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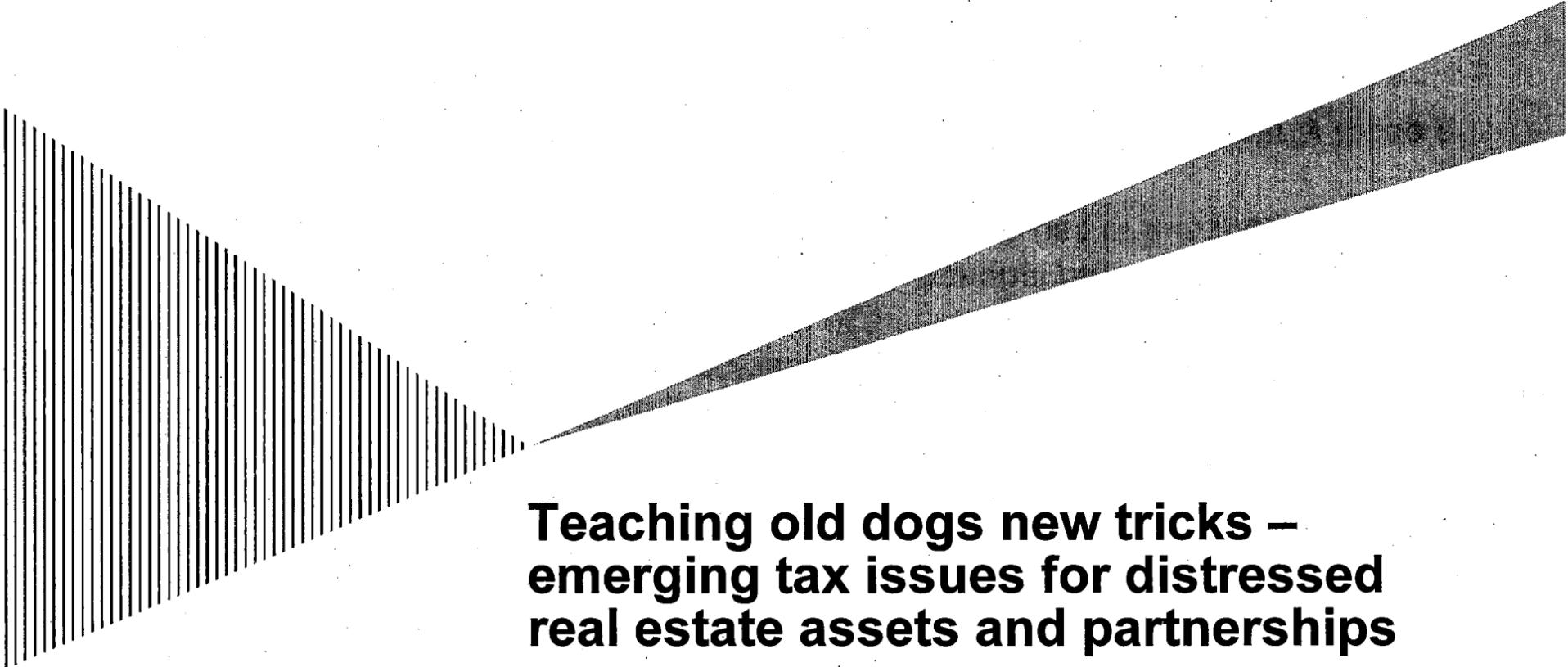
Teaching Old Dogs New Tricks - Emerging Tax Issues for Distressed Real Estate Assets and Partnerships (Slides)

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**Teaching old dogs new tricks –
emerging tax issues for distressed
real estate assets and partnerships**

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Emerging workout topics in the modern area

- ▶ Voluntary and involuntary conveyances of underwater assets
- ▶ Characterization of debt as recourse or nonrecourse for purposes of IRC section 1001
- ▶ Lender acquires ownership of LLC borrower
- ▶ Like-kind exchanges of underwater assets
- ▶ Self-help: abandonment and worthlessness deductions
- ▶ A collision of worlds – debt workouts and Subchapter K

Character matters

- ▶ Cancellation of indebtedness (COD) income
 - ▶ Applies to recourse and nonrecourse debt
 - ▶ Ordinary income
 - ▶ Exclusions – bankruptcy, insolvency, qualified real property business indebtedness
 - ▶ 5-year deferral – IRC section 108(i) – 2009-10 only
- ▶ Capital gains and losses
 - ▶ COD income exclusion and deferral rules do not apply
 - ▶ Capital loss does not reduce ordinary income
 - ▶ Taxed at lower rates for some taxpayers
- ▶ Foreclosure/“deed in lieu” transactions
 - ▶ May give rise to COD, capital gain, or both

What may trigger COD?

- ▶ Straight cancellation/reduction in principal amount
- ▶ Deemed cancellations
 - ▶ Acquisition of debt by borrower
 - ▶ Significant modifications – IRC section 1001
 - ▶ Related party acquisition – IRC section 108(e)(4)
- ▶ Foreclosure or deed in lieu of foreclosure transactions
 - ▶ Recourse debt (for purposes of IRC section 1001) – Probably
 - ▶ Nonrecourse debt – No
 - ▶ Identifying debt as recourse or nonrecourse for tax purposes is critical – CHARACTERIZATION MATTERS TOO

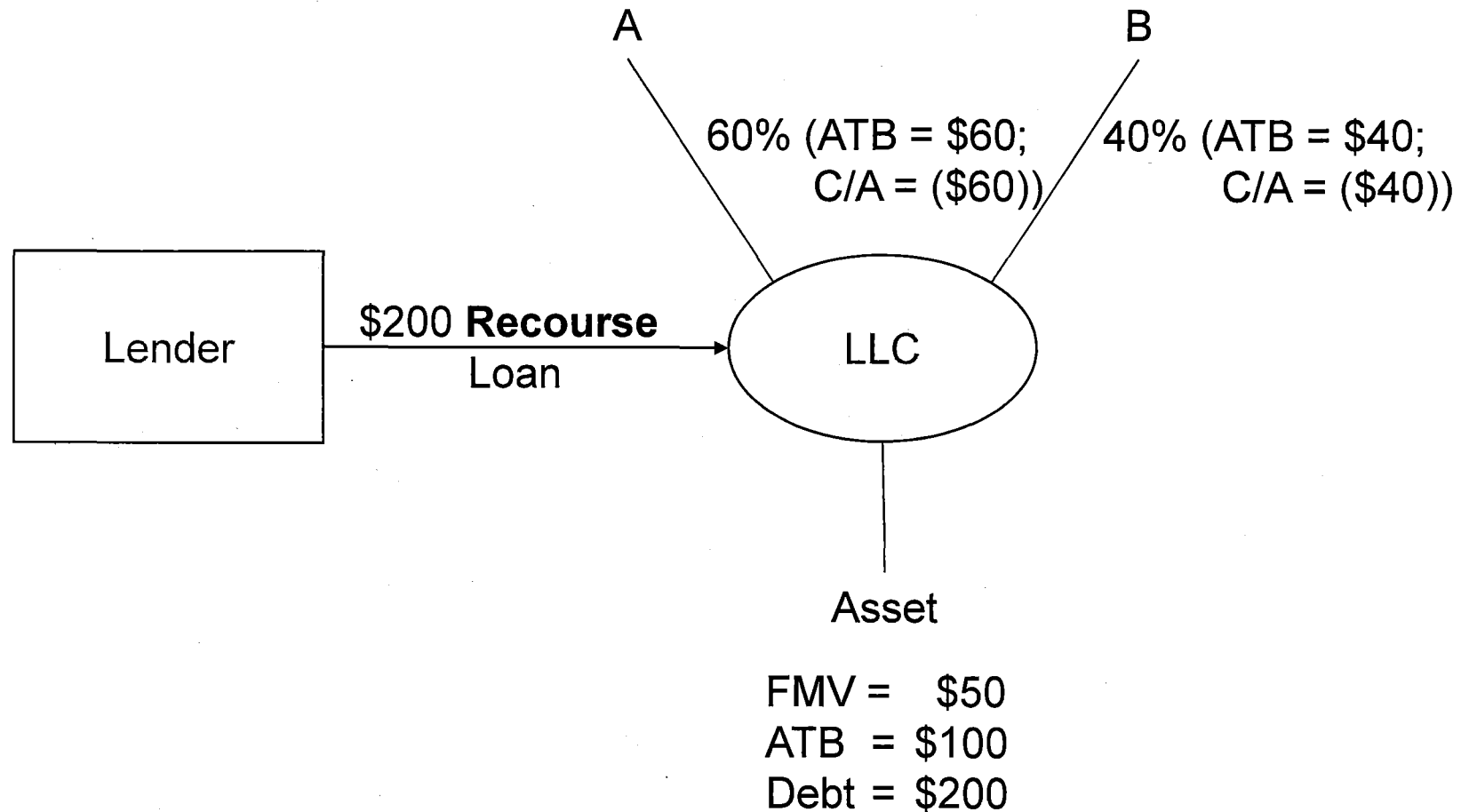
Voluntary and involuntary conveyances of underwater assets

- ▶ Acquisition by Lender – foreclosure and deed in lieu of foreclosure transactions
- ▶ Sale of underwater asset subject to nonrecourse debt – functional equivalent of foreclosure
- ▶ No formal sale – doctrine of constructive foreclosure/abandonment

Basic fact pattern

- ▶ Unrelated Partners A and B contribute \$120 and \$80, respectively, to LLC
- ▶ Unrelated Lender makes a state law **recourse** loan of \$200 to LLC
- ▶ LLC acquires a depreciable asset (“**Asset**”) for \$400
- ▶ LLC has claimed depreciation deductions of \$300 and LLC’s adjusted tax basis (“**ATB**”) in the Asset is now \$100
- ▶ Capital Accounts (“**C/A**”)
 - ▶ A: (\$60) (\$120-\$180)
 - ▶ B: (\$40) (\$80-\$120)
- ▶ Asset has declined in value to \$50
 - ▶ Built-in tax loss of \$50 (\$100-\$50)
 - ▶ Excess of debt over FMV of \$150 (\$200-\$50)

Basic fact pattern – recourse debt



Lender acquires Asset via foreclosure/deed in lieu of foreclosure transaction

- ▶ LLC transfers Asset to Lender
- ▶ Consequences –
 - ▶ If the Loan is recourse for purposes of IRC section 1001 –
 - ▶ LLC is treated as having sold asset for \$50 (FMV)
 - ▶ LLC recognizes \$150 of COD Income if debt is forgiven/discharged (which may be excluded or deferred in certain cases – determination made at partner level)
 - ▶ LLC recognizes a loss of \$50 (which may be capital or ordinary depending on facts) – potential for character mismatch if property is not IRC section 1231 property
 - ▶ If the Loan is nonrecourse for purposes of IRC section 1001 –
 - ▶ LLC is treated as having sold Asset for \$200 (amount of the loan)
 - ▶ LLC recognizes \$100 of gain (because AB = \$100) (which may not be excluded or deferred)
 - ▶ LLC recognizes no COD Income

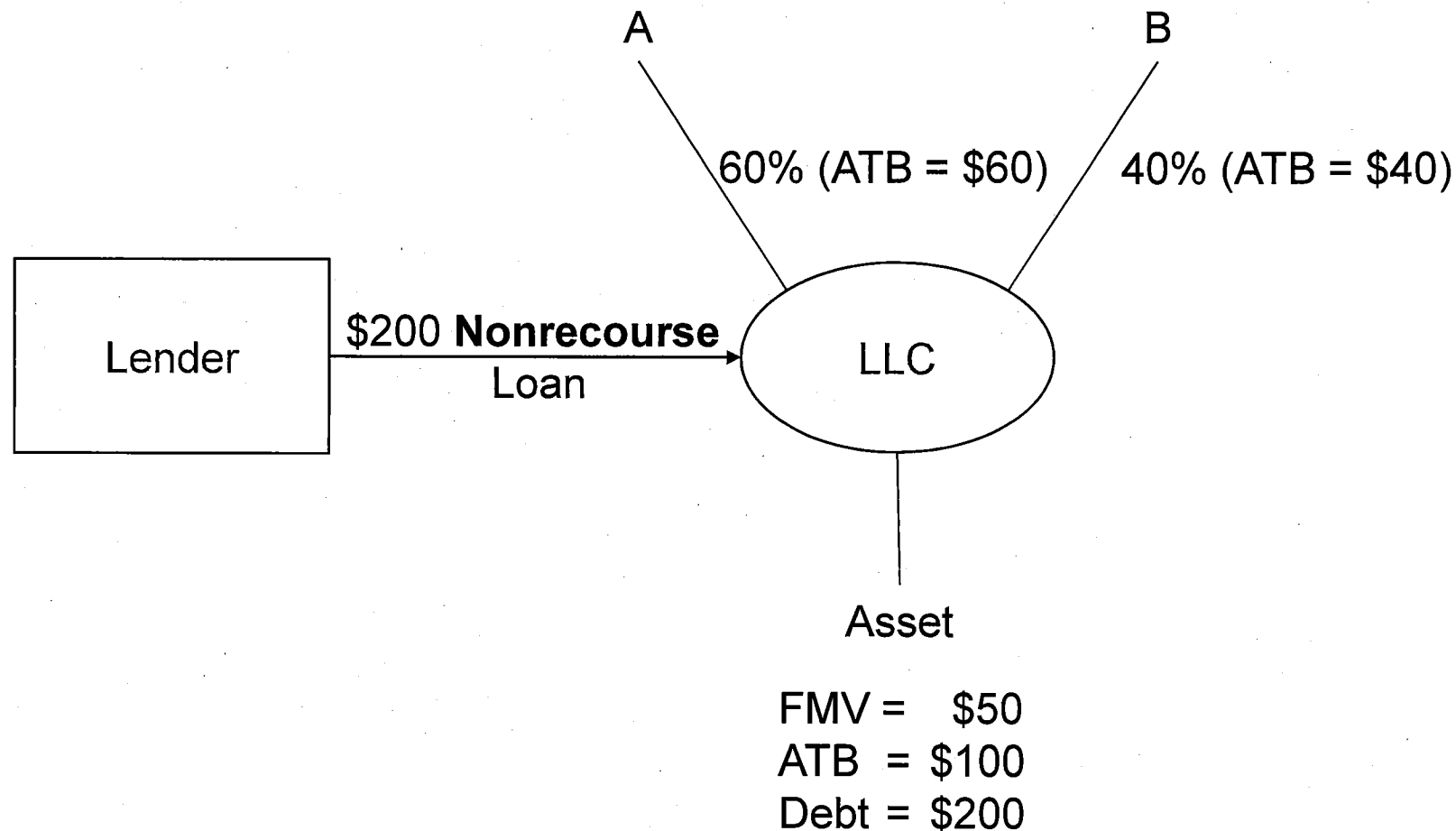
Cancellation/foreclosure – summary of the basic rules and the stakes involved

Type of Transaction	Solvent Taxpayer	Insolvent/Bankrupt Taxpayer*
Cancellation/Reacquisition	COD: <ul style="list-style-type: none"> ▶ Ordinary income ▶ IRC section 108(i) deferral ▶ Qualified real property business indebtedness? 	Choice of: <ul style="list-style-type: none"> ▶ Exclusion, with attribute reduction** ▶ IRC section 108(i) deferral
Foreclosure		
Recourse Debt: Bifurcation Taxable sale of property (gain/loss = FMV - basis) Cancellation of debt in excess of FMV	<ul style="list-style-type: none"> ▶ COD - same as above ▶ Capital gain may not be excluded/deferred 	<ul style="list-style-type: none"> ▶ COD - same as above ▶ Capital gain may not be excluded/deferred
Nonrecourse Debt Taxable sale of property (gain/loss = debt - basis)	<ul style="list-style-type: none"> ▶ No COD ▶ Capital gain may not be excluded/deferred 	<ul style="list-style-type: none"> ▶ No COD ▶ Capital gain may not be excluded/deferred

* For partnerships, exclusions for insolvency and bankruptcy apply at the partner level.

** An insolvent taxpayer may exclude COD only to the extent it is insolvent.

Basic fact pattern – nonrecourse debt



Sale to third party: functional equivalent of foreclosure

In a pre-arranged transaction LLC sells Asset to Buyer for \$50, which cash is paid directly by Buyer to Lender; Lender simultaneously releases its lien on Asset

Issue: Does either Seller or Buyer recognize COD Income?

Authorities: 2925 Briarpark, Ltd. v. Commissioner, 163 F.3d 313 (5th Cir. 1999); FSA 200135002 (April 10, 2001)

Briarpark

- ▶ Holding: Transaction had same practical effect as other transactions: (1) involuntary foreclosure, (2) reconveyance to lender, (3) abandonment of property, (4) deed in lieu of foreclosure transactions
- ▶ *Gershkowitz* (88 T.C. 984) distinguished because *Gershkowitz* involved **two separate** transactions: (1) reduction in loan principal; (2) sale of property three months later
- ▶ In Briarpark, two years prior to the sale, loan had been converted from recourse to nonrecourse (FMV < loan but lender expected repayment)
- ▶ Court implicitly held no constructive foreclosure or abandonment

Constructive foreclosure/abandonment

- ▶ Is there a set of facts/course of conduct under which Lender becomes the owner of the Asset for tax purposes (*i.e.*, in advance of legal foreclosure)?
- ▶ What are the potentially relevant factors?
 - ▶ Is mere fact Asset is hopelessly underwater enough?
 - ▶ Substantial modification of loan (do Treas. Reg. § 1.1001-3(e)(5)(i) and Prop. Reg. § 1.1001-3(f)(7)(ii) save the day)?
 - ▶ Transfer of effective operating control of the Asset?
 - ▶ Worthlessness deductions claimed by LLC members?
 - ▶ Timing of gain recognition – *L&C Springs Associates v. Commissioner*, 188 F.3d 866 (7th Cir. 1999)
 - ▶ Does it matter if the Loan is recourse – deficiency amount unknown prior to actual sale?

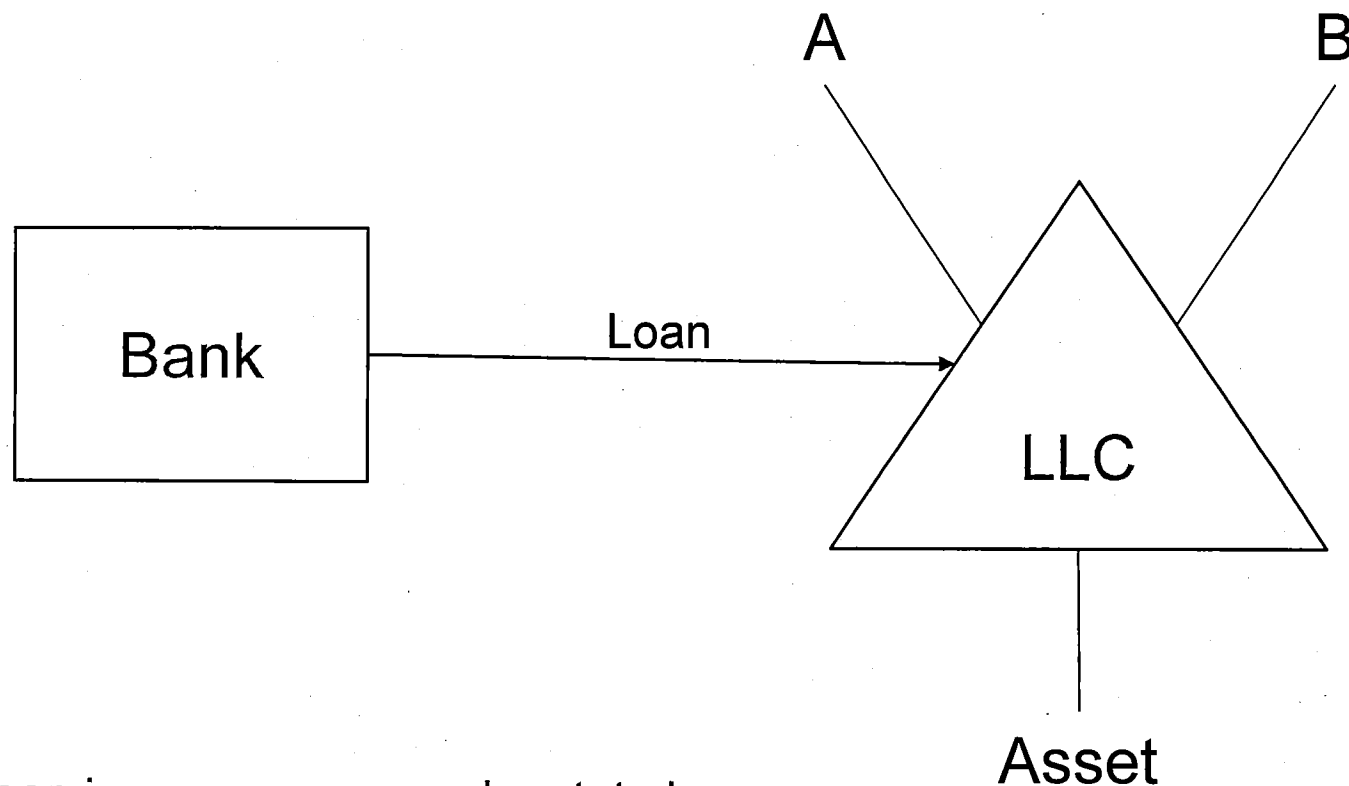
Characterization of debt as recourse or non-recourse for purposes of IRC section 1001

- ▶ Basic questions
- ▶ Illustrative fact patterns

Characterization of debt as recourse or non-recourse for purposes of IRC section 1001 – basic questions

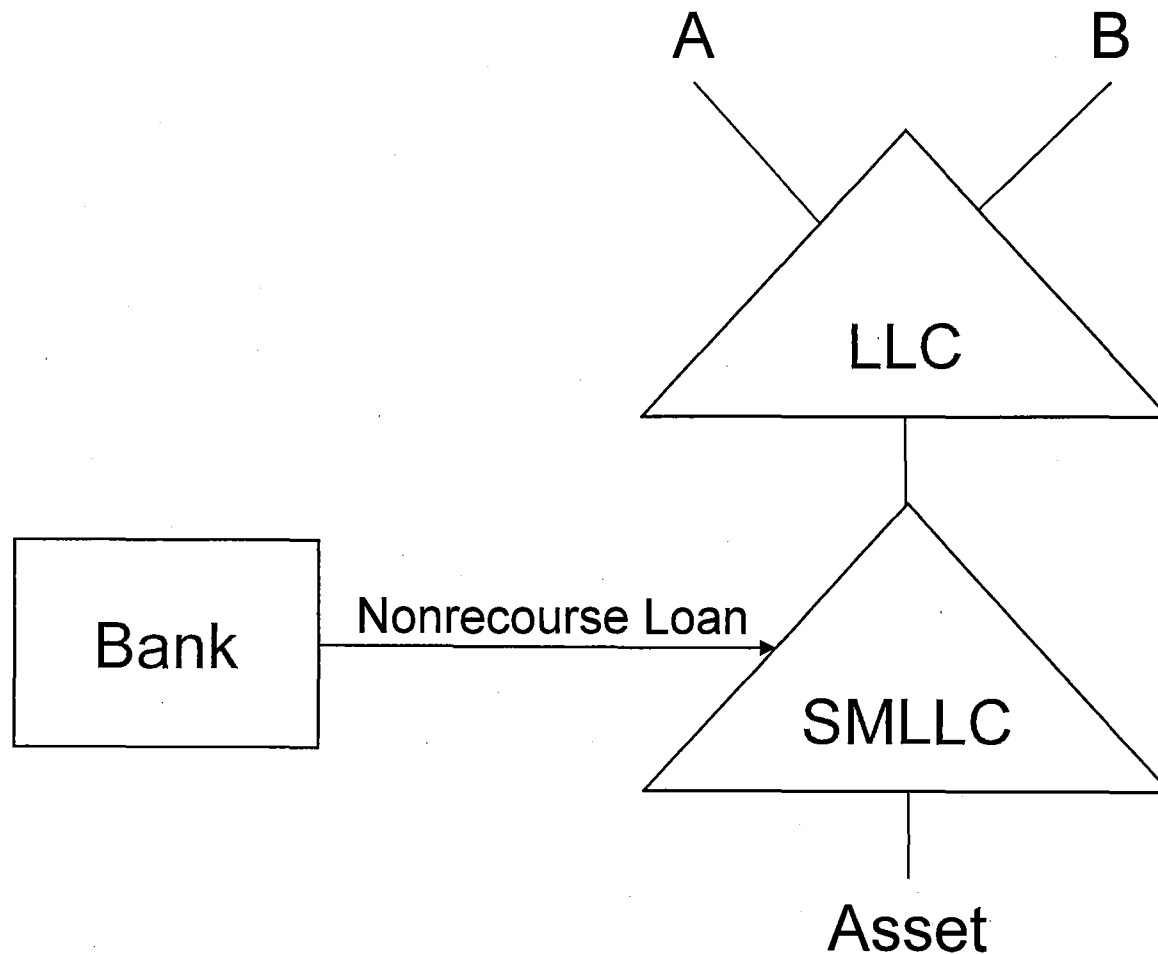
- ▶ Assume loan is state law recourse to LLC – creditor has access to all assets of borrower and can seek remedies under bankruptcy laws
 - ▶ Is the Loan recourse or nonrecourse for tax (*i.e.*, IRC section 1001) purposes?
 - ▶ Does it matter if LLC is a general or limited partnership, rather than an LLC?
 - ▶ If one or more members guaranteed the Loan?
 - ▶ Is the status of the loan as recourse or nonrecourse for purposes of IRC section 752 relevant?
 - ▶ Does it matter if LLC is a special purpose entity?
- ▶ Assume LLC owns Asset through disregarded Subsidiary LLC (SMLLC) and SMLLC borrows on a state law recourse basis from Lender
 - ▶ Is the Loan recourse or nonrecourse for tax (*i.e.*, IRC section 1001) purposes?
 - ▶ Does it matter what assets SMLLC owns (*i.e.*, single asset v. operating business)?
 - ▶ Does it matter if LLC owns other assets?
 - ▶ What is the impact, if any, of a guarantee by LLC? By one or more of its members?

Characterization of debt as recourse or non-recourse for purposes of IRC section 1001 (cont'd)



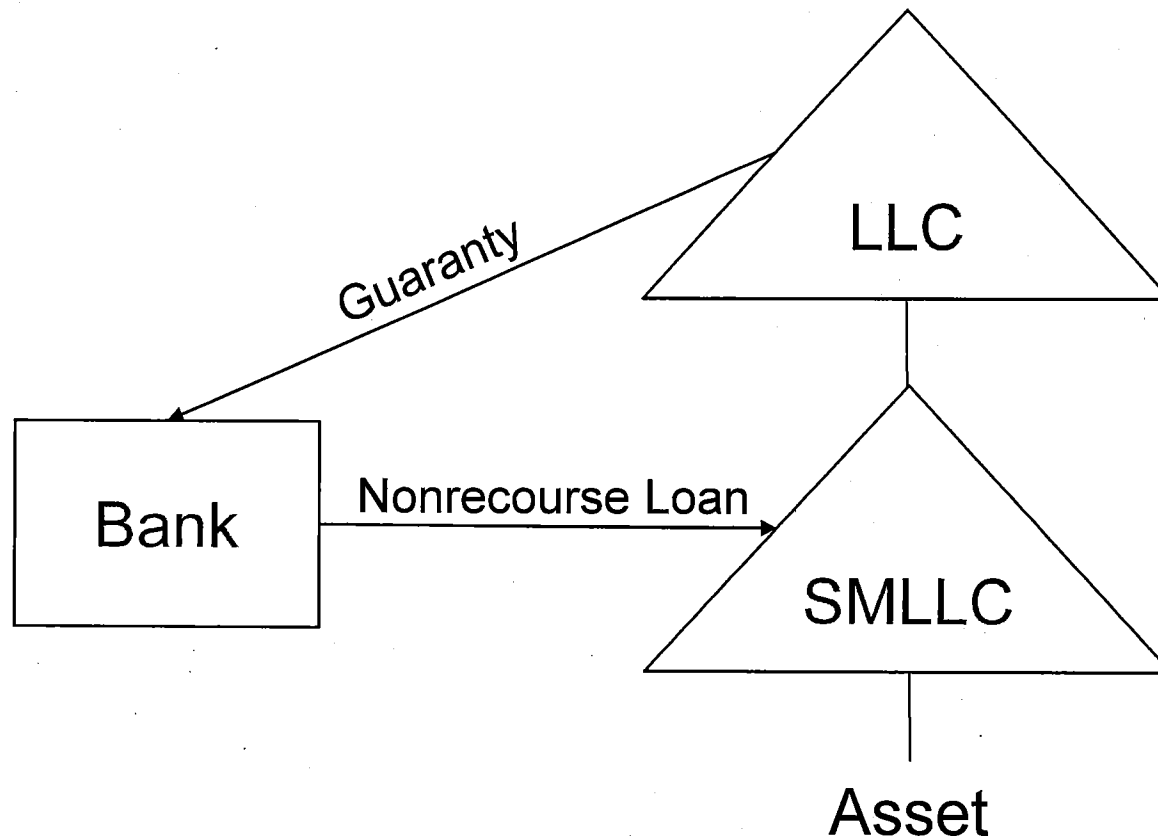
- ▶ If Loan is nonrecourse under state law
 - ▶ LPRS v. GPRS v. LLC – does it matter?
 - ▶ Does guaranty by A or B matter?
- ▶ If Loan is recourse under state law, is it automatically recourse for purposes of IRC section 1001?

Nonrecourse loan to SMLLC



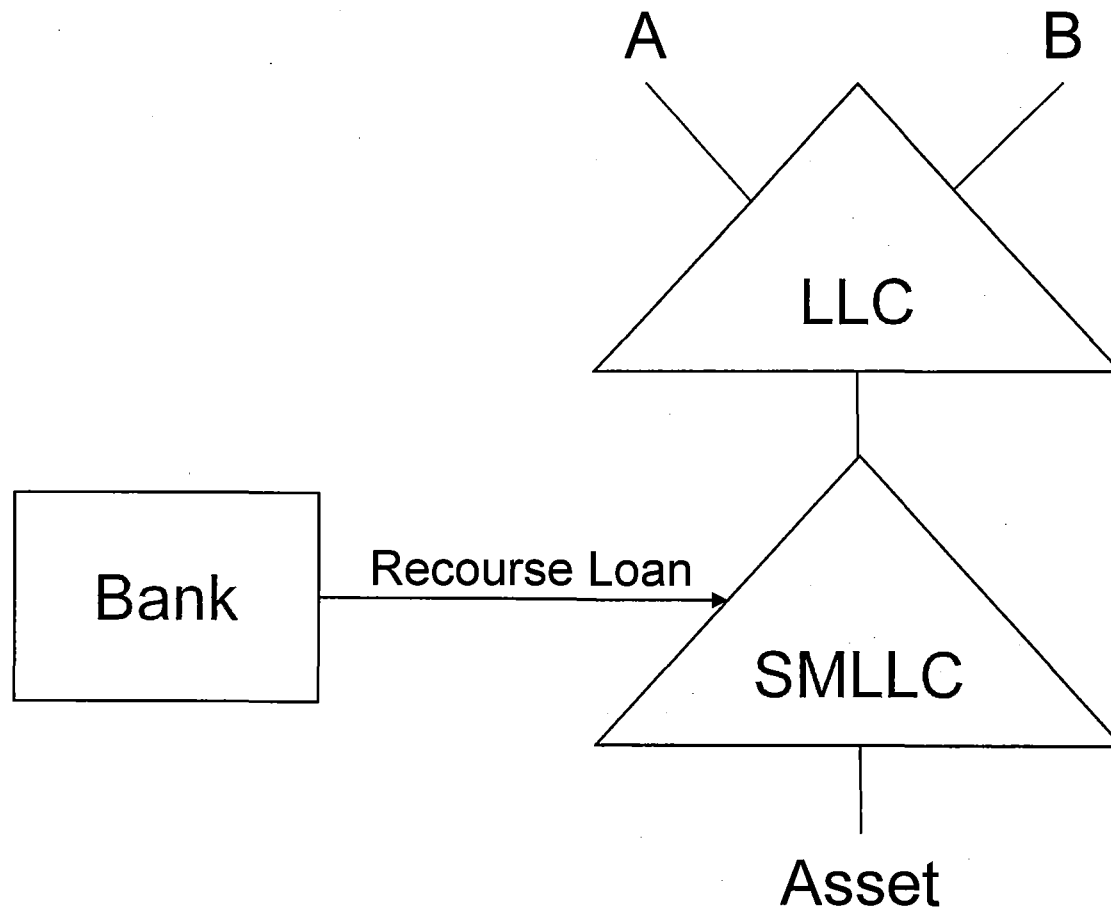
- Is the Loan recourse or nonrecourse for purposes of IRC section 1001?

Nonrecourse loan to SMLLC guaranteed by owner of SMLLC



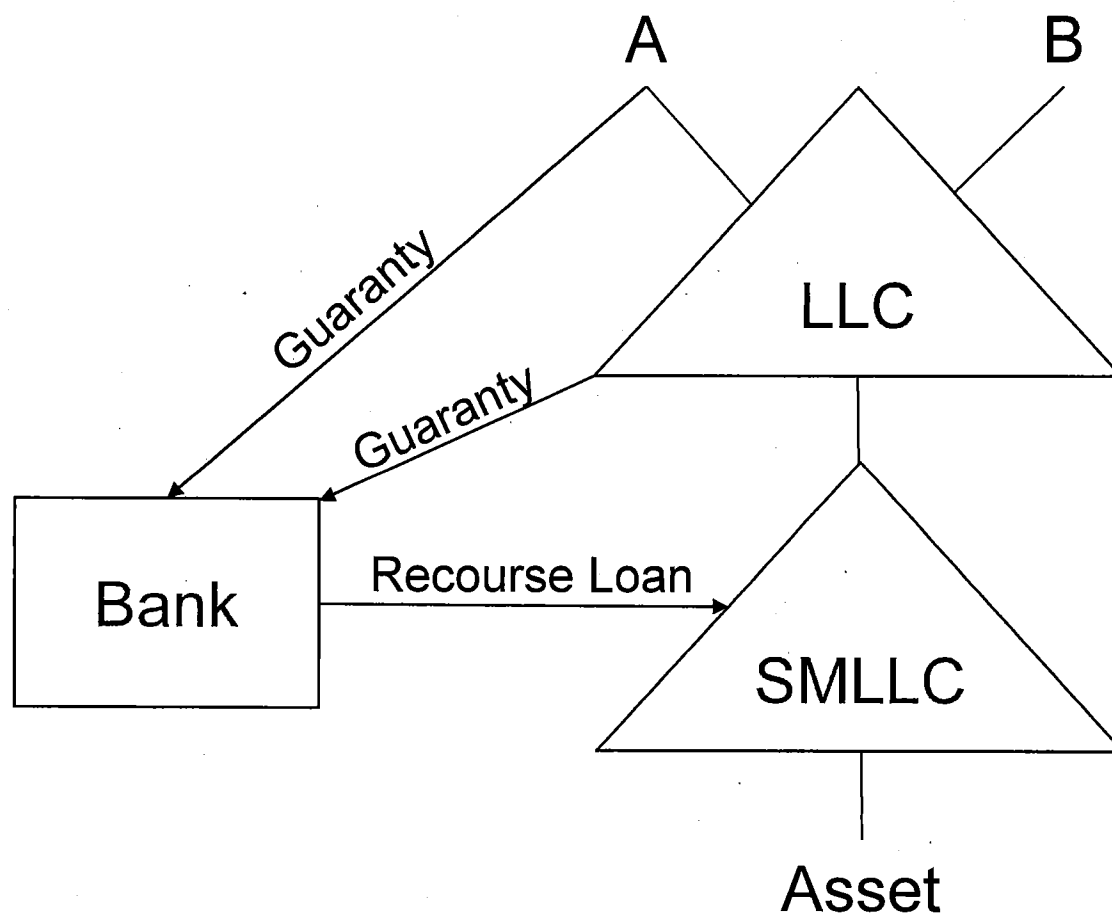
- Does a guaranty by LLC affect the characterization of the loan for purposes of IRC section 1001?

Recourse loan to SMLLC – basic fact pattern



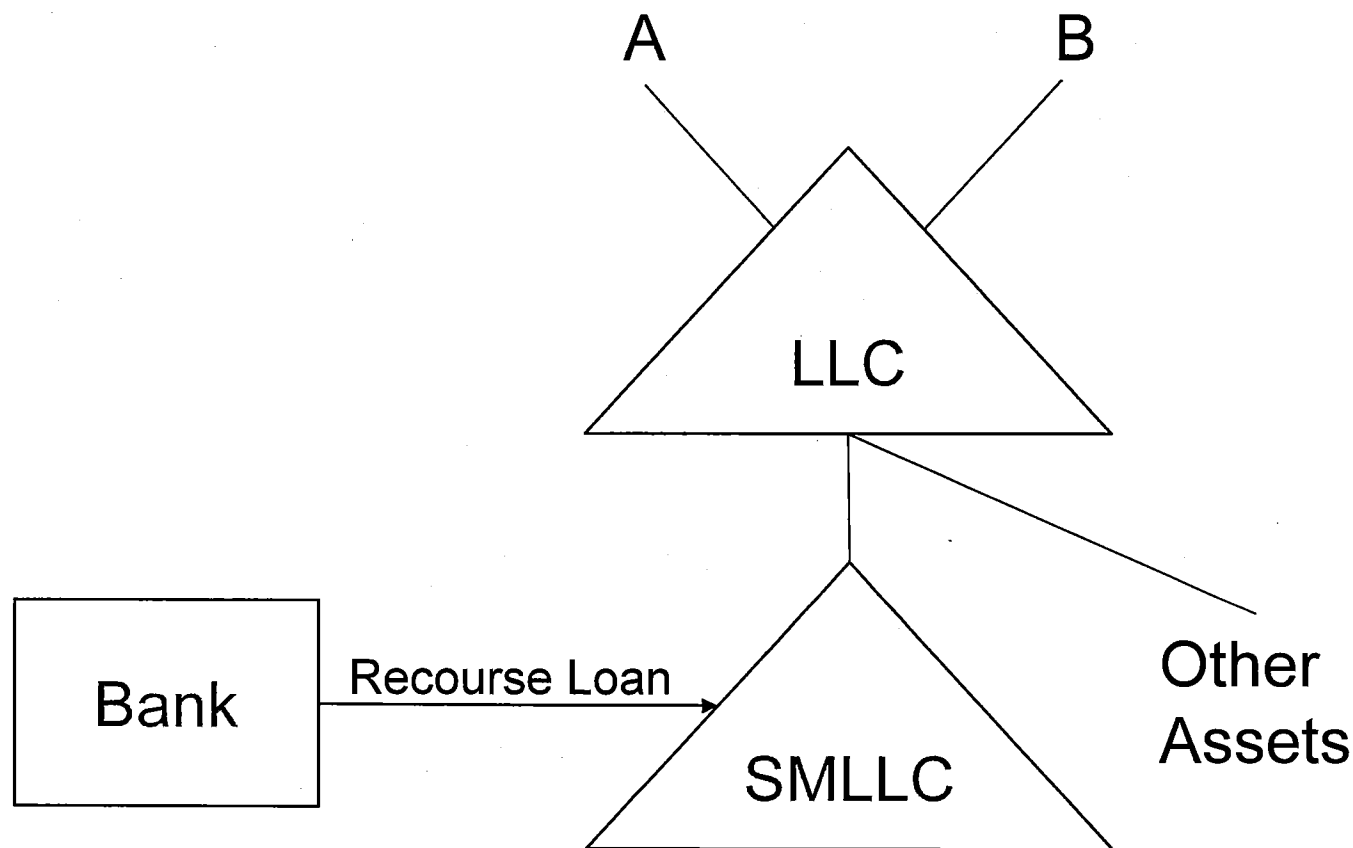
- ▶ Is the Loan recourse or nonrecourse for purposes of IRC section 1001?
- ▶ Can Bank sue LLC/reach all of LLC's assets?

Recourse loan to SMLLC – guaranteed by owner of SMLLC



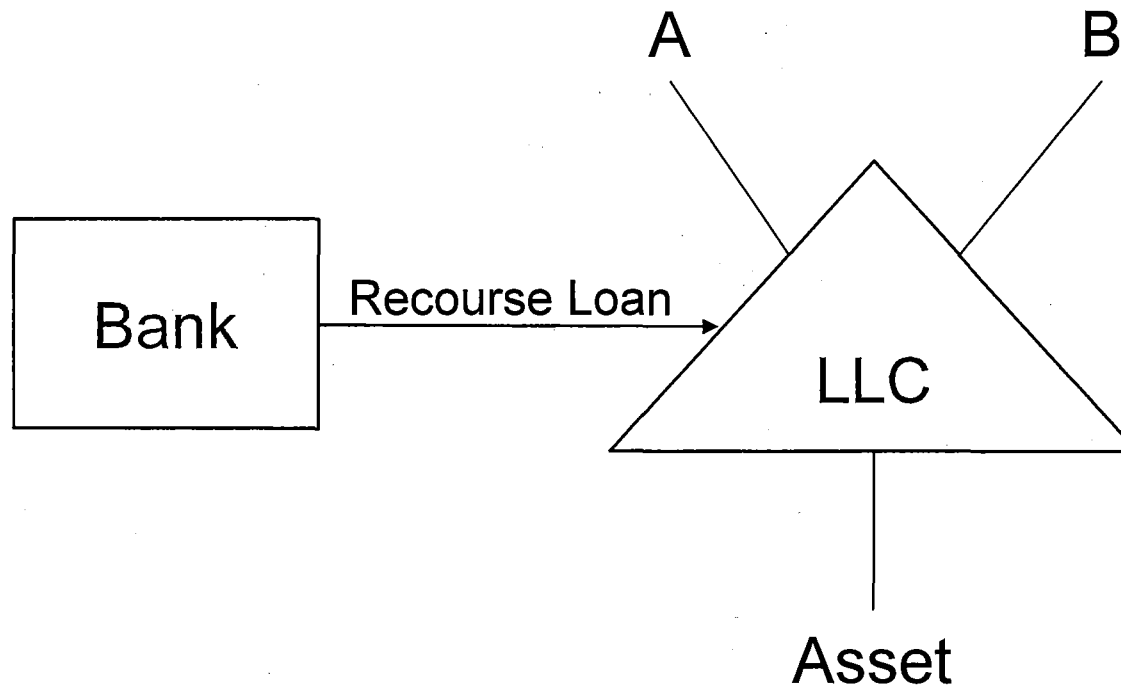
- Does a guaranty by LLC, A or B affect the characterization of the Loan for purposes of IRC section 1001?

Recourse loan to SMLLC – LLC owns other assets



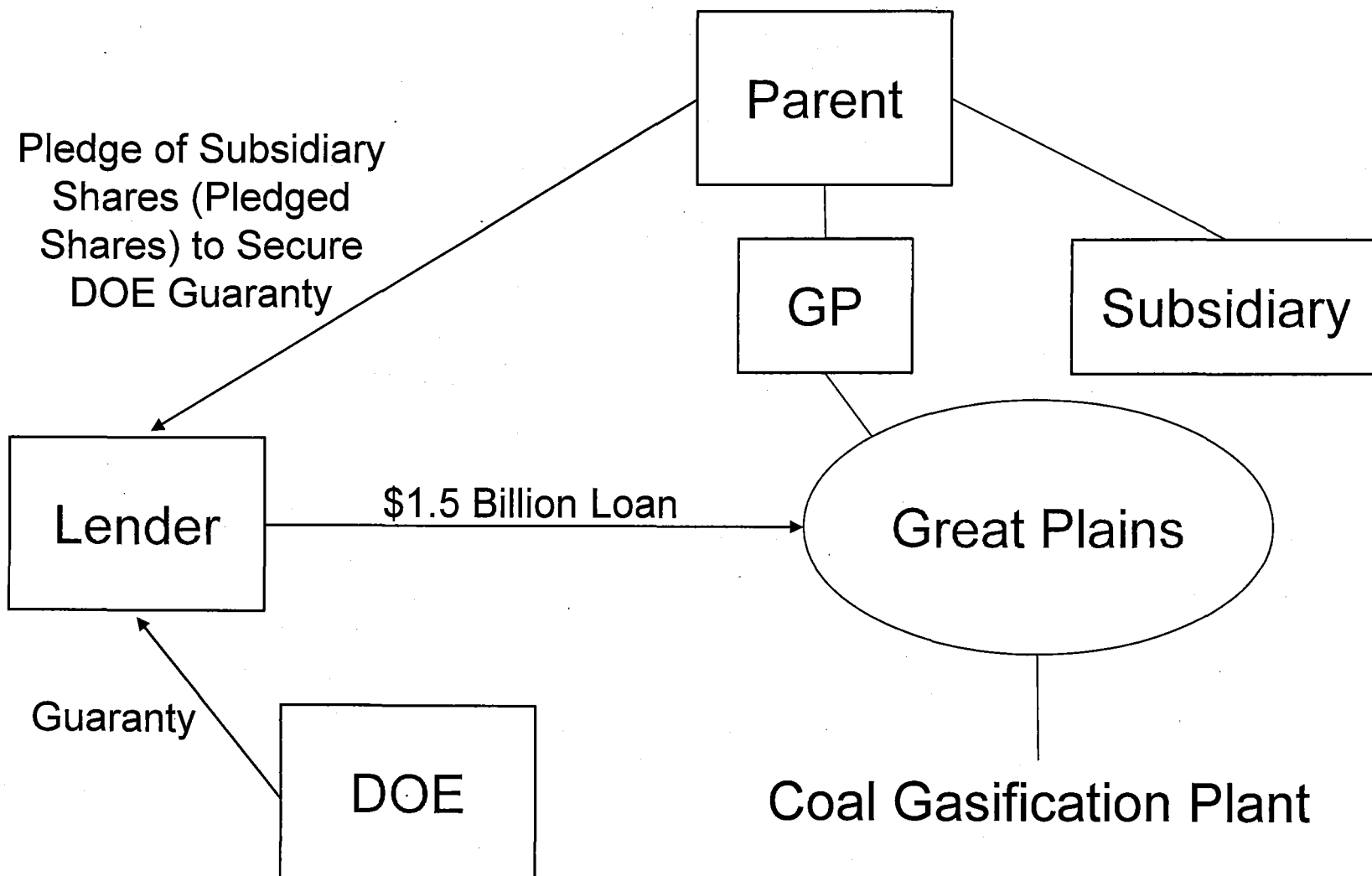
- ▶ Is the Loan recourse or nonrecourse for purposes of IRC section 1001?
- ▶ Bank cannot reach the Other Assets

Recourse loan to LLC that owns single asset



- ▶ Is the Loan recourse or nonrecourse for purposes of IRC section 1001?
- ▶ Does it matter if LLC is prohibited from owning other assets under the controlling agreements?
- ▶ Is the debt “in substance” a nonrecourse debt under these facts?

Great Plains Gasification Associates v. Commissioner, 92 T.C.M. 534 (2006)



Great Plains Gasification (cont'd)

- ▶ Loan was not nonrecourse by its terms
- ▶ Great Plains defaulted on the loan
- ▶ DOE paid off the loan and foreclosed on the plant, bidding \$1.0 billion
- ▶ Following year, DOE released remaining debt (\$500 million) upon receipt of Pledged Shares
- ▶ Issues:
 - ▶ Was the entire \$1.5 billion debt discharged on the foreclosure?
 - ▶ Was the debt nonrecourse?

Great Plains Gasification (cont'd)

▶ Holdings:

- ▶ Great Plains did not abandon the project prior to the foreclosure sale
- ▶ Recourse/nonrecourse determination is made at partnership level
- ▶ Debt is nonrecourse if creditor's remedies limited to pledged assets (citing *Raphan*)
 - ▶ Tax Court analyzed old IRC section 752 regulations
- ▶ Debt held nonrecourse because partnership could not acquire other assets
 - ▶ State law rights of creditors seemingly irrelevant

Great Plains Gasification (cont'd)

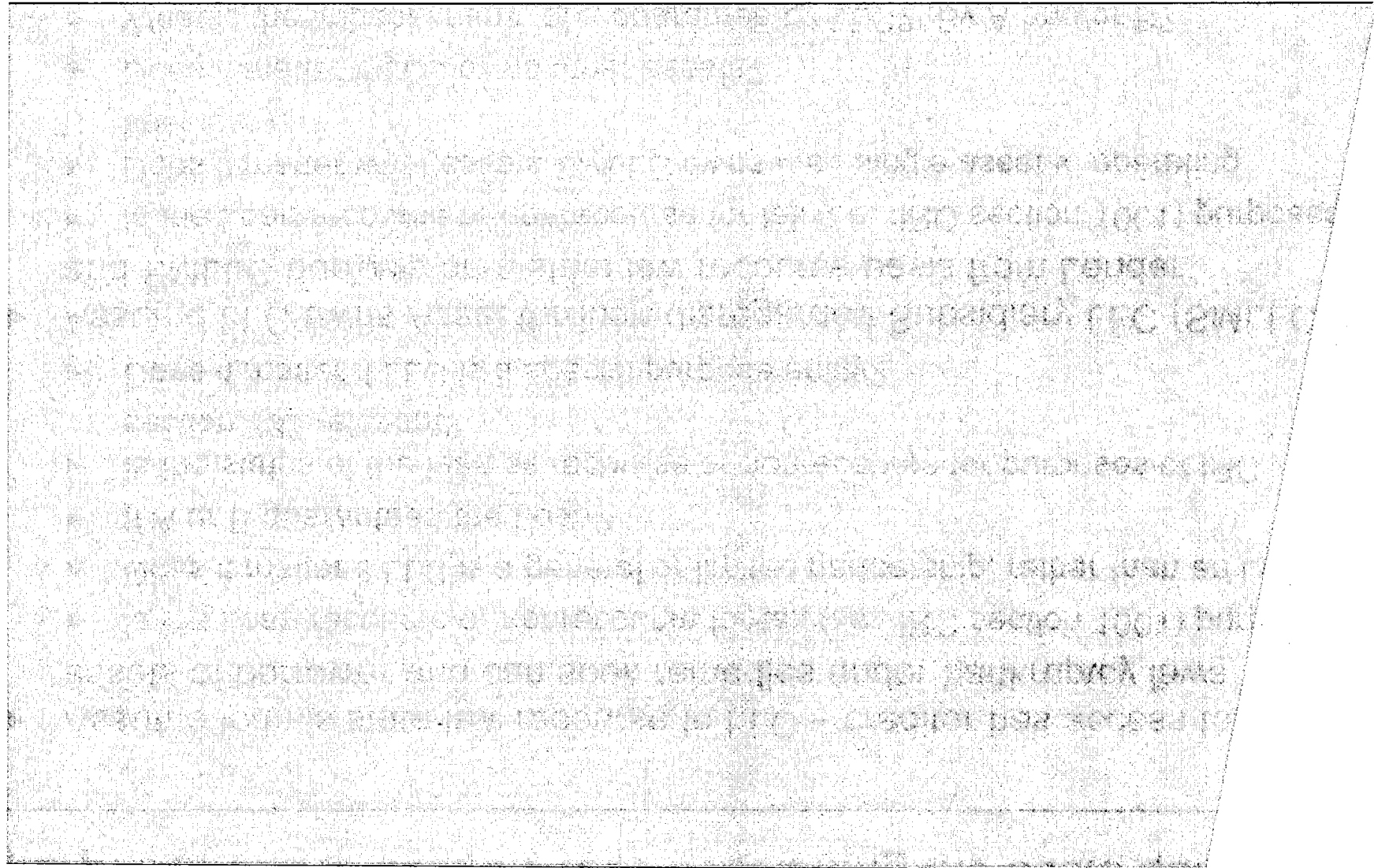
WHERE DO WE GO FROM HERE

- ▶ Was *Great Plains* wrongly decided since the loan was recourse for state law purposes?
- ▶ Was *Great Plains* wrongly decided because it ignored the Pledged Shares?
- ▶ Was *Great Plains* wrongly decided because it relied on IRC section 752 principles?
- ▶ **OR** is *Great Plains* important because it focused on the “substance” of the situation – that the partnership essentially owned a single asset and the loan therefore should be viewed as nonrecourse?
- ▶ If so, can nature of debt change as assets are acquired? Disposed of?

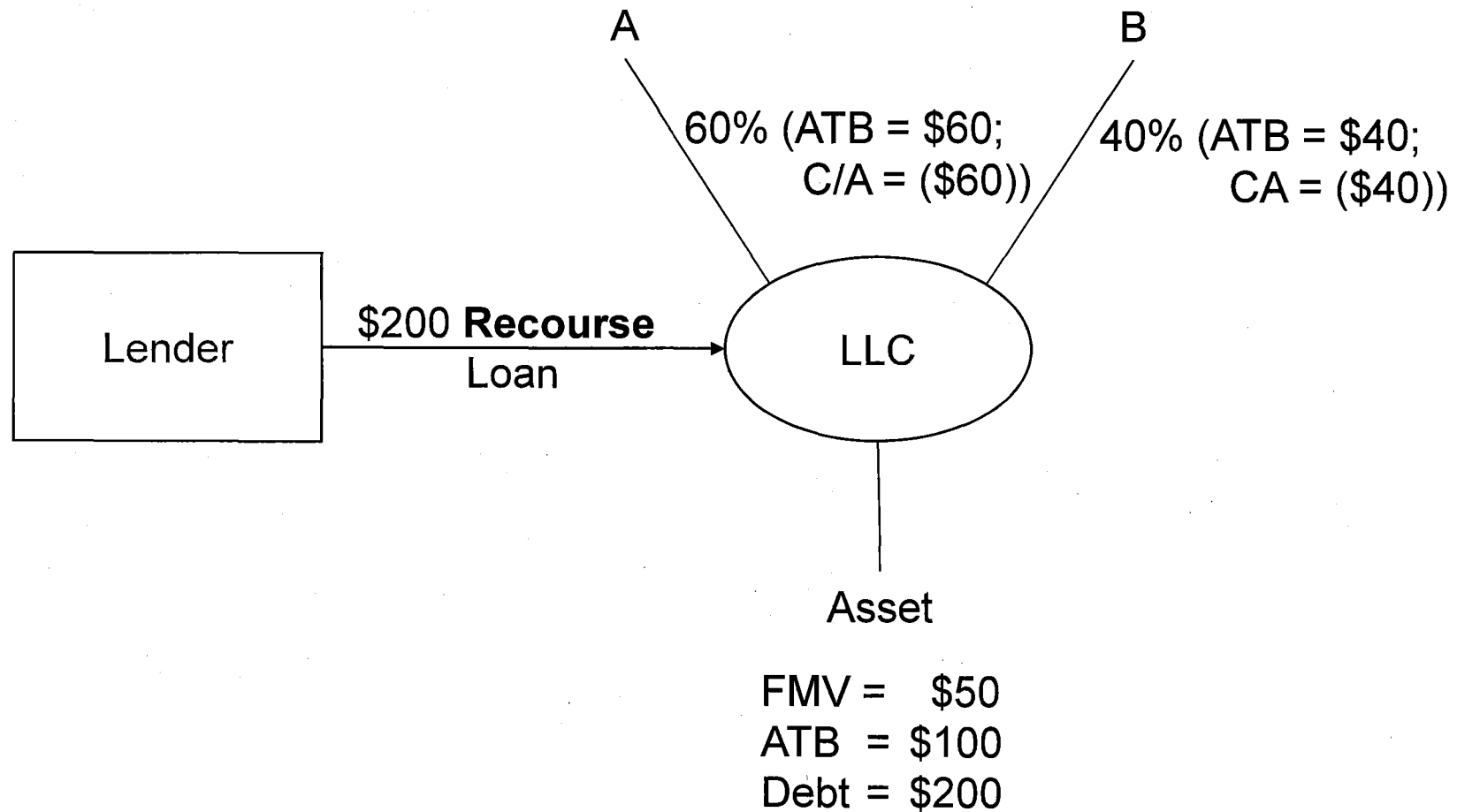
Characterization of debt as recourse or non-recourse for purposes of IRC section 1001 – revisiting the basic questions

- ▶ Assume loan is state law recourse to LLC – creditor has access to all assets of borrower and can seek remedies under bankruptcy laws
 - ▶ Is the Loan recourse or nonrecourse for tax (*i.e.*, IRC section 1001) purposes?
 - ▶ Does it matter if LLC is a general or limited partnership, rather than an LLC?
 - ▶ If A or B guaranteed the Loan?
 - ▶ Is the status of the loan as recourse or nonrecourse for purposes of IRC section 752 relevant?
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 - ▶ Is the Loan recourse or nonrecourse for tax (*i.e.*, IRC section 1001) purposes?
 - ▶ Does it matter what assets SMLLC owns (*i.e.*, single asset v. operating business)?
 - ▶ Does it matter if LLC owns other assets?
 - ▶ What is the impact, if any, of a guarantee by LLC? By A and/or B?

Transfer of interests in LLC to Lender



Basic fact pattern - refresher



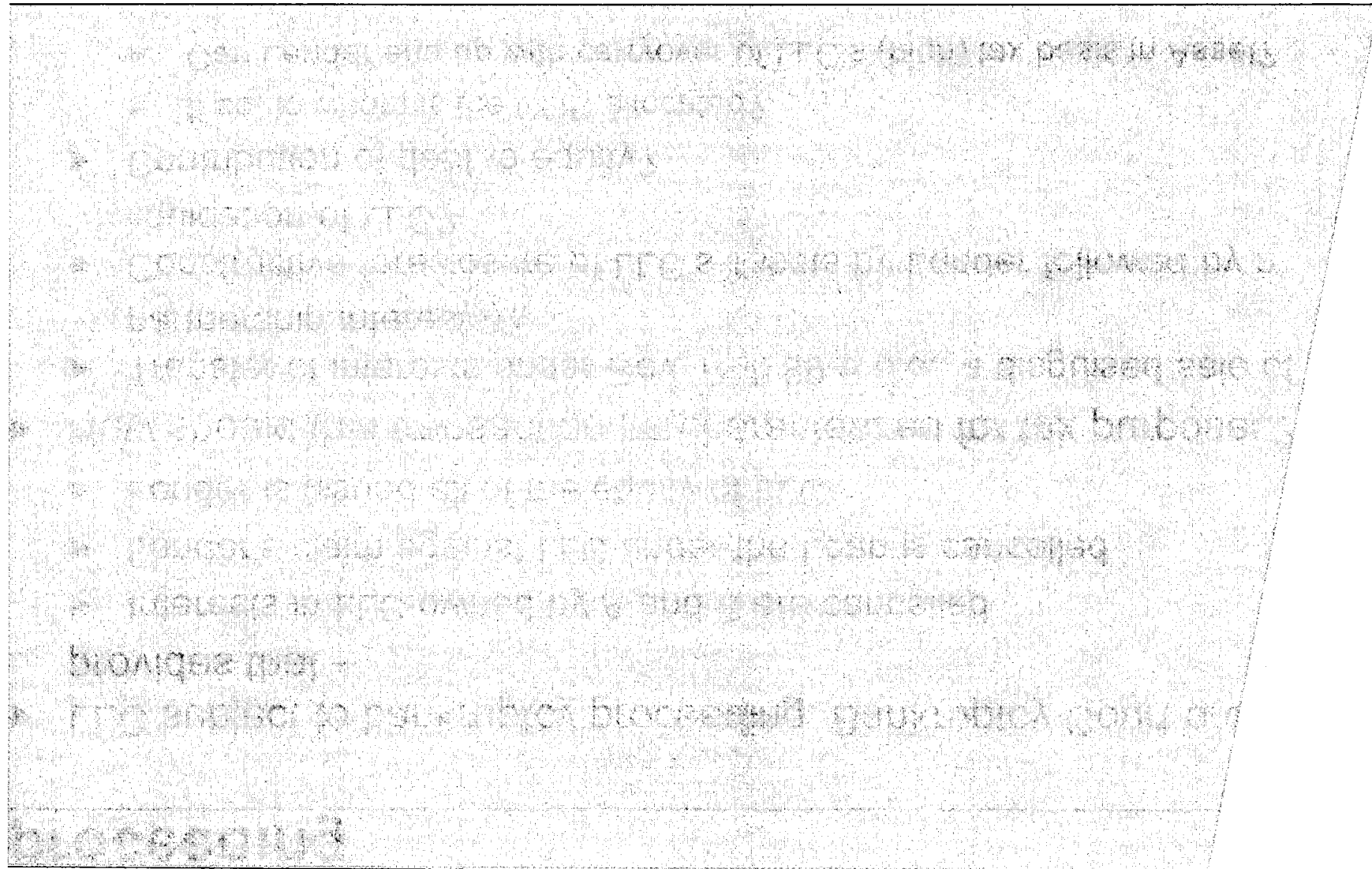
Lender acquires LLC through consensual transfer of interests from A and B

- ▶ A and B transfer 100% of their interests in LLC to Lender
 - ▶ For nothing
 - ▶ For \$1 each
 - ▶ For release from a guarantee/release of any other claims Lender may have against them
- ▶ How should this transaction be treated for federal income tax purposes?
 - ▶ Is it governed by Rev. Rul. 99-6 (*i.e.*, transfer of interests as to A and B and purchase of assets by Lender)?
 - ▶ If so, does the transaction give rise to COD Income?
 - ▶ If so, to whom is it allocable?
 - ▶ Should the transaction instead be characterized as a foreclosure/deed in lieu as to LLC for tax purposes?
- ▶ Does the answer change if the Loan were instead held by two independent lenders and each Lender acquires an interest in LLC?
- ▶ Does the answer change if LLC were instead a joint venture?

Lender acquires LLC through bankruptcy proceeding

- ▶ LLC subject to bankruptcy proceeding. Bankruptcy Court order provides that –
 - ▶ Interests in LLC owned by A and B are cancelled
 - ▶ Lender's claim against LLC under the Loan is cancelled
 - ▶ Lender is issued all of the equity of LLC
- ▶ How should this transaction be characterized for tax purposes?
 - ▶ Transfer of interests under Rev. Rul. 99-6 (*i.e.*, a disguised sale of partnership interests)?
 - ▶ Constructive foreclosure of LLC's assets by Lender followed by a liquidation of LLC?
 - ▶ Contribution of debt to equity?
 - ▶ If so, to whom is the COD allocated?
 - ▶ Can Lender end up with carryover of LLC's (high) tax basis in Asset?

Like-kind exchange of underwater asset



Like-kind exchange of underwater asset (cont'd)

- ▶ Assume LLC debt is nonrecourse for all purposes
- ▶ LLC transfers Asset to QI
 - ▶ Will QI be willing to acquire title to asset?
 - ▶ Can LLC direct deed asset to lender in a deed-in-lieu transaction?
- ▶ Title to Asset acquired by Lender pursuant to foreclosure or deed-in-lieu of foreclosure
- ▶ LLC directs QI to acquire replacement property with FMV of at least \$200
 - ▶ Purchase price of replacement property financed with debt (to the extent possible)
 - ▶ Balance of purchase price financed with cash provided by LLC

Like-kind exchange on eve of foreclosure (cont'd)

Issue:

- ▶ At the time of the conveyance from LLC to QI, FMV of Asset (\$50) is substantially less than debt secured by Asset (\$200) – has LLC transferred “property” for purposes of IRC section 1031?

Analysis/authorities/other considerations:

- ▶ No direct authority in context of a like-kind exchange
- ▶ Indirect authority: *Rosen v. Commissioner*, 62 T.C. 11 (1974), *aff'd*, 515 F.2d 507 (3rd Cir. 1975) (IRC section 351 applies to the incorporation of an insolvent sole proprietorship where business to be continued)
- ▶ Asset is not worthless – merely underwater – LLC is still the tax owner
- ▶ Asset treated as being worth amount of nonrecourse debt under IRC section 7701(g)
- ▶ Treas. Reg. § 1.1031(d)-2 specifically allows taxpayer to furnish cash to QI to fund acquisition of replacement property
- ▶ Review loan documents and understand all of the facts
- ▶ Be cautious

Abandonment and worthlessness of partnership interests

- ▶ General rules and basic considerations
- ▶ Tejon Ranch
- ▶ Echols
- ▶ Rev. Rul. 93-80
- ▶ Analysis of base case

Abandonment and worthlessness – general rules

- ▶ IRC section 165(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): The loss must be evidenced by (1) a closed and completed transaction, (2) fixed by identifiable events, and (3) actually sustained during the year for which the deduction is claimed
- ▶ Loss is ordinary if it does not arise as a result of a sale or exchange

Abandonment – basic considerations

- ▶ Law is well settled that a partner may abandon his interest in a partnership and deduct the loss realized as a result of the abandonment
 - ▶ See Rev. Rul. 93-80, 1993-2 C.B. 239; *Citron v. Commissioner*, 97 T.C. 200 (1991), *Echols v. Commissioner*, 935 F.2d 703 (5th Cir. 1991), *rehearing denied*, 950 F.2d 209 (5th Cir. 1991)
- ▶ To establish that the partnership interest has been abandoned, the partner must demonstrate both an intent to abandon the interest and must overtly act to abandon such interest
- ▶ The loss will be ordinary only if (1) the partner is not deemed to receive any cash in connection with the abandonment and (2) there has not been in substance a sale or exchange

Worthlessness – basic considerations

- ▶ The law is not as well settled regarding a partner's ability to claim a deduction on the basis that his partnership interest is worthless
- ▶ To sustain a deduction, the partner must **objectively** prove its interest is worthless
- ▶ Character of the loss: courts (ordinary); IRS (capital if taxpayer has a share of debt)

Worthless partnership interests: *Tejon Ranch v. Commissioner*, 49 T.C.M. 1357 (1985)

- ▶ Partnership interest held worthless where partnership was insolvent beyond hope of rehabilitation
- ▶ Loss to partner was ordinary since there was not a sale or exchange by the partner (**entity principle**) – character of deduction was not affected by partner sharing in partnership liabilities (although court did not specifically address this issue)
- ▶ IRS had argued IRC section 165(a) deduction was unavailable because there had not been a liquidation or dissolution of the partnership (**aggregate principle**)
- ▶ Deduction claimed by partner appears to have been equal to its capital contribution to the partnership (share of partnership debt not claimed as a deduction)

Worthless partnership interests: *Echols v. Commissioner*, 935 F.2d 703 (5th Cir. 1991), rehearing denied, 950 F.2d (209) (5th Cir. 1991)

Echols I

- ▶ Abandonment and worthlessness are distinct concepts
- ▶ Fifth Circuit found taxpayers entitled to deduction under IRC section 165(a) on both abandonment and worthlessness grounds
- ▶ Test for worthlessness is both **subjective** (partner considers interest worthless) and **objective** (closed and completed transaction); objective events need not be **asset level events**
- ▶ Abandonment does not require relinquishing title
 - ▶ Tax Court had focused on abandonment by the **partnership of its asset**
 - ▶ Fifth Circuit found taxpayers' announcement they were walking away and would not fund deficits sufficient
- ▶ Worthlessness
 - ▶ Fifth Circuit – no single date for worthlessness
 - ▶ No need to prove zero value

Worthless partnership interests: *Echols v. Commissioner*, 935 F.2d 703 (5th Cir. 1991), rehearing denied, 950 F.2d (209) (5th Cir. 1991) (cont'd)

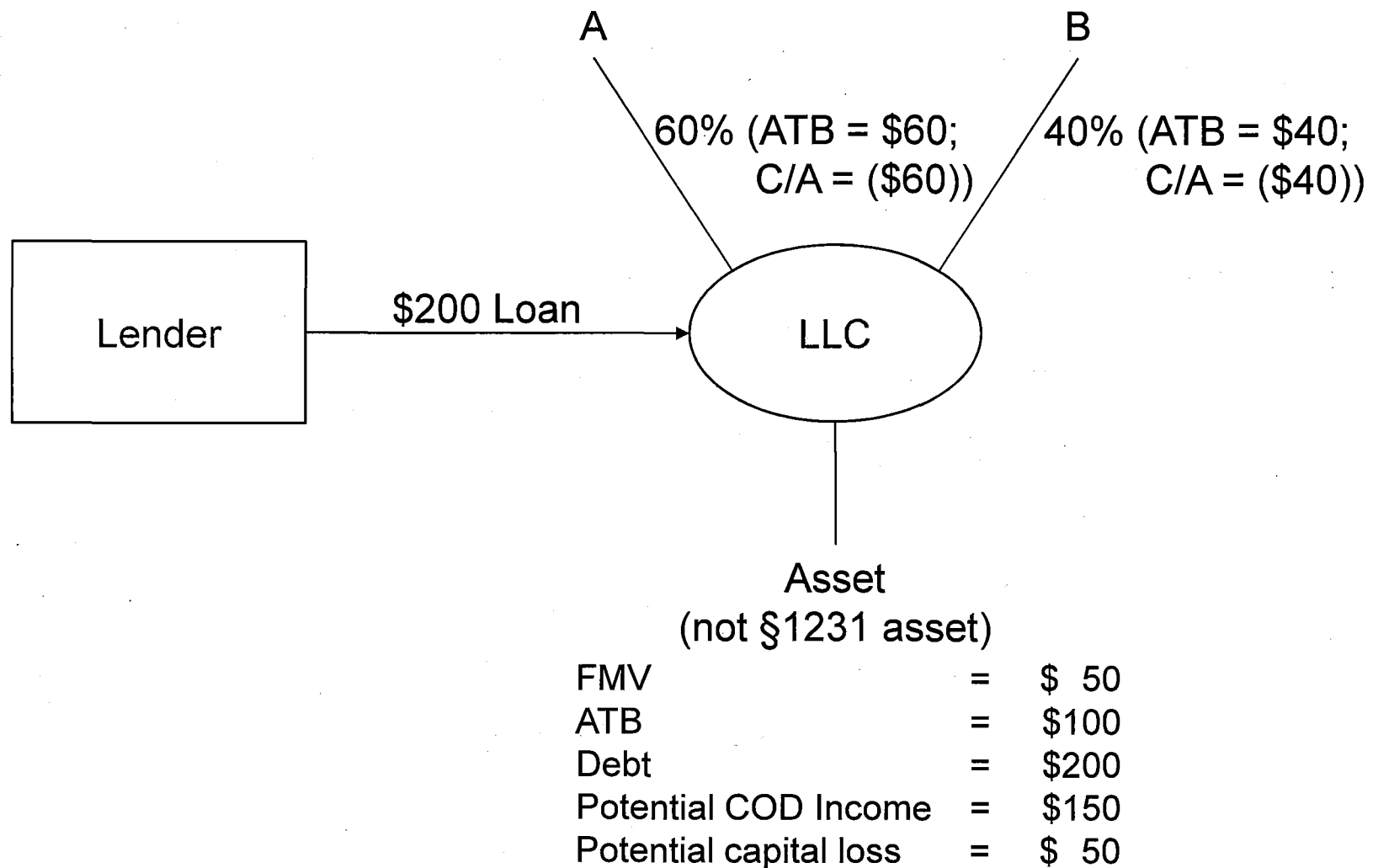
Echols II

- ▶ IRS petitioned for rehearing on ground Fifth Circuit holding would irreparably harm IRC section 165(a)
- ▶ Fifth Circuit rejected IRS argument on the ground it would **subsume worthlessness in abandonment**
- ▶ Fifth Circuit noted IRS only cited abandonment cases to support its worthlessness argument – those cases required relinquishing title
- ▶ The test is whether there has been a completed and closed transaction or an identifiable event supporting worthlessness – are there **objective events** confirming the **subjective determination**
- ▶ Key facts in *Echols II*: Default by the third party developer and inability to restructure the debt
- ▶ Note that court found abandonment and therefore sustained the capital loss claimed by the taxpayer

Rev. Rul. 93-80, 1993-2 C.B. 239

- ▶ Two fact patterns considered
 - ▶ Insolvent partnership in both fact patterns
 - ▶ Partner properly abandoned its interest in both fact patterns
 - ▶ In one fact pattern partnership's liabilities were previously allocated to taxpayer abandoning its partnership interest; in the other case, there were no partnership liabilities allocated to the taxpayer
- ▶ IRS: An asset is worthless only if it has **no value**
 - ▶ This position is contrary to various court decisions
- ▶ Nature of loss from abandonment or **worthlessness** as capital or ordinary turns on whether there was a sale or exchange
 - ▶ Deemed distribution under IRC section 752(b) (even if nominal) creates sale or exchange (capital loss) in either case
- ▶ Although fact patterns only involved abandonments, ruling extended to worthlessness as well (without discussion or analysis)
 - ▶ IRS seems to subsume worthlessness within abandonment
- ▶ No mention whatsoever of *Tejon Ranch* or *Echols*
- ▶ IRS position restated in 1997 FSA Lexis 190 (July 7, 1997)

Basic fact pattern - refresher



Abandonment deduction

- ▶ Can A and/or B claim an abandonment loss with respect to its interest in LLC?
- ▶ What must A and/or B demonstrate to sustain such deduction?
- ▶ What is the character of the deduction?
- ▶ Last man standing (not a good thing)
 - ▶ What happens to A if B abandons its interest prior to a foreclosure/deed in lieu of foreclosure transaction? Might the debt be converted into nonrecourse debt for IRC section 1001 purposes)?
- ▶ If A and B both abandon their interests simultaneously, is COD Income avoided?

Worthlessness deduction

- ▶ Can A and/or B claim a deduction under IRC section 165(a) that its LLC interest is worthless?
- ▶ Must the Asset have a zero value? Must the LLC interest have a zero value (with no possibility of ever being positive)?
 - ▶ Subjective and objective factors
 - ▶ Aggregate v. entity analysis
- ▶ What is the character of the deduction?
- ▶ What if A claims a worthlessness deduction under IRC section 165(a) in 2010 and B does not? Can B claim such a deduction in 2011? What if the facts indicate the interest was actually worthless in 2009?

Additional observations on worthlessness

- ▶ Contrast (1) abandonment of LLC interest where member previously allocated share of debt (capital loss) with (2) worthlessness of LLC interest (arguably ordinary deduction regardless of whether member allocated any LLC debt)
- ▶ The Service believes asset is worthless if it has zero value while courts have not required a showing of zero value

A closer look at worthlessness deductions

- ▶ Under IRC section 165(a), the loss is based upon the taxpayer's adjusted tax basis ("**ATB**") in the worthless asset
- ▶ The ATB of the LLC interest includes the partner's share of LLC's liabilities. May these liabilities be taken into account in measuring the deduction?
 - ▶ *Proesel v. Commissioner*, 77 T.C. 992 (1981)
 - ▶ Rev. Rul. 74-80, 1974-1 C.B. 117
 - ▶ 1995 FSA Lexis 223 (Feb. 21, 1995)

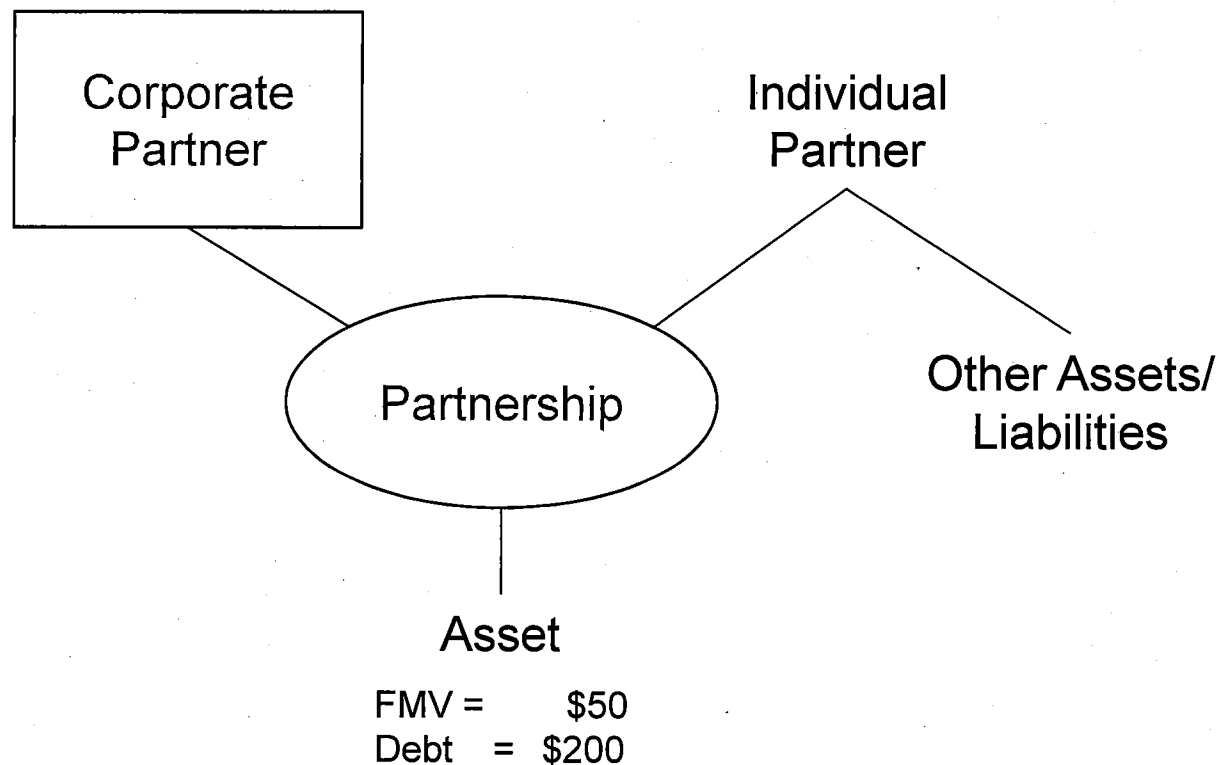
Intersection of constructive foreclosure, abandonment and worthlessness

- ▶ Taxpayer can allow events to unfold
 - ▶ Hope for the best
 - ▶ Inevitable foreclosure
 - ▶ Recourse debt – COD Income/deficiency; gain and loss on sale; potential character mismatch
 - ▶ Nonrecourse debt – sale for the debt
 - ▶ Timing of tax recognition – constructive foreclosure if debt nonrecourse
 - ▶ Use it or lose it dilemma
- ▶ Taxpayers becoming proactive
 - ▶ Abandonment of partnership interest
 - ▶ Avoid COD Income (especially LLC context)
 - ▶ Capital loss likely – IRC section 752 debt share – assumes positive capital account
 - ▶ Worthlessness deduction
 - ▶ Ordinary deduction notwithstanding IRC section 752 debt share
 - ▶ Positive tax capital account yields corresponding loss (without taking debt share into account)
 - ▶ IRS position inconsistent with court decisions

A collision of worlds – debt workouts and Subchapter K

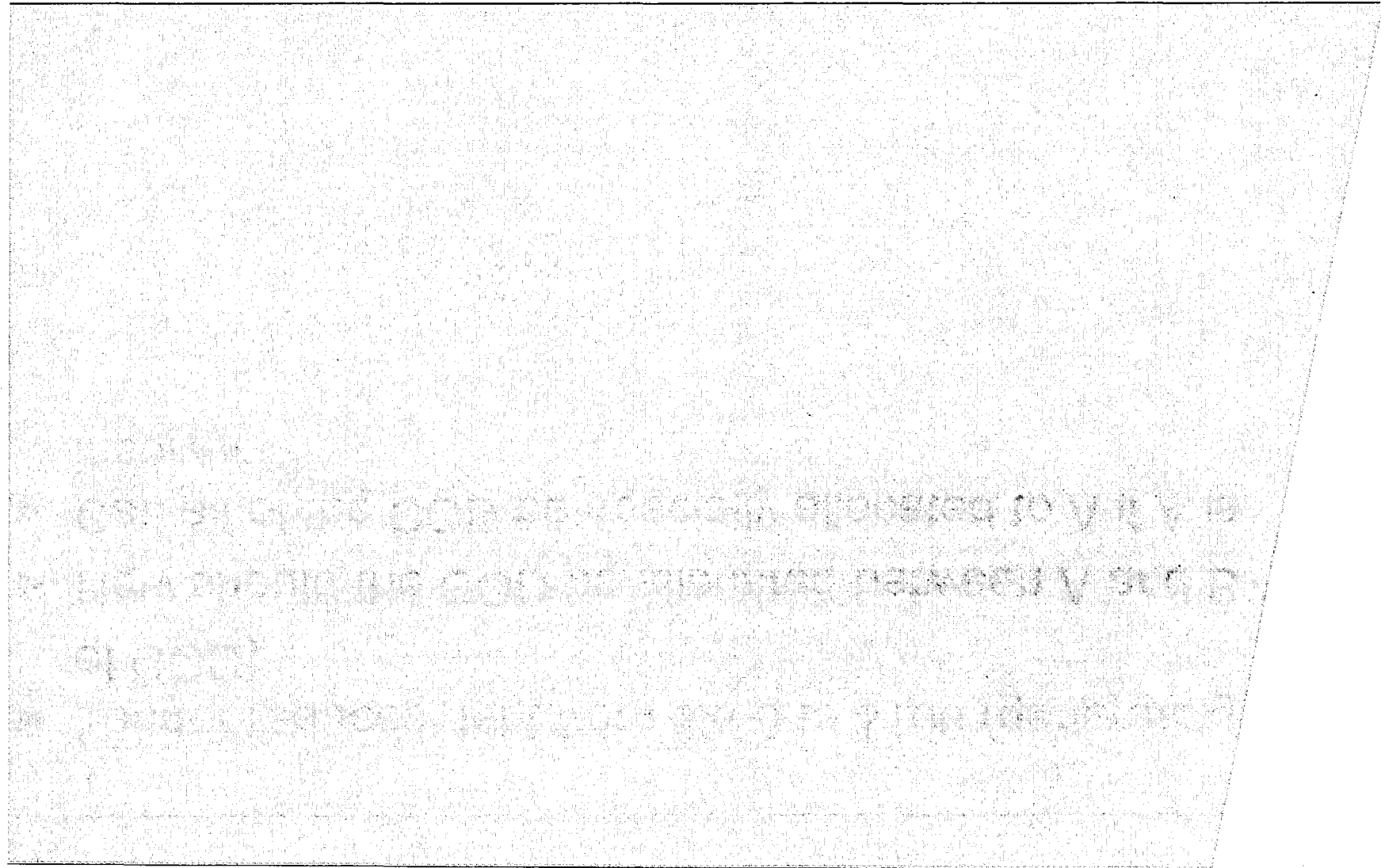
- ▶ Measuring insolvency – partnership liabilities
- ▶ Allocating COD Income under IRC section 704(b)
- ▶ Collateral consequences of partnership debt reduction

Measuring insolvency – partnership liabilities



- ▶ COD Income determined at partnership level
- ▶ Insolvency determined at partner level
- ▶ Impact of partnership level debt on determination of insolvency of a partner? See Rev. Rul. 92-53; 1992-2 C.B. 48 (taxpayer may take excess nonrecourse debt into account in determining its solvency only if such debt gives rise to COD Income)
- ▶ To what extent may a partner take partnership nonrecourse debt into account? Partnership recourse debt? Does it matter if the debt being cancelled is not partnership debt?

Allocating COD Income under IRC section 704(b)



IRC section 704(b) – allocation of COD

- ▶ Lender reduces debt from \$200 to \$100 (generating \$100 of COD)
- ▶ How should the COD be allocated between A and B?
- ▶ Can all of the COD be specially allocated to A if A is insolvent?

IRC section 704(b) – a refresher

- ▶ To be respected, partnership allocations must be set forth in the partnership agreement and –
 - ▶ have substantial economic effect,
 - ▶ be in accordance with the partners' interests in the partnership, or
 - ▶ be deemed to be in accordance with the partners' interests in the partnership (e.g., nonrecourse deductions, tax credits).
 - ▶ See Treas. Reg. § 1.704-1(b)(2)
- ▶ Otherwise, items will be allocated in accordance with the partners' interests in the partnership or "PIP"
 - ▶ See Treas. Reg. § 1.704-1(b)(3)

Three tests for economic effect

- ▶ Primary test
 - ▶ Capital account maintenance
 - ▶ Liquidation in accordance with positive capital accounts
 - ▶ Deficit restoration obligation (“**DRO**”)
 - ▶ See Treas. Reg. § 1.704-1(b)(2)
- ▶ Alternate test for economic effect
 - ▶ Same as above, but in lieu of DRO
 - ▶ Loss allocation may not cause or increase adjusted capital account deficit
 - ▶ Agreement must contain a qualified income offset (“**QIO**”)
 - ▶ See Treas. Reg. § 1.704-1(b)(2)(ii)(d)
- ▶ Economic equivalence test
 - ▶ See Treas. Reg. § 1.704-1(b)(2)(ii)(i)

Substantiality

- ▶ An allocation is substantial “if there is a reasonable possibility that the allocation will affect substantially the dollar amounts to be received by the partners from the partnership, independent of tax consequences” Treas. Reg. § 1.704-1(b)(2)(iii)
- ▶ Three general rules
 - ▶ Intra-year shifting rule
 - ▶ Inter-year transitory allocation rule
 - ▶ Overall tax effect rule

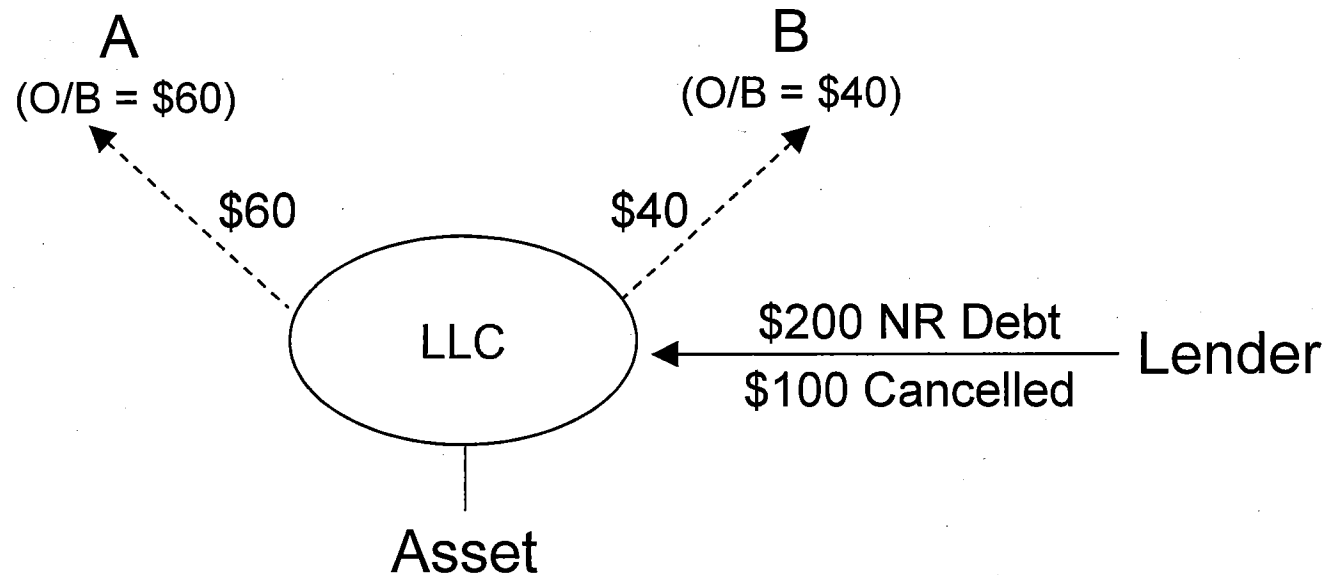
Partner's interest in partnership (PIP)

- ▶ Facts-and-circumstances test including:
 - ▶ Relative contributions of partners
 - ▶ Relative interests in distributions upon liquidation
 - ▶ Relative interests in cash flow
 - ▶ Relative interests in economic profit and loss sharing ratios
 - ▶ See Treas. Reg. § 1.704-1(b)(3)

COD and IRC section 704(b) – the problem

- ▶ There is no economic benefit associated with COD Income
 - ▶ COD Income does not generate current or future cash to the debtor partnership or its partners
 - ▶ The only benefit associated with COD Income is the future benefit of basis recovery attributable to the debt (unless that basis has already been recovered)
- ▶ Allocations of COD Income under a safe harbor agreement may satisfy (or be treated as having satisfied) the SEE rules based upon the value equals basis rule
- ▶ How does one go about allocating a noneconomic item under PIP?
 - ▶ Why is one approach with respect to a truly noneconomic item logically any better than another (particularly where the partnership has not taken any deductions based on the indebtedness at the time of the cancellation)?

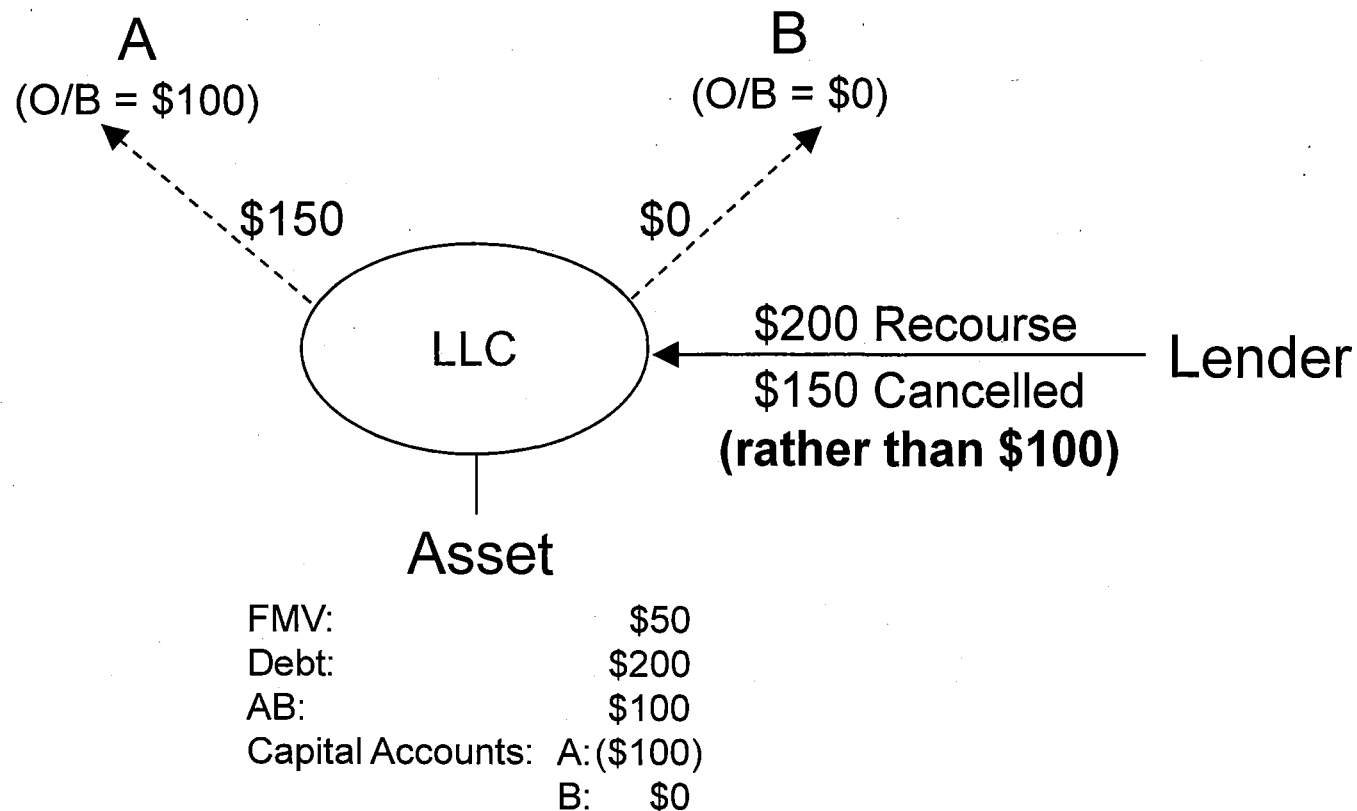
Special allocation of COD Income – compliant agreement



FMV:	\$50
Debt:	\$200
AB:	\$200
Capital Accounts:	A: \$0
	B: \$0

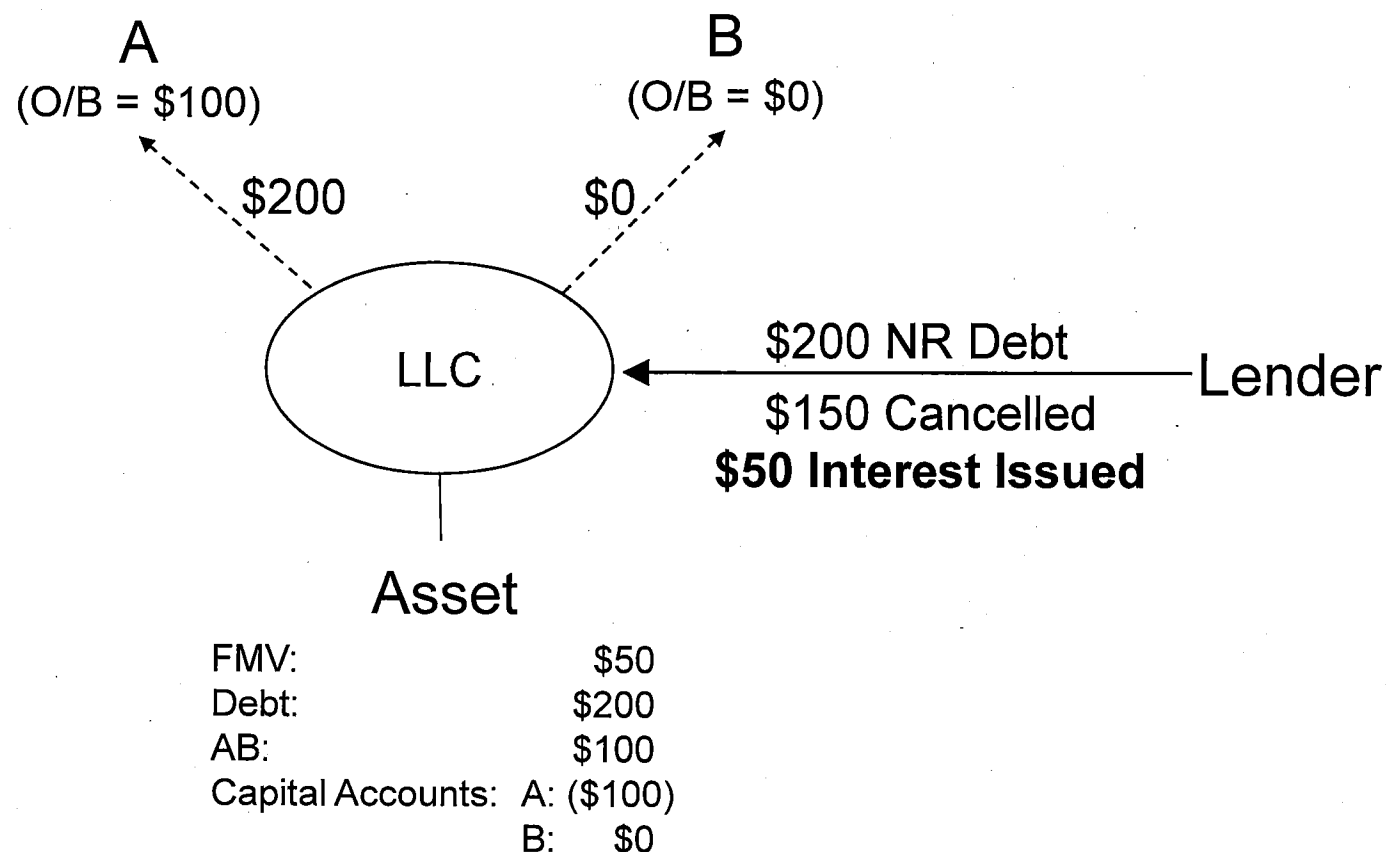
- ▶ Allocation of \$100 of COD Income to A causes his IRC section 704(b) book capital account to increase to \$100 (whereas B's remains \$0)
- ▶ Rev. Rul. 99-43, 1999-2 C.B. 506 (allocation of COD income is substantial if NOT reversed or offset by a special allocation of a book loss on the revaluation of the property in the same year or as part of an overall plan)
- ▶ Does the value equals basis rule save the day (book basis remains unchanged at \$200)?
- ▶ Why would B agree to a special allocation of all of the COD Income to A?
- ▶ What if the agreement is not compliant (all distributions shared 60-40)?

Allocation of COD Income from recourse debt – noncompliant agreement



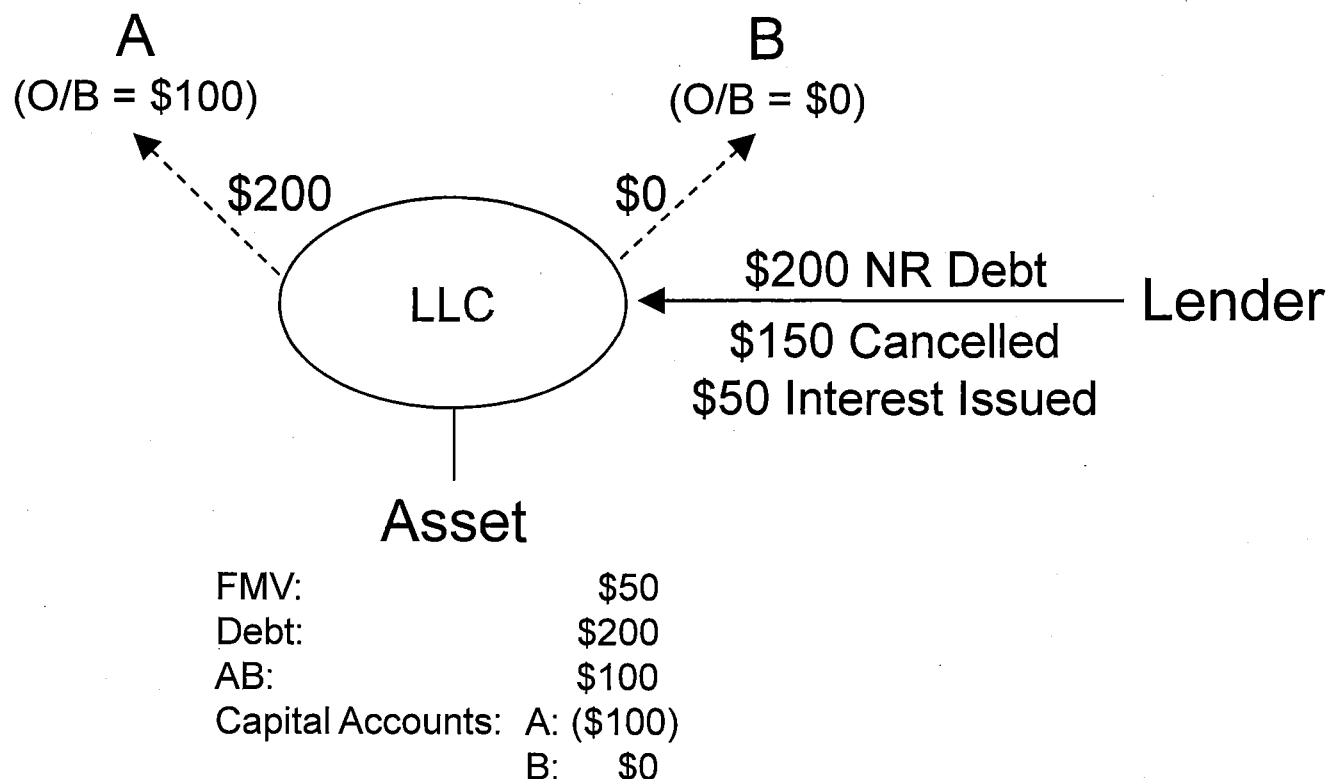
- ▶ A guaranteed the debt, has been allocated the debt under IRC section 752 and has been allocated the deductions attributable to the debt.
- ▶ Should the allocation of \$100 presumably required under the agreement to restore A's negative book capital account be respected? What if the agreement is silent?
- ▶ Can the chargeback be sourced solely to COD Income if Partnership has other income?
- ▶ How should the remaining \$50 of COD Income be allocated (i.e., does it matter that the related debt was allocated to A under IRC section 752)?

Allocation of COD Income from nonrecourse debt – compliant agreement



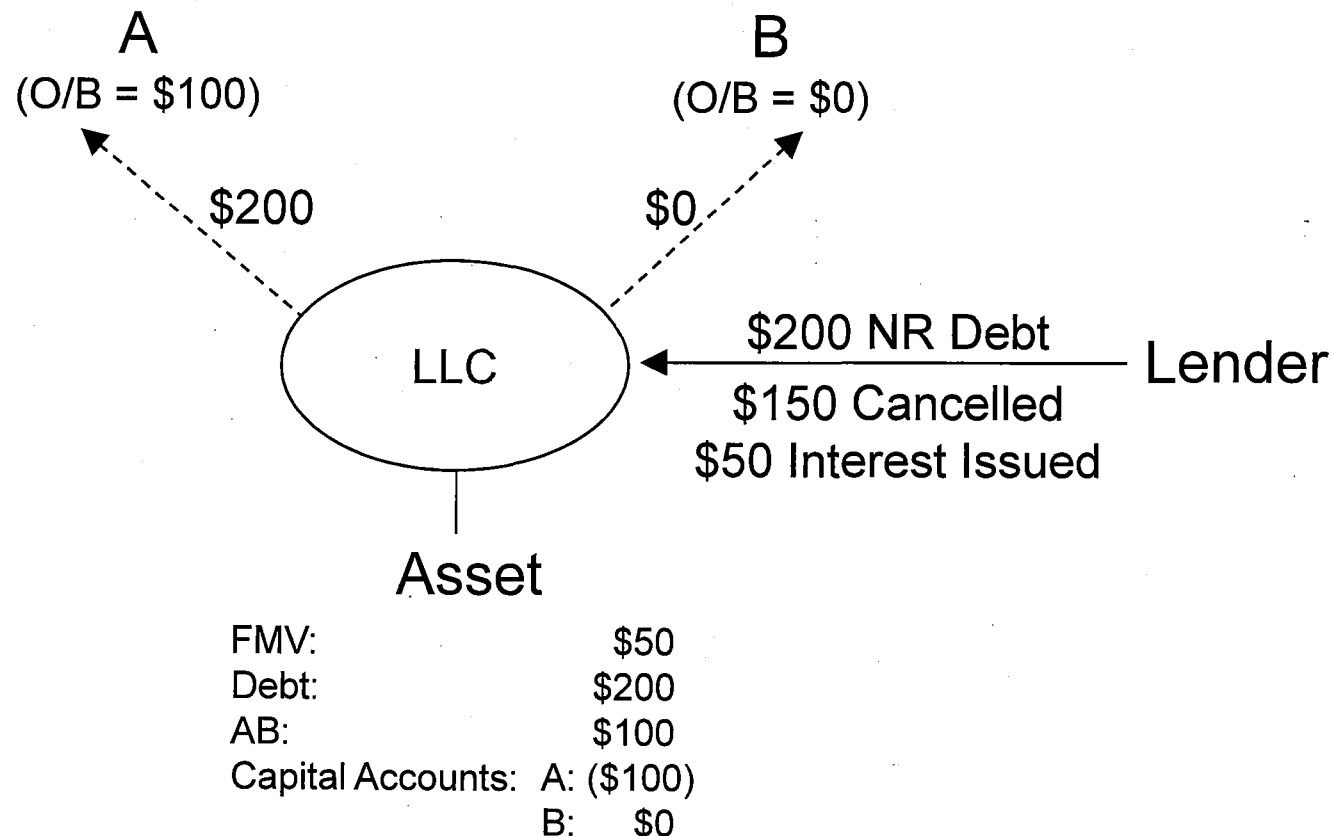
- ▶ LLC allocated all nonrecourse deductions (and NR debt) to A such that A's share of partnership minimum gain before cancellation is \$100.
- ▶ Lender contributes debt to LLC in exchange for an interest therein with a capital account of \$50.
- ▶ LLC revalues its assets immediately prior to such contribution.
- ▶ What is the value of Asset for purposes of the revaluation (*i.e.*, \$200 (nonrecourse debt) or \$50 (actual FMV))?

Allocation of COD Income from nonrecourse debt – compliant agreement (cont'd)



- ▶ If \$200 based upon IRC section 7701(g) (notwithstanding the fact that \$150 of that debt is being cancelled as part of the transaction requiring the revaluation), the historic partners will have positive book capital of \$150 (\$100 of revaluation gain plus \$150 of COD Income). Would Lender ever agree to this?
- ▶ Note that A's IRC section 704(b) minimum gain would transmogrify into reverse IRC section 704(c) gain (*i.e.*, there would not be a minimum gain chargeback). Who should be allocated the COD Income in this case?
- ▶ Note that Lender presumably will be entitled to at least a portion of the deductions generated by the basis, but CANNOT be allocated any of the COD Income by virtue of IRC section 108(e)(8).

Allocation of COD Income from nonrecourse debt – compliant agreement (cont'd)



- ▶ If Asset instead is treated as being worth \$50 for purposes of the revaluation (*i.e.*, its actual FMV notwithstanding IRC section 7701(g) because the debt will be cancelled as part of the transaction), there will be a minimum gain chargeback to A of \$100.
- ▶ Can the minimum gain chargeback/must the minimum gain chargeback be satisfied with COD Income?
- ▶ How should/may the remaining \$50 of COD Income be allocated among A and B: Note that whoever is allocated such \$50 of COD Income presumably is entitled to \$50 of built-in loss attributable to Asset (\$100 AB - \$50 revalued basis)?

Collateral consequences of partnership debt reduction – IRC sections 731 and 752(b)

- ▶ **IRC section 731**
 - ▶ A distribution of money is taxable to the extent it exceeds the partner's basis
- ▶ **IRC section 752(b)**
 - ▶ Decrease in a partner's share of partnership liabilities treated as a DISTRIBUTION OF MONEY (and will be taxable under IRC section 731 to the extent it exceeds the partner's basis)
- ▶ Cancellation/reduction of partnership debt results in a deemed distribution of money to its partners. Avoiding COD Income may be only half the battle!

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