."

In so holding, the court noted that, although an interest in a partnership is a capital asset, a loss resulting from the worthlessness of the interest is not a capital loss since there has not been a sale or exchange of the interest.⁷ While not explicitly addressed by the court, it appears that the taxpayer had a share of partnership liability under section 752 by virtue of the fact that it was a general partner.

c. ***Echols II***. Following the Fifth Circuit's decision in *Echols I*, the Service petitioned for rehearing and asked the court to withdraw its alternative holding that the taxpayers were entitled to claim a worthlessness deduction under IRC section 165(a) with respect to their partnership interest. The Service claimed that the court's "treatment of worthlessness 'threatens substantial and lasting damage to the law governing loss under § 165(a)'."

In rejecting the Service's motion, the Fifth Circuit noted that the Service's argument, "if accepted, would totally subsume 'worthlessness' in 'abandonment.'" The court stated that a taxpayer may claim a loss deduction under IRC section 165(a) for both (i) non-worthless assets that have been abandoned, and (ii) worthless assets that have not been abandoned, noting again that the two concepts are separate and distinct from one another, and not simply two sides of the same coin.

The court also observed that the Service only cited abandonment cases to support its position on worthlessness and that the Service failed to cite any support for its argument that a taxpayer must divest itself of title to the property in question to sustain a worthlessness deduction. Rather, in the view of the Fifth Circuit, a taxpayer is entitled to a deduction under IRC section 165(a), in the absence of an abandonment, so long as there has been either **any** closed and completed transaction or **any** identifiable event supporting worthlessness. The court cited *Rhodes v. Commissioner*⁸ for the proposition that "abandonment is not the exclusive way to establish worthlessness."

The court also cited *Proesel v. Commissioner*,⁹ where the Tax Court addressed the types of "closed and completed transactions" and "identifiable events" needed to demonstrate worthlessness and noted that these transactions and events include not only sales and abandonments, but also "other acts or events" indicating worthlessness. The Fifth Circuit then noted that the analysis should focus on "**objective events** confirming the taxpayer's **subjective determination**" that the asset is worthless.

⁷ The Tax Court cited IRC sections 1222 and 741 and also referred to *Gannon v. Commissioner*, 16 T.C. 1134 (1951).

⁸ 100 F.2d 966 (6th Cir. 1939).

⁹ 77 T.C. 992 (1981).

The Fifth Circuit next observed that the Service had misinterpreted its alternative holding in *Echols I* in arguing that such alternative holding abolished the need for the taxpayer to meet the identifiable event standard for the year in which the loss is claimed. Rather, the court reiterated that worthlessness requires (i) a **subjective** determination by the taxpayer that the asset was worthless during the year in question, **and** (ii) the presence of **objective** factors reflecting a **completed transaction** and/or an **identifiable event** during such year, and that such transactions and events are not limited to the transfer of title or an abandonment. The Fifth Circuit also supported its position by noting that the Service's position was specifically rejected in *Helvering v. Gordon*,¹⁰ *Tejon Ranch, supra*, and Rev. Rul. 54-581.¹¹ In *Echols*, the default by the third party developer and the inability to restructure the debt were viewed as closed and completed events that evidenced the worthlessness of the taxpayers' partnership interest.

The final point addressed by the Fifth Circuit in *Echols II* was whether the court's holding in *Echols I* would permit taxpayers to select the year of deduction because of the subjective prong of the test. The court summarily dismissed this argument by noting that while a subjective determination does belong to a taxpayer, to sustain the deduction the taxpayer must also objectively show that identifiable events or closed transactions had occurred.

d. **Proesel.** In *Proesel v. Commissioner, supra*, the taxpayers owned an interest in an upper tier partnership that owned an interest in a lower tier partnership, which lower tier partnership produced a motion picture for a third party. The lower tier partnership incurred debt and pledged its rights under the production agreement to the lender. The taxpayers claimed that the motion picture became worthless in 1972 (as a result of the inability of the parties to find a distributor for the film). The Service argued that, at the earliest, the film became worthless in 1977 when the lender foreclosed on its security interest.

In considering whether the taxpayers were entitled to a deduction under IRC section 165(a), the Tax Court focused first on the amount that might be allowed as a deduction if the lower tier partnership's right to be paid for the production of the film was worthless.¹² The court held that, under IRC section 165(b), the amount of a deduction under IRC section 165(a) is equal to the taxpayer's adjusted tax basis in the property in question. The court then analyzed the taxpayers' interest in the partnership (presumably using entity principles) and that their basis in the upper tier partnership interest included their share of the liabilities of the upper and lower tier partnerships. The Service argued that the taxpayers' share of the partnership liabilities should not be taken into account unless and until the taxpayers in fact satisfied or paid such liabilities. The Tax Court rejected the Service's argument, noting that the taxpayers did have personal liability for their share of the debt and that they might be called upon to pay such share in the future.

The Tax Court next considered whether the lower tier partnership's right to be paid for the production of the film became worthless in 1972. The court observed that while a mere decline in the value of the asset is not sufficient to establish a worthlessness loss with respect to an asset, the taxpayer "need not be an incorrigible optimist" in determining when the asset becomes worthless. In holding that the taxpayers were not entitled to a loss deduction in 1972,

¹⁰ 134 F.2d 685 (4th Cir. 1943).

¹¹ 1954-2 C.B. 112.

¹² It should be noted that the taxpayer appeared to use aggregate principles to sustain its deduction and did not argue that its interest in the upper tier partnership was worthless.

the court emphasized that the commercial exploitation of the film was still viable and, in its view, the film had suffered merely a diminution in value during 1972 and did not become worthless until 1977 when the lender foreclosed on its security interest.

4. **The Empire Strikes Back – Revenue Ruling 93-80.** In Rev. Rul. 93-80, the Service set forth its views with regard to the abandonment or worthlessness of a partnership interest, presumably in an attempt to close the books once and for all regarding when such a deduction can be claimed and the character of any such loss. In the ruling, the Service posited two situations, each of which addressed an abandonment of a partnership interest and neither of which mentioned whether the interests in the two partnerships were worthless. Rather, the facts recited in each situation merely stated that the partnerships in question were insolvent and that a partner in each partnership took all steps necessary to effect a proper abandonment of his partnership interest, including the delivery of written notice to the partnership. In one case, liabilities of the partnership had been allocated to the abandoning partner while in the other case none of the partnership's liabilities had been allocated to the abandoning partner.

The Service stated in Rev. Rul. 93-80 that, to establish the abandonment of an asset, the taxpayer must demonstrate an intent to abandon the asset and must overtly act to abandon same. Without mentioning *Echols* or *Tejon Ranch* (or the courts' analyses therein), the Service also stated that an asset is worthless when it in fact has no value.¹³ Rev. Rul. 93-80 further stated that: "whether a loss from the abandonment or worthlessness of a partnership interest is capital or ordinary depends on whether or not the loss results from the sale or exchange of a capital asset," and "a loss from the abandonment or worthlessness of a partnership interest will be ordinary if there is neither an actual nor a deemed distribution to the partner under the principles [of IRC § 752(b)] described above." **"The Transaction"** [emphasis added] also cannot otherwise be "in substance a sale or exchange."

It is interesting to note that the conclusions drawn in Rev. Rul. 93-80 addressed both abandonment and worthlessness while the two fact patterns only involved abandonment. As pointed out by the Fifth Circuit in *Echols*, it appears that the Service continues to confuse the distinction between abandonment and worthlessness by referring to **"a transaction."** In the case of a worthlessness claim, of course, there is no transaction in the sense intended by the Service (sale or exchange transaction); rather, the partner is merely claiming that his asset (the partnership interest) has become worthless, which as noted by the courts in *Tejon Ranch* and *Echols* does not require a sale or exchange by the partner of its partnership interest or a sale or exchange by the partnership of its assets. Rather, the proper test for determining if a partnership interest has become worthless is whether an event has occurred that confirms that the partnership interest is in fact worthless, which can include the hopeless insolvency of the partnership in question and the irretrievable failure of the parties to restructure the debt of the partnership.

Subsequent to the issuance of Rev. Rul. 93-80, the Service issued a Field Service Advice,¹⁴ wherein the Service expressed its disagreement with the Fifth Circuit's opinion in *Echols* regarding worthlessness and stated that worthlessness losses are arguably capital losses since the Fifth Circuit did not "distinguish the character of the loss based on worthlessness from the capital loss based on abandonment." As noted by Sowell, *supra*, the

¹³ The Service cited two cases to support this conclusion: *Laport v. Commissioner*, 671 F.2d 1028 (7th Cir. 1982); *Boehm v. Commissioner*, 326 U.S. 287 (1945).

¹⁴ 1997 FSA-Lexis 190 (July 7, 1997).

taxpayers in *Echols* had in fact abandoned their partnership interest and, thus, their loss was a capital loss since they no longer owned an interest in the partnership. As also noted by Sowell, all of the cases allowing a deduction based solely on the worthlessness of a partnership interest have allowed an ordinary deduction to be claimed.

5. Basis Consequences of Worthlessness Deduction. In the event that a partner claims a worthlessness deduction with respect to his partnership interest, it appears that such partner must reduce his outside basis with respect to such partnership interest by the amount of the deduction. It would appear that the partner's share of the partnership's liabilities (as determined under IRC section 752) would not be reduced or otherwise affected by the deduction nor would the partner's IRC section 704(b) capital account be reduced or otherwise impacted. In addition, because the deduction does not require a reduction in the partnership's basis in its assets (under IRC section 734 or 743), it appears that the deduction can result in an inside-outside basis difference vis-à-vis the partner(s) claiming the deduction.

6. Interplay between IRC sections 165 and 172: Is the worthlessness deduction a "business loss?" In the event that an individual taxpayer claims an ordinary loss in respect of a worthless partnership interest under IRC section 165(a), the taxpayer must also ascertain whether such loss is a "business" loss pursuant to IRC section 172. If the loss is not a business loss under such section, the taxpayer will not be entitled to carry the loss back or forward as a net operating loss under IRC section 172 nor may the taxpayer carry the loss forward as a capital loss. In other words, in the case of a worthlessness loss that it is not a "business" loss, the loss will be of benefit to the taxpayer only if it can be used in the year the loss is claimed.

7. Summary regarding worthlessness deductions. The critical question for a taxpayer who is considering whether his partnership interest is worthless is whether an identifiable event has occurred that supports the worthlessness claim, and what "objective" facts or actions have occurred or need to occur or exist to support such claim? Is the mere insolvency of the partnership sufficient? Or that the partnership has defaulted on its loan obligations or does not have the wherewithal to pay its operating expenses? Or that the taxpayer-partner (as in *Echols*) made clear his intention not to fund any additional operating needs of the business? With regard to the last point, does it matter if the taxpayer-partner has never previously funded any such deficits?

Based upon the Fifth Circuit's analysis and statements in *Echols*, it seems prudent for taxpayers seeking to claim worthlessness deductions with respect to their partnership interests to identify the objective facts that exist at the time to support their claimed deductions and not to rely solely upon the fact that the partnership's liabilities exceed the value of its assets.

8. Final Comments – The Intersection of the Doctrines of Constructive Foreclosure, Abandonment and Worthlessness. The intersection of (1) the doctrine of constructive foreclosure/abandonment (a partnership level event where the owner of an underwater asset ceases to be considered the owner of such asset for tax purposes, with the asset being deemed sold or transferred to the creditor for an amount equal to the debt owing to such creditor), (2) the doctrine of abandonment (a partner level event where a partner in a troubled partnership affirmatively walks away from his interest in such partnership and is entitled to deduct the loss inherent in his partnership interest without actually selling such interest) and (3) the doctrine of worthlessness (where a partner in a troubled partnership continues as a full

partner in the troubled partnership but nevertheless claims a loss deduction on the ground his partnership interest is worthless) requires a careful consideration of the facts presented in each particular case because the applicability of or decision to utilize each doctrine is inextricably linked to and emanates from the distress that exists at the partnership/property level. As a result, being aware of the different tax consequences that result from foreclosure transactions (gain, loss and/or COD Income recognition at the partnership level) or abandonment or worthlessness deductions (claimed at the partner level) can allow partners and their tax advisors to determine the most tax efficient course of action (or inaction) to pursue.

a. **Actual or Constructive Foreclosure.** The challenges posed by the intersection of these three doctrines can be best illustrated by an example that frequently arises. In this example, one or more real estate assets are owned by an LLC that is treated as a partnership for federal income tax purposes, the asset(s) are encumbered by debt and the debt is characterized as recourse debt for purposes of IRC section 1001. If the LLC defaults on the loan and the creditor forecloses on or otherwise acquires the asset, it is likely that the LLC will recognize COD Income, such income will be allocated by the LLC to its members, and the members will be taxed thereon at ordinary income tax rates unless a member can utilize one of the exclusions provided for in IRC section 108(a) (typically the insolvency exclusion, which exclusion requires a detailed analysis of the assets and liabilities of the member), or, if the COD event occurs during 2009 or 2010, the member elects to defer the recognition of the COD Income under IRC section 108(i).¹⁵ If the LLC owns a capital asset then, in addition to recognizing COD Income on the foreclosure event, the LLC may also recognize a capital loss that would be allocated to its members, and such members may not offset their shares of the COD Income with their shares of the capital loss. On the other hand, if the LLC owns an asset described in IRC section 1231 (a “**1231 Asset**”), then the possibility of a character mismatch is less problematic because any loss realized by the LLC on the foreclosure transaction or other disposition presumably would constitute a loss governed by IRC section 1231 which effectively could be used to offset any COD Income allocated to and recognized by the taxpayer who owns an interest in the LLC.¹⁶

It is important to note that, in the foregoing example, the COD Income arises because the debt is a recourse liability as to the LLC for purposes of IRC section 1001 even if the liability is a nonrecourse liability for purposes of IRC sections 704(b) and 752. If the owners of the LLC (or if the debtor is a general or limited partnership, the partners therein) have personal liability with respect to the underwater debt, such owners will remain liable to the creditor for their respective shares of any deficiency that is owing to the creditor following the foreclosure.

On the other hand, if the LLC debt is nonrecourse for purposes of IRC section 1001, a foreclosure or other disposition event should not result in COD Income; rather, the asset(s) securing the debt would simply be viewed as sold for an amount equal to the nonrecourse debt and the LLC would have gain or loss on such sale equal to the difference between the amount of the debt and the LLC’s tax basis in the asset(s).

In recent years, taxpayers have had to decide whether they should simply wait for the inevitable (foreclosure and loss of the asset), or whether they should take proactive steps before the foreclosure event occurs. In these instances, the taxpayer first must assess the resulting tax

¹⁵ See Appendix IV for a summary of IRC section 108(i).

¹⁶ Ordinary losses claimed under IRC section 1231 may be recaptured as ordinary income under IRC section 1231(c) if the taxpayer recognizes IRC section 1231 gain during the ensuing five-year period.

consequences if he does nothing. If the debt is nonrecourse for purposes of IRC section 1001, it may be in the taxpayer's best interest to simply wait the situation out and hope for the best – that the property recovers and is no longer underwater. In the meantime, the taxpayer will defer recognizing any built-in gain inherent in his partnership interest (the so-called negative basis (debt over basis) that will be triggered when the eventual foreclosure occurs). If the taxpayer elects this route, his primary risk is that the Service may take the position that the partnership should be deemed to have constructively abandoned its property. As noted elsewhere in this outline, a mere decline in the value of the property (even a substantial decline in value) is not enough by itself to cause the property to be deemed constructively foreclosed upon or abandoned. The factors that may bear upon whether a property should be deemed constructively foreclosed upon or abandoned include (among others) whether (1) the lender and the debtor have effectively agreed upon the lender's taking over control and management of the property (without a formal transfer to the creditor of title to the property or the interests in the LLC), (2) the modification of the debt with the lender acquiring various control and "ownership" type rights, or (3) other events indicating that the creditor has acquired de facto ownership of the property.

If the LLC's debt is recourse for purposes of IRC section 1001, delaying the inevitable foreclosure may be beneficial for both tax and economic purposes. If the LLC's members do not have any personal liability for the debt, deferring the transfer of tax ownership will defer the recognition by the LLC of both COD Income and gain or loss on the foreclosure provided that the Service does not successfully invoke the doctrine of constructive foreclosure. In this case, of course, the LLC's members eventually could recognize both COD Income and a capital loss. If the FMV of the asset(s) increase while the tax recognition is deferred, then the amount of COD Income that would be recognized will decline. Deferral of the taxable event at the LLC level will also be economically beneficial when the LLC's members have assumed or undertaken personal liability for the LLC's debt to the extent the FMV of the asset(s) increases and the resulting deficiency that would be owing by such members correspondingly decreases. This all assumes, of course, that values increase. If values decline, the opposite would be true and the LLC members could suffer both economically and on a net tax basis.

b. Abandonment. In situations where the taxpayer believes that he will never recoup his investment in the LLC and/or that a foreclosure is imminent (presumably in the next year or two) and that such foreclosure could result in the taxpayer recognizing both COD Income and a capital loss upon the liquidation of the LLC (to the extent the taxpayer has basis in his LLC interest as a consequence of the allocation of the COD Income to him), taxpayers increasingly are considering abandoning their LLC (partnership) interests in advance of the foreclosure event. If the LLC or partnership interest is effectively abandoned, the taxpayer will recognize gain or loss depending on whether such taxpayer has a negative tax capital account in respect of its LLC or partnership interest at the time of the abandonment. Any such gain may be capital gain or ordinary income depending on the nature of the LLC's assets, while any loss will be ordinary or capital under IRC section 165(a) depending on whether the taxpayer has been allocated liabilities of the LLC or partnership under IRC section 752 prior to the abandonment.

c. Worthlessness. As noted above, if a taxpayer has a tax loss inherent in his LLC or partnership interest (typically reflected by the taxpayer having a positive tax capital account with respect to his partnership interest), a foreclosure event can result in both ordinary income and capital loss to the taxpayer, and an abandonment can result in a capital loss if the

taxpayer previously has been allocated debt under IRC section 752. In this setting, the taxpayer should consider whether his LLC or partnership interest is in fact worthless and if so, whether the taxpayer is entitled to claim a worthlessness deduction under IRC section 165(a). If the taxpayer can establish that the LLC or partnership interest is worthless (satisfying the subjective and objective tests as articulated in *Echols*), it appears that such loss may be treated as an ordinary loss under *Tejon Ranch* and *Echols*. It should be kept in mind, however, that the Service has never conceded that the loss is an ordinary loss when the taxpayer previously has been allocated debt of the LLC or partnership under IRC section 752, and in fact took the contrary view in Rev. Rul. 93-80 and 1997 FSA Lexis 190, *supra*. Another reason that a taxpayer may wish to affirmatively claim a worthlessness deduction is that by doing so, the taxpayer would preclude the Service from later taking the position that the taxpayer, by failing to claim the loss under IRC section 165(a) in the earlier year (of worthlessness) lost its opportunity to claim a deduction for its economic loss (often referred to as the “use it or lose it” dilemma). While the authors are not aware of any instances where the Service has argued that a taxpayer’s partnership interest was worthless in a year that preceded the year in which the taxpayer eventually claimed a deduction for his economic loss, this possibility increasingly has become a concern for partners and their tax advisors. For this reason, a taxpayer with an interest in a troubled partnership should closely scrutinize his facts, analyze such facts in light of the applicable authorities, and tread very cautiously.

PARTNERSHIP WORKOUTS – SELECT TAX ISSUES

In most cases, real estate is held through a flow-through entity. In some cases, the entity may be an SMLLC while in other cases the real estate may be owned by a joint venture, LLC, general partnership or limited partnership that is treated as a partnership for federal income tax purposes and is subject to the various rules contained in Subchapter K of the Code. While it is beyond the scope of this outline to address all of the difficult questions that can arise in the context of a partnership workout transaction (and there are many), we instead will focus on some of the more vexing problems that can arise.¹

1. Allocation of COD Income Among the Partners. The question regarding how a partnership should allocate its COD Income among its partners is not addressed by IRC section 108 or the legislative history of IRC section 108 contained in the Bankruptcy Tax Act of 1980 (“**BTA 1980**”). In addition, neither IRC section 704(b) nor the regulations promulgated thereunder provide any guidance or discussion as to how such income should be allocated by a partnership among its partners. It appears that Congress assumed that the amount of COD Income allocated to a partner would be exactly equal to the portion of the debt discharged which theretofore had been allocated to him under IRC section 752.² Under this assumption, the partner's adjusted basis in his partnership interest would be increased by the COD Income allocated to him (IRC section 705(a)(1)) and then reduced (in an equal amount) by virtue of the decrease in the partnership's liabilities occasioned by the debt discharge (IRC sections 752(b) and 733(l)). As a result, the partner's adjusted basis would remain unchanged and the partner would not recognize any additional amounts of income or gain under IRC section 731.³

a. General Partnerships. In the case of a typical general partnership where the general partners bear all items of partnership income, gain, loss and deductions on the same proportionate basis, COD Income recognized by the partnership will typically be allocated to the partners in accordance with their respective partnership percentages. The decrease in the partnership's liabilities resulting from the debt discharge would likewise be shared by the partners in accordance with their partnership percentages. As a result, the debt modification or exchange would not result in income to any partner in excess of any COD Income allocated to him by the partnership.

b. Limited Partnerships and LLCs. In the case of a limited partnership or LLC (or a general partnership in which the partners do not share all items on the same proportionate basis), the determination of how the partnership's COD Income should be allocated among the partners will depend upon a variety of factors, the most significant of which are the nature of the debt (recourse or nonrecourse) and the extent to which a particular partner is personally liable for the repayment of the debt.

¹ For a more thorough analysis of some of the partnership tax issues that can arise in a working setting, see Frankel, “Tax Planning for Troubled Real Estate and Partnership Transactions – Parts 1 and 2,” 19 and 20 *J. Real Est. Tax.* 267, 6 (Summer and Fall 1992); Frankel and Coffin, “Partnership Workouts: Problems and Solutions Under Final Section 704(b) and 752 Regulations,” 9 *J. Partnership Tax.* 287 (Winter 1993); Frankel and Coffin, “New Section 752 Regulations Clarify Treatment of Partnership Liabilities,” 6 *J. Partnership Tax.* 179 (Fall 1989); Frankel and Coffin, “Treatment of Allocations Attributable to Loans Under New 704(b) Regulations,” 6 *J. Partnership Tax.* 294 (Winter 1990).

² See S. Rep. No. 96-1035, 96th Cong. 2d Sess. (1980) (reprinted at 1980-2 C.B. 620-647) [hereinafter “**1980 S.Rep.**”], at 14, 16, 20, n. 24.

³ This analysis assumes that the deemed distribution is not taken into account under IRC section 731(a) at the time of the debt discharge, but rather is taken into account at the end of the year. See Rev. Rul. 92-97, 1992-2 C.B. 124; Rev. Rul. 94-4, 1994-1 C.B. 196.

(1) **Nonrecourse Debt.** If the debt discharged is a nonrecourse liability, it appears that the COD Income resulting from the discharge may be allocated to the partners in the same ratios in which the nonrecourse debt is allocated to them under IRC section 752. If the COD Income is allocated in this manner, the Congressional assumption that the partner's adjusted basis will be unaffected will be fulfilled and the only income recognized by the partner will be the COD Income so allocated to him. Allocating the COD Income in this manner should be respected under IRC section 704(b).

(2) **Recourse Debt.** If the debt discharged is a recourse liability, the COD Income should be allocated first to the partners who have negative tax capital accounts (such negative balances being attributable to prior deductions associated with the debt in question). If there is further COD Income to allocate among the partners, the partners must decide whether the COD Income should be allocated in accordance with their profit-sharing percentages or in accordance with the manner in which they bore the economic risk of loss for the remaining discharged debt immediately prior to the discharge. If the COD Income is allocated in accordance with the partners' profit-sharing percentages, the partners who did not bear any economic risk of loss for the discharged debt (the "**Non-Liable Partners**") will be allocated COD Income with respect to a debt for which another partner bore the economic risk of loss. While such an allocation might not prove to be burdensome to a Non-Liable Partner who is insolvent (and thus can exclude such COD Income under IRC section 108(a)(1)(B)) or has NOLs or passive activity losses that can be used to offset such COD Income, the Non-Liable Partner who is both solvent and profitable will not be so lucky, and will be forced to recognize and pay tax on what could be a significant amount of phantom income (although such partners ultimately should be allocated the tax deductions attributable to basis generated by the nonrecourse indebtedness). In addition, an allocation of COD Income to the partners in accordance with their profit-sharing ratios will also result in a deemed distribution to the partners who bore the economic risk of loss for the discharged debt ("**Liable Partners**") under IRC sections 731/752 in an amount greater than such partners' shares of the COD Income, which could result in such partners recognizing additional gain under IRC section 731(a).⁴ For this reason, many tax advisors believe that the COD Income should be allocated entirely to the Liable Partner(s) in the same proportions that the discharged debt was allocated to them under IRC section 752 immediately prior to the discharge.⁵ If the COD Income is allocated in this manner, the Non-Liable Partners will not be allocated any phantom income and the Liable Partners' adjusted bases in their partnership interests will remain unchanged. If this second alternative is employed, however, the allocation of COD Income solely to the Liable Partners may alter the parties' economic arrangement. The potential for such an alteration will exist because the Liable Partners' *capital accounts* have not been reduced prior to the debt discharge transaction to reflect the presumed decline in the FMV of the partnership's assets. In such a case, it may be advisable for the partnership agreement to be amended to provide that the loss inherent in the partnership's assets will, when recognized, be allocated solely to the Liable Partner to whom the COD Income was allocated.⁶ By taking this step, the partners would ensure that the decline in value which the Liable Partner agreed to bear is effectively allocated to his

⁴ *But see* Rev. Rul. 71-301, 1971-2 C.B. 256 (insolvency exception applied to partner who recognized gain pursuant to IRC section 731(a) in connection with debt discharge transaction). Although it is not clear, it is possible that this ruling has vitality following BTA 1980, particularly since Congress did not envision COD Income being allocated to partners in a ratio varying from the ratio in which the discharged debt was previously allocated to them under IRC section 752.

⁵ This position may have been given some support by the holding in *Great Plains Gasification Associates, supra*.

⁶ Such an amendment would have the same effect as a book-down under Treas. Reg. § 1.704-1(b)(2)(iv)(f). It is not clear that any such adjustments may be made under IRC section 704(b) or Treas. Reg. § 1.704-1(b).

capital account, which allocation would offset the amount of COD Income previously allocated to him.

(3) Special Allocations of COD Income. In some cases, the partners may attempt to specially allocate the partnership's COD Income to a partner who is insolvent and thus able to exclude such COD Income from his gross income under IRC section 108(a)(1)(B). While such an allocation may be crafted to satisfy the economic effect prong of IRC section 704(b) and the regulations promulgated thereunder, it appears that such allocation may not be "substantial," in which event the Service may ignore such allocation and reallocate the COD Income in accordance with the partners' interests in the partnership.⁷

2. Partnership Restructurings – Admission of the New Equity Partners and Contributions of Debt to Equity. Instead of modifying or restructuring the partnership's debt, the partnership may itself be restructured, with a new partner (or the lender itself) being admitted to the partnership. In certain cases, the new partner will be a third party who contributes cash that is used to pay down part of the existing loan balance or commits to contribute or loan cash to the partnership, as needed, to enable the partnership to satisfy its debt service obligations or other operating expenses. In other cases, the lender will be admitted to the partnership in exchange for its contribution to the partnership of part or all of the debt owing to it by the partnership. The following discussion assumes that the existing debt of the partnership is nonrecourse debt.⁸

3. Third Party as New Partner. If a third party is willing to carry the troubled property by agreeing to contribute cash to the partnership to fund the partnership's operating deficits or to pay down the existing partnership debt, the transaction can be structured in one of two ways: either the third party can be admitted to the partnership and become a partner directly therein or the third party and the partnership (the "**old partnership**") can form a new partnership ("**subpartnership**") with the third party contributing cash and the old partnership contributing its property to the subpartnership. These alternatives can have drastically different results for the parties.

a. Direct Admission. If the third party is admitted directly into the old partnership, the partnership agreement will be amended and the old partners' percentage interests in the partnership's income and loss will be reduced.

⁷ See Treas. Reg. § 1.704-1(b)(2)(iii); Rev. Rul. 99-43, 1999-2 C.B. 506; FSA 2001-31-013 (May 1, 2001). It should be noted that neither IRC section 108, IRC section 704(b) nor the legislative history of such sections prohibits special allocations of COD Income. See McKee, Nelson & Whitmire, *FEDERAL TAXATION OF PARTNERSHIPS AND PARTNERS*, Chapter 24, at ¶ 9.02[2][a][ii], n. 160. The IRS addressed allocations of COD Income among partners in Rev. Rul. 92-97, 1992-2 C.B. 124. The gist of this ruling is that an allocation of COD Income will not be respected if, following the allocation, any partner has a negative capital account which he has no liability to restore upon the liquidation of the partnership and is not otherwise matched by a share of minimum gain.

⁸ The following discussion is a summary of the types of questions that must be focused upon whenever a partnership is being restructured. Similar questions will arise if the partners' interests in the partnership are being adjusted pursuant to a squeezedown procedure contained in the partnership agreement or otherwise agreed to by the partners. The discussion that follows only focuses on two of a myriad of possible restructuring transactions and is designed merely to remind the reader of the need to examine the impact that these transactions may have on partners under IRC sections 704(b), 731 and 752. The discussion is not exhaustive, however, and other Code provisions also must be considered, including IRC section 465(e) (relating to at risk recapture). For a more complete analysis of the impact of IRC sections 704(b) and 752 and the regulations promulgated thereunder on partnership workouts, and also for a discussion of other workout scenarios and issues, see Frankel and Coffin, "Partnership Workouts: Problems and Solutions Under Final Section 704(b) and 752 Regulations," 9 *J. Partnership Tax*. 287 (Winter 1993).

(1) **Book Adjustments Made.** In connection with such admission, the parties must determine whether the old partners' capital accounts and the book values of the partnership's assets are to be adjusted (*i.e.*, booked-up or booked-down) under Treas. Reg. § 1.704-1(b)(2)(iv)(f). While it is likely that these adjustments would not be intended to generate any income or gain to the old partners, such adjustments may, in fact, result in the old partners recognizing income or gain, as illustrated below.

(a) **Impact on Minimum Gain Shares and Minimum Gain Chargeback.** If the partnership has minimum gain immediately prior to the admission of the third party to the partnership, the partnership's debt remains constant, and the partnership's assets are revalued, the adjusted book bases of the assets will be at least equal to the outstanding balance of the nonrecourse debt, thereby reducing the partnership's minimum gain to zero. At the same time, the old partners' capital accounts would be increased (presumably to zero) if the value of the partnership property is equal to the nonrecourse debt. As a result, the minimum gain chargeback would be avoided. This result has been explicitly provided for in, and is based upon a literal reading of, Treas. Reg. §§ 1.704-2(d)(4) and 1.704-2(g)(2).

(b) **Impact on Shares of Basis.** Under Treas. Reg. § 1.752-3(a), the admission of the new partner and the adjustment of the book bases of the partnership's assets will result in a shift of a portion of the partnership's nonrecourse debt from the old partners to the new partner. The amount so shifted will depend upon several factors, the most significant of which are the profit percentage of the new partner and the partnership's book basis in its assets immediately prior to the admission. In general, the amount of liabilities that will be shifted to the new partner will be equal to the new partner's profit percentage multiplied by the old book basis.⁹ Although this shift will result in a deemed distribution of cash to the old partners under IRC sections 752(b) and 733(1), the amount deemed distributed should never exceed the basis of an old partner in his partnership interest. Consequently, the deemed distribution should not result in gain to any old partner under IRC section 731(a)(1).¹⁰ It should also be observed that over time, as the partnership claims depreciation deductions with respect to its booked-up assets, the partnership will experience increases in its IRC section 704(b) minimum gain (which will be shared by the partners in accordance with the new profit percentages), and decreases in its IRC section 704(c) minimum gain. This will effectively result in a further shift in liabilities from the old partners to the new partner, with the old partners experiencing deemed distributions under IRC sections 752(b) and 733(1) as these shifts occur. Under these circumstances, the old partners eventually will receive deemed distributions in excess of their bases, and thus will be forced to recognize income under IRC section 731(a)(1).¹¹

⁹ The balance of the debt, which already produced deductions or distributions enjoyed by the old partners, initially will be allocated solely to the old partners as their IRC section 704(c) minimum gain amounts.

¹⁰ This assumes that the partnership debt remains unchanged following the admission of the new partner to the partnership. If the new partner contributes cash to the partnership which is used to repay part or all of the partnership's debt, the old partners may be deemed to receive taxable distributions under IRC section 731(a)(1). In this event, if the partnership has an IRC section 754 election in effect, the partnership will be entitled to increase its basis in its property under IRC section 734(b), subject, however, to IRC section 755 and the regulations promulgated thereunder. In this event, the old partners generally should be permitted to correspondingly increase their capital accounts under Treas. Reg. § 1.704-1(b)(2)(iv)(m)(4).

¹¹ See Rev. Rul. 84-102, 1984-2 C.B. 119 (deemed distribution under IRC section 752 to historic partners upon admission of new partner may trigger income to historic partners under IRC section 751.)

(2) **Book Adjustments Not Made.** If the partners elect not to revalue the partnership's assets in connection with the admission of the third party as a new partner, and the partnership's debt is not reduced, the partnership will retain its historic amount of minimum gain (and the old partners their shares thereof). In addition, because the old partners will retain their historic shares of IRC section 704(b) minimum gain, the old partners will retain sufficient shares of partnership debt to avoid gain recognition under IRC section 731(a)(1).¹² In addition, because IRC section 704(c) minimum gain amounts are not created, there will not be a shift of basis over time from the old partners to the new partners, as is the case where the partnership's assets are revalued. Thus, not making the revaluation election can produce several meaningful benefits to the old partners. However, the failure to book-up will mean that the principles of IRC section 704(c) will not be applicable to the partnership and, consequently, the amount of taxable income (or loss) allocated to the new partner may be greater (less) than the amount of taxable income (loss) that would have been allocated to such partner had the partnership's assets been revalued and the principles of IRC section 704(c) became applicable.

4. **Use of Subpartnership.** In some cases, the third party may insist that he be admitted to a subpartnership, with the old partnership contributing its assets to such subpartnership. This desire may be prompted by the third party's desire to avoid undisclosed or unknown liabilities of the old partnership. If this technique is used, a threshold question that must be answered is whether the transaction is governed by IRC section 721.¹³ If the contribution is governed by IRC section 721, any book-tax disparity must be accounted for under the rules of IRC section 704(c), with the subpartnership's initial book basis in the contributed property being equal to its FMV¹⁴ and the old partnership's initial capital account in the subpartnership being equal to zero.¹⁵ If IRC section 721 applies, then pursuant to IRC section 752(c), the subpartnership will be deemed to acquire the property subject to only that portion of the nonrecourse debt that does not exceed the FMV of the property. Although not entirely clear, it appears that the remainder of the debt (*i.e.*, the portion in excess of the property's FMV) should be deemed to remain outside the subpartnership. If this analysis is correct, this excess portion would remain a liability of the old partnership that arguably continues to *burden* its interest in the subpartnership.¹⁶ As a result, the old partnership's historic minimum

¹² So long as a partner's IRC section 704(b) minimum gain amount under Treas. Reg. § 1.752-3(a)(1) is equal to the deficit balance in his capital account, deemed distributions of cash to such partner under IRC section 752(b) will never result in any taxable gain to such partner under IRC section 731(a)(1).

¹³ See Like Kind Exchange on the Eve of Foreclosure, *supra*, footnote 1 and the accompanying text.

¹⁴ See Treas. Reg. § 1.704-1(b)(2)(iv)(d)(1).

¹⁵ See Treas. Reg. §§ 1.704-1(b)(2)(iv)(b)(2), -1(b)(2)(iv)(d)(1) (IRC section 7701(g) does not apply in determining the FMV of contributed property). See generally McKee, Nelson & Whitmire, *supra*, at ¶ 7.04[3]; Burke, "Partnership Formation Under the Temporary Section 752 Regulations: A Reply and Further Discussion," 69 *Taxes* 116, 125 (Feb. 1991); Lokken, "Contributions of Overencumbered Property: A Reply and Further Discussion," 5 *J. Partnership Tax* 242, 243 (Fall 1988); but see Carman & Brown, "Another Look at Accounting for Contributions of Overencumbered Property: Turning Basis Inside Out," 7 *J. Partnership Tax* 192, 193-94 (Summer 1990) (contributing partner's initial capital account should be equal to FMV of contributed property less the total amount of nonrecourse debt secured thereby).

¹⁶ See Burke, *supra* note 219, at 125; Stafford, "Section 752(c): The Other Issue in *Tufts v. Commissioner*," 42 *Tax Law* 93 (Fall 1988). It has been suggested that while IRC section 752(c) may limit the amount of liabilities deemed taken subject to by the subpartnership, the old partnership nevertheless should be deemed relieved of the entire liability for purposes of determining its basis in its interest in the subpartnership. See Burke, *supra*, at 125; Andrews, "On Beyond *Tufts*," 61 *Taxes* 949, 958-59 (Dec. 1983). The latter theory seems incongruous, however, because it would effectively result in the excess portion of the debt vanishing both inside and outside the partnership (*i.e.*, such amount would not be considered a liability of either the old partnership or the subpartnership). Such a conclusion would thus ignore the fact that the liability does exist and that it burdens the property. The better view, therefore, is that by virtue of IRC section 752(c), the excess portion of the debt should be deemed to be a continuing liability of the old partnership that is "secured" by its interest in the subpartnership.

gain initially would be preserved because its share of the subpartnership's debt under IRC section 752 plus the excess portion of the debt deemed returned by it would exceed its basis in its interest in the subpartnership by an amount equal to its historic minimum gain amount.¹⁷ Similarly, because the regulations issued under IRC section 752 were drafted to ensure that the old partnership's share of the subpartnership's liabilities for purposes of IRC section 752 would not be less than the old partnership's minimum gain (immediately prior to the contribution), the amount of any deemed distribution from the subpartnership to the old partnership pursuant to IRC sections 752(b) and 733(1) should be less than the old partnership's basis in its subpartnership interest and, thus, the old partnership should not recognize any gain under IRC section 731(a)(1). However, as the old partnership's share of the subpartnership's debt is shifted over time to the new partner, the old partnership (and thus its partners) will be required to recognize income as the amount of cash deemed distributed to it exceeds its basis in its subpartnership interest. A yet unanswered question is the extent to which the regulations issued under IRC section 707(a)(2)(B) may change the results described above. It appears that these regulations should be totally inapplicable to the subpartnership so long as the debt secured by the contributed property was incurred more than two years ago or was incurred to purchase the property. The result seems less clear, however, if the subpartnership simultaneously pays down part of the debt with cash contributed by the new partner.

5. Contributions and Distributions of Overencumbered Property. As referenced in the preceding paragraph, IRC section 752(c) provides that, *for purposes of* IRC section 752, a liability to which property is subject shall, *to the extent of the FMV of such property*, be considered a liability of the owner. The consequences of this rule for purposes of IRC section 752 and beyond are not entirely clear.¹⁸ It would appear, at least for purposes of IRC section 752, that in the context of the contribution of overencumbered property, the partnership would be treated as having assumed the liability only to the extent of the FMV of the contributed property, while the contributing partner would be considered to remain the debt holder with respect to the excess debt after the contribution. Similarly, in the case of a distribution of overencumbered property from a partnership, this rule would appear to limit the decrease in the partnership's liabilities to the FMV of the distributed property, with the partnership remaining the debtor for the balance of the liability.

6. Admitting the Nonrecourse Lender to the Partnership. If the lender (or a related person) is admitted to the partnership, the following tax issues should be carefully considered. The remainder of this section of the outline assumes that the lender is admitted to the partnership in exchange for the debt owing to it by the partnership or, alternatively, to satisfy the lender's demand that it receive a portion of any profits the partnership may realize in the future.¹⁹

¹⁷ The excess of the FMV of the contributed property over the adjusted basis of such property will constitute the old partnership's IRC section 704(c) minimum gain amount which, if the subpartnership were to immediately sell the contributed property for the nonrecourse debt secured by such property, would be specially allocated to the old partnership under IRC section 704(c). If the actual FMV of the contributed property is less than the nonrecourse debt and, as posited above, the excess debt is deemed to burden the old partnership's interest in the subpartnership, the excess amount presumably would be taken into account in determining the old partnership's minimum gain. If the excess debt is not taken into account in this manner, it appears that the old partnership's minimum gain would be deemed to decrease, which could trigger a minimum gain chargeback at the old partnership level.

¹⁸ See, Miller and Bowers, "Section 752(c): A Riddle Wrapped In A Mystery Inside an Enigma," PLI Tax Planning for Domestic & Foreign Partnerships, for a discussion of the issues associated with the contribution, distribution, foreclosure and other topics related to overencumbered property.

¹⁹ See Appendix III, regarding the consequences of the exchange of debt for an interest in a partnership under IRC section 108(e)(8).

a. **Recharacterization of the Debt as Partner Nonrecourse.** If the lender is admitted to the partnership and the loan is not contributed to the partnership in exchange for the partnership interest, the loan will cease to be a nonrecourse loan unless the lender does not acquire more than a ten percent interest in any item of income or loss of the partnership.²⁰ The loan will instead be characterized as a partner nonrecourse loan.

b. **Impact on Shares of Liabilities.** If the debt is contributed to the partnership and thereby canceled, the old partners' shares of the partnership's liabilities will be reduced, thereby triggering deemed distributions under IRC sections 752 and 733(l). Similarly, if the debt remains outstanding but is converted into a partner nonrecourse loan, the old partners will receive deemed distributions of cash under such sections. If the partners recognize income under IRC section 731(a)(1) and the partnership has an IRC section 754 election in effect for such year, however, the partners' capital accounts may be increased pursuant to Treas. Reg. § 1.704-1(b)(2)(iv)(m)(4).

c. **Minimum Gain Chargeback.**

(1) **Debt Exchanged for Partnership Interest.** If the lender contributes the debt to the partnership in exchange for a partnership interest, the debt will disappear and the partnership's minimum gain with respect to such liability will be reduced to zero. In such event, the minimum gain chargeback rules will apply and the old partners must be allocated items of income to eliminate that portion of the deficits in their capital accounts that were attributable to the nonrecourse loan.

(2) **Debt Remains Outstanding.** Even if the debt is not contributed to the partnership, because the loan will be transformed into a partner nonrecourse loan, the partnership's minimum gain will be reduced to zero, thereby triggering a minimum gain chargeback.

d. **Impact on Future Deductions.** If the loan remains outstanding, in whole or in part, any deduction thereafter claimed by the partnership in respect of the loan will constitute partner nonrecourse deductions, which must be allocated entirely to the lender.²¹

²⁰ Treas. Reg. § 1.752-2(d).

²¹ Treas. Reg. § 1.704-2(i).

**APPENDIX I
LEGISLATIVE AND REGULATORY AUTHORITIES
FROM THE GOLDEN AGE OF WORKOUTS**

Revenue Rulings and Revenue Procedures

Discharge of Nonrecourse Debt. Rev. Rul. 91-31, 1991-1 C.B. 19: Discharge of nonrecourse debt results in COD Income regardless of whether the FMV of the property securing such loan exceeds or is less than the outstanding debt prior to the discharge.

Insolvency Measurement – Excess Nonrecourse Debt. Rev. Rul. 92-53, 1992-2 C.B. 48: For purposes of measuring a taxpayer's insolvency under IRC section 108(d)(3), the amount by which a nonrecourse debt exceeds the FMV of the property securing such debt is taken into account only to the extent the excess nonrecourse debt is discharged.

Treatment of COD Income as Passive Income. Rev. Rul. 92-92, 1992-2 C.B. 103: COD Income constitutes passive income under IRC section 469 to the extent that, at the time of the debt cancellation, the debt is allocated to passive activity expenditures.

Purchase Price Adjustments Under IRC Section 108(e)(5). Rev. Proc. 92-92, 1992-2 C.B. 505: The Service will not challenge a bankrupt or insolvent partnership's treatment of a reduction of such partnership's debt as a purchase price adjustment under Service section 108(e)(5) provided the transaction would otherwise qualify as a purchase price adjustment under IRC section 108(e)(5) but for the bankruptcy or insolvency of the partnership.

Partnership COD Income – Treatment as Draw. Rev. Rul. 92-97, 1992-2 C.B. 124: Constructive distributions under IRC section 752(b) resulting from a cancellation of debt is treated as occurring on the last day of the partnership taxable year under the "drawing rule" found in Treas. Reg. § 1.731-1(a)(1)(ii).

Allocation of COD Income – Substantial Economic Effect. Rev. Rul. 92-97, 1992-2 C.B. 124: An allocation of COD Income to a partner that differs from the partner's share of the cancelled debt under IRC section 752(b) has substantial economic effect under IRC section 704(b) even where, as a result of the deemed distribution, a partner's capital account is reduced below zero, if (1) such partner has an obligation to restore such deficit capital account balance to satisfy other partners' positive capital account balances, (2) the requirements of the economic effect test are otherwise met, and (3) substantiality is independently established.

Partnership COD Income – Timing of Draw. Rev. Rul. 94-4, 1994-1 C.B. 196: A deemed distribution of money under IRC section 752(b) resulting from a decrease in a partner's share of the liabilities of a partnership in connection with the cancellation of debt of such partnership is treated as an advance or drawing of money under Treas. Reg. § 1.731-1(a)(1)(ii) to the extent of the partner's distributive share of the partnership's income for the taxable year in question; such advance or draw is taken into account at the end of the taxable year and not at the time of the debt cancellation event.

Allocation of COD Income – Book Adjustments and Substantiality. Rev. Rul. 99-43, 1999-2 C.B. 506: Special allocation of COD Income solely to an insolvent partner lacked

substantiality under Treas. Reg. § 1.704-1(b)(2)(iii) where increase in insolvent partner's capital account by virtue of the COD Income allocation was effectively offset by book loss allocated pursuant to a contemporaneous revaluation of the partnership's assets; following the COD Income and book loss allocations, the partners' capital accounts continued to be in the same ratio to one another as existed prior to the cancellation event.

Legislative and Regulatory Changes

Qualified Real Property Business Indebtedness. As a result of substantial discussions between the Service, various industry groups and tax professionals, IRC sections 108(a)(1)(D) and 108(c) were added to the Code in 1993 to allow individual taxpayers (and S corporations) to exclude COD Income where the taxpayer is not insolvent or in bankruptcy if the debt in question was incurred in connection with the acquisition of real property used in a trade or business and is secured by such real property. This exclusion, for "qualified real property business indebtedness," may be elected only if the taxpayer reduces, on a dollar-for-dollar basis, the taxpayer's adjusted tax basis in depreciable real property owned by such taxpayer (including the taxpayer's share of basis in depreciable real property owned by partnerships in which he is a partner). See Appendix II for a summary of these provisions (and related regulations issued under IRC section 1017).

Partnership Debt for Equity Exchanges. IRC section 108(e)(8) modified to explicitly provide that a partnership that issues an interest in such partnership to its creditor is treated as having satisfied the debt with an amount of money equal to the value of the partnership interest issued to the creditor, with the partnership realizing COD Income to the extent the FMV of the partnership interest is less than the amount of debt exchanged therefor. Prior to this legislative change, some advisors took the position that the partnership debt for equity exchange did not result in COD Income to the debtor partnership on the theory that the transaction was governed by either (i) the common law debt for equity exception and/or (ii) IRC section 721. In 2008, the Service proposed regulations to address the application of IRC section 108(e)(8) to partnerships (see Prop. Reg. § 1.108-8(b)(1); Prop. Reg. § 1.721-1(d)(1)). See Appendix III for a summary of these regulations.

APPENDIX II
QUALIFIED REAL PROPERTY BUSINESS INDEBTEDNESS REGULATIONS
ISSUED UNDER IRC SECTIONS 108 AND 1017

On October 22, 1998, regulations were finalized regarding the application of the basis reduction rules in IRC sections 108 and 1017. These regulations are effective for debt discharges occurring on or after October 22, 1998. In addition to providing the classification and order in which the debtor's basis in property is to be reduced for COD Income excluded under IRC section 108, the regulations provide rules regarding the treatment of a partnership interest as depreciable property under IRC section 1017(b)(3)(C). The regulations also provide guidance on applying the limitations on basis reduction found in IRC sections 108 and 1017. On December 15, 1999, final regulations were issued that, among other things, provide guidance relating to the computation of a partner's proportionate share of the adjusted basis of depreciable property (or depreciable real property) under IRC section 1017. These regulations apply to elections made under IRC sections 108(b)(5) and 108(c) on or after December 15, 1999.

1. Making IRC section 108(b)(5) and 1017(b)(3)(E) Elections. Under Treas. Reg. § 1.108-4, a bankrupt or insolvent debtor can elect on Form 982 (Reduction of Tax Attributes Due to Discharge of Indebtedness (and IRC section 1082 Basis Adjustment)) to reduce the basis of depreciable property under IRC section 108(b)(5). Similarly, under Treas. Reg. § 1.1017-1(f), a debtor can elect on Form 982 to treat real property held for sale as depreciable property. The Form 982 must be attached to the debtor's timely filed (including extensions) Federal income tax return for the tax year in which the debtor realized the COD Income that is excluded under IRC section 108(a). The election only may be revoked with the consent of the Service. These regulations replaced a similar rule in Temp. Reg. § 301.9100-13T. The temporary regulation permitted the debtor to make the election with an amended return or claim for refund if the debtor established reasonable cause for failing to file the election with the original return. The final regulations do not contain this reasonable cause exception.

2. IRC section 108(c) Limitations on COD Income Exclusion. Treas. Reg. § 1.108-6 provides rules regarding the two limitations, found in IRC section 108(c)(2), on the amount of discharged QRPBI that can be excluded under IRC section 108(a)(1)(D). The regulations make some additions to the statutory requirements that are not provided for in the legislative history.

a. Debt Over FMV Limitation. Treas. Reg. § 1.108-6(a) provides that the amount of the excluded debt cannot exceed the excess of the outstanding principal amount of the discharged debt immediately before the discharge over the net FMV of the qualifying real property immediately before the discharge. The timing of this determination is consistent with the legislative history. The regulations go beyond the legislative history and the statute, however, by providing that the net FMV is calculated by reducing the FMV of the property (disregarding IRC section 7701(g)) by the outstanding principal amount of any other QRPBI secured by qualifying real property immediately before *and after* the discharge.¹

¹ IRC section 7701(g) generally provides that, for purposes of determining gain or loss, the FMV of the sold property is treated as being not less than the amount of nonrecourse debt to which the property is subject.

b. Depreciable Real Property Basis Limitation. The second statutory limitation provides that the amount of discharged QRPBI that can be excluded cannot exceed the adjusted basis of depreciable real property of the debtor immediately before the discharge (other than depreciable real property acquired in contemplation of the discharge) after the basis reductions made to the property under IRC section 108(b) or 108(g) (regarding qualified farm indebtedness). Treas. Reg. § 1.108-6(b) provides that the determination of this limitation is made after the basis of the depreciable real property is reduced by the depreciation claimed for the year.

3. Order of IRC section 108(b)(2)(E) Basis Reduction. For title 11 and insolvent debtors, the regulations generally retain the tracing approach to basis reduction and the ordering rules found in previously applicable regulations under IRC sections 1016 and 1017. The regulations, however, eliminate the requirement that basis first be reduced in property purchased with the discharged debt. The regulations also do not carry over the FMV limitations found in the IRC section 1016 regulations applicable to bankrupt debtors.

a. Order of Reduction. Under Treas. Reg. § 1.1017-1(a), a title 11 or insolvent debtor will reduce the basis of its property in the following order:

- real property, used in a trade or business or held for investment and not held for sale, that secured the discharged indebtedness immediately before the discharge;
- personal property, used in a trade or business or held for investment, other than inventory, accounts receivable and notes receivable, that secured the discharged indebtedness immediately before the discharge;
- remaining property used in a trade or business or held for investment (other than inventory, accounts receivable, and notes receivable and real property held for sale);
- inventory, accounts receivable, and notes receivable, and real property held for sale; and
- property not used in a trade or business nor held for investment.

The basis reduction in each class of property is to be made in proportion to the relative amounts of adjusted basis within the class.

b. Debtor's Partnership Interests. A debtor's interest in a partnership may be considered real or personal property secured by the discharged debt to the extent of the partner's distributive share of partnership COD Income. This rule is discussed in more detail below.

c. Operating Rules. Treas. Reg. § 1.1017-1(b) provides three operating rules to be applied to IRC section 108(b)(2)(E) basis reductions.

(1) First, the regulations provide that the amount of basis to be reduced under IRC section 108(b)(2)(E) equals the amount of the excluded COD Income less the prior reduction of other tax attributes required under IRC section 108(b)(2) or elected under IRC section 108(b)(5).

(2) Second, a special rule is provided in the case of multiple discharged debts to determine what portion of each discharged debt remains to be applied

against the basis in the debtor's property after the non-basis tax attributes have been reduced. The determination is made by allocating the non-basis tax attribute reductions among the discharged debts in proportion to the amount of COD Income attributable to each discharged debt. The unapplied portion of each discharged debt then will be applied to reduce basis in accordance with the ordering rules.

(3) The third rule incorporates and clarifies the IRC section 1017(b)(2) limitation on basis reduction. Under the regulation, the IRC section 108(b)(2)(E) basis reduction cannot exceed the excess of the aggregate bases of the property and the amount of money of the debtor immediately after the discharge over its aggregate post-discharge liabilities. IRC section 1017(b)(2) does not specifically refer to the debtor's money in its calculation of the limitation. Under Treas. Reg. § 1.1017-1(c)(3), the IRC section 1017(b)(2) calculation is made after reducing the debtor's basis in property under IRC section 108(b)(5).

The regulations formerly applicable under IRC sections 1016 and 1017 allowed a debtor to request from the Service that the basis reductions be applied only to certain of its properties. A debtor could make this request to avoid making small reductions in basis in many of its properties. The current regulations do not provide for such a ruling request.

d. Modification of Ordering Rules for Basis Reductions Under IRC sections 108(b)(5) and 108(c). Treas. Reg. § 1.1017-1(c) modifies the IRC section 108(b)(2)(E) basis reduction ordering rules for debtors electing to first reduce the tax basis in depreciable property under IRC section 108(b)(5), or electing to treat the discharged debt as QRPBI under IRC section 108(c). Under these modifications, a debtor electing under IRC section 108(b)(5) can reduce only the basis of depreciable property, and a debtor electing under IRC section 108(c) can reduce only the basis of depreciable real property. The regulations also modify the general ordering rule by requiring that the basis reduction under IRC section 108(c) first be applied against the basis of the real property securing the discharged QRPBI and then against the basis of the debtor's other real property.

A debtor electing under IRC section 108(b)(5) to first reduce basis in depreciable property may elect under IRC section 1017(b)(3)(E) to treat real property held for sale as depreciable property. The general ordering rule of the regulations includes real property held for sale in the class of property with inventory and notes and accounts receivable. Presumably, real property held for sale that did not secure the discharged debt and for which an IRC section 1017(b)(3)(E) election was made will be included in the inventory and receivables class under the basis ordering rules applicable to IRC section 108(b)(5) as well.

e. Anti-Abuse Rule. Like many recent regulations, the regulations contain an anti-abuse rule. Under Treas. Reg. § 1.1017-1(d), if any property is added or eliminated as security for indebtedness, such addition or elimination during the one-year period preceding the discharge of the indebtedness will be disregarded if a principal purpose of the change is to affect the basis reductions under IRC section 1017. This rule would prevent debtors from manipulating the requirement that basis first be reduced in the property securing the discharged debt by either securing or releasing the lien on a particular property in contemplation of the discharge.

f. **Treatment of Partnership Interests as Depreciable Property.**

Treatment of Allocated Share of Partnership COD Income. Treas. Reg. § 1.1017(g)(1) requires a partner to treat its distributive share of partnership COD Income as attributable to discharged debt secured by the partner's interest in the partnership. Treas. Reg. § 1.1017-1(g)(2) provides that if a partner makes an election under IRC section 108(b)(5) (or 108(c)), the partner must treat the partnership interest as depreciable property (or depreciable real property) to the extent of the partner's proportionate share of the partnership's basis in depreciable property (or depreciable real property), provided the partnership consents to a corresponding reduction in the partnership's inside basis in depreciable property (or depreciable real property) with respect to such partner. The partner must request that the partnership reduce the partner's share of basis in depreciable partnership property if basis reductions are being made to the partner's depreciable property with respect to its distributive share of partnership COD Income. The partnership, however, is not required to consent to the partner's request unless the requesting partners in the aggregate own more than 80 percent of the capital and profits interests in the partnership or if five or fewer partners owning (directly or indirectly) in the aggregate more than 50 percent of the interests in capital and profits of the partnership so request.²

The regulations do not specify how to allocate the reduction in the partner's share of partnership property basis among the partnership's properties, other than to refer to the other rules in the IRC section 1017 regulations. It is possible that the partnership would ignore the characterization of the debt at the partner level as secured by the partnership interest, and would reduce basis under the ordering rules applicable to the discharged debt that generated the COD Income.

g. **Partner Electing Under IRC section 108(b)(5) or 108(c).** IRC section 1017(b)(3)(C) provides that a partnership interest "shall be treated as depreciable property" to the extent of the partner's share of the depreciable property held by the partnership, provided the partnership makes a corresponding reduction in the partnership's basis in depreciable property with respect to that partner. Treas. Reg. § 1.1017-1(g)(2)(i) follows the statutory rule by providing that a partner that elects to reduce basis under IRC section 108(b)(5) or 108(c) must treat a partnership interest as depreciable property or depreciable real property, to the extent of the partner's proportionate share of the partnership's basis in depreciable property or depreciable real property, if the partnership consents to a corresponding reduction in the partnership's basis in depreciable property or depreciable real property with respect to that partner. If the partnership does not grant consent, the partnership interest may not be treated as depreciable property or depreciable real property.

(1) **When Consent Must be Requested.** An electing debtor is required to request consent of the partnership to reduce the debtor's share of partnership basis only if he owns (directly or indirectly) more than 50 percent of the capital and profits interests of the partnership, or if basis reductions are being made in the partner's depreciable property with respect to its distributive share of partnership COD Income. If a partner is a greater than 50

² The preamble to the regulations clarify that a partnership's consent to reduce the basis of the partnership's depreciable property is neither required nor relevant where a partner reduces the basis in its partnership interest under IRC section 108(b)(2)(E).

percent partner in many partnerships, he would be required to request consent from each partnership.

(2) Purpose of Consent Requirement. The purpose of requiring the consent request by a more than 50 percent partner is to prevent the partnership from being used as a vehicle to avoid the general ordering rules. Without this requirement, a debtor could avoid reducing the basis in the property that secured the excluded COD Income under the general ordering rules by transferring the property prior to the debt discharge to a controlled partnership that would not consent to reduce the property's basis. Treasury did not want to allow taxpayers to obtain a different tax result through the use of a controlled partnership than would be achieved had they owned the partnership property directly.

(3) When Consent Must be Granted. The regulations require the partnership to consent to reduce its partners' shares of depreciable basis of partnership property if consent is requested by partners owning, directly or indirectly, in the aggregate more than 80 percent of the capital and profits interests in the partnership or by five or fewer partners owning, directly or indirectly, more than 50 percent of the interests in capital and profits of the partnership. The regulations do not provide a standard by which indirect ownership would be determined nor do they specify at what point in time the percentage interests in the partnership are measured. This partnership consent requirement may be inconsistent with the IRC section 1017 legislative history, which appears to make the partnership's consent elective.³

(4) Partnership Basis Reduction. Regulations issued in 1999 provide guidance with respect to determinations of a partner's proportionate share of the partnership's basis in depreciable property and the treatment of the partner's basis adjustment in its share of depreciable partnership property.⁴ A partner's proportionate share of the partnership's depreciable property is equal to the sum of (i) the partner's IRC section 743(b) basis adjustments to items of partnership depreciable property and (ii) the common basis depreciation deductions (excluding remedial allocations of depreciation deductions) that are reasonably expected to be allocated to the partner over the property's remaining useful life under the terms of the partnership agreement effective for the year in which the discharge occurs. For this purpose, the partnership may not treat the same depreciation deductions as being reasonably expected by more than one partner.

The amount of the basis reduction to depreciable partnership property is an adjustment to such property with respect to the partner only. No adjustment is made to the common basis of partnership property. Recovery of the adjustment is made in the same manner as provided in Treas. Reg. § 1.743-1 and the adjustment is treated in the same manner and have the same effect as an adjustment to the basis of partnership property under IRC section 743(b). The properties in which the partnership will reduce basis are determined under the ordering rules of Treas. Reg. § 1.1017-1 described above.⁵

³ S. Rep. No. 1035, 96th Cong, 2d Sess. 22, 1980-2 C.B. 620, 631 (1980) (partnership interest treated as depreciable real property "if the partnership agrees to make a corresponding reduction in the basis of the partnership property with respect to such partner"). Compare H.R. Rep. No. 111, 103rd Cong., 1st Sess. 624 (1993), 1993-3 C.B. 167, 200 (partnership basis in depreciable property with respect to partner electing under IRC section 108(c) "is correspondingly reduced").

⁴ Treas. Reg. § 1.1017-1(g)(2)(iv) and (v).

⁵ Treas. Reg. § 1.1017-1(g)(3).

(5) Mechanics of Partner Request and Partnership Consent. A partner's request to the partnership must be made prior to the due date (including extensions) for the filing of the partner's Federal income tax return for the year in which the partner has excluded COD Income under IRC section 108(a). The consent of the partnership must be included with its Form 1065 for the year of the partnership following the year that ends with or within the tax year the taxpayer excludes the COD Income. The partnership must provide the requesting partner with a statement of consent on or before the due date of the partner's tax return (including extensions) for the tax year in which the partner excludes the COD Income. The statement must contain the name, address, and taxpayer identification number of the partnership and state the amount of the reduction in the partner's share of the partnership's basis in its depreciable property or depreciable real property. The partner, in turn, is required to attach the consent statement to its timely filed (including extensions) Federal income tax return for the year the COD Income is excluded. The partnership's consent statement need only show the aggregate reduction in the partner's share of partnership basis. This aggregate rule is not clearly stated in the regulations, but is apparent from a statement in the preamble to the proposed regulations that a property-by-property basis disclosure requirement was considered but rejected as too burdensome.

(6) Timing Concerns. The preamble to the regulations recognize that a partner might not have sufficient information with which to decide to request a basis reduction until on, or shortly before, the due date (including extensions) for filing the partner's return. The Service decided not to require partnerships to inform their partners of COD Income prior to the date the Form 1065 is filed. Rather, it was determined that additional administrative burdens imposed on partnerships should be the result of an understanding between the partners and the partnership.⁶

(7) Tiered Partnerships. The regulations do not address how the partnership interest as depreciable property rule is to be applied to tiered partnerships. While the legislative history to BTA 1980 specifically provides that the subsidiary stock as depreciable property rule can be applied successively through chains of corporations so long as the lowest tier subsidiary reduces its basis in depreciable property,⁷ it made no mention of tiered partnerships.

In a series of private letter rulings, the "partnership interest as depreciable property" rule has been applied to two-tier partnerships. In each of these private rulings, the upper tier partnerships' interests in the lower tier partnership were treated as depreciable property to the extent of the upper tier partnerships' interests in the depreciable property held by the lower tier partnership, provided a corresponding basis reduction was made in the lower tier partnership's basis in depreciable property with respect to the upper tier partnerships. The partners' interests in the upper tier partnerships, in turn, was treated as depreciable property to the extent of their proportionate interest in the depreciable property held by the upper tier partnerships, provided a

⁶ The Service also determined the Treas. Reg. § 1.703-1(a)(1) required the partnership to separately state QRPBI and identify it as such and, therefore, rejected the comment that partnerships should be required to attach a statement to the K1 stating that the COD Income is from QRPBI and the date of the discharge.

⁷ S. Rep. No. 1035, 96th Cong., 2d Sess. 13 (1980), 1980-2 C.B. 620, 627.
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corresponding basis reduction was made in the upper tier partnerships' basis in depreciable property with respect to the upper tier partners.⁸

⁸ See, e.g., PLR 9426006 (March 25, 1994). Also issued the same day were: PLRs 9426007-9426019 (March 25, 1994).
Appendix II

APPENDIX III
PARTNERSHIP DEBT FOR EQUITY EXCHANGES –
SUMMARY OF PROPOSED REGULATIONS UNDER IRC SECTIONS 108 AND 721

Congress extended IRC section 108(e)(8) to debtor partnerships in the American Jobs Creation Act of 2004 with respect to cancellations of indebtedness occurring on or after October 22, 2004. As a result, a partnership that issues a capital or profits interest in satisfaction of an indebtedness will be treated as having satisfied such indebtedness with an amount of money equal to the FMV of the partnership interest (and realizing COD Income to the extent the adjusted issue price of the indebtedness exceeds the FMV of the partnership interest). Note that IRC section 108(e)(6) does not apply to capital contributions of debt by a partner to a partnership. IRC section 108(e)(8) provides that any COD Income recognized by a partnership pursuant to IRC section 108(e)(8) must be allocated to the taxpayers who were partners in the partnership immediately prior to the discharge.

On October 31, 2008, the Service issued proposed regulations addressing certain items associated with the application of IRC section 108(e)(8) to partnerships and their partners in the case of a debt-for equity exchange. The proposed regulations create a safe harbor which, if certain requirements are met, allows the partnership and the creditor to value the partnership interest transferred as part of the debt-for equity exchange based on a “liquidation value” approach.¹ For this purpose, liquidation value equals the amount of cash that the creditor would receive with respect to the partnership interest if, immediately after the debt-for-equity exchange, the partnership sold all of its assets for their FMV and then liquidated.² Liquidation value can be used only if: (1) the debtor partnership determines and maintains capital accounts in accordance with Treas. Reg. § 1.704-1(b)(2)(iv)³; (2) the creditor, the debtor partnership, and the debtor’s partners treat the liquidation value as the FMV of the interest for purposes of determining the tax consequences of the debt-for-equity exchange; (3) the debt-for-equity exchange is an arm’s-length transaction; and (4) subsequent to the debt-for-equity exchange, there is no redemption by the partnership nor a purchase by any person related to the partnership of the applicable partnership interest as part of a plan that has as a principal purpose the avoidance of COD Income by the partnership.⁴ If each of these requirements is not met, the FMV of the partnership interest must be determined based on all of the facts and circumstances.

The proposed regulations also provide that, except as otherwise provided in IRC section 721, and notwithstanding Prop. Reg. § 1.108-8(a), IRC section 721 applies to the contribution of a partnership’s recourse or nonrecourse indebtedness by a creditor to the debtor partnership in exchange for a capital or profits interest.⁵ IRC section 721 does not apply to the transfer of the

¹ Prop. Reg. § 1.108-8(b)(1). The proposed regulation would apply to debt-for equity exchanges occurring on or after the date that the regulations are published as final regulations.

² *Id.*

³ There does not appear to be any requirement that the partnership liquidate in accordance with those capital account calculations, which would appear to make the safe harbor available to partnerships that maintain targeted capital accounts. In that regard, a Treasury official stated that the regulations were intended to have application to partnerships using such an allocation approach. See, “Practitioners Question Proposed Rules on Partnership Cancellation of Debt Income,” 2009 TNT 27-2.

⁴ *Id.*

⁵ Prop. Reg. § 1.721-1(d)(1). The proposed regulation would apply to debt-for equity exchanges occurring on or after the date that the regulations are published as final regulations.

partnership interest to the creditor in satisfaction of a partnership's indebtedness for unpaid rent, royalties or interest (including accrued OID).⁶

In addition, the preamble to the proposed regulations addresses the creditor's basis and holding period in the partnership interest. In that regard, the proposed regulations provide that because IRC section 721 applies to a debt-for-equity exchange, the basis of the creditor's interest in the partnership is determined under IRC section 722. Importantly, the Service expressed its belief that a creditor should not recognize a loss in a debt-for-equity exchange where the liquidation value of the partnership interest transferred to the creditor is less than the outstanding principal balance of the indebtedness by virtue of IRC section 721. Rather, the creditor's basis in the transferred partnership interest would be increased by the adjusted basis of the indebtedness. This result for the creditor would appear to be inconsistent with IRC section 108(e)(7), which was made applicable to interests in a partnership transferred pursuant to a debt-for-equity exchange and appears to contemplate the possibility of the recognition of a deduction (loss) by the creditor.⁷ Under that provision a creditor who acquires a partnership interest in satisfaction of a debt must recognize ordinary income (recapture) on a subsequent disposition of that partnership interest with respect to any bad-debt deduction or exchange loss allowed to the creditor.⁸

⁶ Prop. Reg. § 1.721-1(d)(2). Further, the proposed regulation provides that Treas. Reg. §§ 1.446-2(e) and 1.1275-2(a) apply to determine whether a partnership interest transferred to a creditor is treated as a payment of interest or accrued OID, respectively.

⁷ IRC section 108(e)(7) was added to the Code in 1980 and extended to interests received by a creditor in a partnership as part of the AJCA 2004. See IRC section 108(e)(7)(E).

⁸ 2009 TNT 85-13 (May 4, 2009).

APPENDIX IV
IRC SECTION 108(i) – FIVE-YEAR ELECTIVE DEFERRAL
OF COD INCOME REALIZED DURING 2009-2010

A. Basic Rules. IRC section 108 contains a number of special rules of exclusion that taxpayers may use to avoid **recognition** of COD Income that they have **realized**. Certain of these rules are applied at the corporate level (where the debtor is a corporation, including S corporations) while other rules are applied solely at the level of the individual taxpayer. If the debtor is a partnership, the determination as to whether COD Income has been realized is made solely at the partnership level. Once that determination is made, the COD Income (if any has been **realized**) is allocated to the partners who, in turn, must ascertain the extent to which the special rules of exclusion are available to them. If a partnership (the “**upper-tier partnership**”) is itself a partner in a partnership that realizes COD Income (the “**lower-tier partnership**”), the upper-tier partnership must, in turn, allocate such COD Income to its partners who (unless they are also partnerships) must then apply these special rules of exclusion. In addition to these rules of exclusion, the 2009 Stimulus Act added IRC section 108(i), a provision permitting a taxpayer to elect to defer COD Income resulting from a reacquisition of its indebtedness, which occurs in 2009 and 2010 (the “**COD Income Deferral Rule**”). This special deferral provision is discussed below.

B. Temporary COD Income Deferral Rule. The COD Income Deferral Rule permits a taxpayer to elect to defer COD Income resulting from reacquisitions of an applicable debt instrument by the taxpayer or certain related persons¹ occurring after December 31, 2008, and prior to January 1, 2011.²

An “applicable debt instrument” is defined as any debt instrument issued by a C corporation or any other person if the instrument was issued in connection with that person’s conduct of a trade or business.³ The term debt instrument, for this purpose, means a bond, debenture, note, certificate, or any other instrument or contractual arrangement constituting indebtedness (within the meaning of IRC section 1275(a)(1)).⁴

The provision applies only to a reacquisition of an applicable debt instrument. A “reacquisition” is defined as an acquisition, by the taxpayer or related person, of (1) the debt instrument for cash, (2) the exchange of the debt instrument for another debt instrument (including an exchange resulting from a modification of the debt instrument), (3) the exchange of the debt instrument for corporate stock or a partnership interest, (4) the contribution of the debt

¹ For this purpose the determination of whether a person is related to another person is made in the same manner as under IRC section 108(e)(4). IRC section 108(i)(5)(A).

² IRC section 108(i)(1).

³ IRC section 108(i)(3)(A).

⁴ IRC section 108(i)(3)(B).

instrument to capital, and (5) the “complete” forgiveness⁵ of the indebtedness by the holder of the debt instrument.⁶

Deferred COD Income is includible in gross income ratably over a 5-taxable-year period.⁷ For reacquisitions occurring in 2009, the deferred COD Income must be included in gross income ratably over five taxable years beginning in the fifth “taxable” year following the year of the reacquisition. For reacquisitions occurring in 2010, the deferred COD Income is included in gross income over five years beginning in the fourth “taxable” year following the year of reacquisition. Accordingly, for calendar-year taxpayers the five-year inclusion period begins in 2014 for reacquisitions occurring in 2009 or 2010.⁸

The deferred COD Income as well as any related deduction for OID (as discussed below) that was deferred by the electing taxpayer generally will be accelerated in the case of the (1) death of the taxpayer; (2) the liquidation⁹ or sale of substantially all of the taxpayer’s assets (including in a title 11 or similar case); (3) the cessation of business by the taxpayer¹⁰; or (4) in any similar circumstance (an “**Acceleration Event**”).¹¹ The deferred items accelerate into the taxable year in which the Acceleration Event occurs. If an Acceleration Event occurs under Title 11 or a similar case, any deferred items are taken into income as of the day before the petition is filed.¹² In the case of a pass thru entity, acceleration of the deferred items occurs upon the sale, exchange or redemption of “an interest” in the partnership, S corporation or other pass-thru entity.¹³

The COD Income Deferral Rule is elected on an instrument by instrument basis and once made is irrevocable.¹⁴ The taxpayer makes the election with its tax return for the taxable year in which the reacquisition occurs.¹⁵

1. Coordination with the Exclusion Provisions. Where a taxpayer makes the election to apply the COD Income Deferral Rule, the exclusions provided by IRC sections 108(a)(1)(A),(B),(C) and (D) may not be applied, with respect to the repurchased indebtedness, for the year in which the taxpayer makes the election or any subsequent year.¹⁶ Thus, for

⁵ While the statutory language refers only to a complete forgiveness of the indebtedness, a partial forgiveness of a debt may result in a deemed exchange of the debt, under the significant modification rules, with the result that the partial forgiveness would nevertheless qualify as a reacquisition. Further, the conference report provides that an acquisition “includes, without limitation” the specific items listed above and in that regard would appear to suggest that other similar transactions may represent a qualifying acquisition of indebtedness. See H. Rept. 111-16 at page 56. Similarly, neither the statute nor the conference report specifically reference an acquisition of a debt in exchange for property (e.g., a foreclosure event).

⁶ IRC section 108(i)(4)(B).

⁷ IRC section 108(i)(1).

⁸ Based on an assumption that the taxpayer does not experience any “short” taxable years.

⁹ Neither the statute or the conference report consider whether a deemed liquidation associated with a technical termination under IRC section 708(b)(1)(B) would not be considered an Acceleration Event for partners that did not transfer an interest in the historic partnership.

¹⁰ A circumstance that may arise in connection with a partnership that owns a single property that may be transferred pursuant to a foreclosure event.

¹¹ IRC section 108(i)(5)(D)(i).

¹² *Id.*

¹³ IRC section 108(i)(5)(D)(iii). The provision does not specify whether this rule applies only in the case of a transfer of the partner’s entire interest in the pass-through entity.

¹⁴ IRC section 108(i)(5)(D)(ii).

¹⁵ 2009 TNT 85-22 (May 5, 2009).

¹⁶ IRC section 108(i)(5)(C).

example, an insolvent taxpayer that elects to defer COD Income (or the partners of a partnership that has made the election) may not exclude that income, in exchange for a reduction in attributes, in a subsequent taxable year in which the deferred COD Income is taken into income. As discussed below, in the case of a partnership the election to apply the COD Income Deferral Rule is made by the partnership – which may raise competing fiduciary issues where the tax profile of partners may support a decision to apply the COD Income Deferral Rule for certain partners, while other partners may be eligible for and prefer the application of an available exclusion.

2. Special Rules for Partnerships. As noted above, in the case of a partnership, the election to apply the COD Income Deferral Rule is made by the partnership.¹⁷ Any COD Income deferred under the provision is allocated to the partners in the partnership immediately before the discharge in the manner such amounts would have been included in the distributive shares of such partners under section 704 if such COD Income were recognized at the time of the discharge.¹⁸

As discussed in greater detail elsewhere in this outline, a decrease in a partner's share of a partnership liability results in a deemed distribution to that partner, and would result in a gain under section 731(a) to the extent that any such deemed distribution exceeded the applicable partner's basis in its partnership interest. In that regard, a partner's share of liabilities may decrease in connection with the discharge of a partnership indebtedness. If associated COD Income is allocated consistent with the manner in which partners share a discharged liability, the partners would generally not expect to recognize a gain pursuant to section 731 from the discharge of a partnership debt. In that regard, a partner's tax basis would increase from the allocation of COD Income in an amount equal to the deemed distribution resulting from the discharge of the debt.¹⁹ This approach would, however, be disrupted by a deferral of COD Income under section 108(i). To address the impact of the deferral of COD Income, section 108(i)(6) provides that any decrease in a partner's share of partnership liabilities as a result of discharge of indebtedness shall not be taken into account for purposes of section 752 at the time of the discharge to the extent it would cause the partner to recognize gain under section 731.²⁰ Neither the statute nor the conference report address how the "suspended" portion of the deemed section 752(b) distribution is subsequently accounted for by the partner.²¹

3. Special Rules for Debt-for-Debt Exchanges. If the taxpayer makes an election to apply the COD Income Deferral Rule in the case of a debt-for-debt exchange and OID is created in connection with the newly issued (or deemed issued) debt, then any otherwise allowable deduction of the OID that accrues before the deferral period ends must also be deferred to the extent of the deferred COD Income.²² Any deferred OID accrued during the

¹⁷ IRC section 108(i)(5)(B)(iii).

¹⁸ IRC section 108(i)(6).

¹⁹ Rev. Rul. 92-97, 1992-2 C.B. 124, provides that constructive distributions under IRC section 752(b) resulting from a cancellation of debt, should be treated as occurring on the last day of the partnership tax year under the drawing rule in Treas. Reg. § 1.731-1(a)(1)(ii); Rev. Rul. 94-4; 1994-1 C.B. 196.

²⁰ Note, under this provision the partner would be expected to have a zero basis in the partnership interest as a result of the discharge of the partnership indebtedness. In that regard, the partner may be unable to claim future losses or may be subject to the recognition of gain as a result of other distributions from the partnership.

²¹ 2009 TNT 79-12 (April 27, 2009).

²² Presumably this rule would extend to deductions associated with an applicable high yield discount obligation ("AHYDO") as described in IRC section 163(e)(5). In that regard, however, the 2009 Stimulus Act provides for a temporary suspension of the AHYDO rules (which, if applicable, operate to defer the deduction of interest on certain high

deferral period is allowed as a deduction ratably over the same inclusion period in which the deferred COD Income is taken into gross income.²³

4. Temporary Regulations and Guidance Under IRC section 108(i).

During September 2010, the Service issued temporary regulations under IRC section 108(i) addressing the deferral of COD Income and original issue discount (“OID”) deductions for partnerships and S corporations, including guidance on what constitutes an applicable debt instrument, what events will trigger an acceleration of the IRC section 108(i) deferral, and how the rules apply to tiered partnerships.²⁴ These temporary regulations expand on guidance contained in Revenue Procedure 2009-37, released in August 2009, which explained how to make an IRC section 108(i) election and required annual reporting of certain additional information.

yield debt instruments issued by a corporation) for certain debt instruments issued during the period beginning on September 1, 2008, and ending on December 31, 2009, in exchange for an obligation that is not an AHYDO instrument (including an exchange resulting from a modification of a debt instrument). See IRC section 1232 of the 2009 Stimulus Act.

²³ This rule can apply also in certain cases when the debtor reacquires its debt for cash. If the taxpayer issues a debt instrument and the proceeds of such issuance are used directly or indirectly to reacquire a debt instrument of the taxpayer, the provision treats the newly issued debt instrument as if it were issued in satisfaction of the retired debt instrument. If the newly issued debt instrument results in OID, the rule described above applies.

²⁴ See T.D. 9498.