

PARTNERSHIP BANKRUPTCY TAX ISSUES[©]

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PARTNERSHIP BANKRUPTCY TAX ISSUES*

I. INTRODUCTION

Bankruptcies and restructurings involving partners and partnerships¹ raise a number of unique tax issues. While the Internal Revenue Service (the “IRS”) has provided guidance with respect to a number of these issues, a surprising number of unresolved issues remain. The first part of this outline summarizes the state of the law with respect to general tax issues that typically arise in connection with partner and partnership bankruptcies and restructurings. The balance of the outline discusses tax issues that arise under Subchapter K when troubled partnerships are reorganized.

II. GENERAL ISSUES

A. Individual Partner Debtors and Their Estates

1. Creation of New Entity

For purposes of Federal, state or local income taxes, the filing of a bankruptcy petition for or against an individual partner creates a separate taxable entity.² The partner and the bankruptcy estate must file separate tax returns.

- The bankruptcy estate succeeds to the debtor’s post-bankruptcy interest in the debtor’s assets, including income, gain, loss and deductions of partnerships owned by the debtor.³

* I am grateful to Christopher Slimm and Hoon Lee for graciously updating and substantially improving this article.

¹ References to partnerships in this article are generally equally applicable to limited liability companies that are subject to Federal income tax as partnerships under the “check-the-box” Treasury regulations.

² Internal Revenue Code of 1986, as amended (the “I.R.C.”) § 1398(d)(1).

³ I.R.C. § 1398(b)(2); Bankruptcy Code (the “BC”) § 346(b).

- For Federal income tax purposes, the bankruptcy estate succeeds to most of the debtor's tax attributes existing at the time of the bankruptcy filing.⁴ No new taxable entity is created for Federal income tax purposes where the debtor is a partnership or a corporation.⁵ State and local tax provisions of the bankruptcy code conform to Federal income tax treatment for these purposes.⁶
- "No Disposition Rule" The transfer of the debtor's assets to the individual's bankruptcy estate is not a taxable event.⁷ Thus, no gain or loss is recognized; no investment credit or depreciation is recaptured; and no installment gain is accelerated.⁸ Since the transfer of a partnership interest to a partner's bankruptcy estate is not a disposition, a bankruptcy filing by a partner does not trigger a partnership termination under section 708(b)(1)(B), does not close the partnership books with respect to the partner under section 706(c), and does not cause a change in interest under section 706(d).⁹ Treasury Regulations further provide that no sale or exchange occurs upon a disposition by gift (including assignment to a successor in interest).¹⁰ Presumably, the bankruptcy estate would be a "successor in interest."
- Query whether the transfer of partnership liabilities to the bankruptcy estate creates a

⁴ I.R.C. § 1398(g). The bankruptcy estate now succeeds to the debtor's passive activity losses. Treas. Reg. § 1.1398-1(c).

⁵ I.R.C. § 1399.

⁶ See BC § 346(b), (i).

⁷ I.R.C. § 1398(f)(1).

⁸ H.R. REP. NO. 96-833, at 25 (1980); S. REP. NO. 96-1035, at 31 (1980).

⁹ See *Gulley v. Commissioner*, T.C. Memo 2000-190.

¹⁰ Treas. Reg. § 1.708-1(b)(2).

constructive distribution of money that triggers gain for the bankrupt partner if and to the extent the amount deemed distributed exceeds the partner's basis in his partnership interest.¹¹ This result would be contrary to section 1398(f)(1), which generally does not treat transfers to the bankruptcy estate as taxable events.

2. Taxable Years of an Individual Partner and the Bankruptcy Estate

- Bankruptcy Filing Does Not Close Individual's Taxable Year For the year of the bankruptcy filing, an individual partner reports all his income earned during the year, but does not include any income earned by the bankruptcy estate. Unless the individual elects to divide his taxable year (as described below), the corresponding tax is a liability of the partner rather than a claim against the partner's bankruptcy estate.¹² The treatment is different in the case of income and loss flowing from a partnership to a partner that files for bankruptcy. The Tax Court has interpreted section 706(a) as providing for the pass-through of a partner's share of partnership income, gain, loss and deduction on the last day of the partnership's tax year.¹³ Thus, if the partner's bankruptcy estate holds the partnership interest at the end of the year, the distributive share of the partnership's income and loss for the entire year is allocated to the bankruptcy estate, regardless of whether the individual partner elects to close his taxable year at the time of the bankruptcy filing (as described below).¹⁴

¹¹ I.R.C. §§ 731(a)(1), 752(b).

¹² See *In Re Mirman*, 98 B.R. 742 (Bankr. E.D. Va. 1989).

¹³ See *Katz v. Commissioner*, 116 T.C. 5 (2001); *Gulley v. Commissioner*, T.C. Memo 2000-190.

¹⁴ See *Katz v. Commissioner*, 116 T.C. 5 (2001); *Gulley v. Commissioner*, T.C. Memo 2000-190.

- For state and local income tax purposes, the debtor's tax year terminates only if, and to the extent that, the debtor's tax year terminates for Federal income tax purposes.¹⁵
- Federal income tax refunds (or portions thereof) attributable to periods prior to the filing of the bankruptcy petition will likely be treated as property of the bankruptcy estate.¹⁶
- Individual Partner Election to Close His Taxable Year An individual partner can elect, without permission, to close his taxable year as of the day *before* the commencement of the bankruptcy case.¹⁷ If the election is made, the individual partner's taxable year is divided into two short taxable years.¹⁸ The first short year begins on the first day of the individual's normal taxable year and ends on the day before the commencement date.¹⁹ The second short year begins on the commencement date and ends on the last day of the individual's normal taxable year.²⁰
- The individual's Federal tax liability for the first short year is determined based on the partner's tax attributes available immediately before the partner's assets are transferred to his estate. The tax liability becomes a claim against the bankruptcy estate. This claim is a pre-petition liability, subject to eighth priority, and is not

¹⁵ BC § 346(d).

¹⁶ *See In re Wilson*, 49 B.R. 19 (Bankr. N.D. Tex. 1985); C.C.A. 1999-41-002 (Oct. 15, 1999).

¹⁷ I.R.C. § 1398(d)(1), (2).

¹⁸ I.R.C. § 1398(d)(2)(A).

¹⁹ I.R.C. § 1398(d)(2)(A)(i).

²⁰ I.R.C. § 1398(d)(2)(A)(ii).

dischargeable.²¹ Accordingly, the individual bears the ultimate burden for payment of any portion of the liability not satisfied by the bankruptcy estate.²²

- The tax liability for the second short year (including tax attributable to the partnership's taxable year ending with or within the second short year) is a liability of the bankruptcy estate.
- The tax liability of an individual debtor's estate is an administrative expense.²³ An individual debtor is discharged from personal responsibility for any unpaid bankruptcy estate tax liability.²⁴
- In a declaratory judgment action, the Supreme Court held that a trustee appointed to liquidate property transferred by a bankrupt corporation to a trust created pursuant to a Chapter 11 plan must, as a fiduciary of the trust, file returns and pay taxes due on income attributable to the debtor's property.²⁵
- Termination of Bankruptcy Proceeding When the bankruptcy estate terminates, the individual debtor succeeds to the assets and the tax

²¹ BC § 507(a)(8).

²² BC § 523(a)(1).

²³ BC § 503(b)(1)(B). Any remaining tax attributes of the estate, including carryforwards, revert to the individual when the estate is terminated. I.R.C. § 1398(i). Although beneficial to the taxpayer, this treatment is asymmetrical.

²⁴ BC § 727(b). As a practical matter, a Chapter 11 plan cannot be confirmed absent provision for payment in full of all administrative claims, including bankruptcy estate income taxes. If a bankrupt estate lacks sufficient funds to pay these taxes, the case would ordinarily be converted to a Chapter 7 liquidation case.

²⁵ I.R.C. § 6012(b)(4); *Holywell Corporation v. Smith*, 503 U.S. 47 (1992).

attributes of the bankruptcy estate in a nontaxable transfer.²⁶ Query whether this transfer can terminate the partnership and/or produce section 731 gain.

B. Partnership Debtors and Their Estates

1. Creation of New Entity

The commencement of a Title 11 case for a partnership does not create a new taxable entity for Federal income tax purposes.²⁷ Thus, no gain or loss is recognized by the partnership in connection with a deemed asset transfer, no tax credits are recaptured, and the partnership's tax year does not end.²⁸

- The debtor partnership continues to use its historic taxpayer ID number.²⁹
- The consolidation of a group of related partnerships for bankruptcy proceeding purposes does not constitute a consolidation or merger of the partnerships for tax purposes.³⁰
- The bankruptcy of a member of a consolidated group causes its partnership items to convert to non-partnership items.³¹ After the conversion, the other members of the consolidated group will no longer have their tax liability determined by reference to these items as “partnership items,” and will no longer be considered “partners” under section 6231(a)(2)(B) with

²⁶ I.R.C. § 1398(f)(2), (i).

²⁷ I.R.C. §§ 1398(b)(2); 1399.

²⁸ I.R.C. §§ 1398(b)(2); 1399.

²⁹ I.R.S., *Taxpayer Identification Numbers (TIN)*, available at [http://www.irs.gov/Individuals/International-Taxpayers/Taxpayer-Identification-Numbers-\(TIN\)](http://www.irs.gov/Individuals/International-Taxpayers/Taxpayer-Identification-Numbers-(TIN)) (last visited June 2, 2014).

³⁰ FSA 1999-52-016 (Sept. 24, 1999).

³¹ FSA 2002-03-007 (Sept. 28, 2001).

respect to the bankrupt corporation's separately held items.³²

2. Post-Petition Tax Returns and Liability

The trustee of a partnership in bankruptcy is responsible for filing the partnership's tax returns for periods after the petition date.³³

- Post-petition partnership income or gain will be passed through to the partners, which will result in phantom income if the assets of the partnership may not be used to make tax distributions to partners.³⁴

C. **Abandonment of Property by Bankruptcy Estate**

- After notice and hearing, a trustee may abandon "burdensome" property to an individual debtor or his creditors during a bankruptcy proceeding.³⁵ A trustee may be motivated to abandon property whose sale would cause the estate to realize a taxable gain without generating cash sufficient to pay the tax because unpaid bankruptcy estate taxes are *pari passu* with trustee fees.³⁶ The IRS and several courts have held that an individual's bankruptcy estate should not recognize gain when

³² FSA 2002-03-007 (Sept. 28, 2001). *But see* CCA 2012-41-007 (Oct. 12, 2012) (bankruptcy of a disregarded LLC, which was a pass-thru partner in a TEFRA partnership, did not cause partnership items attributed to LLC's owner to convert into nonpartnership items).

³³ I.R.C. § 6012(b)(3); Rev. Rul. 79-120, 1979-1 C.B. 382; *see* H.R. REP. NO. 96-833, at 21 (1980); S. REP. NO. 96-1035, at 26 (1980).

³⁴ *See* BC § 541(a)(6).

³⁵ BC § 554(a). It should be noted that lifting the automatic stay against property of the bankruptcy estate generally does not, without more, constitute abandonment of the property by the bankruptcy estate. *See Catalano v. Commissioner*, 89 A.F.T.R.2d 2002-707 (9th Cir. 2002).

³⁶ BC § 503(b)(1), (5).

property is abandoned.³⁷ These authorities rely on section 1398(f)(2) to hold that the abandonment of property is not a sale or exchange of assets, because it is a transfer from the estate to the debtor pursuant to the termination of the estate.

- However, the bankruptcy court in *In re A.J. Lane & Co.*³⁸ declined to follow the authorities cited above. In *A.J. Lane*, the trustee requested authority to abandon property of the estate, shifting the tax consequences of a subsequent foreclosure to the debtor. The court denied the trustee's request, determining that the estate would be liable for tax on the abandonment, because although section 1398(f)(2) is applicable only at the "termination" of the estate, it would be asymmetrical to have a tax-free transfer of an asset back to the individual before the individual received his other tax attributes under section 1398(i). The court acknowledged that its decision was contrary to *Olson* and *McGowan*. Although the *A.J. Lane* opinion may constitute a literally correct reading of section 1398(f)(2), courts may decline to follow the decision for policy reasons.³⁹

³⁷ For an excellent discussion of these issues, see Onsager, *Assigning Tax Liability between the Bankruptcy Estate and the Individual Debtor*, 75 J. TAX'N 102, 103 (Aug. 1991). See, e.g., *In re Olson*, 930 F.2d 6 (8th Cir. 1991) (per curiam) (real estate abandoned by a Chapter 7 trustee was later sold at foreclosure; court determined that debtor was taxable on the gain realized at foreclosure and that a taxable exchange had not occurred earlier when the property was abandoned); *In re McGowan*, 95 B.R. 104 (N.D. Iowa 1988) (Chapter 7 trustee abandoned machinery in which the debtor had no equity; relying on section 1398(f)(2), the court determined that the estate was not liable for income tax from the abandonment, because termination of an estate includes termination of an interest in property due to abandonment); Priv. Ltr. Rul. 90-17-075 (Jan. 31, 1990); Priv. Ltr. Rul. 89-18-016 (Jan. 31, 1989).

³⁸ *In re A.J. Lane & Co.*, 133 Bankr. 264 (1991).

³⁹ See *In re Olson*, 100 B.R. 458, 463 (Bankr. N.D. Iowa 1989), *aff'd*, 121 B.R. 346 (N.D. Iowa 1990), *aff'd*, 930 F.2d 6 (8th Cir. 1991) (per curiam). Defining termination of the estate as the closing of a case "would prevent the assignment of tax consequences to the estate

- When property abandoned from a bankruptcy estate is subject to recourse debt in excess of the property's fair market value, the IRS has taken the position that the bankruptcy estate has cancellation of debt ("COD") income on abandonment to the extent of the lender's claim and that the debt survives the bankruptcy discharge as *nonrecourse* debt.⁴⁰ A subsequent foreclosure by the lender would produce *Tufts* gain if the property's basis is less than the debt.⁴¹ Because COD income realized on the abandonment would reduce carryforwards, a threat of double taxation exists on a subsequent foreclosure. The IRS is apparently reconsidering its position.
- It is not clear why the IRS viewed this abandonment as a taxable event that created COD income. Query whether the basis of property abandoned by a trustee should be reduced under sections 108 and 1017. Consistent with the authority cited above, basis would not be reduced because abandoned property would be treated as if it had not entered the bankruptcy estate.

D. Abandonment of Property Outside of Bankruptcy

- Outside of the bankruptcy context, abandonment of property subject to debt is generally treated as a sale or exchange of the property that produces capital gain or loss.⁴²

when property is abandoned by operation of law as a result of its being unadministered at the close of a case." The court saw no reason why abandoning property during administration of a case should be treated differently than at the close of a case.

⁴⁰ Priv. Ltr. Rul. 89-18-016 (Jan. 31, 1989).

⁴¹ See M. Cook, C. Beckett, *The Tax Aspects of Real Estate Loan Workouts*, at 43 (unpublished manuscript on file with the author) for an analysis that this result may double count income when a taxpayer has NOLs or other carryforwards that are reduced by COD income realized by the estate.

⁴² See, e.g., *Yarbro v. Commissioner*, 737 F.2d 479 (5th Cir. 1984); *Arkin v. Commissioner*, 76 T.C. 1048 (1981); *Middleton v.*

- In a 1993 revenue ruling, the IRS held that an ordinary loss may occur on the abandonment of a partnership interest by a partner who has not been allocated a share of the partnership's debt. In such a case, the abandonment would not be accompanied by an actual or deemed distribution to the partner (*e.g.*, as a result of a decrease in the partner's share of partnership liabilities under section 752(b)), and the transaction may not otherwise constitute in substance a sale or exchange.⁴³
- Whether and to what extent Revenue Ruling 93-80 has been affected by the 1997 Taxpayer Relief Act's expansion of Section 1234A remains a somewhat open question. Section 1234A now treats gain or loss from the cancellation, lapse, expiration, or "other termination" of a right or obligation with respect to any property that is a capital asset in the hands of the taxpayer as capital gain or loss.⁴⁴
- The Fifth Circuit, reversing the Tax Court's ruling in *Pilgrim's Pride Corp. v. Commissioner*, relied on the legislative history to Section 1234A to limit the section's application to derivative or contract rights attributable to a capital assets.
 - The Tax Court had cast doubt on the viability of Revenue Ruling 93-80 in dicta in *Pilgrim's Pride Corp. v. Commissioner*, stating that the IRS does not need to update a revenue ruling to reflect changes in law, but changes in law (such as the enactment of

Commissioner, 77 T.C. 310 (1981), *aff'd* 693 F.2d 124 (11th Cir. 1982).

⁴³ See Rev. Rul. 93-80, 1993-2 C.B. 239; Treas. Reg. § 1.165-2.

⁴⁴ The legislative history to section 1234A as originally enacted, and as subsequently amended, discusses abandonment as one type of disposition that courts have held does not give rise to a sale or exchange, but the 1997 legislative history does not indicate whether the term "other termination" is meant to include abandonment. See H.R. REP. NO. 105-148, at 451-454 (1997); H.R. REP. NO. 97-201, at 212-213 (1981).

section 1234A) can change the result reached in a revenue ruling. The actual holding in the case was that the abandonment of corporate securities produced a capital loss.⁴⁵

- With respect to abandonment of partnership property, such as securities, Treasury issued final regulations in March 2008, stating that a loss resulting from the abandonment of a security will be treated in the same manner as a loss from a worthless security.⁴⁶ Therefore, a loss on the abandonment of a security that is a capital asset will generally be a capital loss.⁴⁷

E. Basis of Undersecured Property

1. Basis of Undersecured Property Acquired by Third Parties

In workout situations where property is acquired subject to nonrecourse debt in excess of the fair market value of the securing property, the author believes the purchaser should receive a basis in the property equal to the property's fair market value.⁴⁸ The IRS should not be able to successfully rely on the tax shelter cases discussed below to disallow the purchaser's basis entirely.

⁴⁵ *Pilgrim's Pride Corp. v. Commissioner*, 141 T.C. No. 17 (Dec. 11, 2013).

⁴⁶ Treas. Reg. § 1.165-5(i).

⁴⁷ See B. Peabody, *Continuing Questions Regarding Worthless Securities*, 2008 TNT 219-29 (Nov. 12, 2008).

⁴⁸ For an excellent discussion of this issue, see Taggart, P., *Workouts – Lender's Basis and Lender's Income*, 45 TAX LAW. 263 (1991-1992). Taggart, along with his partner Paul Windels, represented the taxpayers in *Pleasant Summit* and its related cases. See also E. Jensen, *The Unanswered Question in Tufts: What Was the Purchaser's Basis?*, 10 VA. TAX REV. 455 (1990-1991).

- In *Estate of Franklin*,⁴⁹ the owner of a motel “sold” the property to a buyer subject to a \$1,224,000 nonrecourse mortgage. The buyer paid the seller \$75,000 cash, which the buyer and seller characterized as prepaid interest, and agreed to pay \$9,000 a month as principal and interest installments plus a balloon payment of \$975,000 at the end of 10 years. The property was leased back to the seller for \$9,000 (an amount that exactly matched the debt service).
- The Ninth Circuit denied all depreciation deductions, holding that the taxpayer did not acquire equity in the property, because even after payments of the purchase price, the unpaid balance of the nonrecourse debt exceeded the property’s fair market value.
- In *Pleasant Summit*,⁵⁰ the taxpayer was permitted basis and depreciation deductions equal to the fair market value of the property where the debt exceeded the property’s fair market value.⁵¹ The court allowed a limited fair market value basis in the property by reasoning that a creditor would not foreclose on a property with nonrecourse debt in excess of fair market value if the debtor offered to pay the creditor an amount equal to the property’s fair market value.

⁴⁹ 554 F.2d 1045 (9th Cir. 1976), *cert. denied*, 434 U.S. 856 (1977).

⁵⁰ 863 F.2d 263 (3d Cir. 1989).

⁵¹ In *Mayerson v. Commissioner*, 47 T.C. 340 (1966), *acq.*, 1969 2 C.B. xxiv, the Tax Court held that a 99-year nonrecourse note given to purchase a building requiring minimal principal payments was nonetheless valid indebtedness that could be included in the taxpayer’s basis in the building. The parties negotiated a cash price of \$275,000, or a financed price of \$332,000. If the buyer could obtain refinancing within three years, the note could be prepaid at a discount.

- In *Isaacson v. Commissioner*,⁵² the companion case to *Pleasant Summit*, the Second Circuit reached the opposite conclusion on the same facts. That court relied on *Estate of Franklin* to deny any basis for the debt on the theory that the taxpayer lacked economic incentive to pay off the debt. The Fifth Circuit and the Ninth Circuit have adopted the approach of the Second Circuit.⁵³
- In Revenue Ruling 77-110,⁵⁴ film rights acquired in an arm's-length transaction for 200x were resold for 200x and a nonrecourse note of 1,800x. The IRS allowed a basis of 200x, holding that the note was a contingent liability that could not be included in basis because the property's fair market value was less than the nonrecourse note.⁵⁵
- In Revenue Ruling 82-224,⁵⁶ food storage containers (five-year property under I.R.C. section 168) were sold by a distributor at a price of 532x dollars. Purchasers paid 52x cash and gave a 480x note, the first 208x of which was recourse. The debt was payable in 20 years without interest, but prepayments were required monthly if profit thresholds were met.

⁵² 860 F.2d 55 (2d Cir. 1989).

⁵³ *Lukens v. Commissioner*, 995 F.2d 92 (5th Cir. 1991); *Hiderbrand v. Commissioner*, 967 F.2d 350 (9th Cir. 1992).

⁵⁴ 1977-1 C.B. 58.

⁵⁵ The IRS has determined that if a purchaser pays cash in excess of fair market value, the excess cash is not included in a purchaser's basis. See Rev. Rul. 80-42, 1980-1 C.B. 182 (film rights bought in an arm's-length transaction for 400x were resold to a partnership for 500x in cash and a 1,500x nonrecourse note; the IRS allowed a basis of only 400x (100x less than the cash paid and no inclusion of the nonrecourse debt) because the partnership could not prove that the fair market value of the property exceeded 400x)). *But see MacKenzie v. United States*, 714 F. Supp. 268 (E.D. Mich. 1989).

⁵⁶ 1982-2 C.B. 5.

Prepayments reduced the recourse debt. In determining basis, the IRS bifurcated the debt into recourse and nonrecourse obligations and ignored the nonrecourse debt. Because the taxpayer was unable to demonstrate that payments would be made prior to the 20th year, only the present value of the 208x (29.5x) plus the cash paid was included in basis. Although the IRS did not specifically mention the fair market value of the containers, it noted that 532x was more than six times the distributor's cost. The amount the IRS allowed as the depreciable basis (81.5x) was less than the distributor's cost of 88.6x.

- In *Edna Morris*,⁵⁷ a bankrupt borrower's only asset was a motel. Its obligations included a \$334,000 first lien, secured by the motel, a \$174,000 lien, secured by a second lien on the motel, and \$80,000 of unsecured claims. The court determined the motel was worth no more than \$250,000. The petitioner first purchased the stock of the corporation, which held the first and second mortgage for \$195,000, and then purchased the motel from the bankruptcy trustee for \$25,000.
- The court stated that “[w]here a corporate purchaser takes property subject to debt, the fact that the same individual or individuals own the stock of both the debtor and the creditor is not sufficient reason to disregard the debt.”⁵⁸ Relying on *Crane*, the court

⁵⁷ 59 T.C. 21 (1972), *acq.*, 1973-2 C.B. 3.

⁵⁸ The court cited *Imperial Car Distributors, Inc. v. Commissioner*, 427 F.2d 1334 (3d Cir. 1970) to support this proposition. In *Imperial*, investors bought the stock of Imperial Car Distributors, an insolvent corporation, from Imperial's parent Hambro for \$2,000. Imperial had notes to Hambro in the amount of \$115,000. For an additional \$2,000, Hambro assigned these notes to the investors. The issue before the court was whether the notes were genuine indebtedness or whether payment of the notes to the investors should be regarded as a disguised dividend. The court determined that the notes were

held that the basis of the motel included the portion of the debt that did not exceed the motel's fair market value. This result is consistent with Treasury Regulation section 1.166-6.

- In *Finkleman*,⁵⁹ the Tax Court disallowed basis for property acquired in a non-arm's-length transaction subject to debt equaling 139% to 172% of the property's fair market value, because the debt did not "approximate" such fair market value.
- In *MacKenzie v. U.S.*,⁶⁰ a purchaser paid \$70,000 in cash and issued \$130,000 of notes to purchase two films. The court's opinion did not specify whether the notes were recourse or nonrecourse. The jury determined that the purchaser paid \$300,000 for the two films and that the fair market value of the two films was only \$135,000. The court allowed a basis of \$300,000 pursuant to a jury determination that the films were purchased to achieve a profit and the parties intended the debt to be repaid. The jury relied on the court's statement in *Estate of Franklin* that the "focus on the relationship of the fair market value of the property to the unpaid purchase price should not be read as premised upon the belief that a sale is not a sale if the purchaser pays too much."

genuine debt. Taggart criticizes *Edna Morris*'s reliance on *Imperial* because "the opinion [in *Imperial Car*] does not reveal that anyone argued that the debt should be disregarded merely because it was held by the owners of the capital stock." Taggart, *Workouts – Lender's Basis and Lender's Income* at 270, n.34.

⁵⁹ T.C. Memo 1989-72 (1989), *aff'd*, 937 F.2d 612 (9th Cir. 1991).

⁶⁰ 714 F. Supp. 268 (E.D. Mich. 1989).

2. Basis of Undersecured Property Acquired by Lenders

Foreclosures and deeds in lieu of foreclosure are each treated as sales or exchanges of property.⁶¹

- The creditor realizes income or loss (a bad debt deduction) equal to the difference between the amount of the debt and the fair market value of the property when it acquires the property.⁶² Any gain recognized, *e.g.*, because the creditor had previously written down its debt below the property's fair market value, is ordinary income to the creditor.⁶³ If the creditor takes title to the property in a separate entity to avoid extinguishing the debt, the amount of the debt is subsequently limited to the property's fair market value.⁶⁴
- A 2011 generic legal advice memorandum (the "GLAM") denied a bad debt deduction to the parent and creditor of an insolvent foreign corporate subsidiary that elected classification as a partnership under the "check-the-box" regulations. The parent was deemed to receive the assets in a liquidation, then contribute them to the partnership, and the fact that local law treated the debt as surviving the

⁶¹ *Allan v. Commissioner*, 86 T.C. 655 (1986), *aff'd*, 856 F. 2d 1169 (8th Cir. 1988).

⁶² Treas. Reg. § 1.166-6(c).

⁶³ Rev. Rul. 72-238, 1972-1 C.B. 65.

⁶⁴ Treas. Reg. § 1.166-6(a). The separate entity could be structured as an LLC or a corporation. Use of an LLC presents tax issues for REITs, RICs, tax-exempts, and foreign holders, whereas a corporation avoids many of these issues (although it may be subject to FIRPTA tax as a United States real property holding corporation). *See* I.R.C. § 897. However, use of a corporation would generally subject U.S. holders to two levels of tax.

reclassification meant that it was not worthless.⁶⁵

- The GLAM conflicts with Revenue Ruling 2003-125, which indicated that the creditor might be entitled to a deduction if the debtor elected disregarded entity treatment, and with the proposed “no net value” regulations, which implied that contributions of overencumbered property to a partnership would not be protected by section 721.⁶⁶ Other commentators have pointed out that the GLAM’s conclusion that no significant modification of the debt occurred under Treasury Regulation section 1.1001-3 might be incorrect if the debt were recharacterized as equity under an *Estate of Franklin* theory.⁶⁷ The GLAM also relied on the application of section 752(c) to check-the-box transactions, which could produce additional basis consequences.⁶⁸
- The creditor’s tax basis in property received in satisfaction of undersecured debt is the fair

⁶⁵ A.M. 2011-003 (Aug. 18, 2011). *See also* Wade Sutton, *Check-the-Box Elections of Insolvent Entities*, 2012 TNT 79-5 (Mar. 28, 2012) (discussing implications of the GLAM).

⁶⁶ *See, e.g.*, Amy S. Elliott, *Practitioners Troubled by Memo Involving Worthless Partnership*, 135 TAX NOTES 545 (Oct. 31, 2011); Debra J. Bennett, “Check-the-Box on an Insolvent Corporation? Maybe Not,” TAXES—THE TAX MAGAZINE, at 7 (Feb. 2012).

⁶⁷ *See* Sutton, *Check-the-Box Elections of Insolvent Entities*, 2012 TNT 79-5 (Apr. 1992)

⁶⁸ If a partner is able to apply section 752(c) to a deemed distribution of overencumbered property, the distributee partner’s basis will be reduced by the fair market value of the property, rather than the larger liability. Section 752(c) may also shift basis among contributing partners. For a general discussion of these issues, *see* Jackel and Holovach, *Contributions to No Net Equity Partnerships*, 2012 PARTNERSHIP TAX REPORT 569 (2012).

market value of the property at the time of acquisition.⁶⁹

- When two creditors jointly take back overencumbered property subject to two loans and only the second mortgage is under water, the better view is that the first lender should take basis equal to the face amount of its note, and receive no bad debt loss. The junior lender should take a basis equal to the fair market value in excess of the first note, if any, and receive a bad debt loss.

F. Gain and COD Income Recognition when Debt Is Discharged

1. Forgiveness of Nonrecourse Debt

When nonrecourse debt is forgiven in return for a transfer of the collateral, a debtor recognizes section 1001 gain equal to the adjusted issue price of the debt less the adjusted basis of the property that secures the debt, but the transfer does not give rise to COD income.⁷⁰ A creditor's foreclosure on property purchased with nonrecourse debt is considered a sale by the debtor partnership, and any resulting gain would be allocated among the partners under section 704.⁷¹ By contrast, a

⁶⁹ Treas. Reg. § 1.166-6(c). Prior to 1996, if a creditor was a section 593(a) organization (a mutual savings bank, a domestic building and loan association or a cooperative bank), no gain or loss was recognized and no debt became worthless when the creditor received the property. Gain or loss was recognized only upon the final disposition of the secured property. The creditor's basis in the property was the adjusted basis of the debt when the creditor acquired the property. Section 595(a), (c). Section 595 was repealed by the Small Business Job Protection Act of 1996, effective January 1, 1996. See Pub. L. No. 104-188.

⁷⁰ *Commissioner v. Tufts*, 461 U.S. 300 (1983); see also Treas. Reg. § 1.1001-2(c), Ex. 7.

⁷¹ See *Dannenberg v. Commissioner*, 73 T.C. 370 (1979), *acq.*, 1980-1 C.B. 1.

reduction in a nonrecourse liability without a surrender of the collateral gives rise to COD income.⁷²

- The Fifth Circuit held in *Briarpark v. Commissioner*⁷³ that discharge of a portion of undersecured nonrecourse debt conditioned on a sale of the real property securing the debt results in gain from a disposition of property under section 61(a)(3) rather than COD income under section 61(a)(12). In *Briarpark*, the lender allowed the debtor partnership to sell the property, but conditioned the release of its lien upon sale for a minimum gross sale price and receipt of the sale proceeds. Because the debtor's cancellation of income was simultaneous and closely intertwined with the sale of the property, the Fifth Circuit Court of Appeals held that the cancellation and sale constituted a single transaction, causing the debtor to recognize a capital gain on the sale.⁷⁴
- *Briarpark* suggests that if the debtor and lender agree to reduce the amount of outstanding debt to the fair market value of the collateral, and the debtor uses other funds to satisfy the debt, the debtor should realize COD income rather than capital gain with respect to the reduction in debt, even if the debtor subsequently disposes of the property.⁷⁵ It may be difficult to convince a lender to permit a sale of collateral before the debt is repaid in a transaction that would be

⁷² Rev. Rul. 91-31, 1991-1 C.B. 19; *see also Gershkowitz v. Commissioner*, 88 T.C. 984 (1987).

⁷³ 163 F.3d 313 (5th Cir. 1999).

⁷⁴ *Briarpark*, at 318.

⁷⁵ Jim Sowell thoughtfully raises the issue of what result would obtain if the debtor borrows money to pay off the current lender, and the new lender conditions the loan on the borrower's commitment to dispose of the property and transfer the proceeds to the lender in a short period of time. For a discussion of these issues, *see J. Sowell, Partnership Workouts*, 750 PLI/TAX 69 (2007).

treated as separate from the discharge of the liability under the *Briarpark* standards, although these transactions could also be explored. If the debtor provides additional security, however, a lender may be willing to substitute collateral and reduce the principal amount of outstanding debt.

- By contrast, COD income may result when nonrecourse debt is satisfied with an amount of cash less than the debt cancelled, and the borrower retains the collateral.⁷⁶
- COD income is also recognized when the principal amount of nonrecourse debt is reduced. For example, COD income would be recognized if a lender chose to reduce the principal amount of the debt, rather than foreclose on its collateral, where the property's fair market value had decreased below the amount of outstanding debt.⁷⁷
- Commentators have criticized the conclusion that such a reduction of debt results in COD income (rather than section 1001 gain) because, contrary to the situation in *United States v. Kirby Lumber*⁷⁸ (where a corporation bought its own bonds back at a discount), the debtor in Revenue Ruling 91-31 was not relieved of personal liability on the note, and the fair market value of the property securing the note was less than the amount of debt.⁷⁹

⁷⁶ *Gershkowitz v. Commissioner*, 88 T.C. 984, 1006 (1987).

⁷⁷ See Rev. Rul. 91-31, 1991-1 C.B. 19.

⁷⁸ 281 U.S. 1 (1931).

⁷⁹ See Ricketts, *Discharged Indebtedness: Evaluating the Service's Position in Revenue Ruling 91-31*, 9 J. TAX INVEST. 108 (1992) (arguing that Revenue Ruling 91-31 is inconsistent with prior law and that the correct result might have been a retroactive basis adjustment).

- Others have noted that requiring immediate recognition of COD income after restructurings thwarts the fresh start goal of section 108.⁸⁰
- Applicability of COD Income Insolvency Exclusion The IRS has ruled that when nonrecourse partnership debt is discharged it is treated as a “liability” for purposes of determining whether a partner would be eligible for the insolvency exception to COD income. In Revenue Ruling 2012-14, the IRS concluded that discharged excess nonrecourse liabilities “should be associated with the partner who in the absence of the insolvency or other section 108 exclusion would be required to pay the tax liability arising from the discharge of that debt.”⁸¹ Thus, a partner could treat a partnership’s discharged excess nonrecourse debt as a liability for insolvency purposes under section 108(d)(3) to the extent of its allocable share of the partnership’s liabilities.

Example: A debtor incurs a \$1 million nonrecourse debt secured by a building having a \$1 million fair market value. The value of the building then depreciates to \$800,000, and the lender agrees to reduce the nonrecourse debt to

⁸⁰ See Witt, *Canceled Debt May Leave Taxes Due*, 135 TAX NOTES 201 (Apr. 9, 2012) (arguing that changes to section 108, such as the repeal of the qualified business indebtedness and equity-for-debt exceptions, have made it extremely difficult for debtors to obtain relief, and that COD income should be deferrable though the use of tax attributes); Levy and Hofheimer, *Bankrupt Partnerships and Disregarded Entities*, 127 TAX NOTES 1103, 1124–25 (June 7, 2010) (describing situations in which inapplicability of section 108 exemptions harms debtors, creditors, and the public and urging entity-level analysis of the exceptions).

⁸¹ Rev. Rul. 2012-14, 2012-24 I.R.B. 1012, *amplifying* Rev. Rul. 92-53, 1992-2 C.B. 48 (ruling similarly in the context of individual taxpayer nonrecourse liabilities); *see also* James B. Sowell, *Good News Regarding Partnership Debt and Partner Insolvency*, 136 TAX NOTES 99 (July 2, 2012).

\$825,000. The debtor has other assets with an aggregate fair market value of \$100,000.

Result: The debtor realizes COD income of \$175,000 that is excluded under section 108(a)(1)(B) to the extent of the debtor's insolvency. In determining the debtor's insolvency, the \$1 million nonrecourse debt is treated as a "liability" to the extent of \$975,000, *i.e.*, the sum of (i) the collateral's fair market value of \$800,000 and (ii) the "excess" nonrecourse debt discharged of \$175,000. Thus, the debtor is "insolvent" to the extent of the excess of liabilities (\$975,000) over the fair market value of its assets (\$900,000). Because the debtor is "insolvent" to the extent of \$75,000 immediately prior to the discharge, the debtor recognizes COD income of \$100,000.

Note: The IRS has ruled that a partner that has loaned nonrecourse debt to a partnership should not be allocated a share of those liabilities for purposes of applying the insolvency exception.⁸² In the example above, if the debtor were a partnership, the partners would normally be allocated both the COD income and the discharged nonrecourse liabilities according to the partnership agreement, under section 704(b).⁸³ However, it is not clear how the liabilities would be taken into account (or allocated) to determine insolvency once the lender-partner's share is excluded from the calculation.

2. Forgiveness of Recourse Debt

When recourse debt is forgiven, a debtor recognizes COD income equal to the excess of adjusted issue price of the debt over the property's fair market

⁸² See Amy S. Elliott, *Recent Share-of-Liability Guidance Doesn't Extend to Partner Lender*, 2013 TNT 86-1 (May 6, 2013).

⁸³ Rev. Rul. 2012-14, 2012-24 I.R.B. 1012.

value, and section 1001 gain equal to the property's fair market value less its adjusted basis.⁸⁴

- In *Chilingirian v. Commissioner*,⁸⁵ a debtor was relieved of personal liability on two mortgages in the amount of \$170,000. The debtor quit-claimed the deed to one of the mortgage holders, who then assumed liability for the remaining mortgage. The Sixth Circuit affirmed the Tax Court's decision that the debtor recognized capital gain under section 1001 equal to the excess of the amount of the mortgages discharged on the foreclosure over its basis in the property. It is not clear whether the property's value equaled \$170,000—the principal amount of the two recourse mortgages—because the fair market value was neither disclosed nor discussed.
- It is unclear whether debt that is recourse to the assets of a partnership but as to which some or all of the partners have no liability should properly be characterized as recourse or nonrecourse for purposes of determining whether the partners should be allocated *Tufts* gain or COD income. On one hand, the partnership's recourse debt has been discharged, which could logically produce COD income that should be allocated among the partners.⁸⁶ On the other hand, the section 752 regulations provide that a partnership liability is a "nonrecourse liability" if and to the extent that no partner or related person bears the economic

⁸⁴ Rev. Rul. 90-16, 1990-1 C.B. 12.

⁸⁵ 918 F.2d 1251 (6th Cir. 1990).

⁸⁶ See K. Burke, *Exculpatory Liabilities and Partnership Nonrecourse Allocations*, 57 TAX LAW. 33, 37 (2003). This would lead to the somewhat odd result, for example, of a partner-member in an LLC being allocated COD income despite the member's limited liability and the general nonrecourse treatment of such debt for section 752 purposes.

risk of loss for that liability.⁸⁷ These regulations would imply that COD income is an inappropriate result for a partner who bears no economic risk of loss and therefore, had no liability discharged.⁸⁸ A Tax Court decision seems to provide some support for this view.⁸⁹

3. Forgiveness of Guaranteed Debt

When a nonrecourse note is subject to a partial guarantee, the note should be split into recourse and nonrecourse notes.

- Where a limited partnership purchased property with a fair market value of 400x for 50x cash and a 350x note secured by the property, and the general partner was personally liable for up to 150x if a default occurred, the IRS bifurcated the 350x note. For purposes of Treasury Regulation section 1.752-1(e), 150x represented a recourse note and 200x represented a nonrecourse note. The IRS increased the limited partner's basis by only its proportionate

⁸⁷ See Treas. Reg. § 1.752-1(a)(2).

⁸⁸ Proponents of treating the debt as producing COD income would counter that the section 752 regulations only technically apply for purposes of classifying partnership debt at the partner level and not for characterizing income that results in the partnership. For an excellent discussion of this issue, see J. Sowell, *Debt Workouts: The Partnership and the Partners*, 871 PLI/TAX 817 (2009).

⁸⁹ *Great Plains Gasification Associates v. Commissioner*, T.C. Memo 2006-276 (2006). In this case, the Tax Court held that ostensibly recourse debt of a general partnership was treated as nonrecourse, due in part, to the fact that no partner was personally liable for the partnership's debt. Some commentators have criticized the decision as importing a partnership definition of nonrecourse debt to section 1001 (as the decision involved the amount realized from a foreclosure sale). See Brown, *Difference Between Recourse, Nonrecourse Debt Unclear in Law, Conference Panel Says*, DAILY TAX REP. (BNA), No. 87, at G-6 (May 6, 2013).

share of the non-guaranteed portion of the note that was treated as nonrecourse.⁹⁰

- Basis and fair market value are allocated first to nonrecourse debt (because a nonrecourse lender looks only to the property to satisfy the debt).⁹¹ This arbitrary result maximizes the potential for COD income.

4. Exclusion of Qualified Principal Residence Debt

Qualified principal residence indebtedness (“QPRI”) secured by the taxpayer’s principal residence that is discharged before January 1, 2014 due to a decline in the value of the residence or the financial condition of the taxpayer will be excluded from the taxpayer’s income.⁹²

- QPRI is defined as up to \$2 million of debt (\$1 million for married persons filing separately) secured by the taxpayer’s principal residence that is incurred to acquire, construct, or substantially improve such residence, including debt incurred to refinance outstanding QPRI.⁹³
- Any QPRI excluded from a taxpayer’s income will reduce the taxpayer’s basis in his or her principal residence dollar for dollar, but not below zero.⁹⁴
- The QPRI exclusion will apply before the section 108(a)(1)(B) insolvency exception, unless a taxpayer elects to apply the insolvency exception in lieu of the QPRI exclusion.⁹⁵

⁹⁰ Rev. Rul. 84-118, 1984-2 C.B. 120.

⁹¹ Priv. Ltr. Rul. 83-480-01 (Aug. 18, 1983).

⁹² I.R.C. § 108(a)(1)(E), (h)(3).

⁹³ I.R.C. § 108(h)(2).

⁹⁴ I.R.C. § 108(h)(1).

⁹⁵ I.R.C. § 108(a)(2)(C).

5. Exclusion of COD Income and Forgiveness of a Contingent Liability

Generally, part or all of a debtor's COD income may be excluded from gross income if the debtor is insolvent at the time the debt is discharged.⁹⁶

However, this exclusion is limited to the amount by which the taxpayer is insolvent.⁹⁷ For these purposes, insolvency is defined as "the excess of liabilities over the fair market value of assets."⁹⁸

There has been significant uncertainty regarding the extent to which contingent liabilities will be taken into account in determining solvency. The Ninth Circuit has affirmed the Tax Court's holding that a contingent obligation constitutes a liability for these purposes only when it is "more likely than not" that the taxpayer will be required to pay such liability.⁹⁹

6. Exclusion of "Lost" Deductions

No COD income is realized to the extent payment of the cancelled liability would give rise to a deduction.¹⁰⁰ Common examples of such liabilities are interest (and OID), salary, and rent.¹⁰¹ Thus, to the extent a debtor has not already claimed a

⁹⁶ I.R.C. § 108(a)(1)(B).

⁹⁷ I.R.C. § 108(a)(3).

⁹⁸ I.R.C. § 108(d)(3).

⁹⁹ *Merkel v. Commissioner*, 192 F.3d 844 (9th Cir. 1999), *aff'g* 109 T.C. 463 (1997). *See also* Raby and Raby, *Measuring Assets and Liabilities for DOI Purposes*, 1999 TNT 189-34 (Sept. 1999).

¹⁰⁰ I.R.C. § 108(e)(2). The debtor is treated as recognizing income with respect to the payment and an offsetting deduction on repayment of the money to the creditor. Prior to the enactment of section 108(e)(2) in 1980, common law did not contain a similar rule that would exclude from COD income liabilities the payment of which would have been deductible. *See Schrott v. Commissioner*, T.C. Memo 1989-346 (1989).

¹⁰¹ Section 108(e)(3) adjusts the amount of COD income by remaining premium or discount on the discharged debt.

deduction for such liabilities, *e.g.*, as accrued expenses, the forgiveness of such liabilities would not create COD income.

- Depending on the character of the deductible expenditure, this exclusion might apply at either the partnership or partner level, since section 702 allows certain deductions to be netted against income at the partnership level and permits other items to be passed through and deducted as separately stated items on the partner's return. Accordingly, the exclusion should logically apply to a liability (or not) at the same level where the deduction would be claimed.

7. Exclusion of COD Income Associated with Qualified Real Property Businesses

- Solvent taxpayers other than C corporations may generally elect to exclude certain COD income generated when qualified real property business indebtedness ("QRPBI") is discharged.¹⁰² The election requires the taxpayer to reduce its tax basis of its depreciable real property by a corresponding amount.¹⁰³ An amount equal to the excluded COD income (*i.e.*, the amount of the basis reduction) is recaptured as ordinary income upon a sale of the reduced-basis property.¹⁰⁴ The taxpayer may select the depreciable assets whose basis will be reduced.¹⁰⁵

¹⁰² I.R.C. § 108(a)(1)(D), (c).

¹⁰³ I.R.C. §§ 108(a)(1)(D), (c)(1); 1017.

¹⁰⁴ I.R.C. § 1017(d).

¹⁰⁵ See Priv. Ltr. Rul. 88-24-005 (Jan. 29, 1988); Priv. Ltr. Rul. 87-480-05 (June 26, 1987); Rev. Proc. 85-44, 1985-2 C.B. 504; Bruce D. Haims, *Bankruptcy as a Tax Planning Device: Workouts vs. Chapter 11*, 49 N.Y.U. ANN. INST. ON FED. TAX'N § 23.04[1] n.47 (1991).

- The general attribute reduction rules of section 108(b)(2) require basis reduction in both depreciable and non-depreciable assets but do not require the basis of assets to be reduced below the aggregate amount of liabilities immediately after the discharge.¹⁰⁶ Under section 108(b)(5), basis reduction applies only to depreciable assets, but their basis may be reduced to zero.¹⁰⁷
- Basis reductions under either section 108(b)(2) or section 108(b)(5) are treated as depreciation deductions, and the reduced-basis property is treated as section 1245 property if it would not otherwise be treated as section 1245 or 1250 property.¹⁰⁸ Accordingly, subsequent dispositions of that property may result in section 1245 or 1250 recapture that treats all or part of the gain as ordinary income.
- QRPBI generally includes debt incurred or assumed in connection with the acquisition or substantial improvement of real property used in a trade or business *and* secured by the real property.¹⁰⁹
- Revenue Procedure 2014-20 provides a safe harbor under which debt that is secured by 100% of the ownership interests in a disregarded entity that holds real property may be treated as debt secured by real property for

¹⁰⁶ I.R.C. § 1017(b)(2).

¹⁰⁷ I.R.C. § 1017(b)(2).

¹⁰⁸ I.R.C. § 1017(d)(1).

¹⁰⁹ I.R.C. § 108(c)(3). Debt incurred or assumed before January 1, 1993 will constitute QRPBI if it is secured by real property used in a trade or business at the time the debt is incurred or assumed. I.R.C. § 108(d)(3)(B); *see also* TAM 2000-14-007 (Dec. 13, 1999).

purposes of section 108(c)(3)(A) if certain requirements are satisfied.¹¹⁰

- Debt secured by raw land, or by real estate that is subject to a net lease, generally is not QRPBI.
- It is not clear whether accrued unpaid interest on QRPBI is itself QRPBI.¹¹¹ However, the author believes the better view is to treat accrued but unpaid interest on QRPBI as QRPBI.
- In light of the ordinary income recapture rule, taxpayers should, in general, make a QRPBI COD income election only if and when they intend to retain the real property whose basis is reduced for a period such that the benefit of deferring COD income recognition outweighs the detriment of transforming a like amount of long-term capital gain into ordinary income when the property is sold.
- The amount of COD income that may be excluded when QRPBI is discharged is subject to two limitations:
 - First, the excluded COD income is limited to the excess of (i) the outstanding principal amount of QRPBI, including other QRPBI secured by the same real property (whether or not such other debt is discharged), over (ii) the fair market value of the real property securing the QRPBI immediately before the

¹¹⁰ Rev. Proc. 2014-20, 2014-9, I.R.B. 614.

¹¹¹ The preamble to the final regulations under section 108 notes the receipt of comments requesting that accrued and unpaid interest be included in determining outstanding principal amount of debt for purposes of the section 108(c)(2)(A) limitation. T.D. 8787, 1998-46 I.R.B. 5 (Oct. 21, 1998). The regulation includes accrued and unpaid interest, but only for the purposes of computing outstanding principal amount and not (at least explicitly) for purposes of determining the amount of QRPBI. Treas. Reg. § 1.108-6(a).

discharge.¹¹² To the extent the discharge creates equity in the secured property, taxpayers may not exclude COD income related to QRPBI.¹¹³

- Second, the amount of excludable COD income is limited to the taxpayer's aggregate adjusted tax basis in its depreciable real property held immediately prior to the discharge, determined after reducing the property's basis pursuant to sections 108(b) and (g), and excluding any depreciable real property acquired in contemplation of the discharge.¹¹⁴ The second limitation ensures that a taxpayer incurs some tax detriment to offset the benefit of excluding COD income.
- The QRPBI COD income election generally applies at the partner level.¹¹⁵ However, the determination of (i) whether partnership debt constitutes QRPBI, and (ii) the fair market value limitation on the amount of COD income a taxpayer may elect to exclude are each made at the partnership level.¹¹⁶

¹¹² I.R.C. § 108(c)(2)(A). The outstanding principal amount of QRPBI is not necessarily the stated principal amount of the liability. Rather, the outstanding principal amount of debt includes all additional amounts owed with respect to which interest accrues and compounds. Outstanding principal amount does not include amounts subject to section 108(e)(2), and is also adjusted for unamortized premium and discount pursuant to section 108(e)(3). Treas. Reg. § 1.108-6(a).

¹¹³ H.R. REP. NO. 103-111, at 622-23 (1993).

¹¹⁴ I.R.C. § 108(c)(2)(B).

¹¹⁵ I.R.C. § 108(d)(6).

¹¹⁶ H.R. REP. NO. 103-111, at 624 (1993). In the case of a tiered partnership, the partners in the upper tier can treat their portions of any lower-tier partnership's QRPBI as QRPBI and their interests in the lower-tier partnership as depreciable real property in proportion to their allocable shares of the depreciable real property of the partnership. Priv. Ltr. Rul. 94-26-006 (Mar. 25, 1994). *See*

- A partner's interest in a partnership may constitute depreciable real property to the extent of the partner's allocable share of the partnership's basis in depreciable real property taking into account section 704(c), but only if the partnership agrees to reduce its inside basis in its depreciable real property with respect to the electing partner.¹¹⁷ Such a reduction is made consistent with, and has the same effect as, basis adjustments occasioned by elections under sections 743(b) and 754.¹¹⁸
- If the electing partner's interest is subsequently completely liquidated in exchange for a distribution of property acquired after the reduction in the electing partner's inside basis, the basis of the distributed property would presumably be reduced by an amount equal to the electing partner's inside basis reduction immediately before the distribution under section 743 principles.¹¹⁹
- A partner that makes the QRPBI COD income election must request the partnership's consent to reduce the partnership's basis in depreciable property

SHEINFELD, COLLIER ON BANKRUPTCY TAXATION ¶ 13.03[1] (2007).

¹¹⁷ I.R.C. § 1017(b)(3)(C); Treas. Reg. § 1.1017-1(g)(2)(i), (iv). Though not statutorily prescribed, the basis limitation used to determine the amount of excludable COD income should include the partnership interest to the extent of each partner's allocable share of the partnership's depreciable real property. See Pollack, Goldring and Oliver, *Federal Income Tax Consequences of the Discharge of Qualified Real Property Business Indebtedness*, 12 TAX MGMT. REAL EST. J. 230 (1996).

¹¹⁸ Treas. Reg. § 1.1017-1(g)(2)(v)(C).

¹¹⁹ See Treas. Reg. § 1.743-1(g)(3).

with respect to that partner.¹²⁰ Partnership consent is required if requested by (i) partners owning directly or indirectly more than 80 percent of the capital and profits interests of the partnership, or (ii) five or fewer partners owning directly or indirectly more than 50 percent of the capital and profits interest of the partnership.¹²¹

- An election to exclude COD income from QRPBI may not be beneficial to some (or all) partners when nonrecourse partnership debt is discharged. Because an electing partner's mandatory inside basis reduction does not occur until the first day of the subsequent taxable year, the partnership may have a decrease in minimum gain at year end, requiring a minimum gain chargeback. The resulting income allocations required under minimum gain chargeback rules may be inconsistent with the otherwise anticipated allocation of COD income among the partners.¹²²

8. Scope of Section 108(e)(5) COD Income Exclusion

Section 108(e)(5) provides that a reduction in the principal amount of a purchase-money nonrecourse debt that would normally produce COD income for the debtor will be automatically treated as a purchase price adjustment. However, if the principal amount of a purchase-money nonrecourse debt is reduced by a debtholder other than the seller of the property, the debt reduction generally may not be treated as a purchase price adjustment (unless the reduction is due to an infirmity that clearly

¹²⁰ Treas. Reg. § 1.1017-1(g)(2)(ii)(B).

¹²¹ Treas. Reg. § 1.1017-1(g)(2)(ii)(C).

¹²² See Treas. Reg. § 1.704-2(j)(2)(i).

relates back to the original sale).¹²³ Instead, the debt reduction generates COD income.¹²⁴

- Section 108(e)(5) applies at the partnership level and technically does not apply when the partnership that owns the subject property is bankrupt or insolvent.¹²⁵ The IRS has recognized, however, that determining the partnership's eligibility for this reduction based on its own bankruptcy or insolvency is inconsistent with other (partner-level) COD income determinations, and has provided that it will not challenge the treatment of the reduction of debt of a bankrupt or insolvent partnership as a purchase price adjustment if the transaction would so qualify under section 108(e)(5) but for the partnership's bankruptcy or insolvency,¹²⁶ and the partnership and all its partners report the transaction consistently.¹²⁷

9. COD Income and Passive Activity/At-Risk Loss Limitation

COD income will be characterized as income from a passive activity for section 469 purposes if, and to the extent that, the debt is allocated to passive

¹²³ *Preslar v. Commissioner*, 167 F.3d 1323 (10th Cir. 1999); Rev. Rul. 92-99, 1992-2 C.B. 518. This ruling does not address whether a common law exception would apply in a similar case.

¹²⁴ See I.R.C. § 108(e)(5)(A) (statutory purchase price reduction rule applies only if debt held by original seller and owed by original buyer at time of reduction). *But see* Priv. Ltr. Rul. 90-37-033 (June 18, 1990) (section 108(e)(5) applies even though debt obligation assumed by wholly owned corporation of original buyer).

¹²⁵ I.R.C. § 108(e)(5)(B); Priv. Ltr. Rul. 84-29-001 (Mar. 12, 1984) (holding that 108(e)(5) applies at the partnership level).

¹²⁶ Rev. Proc. 92-92, 1992-2 C.B. 505; *see also* Priv. Ltr. Rul. 2003-36-032 (June 10, 2003) (insolvent partnership allowed to treat discharge of indebtedness as a purchase price adjustment rather than taxable income).

¹²⁷ Rev. Proc. 92-92, 1992-2 C.B. 505.

activity expenditures when the debt is discharged.¹²⁸ COD income resulting from the same activity that generates losses limited by the at-risk rules may be counted as income that increases the loss limitation under section 465(d).¹²⁹

10. Deferral of COD Income Under Section 108(i)

- The American Recovery and Reinvestment Act of 2009¹³⁰ (the “Recovery Act”) enacted section 108(i), which provided a limited elective exception from current recognition of COD income for debt restructured before January 1, 2011.
- Under section 108(i), a corporation or any other taxpayer that issued a debt instrument in connection with a trade or business may irrevocably elect to defer COD income resulting from the acquisition of the taxpayer’s debt instrument in 2009 and 2010 by the taxpayer or any person related to the taxpayer.¹³¹
- Where a partnership that issued a debt instrument had both “trade or business assets” and “non-trade or business assets,” it is unclear whether the debt instrument would have been treated as issued “in connection with a trade or business.” Furthermore, where a partnership used only part of the proceeds from a debt issuance in connection with a trade or business, it is

¹²⁸ Rev. Rul. 92-92, 1992-2 C.B. 103.

¹²⁹ See FSA 2000-43-004 (Jul. 11, 2000) (allowing limited partners in a registered tax shelter to deduct losses to the extent of COD income arising from the same activity, subject to the basis limitation of section 704(d)).

¹³⁰ Pub. L. No. 111-5.

¹³¹ I.R.C. § 108(i)(1). Taxpayers deferring income under section 108(i) do not reduce their tax attributes, such as NOLs or their tax basis in property, as would be required for COD income exclusions under section 108(a)(1).

unclear whether section 108(i) would have required the partnership to trace the proceeds of the debt issuance. It is also unclear whether a debt instrument issued by a partnership that held only investment assets would be treated as issued “in connection with a trade or business.” Accordingly, the New York State Bar Association and other commentators have sought guidance on the meaning of “in connection with a trade or business.”¹³²

- For the purpose of section 108(i), an “acquisition” includes (i) the acquisition of a debt instrument for cash, (ii) the exchange of a debt instrument for another debt instrument (including any deemed exchange resulting from a modification of the debt instrument), (iii) the exchange of corporate stock or a partnership interest for a debt instrument, (iv) the contribution of a debt instrument to the capital of the issuer, and (v) the complete forgiveness of a debt instrument by a holder of the instrument.¹³³
- Commentators have noted that the exchange of a debt instrument for property, *e.g.*, in a foreclosure, is not included in the definition of “acquisition” in section 108(i)(4)(B).¹³⁴ There is no stated policy reason for this omission, and the House Conference Report makes clear that the list of “acquisition” transactions in

¹³² See New York State Bar Association Tax Section, *Report on the Cancellation of Indebtedness and HYDO Rules of Section 108(i) and 163(E)(5)(F)*, 2009 TNT 80-22 (April 29, 2009).

¹³³ I.R.C. § 108(i)(4)(B).

¹³⁴ J. Sowell, *Partnerships and COD Deferral: Not Exactly a Match Made in Heaven*, 2009 TNT 79-12 (April 27, 2009).

section 108(i)(4)(B) is not exclusive.¹³⁵
 Treasury has indicated that it is
 considering this issue.¹³⁶

- COD income that is deferred under section 108(i) must be included in the taxpayer's gross income ratably in the five taxable years beginning in (i) the fifth taxable year following the taxable year of reacquisition for reacquisitions in 2009, or (ii) the fourth taxable year following the taxable year of reacquisition for reacquisitions in 2010. Thus, calendar year taxpayers that elect to defer COD income under section 108(i) will defer their COD income realized in 2009 and 2010 until 2014, and will include 20% of the COD income in each of taxable years 2014 through 2018.¹³⁷
- If a taxpayer elects to defer COD income under section 108(i) and issues a debt instrument in connection with the acquisition of the taxpayer's original debt instrument, any OID deductions on the newly issued debt instrument that accrue before the taxpayer begins to report the deferred COD income are also deferred to the extent of the deferred COD. Therefore, the OID deductions will be allowed ratably over the same five-year period over which the COD income is recognized.¹³⁸
- Any deferred COD income will be accelerated in the taxable year in which the taxpayer (i) liquidates or sells substantially all of its assets (including in a Title 11 or similar case), (ii) ceases to do business, or (iii) experiences

¹³⁵ See H.R. CONF. REP. NO. 111-16, at 564 (2009) (list of "acquisition" transactions is "without limitation").

¹³⁶ See *Guidance On Election For Deferral of COD Income Expected This Summer, Officials Say*, DAILY TAX REP. (BNA), No. 106, at G-6 (June 5, 2009).

¹³⁷ I.R.C. § 108(i)(1).

¹³⁸ I.R.C. § 108(i)(2).

similar circumstances.¹³⁹ In the case of a pass-through entity, such as a partnership, deferred COD income will be accelerated upon the sale, exchange or redemption of an interest in the entity.¹⁴⁰ In such a case, presumably, only the selling partner's share of the deferred COD income would be accelerated, and not the entire amount of deferred COD income of the partnership; the language of section 108(i), however, is ambiguous on this point. The ABA has recommended that Treasury or the IRS clarify that a sale, exchange or redemption of a partnership interest by one partner does not accelerate recognition of deferred COD income to the other partners.¹⁴¹

- A taxpayer that elected to defer COD income under section 108(i) with respect to the acquisition of a debt instrument may not benefit from any other COD income exclusions with respect to the same debt instrument.¹⁴² Therefore, taxpayers who would otherwise qualify for a COD income exclusion under section 108(a)(1) had to carefully evaluate the advantages and disadvantages of making a section 108(i) election. Generally, taxpayers who were eligible for a COD income exclusion, such as bankrupt or insolvent taxpayers, would have preferred to exclude (rather than defer) COD income, although there may have been some scenarios where taxpayers would have preferred to make the section 108(i) election.
- The section 108(i) election was made on a debt-instrument-by-debt-instrument basis.¹⁴³

¹³⁹ I.R.C. § 108(i)(5)(D).

¹⁴⁰ I.R.C. § 108(i)(5)(D)(ii).

¹⁴¹ *See ABA Members Seek Guidance For Partnerships on COD Deferral Election*, 2009 TNT 85-22 (May 6, 2009).

¹⁴² I.R.C. § 108(i)(5)(C).

¹⁴³ I.R.C. § 108(i)(5)(B)(i).

Moreover, the IRS clarified that a taxpayer could elect to limit its deferral to a portion of the COD income relating to a debt instrument.¹⁴⁴

For example, if a taxpayer that was insolvent to the extent of \$60 realized \$100 of COD income from the reacquisition of a debt instrument, the taxpayer could elect to defer \$40 under section 108(i) and exclude the remaining \$60 under section 108(a)(1)(B).

- The election was made by including a statement on the taxpayer's tax return for the year of the election specifying the applicable debt instrument and the amount of COD income being deferred.¹⁴⁵ In subsequent years, the taxpayer must attach an annual information statement to its federal tax returns beginning with the taxable year following the taxable year for which the taxpayer makes the election and ending with the first taxable year in which all items deferred under Section 108(i) have been recognized.¹⁴⁶ Once an election under section 108(i) has been made, it is irrevocable.¹⁴⁷ A taxpayer can file a protective section 108(i) election.¹⁴⁸
- If the debtor/taxpayer is a partnership, the section 108(i) election to defer COD income is made at the partnership level.¹⁴⁹ Also, where a partnership elects to defer the entire amount of COD income, the deferred COD income is allocated to the partners in the partnership in the

¹⁴⁴ Rev. Proc. 2009-37, 2009-36 I.R.B. 309.

¹⁴⁵ I.R.C. § 108(i)(5)(B)(i). For instructions describing the information that must be included in the election statement and other information reporting requirements pursuant to section 108(i), *see* Rev. Proc. 2009-37, 2009-36 I.R.B. 309.

¹⁴⁶ Rev. Proc. 2009-37, 2009-36 I.R.B. 309.

¹⁴⁷ I.R.C. § 108(i)(5)(B)(ii).

¹⁴⁸ Rev. Proc. 2009-37, 2009-36 I.R.B. 309.

¹⁴⁹ I.R.C. § 108(e)(5)(B)(iii).

manner it would have been allocated if the COD income were recognized in accordance with the normal partnership accounting rules under section 704 immediately before the discharge of indebtedness. Furthermore, any decrease in a partner's share of liabilities resulting from the discharge of indebtedness that would cause the partner to recognize gain is deferred and recognized at the same time and, to the extent remaining, in the same amount as the COD income is recognized.¹⁵⁰

- Following the enactment of section 108(i), commentators questioned whether partners should have the ability to “opt out” of a partnership level 108(i) election.¹⁵¹ They were concerned that because insolvent partners may prefer to exclude COD income under section 108(a)(1)(B) rather than defer it under section 108(i), the utility of section 108(i) would be limited in large part to partnerships with solvent managing partners.
- The IRS addressed this concern in Revenue Procedure 2009-37 by generally permitting the partnership flexibility in allocating any deferred COD income among the partners. A partnership that realizes COD income must first allocate the entire amount of COD income to the partners in the manner in which the income would be included in the distributive shares of the partners under section 704. If the partnership then elects to defer a portion of the COD income, it may allocate the deferred COD income among the partners *in any manner*, provided that a partner's share of deferred COD may not exceed that partner's share of COD income, determined as described above.¹⁵²

¹⁵⁰ I.R.C. § 108(i)(6).

¹⁵¹ *ABA Members Seek Guidance For Partnerships on COD Deferral Election*, 2009 TNT 85-22 (May 6, 2009).

¹⁵² Rev. Proc. 2009-37, 2009-36 I.R.B. 309.

- The Treasury Department and the IRS have stated that they intend to issue additional guidance under Section 108(i) that may include retroactive regulations.¹⁵³

G. COD Income Recognition in Related Party Acquisitions and Debt Exchanges

1. Related Party Acquisitions

Section 108(e)(4) is designed to prevent a debtor from avoiding COD income by causing a related party to reacquire the debtor's outstanding debt.¹⁵⁴ Under section 108(e)(4)(A), a debtor is deemed to acquire its debt if a person related to the debtor acquires the debt from a third party.

- Section 108(e)(4) also applies to indirect acquisitions whereby a holder of debt becomes related to the debtor and the holder acquired the debt in anticipation of becoming related to the debtor.¹⁵⁵ A holder that acquired debt within six months of becoming related to the debtor will be treated as having made an indirect acquisition on the date the holder becomes related to the debtor.¹⁵⁶ Thus, under the indirect acquisition rule, section 108(e)(4) could apply where two parties become related because of fluctuations in value or other innocuous changes that are not tied to debt acquisitions (*e.g.*, in a partnership context, a change in profit ratio).

¹⁵³ Rev. Proc. 2009-37, 2009-36 I.R.B. 309.

¹⁵⁴ Prior to the legislative change, where the related purchaser did not act as a conduit or agent for the debtor, no COD income was triggered when the debt was acquired by a person related to the debtor. *See Peter Pan Seafoods, Inc. v. United States*, 417 F.2d 670 (9th Cir. 1969); *Forrester v. Commissioner*, 4 T.C. 907 (1945), *acq.*, 1945 C.B. 3.

¹⁵⁵ Treas. Reg. § 1.108-2(a), (c)(1).

¹⁵⁶ Treas. Reg. § 1.108-2(c)(3).

- Where the related person acquires the debt at less than its adjusted issue price, the debtor would realize COD income equal to the difference between the adjusted issue price of the old debt and either the related party's adjusted basis or the fair market value of the debt on the acquisition date (*i.e.*, in an indirect acquisition, the date on which the parties become related). If a related person acquires the debt or a person acquires the debt "by purchase" on or less than six months before becoming related to the debtor, the reference value is the person's adjusted basis (*i.e.*, generally the cost of acquiring the debt).¹⁵⁷ Where new debt is issued in satisfaction of old debt, the acquirer's cost is the issue price of the debt.¹⁵⁸ If a person does not acquire the debt "by purchase" on or less than six months before the date on which the person becomes related to the holder and section 108(e)(4) applies, the reference value is the fair market value of the debt on the date the parties become related.¹⁵⁹
- The debtor is deemed to issue new debt to the related acquirer with an issue price equal to the reference value used to determine the amount of COD income realized by the debtor.¹⁶⁰ If the related person does not

¹⁵⁷ Treas. Reg. § 1.108-2(f)(1).

¹⁵⁸ Treas. Reg. § 1.1012-1(g)(1). Issue price of debt is determined under Treasury Regulations sections 1.1273-2 and 1.1274-2.

¹⁵⁹ Treas. Reg. § 1.108-2(f)(2). The regulations contain an anti-abuse provision which provides that the COD income will be measured by reference to fair market value rather than adjusted basis if a principal purpose for the acquisition is the avoidance of Federal income tax. Treas. Reg. § 1.108-2(f)(4). The related holder is deemed to receive a new debt instrument with an issue price in accordance with the amount used to determine the debtor's COD income. Treas. Reg. § 1.108-2(g)(2). Therefore, if the principal amount of the original debt is reduced, the related holder could have significant original issue discount related to the deemed reissued debt instrument.

¹⁶⁰ Treas. Reg. § 1.108-2(g)(1).

reduce the principal amount of the acquired debt, the new debt would bear a significant amount of original issue discount (“OID”), and may be subject to the rules for high-yield discount obligations (“HYDOs”) (see below for applicability of the HYDO rules to partnership debtors).¹⁶¹

- Whether a party is related to the debtor is determined under either section 267(b) or section 707(b)(1).¹⁶² Parties related under section 267(b) include (i) members of a family (as modified by section 267(c)(4)),¹⁶³ (ii) individuals and corporations if the individual directly or indirectly owns more than 50% of the value of the corporation,¹⁶⁴ (iii) two corporations in the same controlled group (as defined in section 1563(a)),¹⁶⁵ and (iv) a corporation and a partnership if the same person owns greater than 50% in value of the stock of such corporation and greater than a 50% capital or profits interest in such

¹⁶¹ The preamble to the regulations under section 108(e)(4) states that Treasury may issue guidance in the future that addresses whether HYDO rules apply to a deemed issuance of debt. T.D. 8460, 1993-1 C.B. 90. No such guidance has yet been issued.

¹⁶² I.R.C. § 108(e)(4)(A).

¹⁶³ I.R.C. § 267(b)(1).

¹⁶⁴ I.R.C. § 267(b)(2).

¹⁶⁵ I.R.C. § 267(b)(3). Whether a party is a member of a section 1563 controlled group is determined by reference to ownership of 50% of the vote or value of an affiliated corporation’s stock. The regulation does not specify whether or when fluctuations in the value of stock, *i.e.*, an increase in the relative value of preferred stock, should be considered in the determining related party status. Section 1563(e)(1) provides that options to acquire stock are deemed exercised for purposes of determining controlled group status. Query whether options to acquire stock of a related party, or the debtor, that are held by otherwise unrelated third parties, are properly (i) disregarded in determining related party status, or (ii) deemed exercised when a holder acquires stock of a debtor. *See* I.R.C. § 1563(a).

partnership.¹⁶⁶ Parties related under section 707(b)(1) include (i) a partnership and a partner owning, directly or indirectly, more than a 50% capital or profits interest, and (ii) two partnerships in which the same persons own, directly or indirectly, more than a 50% capital or profits interest. The applicable attribution rules for purposes of determining related party status under section 707(b)(1) are provided in section 267(c)(1), (2), (4) and (5).¹⁶⁷ It is important to note that, because the application of section 267(c)(3) is excluded, a partner does not have constructive ownership of any portion of the capital or profits interest of another partner in a partnership.¹⁶⁸

- Even if the transfer of a debt instrument is not made to a related party, the parties must ensure that a “significant modification” is not made to the debt instrument in connection with the transfer. A significant modification of legal right or obligation of a debtor or holder of the debt instrument will trigger a deemed exchange.¹⁶⁹

2. Satisfaction of Old Debt with New Debt

- A borrower will recognize COD income upon certain actual or deemed debt-for-debt exchanges in which the issue price of the new debt is less than the adjusted issue price¹⁷⁰ of the

¹⁶⁶ I.R.C. § 267(b)(10).

¹⁶⁷ I.R.C. § 707(b)(3); Treas. Reg. § 1.707-1(b)(3).

¹⁶⁸ See Priv. Ltr. Rul. 87-05-005 (Oct. 23, 1986).

¹⁶⁹ Treas. Reg. § 1.1001-3(a).

¹⁷⁰ The adjusted issue price of a debt instrument is its issue price, increased by the portion of any OID previously includable in the gross income of any holders and decreased by the portion of any bond premium previously included in the gross income of the

old debt.¹⁷¹ Specifically, the borrower will recognize COD income in any exchange where the issue price of the new debt plus the fair market value of any property, stock and cash received in satisfaction of the old debt is less than the adjusted issue price of the old debt.¹⁷²

- If neither the old debt nor the new debt is publicly traded, and the new debt bears “adequate stated interest,” the new debt’s issue price will equal its stated redemption price, *i.e.*, the adjusted issue price of the old debt, and no COD income will be recognized.¹⁷³
- If either the old or new debt is publicly traded, the issue price of the new debt will

borrower. I.R.C. § 1272(a)(4); Treas. Reg. § 1.61-12(c)(3); I.R.C. § 108(e)(3). *See* Section IV below for a more detailed description of the OID rules.

¹⁷¹ *See* I.R.C. § 108(e)(10) (issue price of debt instrument issued in satisfaction of debt is determined under section 1273 or 1274). *See also* FSA 1999-665 (Aug. 9, 1993) (during the time period the proposed debt exchange regulations were outstanding, the IRS position was that COD income in debt exchanges is properly measured based on the respective issue prices of the debt instruments, even for debt exchanges occurring prior to the effective date of section 108(e)(10) or its predecessor); C.C.A. 201250022 (Dec. 14, 2012) (under pre-1993 version, former 108(e)(10)(B)(i)(II) excluded this COD income to the extent stock was transferred by an insolvent subsidiary in satisfaction of a larger debt).

¹⁷² *See* I.R.C. § 61(a)(12); Treas. Reg. § 1.61-12(c)(3); Rev. Rul. 77-437, 1977-2 C.B. 28. Section 61(a)(12) codifies the rule of *United States v. Kirby Lumber Co.*, 284 U.S. 1 (1931), that a debtor recognizes taxable income upon a satisfaction of its indebtedness for less than its adjusted issue price because the satisfaction of a liability at a discount enriches the debtor and should therefore be treated as income; *cf.* TAM 98-22-005 (Jan. 16, 1998) (wholly owned subsidiary did not realize COD income upon cancellation of its debt to its parent).

¹⁷³ I.R.C. § 1273(b)(4).

be the fair market value of the publicly traded debt.¹⁷⁴

- If the modified debt is treated as equity, the borrower's tax consequences would be the same as a deemed exchange of publicly traded debt. The borrower would recognize COD income equal to the difference between the outstanding balance on the old debt and the fair market value of the equity, as the property received.¹⁷⁵ This result would presumably obtain without regard to whether COD income would have been avoided if the debt were not recharacterized as equity.
- The regulations provide that a significant modification occurs if and when a restructured debt instrument no longer qualifies as debt for tax purposes.¹⁷⁶ However, unless there is a substitution of a new obligor or a change in co-obligor, any deterioration in the financial condition of the obligor is disregarded in determining whether the modified instrument is properly characterized as debt.¹⁷⁷
- This rule prevents a modification that would not otherwise be a significant modification from triggering a deemed exchange where the treatment of the instrument as equity arises from the deterioration of the borrower's financial situation. Based on a literal reading of the regulation, however, if a significant modification has occurred, the new debt instrument may be recharacterized as

¹⁷⁴ I.R.C. § 1273(b)(3).

¹⁷⁵ I.R.C. § 108(e)(8).

¹⁷⁶ Treas. Reg. § 1.1001-3(e)(5).

¹⁷⁷ Treas. Reg. § 1.1001-3(e)(5)(i).

equity based on the deterioration of the borrower's financial condition, with the potential for recognition of COD income.¹⁷⁸ However, an IRS representative has publicly stated that this rule was intended to be more favorable; thus, the financial condition of the issuer should be disregarded in determining whether an instrument is debt or equity after any modification.¹⁷⁹

3. Applicability of HYDO Rules

Debt instruments issued with more than a five-year term generally constitute applicable HYDOs if (i) their yield to maturity equals or exceeds the sum of the applicable federal rate ("AFR") for debt instruments at the time an instrument is issued plus five percentage points, and (ii) they are issued with "significant OID."¹⁸⁰

- There is considerable uncertainty as to whether the HYDO rules apply to issuers that are taxed as partnerships. By its terms, section 163(e)(5)(A) disallows interest deductions only for HYDOs issued by corporations, and section 163(e)(5)(D) specifically exempts S corporations from the application of the HYDO rules. However, section 163(i)(5)(B) provides that regulations may be issued to prevent the avoidance of the HYDO rules "through the use of issuers other than C corporations." Consequently, certain HYDOs issued by partnerships with corporate partners may be subject to the HYDO interest

¹⁷⁸ See R. Lipton, *The Section 1001 Debt Modification Regulations: Problems and Opportunities*, 85 J. TAX'N 216 (1996).

¹⁷⁹ See J. Martin, *ABA Briefs: IRS Official Addresses Cottage Savings Regs' Debt/Equity Testing Rule*, 72 TAX NOTES 1104 (Aug. 26, 1996) (quoting Thomas Kelly, principal IRS drafter of the regulations).

¹⁸⁰ I.R.C. § 163(i).

deferral and disallowance rules if the partnership structure is used to avoid the HYDO rules.

- An example in the partnership anti-abuse regulations provides that a partnership issuer formed by two corporations will be ignored, and each corporate partner will be treated as directly issuing its allocable portion of the partnership's debt obligations for purposes of applying the HYDO rules, without regard to whether the partnership was either formed or chosen as the issuer for the purpose of avoiding the HYDO rules.¹⁸¹ Notably, this example goes beyond the scope of the statute by applying the HYDO rules to operating partnership issuers without regard to whether the partnership (or its partners) intended to avoid the HYDO rules through the use of such partnership.
- Neither the statute nor the regulation example makes clear whether the same treatment would follow for a partnership that was not solely comprised of corporate partners that issues debt, or whether the absence of a tax avoidance motive would exempt such a partnership issuer from the HYDO rules under any circumstances. As a general matter, the HYDO rules should only be applied, if at all, at the partner level rather than at the partnership level.¹⁸²
- If a debt instrument constitutes a HYDO, corporate partners of a partnership issuer may not be entitled to deduct OID that accrues with respect to such debt instrument until amounts

¹⁸¹ Treas. Reg. § 1.701-2(f), Ex. 1.

¹⁸² Such treatment would be consistent, for example, with the determination of "excludible COD income" and other income items determined at the partner level.

attributable to such OID are paid.¹⁸³ In addition, if the yield to maturity of the debt instrument exceeds the sum of the relevant AFR and six percentage points (the “Excess Yield”), those partners’ deductions for their allocable shares of the disqualified portion of the OID accruing on the instrument may be disallowed.¹⁸⁴ In general, the disqualified portion of the OID for any accrual period will be equal to the product of (i) the Excess Yield divided by the yield to maturity on the debt instrument, and (ii) the OID for the accrual period.¹⁸⁵

- In addition, although extremely unclear, it is possible that a corporate holder of a debt instrument issued by a partnership could treat as a dividend that portion of the Excess Yield on the instrument that is allocated to U.S. corporations that are partners of the partnership issuer if, and only to the extent that, such amount would have been treated as a dividend if it had been distributed by each corporate partner with respect to its stock.¹⁸⁶
- Turmoil in the credit markets during the 2008 financial crisis prompted the IRS and Congress to address the increased likelihood that, due to deterioration in the credit markets, newly issued debt instruments would be treated as HYDOs. For example, where a borrower (issuer) obtains a financial commitment from a lender and market conditions subsequently worsen before funding, the issue price of the debt may be significantly less than the amount of money received by the borrower. Thus, in August 2008, the IRS issued Revenue Procedure 2008-

¹⁸³ I.R.C. § 163(e)(5)(A)(ii).

¹⁸⁴ I.R.C. § 163(e)(5)(C).

¹⁸⁵ I.R.C. § 163(e)(5)(C)(i).

¹⁸⁶ I.R.C. § 163(e)(5)(B).

51, which suspended the HYDO rules for certain debt instruments issued pursuant to a financing commitment that was entered into prior to January 1, 2009.¹⁸⁷

- Similarly, the Recovery Act suspended the HYDO rules for a debt instrument issued in exchange for a debt instrument that was not an existing HYDO (including a deemed exchange that arises as a result of a significant modification of an outstanding debt instrument) between August 31, 2008 and December 31, 2009.¹⁸⁸ Moreover, the suspension of the HYDO rules did not apply to certain newly issued contingent debt instruments or newly issued debt instruments issued to a person related to the issuer.
- The Recovery Act granted Treasury the authority to extend the suspension of the HYDO rules beyond 2009¹⁸⁹ or to use a rate that is higher than the AFR for purposes of applying the HYDO rules to debt instruments issued after 2009.¹⁹⁰
- With Notice 2010-11, the IRS further suspended the HYDO rules for certain “qualified obligations” until December 31, 2010.¹⁹¹

¹⁸⁷ Rev. Proc. 2008-51, 2008-35 I.R.B. 562.

¹⁸⁸ I.R.C. § 163(e)(5)(F)(i).

¹⁸⁹ I.R.C. § 163(e)(5)(F)(iii).

¹⁹⁰ I.R.C. § 163(i)(1).

¹⁹¹ Notice 2010-11, 2010-4 I.R.B. 326. A HYDO will be a “qualified obligation” if it meets the following six conditions: (i) it is issued after December 31, 2009 and before January 1, 2011 in exchange for an obligation that is not a HYDO; (ii) the issuer of the HYDO is the same as the issuer of the obligation exchanged for the HYDO; (iii) the HYDO does not pay interest that would be treated as contingent interest under section 871(h)(4); (iv) the HYDO is not issued to a related person; (v) the issue price for the HYDO is determined under section 1273(b)(1), (b)(2), (b)(3) or section 1274(b)(3), whichever applies; and (vi) the HYDO would not

H. Interest and OID Accrual Involving Troubled Debtors

1. Deduction by Issuer

Troubled partnerships that deduct OID and troubled accrual method partnerships¹⁹² that deduct unpaid interest on a debt obligation should each consider the following issues that bear on when a taxpayer must cease accruing deductions for interest and OID.

- Early cases held that an issuer of a debt obligation could continue to deduct interest even after there was no intention or expectation that it would ever pay the interest.¹⁹³ However, later courts have questioned this rule, and have declined to follow it where the obligor was hopelessly insolvent.¹⁹⁴ Although the cases do

otherwise be a HYDO if its issue price was increased by the amount of COD income realized by the issuer upon the exchange.

¹⁹² Partnerships can generally choose either the accrual or the cash basis method of accounting, except that a partnership that is a tax shelter or that has a C corporation as one of its partners cannot use the cash basis method. I.R.C. § 448(a).

¹⁹³ See *Fahs v. Martin*, 224 F.2d 387 (5th Cir. 1955); *Zimmerman Steel Co. v. Commissioner*, 130 F.2d 1011 (8th Cir. 1942); see also Rev. Rul. 70-367, 1970-2 C.B. 37.

¹⁹⁴ See *Kellogg v. United States*, 82 F.3d 413 (5th Cir. 1996) (no deductions allowed on accrued interest where taxpayer is so hopelessly insolvent that the interest will never be paid); *Tampa and Gulf Coast Railroad Co. v. Commissioner*, 469 F.2d 263 (5th Cir. 1972) (holding that where a parent was excluding accrued interest from income as unlikely to be collected from a debtor-subsidiary, subsidiary could not accrue the deduction); *Mooney Aircraft, Inc. v. Commissioner*, 420 F.2d 400 (5th Cir. 1969) (denying deduction for amounts due at a non-fixed time in the future that may never be paid and questioning the ruling in *Zimmerman* as “dubious”); *Continental Vending Machine Corp.*, 77-1 U.S.T.C. ¶ 9121 (E.D.N.Y. 1976) (Chapter 11 company permitted to deduct accrued interest only on secured debt). *But see* C.C.A. 2008-01-039 (Jan. 4, 2008) (consolidated group permitted to treat interest expense of bankrupt

not distinguish between recourse and nonrecourse debt, a separate rule discussed below applies to OID deductions, and possibly also to interest deductions, on nonrecourse debt.

- A 1987 GCM interprets the prior legislative history as disallowing an issuer's deductions for accrued OID on nonrecourse debt in a given taxable year if and to the extent the value of the property securing the nonrecourse debt does not exceed the principal balance of the obligation, plus any previously deducted OID, at the time of such deduction.¹⁹⁵
- The rule espoused by the GCM is questionable in light of the actual language of the legislative history, which describes a nonrecourse obligation given in exchange for collateral with a value less than the principal amount as an example of debt that may not be true debt, as opposed to the more typical situation in which the value of collateral exceeds the principal amount of the loan when the loan is made, but subsequently decreases in value below the adjusted issue price of the loan. Notably, the subsequently issued regulations under section 1001 do not require debt to be retested as equity absent a significant modification.
- It is not clear whether deductions that are disallowed under this rule would be permanently lost or merely postponed until the value of the property once again exceeds the outstanding amount of the debt.

subsidiary as incurred and deductible until resolution of bankruptcy proceeding).

¹⁹⁵ G.C.M. 39668 (Oct. 1, 1987) (interpreting S. REP. NO. 98-169, at 255 (Apr. 2, 1984)).

- Since the GCM and the legislative history only address deductions of OID, it is also not clear whether the IRS would attempt to extend this rule to deductions of interest as well. Notwithstanding any IRS argument, however, interest deductions on nonrecourse as well as recourse debt would be governed by the case law described in the previous paragraph.

2. Interest Accruals by Creditors

- Under case law, an accrual method creditor is only required to continue accruing interest income on recourse or nonrecourse debt until there is no reasonable expectation that the income will be collected.¹⁹⁶ The IRS has taken the position that the “no reasonable expectation of payment” exception should be strictly construed and interest income must be accrued until the loan becomes uncollectible.¹⁹⁷ In addition, the IRS has issued guidance providing that a creditor must accrue interest until it can substantiate that the interest is uncollectible.¹⁹⁸ It is fair to say that this IRS position is not widely accepted.

3. OID Accruals by Creditors

- The IRS has taken the position that creditors must continue to accrue OID income despite the

¹⁹⁶ See, e.g., *Corn Exchange Bank v. United States*, 37 F.2d 34 (2d Cir. 1930); *H. Liebes & Co. v. Commissioner*, 90 F.2d 932 (9th Cir. 1937); *European American Bank and Trust Co. v. United States*, 20 Cl. Ct. 594 (Ct. Cls. 1990), *aff'd*, 940 F.2d 677 (Fed. Cir. 1992).

¹⁹⁷ Rev. Rul. 2007-32, 2007-21 I.R.B. 1278; Rev. Rul. 80-361, 1980-2 C.B. 164. Temporary financial difficulty of the debtor cannot support non-recognition of income unless there is real doubt regarding payment.

¹⁹⁸ IRS Industry Specialization Paper, *Savings and Loan Industry: Accrued Interest on Nonperforming Loans* (Oct. 31, 1991); FSA 2000-18-017 (Jan. 13, 2000).

doubtful collectibility of such OID, although this position has not been widely followed.¹⁹⁹ A number of commentators have argued for some limitation on such income to better reflect the economic reality, by either exempting a defined class of distressed instruments from accruals, or establishing a “yield limit” for all debt.²⁰⁰

- Notably, the GCM limiting OID deductions with respect to undersecured obligations does not provide a symmetric rule for creditors. While it would seem that a holder of nonrecourse debt should properly be permitted to stop accruing OID income when the issuer stops deducting OID accruals, no authority so holds. Thus, the IRS would limit OID deductions for borrowers while requiring creditors to accrue the same OID, a position at odds with the analogous case law.

4. Allocation of Payments Between Interest/OID and Principal

- Historically, parties could control the allocation of payments between principal and interest through an arm’s-length expression of intent.²⁰¹ Absent an agreement, payments made on debt

¹⁹⁹ TAM 95-38-007 (Jun. 13, 1995); FSA 2000-18-017 (Jan. 13, 2000). Commentators have called on the IRS to rescind this guidance. *See, e.g.,* New York State Bar Association Tax Section, *Report of the Tax Section of the New York State Bar Association on the Taxation of Distressed Debt* (2011) (recommending that accruals cease once the instrument satisfies an established definition of “distressed debt”); American Bar Association Section of Taxation, *Options for Tax Reform in the Financial Transactions Tax Provisions of the Internal Revenue Code* (2011) (proposing certain caps on accrued interest, ending accruals on certain “severely distressed debt instruments,” or codification of the doubtful collectability doctrine).

²⁰⁰ KEVIN M. KEYES, FEDERAL TAXATION OF FINANCIAL INSTRUMENTS AND TRANSACTIONS ¶ 3.02 (2000); Dalton, *Potential Distressed Debt Treatment Discussed*, 2012 TNT 21-7 (Feb. 2012).

²⁰¹ *See Newhouse v. Commissioner*, 59 T.C. 783 (1973); Rev. Rul. 63-57, 1963-1 C.B. 103.

before retirement were generally applied first to accrued unpaid interest and then to principal, and payments made at maturity were applied proportionately to accrued unpaid interest and principal.²⁰² However, courts have held that a final payment where principal is not recovered can be allocated solely to principal.²⁰³

- The section 446 regulations and the OID regulations may have curtailed, and the IRS would argue, eliminated the ability of taxpayers to control the allocation of these payments. Under these regulations, payments must be allocated first to accrued unpaid interest or OID, as applicable, and then to principal.²⁰⁴ It is not clear whether either or both of Treasury Regulation section 1.446-2(e), which applies to “each payment under a loan” (other than pro rata prepayments and payments of additional interest or similar charges provided with respect to amounts that are not paid when due), and Treasury Regulation section 1.1275-2(a), which applies to “each payment under a debt instrument” (other than qualified stated interest, currently deductible home mortgage points, pro rata prepayments, and additional interest or similar charges provided with respect to amounts that are not paid when due), are meant to cover payments made in partial or complete

²⁰² See *European American Bank & Trust Co. v. United States*, 20 Cl. Ct. 594 (Cl. Ct. 1990), *aff'd*, 940 F.2d 677 (Fed. Cir. 1991); *Warner Co. v. Commissioner*, 11 T.C. 419 (1948), *aff'd per curiam*, 181 F.2d 599 (3d Cir. 1950); Priv. Ltr. Rul. 88-19-068 (Feb. 17, 1988).

²⁰³ See *Newhouse v. Commissioner*, 59 T.C. 783 (1973); *Petit et al. v. Commissioner*, 8 T.C. 228 (1947); *Lackey v. Commissioner*, T.C. Memo 1977-213 (1977); *Drier v. Helvering*, 72 F.2d 76 (D.C. Cir. 1934); see also Priv. Ltr. Rul. 88-21-018 (Feb. 23, 1988) (ruling that where holders of tax-exempt bonds receive only half of the bond issue price, payments must be applied to principal since holders have incentive to apply payments to tax-exempt interest and thereby increase capital loss).

²⁰⁴ Treas. Reg. §§ 1.446-2(e), 1.1275-2(a).

discharge of debt. Commentators have persuasively argued that, as a policy matter, neither regulation should apply in distressed situations where the holder does not recover the outstanding principal balance on its loan.²⁰⁵

Assuming the regulations do not apply, the case law permitting taxpayers to control the allocation of payments by agreement, as well as the case law allocating payments to principal in distressed situations, would apply.²⁰⁶

- For cash basis holders, allocating more of a final payment to principal would decrease the holder's ordinary interest income before producing a larger capital loss.
- Where the holder is an accrual basis taxpayer, or the debt instrument was issued with OID, interest or OID may already have been accrued (unless collection of such interest or OID was doubtful). If so, the issue is whether the holder's loss on the debt should be treated as ordinary to the extent of prior interest or OID income accruals not recovered by the final payment.

²⁰⁵ See New York State Bar Association Tax Section, "Comments on the Final OID Regulations," 64 TAX NOTES 1747 (Sept. 26, 1994); KEVIN M. KEYES, FEDERAL TAXATION OF FINANCIAL INSTRUMENTS AND TRANSACTIONS ¶ 3.02 (2000).

²⁰⁶ A 2000 private letter ruling applied the above case law to hold that, in the absence of an agreement between the parties, an issuer's payments on tax-exempt bonds prior to insolvency would be applied to accrued interest first, while later payments in liquidation of the bonds made when the issuer is insolvent would be applied first to principal. See Priv. Ltr. Rul. 2000-35-008 (May 23, 2000). Interestingly, the letter ruling did not discuss Treasury Regulation section 1.446-2(e). Although it is not clear from the facts of the ruling, the omission may be due to the fact that the bonds were issued prior to April 4, 1994, the effective date of that regulation.

- Legislative history to section 354(a)(2)(B),²⁰⁷ the contingent payment debt instrument regulations,²⁰⁸ the bond premium amortization regulations,²⁰⁹ and the bad debt regulations²¹⁰ each provide support for the position that losses on debt may be treated as ordinary to the extent of prior income accrual. However, there is no direct authority for this proposition. As a result, the IRS can be expected to challenge ordinary loss treatment in the absence of direct authority.

III. ISSUES UNIQUE TO PARTNERSHIPS

Unique issues arise with respect to troubled partnerships in connection with restructurings and bankruptcies, including the

²⁰⁷ S. REP. NO. 96-1035, at 38 (1980) (stating that under section 354(a)(2)(B) an exchanging security holder that previously accrued interest or OID to which property received is allocable recognizes a loss, which presumably is ordinary, to the extent the interest is not paid in the exchange); TAM 95-38-007 (June 13, 1995). *See* GORDON D. HENDERSON AND STUART J. GOLDRING, FAILING AND FAILED BUSINESSES ¶ 304 n.3 (2008).

²⁰⁸ Under the contingent payment debt instrument regulations, negative adjustments are treated as ordinary losses of the holder to the extent of its prior ordinary income inclusions. Treas. Reg. § 1.1275-4(b)(6)(iii)(B). *See* DAVID C. GARLOCK, FEDERAL INCOME TAXATION OF DEBT INSTRUMENTS ¶ 6.03[D][1] (5th ed. 2005).

²⁰⁹ The bond premium amortization regulations provide that the excess of allocable bond premium over qualified stated interest for a taxable year can be claimed as a deduction to the extent of prior net income inclusions with respect to the bond. Treas. Reg. § 1.171-2(a)(4)(i)(A).

²¹⁰ In the case of certain debt obligations, if a portion of the debt remains unsatisfied after applying proceeds from a foreclosure sale of the collateral, a corporate creditor may generally claim the unsatisfied amount, including accrued interest previously taken into income, as an ordinary bad debt loss. A noncorporate creditor may also claim an ordinary bad debt loss if the debt was a “business” debt in the hands of the (noncorporate) creditor. *See* I.R.C. § 166(a), (d)(1); Treas. Reg. § 1.166-6(a). Ordinary loss treatment would not apply to unsatisfied amounts on debt issued by corporations that constitutes a “security” under section 165(g)(2)(C). *See* I.R.C. §§ 166(e); 165(g).

application of section 108 to a partnership and its partners and the impact of sections 704 and 752 on partners. This portion of the outline summarizes the relevant partnership rules, and then discusses the issues that arise when the rules are applied to troubled and bankrupt partnerships.

A. General Partnership Rules

1. A Partner's Basis in Its Partnership Interest

- One Basis, Divided Holding Period A partner has a unitary basis in his partnership interest.²¹¹ A partnership interest will have divided holding periods, however, if (i) the partner acquired portions of the interest at different times, or (ii) the partner acquired the interest by transferring property that had different holding periods, thus creating different results under the tacked holding period rule of section 1223(1).²¹² Thus, a sale of all or a portion of a partnership interest that reflects one or more holding periods may result in a portion of the capital gain or loss being treated as short-term and another portion being treated as long-term. The fraction of a partnership interest having a particular holding period equals the fair market value of the portion received in the transaction to which the holding period relates (determined immediately after the transaction) over the fair market value of the entire partnership interest.²¹³
- Accordingly, a fresh contribution by a partner that adds value to his partnership interest could convert long-term gain into short-term gain if the value of the partnership interest had declined over the previous years. In this case, real estate partnership workouts may be hampered, because partners may be reluctant to respond

²¹¹ Rev. Rul. 84-53, 1984-1 C.B. 159.

²¹² Treas. Reg. § 1.1223-3(a).

²¹³ Treas. Reg. § 1.1223-3(b)(1).

to a call for additional capital contributions for necessary improvements to depreciated property if the partners anticipate another call for equity infusion within a year that would require them to either contribute or transfer their interests.²¹⁴

- A partner's basis in its partnership interest is *increased* by (i) cash and the adjusted basis of property contributed by the partner to the partnership,²¹⁵ and (ii) the partner's distributive share of the partnership's income.²¹⁶ A partner's basis in its partnership interest is *decreased* (but not below zero) by (i) cash distributed to the partner by the partnership,²¹⁷ (ii) the partner's adjusted basis in property distributed to it by the partnership,²¹⁸ and (iii) the partner's distributive share of the partnership's losses.²¹⁹
 - Under section 752, a partner is treated as making a cash contribution to the partnership equal to any increase in its share of the partnership's liabilities, and receiving a cash distribution equal to any decrease in its share of the partnership's liabilities.
 - A partner's basis in its partnership interest generally equals the sum of the partner's section 704(b) capital account, and the partner's share of partnership liabilities.

²¹⁴ See Banoff and Lipton, *Partnership Holding Period Prop. Regs. Will Thwart Real Estate Workouts*, 92 J. TAX'N 253 (2000).

²¹⁵ I.R.C. § 722.

²¹⁶ I.R.C. § 705(a)(1).

²¹⁷ I.R.C. § 733(1).

²¹⁸ I.R.C. § 733(2). Basis of distributed property is determined pursuant to section 732.

²¹⁹ I.R.C. § 705(a)(2).

- In a partnership workout transaction, a partner's basis in its partnership interest will generally be (i) increased by COD income recognized by the partnership and allocated to the partner (whether or not the partner can exclude such COD income),²²⁰ and (ii) decreased by the partner's share of discharged partnership liabilities previously included in the partner's basis under sections 752(a) and 722.²²¹
- One commentator has proposed that the fair market value of a taxpayer's partnership interest should be taken into account to determine the taxpayer's solvency as long as the partnership is solvent and has a net positive value.²²² Under the proposal, fair market value would be determined by reference to the balance of the partner's capital account after adjusting for a hypothetical disposition of all of the partnership's assets at fair market value and satisfaction of the partnership's liabilities. If the partner has a negative capital account after the adjustments, the partner's interest in the partnership would be treated as a liability to the extent of the partner's deficit restoration obligation (if any).

²²⁰ See Priv. Ltr. Rul. 97-39-002 (May 19, 1997).

²²¹ The Tax Court has considered the treatment of a decrease in the limited partners' share of partnership liabilities as a result of a settlement between a partnership's limited partners and a bonding company. Because the limited partners had been relieved of personal liability, the Tax Court held that the limited partners received a constructive distribution of cash under section 752. *Dakotah Hills Offices v. Commissioner*, T.C. Memo 1998-134 (1998).

²²² See Livsey, *Determining if a Taxpayer is Insolvent for Purposes of the COD Exclusion*, 76 J. Tax'n 224, 226 (1992).

2. Allocation of Partnership Liabilities

Recourse and nonrecourse partnership liabilities are separately allocated among partners pursuant to the section 752 regulations.²²³

- Recourse Liabilities Partnership liabilities are recourse liabilities to the extent one or more partners or related persons (the “Liable Partners”) bear the “economic risk of loss” for the liability.²²⁴ A partner’s share of a recourse liability is that portion of the liability for which the partner bears the economic risk of loss.²²⁵ A partner bears economic risk of loss to the extent that the partner would be obligated to make a payment to any person for a liability that becomes due and payable, if the partnership were constructively liquidated.²²⁶ It is generally assumed that all partners will actually perform their obligations to make payments, irrespective of their actual net worth, absent facts and

²²³ Treas. Reg. §§ 1.752-1, through -5. These regulations generally govern only liabilities incurred after 1991. A discussion of the previous section 752 regulations is beyond the scope of this outline. The precise structure of a contribution of encumbered property may produce different tax results even when the economics of the contribution are the same. *See* Wile, *Partnership Contributions of Encumbered Property Revisited*, 84 TAX NOTES 1181 (Aug. 23, 1999).

²²⁴ Treas. Reg. § 1.752-1(a)(1).

²²⁵ Treas. Reg. § 1.752-2(a). Proposed regulations would adjust for overlapping economic risk of loss (*i.e.*, double counting). *See* Prop. Treas. Reg. § 1.752-2(a)(2); Preamble, 78 Fed. Reg. 76092 (Dec. 16, 2013).

²²⁶ Treas. Reg. § 1.752-2(b). In making that determination, proposed regulations would further require that certain recognition requirements be satisfied and, with limited exceptions, would only recognize the payment obligation to the extent of the partners’ “net value,” as determined under Proposed Treasury Regulation section 1.752-2(k). *See* Prop. Treas. Reg. § 1.752-2(b)(3)(ii) (recognition requirements), (iii) (net value requirement).

circumstances that support a plan to avoid the obligation.²²⁷

- Liabilities of Disregarded Entities The section 752 regulations limit the debt of a disregarded entity for which a partner bears economic risk of loss to the net value of the disregarded entity on the relevant allocation date.²²⁸ A disregarded entity's net value is determined as of the earlier of the next date on which partners' liability shares are determined, or the end of the partnership's taxable year in which the net value of the disregarded entity must be determined.²²⁹
- Nonrecourse Liabilities Nonrecourse partnership liabilities are liabilities for which no partner or related person bears the economic

²²⁷ Treas. Reg. § 1.752-2(b)(6), (j). The extent to which a partner has an obligation to make a payment is based on the facts and circumstances. All statutory and contractual obligations are taken into account including (i) contractual obligations outside the partnership agreement (including guarantees, indemnifications, and reimbursements), (ii) obligations imposed by the partnership agreement, and (iii) payment obligations imposed by state law. Treas. Reg. § 1.752-2(b)(3). These obligations include joint and several liability and rights of contribution. C.C.A. 200023001 (June 9, 2000); *Stevens v. Commissioner*, T.C. Summary Op. 2008-61 (2008); *Kahle v. Commissioner* T.C. Memo 1997-91 (1997). This treatment differs from the treatment of guarantees outside the partnership context. *Landreth v. Commissioner*, 50 T.C. 803 (1968) (stating that a personal guarantee of a loan did not yield COD income when the loan was discharged). Under proposed changes to Treasury regulations section 1.752-2(j), that would render all or some "bottom guarantee" or "last dollar" arrangements invalid for purposes of determining if a partner bears the economic risk of loss. See Prop. Treas. Reg. § 1.752-2(j)(4); see also Preamble, 79 Fed. Reg. 4926 (Jan. 30, 2014) (expressing concern that structures or financial arrangements could be employed to avoid the bottom-dollar guarantee rules and proposing revisions to the anti-abuse rule to address that concern).

²²⁸ Treas. Reg. § 1.752-2(k).

²²⁹ Treas. Reg. § 1.752-2(k)(2)(iv).

risk of loss.²³⁰ Accordingly, nonrecourse liabilities are generally allocated consistently with the allocation of gain (if any) from a sale of the collateral securing the liability. A partner's share of a nonrecourse liability equals the sum of the partner's (i) share of the partnership's "section 704(b) minimum gain" attributable to the liability,²³¹ (ii) "section 704(c) minimum gain amount" with respect to the liability,²³² and (iii) share of the portion of the liability, if any, that is an "excess nonrecourse liability."²³³ As

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- ²³⁰ Treas. Reg. § 1.752-1(a)(2). Under the section 752 regulations, a loan by a partner or a related person to a partnership will be treated as a nonrecourse liability if (i) no partner other than the lender bears any economic risk of loss therefor, (ii) the lender and related persons own no more than a 10% direct and indirect interest in any item of partnership income or loss during any year, and (iii) the loan constitutes "qualified nonrecourse financing" under section 465(b)(6), determined without regard to the type of activity for which the loan is made. Treas. Reg. § 1.752-2(d).
- ²³¹ Section 704(b) minimum gain with respect to any property equals the gain the partnership would recognize if the property were sold for the amount of the nonrecourse debt it secures. Thus, a partner's share of such minimum gain will generally equal the sum of the partner's allocable share of prior "book" deductions from the nonrecourse liability, and any distributions of cash made to the partner with respect to the liability. *See* Treas. Reg. § 1.752-3(a)(1).
- ²³² This amount is equal to the amount of taxable gain (if any) that would be allocated to the partner under section 704(c) (or, if the partnership's assets are revalued, by using section 704(c) principles) upon a sale of the property. Treas. Reg. § 1.752-3(a)(2). Section 704(c) minimum gain essentially reflects deductions taken or cash received in respect of a nonrecourse liability prior to a contribution of property subject to such liability to the partnership or a revaluation of the partnership assets.
- ²³³ An excess nonrecourse liability equals the gross amount of the nonrecourse liability, less the aggregate section 704(b) and 704(c) minimum gain attributable to the liability, *i.e.*, the portion of the nonrecourse liability that has not yet produced deductions to, or distributions by, the partnership. The partners' shares of an excess nonrecourse liability will generally be based upon their respective percentage interests in the partnership's profits, or the expected allocation of deductions attributable to these liabilities. Recently

the partnership claims additional deductions in respect of a nonrecourse liability, amounts initially allocable to categories (ii) and (iii) will shift to category (i).

3. Allocation of Partnership Income and Loss

Under section 704(b), the partnership agreement allocations of a partnership's income or loss to its partners will govern, provided such allocations have "substantial economic effect." A detailed summary of the substantial economic effect test in the section 704(b) regulations is attached as Appendix I.

- Section 704(b) Principles Under the section 704(b) regulations, allocations of income and loss will have economic effect, and absent a non-economic result, will generally be respected, if (i) assets are distributed in accordance with the partners' capital accounts on a partnership liquidation, (ii) a partner is not allocated losses that would result in a deficit balance in his capital account unless the partner is obligated to restore the deficit balance on a liquidation of his partnership interest (for this purpose a partner is deemed obligated to restore the portion of his negative capital account balance equal to his share of the partnership's minimum gain), and (iii) a partner is allocated items of gross income to eliminate any deficit capital account balance that he is not obligated to restore upon liquidation.²³⁴
- Allocations Attributable to Nonrecourse Liabilities A liability is nonrecourse if no partner (or related person) bears any economic

issued regulations allow the partnership to apply these percentages to any excess nonrecourse liability remaining after first allocating section 704(c) gain not previously allocated as section 704(c) minimum gain. Treas. Reg. § 1.752-3(a)(3).

²³⁴ Treas. Reg. § 1.704-1(b)(2).

risk of loss for the liability.²³⁵ Items of loss or deduction attributable to a nonrecourse liability are nonrecourse deductions.²³⁶ A partnership deduction will generally be treated as a nonrecourse deduction if and to the extent the partnership's minimum gain increases during the year in question.²³⁷ A partner that has been allocated nonrecourse deductions by the partnership will typically have a negative

²³⁵ Treas. Reg. § 1.704-2(b)(3).

²³⁶ Treas. Reg. § 1.704-2(b)(1). In Federal Service Advice 2001-31-013 (May 1, 2001), a partnership restructured after the value of property securing nonrecourse liabilities fell below the principal balance of the notes. The partners were generally allocated nonrecourse deductions in accordance with their interests in the partnership. The partnership allocated COD income first to withdrawing partners to the extent each of those partners had a negative capital account balance, and the rest to the remaining partners. Because (i) the partnership agreement did not contain a minimum gain chargeback provision, (ii) none of the partners had a deficit restoration obligation, and (iii) the partnership agreement did not contain a qualified income offset provision, the IRS ruled that the allocation lacked economic effect and required that COD income be allocated in accordance with each partner's interest in the partnership pursuant to Treasury Regulation section 1.704-1(b)(3). Further, the IRS noted that the same result would have been reached even if the agreement had a minimum gain chargeback provision because the minimum gain chargeback requirement of the section 704(b) regulations requires that any decrease in partnership minimum gain be allocated to the respective partners in accordance with each partner's share of the decrease. Accordingly, because the nonrecourse deductions were allocated in accordance with each partner's interest in the partnership, the IRS stated that COD income equal to the minimum gain chargeback amount would also need to be allocated in the same manner.

²³⁷ Treas. Reg. § 1.704-2(b)(2). The partnership's book and tax bases in an asset will generally be equal, except where built-in gain or loss property is contributed to the partnership, or the partnership's assets have been revalued under Treasury Regulation section 1.704-1(b)(2)(iv)(f). Minimum gain and nonrecourse deductions are determined with reference to book bases, because the partners' capital accounts are determined on a book (rather than tax) basis. *See* Treas. Reg. § 1.704-2(d)(3).

balance in his capital account equal to his share of the partnership's minimum gain.²³⁸

- Because partners do not bear any economic risk of loss for nonrecourse liabilities, allocations of nonrecourse deductions cannot have substantial economic effect. Accordingly, nonrecourse deductions must be allocated in a manner consistent with the partners' interests in the partnership.²³⁹ If the partners comply with certain basic requirements, including the minimum gain chargeback rules, they may allocate the partnership's nonrecourse deductions consistent with allocations of a significant partnership item, *e.g.*, gain attributable to the collateral.²⁴⁰ Otherwise, nonrecourse deductions must be allocated in accordance with the partners' overall economic interests in the partnership.²⁴¹
- If a partner or a related person who is a lender directly or indirectly holds more than a 10% capital or profits interest in the partnership, the liability will constitute a partner nonrecourse liability and all deductions attributable to the loan must be allocated to the lender or its related partner.²⁴² If more than one partner bears the economic risk of loss with respect to a liability, all deductions attributable to the

²³⁸ A partner's share of the partnership's minimum gain equals the aggregate nonrecourse deductions allocated to him, and proceeds distributed to him, attributable to nonrecourse liabilities, less the partner's aggregate share of any net decreases in the partnership's minimum gain (including decreases from revaluations). Treas. Reg. § 1.704-2(g)(1).

²³⁹ Treas. Reg. § 1.704-2(b)(1), (e).

²⁴⁰ Treas. Reg. § 1.704-2(e).

²⁴¹ Treas. Reg. § 1.704-2(b)(1).

²⁴² Treas. Reg. §§ 1.752-2(c)(1), (d)(1); 1.704-2(i).

liability must be allocated among such partners according to the ratio in which they bear the risk of loss.²⁴³ Where partners bear the economic risk of loss for different portions of a liability, each portion is treated as a separate partner nonrecourse liability.²⁴⁴

- Minimum Gain Chargebacks Partners must be allocated items of income equal to the net decrease in the partnership's minimum gain in any year, pursuant to the minimum gain chargeback rules.²⁴⁵ Specifically, each partner is allocated items of income and gain equal to the greater of (i) the decrease in the partner's share of minimum gain allocable to a disposition of property, or (ii) the excess of the deficit balance in his capital account (determined as of the end of the year) over the sum of (A) his remaining share of minimum gain, and (B) any amount he would be obligated to restore to his negative capital account.²⁴⁶ The first partnership income allocated under the minimum gain chargeback rules is gain from the sale of property securing the nonrecourse liability that triggered the chargeback.²⁴⁷ Other items of partnership income and gain are then allocated to satisfy any remaining chargeback requirement.²⁴⁸

²⁴³ Treas. Reg. § 1.704-2(i)(1).

²⁴⁴ Treas. Reg. § 1.704-2(i)(1).

²⁴⁵ Treas. Reg. § 1.704-2(b)(2).

²⁴⁶ Treas. Reg. § 1.704-2(f), (g). A partner is deemed obligated to restore the portion of his deficit capital account balance attributable to his allocable share of nonrecourse deductions and nonrecourse loan proceeds previously distributed to him still included in his minimum gain share, because this portion of his deficit balance will be restored as and when the partnership's minimum gain is reduced to zero.

²⁴⁷ Treas. Reg. § 1.704-2(j)(2)(A).

²⁴⁸ Treas. Reg. § 1.704-2(j)(2)(B).

- The amount in (i) will typically be zero in a new multi-tiered debt restructuring, unless there is a disposition of property. The amount in (ii) should generally equal the decrease in the partner's share of minimum gain.

4. Revaluations of Partnership Assets: Book Ups and Book Downs

- Under the section 704(b) regulations, partners may adjust their capital accounts pursuant to a revaluation of the partnership's assets for book purposes upon (i) the contribution of a non *de minimis* amount of cash or other property to the partnership by a new or existing partner in exchange for a partnership interest, and (ii) a distribution of a non *de minimis* amount of cash or other property by the partnership to a retiring or continuing partner as consideration for his partnership interest (such adjustments, a "Revaluation").²⁴⁹ Revaluations are not permitted in connection with sales of partnership interests.
- A Revaluation will cause the partners' capital accounts to more closely reflect the then fair market value of the partnership's assets. If the partners elect a Revaluation, the book basis of each partnership asset will be restated to its then fair market value (with an asset subject to nonrecourse debt valued at not less than the amount of the debt).²⁵⁰ The existing partners' book capital accounts will also be adjusted to reflect the allocation of unrealized income or loss in each revalued asset under section 704(c) principles as if the asset were immediately sold for its fair market value.²⁵¹

²⁴⁹ Treas. Reg. § 1.704-1(b)(2)(iv)(f)(5).

²⁵⁰ Treas. Reg. § 1.704-1(b)(2)(iv)(f)(1).

²⁵¹ Treas. Reg. § 1.704-1(b)(2)(iv)(f)(3).

- Because the book bases of the partnership's assets will generally vary from the assets' tax bases after a Revaluation, the partnership's subsequent income and loss (and items thereof) must be allocated in accordance with the principles of section 704(c).²⁵² After the partners' book capital accounts are adjusted to reflect the restated book values of the partnership's assets, future depreciation deductions must be determined on the basis of the restated book values.²⁵³
- Where partnership property subject to a nonrecourse liability is revalued and the amount of the liability remains constant, the increase in the book basis of the partnership's assets to equal the nonrecourse debt amount will reduce the partnership's section 704(b) minimum gain to zero. The partners' capital accounts will be correspondingly increased (generally to zero) as a result of the revaluation. The increase will typically equal a partner's share of the partnership's section 704(b) minimum gain reduction. These changes effectively offset one another. The decrease in partnership minimum gain from a Revaluation does not trigger a minimum gain chargeback.²⁵⁴
- A Revaluation transforms existing partners' prior section 704(b) minimum gain amounts into section 704(c) minimum gain amounts, thereby preventing the partners from suffering any immediate reduction in their shares of partnership nonrecourse debt under section 752 with respect to the extent of their section 704(b) minimum gain

²⁵² Treas. Reg. § 1.701-1(b)(2)(iv)(f)(4).

²⁵³ Treas. Reg. § 1.704-1(b)(2)(iv)(f)(4), (g).

²⁵⁴ Treas. Reg. § 1.704-2(g)(2); -2(m), Ex. 3(ii).

amounts.²⁵⁵ However, as debt is paid off, existing partners may recognize gain under section 731 on deemed cash distributions in excess of basis. The same result may obtain as a result of depreciation or amortization that reduces the existing partners' section 704(c) minimum gain amounts (and correspondingly increases the new partners' minimum gain amounts).²⁵⁶

B. COD Income and Partnerships

1. Recognition by Partnership

Whether COD income is realized and recognized in connection with a partnership debt restructuring is determined at the partnership level, while the section 108(a) exceptions to COD income recognition and corresponding tax attribute reductions are applied at the partner level.²⁵⁷ Notably, a section 108(i) election to defer COD income is made at the partnership level.²⁵⁸ COD income recognized by a partnership is allocated to its partners as an item of income under section 702(a),²⁵⁹ and each partner's allocable share

²⁵⁵ Treas. Reg. §§ 1.704-1(b)(2)(iv)(f); 1.752-3(a)(2).

²⁵⁶ Treas. Reg. § 1.752-3(a)(1), (2).

²⁵⁷ I.R.C. § 108(d)(6); *see Marcaccio v. Commissioner*, T.C. Memo 1995-174 (1995).

When an LLC treated as a partnership converts to a single-member LLC by redeeming the other member, the partnership terminates, and the LLC is deemed to distribute all of its assets and liabilities to the remaining sole member. *See* Priv. Ltr. Rul. 2002-22-026 (Mar. 1, 2002). Where the liabilities deemed distributed to the sole member include liabilities of the LLC, the liabilities are deemed cancelled. However, the IRS has ruled that no COD income will result if the fair market value of assets deemed distributed equals or exceeds the amount of liabilities deemed distributed. *Id.*

²⁵⁸ I.R.C. § 108(e)(5)(B)(iii).

²⁵⁹ H.R. REP. NO. 96-833, at 17 (1980); S. REP. NO. 96-1035, at 21 (1980).

of COD income increases that partner's basis in its partnership interest on a dollar for dollar basis.²⁶⁰ The IRS has ruled that COD income allocated to a partner will increase a partner's basis in its partnership interest even if the partner qualifies for the insolvency exception to COD income recognition.²⁶¹

- Each partner separately determines its eligibility to exclude its allocable share of COD income from its taxable income under section 108.²⁶² Any required tax attribute reduction applies at the partner level, as discussed below.
- Query whether a partner in bankruptcy is eligible for the section 108(a)(1)(A) bankruptcy exclusion for his allocable share of a partnership's COD income, if and when a debt discharge (occurring at the partnership level) is not granted by the bankruptcy court having jurisdiction over the partner. The 1980 Act legislative history is clear that only the partner, and not the partnership, needs to be in bankruptcy for the bankruptcy exception to apply.²⁶³ In any event, the partner may be insolvent, and therefore would also be eligible for the section 108(a)(1)(B) exclusion to the extent of his insolvency. However, it is not clear whether, or to what extent, the partnership transaction giving rise to the COD income would affect the partner's solvency, particularly where nonrecourse debt is discharged.

²⁶⁰ I.R.C. § 705(a)(1)(A).

²⁶¹ See TAM 9739002 (May 19, 1997).

²⁶² I.R.C. § 108(d)(6). It is not clear whether the section 108(e)(2) exception, which provides that no COD income is recognized to the extent payment of a liability would have given rise to a deduction, applies at the partner level.

²⁶³ S. REP. NO. 96-1035, at 21 (1980).

- A taxpayer is considered to be “insolvent” to the extent his liabilities exceed the fair market value of his assets immediately prior to the debt discharge.²⁶⁴ Where the taxpayer owns a partnership interest, two questions arise in determining the amount of the taxpayer’s insolvency:
 - Is the “asset” for this purpose the partnership interest itself or a *pro rata* share of the partnership assets?²⁶⁵
 - To what extent should the taxpayer include any partnership nonrecourse debt in determining his insolvency?²⁶⁶
- Individual partners are also each treated as receiving deemed cash distributions equal to their allocable shares of the discharged partnership debt.²⁶⁷ Such a deemed distribution is taxable if, and to the extent, it exceeds a partner’s basis in its partnership interest, taking into account any increase in basis attributable to

²⁶⁴ I.R.C. § 108(d).

²⁶⁵ Consider ABA Task Force Report, Topic V (Insolvency), Q-2. Before the Bankruptcy Tax Act of 1980, assets unavailable to creditors were not included in determining whether a taxpayer was considered insolvent, but all assets, including some of the assets exempt from the claims of creditors, are currently included in measuring insolvency. See, e.g., *Carlson v. Commissioner*, 116 T.C. 87 (2001); *Babin v. Commissioner*, T.C. Memo 1992-673 (1992), *aff’d*, 23 F.3d 1032 (6th Cir. 1994); *Marcus Estate v. Commissioner*, T.C. Memo 1975-9 (1975); Priv. Ltr. Rul. 1999-32-013 (May 4, 1999); TAM 1999-35-002 (May 3, 1999); Priv. Ltr. Rul. 91-25-010 (Mar. 19, 1991), *revoked*, Priv. Ltr. Rul. 1999-32-013 (May 4, 1999).

²⁶⁶ See discussion of Revenue Ruling 92-53; consider Sheppard, *Questions Arise from Cancellation of Nonrecourse Debt*, 51 TAX NOTES 959 (May 27, 1991).

²⁶⁷ I.R.C. § 752(b). Such deemed distributions can also occur as a result of an assumption of partnership debt by another person. See FSA 2002-33-018.

the partner's allocable share of the COD income recognized by the partnership.²⁶⁸

- In many cases, the amount of COD income allocated to a partner will equal the amount of discharged debt the partner is deemed to be relieved of, in which case the partner would not recognize gain under section 731. However, this result is not mandated in all cases, and partners may therefore recognize section 731 gain if they were allocated discharged debt in a different proportion than their allocated COD income.²⁶⁹
- The discharge of nonrecourse partnership debt may trigger income to one or more partners under the section 704(b) “minimum gain chargeback” rules discussed above.²⁷⁰
- If a discharge of partnership debt involves a modification that constitutes a deemed exchange of the debt under section 1001, the “reissued” debt may bear OID.
- Treasury and the IRS believe that section 1446 requires a partnership to withhold tax on its foreign partners' allocable share of COD income recognized by reason of a foreclosure or deed in lieu of foreclosure.²⁷¹

²⁶⁸ I.R.C. § 731(a)(1); Rev. Rul. 92-97, 1992-2 C.B. 124.

²⁶⁹ For example, the IRS has ruled that, when a partnership cancels a note issued by a partner in that partnership, the partner-obligor will be treated as having received a distribution of money or property at the time of the cancellation. *See* Priv. Ltr. Rul. 2013-14-004 (Dec. 20, 2012).

²⁷⁰ Treas. Reg. § 1.704-2(f)(6) (COD income treated as first-tier item).

²⁷¹ T.D. 9200, 2005-23 I.R.B. 1158 (May 13, 2005). Regulations under section 1446 permit a foreign partner to certify that it has deductions and losses it reasonably expects to be available to reduce U.S. income tax liability on the foreign partner's allocable share of effectively connected income, which certification would in turn

2. Tax Attribute Reduction When COD Income Is Excluded

Partners may either follow the general attribute reduction rules under section 108(b)(2), *i.e.*, a reduction of NOLs, business and alternative minimum tax credits, capital losses, asset basis (not below aggregate remaining debt), passive activity losses and credits, and foreign tax credits, *or* they may elect pursuant to section 1017 to first reduce basis in some or all of their depreciable property to *zero*.²⁷² Attribute reduction under either scenario is performed *after* determining the tax due for the taxable year of the discharge.²⁷³ Thus, a partner's gain recognized in the same taxable year that debt is discharged may be offset by the partner's NOL for such year before the NOL is reduced by excluded COD income, maximizing preservation of depreciable asset basis.²⁷⁴

- Depreciable Property Election A partner may elect to treat its partnership interest as depreciable property to the extent of the partner's share of depreciable partnership property, but only if the partnership agrees to effect a corresponding reduction in the basis of its depreciable property.²⁷⁵ Since a partner need not reduce the basis of depreciable property up to the full amount of the COD income, a partner

reduce the partnership's withholding obligation. *See* Treas. Reg. § 1.1446-6; T.D. 9394, 2008-21 I.R.B. 988 (Apr. 29, 2008).

²⁷² Regulations under section 1017 contain the basis reduction rules that apply following the discharge of indebtedness. T.D. 8787, 1998-46 I.R.B. 5; Treas. Reg. § 1.1017-1(c)(2) (a taxpayer may elect to reduce basis in only part of the taxpayer's depreciable real property first; other attributes are then reduced in the same amount as the remaining excluded COD income).

²⁷³ I.R.C. § 108(b)(4)(A).

²⁷⁴ *See* Levy and Hofheimer, *Bankrupt Partnerships and Disregarded Entities*, 127 TAX NOTES 1103, 1113 (June 7, 2010).

²⁷⁵ I.R.C. § 1017(b)(3)(C).

may choose to reduce only part of the depreciable property basis.²⁷⁶ If the decrease in the partner's basis in its partnership interest is less than the amount of the excluded COD income, the partner must reduce the balance of his attributes to the extent of the remaining COD income.²⁷⁷

- Because there is no consistency requirement among partners, some partners may elect to treat their partnership interests as depreciable property even though other partners do not. In addition, an election may be made with respect to a partnership interest that is unrelated to the source of the COD income.
- Except as described below, a partner may (but need not) request that the partnership consent to a reduction of his inside basis, and the partnership may withhold such consent in its sole discretion.²⁷⁸ The partnership must obtain a partner's consent to reduce inside basis if (i) the partner owns a greater than 50% interest in the capital and profits of the partnership at the time of discharge, or (ii) reductions to the basis of the partner's depreciable property are being made with respect to the partner's distributive share of COD income.²⁷⁹ There are two exceptions to this general rule. If at the time of the discharge the partner owns, directly or indirectly, an more than 80% of the aggregate capital and profits interests of the partnership, or five or fewer partners collectively own, directly or indirectly, more than 50% of the capital and profits interests

²⁷⁶ Treas. Reg. § 1.1017-(1)(c)(2).

²⁷⁷ Treas. Reg. § 1.1017-(1)(c)(2).

²⁷⁸ Treas. Reg. § 1.1017-1(g)(2)(i).

²⁷⁹ Treas. Reg. § 1.1017-1(g)(2)(ii)(B).

of the partnership, the partner and partnership are automatically treated as having requested and consented to the basis reduction. These rules are designed to preclude transfers to partnerships in order to shield the respective bases in transferred assets from reduction under section 108(b)(2).²⁸⁰

- The legislative history states that an adjustment will be made “in a manner similar to that which would be required if the partnership had made an election under section 754 to adjust basis in the case of a transfer of a partnership interest.”²⁸¹ Presumably, this adjustment would ensure that the reduced depreciation and the increased gain on disposition of the asset resulting from the basis reduction would be allocated to the partner benefiting from the discharge.
- Basis reductions are subject to recapture as ordinary income upon a subsequent taxable sale or disposition of the property whose basis has been reduced.²⁸² Query whether both the partnership asset and the partnership interest are subject to recapture, which would be the case if the statute were applied literally.

3. Allocation of COD Income Among the Partners

Neither section 108 nor the legislative history of the 1980 Act addresses how a partnership should allocate its COD income among its partners.²⁸³ The

²⁸⁰ T.D. 8787, 1998-46 I.R.B. 5.

²⁸¹ S. REP. NO. 96-1035, at 22 (1980).

²⁸² I.R.C. §§ 1017(d); 1245; 1250.

²⁸³ Whatever formula is used will also apply to the allocation of discharged nonrecourse liability for purposes of the section 108(d)(3)

1980 Senate Report assumes that the COD income allocated to a partner would equal the partner's section 752 allocable share of the discharged debt.²⁸⁴ However, the allocation of COD income realized by a limited partnership depends on whether the debt is recourse or nonrecourse, and the extent to which each partner is liable for the repayment of the debt, as indicated in Revenue Rulings 92-97 and 99-43 (discussed below).

- Each partner's adjusted basis in its partnership interest would be increased by its allocable share of COD income²⁸⁵ and reduced by the partner's section 752 deemed cash distribution attributable to its allocable share of the decrease in partnership liabilities. If these two amounts are equal, the partner's adjusted basis would remain unchanged and the partner would recognize no income or gain under section 731.
- A partnership's discretion in allocating COD income attributable to a reduction of nonrecourse debt is separately limited if the debt cancellation triggers a minimum gain chargeback. In such case, the COD income that produced a decrease in partnership minimum gain must be allocated under the minimum gain chargeback rules to the partners whose shares of nonrecourse debt were reduced in the same ratio

insolvency determination. Rev. Rul. 2012-14, 2012-24 I.R.B. 1012. However, as applied to the insolvency exclusion, the treatment of discharged debt that is recourse debt for purposes of section 752 remains unclear. See Blake D. Rubin, Andrea M. Whiteway & Jon G. Finkelstein, *Revenue Ruling 2012-14: The IRS Lends a Helping Hand to Insolvent Partners*, J. PASSTHROUGH ENTITIES, at 25 (July-Aug. 2012).

²⁸⁴ S. REP. NO. 96-1035, at 21 (1980). In general, COD income and the corresponding decrease in partnership liabilities realized by a general partnership should each be allocated to the partners in accordance with their respective partnership percentages. As a result, each general partner would recognize income from a debt exchange equal to his allocable share of the partnership's COD income.

²⁸⁵ I.R.C. § 705(a)(1).

as the debt was reduced.²⁸⁶ Moreover, if gain or loss is recognized with respect to section 704(c) property, gain or loss must be allocated to the contributing partner (or its successor) to eliminate any remaining book-tax difference.²⁸⁷

- Distributions in Excess of Basis²⁸⁸ If a partner's deemed or actual cash distribution from the partnership exceeds the partner's basis in his partnership interest immediately before the distribution, the partner will recognize income equal to such excess.²⁸⁹ If the partner holds his partnership interest as a capital asset, the income will generally be treated as capital gain.²⁹⁰
- Accordingly, if a partner's share of discharged debt exceeds his allocable share of COD income created by the discharge, the partner would receive an excess deemed cash distribution under section 731(a)(1), triggering taxable gain. In contrast, debt discharge would not result in gain to the partner under section 731(a)(1) if the

²⁸⁶ Treas. Reg. § 1.704-2(i)(4); *see* Rev. Rul. 99-43, 1999-4 C.B. 506; Rev. Rul. 92-97, 1992-2 C.B. 124.

²⁸⁷ Treas. Reg. § 1.704-3(a).

²⁸⁸ In general, if a lender either forecloses on a partner's partnership interest, or acquires at least a 10% equity interest in the partnership in exchange for forgiving debt, the partner will have taxable income equal to its "negative capital account," and will also owe tax on an amount equal to its allocable share of the vested investment tax credit ("ITC") claimed by the partnership (if any). The partner's negative capital account should equal its capital contributions, less its allocable share of the partnership's depreciation deductions, half of its allocable share of the partnership's vested ITC (assuming basis election), and its allocable share of accrued, unpaid interest expense (if any).

²⁸⁹ I.R.C. § 731(a)(1).

²⁹⁰ I.R.C. § 731. The gain should be passive activity income if the partnership owns and operates only rental real estate. If the partnership holds unrealized receivables, however, part or all of the gain may be characterized as ordinary income.

decrease in the partner's share of the partnership's liabilities is matched or exceeded by an allocation of COD income at the end of the year.²⁹¹

- It should be noted that if a partnership has remaining debt, its partners may be able to avoid gain recognition under section 731 by guaranteeing part or all of such remaining debt. The guarantee would be treated as a deemed cash contribution that increases a guaranteeing partner's basis in its partnership interest.²⁹²
- The IRS has held that, even if a partnership satisfies the alternate tests (but not the safe harbor) for substantial economic effect, an allocation of partnership COD income that differs from the partners' respective shares of the cancelled debt under section 752(b) will be respected under section 704(b) only if the deficit restoration obligation of the partners can be enforced. If this requirement is not satisfied, COD income must be allocated in accordance with the partners' respective shares of the

²⁹¹ Rev. Rul. 94-4, 104-1 C.B. 196; Rev. Rul. 92-97, 1992-2 C.B. 124.

²⁹² Treas. Reg. § 1.752-2(b)(3)(i) (recognizing certain contractual payment obligations beyond the scope of the partnership agreement as an obligation to make a payment under Treas. Reg. § 1.752-2(b)(1)). Note, however, that to recognize such outside contractual obligations as an economic risk of loss for a partnership liability, proposed regulations would further require (i) limitations to ensure ability to make payments, (ii) periodic updates as to the guarantor's financial condition, (iii) that the term of the guarantee extends beyond that of the partnership liability, (iv) that the guarantee not impose limits on the liquidity of the guarantor's assets, (v) that the guarantor received arm's-length consideration for assuming the obligation, (vi) that the guarantor would be liable if and to the extent that any amount of the partnership liability were not otherwise satisfied, and (vii) that the economic risk of loss be limited to the partner's "net value" under the proposed regulations. *See* Prop. Treas. Reg. § 1.752-2(b)(3)(ii), (iii); *see also* Preamble, 79 Fed. Reg. 4826 (Jan. 30, 2014).

cancelled debt, at least in transactions in which all partnership debt is transferred.²⁹³ More generally, such as when only a portion of a partnership's debt is cancelled, COD income would be allocated in accordance with the partner's interests in the partnership.

- Amending a partnership agreement to specially allocate COD income and offsetting amounts of book loss after the events giving rise to the items have occurred may not satisfy section 704(b). In Revenue Ruling 99-43,²⁹⁴ after a lender reduced the principal amount of a partnership loan, the partners amended the partnership agreement to add a special allocation of the partnership's COD income to an insolvent partner who was eligible to exclude such income. The partnership agreement was also amended to provide for the same special allocation of the book loss resulting from the revaluation. The IRS held that the paired special allocations lacked substantial economic effect because the overall effect of such allocations was not substantially different than the economic effect of the original allocations.
- Even if a partner's deemed cash distribution from a decrease in the partner's share of partnership liabilities avoids the minimum gain chargeback rules, the IRS may nonetheless argue that the decrease in partnership liabilities is governed by the section 707 disguised sale rules. If, as is typical in workouts, part or all of the discharged partnership debt would constitute a "qualified liability" for purposes of section 707, a "transfer" of the debt (*i.e.*, a

²⁹³ See Rev. Rul. 92-97, 1992-2 C.B. 510; see also R. Lipton, *IRS Addresses Cancellation of Debt Income under Partnership and Passive Activity Rules*, 78 J. TAX'N 14, 18-19 (1993) (criticizing analysis in ruling and describing alternative ways that the IRS could have reached the same result).

²⁹⁴ 1992-2 C.B. 506.

reduction of the partner's share of the debt), would not be treated as a disguised sale if the transaction is not otherwise treated as a sale. This would be the case if no actual cash distributions are made to any partners as part of the transaction.²⁹⁵ However, it is quite possible that only the portion of the discharged debt equal to the fair market value of the collateral would be treated as qualified debt.²⁹⁶ In that case, the disguised sale rules could apply with respect to the balance of the debt, even if no cash distributions are made.

- Allocation of COD Income from Discharge of Recourse Debt If the test discussed above is satisfied, COD income resulting from the discharge of recourse debt may be allocated either according to partners' profit-sharing percentages, or only to the partners who bore the economic risk of loss for the discharged debt immediately prior to the discharge (the "Liable Partners"). If COD income is allocated in accordance with profit-sharing percentages, partners who bore no economic risk of loss for the discharged debt (the "Non-Liable Partners") will be allocated COD income, with the result that a solvent Non-Liable Partner will recognize (and pay tax) on phantom COD income. In addition, Liable Partners would receive deemed cash distributions greater than their allocable shares of COD income, which may cause some or all of the Liable Partners to recognize additional gain under section 731(a).
 - To avoid this result, COD income should, to the extent consistent with the principles of Revenue Ruling 92-97, be allocated solely to the Liable Partner(s) in accordance with their section 752 shares of the discharged debt immediately prior to the discharge. A

²⁹⁵ Treas. Reg. § 1.707-5(a)(5).

²⁹⁶ See Treas. Reg. § 1.707-5(a).

special allocation of COD income to the partner bearing the economic burden of the partnership debt (and therefore enjoying the benefit when such debt is released) should be respected so long as the allocation otherwise has substantial economic effect.²⁹⁷

- However, it should be noted that COD income created with respect to nonrecourse debt would be treated as gain recognized from the disposition of partnership property subject to partnership nonrecourse debt. As a result, such COD income would be subject to a different allocation if the minimum gain chargeback rules apply.
- If the COD income is so allocated, the Non-Liable Partners will not be allocated phantom income, and the Liable Partners' adjusted bases in their partnership interests should remain unchanged. This allocation may alter the partners' economic arrangement if the Liable Partners' capital accounts were not revalued prior to the debt discharge transaction to reflect the presumed decline in the fair market value of the partnership's assets. To preserve the prior business deal, the partnership agreement should be amended to provide that, upon a subsequent recognition event, any loss inherent in the partnership's assets will be allocated solely to the Liable Partners to

²⁹⁷ An allocation may have economic effect, but such effect may not be "substantial." In that case, the IRS would likely reallocate COD income in accordance with partners' profit interests. *See* Treas. Reg. § 1.704-1(b)(2)(iii). Nevertheless, it is interesting to note that none of section 108, section 704(b) and section 752 prohibit special allocations of COD income. *See* MCKEE, NELSON AND WHITMIRE, *FEDERAL TAXATION OF PARTNERSHIPS AND PARTNERS* ¶ 9.02[2][a][ii], n.294 (4th ed. 2008).

whom (and in the same ratio as) the COD income was allocated.²⁹⁸

4. Discharge of Partnership But Not General Partner

In general, a bankruptcy discharge of recourse partnership debt will not discharge the personal liability of the general partners for such debt; rather, the bankruptcy trustee of the partnership will attempt to recover the amount of the discharged debt from the general partners. Similarly, outside of bankruptcy, partnership creditors may release the partnership while retaining recourse against the general partners.

- Query whether the partnership still recognizes 100% of the COD income, and if so, whether general partners must recognize their allocable shares of COD income even though they remain liable for the debt. Can the general partners ignore their shares of the COD income, and treat themselves as assuming the debt? Alternatively, should the partnership only treat a portion of the debt as cancelled equal to the percentage of the partners who do not have continuing liability (*i.e.*, limited partners)?²⁹⁹

5. Discharge of General Partner But Not Partnership

Conversely, where the general partner is discharged from any personal liability for recourse partnership debt, but the partnership remains liable for the debt on a nonrecourse basis, the general partner could properly be viewed as a guarantor released from its guarantee obligations. Under that analysis, the recourse debt of the partnership should be re-

²⁹⁸ This amendment would have the same effect as a Revaluation under Treas. Reg. § 1.704-1(b)(2)(iv)(f).

²⁹⁹ Consider ABA Task Force Report, Topic XI (Interaction of COD Rules With Sections 752 and 731); see also Sheppard, *Analyzing Dwarf Stars: Problems of Professional Partnership Bankruptcies*, TAX NOTES at 1021 (May 25, 1992).

allocated under section 752 as nonrecourse debt. If the partner was completely discharged from liability on the partnership debt, his share of the liability under section 752 would be reduced to zero, raising the possibility that the corresponding deemed cash distribution to the partner would trigger gain under section 731.

- The IRS has ruled on similar facts that the partnership (and, therefore, the partner) does not recognize COD income, since the partnership remains liable on the debt.³⁰⁰ Whether any COD income is created pursuant to the general partner's discharge would be determined at the partnership level, and any COD income would be an item of partnership income. To conclude otherwise, and create COD income to the general partner in his personal capacity, would potentially tax the general partner twice: once when he is personally discharged, and then again under section 108 when the partnership is discharged. Moreover, the general partner might have to recognize gain under section 731 if the deemed cash distribution that would occur if the debt were cancelled exceeds the general partner's allocable share of the partnership's COD income).

6. Discharge of General Partner and Partnership

A series of tax court memorandum decisions issued in 2004 held that a solvent general partner who personally guaranteed a bankrupt partnership's debt could exclude his allocable share of the

³⁰⁰ See TAM 96-19-002 (Jan. 31, 1996); *but see Marcaccio v. Commissioner*, T.C. Memo 1995-174 (1995) (partner realized COD income on difference between amount paid to creditor in cancellation of debt and amount of guaranteed debt; partner was primary obligor on debt at time of forgiveness after partnership terminated two years earlier).

partnership's COD income.³⁰¹ Because the general partner's remaining potential liability for the partnership's debt was discharged pursuant to an order of the bankruptcy court, which order specifically provided that the general partner was subject to the jurisdiction of the bankruptcy court, the tax court held that the general partner could rely on the section 108(a)(1)(A) exclusion for COD income from the discharge of the taxpayer's debt in a Title 11 bankruptcy case. Note that this result in effect requires the assumption that the partnership's discharged debt was debt of the general partner by reason of his guarantee.³⁰² Note also that if this result were correct, the section 108(a)(1)(D) exclusion from QRPBI COD income for solvent partners should not be needed.

C. Admission of a New Partner to the Partnership

A partnership may admit as a new partner an investor who contributes cash to service existing debts, or a creditor who contributes part or all of the nonrecourse debt by the partnership to the creditor in exchange for a partnership interest. The third party may either be directly admitted to the partnership as a partner, or the third party and the partnership (the "old partnership") can form a new partnership ("subpartnership") with the third party contributing cash (or the old partnership nonrecourse debt) and the old partnership contributing

³⁰¹ See *Gracia v. Commissioner*, T.C. Memo 2004-147 (2004); *Mirarchi v. Commissioner*, T.C. Memo 2004-148 (2004); *Estate of Martinez v. Commissioner*, T.C. Memo 2004-150 (2004). IRS officials have publicly indicated disagreement with *Gracia*. Elliott, *Recent Share-of-Liability Guidance Doesn't Extend to Partner*, 2013 TNT 86-1 (May 2013). Proposed regulations under section 108, while not mentioning these cases, would directly contradict them. Prop. Treas. Reg. § 1.108-9, 76 Fed. Reg. 20593 (Apr. 13, 2011). These regulations have not been promulgated in final form.

³⁰² Compare *Yamamoto v. Commissioner*, T.C. Memo 1990-549 (1990) (section 108 applies to a partnership debtor in a Title 11 case, but not to a partner of a debtor).

its property to the subpartnership.³⁰³ These alternatives may have significantly different results, as illustrated below.

1. Direct Admission of Partner

If the third party is directly admitted to the existing partnership by contribution, the partnership agreement will be amended and the historic partners' percentage interests in the partnership's income and loss will be reduced. The partners must decide whether to elect a Revaluation, which Revaluation may cause old partners to recognize gain.

- Effect of Revaluation on Partners' Shares of Minimum Gain If a partnership has minimum gain immediately prior to the admission of the third party partner, and the partnership's debt remains constant, a Revaluation will cause the adjusted book bases of the assets to be (at least) equal to the outstanding balance of the nonrecourse debt. As a result, a Revaluation will reduce the partnership's minimum gain to zero. The old partners' book capital accounts would be increased (generally to zero) by the increase in value of the partnership property, to equal the amount of the nonrecourse debt. No minimum gain chargeback would be required with respect to the decrease in minimum gain attributable solely to the Revaluation.³⁰⁴ Note, however, that if partnership debt becomes partner nonrecourse debt of the new partner, the above-described rule would not apply and minimum gain chargeback would typically occur. It is, of course, also possible that the decrease in minimum gain could exceed the basis increase resulting from a Revaluation, for

³⁰³ Note that the creation of a new partnership between a creditor and a disregarded entity could be characterized as a partial asset sale. *See* Rev. Rul. 99-6, 1999-1 C.B. 432.

³⁰⁴ Treas. Reg. § 1.704-2(g)(2).

example, if the partnership's aggregate nonrecourse debt is reduced as part of the same transaction.

- Effect of Revaluation on Partnership Interest Basis The admission of the new partner by contribution and the “book up” of the partnership's assets will shift a portion of the partnership's nonrecourse debt from the old partners to the new partner.³⁰⁵ The amount so shifted will depend on the new partner's profit percentage and the partnership's book bases in its assets immediately prior to the new partner's admission. The new partner will generally assume liabilities equal to the new partner's profit percentage multiplied by the old book bases. The balance of the debt, which produced deductions or distributions enjoyed by the old partners, will be allocated solely to the old partners as section 704(c) minimum gain amounts as a result of the Revaluation.
- If the amount of the partnership's debt remains constant, the cash deemed distributed to the old partners under sections 752(b) and 733(1) in connection with the liability shift should not exceed the old partner's basis in his partnership interest. Accordingly, no section 731(a)(1) gain should be recognized by any old partner.³⁰⁶

³⁰⁵ This shift in liabilities must also be analyzed in light of section 751.

³⁰⁶ If the new partner contributes cash to the partnership, and such cash is used to repay part or all of the partnership's debt, the old partners will be deemed to receive cash distributions, which may trigger taxable gain under section 731(a)(1). It is worth noting, however, that if the partnership has a section 754 election in effect, and the partnership qualifies to adjust the “common” basis of its partnership property pursuant to Treasury Regulation section 1.734-2(b)(1) (subject to section 755 and the regulations promulgated thereunder), the old partners generally should be permitted corresponding capital account increases under Treasury Regulation sections 1.704-1(b)(2)(iv)(m)(4) and (5). Under such circumstances, some or all of the old partners may avoid gain recognition under section 731.

As the partnership subsequently claims depreciation deductions with respect to its booked-up assets, however, the partnership's section 704(b) minimum gain will increase, and its section 704(c) minimum gain will decrease, shifting additional liabilities from the old partners to the new partner. The old partners will receive deemed cash distributions under sections 752(b) and 733(1) as these shifts occur, and may eventually be required to recognize income under section 731(a)(1).

- Effect of Admission without Revaluation If the partners do not elect a Revaluation when a third party is admitted as a new partner, and the partnership's debt is not reduced, the partners will retain their shares of partnership minimum gain. As a result, in cases where the partnership has significant section 704(b) (or section 704(c)) minimum gain, the old partners should retain sufficient shares of partnership debt to avoid section 731 gain. Deemed distributions of cash under section 752(b) should not result in section 731 taxable gain to a partner whose entire deficit capital account balance is attributable to the partner's share of section 704(b) minimum gain. In addition, because no section 704(c) minimum gain amounts are created, basis will not shift over time from the old partners to the new partners. However, if a Revaluation does not occur, section 704(c) will not apply, and the amount of taxable income (or loss) allocated to the new partner therefore may be greater (less) than the amount of taxable income (loss) that would have been allocated to the new partner had a Revaluation occurred.

2. Admission of New Partner to Subpartnership

In some cases, a third party may insist on admission to a subpartnership of the old partnership, in order to avoid undisclosed or unknown liabilities of the

old partnership. The issues discussed above with respect to the direct admission of a new partner to the existing partnership generally apply to admission to a subpartnership. In addition, section 704(c) would govern the old partnership's transfer of assets to a subpartnership. The subpartnership will take an initial fair market value book basis in the contributed property.³⁰⁷ The old partnership's initial capital account in the subpartnership would be zero, assuming that the assets are contributed subject to debt at least equal to their fair market value, as is typically the case in a workout or bankruptcy.³⁰⁸

- Pursuant to section 752(c), the subpartnership is deemed to acquire the property subject only to that portion of the nonrecourse debt that does not exceed the fair market value of the property.³⁰⁹ The remainder of the debt (*i.e.*, the portion in excess of the property's fair market value) remains outside the subpartnership and may remain a liability of the old partnership that continues to encumber its interest in the subpartnership.³¹⁰

³⁰⁷ See Treas. Reg. § 1.704-1(b)(2)(iv)(d)(1), (3).

³⁰⁸ See Treas. Reg. § 1.704-1(b)(2)(iv)(b)(2). See generally MCKEE, NELSON AND WHITMIRE, *FEDERAL TAXATION OF PARTNERSHIPS AND PARTNERS* ¶ 7.04[3] (4th ed. 2008); Burke, *Partnership Formation Under the Temporary Section 752 Regulations: A Reply and Further Discussion*, 69 TAXES 116, 125 (Feb. 1991); Lokken, *Contributions of Overencumbered Property: A Reply and Further Discussion*, 5 J. PARTNERSHIP TAX 242, 243 (Fall 1988); but see Carman & Brown, *Another Look at Accounting for Contributions of Overencumbered Property: Turning Basis Inside Out*, 7 J. PARTNERSHIP TAX 192, 193-194 (Summer 1990) (contributing partner's initial capital account should equal the fair market value of contributed property less the total amount of nonrecourse debt secured by such property).

³⁰⁹ For this purpose, section 7701(g) does not apply in determining such fair market value. Treas. Reg. § 1.704-1(b)(2)(iv)(d)(i).

³¹⁰ See Burke, *Partnership Formation Under the Temporary Section 752 Regulations: A Reply and Further Discussion*, 69 TAXES 116, 125

- Commentators have suggested that while section 752(c) may limit the amount of liabilities the subpartnership is deemed to take, the old partnership nevertheless should be deemed relieved of the entire liability for purposes of determining its basis in its interest in the subpartnership.³¹¹ Under this theory, the excess portion of the debt would vanish both inside and outside the partnership, ignoring the fact that the liability continues to exist, secured by the property. Query whether the excess portion of the debt should instead be deemed to be a continuing liability of the old partnership that is “secured” by its interest in the subpartnership.
- The old partnership’s minimum gain should initially be preserved because its share of the subpartnership’s debt under the section 752 regulations, together with the excess portion of the debt it is deemed to retain, would exceed its basis in its subpartnership interest by only its original minimum gain amount.³¹² Similarly, the amount of any

(Feb. 1991); Stafford, *Section 752(c): The Other Issue in Tufts v. Commissioner*, 42 TAX LAW. 93 (Fall 1988).

This issue also occurs under the disguised sale regulations, discussed above in the text, pursuant to which nonrecourse debt in excess of the fair market value of property that secures the debt is treated as a qualified liability only to the extent of the contributed property’s fair market value. Treas. Reg. § 1.707-5(a). The treatment of the excess amount of the debt is not clear. Thus, it is possible that contributions of overencumbered property would be treated in part as taxable sales under section 707(a)(2)(B), even if the contributing partner receives no cash and the partnership is relieved of no debt as a result of the contribution.

³¹¹ See Burke, *Partnership Formation Under the Temporary Section 752 Regulations: A Reply and Further Discussion*, 69 TAXES 116, 125 (Feb. 1991); Andrews, *On Beyond Tufts*, 61 TAXES 949, 958-959 (Dec. 1983).

³¹² The excess of the fair market value of the contributed property over its adjusted basis is the amount which, if the subpartnership were to immediately sell the contributed property for the amount of the

deemed distribution from the subpartnership to the old partnership under section 752 should be less than the old partnership's basis in its subpartnership interest. Thus, the old partnership should not recognize gain under section 731(a)(1). However, as the old partnership's share of the subpartnership's debt shifts over time to the new partner, the old partnership (and thus its partners) may receive deemed distributions of cash that exceed its basis in its subpartnership interest, triggering gain.³¹³

- It is not clear how subsequent payments by the subpartnership with respect to the portion of debt deemed retained by the old partnership should be treated.
- Subsequent payments on the unassumed debt could be applied to the portion of the liability assumed by the partnership, with the attendant tax consequences under section 752(b) for the satisfaction of a portion of the partnership liability.³¹⁴ Under this analysis, once the assumed portion is exhausted, the additional payments probably should be deemed distributed as a

nonrecourse debt secured by the property, would be specially allocated to the old partnership under section 704(c). If the actual fair market value of the contributed property is less than the nonrecourse debt, and the excess debt is deemed to burden the old partnership's interest in the subpartnership, query whether the excess amount would be included in the old partnership's minimum gain. If it is not, the old partnership's minimum gain may be deemed to decrease, triggering a possible minimum gain chargeback at the old partnership level when the subpartnership is formed.

³¹³ The section 707(a)(2)(B) regulations may change the results if the debt secured by the contributed property was incurred less than two years ago or was incurred to purchase the property. The result may be less clear, however, if the subpartnership pays down part of the debt with cash contributed by new partners.

³¹⁴ A. WILLIS, J. PENNELL & P. POSTLEWAITE, *PARTNERSHIP TAXATION* § 44.04 (3d ed. 1988).

section 752(b) payment to the old partnership by the subpartnership.

- Such subsequent payments could also be viewed as additional assumptions by the subpartnership of portions of the contributing partnership's liability, triggering additional constructive distributions to the contributing partner under section 752(b), additional constructive contributions by the other partners under section 752(a), and constructive distributions to all partners under section 752(b) by reason of the debt payment.³¹⁵ This analysis would result in no net distribution to the contributor and no net change for all other partners.
- Until the liability in excess of the fair market value of the contributed property is discharged, the subpartnership may not be viewed as having true equity in the property.³¹⁶ Under that analysis, payments on the debt should first be applied to the portion of the liability not assumed by the subpartnership. However, the subpartnership might also be viewed as making a cash distribution to the contributing partnership to service the liability. This analysis avoids shifting the unassumed liabilities to the subpartnership while in effect paying the partnership's outside liabilities.

³¹⁵ MCKEE, NELSON AND WHITMIRE, *FEDERAL TAXATION OF PARTNERSHIPS AND PARTNERS* ¶ 7.04[3] (4th ed. 2008).

³¹⁶ Stafford, *Section 752(c): The Other Issue in Tufts v. Commissioner*, 42 Tax Law. 93, 103 (Fall 1988).

3. Admission of a Nonrecourse Lender to a Partnership

The admission of the lender (or a related person) to the partnership in exchange for the cancellation of debt owed by the partnership or, alternatively, for a future interest in the partnership's profits, also raises several tax issues.³¹⁷

- Recharacterization of Debt that Remains Outstanding If the lender is admitted to the original partnership, and the loan is not contributed to the partnership in exchange for the partnership interest, the loan will cease to be a nonrecourse loan if the lender acquires more than a 10% interest in any item of income or loss of the partnership.³¹⁸ In that case, the loan would be recharacterized as a partner nonrecourse loan, and all subsequent deductions attributable to the loan would be allocated entirely to the lender.³¹⁹
 - The partnership's minimum gain will be reduced to zero, triggering the minimum gain chargeback rules. The old partners may be able to avoid immediate income recognition under those rules by effecting a Revaluation.³²⁰
- Debt Exchanged for Partnership Interest If the lender contributes partnership debt in exchange for a partnership interest, the partnership's

³¹⁷ Several commentators have raised the issue of whether the contribution of debt to a partnership qualifies as a contribution of property that is subject to nonrecognition treatment under section 721, noting that if section 721 does not apply, the transfer of debt for an interest in the partnership is a taxable exchange. For a discussion of these issues, see J. Sowell, *Partnership Workouts*, 750 PLI/TAX 69 (2007).

³¹⁸ Treas. Reg. § 1.752-2(c)(1), (d)(1).

³¹⁹ Treas. Reg. § 1.704-2(i).

³²⁰ Treas. Reg. § 1.704-1(b)(2)(iv)(f)(5).

minimum gain with respect to the contributed liability will be reduced to zero and the old partners will receive a deemed cash distribution under section 752. Unless the existing partners' capital accounts are increased to zero pursuant to a Revaluation, each old partner would be allocated items of income sufficient to eliminate that portion of the deficit in its capital account attributable to the nonrecourse debt (its minimum gain with respect to the loan). Accordingly, minimum gain chargeback may cause the old partners to recognize COD income (and may limit the partnership's flexibility with regard to the allocation of some or all of such income).³²¹ The ABA Task Force recommends that the IRS exercise its power to waive the minimum gain chargeback requirement under these circumstances.³²² Instead, the Task Force recommends that the old partners be required to reduce their bases in their respective partnership interests by the amount of income they would recognize under the minimum gain chargeback rules (which will insure recognition of such income on sales of partnership interests).

- As discussed above, if the partnership has a section 754 election in effect, and the old partners' capital accounts may be increased (or any deficit balance reduced) pursuant to Treasury Regulation section 1.704-1(b)(2)(iv)(m)(4) in connection with an increase in the common basis of the

³²¹ For a thorough discussion of these issues, see Gall & Wang, *The Mysterious Case of Disappearing Debt in Partnership Transactions*, TAXES 157 (Mar. 2012) (proposing a new framework for examining cancellation of debt involving partnerships).

³²² Treas. Reg. § 1.704-2(f)(4); ABA Task Force Report, Topic X (Partnership Equity For Debt), A-9. Request for a waiver will be considered if (i) partners have made capital contributions or received net income allocations that have restored previous non-recourse deductions and distributions attributable to proceeds of non-recourse liabilities, and (ii) minimum gain chargeback would distort partners' economic arrangement.

partnership property, the amount of an old partner's income under the minimum gain chargeback rules should be reduced.

- The capital account for the creditor contributing debt to the partnership in exchange for a partnership interest should reflect an amount equal to the fair market value (rather than the adjusted issue price) of the contributed debt.³²³
- Availability of Partnership Interest-for-Debt Exception to COD Income The American Jobs Creation Act of 2004 (the "Jobs Act") amended section 108(e)(8) to provide that the transfer of a capital or profits partnership interest to a creditor in satisfaction of a partnership (recourse or nonrecourse) debt obligation will cause the partnership to recognize COD income, measured as if the debt were satisfied with cash equal to the fair market value of the partnership interest received.³²⁴
 - Any COD income recognized by the partnership must be allocated solely among the partners who held partnership interests immediately prior to the exchange of the debt.³²⁵
- Historically, there was no specific authority applying the equivalent of the corporate stock-for-debt exception in the partnership area, and the repeal of the stock-for-debt exception cast doubt on the viability of such an exception. Nevertheless, the legislative histories behind the Bankruptcy Tax Act of 1990 and the Omnibus

³²³ See Treas. Reg. § 1.704-1(b)(2)(iv)(f)(5)(i).

³²⁴ I.R.C. § 108(e)(8); *see also* Treas. Reg. § 1.61-12(c)(2) (issuer realizes COD income on repurchase of a debt instrument for an amount less than its adjusted issue price, including upon a transfer of the debt instrument in exchange for a (less valuable) partnership interest).

³²⁵ H.R. REP. NO. 108-755, at 561 (2004); S. REP. NO. 108-192 (2004).

Budget Reconciliation Act of 1993 indicated the possible existence of a partnership equity-for-debt exception,³²⁶ and numerous commentators believed that such an exception did in fact exist.³²⁷

- After a long silence on the matter, Treasury announced in 1999 that no direct authority existed to support a partnership equity-for-debt exception to COD income.³²⁸ In addition, the Tenth Circuit held that where a creditor (who also held a partnership interest) expressly intended to disassociate itself from the partnership, the creditor's surrender of its interest for less than the loan amounts resulted in COD income and should not be treated as a tax-free contribution to the partnership's capital.³²⁹
- The existence of a partnership equity-for-debt exception remained in doubt until its

³²⁶ See Sheppard, *Another Nail in the Partnership Equity-for-Debt Exception Coffin?*, 2000 TNT 15-8 (Jan. 21, 2000) (the Conference Report for the Omnibus Budget Reconciliation Act of 1993 repealing the stock-for-debt exception states that no inference should be made from the repeal regarding the treatment of COD income for entities other than corporations). See also Lipton, *The Tax Consequences to a Debtor from a Transfer of Its Indebtedness*, 69 TAXES 939, 951 (Dec. 1991) (the House version of the Bankruptcy Tax Act of 1990 abolished the equity for debt exception for partnerships, but this provision was not included in the final legislation).

³²⁷ See, e.g., Sheffield and Maynes, *Selected Tax Issues in Partnership Debt Restructurings*, 68 Taxes 861, 875 (Dec. 1990); Seago and Strobel, *Cancellation of Indebtedness in Exchange for a Partnership Interest: Should the Transaction Be Nontaxable Under Sec. 721?*, 19 Tax Adviser 443 (June 1988).

³²⁸ 1999 TNT 201-3 (Oct. 19, 1999).

³²⁹ *Twenty Mile Joint Venture v. Commissioner*, 200 F.3d 1268 (1999). See also Sheppard, *Another Nail in the Partnership Equity-for-Debt Exception Coffin?*, 2000 TNT 15-8 (Jan. 21, 2000); Magin, *Court Opinions*, TAX NOTES, Jan. 10, 2000, at 193.

elimination by the Jobs Act.³³⁰ Prior to 2005, the Bankruptcy Code expressly provided an exception to COD income for state and local tax purposes for equity-for-debt exchanges involving general partner interests (in either a general or limited partnership).³³¹ However, the Bankruptcy Abuse Prevention and Consumer Protection Act of 2005³³² eliminated this provision. As a result, there is no longer an equity-for-debt exception for state and local tax purposes in bankruptcy proceedings.

- In November 2011 the government issued final regulations that address certain tax issues arising in a partnership equity-for-debt exchange.³³³ The regulations allow the parties in a partnership equity-for-debt exchange to use a liquidation value³³⁴ approach to determine the fair market value of the partnership interest if the following four conditions are met:

³³⁰ The original justifications for the corporate stock-for-debt exception are equally applicable and persuasive in the partnership context. Section 108(e)(7)(E) expressly anticipates rules in the partnership area analogous to the rules in the corporate stock-for-debt context that focus on the creditors' treatment and specifically treat all or part of the creditors' gain on a subsequent sale of stock received as ordinary (recapture) income.

³³¹ BC § 346(j)(7) (repealed).

³³² Pub. L. No. 109-8 (2005).

³³³ Treas. Reg. §§ 1.108-8, 1.704-2, 1.721-1. For the original proposed regulations, *see* 73 Fed. Reg. 64903 (Oct. 31, 2008). For a discussion of the final regulations, *see, e.g.*, Feely & McMurry, *Partnership Debt-For-Equity Regulations: Lender Beware*, 26 J. TAX'N & REG. FIN. INSTITUTIONS 5 (2012); Blake D. Rubin, Andrea M. Whiteway & Jon G. Finkelstein, *Final Partnership Debt-for-Equity Regs Deny Creditors' Losses*, 135 TAX NOTES 81 (Apr. 2, 2012)..

³³⁴ The regulations define this as the amount of cash a creditor would receive if the partnership sold all its assets and liquidated immediately after a debt-for-equity exchange. Treas. Reg. § 1.108-8(b)(2)(iii).

- The debtor partnership determines and maintains its capital accounts in accordance with the capital accounting rules of Treasury Regulation section 1.704-1(b)(2)(iv);
 - The creditor, debtor partnership, and its partners treat the fair market value of the indebtedness as being equal to the liquidation value of the debt-for-equity interest for purposes of determining the tax consequences of the debt-for-equity exchange;
 - The debt-for-equity exchange has terms comparable to those that would arise from an arm's-length transaction; and
 - Subsequent to the debt-for-equity exchange, the partnership does not redeem, and no person related to the partnership purchases, the debt-for-equity interest as part of a plan at the time of the debt-for-equity exchange that has as a principal purpose the avoidance of COD income by the partnership.³³⁵
- If these liquidation value requirements are not satisfied, the fair market value of the partnership interest is determined under all relevant facts and circumstances.
 - Note that liquidation value may be artificially high, as in the case of a perpetual preferred interest with a low coupon, or artificially low, as in the case of a profits interest with significant option value. In the latter case, avoiding the liquidation value safe harbor may reduce the amount of COD realized on the exchange.
 - Section 721 will generally apply to a contribution of partnership debt by a creditor to the partnership in exchange for an interest in the

³³⁵ Treas. Reg. § 1.108-8.

partnership.³³⁶ Where a creditor contributes partnership debt that exceeds the fair market value of the partnership interest received, the excess amount will be added to the creditor's basis in his partnership interest. Section 721 also generally applies to partnership interests exchanged for transfers of interests in satisfaction of unpaid rent, royalties, or interest.³³⁷

- The debtor partnership must recognize COD income equal to the excess amount of debt contributed over the fair market value (liquidation value, under the regulation safe harbor) of the partnership interest received. However, the regulations do not allow the creditor a corresponding bad debt deduction on the excess amount (though some creditors may be able to separately take such a deduction prior to the exchange). Commentators questioned this asymmetrical tax treatment to the creditor and the debtor partnership under the 2008 proposed regulations,³³⁸ and the ABA

³³⁶ Treas. Reg. § 1.721-1(d).

³³⁷ Existing regulations force a partnership's payment of debt to be applied first to these items. Treas. Reg. §§ 1.446-2(e), 1.1275-2(a). For a thoughtful critique of bifurcating the transaction in this way, see Rubin, Whiteway, and Finkelstein, *Final Partnership Debt-for-Equity Regulations Maintain Denial of Creditor's Loss*, 15 J. PASSTHROUGH ENTITIES 41 (2012). Nevertheless, the IRS has affirmed that the interest-first ordering rules apply with respect to payments received in a debt workout. See Amy S. Elliott, *IRS Takes Hard Line in Debt-for-Equity Regs*, 132 TAX NOTES 1460 (Dec. 19, 2011); see also Treas. Reg. § 1.721-1(d)(3) (explicitly cross-referencing the interest-first ordering rules in Treasury regulation sections 1.446-2 and 1.1275-2).

³³⁸ See Rubin, Whiteway and Finkelstein *New Partnership Debt-for-Equity Regulations Deny Lender's Losses*, 2008 TNT 242-47 (Dec. 15, 2008). This rejection of a bifurcated view of the exchange also does not align with the regulations' approach to the satisfaction of unpaid rent, royalties, and interest in such an exchange, which are deemed resolved in a separate transaction that may provide ordinary

recommended that the final regulations expressly permit the creditor to take a bad debt deduction for the portion of the debt contributed to the partnership that exceeds the fair market value of the partnership interest received.³³⁹

The government's rejection of this recommendation means that creditors will want to claim bad debt deductions before discussing a debt for equity swap in order to avoid an IRS assertion that the loss was claimed in connection with the debt for equity exchange and so should be disallowed.³⁴⁰

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income to the creditor and is deductible by the partnership. Treas. Reg. § 1.721-1(d)(2).

³³⁹ American Bar Association Section of Taxation, *Comments on Proposed Regulations Under Section 108(e)(8)*, 2009 TNT 85-13 (May 6, 2009).

³⁴⁰ Note that the creditor will not be able to take such a deduction under section 166(d) if the loan is a "nonbusiness debt" (e.g., if the creditor is not in the business of making loans).

APPENDIX I

SUBSTANTIAL ECONOMIC EFFECT UNDER THE SECTION 704(b) REGULATIONS

I. BASIC PRINCIPLES

- If a partnership agreement does not provide for the allocation of partnership items to a partner, or if such an allocation is provided for but does not have substantial economic effect, each partner's distributive share shall be determined in accordance with such partner's interest in the partnership (taking into account all facts and circumstances).
- An allocation may be respected under section 704(b) if it meets one of the following three tests:
 1. the allocation has substantial economic effect under Treasury Regulation section 1.704-1(b)(2);
 2. taking into account all facts and circumstances, the allocation is in accordance with the partner's interest in the partnership under Treasury Regulation section 1.704-1(b)(3); or
 3. the allocation is deemed to be in accordance with the partner's interest pursuant to one of the special rules in Treasury Regulation section 1.704-1(b)(4) (allocations to reflect revaluations) or Treasury Regulation section 1.704-2 (allocations attributable to non-recourse liabilities).
- Allocations that do not meet one of these tests will be re-allocated in accordance with the partner's interests in the partnership under Treasury Regulation section 1.704-1(b)(3).
- Allocations include allocations of specific items of income, gain, loss, deduction and credit, and allocations of partnership "net taxable income and loss." Allocations of net taxable income and loss are considered an allocation to each partner of the same

shares of each partnership item that is used to compute net income or loss.

II. **SUBSTANTIAL ECONOMIC EFFECT: A TWO-PART TEST**

- To have substantial economic effect, an allocation must have economic effect under Treasury Regulation section 1.704-1(b)(2)(ii), and the economic effect of the allocation must be substantial under Treasury Regulation section 1.704-1(b)(2)(iii).

A. **Economic Effect**

- Primary Test of Economic Effect To have economic effect, an allocation must be consistent with the “underlying economic arrangement” of the partners, so that the partner to whom an allocation is made receives the economic benefit, or bears the economic burden, that corresponds to the allocation. An allocation will have economic effect if, and only if, a partnership agreement provides:
 - for the determination and maintenance of capital accounts in accordance with Treasury Regulation section 1.704-1(b)(2)(iv);
 - that liquidating distributions, in all cases, be made in accordance with partners’ positive capital account balances; and
 - that partners are unconditionally required to restore deficit capital account balances on liquidation (this requirement may be satisfied in certain cases by a partner’s note or other contractual obligation).
- Alternate Test of Economic Effect If capital accounts are maintained, and liquidating distributions are made in accordance with partners’ capital account balances, partners’ deficit restoration obligations may be satisfied if the partnership agreement contains a “qualified income offset.” In that case, an allocation will have

economic effect, provided the allocation does not cause, or increase, a deficit balance in a partner's capital account as of the end of the partnership taxable year to which such allocation relates.

- Whether an allocation will cause or increase a deficit balance is determined by taking into account reductions for oil and gas depletion, losses and deductions reasonably expected to be made by year end, and other distributions expected to exceed increases to capital accounts.
- A qualified income offset exists only if a partner that unexpectedly receives an allocation or distribution will be allocated items of income and gain (consisting of a *pro rata* portion of each item of partnership income, including gross income, and gain for such year) in an amount and manner sufficient to eliminate such deficit balance as quickly as possible. These allocations will be deemed to be made in accordance with partners' interests in the partnership if liquidating distributions are made in accordance with capital accounts.
- Economic Effect Equivalence Allocations that otherwise do not have economic effect will be deemed to have economic effect if a liquidation at the end of the current (or any future) year would produce the same economic results as would occur if the primary test of economic effect were met, regardless of the economic performance of the partnership.

B. Substantiality of Economic Effect

The economic effect of an allocation is substantial if there is a reasonable possibility that the allocation will substantially affect the dollar amounts received by the partners (independent of tax consequences). The following allocations do not have substantial economic effect:

- one or more partners' after-tax economic consequences are enhanced, and no partner's after-tax economic consequences are diminished, by the allocation (taking into account each partner's unrelated tax attributes);
- the net capital account increases and decreases would not differ, and the total tax liability for the partners will be reduced (taking into account each partner's unrelated tax attributes), as a result of the allocation for that taxable year; and
- allocations may be largely offset by other allocations within five or fewer years, and the allocations have the same effect as in the previous bullet. This result is presumed if the consequences occur within one year after allocation takes effect. For this purpose, the tax basis (or book value, if different) of partnership assets will be presumed to be fair market value. Adjustments to tax basis will be deemed to cause corresponding adjustments to the property's fair market value, so that the economic effect of the allocations (in all likelihood) cannot be offset by an allocation of gain or loss attributable to a disposition of partnership property.

III. CAPITAL ACCOUNT MAINTENANCE

A. General Rules

Capital accounts will be considered to be maintained in accordance with section 704(b) only if each partner's capital account is increased by:

- money contributed by the partner to the partnership;
- the fair market value of contributed property (net of liabilities the partnership is considered to have assumed or taken the property subject to); and

- allocations to the partner of partnership income and gain (or items thereof), including tax-exempt income and, following a Revaluation, book income (rather than tax income) attributable to revalued assets;

and decreased by:

- the amount of money distributed to the partner by the partnership;
- the fair market value of property distributed to the partner (net of the partner's share of any liabilities that the partner assumes or takes subject to under section 752);
- allocations to the partner of non-deductible expenses under section 705(a)(2)(B); and
- allocations of partnership loss or deductions (or items thereof), including book (not tax) losses or deductions attributable to revalued assets other than section 705(a)(2)(B) expenses and excess percentage depletion.

B. Contributions of Property

For contributed property, a partner's capital account will be increased by the property's fair market value on the date of contribution. Consistent with section 752(c), section 7701(g) will not apply to determine fair market value.

- For book purposes, capital accounts must be adjusted pursuant to Treasury Regulation section 1.704-1(b)(2)(iv)(g) to reflect pre-contribution gain or loss under section 704(c). Capital accounts are not adjusted to reflect tax allocations of pre-contribution gain or loss pursuant to Treasury Regulation section 1.704-3.
- A partner's capital account will be increased on contribution of a partner's promissory note only when the partnership effects a taxable distribution

of the note, or when the partner makes principal payments on the note, unless the note is readily tradable on a securities market. The fair market value of a partner's note will be its outstanding principal balance, if the note bears interest at or above the AFR when valued.

C. Distributions of Property

Partners' capital accounts must be decreased by the fair market value of property distributed (computed without regard to section 7701(g)). To satisfy this requirement, partners' capital accounts must first be adjusted to reflect the manner in which unrealized income, gain loss, and deduction inherent in the property (not previously reflected in capital accounts) would be allocated on a taxable disposition of the property.

- If the partnership distributes a promissory note, a partner's capital account will not be decreased until the partnership makes principal payments on the note, or the partner effects a taxable distribution of the note.

D. Revaluations of Property

Property must be revalued, and the adjustments set forth below must be made, in connection with a contribution of money or other property to a partnership, in connection with a liquidation or distribution of property to partners, or under GAAP principles for securities partnerships. Capital account adjustments resulting from the revaluation will not have substantial economic effect unless:

- adjustments are based on the fair market value of the partnership property (based on section 7701(g)) on the adjustment date;
- adjustments reflect the manner in which the unrealized income, gain, loss or deduction in the property (not previously reflected in capital accounts) would be allocated among the partners if

the property were disposed of in a taxable transaction for its fair market value on that date;

- partners' capital accounts are adjusted for allocations of partnership items computed on the basis of book (not tax) income or loss with respect to such property;
- partners' distributive shares of partnership items for the revalued property are separately computed for tax (not book) purposes to take into account the variation between the adjusted tax basis and book value of such property in the same manner as under section 704(c) (*see* Treas. Reg. § 1.704-1(b)(4)(i)); and
- adjustments are made principally for a substantial non-tax business purpose.

E. Adjustments to Reflect Book Value

Where property has a different book value than adjusted tax basis, capital accounts must be adjusted by allocations of partnership items computed for book (not tax) purposes. Whether this allocation has substantial economic effect depends on the effect the book allocation has on the determination of the partners' distributive shares of these items for tax purposes under section 704(c). If the book allocation does not have substantial economic effect, the items will be re-allocated in accordance with the partners' interests in the partnership, and the partners' tax items will be determined for section 704(c) purposes based on the re-allocation.

- A book deduction or loss for an item of partnership property is the amount that bears the same relationship to the book (fair market) value of the property as the tax depreciation bears to the adjusted tax basis of the property. Where property has a zero tax basis, book depreciation may be determined under any reasonable method selected by the partnership.

- The fair market value of revalued property will be presumed correct if (i) value is reasonably agreed to in an arm's length negotiation, and (ii) the partners have sufficiently adverse interests.

F. Section 705(a)(2)(B) Expenditures

Partners' capital accounts must be decreased by allocations to partners of section 705(a)(2)(B) expenses.

- Disallowed losses pursuant to sections 267(a)(1) and 707(b) shall, for capital account purposes, be treated as section 705(a)(2)(B) expenses.

IV. PARTNERS' INTERESTS IN THE PARTNERSHIP

A. General Rule

Partners' interests in the partnership represent the manner in which the partners have agreed to share any economic benefits or burdens corresponding to the income, gain, loss, credit or deduction (or item thereof) allocated to the partners. Partners' interests are determined on the basis of all of the facts and circumstances relating to the economic arrangement of the partners.

- All partners' interests in the partnership are presumed to be equal. However, this presumption may be rebutted by either the partners or the IRS by establishing facts and circumstances to the contrary.

B. Factors Considered

- The partners' relative contributions to the partnership;
- The partners' interests in economic profit and loss (if different than their interests in taxable income or loss);
- The interests of the partners in cash flow and other non-liquidating distributions; and

- The rights of the partners to distributions of capital upon liquidation.

C. Reallocations

If allocations do not otherwise have economic effect, the allocations will be determined by comparing the manner in which distributions would be made if all assets were sold at book value and the partnership was immediately liquidated (i) at the end of the prior year, and (ii) at the end of the current year, adjusting for items under Treasury Regulation section 1.704-1(b)(2), (d)(4), (5), (6).