Troubled Projects, Workouts and Debt Restructurings

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TROUBLED PROJECTS, WORKOUTS AND DEBT RESTRUCTURINGS

I. OVERVIEW OF OUTLINE AND GENERAL CONCEPTS

This outline presents an overview of the federal income tax issues commonly associated with troubled projects and debt restructurings/workouts from the perspective of a partnership and its partners. The outline takes a transactional approach to identifying these issues. However, before addressing specific transactions, it provides background on whether a purported debt instrument is in fact debt, or is properly viewed as equity. In addition, it discusses the general concepts relating to a discharge of indebtedness that generates income for tax purposes. A working knowledge of these issues is important to understanding the alternatives and potential planning opportunities that may be present when a project becomes troubled and needs to be restructured.

A. Is Indebtedness in fact Debt, or is it Properly Viewed as Equity for Tax Purposes?

1. The issues discussed in this outline apply to advances that are properly treated as debt for federal income tax purposes. In many cases, it will be clear that an advance is debt for tax purposes. However, each advance should be analyzed separately for its characterization for tax purposes.

2. For example, a partner may advance money to a partnership over time under a loan document, and these advances may properly be viewed as debt for tax purposes. However, if later advances are made at a time when the partnership

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1 This outline is based, in part, on an article entitled Debt Workouts: The Partnership and the Partners, 808 PLI / 9AX311 (May-June 2008) by James Sowell, of KPMG LLP. The author would like to thank James Sowell for his valuable comments in connection with this outline. This article represents the views of the author only, and does not necessarily represent the views or professional advice of KPMG LLP. Also, the information contained herein is general in nature and based on authorities that are subject to change.

2 Any reference to “tax” or “U.S. tax” in this memorandum is intended only to refer to U.S. federal income tax matters and not to foreign, state, local or any other tax matters, unless explicitly indicated otherwise.

3 The terms “partnership” and “partners” are used herein also refer to limited liability companies classified as partnerships for federal income tax purposes, and members in such entities.

4 For a detailed outline of debt workouts that covers many of the issues addressed below, see Sowell, Debt Workouts: The Partnership and the Partners, 808 PLI / TAX 311 (May-June 2008).

The views and opinions are those of the author and do not necessarily represent the views and opinions of KPMG LLP.

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is distressed, there is an increased possibility that these later advances may properly be viewed as equity.

3. In general, indebtedness arises when one party transfers money to another in exchange for a binding legal obligation to repay the sum transferred, either on a date certain or on demand.

   (i) In Deputy v. du Pont, 308 U.S. 488 (1940), the Supreme Court held that the obligation to return borrowed stock pursuant to a securities lending arrangement does not constitute indebtedness.

   (ii) A “liability” for purposes of section 752 is broader than “indebtedness.” See, e.g., Revenue Ruling 95-26, 1995-1 C.B. 107, in which the IRS held that an obligation to provide stock in a short sale is a section 752 liability. See also Salina Partnership LP v. Commissioner, 80 T.C.M. (CCH) 686 (2000), which confirmed this result.

4. In distinguishing debt from equity, the question is whether “the funds were advanced with a reasonable expectation of repayment regardless of the success of the venture or were placed at the risk of the business.” TIFD III-E, Inc. v. United States, 459 F.2d 220, 232, (2d Cir. 2006) (quoting Gilbert v. Commissioner, 248 F.2d at 406). This determination is made based on all the facts and circumstances surrounding the transaction. Certain factors are often used to distinguish debt from equity, but no single factor is controlling, and the weight, if any, to be given to a factor depends on the particular circumstances of each case (see e.g. Roth Steel Tube Co. v. Commissioner, 800 F.2d 625, 630 (6th Cir. 1986) and Fin Hay Realty Co. v. United States, 398 F.2d 694, 697 (3d Cir. 1968)). The factors include:

   (i) The names given to the instruments;
   (ii) The presence or absence of a fixed maturity date and schedule of payments;
   (iii) The presence or absence of a fixed rate of interest and interest payments;
   (iv) The source of repayments;
   (v) The adequacy or inadequacy of capitalization;
   (vi) The identity of interest between creditor and debtor;
   (vii) The security, if any, for the advances;
   (viii) The debtor’s ability to obtain financing from outside lending institutions;
   (ix) The extent to which the advances were subordinated to the claims of outside creditors;
   (x) The extent to which the advances were used to acquire capital assets; and
(xi) The presence or absence of a sinking fund to provide repayments.

5. In the context of determining if the purported creditor is properly treated as holding an equity interest in a partnership, it is also instructive to consider the factors that courts have applied in determining whether a person is properly treated as a partner in a partnership:

   (i) The agreement of the parties and their conduct in executing its terms;
   
   (ii) The contributions each party made to the venture; the parties’ control over income and capital and the right of each to make withdrawals;
   
   (iii) Whether each party was a principal and co-proprietor, sharing a mutual proprietary interest in the net profits and having an obligation to share losses;
   
   (iv) Whether one party was the agent or employee of the other, receiving for his services contingent compensation in the form of a percentage of income;
   
   (v) Whether business was conducted in the joint names of the parties;
   
   (vi) Whether the parties filed federal partnership returns or otherwise represented to the IRS or to persons with whom they dealt that they were joint venturers;
   
   (vii) Whether separate books of account were maintained for the venture; and
   
   (viii) Whether the parties exercised mutual control over and assumed mutual responsibilities for the enterprise.


B. What is Debt Discharge Income (Cancellation of Debt (“COD”) Income)?

1. *United States v. Kirby Lumber Co.*, 284 U.S. 1 (1931), established the principle that income arises on satisfaction of debt for less than the amount due. The Supreme Court held that the debtor’s repurchase of its own debt at a discount in the market caused the debtor to realize an accession to wealth or income in the amount of the discount. The Court reasoned that the income realization was attributable to “freeing of the assets” that had been subject to the debt liability when the liability was satisfied at a discount.

2. Section 61(a)(12) codified the principle that cancellation of indebtedness income (“COD income”) is included as ordinary gross income when the Internal Revenue Code of 1954 was enacted.

3. Other explanations for the principle that COD income is includible as gross income include the following:

   (i) *United States v. Centennial Savings Bank*, 499 U.S. 573, 582 (1991), articulated a tax benefit theory for including COD income as income because the taxpayer’s borrowed funds are excluded from income in
the first instance and, when the obligation to repay is forgiven, the basis for the original exclusion evaporates.

(ii) In *Hillsboro National Bank v. Commissioner*, 460 U.S. 370, 372 (1983), the Court stated, "[T]he tax benefit rule ordinarily applies to require the inclusion of income when events occur that are ‘fundamentally inconsistent’ with an earlier deduction [or other contrary treatment]."

4. As discussed in connection with the transactions outlined below, COD income may result when a debtor transfers property in satisfaction of all or a portion of the debt. In those cases, recognition of COD income depends on whether the debt is considered recourse or nonrecourse for section 1001 purposes. In cases where the debtor retains the property, COD may result regardless of character of debt as recourse or nonrecourse.

(i) If a partial cash payment is made on the debt and the balance of the debt is cancelled, the taxpayer may realize COD income equal to the balance cancelled. See Rev. Rul. 82-202, 1982-2 C.B. 35, and Rev. Rul. 91-31, 1991-1 C.B. 19.

(ii) If the debt is cancelled and no payment of any kind is made, the taxpayer may realize COD income equal to the entire amount of the debt.

5. The remainder of this outline reviews specific types of transactions that occur with respect to distressed debt.

II. TRANSACTIONS INVOLVING TRANSFERS OF PROPERTIES IN SATISFACTION OF DEBT

A. Transfers of Properties in Satisfaction of Nonrecourse Debt

1. For purposes of analyzing the tax issues associated with a transfer of property in satisfaction of nonrecourse debt, assume the following fact pattern (the "Base Case"):

   Individual A, Corporation B, and Corporation C form Partnership PRS with cash and that PRS uses the cash to purchase Property Y. PRS also borrows $800x from a third-party lender ("Bank") and purchases Property X. The loan is nonrecourse and is secured solely by Property X. Several years later, the fair market value of Property X falls to $500x and PRS is unable to repay the loan to Bank. Bank desires to work out the indebtedness. The first transaction contemplated by PRS and the Bank is to transfer Property X to Bank in satisfaction of the $800x note. Assume that at the time of the transfer, PRS's basis in Property X is $700x.

   (i) Under section 1001, PRS will recognize gain or loss equal to the difference between the amount of the liability and the basis PRS had in Property X. Thus, PRS will recognize gain of $100x ($800x debt balance less $700x adjusted basis in Property X). The character of the gain or loss (i.e. capital or ordinary) will be determined based on
the character of the property in the hands of PRS. Thus, if Property X was a capital asset in the hands of PRS, PRS would recognize a $100x capital gain.

(ii) Treas. Reg. section 1.1001-1(a) provides that the amount realized on a sale or other disposition of property includes the amount of liabilities from which the transferor is discharged as a result of the sale or disposition. The sale or other disposition of property that secures a nonrecourse debt discharges the transferor from the liability.

(iii) Two Supreme Court cases established that, when the debtor transfers the collateral to a third party subject to the debt or to the creditor in satisfaction of the debt, the amount realized on the disposition of the property includes the full amount of the debt. In this case, no COD income is realized.

(a) United States v. Crane, 331 U.S. 1 (1947), established the principle that when a taxpayer transfers property subject to a debt, the amount realized on the transfer includes the amount of the debt, at least when the fair market value of the property exceeds the amount of the debt.

(b) In Commissioner v. Tufts, 461 U.S. 300 (1983), the Court held that the amount realized includes the full amount of the debt even when the fair market value of the property is lower than the amount of the debt ("Tufts gain").

(iv) Treas. Reg. section 1.1001-2(c), Example 7, illustrates the principle that the amount realized includes the full amount of nonrecourse debt when the security for the debt is transferred to the creditor in satisfaction of the debt.

(v) The Base Case raises additional tax considerations given that the restructuring occurs in a partnership. While those considerations are discussed in detail below, the following is worth noting here.

(a) The gain recognized by PRS flows through to its partners under section 702. Each partner's basis in his partnership interest is increased by the amount of gain allocated to the partner under section 705(a).

(b) The reduction of the debt in the hands of PRS is treated as a deemed distribution of money to the partners under section 752(b). Gain is recognized under section 731(a) to the extent that the deemed distribution of money to a partner exceeds the partner's basis in his partnership interest.

2. The Base Case facts are revised slightly in order to analyze the tax issues associated with a transfer of property to other than a creditor, with the
proceeds from the transfer used to satisfy the nonrecourse debt (the “Base Case with Sale”):

Assume the same facts as in the Base Case, except that the Bank allows PRS to sell the property to a third party, unencumbered by the debt, for cash, provided that the cash received from the sale is transferred to the Bank in satisfaction of the debt.

(i) If the sale of the property was undertaken in connection with the discharge of indebtedness, the transaction may be viewed as a sale, and PRS will recognize gain or loss under section 1001 (as outlined in the base case above).

(a) See e.g., 2925 Briarpark, Ltd. v. Commissioner, 163 F.3d 313 (5th Cir. 1999) (the Fifth Circuit, affirming the Tax Court, held that where the sale of the property and cancellation of the indebtedness are closely intertwined so as to effectively be one transaction, the debtor will recognize gain rather than COD income).

3. Base Case facts are further revised to illustrate the effect of multiple liabilities (Base Case with Multiple Liabilities): Assume the same facts as in the Base Case, except that PRS borrowed from two Banks (Bank 1 and Bank 2) on a nonrecourse basis. Bank 1 loaned $600x and has a senior claim Property X. Bank 2 loaned $200x and has a junior claim to Property X. PRS sells the property for $500x and transfers the money to Bank 1 in satisfaction of its $600x loan. Bank 2 does not receive any proceeds and cancels its $200x debt.

(i) Under section 1001, PRS will recognize gain or loss equal to the difference between the amount of the Bank 1 loan and the basis of Property X. Thus, PRS will recognize a loss of $100x ($600x debt balance less $700x adjusted basis in Property X). If the property was a capital asset in the hands of PRS, PRS would recognized a capital loss of $100x.

(ii) Because PRS did not transfer any money or other property to Bank 2 in satisfaction of the Bank 2 loan, PRS will recognize COD income equal to the amount of the Bank 2 loan ($200x).

(iii) Note that while the total amount of income realized ($200x COD income less a $100x capital loss) is the same as the Base Case ($100x gain), the character of the income may be different under this fact pattern. That is, the gain or loss could be capital gain or loss, while the COD income is always ordinary income.

B. Transfers of Properties in Satisfaction of Recourse Debt

1. For purposes of analyzing the tax issues associated with a transfer of property in satisfaction of nonrecourse debt, assume the same facts as the Base Case in A. above, except that the debt is recourse debt for section 1001 purposes.
2. Under section 1001, PRS will recognize gain or loss equal to the difference between the fair market value of Property X and its basis. Thus, PRS will recognize a $200x loss ($500x fair market value of Property X less $700x basis in Property X). In addition, PRS will recognize COD income equal to the difference between the amount of the debt and the fair market value of Property X. Thus, PRS will recognize $300x of COD income ($800x debt balance less $500x fair market value of Property X). See Treas. Reg. section 1.1001-2(c), Example 8; Rev. Rul. 90-16, 1990-1 C.B. 12.

(i) Thus, transfers of properties in satisfaction of recourse debt may result in a bifurcated transaction, i.e., both gain or loss and COD income. The debtor is treated as selling the property for an amount equal to the fair market value of the property. To the extent that the amount of debt cancelled exceeds the value of the property transferred, the debtor will have COD income.

(ii) Under this fact pattern, the creditor could have pursued its right to other assets of the debtor because the debt was recourse to PRS. Because the creditor extinguished those rights by cancelling the debt and freed the debtor from that liability, it is appropriate for the excess to be treated as COD income.

3. Note that, similar to the Base Case with Multiple Debts fact pattern, while the total amount of income realized is the same as in the Base Case, the character of the income may be different. That is, the gain or loss could be capital gain or loss, while the COD income is always ordinary income.

4. The same additional considerations discussed in the Base Case also arise because PRS is a partnership for tax purposes. While those considerations are discussed in detail below, the following is worth noting here.

(i) The gain or loss and COD income recognized by PRS flows through to its partners under section 702. Each partner's basis in his partnership interest is increased by the amount of gain allocated to the partner under section 705(a).

(a) As discussed later, the allocation of COD income to a partner increases its basis in its partnership interest even if the partner is able to exclude the COD income under section 108.

(ii) The reduction of the debt in the hands of PRS is treated as a deemed distribution of money to the partners under section 752(b). Gain is recognized under section 731(a) to the extent that the deemed distribution of money to a partner exceeds the partner's basis in his partnership interest.

C. Recourse or Nonrecourse for Section 1001 Purposes

1. For purposes of determining whether debt is recourse or nonrecourse for section 1001 purposes, assume the same facts as in the Base Case, except that PRS is a limited liability company ("LLC") taxed as a partnership and the
debt is a general obligation of PRS. As such, the creditor may proceed against all of the LLC’s assets in satisfaction of the debt. However, the creditor may not proceed against any of the members of the LLC to satisfy the obligation of the LLC. This type of debt is commonly referred to as “exculpatory debt.”

(i) A debt is generally considered recourse for section 1001 purposes if the creditor may proceed against all of the debtor’s assets in satisfaction of the debtor’s obligations. Conversely, if a debt is secured by specific property of the debtor and the creditor’s only remedy for failure to pay is with respect to the property securing the loan, the loan is generally considered “nonrecourse” for section 1001 purposes.

(ii) Applying these definitions to the instant facts, the debt may be considered recourse debt for section 1001 purposes and the tax results of the Base Case would follow.

(a) Note that if the LLC is a special purpose vehicle that holds a single asset, the debt is functionally nonrecourse and may be treated as such for tax purposes. See Federal Income Taxation of Debt Instruments, 5th edition, by David C. Garlock, ¶ 1501.04 at page 15,038.

(iii) It is unclear if these definitions should apply in the context of an LLC taxed as a partnership. While some practitioners believe these are the proper definitions to apply in the context of an LLC, others believe that the section 752 rules should be used to determine if a debt is recourse or nonrecourse for section 1001 purposes.

(iv) As discussed in more detail in the partnership related considerations below, the regulations under section 752 provide that a partnership liability is a “nonrecourse liability” to the extent that no partner or related person bears the economic risk of loss for that liability. Treas. Reg. section 1.752-1(a)(2). Likewise, in determining whether debt is “qualified nonrecourse financing” under the Section 465 “at-risk” rules, the personal liability of a partnership for repayment of a financing is disregarded. See Treas. Reg. section 1.465-27(b)(4). However, these rules technically apply only for purposes of classifying partnership debt at the partner level. Gain or loss and COD income determinations are made at the partnership level and must be evaluated under section 1001. See Brinkman v. Commissioner, 76 T.C.M. (CCH) 506 (1998).

(v) Note that the position for applying the section 752 rules was bolstered by the Tax Court’s decision in Great Plains Gasification Associates v. Commissioner, 92 T.C.M. (CCH) 534 (2006).

2. Effect of partner guarantees

(i) Under section 752, if a partner (or a person who is related to a partner) guarantees a nonrecourse liability of the partnership, the
partner bears the economic risk of loss with respect to that liability, and the liability is then characterized as a recourse liability of the partnership. See Treas. Reg. section 1.752-2(b)(3).

(ii) Release of a partner guarantee should not result in COD income to the guarantor partner. See Brickman, 76 T.C. M. (CCH) 506 (1998); Landreth v. Commissioner, 50 T.C. 803 (1968).

(a) This result is less certain if the guarantor partner becomes primarily liable for the debt as a result of its guarantee before the debt is discharged. See Marcaccio v. Commissioner, T.C. Memo 1995-174.

III. TRANSACTIONS NOT INVOLVING TRANSFERS OF PROPERTIES IN SATISFACTION OF DEBT

A. Reduction of Debt by Creditor

1. For purposes of analyzing the tax issues associated with a reduction of debt by a creditor, assume the same facts as in the Base Case. That is, Individual A, Corporation B, and Corporation C form Partnership PRS with cash and that PRS uses the cash to purchase Property Y. PRS also borrows $800x from a third-party lender ("Bank") and purchases Property X. The loan is nonrecourse and is secured solely by Property X. Several years later, the fair market value of Property X falls to $500x and PRS is unable to repay the loan to Bank. Bank desires to work out the indebtedness. The second transaction contemplated by PRS and the Bank is to reduce the principal amount of the debt from $800x down to $500x, the fair market value of Property X (the Debt Reduction Case).


3. Section 108(a) provides exceptions to the recognition of COD income (e.g., bankruptcy, insolvency). However, as discussed in the partner considerations section below, the section 108(a) exceptions are applied at the partner level, and not at the partnership level. See section 108(d)(6). Thus, PRS may not exclude any of the COD income pursuant to the exceptions contained in section 108(a).

4. Section 108(e)(5) provides an exception for the recognition of COD income with respect to purchase money debt that applies at the partnership level. Under that section, if the debt obligation of a purchaser of property to the seller of such property which arose out of the purchase of such property is reduced, then such reduction shall be treated as a purchase price adjustment. However, in the Debt Reduction Case facts, PRS's debt is not to the seller of Property X. Instead, it arose from a loan by a Bank the proceeds of which were used to purchase Property X. Thus, section 108(e)(5) would not apply to the reduction of PRS's debt.
Note that section 108(e)(5) does not apply if the reduction occurs in a title 11 bankruptcy case, or when the purchaser is insolvent. Section 108(e)(5)(B).

In the case of a partnership, the IRS issued Rev. Proc. 92-92, 1992-2 C.B. 505, indicating that it would not challenge the application of section 108(e)(5) by a partnership because the partnership is bankrupt or insolvent.

5. Rev. Rul. 92-99, 1992-2 C.B. 35, addressed whether and to what extent a purchase money debt exception to the recognition of COD income exists outside the context of section 108(e)(5) pursuant to case law. The IRS concluded that, if the principal amount of an undersecured nonrecourse debt that arose out of the purchase of property is reduced by the holder of the debt who was not the seller of the property, this debt reduction may not be treated as a purchase price adjustment (in the absence of an infirmity that clearly relates back to the original sale), but results in COD income under section 61(a)(12).

B. Conversion of the Debt for an Equity Interest

1. For purposes of analyzing the tax issues associated with a creditor converting its debt for an equity interest in the debtor partnership, assume the same facts as in the Base Case. Individual A, Corporation B, and Corporation C form Partnership PRS with cash and that PRS uses the cash to purchase Property Y. PRS also borrows $800x from a third-party lender ("Bank") and purchases Property X. The loan is nonrecourse and is secured solely by Property X. Several years later, the fair market value of Property X falls to $500x and PRS is unable to repay the loan to Bank. Bank desires to work out the indebtedness. The third transaction contemplated by PRS and the Bank is for the Bank to take an equity interest in PRS in satisfaction of the entire debt (the Conversion Case). Assume further that the value of Property Y is $200x.

2. Under section 108(e)(8), for purposes of determining COD income, if a debtor partnership transfers a capital or profits interest to a creditor in satisfaction of its recourse or nonrecourse debt, such partnership shall be deemed to have satisfied the debt with an amount of money equal to the fair market value of the partnership interest. Thus, in the Conversion Case fact pattern, PRS is deemed to have satisfied the $800x debt with an amount of money equal to the fair market value of the interest received.

   (i) It is not clear how to determine the fair market value of the interest received for purpose of section 108(e)(8). There is a project on the 2008-09 IRS Priority Guidance Plan that may address this issue and other issues that arise in applying section 108(e)(8).

   (ii) In the Conversion Case, if we assume that the fair market value of the partnership interest received is properly viewed as equal to the equity value of PRS ($700x), PRS would have COD income equal
$100x (the difference between the amount of the $800x debt satisfied less the $700x fair market value of the interest received).

(iii) Section 108(e)(8) also provides that any COD income so recognized shall be included in the distributive shares of taxpayers who were the partners in the partnership immediately prior to the discharge. Thus, the converting creditor would not be allocated any of the COD income recognized under section 108(e)(8).

C. Acquisition of the Debt by a Third Party

1. For purpose of analyzing the tax issues associated with a third party acquiring the debt from the creditor, assume the same facts as in the Base Case, except that the Bank and PRS have failed to negotiate a workout arrangement that is satisfactory to both parties. The fourth transaction contemplated by PRS and the Bank is a sale by the Bank of its debt to a third party that may be willing to give PRS more time to turn the business around or that may be willing to engage in a mutually agreeable workout transaction (the Third Party Acquisition Case). Assume that the purchase price paid for the debt is significantly below the amount of the debt (given the distressed nature of the assets securing the debt).

2. Under section 108(e)(4), if the person acquiring the debt is related to PRS, PRS will recognize COD income equal to the excess of the adjusted issue price of the debt over the related party’s adjusted basis in the debt determined on the date of purchase. Treas. Reg. section 1.108-2(f)(1).

   (i) Generally, persons are treated as related if they are related within the meaning of sections 267(b) and 707(b)(1), with certain modifications with respect to the family relationship rules contained in those sections. In addition, two entities treated as a single employer under section 414(b) or (c) will be treated as having a relationship described in section 267(b). Treas. Reg. section 1.108-2(d)(2).

   (ii) Note that section 108(e)(4) also applies if a holder of debt is not related at the time of acquisition but subsequently becomes related to the debtor, and the holder of the debt is deemed to have acquired the debt “in anticipation of becoming related to the debtor.” Treas. Reg. section 1.108-2(c)(1). This determination is generally made based on all the facts and circumstances. However, if a holder acquires debt less than six months before becoming related to the debtor, the acquisition will be treated as being made “in anticipation of becoming related to the debtor.”

3. If the person acquiring the debt is not related to PRS (and is not treated as acquiring the debt in anticipation of becoming related to PRS), PRS may nevertheless recognize COD income if there is a “significant modification” of the debt within the meaning of Treas. Reg. section 1.1001-3. In such case, there is a deemed exchange of the original debt instrument for a modified debt instrument.
4. Under section 108(e)(10), if a debtor is treated as issuing a new debt instrument in satisfaction of an existing debt, the debtor will be treated as satisfying the existing debt with money in an amount equal to the issue price of the new debt.

   (i) If the new debt is not publicly traded and has adequate stated interest, the issue price generally will equal the adjusted issue price of the old debt and no COD will be recognized. Section 1273(b)(4).

   (ii) Treas. Reg. section 1.166-3(a)(3) provides that a holder of a debt instrument that recognizes a gain under Treas. Reg. section 1.1001-1(a) has a deemed bad debt deduction for the same taxable year equal to the amounts previously charged off on the debt (as determined under Treas. Reg. section 1.166-2(a)(3)(iii)). This regulation thus mitigates the gain recognized by an original holder of the debt whose basis in the debt is lower than the adjusted issue price due to a prior bad debt deduction.

      (a) Note, however, that this regulation does not mitigate the gain recognized by a subsequent holder whose adjusted basis in the debt is lower than the adjusted issue price because it is a cost basis attributable to a purchase at a discount. Thus, if the holder of the debt acquired the debt from the original creditor at a discount, the holder may recognize gain on the deemed exchange.

   (iii) If either the old or new debt is publicly traded, the issue price of the new debt would be the fair market value of the debt, which could result in the recognition of COD income. Section 1273(b)(3).

      (a) In this instance, note that the debt instrument may now be subject to the original issue discount (OID) provisions of section 1273. To the extent that the amount of the OID is significant, the AHYDO rules of section 163(e)(5) may be implicated to defer or disallow any interest expense allocated to any corporate partners. However, see Rev. Proc. 2008-51, 2008-35 I.R.B. 562, for potential nonapplication of the AHYDO rules in certain circumstances.

D. Admission of a Third Party to the Partnership

1. For purpose of analyzing the tax issues associated with the admission of a third party to the partnership, assume the same facts as in the Base Case. Assume that the Bank is willing to give PRS more time to turn the business around, but insists on having PRS pay down a portion of the debt. To that end, PRS admits a third party to the partnership for a cash contribution and uses some of the cash to repay a negotiated portion of the debt (the New Partner Case).
2. The admission of a third party to the partnership for cash which is used to pay down a portion of the debt generally will not result in the recognition of COD income by the partnership.

3. However, this transaction will have consequences under the provision of the Code governing partnerships (Subchapter K). These consequences include the following.
   
   (i) The partnership generally will revalue its assets to fair market value, taking section 7701(g) into account, so that the new book value of partnership property subject to a nonrecourse debt will equal at least the amount of the nonrecourse debt attributable to such property.

   (ii) If the partnership has minimum gain prior to the admission of the third party, the minimum gain will be eliminated as a result of the revaluation. However, the reduction of minimum gain attributable to the revaluation will not result in an allocation of income pursuant to the minimum gain chargeback provisions of a partnership agreement that complies with the section 704(b) regulations. Treas. Reg. section 1.704-2(d)(4).

   (iii) Under section 752(b), the reduction of partnership debt that occurs as a result of the repayment of a portion of the debt will be treated as a deemed distribution of money to the partners who were allocated the debt under section 752.

   (iv) Over time, there will be a shift of some of the debt allocation to the new partner. This allocation of debt basis under section 752 should be monitored to determine if a deemed distribution of money under section 752(b) will exceed a partner’s adjusted basis in his partnership interest.

E. Allocation of COD Income to the Partners

   1. Allocation of COD income or gain (including Tufts gain) by the partnership to the partners is generally made in accordance with the partnership agreement.

   2. If the partnership had nonrecourse deductions as defined in Treas. Reg. section 1.704-2(c), when minimum gain is reduced by elimination or reduction of the partnership liability, there will effectively be a “recapture” of those deductions by the partners to whom the nonrecourse deductions were allocated under the minimum gain chargeback provisions. See Treas. Reg. section 1.704-2(f).

   3. Allocations of COD income and gain under the partnership agreement must have substantial economic effect under section 704(b) or be in accordance with the partner’s interest in the partnership. See e.g., Rev. Rul. 92-97, 1992-2 C.B. 124, and Rev. Rul. 99-43, 1999-2 C.B. 506.

   4. Any income or gain (including COD income or Tufts gain) allocated to the partners as a consequence of the reduction or elimination of partnership liabilities increases the bases of the partners in the partnership under section
705(a)(1)(A); the reduction in partnership liabilities when debt is reduced or cancelled reduces the partners’ bases in the partnership (section 752(b)). Therefore, if the COD income or Tufts gain is allocated to the partners in the same manner as the partnership liabilities that are being reduced or eliminated are allocated, there may not be a net change in the partners’ adjusted bases in the partnership and no additional gain recognized as a result of the deemed distribution under section 752(b).

IV. Partner Tax Implications if COD is Recognized by the Partnership and Allocated to the Partners.

A. For purposes of analyzing the tax issues associated with a partner who is allocated COD income recognized by the partnership, assume that the same facts as the Base Case. In addition, assume that each partner has a tax basis in his PRS interest of $67x (comprised of a negative tax capital account of $200x and a share of partnership liabilities of $267x each). Individual A is solvent; Corporation B is insolvent by $200x, not taking into account its interest in PRS; and Corporation C is in Chapter 11 Bankruptcy and has $100x of expiring NOLs.

B. Review of Partnership Tax Implications

1. Under section 705(a)(1)(A), the partners will increase their bases in their partnership interests by their share of any sale gain or COD income allocated to them.

2. The reduction of a partner’s share of partnership liabilities as a result of the debt discharge is treated as a deemed distribution of money to the partner under section 752(b).

   (i) Under Rev. Rul. 94-4 and Rev. Rul. 92-97, the deemed distribution of money under section 752(b) is taken into account as an advance or draw of income allocated to the partner at the end of the year.

   (ii) Gain may be recognized under section 731(a) if the partner’s share of the discharged liability is greater than its share of partnership income (including the sale gain and COD income).

C. Application of COD Exclusions at the Partner Level – Section 108(a)

1. Section 108(a)(1) provides that gross income does not include any amount that would be includable in gross income by reason of the discharge (in whole or in part) of indebtedness of the taxpayer if—(A) the discharge occurs in a title 11 case, (B) the discharge occurs when the taxpayer is insolvent, (C) the indebtedness discharged is qualified farm indebtedness, (D) in the case of a taxpayer other than a C corporation, the indebtedness discharged is qualified real property business indebtedness, or (E) the indebtedness discharged is qualified principal residence which is discharged before January 1, 2013.

2. Under section 108(d)(6), the exceptions to COD income under section 108(a) apply at the partner level.
3. Under section 108(a)(2), if the discharge occurs in a title 11 case, none of the other section 108(a) exclusions apply. If the discharge does not occur in a title 11 case, but the taxpayer is insolvent, then the remaining section 108(a) exclusions do not apply. The principal residence exclusion takes precedence over the insolvency exception unless the taxpayer elects otherwise.

4. Under section 108(b)(2), the bankruptcy exception applies if the taxpayer is under the jurisdiction of a court in a title 11 bankruptcy case, and the discharge is granted by the court or is pursuant to a plan approved by the court.
   (i) In *Price v. Commissioner*, T.C. Memo 2004-149, the Tax Court has permitted a general partner to utilize the bankruptcy exclusion where the general partner was discharged from the liability for partnership debts in connection with bankruptcy proceeding related to the partnership. In that case, the bankruptcy court asserted jurisdiction over the general partner in the partnership’s chapter 11 bankruptcy case. See also *Garcia v. Commissioner*, T.C. Memo 2004-147; *Mirarchi v. Commissioner*, T.C. Memo 2004-148; *Estate of Martinez v. Commissioner*, T.C. Memo. 2004-150.
   (ii) Under the *Base Case* and the partner facts noted above, Corporation C is in Chapter 11 Bankruptcy. Accordingly Corporation C may be able to exclude some or all of the COD allocated to it from PRS.

5. Under section 108(a)(3), the amount excluded under the insolvency exclusion may not exceed the amount by which the taxpayer is insolvent.
   (i) Section 108(d)(3) defines “insolvency” for this purpose. Under section 108(d)(3), a taxpayer is insolvent to the extent that the amount of his liabilities exceed the fair market value of his assets, immediately before the discharge.
   (ii) It appears that all of the taxpayer’s assets are included in determining insolvency, regardless of whether some of the assets are exempt from the claims of creditors. See e.g., *Carlson v. Commissioner*, 116 T.C. 87 (2001).
   (iii) There is significant uncertainty regarding the appropriate treatment of contingent liabilities in determining a taxpayer’s insolvency. In *Merkel v. Commissioner*, 109 T.C. 463 (1997), aff’d 192 F.3d 844 (9th Cir. 1999), the Court of Appeals determined that a contingent liability such as a guarantee may be taken into account in determining whether a partner is insolvent within the meaning of section 108(d)(3) under limited circumstances. The court determined that, “[A] taxpayer claiming the benefit of the insolvency exclusion must prove (1) with respect to any obligation claimed to be a liability, that, as of the calculation date, it is more probable than not that he will be called upon to pay that obligation in the amount
claimed and (2) that the total liabilities so proved exceed the fair
market value of his assets.” Id. at 484.

(iv) In Rev. Rul. 92-53, 1992-2 C.B. 48, the IRS addressed the treatment
of nonrecourse liabilities in determining insolvency. The IRS
concluded that, for purposes of determining insolvency as defined in
section 108(d)(3), undersecured nonrecourse liabilities are taken into
account as follows: (1) if the nonrecourse liability is being
discharged, the amount of the liability in excess of the fair market
value of the property securing the liability is taken into account to the
extent that the excess is discharged; and, (2) if the nonrecourse debt
is not being discharged, only the amount of the nonrecourse liability
equal to the fair market value of the security is taken into account.

(a) As indicated by the IRS in the revenue ruling, the conclusion is
consistent with Congress’ desire to provide insolvent taxpayers
with a “fresh start” following the workout of their debt.

(v) The proper treatment of a partnership interest in determining a
partner’s insolvency is far from clear. This author is not aware of
any definitive authorities that have addressed this issue. There are
several possible ways to treat a partnership interest. Presented below
are two possible approaches to consider in determining how to
properly treat a partnership interest for this purpose.

(a) A partnership interest could be viewed solely as an asset on the
books of a partner. However, treating the partnership interest
solely as an asset ignores the taxpayer’s true economic
situation. Such an approach appears to be inconsistent with the
intent of the insolvency determination.

(b) An alternative approach to consider that attempts to take into
account the partner’s true economic situation may be to do the
following:

- If a partnership is solvent and has a net positive value,
  consider treating the partnership as an asset of the partner at
  its fair market value. The value of a partnership interest
could be determined by means of a hypothetical disposition
of all the partnership’s assets at fair market value and
satisfaction of the partnership’s liabilities. If as a result of
this hypothetical transaction, the partner would be obligated
to restore a deficit in his capital account, it may be
appropriate to treat that obligation as a liability of the
partner in the partner’s insolvency determination.

- In applying the value of the partner’s interest through
this hypothetical transaction, consider treating nonrecourse
debt of the partnership in a manner that is consistent with
Rev. Rul. 92-53. That is, if the COD allocated to the
partner is not from a partnership’s nonrecourse debt (thus, the partnership’s nonrecourse debt has not been discharged), take into account the amount of the nonrecourse liability equal to the fair market value of the security. However, if COD allocated to the partner is from the discharge of a partnership’s nonrecourse liability, the amount of the partner’s share of the discharged liability in excess of the fair market value of the property securing the liability is taken into account to the extent that the excess is discharged.

(vi) Under the Base Case and the partner facts noted above, Corporation B is insolvent by $200 not taking into account its interest in PRS. Thus, Corporation B could exclude COD income under section 108(a)(3) to the extent of $200. Additionally, Corporation B may be able to exclude an additional amount of COD income equal to its share of the excess of the amount of the discharged nonrecourse debt over the fair market value of the property securing the debt.

6. Note that section 108 applies to exclude only COD income, not gain on sale of property (e.g., Tufts gain on foreclosure). Therefore, if the partnership recognizes gain on the sale or exchange of property in satisfaction of debt, there is no exclusion available to the partners even if they are insolvent or bankrupt.

D. Reduction of Tax Attributes as a Result of the Bankruptcy, Insolvency, and Qualified Farm Indebtedness Exceptions

1. Under section 108(b)(1), a taxpayer that excludes COD income under sections 108(a)(1)(A) (Bankruptcy), (B) (Insolvency), or (C) (Qualified farm indebtedness) is required to reduce its tax attributes as provided in section 108(b)(2).

(i) These section 108(a) exclusions of COD income are not limited by the amount of the taxpayer’s attributes. Thus, for example, assume an insolvent taxpayer properly excluded $100x of COD income under section 108(a)(1)(B) but only has $30x of tax attributes. The taxpayer would still be able to exclude the entire $100x of COD income and reduce his tax attributes to $0. This is consistent with the congressional intent of these rules to give taxpayers a “fresh start.”

(ii) Under section 108(b)(2), the tax attributes to be excluded and the general order of attribute reduction is as follows.

(a) Net operating losses,
(b) General Business Credits,
(c) Minimum Tax Credits,
(d) Capital Loss Carryovers,
(e) Basis of the property of the taxpayer,

(f) Passive activity losses and credit carryovers, and

(g) Foreign tax credit carryovers.

- Note that, under section 108(b)(3), credits are reduced 33.3 cents for each dollar of COD income excluded.

(iii) The reduction for tax attributes under section 108(b)(2) is made after the determination of tax for the year of discharge. Thus, if the taxpayer has a loss for the year of discharge, but had income in an available carryback year, the taxpayer can carryback that loss to the carryback year before making the tax attribute reductions. Only those losses remaining (that is, the NOL carried forward from the year of discharge) are subject to reduction under section 108(b)(2).

(iv) Note that a reduction in basis of a partnership interest due to the application of section 108(b)(2) does not appear to require a corresponding adjustment to the basis of partnership property.

(v) The amount of the basis reduction under section 108(b)(2) cannot exceed the excess of the aggregate adjusted basis of property and money held by the taxpayer immediately after the discharge over the aggregate liabilities of the taxpayer immediately after the discharge. Section 1017(b)(2); Treas. Reg. section 1.1017-1(b)(3).

(vi) Under section 1017(d), where the basis of property is reduced as a result of excluding COD income, such reduction creates recapture potential with respect to the property regardless of whether the property is section 1245 or section 1250 property.

(vii) Section 1017 and the regulations thereunder provide rules for making the reductions to basis under section 108(b)(2). Treas. Reg. section 1.1017-1(a) provides an ordering rule for the reduction of a taxpayer's various properties. Treas. Reg. sections 1.1017-1(d) and (g) contain special rules that may affect this ordering rule.

(a) Under section 108(b)(5), a taxpayer, may elect to reduce the basis of depreciable property first (that is, prior to reducing NOL, etc.).

- The amount of the depreciable basis eligible for the election is limited to the aggregate adjusted basis of the depreciable property held by the taxpayer as of the beginning of the taxable year following the taxable year of the discharge.

- Such an election may be beneficial, for example, if the taxpayer has NOLs and likely would be able to use them quicker than it would have benefited from depreciation deductions from its depreciable properties.
Such an election may not be beneficial, for example, if the taxpayer has NOLs that will expire in the near future.

(b) Under section 1017(b)(3)(E), a taxpayer may elect to treat real property described in section 1221(a)(1) (that is, real property held primarily for sale to customers in the ordinary course of the taxpayer’s trade or business) as depreciable property.

(c) Under Treas. Reg. section 1.1017-1(c)(2), the election may be made for an amount that is less than the full amount of the required attribute reduction. The remaining amount of attribute reduction would then be made through the normal ordering rules.

(d) Under section 1017(b)(3)(C) and Treas. Reg. section 1.1017-1(g)(2), a partner that makes the section 108(b)(5) election must treat a partnership interest as depreciable property to the extent of the partner’s proportionate share of the partnership’s basis in depreciable property, provided that the partnership consents to a corresponding reduction in the partnership’s basis (inside basis) in depreciable property with respect to such partner.

- Under Treas. Reg. section 1.1017-1(g)(2)(ii), a partner generally may choose whether or not to request that a partnership make such a corresponding reduction, and a partnership generally may choose whether or not to consent to the partner’s request and make the corresponding reduction. However, under certain circumstances, a partner is required to request and the partnership is required to consent to the request.

- A taxpayer is required to request consent of the partnership if, at the time of the discharge, (i) the taxpayer owns, directly or indirectly, more than a 50 percent interest in the capital and profits of the partnership, or (ii) if the reductions to the basis of the taxpayer’s depreciable property are being made with respect to the taxpayer’s distributive share of COD income of the partnership.

- A partnership must consent to reduce its partner’s share of inside basis if consent is requested with respect to a discharge of indebtedness by (i) partners owning (directly or indirectly) an aggregate of more than 80 percent of the capital and profits interests in the partnership, or (ii) five or fewer partners owning (directly or indirectly) more than 50 percent of the capital or property interests in the partnership.
- Treas. Reg. section 1.1017-1(g)(2)(iv) provides rules for determining a partner's share of partnership basis for this purpose.

(viii) Under section 1.1017-1(g)(2)(v), the reduction in basis of depreciable partnership property constitutes an adjustment to the basis of partnership property with respect to the requesting partner only. No adjustment is made to the common basis of partnership property. These basis adjustments are treated in the same manner and have the same effect as a basis adjustment under section 743(b).

(ix) Under the **Base Case** and the partner facts noted above, Corporation B does not have expiring NOLs, so it may have capacity to carry back a current year loss. Because tax attributes are reduced after year end, if Corporation B otherwise realizes a tax loss for the year of the discharge, only the NOL amount remaining after it is carried back to a prior year (if applicable) would be subject to reduction. Furthermore, Corporation B may want to elect to reduce basis prior to NOLs to the extent it believes that it would have sufficient prospective tax capacity to utilize the remaining NOLs.

(x) Under the **Base Case** and the partner facts noted above, Corporation C has expiring NOLs. Accordingly, Corporation C may not want to make the election to reduce basis first.

E. Application of COD Exclusions at the Partner Level – Section 108(c)

1. Section 108(c) provides rules for applying the exclusion for qualified real property business indebtedness (QRPBI) contained in section 108(a)(1)(D).

2. As provided in section 108(a)(1)(D), taxpayers other than C corporations can elect to exclude COD income derived from the discharge of QRPBI.

3. QRPBI is defined as indebtedness which (1) was incurred or assumed by the taxpayer in connection with real property used in a trade or business and is secured by such real property, (2) was incurred or assumed before January 1, 1993, or was incurred or assumed after such date to acquire, construct, reconstruct, or substantially improve such property, and (3) with respect to which the taxpayer makes an election.

   (i) Under section 108(d)(6), the election to apply this exception is made by the partner, and not by the partnership. However, the determination of whether debt meets the first two requirements of the definition of QRPBI is made at the partnership level.

   (ii) It appears that real property used in a trade or business may include property described in section 1221(a)(1). However, as discussed below, such property may not be treated as depreciable real property for purposes of applying the QRPBI basis reduction rules.
4. Under section 108(c)(2), there are two limitations placed on the amount of COD income that may be excluded by an electing taxpayer – a net fair market value limitation and a basis limitation.

   (i) Under section 108(c)(2)(A)(i), the net fair market value limitation on the amount of COD income that can be excluded is equal to (i) the outstanding principal amount of such indebtedness (immediately before the discharge) over (ii) the fair market value of the qualified real property (described in the first requirement for QRPBI) reduced by the outstanding principal amount of any other qualified real property business indebtedness secured by such property (at such time).

   (ii) Under section 108(c)(2)(B), the basis limitation on the amount of COD income that can be excluded is equal to aggregate basis of depreciable real property (determined after any reductions under sections 108(b) and (g)) held by the taxpayer immediately before the discharge.

      (a) The taxpayer may not include depreciable real property acquired in contemplation of the discharge in determining the basis limitation.

5. Under section 108(c)(1)(A), a taxpayer is required to reduce the basis of depreciable real property to the extent that the COD is excluded with respect to QRPBI. The ordering rule for reducing multiple real properties is the same as in Treas. Reg. section 1.1017-1(a), except that the rule is modified to apply only to depreciable real property. Treas. Reg. section 1.1017-1(c)(1).

6. Unlike section 108(b)(5), under section 1017(b)(3)(F)(ii), a taxpayer may not elect to treat real property described in section 1221(a)(1) as depreciable real property for purposes of the applying the QRPBI basis reduction rules.

7. Also, unlike section 108(b)(5), under section 1017(b)(3)(F)(iii), the timing of the reduction to the basis of property is accelerated from the beginning of the year following the year of discharge if real property taken into account in determining the basis limitation is disposed of before that time. In such a case, the basis of the depreciable property is reduced immediately before the disposition.

8. Like section 108(b)(5), a partner that makes the section 108(c) election must treat a partnership interest as depreciable property to the extent of the partner’s proportionate share of the partnership’s basis in depreciable real property, provided that the partnership consents to a corresponding reduction in the partnership’s basis (inside basis) in depreciable real property with respect to such partner. These rules essentially mirror the rules discussed above that apply for purposes of section 108(b)(5).

9. Under the Base Case and the partner facts noted above, the discharged Bank debt would appear to be QRPBI if Property X was real property used in a trade or business by PRS, was incurred before January 1, 1993, or was
incurred to acquire, reconstruct, or substantially approve real property used in a trade or business. If so, Individual A may elect to exclude COD income derived from the PRS debt under section 108(a)(1)(D). The amount of the COD income excludable by Individual A is determined by applying both the fair market value limitation and the basis limitation discussed above. Additionally, if Individual A elects the QRPB exclusion, it must reduce the basis of depreciable real property, including its interest in PRS (subject to PRS' consent).

V. DEBT RESTRUCTURING - CREDITOR TAX CONSIDERATIONS

A. For purposes of analyzing creditor tax issues associated with a workout situation, assume the following fact pattern (similar to the Base Case):

Individual A, Corporation B, and Corporation C form Partnership PRS with cash and that PRS uses the cash to purchase Property Y. PRS also borrows $800x from a third-party lender ("Bank") and purchases Property X. The loan is nonrecourse and is secured solely by Property X. PRS also borrows $200x from Individual A on a recourse basis to fund operations ("Loan A"). Loan A is secured by Property Y. Property X and Property Y are both capital assets to PRS. Several years later, the partners see that the fair market value of Property X and Y are beginning to fall. Individual A is considering whether he should consider taking any steps to avoid any adverse tax consequences if PRS is ultimately unable to repay Loan A.

B. In considering whether Individual A should take any steps before a restructuring is necessary, below is a discussion of the potentially adverse tax consequences to Individual A of three loan restructuring options – (1) Loan A principal is reduced, (2) Individual A forecloses on Property Y in satisfaction of Loan A, and (3) Loan A is contributed to the equity of PRS.

1. Loan Principal Reduction – Assume the value of PRS’ assets fall and Individual A and PRS negotiate a reduction in the principal of the Loan A from $200x to $100x.

   (i) As discussed above under the Debt Reduction Case, it appears that PRS will recognize $100 of COD income. It does not appear from the facts that section 108(e)(5) would apply to exclude the COD income as Loan A is not purchase money debt as described in section 108(e)(5).

   (ii) It appears that Individual A may be allocated all or part of the COD income recognized by PRS. As discussed above in “Allocation of COD income to the partners,” allocations of COD income are generally made in accordance with the partnership agreement. However, the allocations must have substantial economic effect or be in accordance with the partner’s interest in the partnership to be respected under section 704(b). For purposes of analyzing the potential issues of this option, assume that Individual A is allocated all or part of the COD income.
(a) Since Individual A is not bankrupt or insolvent and the debt does not appear from the facts to be QRPBI, the exceptions to the recognition of COD income at the partner level under section 108(a) do not appear to apply. As such, it appears that Individual A will recognize $100 of ordinary income as a result of the Loan Principal Reduction option.

(iii) Individual A will also have tax consequences as the creditor of Loan A. Under Treas. Reg. section 1.1001-3, a change in the principal amount of a debt may result in a significant modification of the debt. See e.g., Treas. Reg. section 1.1001-3(g), example 3. A significant modification of Loan A may result in a deemed exchange of Loan A for a new Loan A under Treas. Reg. section 1.001-1(a). Deemed exchanges in this type of situation often result in a loss being recognized under section 1271. Such a loss would be a capital loss if the debt was a capital asset of the Creditor. If Loan A was properly treated as a capital asset, Individual A may recognize a capital loss on the reduction of loan principal.

(iv) Losses on the sale or exchange of property (whether capital or ordinary in character) may be subject to disallowance as provided in sections 267 and 707(b). The loss recognized under section 1271 may be subject to disallowance under section 707(b) if Individual A is treated as owning (directly or indirectly) more than 50 percent of the capital interests or profits interests in PRS.

(a) Note that, generally, losses disallowed under sections 267 and 707 generally may offset gain on future disposition of the property sold under section 267(d). Note that section 267(f), and not section 267(d), applies to sale or exchanges of property between members of a controlled group (which provides a more generous loss deferral regime). However, because Loan A is extinguished in the exchange, there does not appear to be any property for section 267(d) to apply to.

(v) Thus, under the Loan Principal Reduction option, Individual A may be faced with being allocated COD income, which he may not be able to exclude, and recognizing a capital loss, which he may not be able to use (or which may be subject to disallowance under section 707(b)).

2. Property X Foreclosure – Assume the value of PRS’ assets fall and Individual A and PRS agree that PRS will transfer Property Y to Individual A in satisfaction of Loan A. Assume that, at the time of the transfer, the value of Property Y has fallen to $100x and its basis is still $200x.

(i) As discussed under “Transfers of Properties in Satisfaction of Recourse Debt,” the transfer of Property Y to Individual A in satisfaction of Loan A results in a bifurcated transaction. Under section 1001, it appears that PRS will recognize gain or loss equal to
the difference between fair market value of Property Y and its tax basis. Thus, it appears that PRS would recognize a capital loss of $100x under this option. In addition, it appears that PRS would recognize COD income under section 61(a)(12) equal to the difference between the amount of Loan A and the fair market value of Property Y. Thus, it appears that PRS would also recognize $100 of COD income under this option.

(ii) As discussed in the Loan Principal Reduction option above, Individual A may be allocated all or a portion of the capital loss and COD income, and the COD income may not be excludable by Individual A under section 108.

(iii) As creditor, Individual A will also recognize gain or loss on the transfer of Property X in satisfaction of Loan A under section 1271 equal to the difference between the value of Property X and his tax basis in Loan A. As such, Individual A may recognize a loss of $100 with respect to the satisfaction of Loan A under this option. The loss would be a capital loss if Loan A were a capital asset to Individual A.

(iv) Also, as discussed above, losses on the sale or exchange of property may be subject to disallowance as provided in sections 267 and 707(b). The loss recognized under section 1001 by PRS, and under 1271 by Individual A, may be subject to disallowance under section 707(b) if Individual A is treated as owning (directly or indirectly) more than 50 percent of the capital interests or profits interests in PRS.

(v) Thus, under the Property Y Foreclosure option, Individual A may be faced with being allocated COD income, which he may not be able exclude, and being allocated a capital loss and recognizing his own capital loss, which he may not be able to use (or may be subject to disallowance under section 707(b)).

3. Contribution to Equity – Assume the value of PRS’ assets fall and Individual A and PRS agree that Individual A will contribute Loan A to PRS in exchange for an additional interest in PRS. Assume that, at the time of the transfer, the fair market value of the additional interest in PRS is $100x and Individual A’s basis in Loan A is still $200x.

(i) As discussed above in “Conversion of the Debt for an Equity Interest,” under section 108(e)(8), PRS is deemed to have satisfied the debt with an amount of money equal to the fair market value of the partnership interest for purposes of determining COD income. As such, it appears that PRS will recognize $100x of COD income (Amount of Loan A ($200x) less the fair market value of the additional interest received ($100x)).

(ii) Under section 108(e)(8), as discussed above, only the taxpayers who were partners immediately prior to the discharge may be allocated
the COD income. In this case, since Individual A was a partner immediately before the discharge, he may be allocated COD income with respect to his existing interest.

(iii) The tax consequences to Individual A, as the transferor of Loan A to PRS for the additional interest, are far from clear. As indicated above, there is an item on the 2008-09 Priority Guidance Plan that may address issues, such as this one, under section 108(e)(8). One possible approach may be to treat Individual A as contributing Loan A in exchange for a partnership interest governed by section 721. If that is the case, Individual A generally would take a basis in the additional interest equal to the basis he had in Loan A.

(iv) Thus, as in the other options, Individual A may be faced with being allocated COD income, which he may not be able exclude. In addition, he may not recognize a loss or be able to take an immediate deduction with respect to the transfer of Loan A to PRS.

C. Potential Steps Individual A Could Take, as Creditor, in Anticipation of a Troubled Project

- Given that there are potential adverse tax consequences of taking a wait and see approach, Individual A should consider any options he may have to minimize or avoid some of those adverse tax consequences. In that regard, below is a discussion of two options that a creditor should consider if the creditor anticipates a troubled project. (1) Partial Bad Debt Deduction or (2) Contribution to Equity.

1. Partial Bad Debt Deduction.

(i) Section 166(a)(2) provides that, when satisfied that a debt is recoverable only in part, the Secretary may allow such debt, in an amount not in excess of the part charged off within the taxable year, as a deduction.

(a) A deduction with respect to a bad debt under section 166 does not arise from a sale or exchange of property. As such, the loss disallowance rules of section 267 and section 707(b) do not apply to disallow the deduction.

(b) Section 166 does not apply to a debt which is evidenced by a security as defined in section 165(g)(2)(C). Section 166(e). Section 165(g)(2)(C) defines a security as a bond, debenture, note or certificate, or other evidence of indebtedness, issued by a corporation or by a government, or political subdivision thereof, with interest coupons or in registered form. Thus, debt issued by a partnership does not qualify as a security and, while a share of stock in a corporation is a security under section 165(g)(2)(A), a partnership interest is not a security for this purpose. See e.g., Draper v. U.S., 62 Fed. Cl. 409 (2004).

(ii) Treas. Reg. section 1.166-3(a) provides that a deduction under section 166(a)(2) on account of partially worthless debts shall be allowed with respect to specific debts only.
(iii) Under section 166(d)(1), in the case of a taxpayer other than a corporation, if a debt is a "nonbusiness debt," no partial bad debt deduction is allowable under section 166(a)(2). A nonbusiness debt is defined in section 166(d)(2) and Treas. Reg. section 1.166-5(b) as a debt other than (i) a debt created or acquired in connection with a trade or business of the taxpayer (determined at the time the debt is acquired or originated), or (ii) a debt the loss from the worthlessness of which is incurred in the taxpayer's trade or business.

(a) Thus, corporations are not subject to the section 166(d) restriction on taking partial bad debt deductions for nonbusiness debts. Note, however, that under Rev. Rul. 93-36, 1993-1 C.B. 187, an S corporation is treated in the same manner as an individual for purposes of section 166(d).

(iv) Treas. Reg. section 1.166-5(b) provides that the determination of whether a debt is business or nonbusiness is a question of fact in each case. Whether a loss is incurred in the taxpayer's trade or business for this purpose is determined in substantially the same manner as whether a loss has been incurred in a trade or business for purposes of section 165(c)(1). For purposes of determining whether a loss is incurred in the taxpayer's trade or business, the character of the debt is determined by the relation that the loss resulting from the debt's becoming worthless bears to the trade or business of the taxpayer. If that relation is a proximate one in the conduct of the trade or business in which the taxpayer is engaged at the time the debt becomes worthless, the debt will be treated as a business bad debt. The debtor's use of the loan proceeds is irrelevant in making a business vs. nonbusiness bad debt determination.

(a) The Supreme Court has held that the requisite inquiry is whether the taxpayer's "dominant motivation" for making the loan is to further the taxpayer's investment in the borrower or to further the taxpayer's trade or business from which it earns a profit. United States v. Generes, 405 U.S. 93 (1972).

(v) The "charge off" requirement under section 166(a)(2) provides book-tax conformity that prevents a taxpayer from taking a tax loss while continuing to carry the debt on his books. See Commissioner v. MacDonald Eng'g Co., 102 F.2d 942 (7th Cir. 1939).

(vi) In a non-docketed service advice review, the IRS provided a detailed discussion regarding the "charge off" requirement and the requirement that the charge off occur "within the taxable year." 2001 IRS NSAR 10364.

(vii) Courts have permitted taxpayers to take "charge off" a debt on the books and take a bad deductions even when the taxpayer disposed of the debt in the same taxable year. See e.g., Mitchell v. Commissioner, 187 F.2d 706 (2nd Cir. 1951), rev'g 13 T.C. 368.
(1949). When the charge-off preceded and was “independent of the sale,” the court of appeals held that the bad debt deduction should be allowed. See also Levine v. Commissioner, 31 T.C. 1121 (1959), acq., 1959-2 C.B. 5 (a bad debt deduction was allowed when the loans were written off in June 1947 and sold in September 1947); IDI Management, Inc. v. Commissioner, 36 T.C.M. 1482, 1502 (1977) (“If partial worthlessness is factually established as happening prior to a sale or exchange, two identifiable events have occurred” (citing Levine; “This is true even where both such events occur within the same taxable year” (citing Mitchell)).

(viii) Thus, a creditor partner that is able to take a partial bad debt deduction prior to engaging in one of the workout options discussed above may lessen some of the potentially adverse tax consequences of taking a wait and see approach (e.g., character mismatch, loss disallowance under section 267 and section 707(b)).

(ix) Applying these rules to Individual A, if Loan A is a nonbusiness debt, Individual A may not take a partial bad debt deduction. However, if Loan A is a business debt and Individual A is able to demonstrate that Loan A is partially worthless, Individual A may be able to take a partial bad debt deduction for an amount not in excess of the part “charged off” “within Individual A’s taxable year.”

2. Contribution to Equity

(i) As discussed above in “Conversion of the Debt for an Equity Interest,” under section 108(e)(8), PRS would be deemed to have satisfied the debt with an amount of money equal to the fair market value of the partnership interest for purposes of determining COD income.

(ii) However, if the contribution is done before the fair market value of the partnership interest has significantly declined, the contribution may not result in a significant amount of COD income.

(iii) Also, as initially discussed above in the “Contribution to Equity” option, the creditor may be required to take a basis in the partnership interest equal to the basis in the contributed debt. However, under the other two options (Loan Principal Reduction and Property X Foreclosure), the creditor may recognize an exchange loss in the transaction that may be disallowed under section 267 or 707(b). Thus, the Contribution to Equity option has the additional potential benefit of preserving basis in the partnership interest.