GOOD DEBT GONE BAD

INTRODUCTION

With U.S. corporate bankruptcies poised to hit a decade-long high as a result of the economic impact of COVID-19, we have prepared these materials that detail the key bankruptcy tax issues and guidance offered by Linda Swartz, the chair of Cadwalader's Tax Group, in old and new speeches and panels. We hope you find this presentation to be both useful and informative.

For additional information, contact Linda Swartz (linda.swartz@cwt.com).

Upcoming speaking engagements:

October 14, 2020	• **Linda Swartz** will be presenting "Tax Strategies for Financially Troubled Businesses and Other Loss Companies" at PLI's Tax Strategies for Corporate Acquisitions, Dispositions, Spin-Offs, Joint Ventures, Financings, Reorganizations & Restructurings 2020
November 5, 2020	• **Linda Swartz** will be presenting "A Cause for Distress? The Ways the Federal Income Tax Pushes Taxpayers into Bankruptcy" at The University of Chicago Tax Conference
January 25, 2021	• **Linda Swartz** will be presenting "Distressed Corporations: Creditor and Shareholder Issues" at the 2021 University of Southern California Federal Tax Institute
February 8, 2021	• **Linda Swartz** will be presenting "Workouts and Debt Restructurings" at PLI's 23rd Annual Real Estate Tax Forum

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Linda Swartz, the longtime chair of Cadwalader's Tax Group and member of the Firm's Management Committee, focuses her practice on structuring complex restructurings, bankruptcies, mergers and acquisitions, spin-offs, joint ventures, and foreign tax planning strategies. She also regularly advises clients on fund structures, financings and derivative transactions.

Linda is consistently recognized as one of the leading tax lawyers in the country. She was recently named one of 14 “Influential Women In Tax Law” by *Law360*, noted for her role as “a key architect on billion-dollar transactions involving major multinational companies” with clients describing her tax structuring expertise as “so strong that we don’t even go to the IRS to get a blessing from them. We go to Linda to get a blessing from her.” She has been described by *Chambers USA* as “acclaimed for her vast reservoir of practical knowledge of the U.S. tax code” and “an expert on the law of today but cognizant of where the law might go in the future, allowing clients to make decisions which last for the next ten years.” Clients quoted by *The Best Lawyers* in America have described Linda as “the foremost U.S. tax advisor on structured acquisition and divestiture deals” and “a professional force of nature” with “extraordinary technical ability, coupled with fiercest and most trenchant deal negotiation skills of any transactional tax lawyer.” She was also recognized as “2017 Foreign Tax Planning Lawyer of the Year” by *Finance Monthly*, and *Dow Jones*, reporting on Procter & Gamble’s Reverse Morris Trust transaction with Coty, noted that “it isn’t often you see a tax adviser credited on a deal, but that’s exactly what happened for Cadwalader, Wickersham & Taft in P&G’s complicated $12.5 billion unloading of its beauty business to Coty.”

Linda is widely regarded as a thought leader in the industry and is a prolific speaker and writer on a wide range of transactional tax issues, with articles that include “Partnership Bankruptcy Tax issues,” “Debt Exchanges,” “Bankruptcy Tax Issues,” and “Bankruptcy Tax 101.” She also authors the chapters on Debt Exchanges in *Collier on Bankruptcy Taxation* (Matthew Bender) and Securities Lending Transactions in *Taxation of Financial Institutions* (Clark Boardman Callaghan). In addition to writing, she speaks on a broad range of topics, including each year on workout and bankruptcy tax issues at the corporate and real estate tax PLI conferences.

Linda is a member of the Executive Committee of the New York State Bar Association Tax Section and has chaired its Tax-Free Reorganizations; Corporations; Bankruptcy; Consolidated Returns; Real Property; and Tax Accounting and Basis Committees.

Linda received her J.D. from University of Pennsylvania Law School, and her B.A. from Bucknell University, where she graduated *magna cum laude* and was elected to Phi Beta Kappa.

DEQUITY

SECTION 382: STOCK OR NONSTOCK?

Section 382 regulations may treat debt as stock under some circumstances if, when it is transferred, it "offers a potential significant participation in the growth of the corporation."

See Treas. Reg. § 1.382-2T(f)(18)(iii).

- Debt of troubled companies has always traded at a deep discount – web-based trading has simply lent increased visibility to pricing.
- Query whether a debtor corporation could undergo a section 382 ownership change each time enough of its debt changed hands at a low enough price – the better view almost always has to be no.

WHEN DOES DEBT = STOCK?

IRS officials have consistently stated that the stock-nonstock regulation will be used to recharacterize debt as stock only where discounted debt is held by one or more related persons who have some ability to manipulate a debtor's future.

- Note that in *Integrated Resources* the IRS argued that consummation of a liquidating plan that did not cancel stock would cause debt to be recharacterized as stock, producing ownership change under section 382.
- IRS rulings are helpful only by analogy and future IRS actions may not be circumscribed by their holdings.

WHEN DOES THE IRS BELIEVE DEBT = STOCK?

PLR 200938010

Corporate taxpayer's paid-in-kind note not considered "stock" under 1.382-2T(f)(18)(ii) even though it was trading at a significant discount where (i) the debtor was not actively involved in the sale of the debt, (ii) more than 50% of the debt was not acquired by one person (or related persons), and (iii) there was no material change in the terms of the debt.

PLR 200445020

Creditors' interests not treated as stock where taxpayer in liquidating bankruptcy had liabilities substantially in excess of assets and shareholders were unlikely to receive any value in liquidation.

FSA 199910009

Agent's broad reading "cannot be correct," because "then possibly every lender to a debtor that subsequently becomes insolvent or bankrupt would be considered as automatically having the potential for significant participation in the growth of the debtor."

RECOURSE vs. NON-RECOURSE DEBT

LLC DEBT: RECOURSE OR NON-RECOURSE

Issue of recourse vs non-recourse debt was discussed in CCA 201525010.

LLC was a special purpose entity formed to purchase specified real estate and construct, market, and sell homes built on that property.

- LLC's sole purpose was to own the property.
- LLC was not permitted to engage in any business not related to property ownership.
- LLC could not own any assets not related to the property.

LLC transferred all of its property in a non-judicial foreclosure to Senior Lender holding the loan secured with a first deed of trust to the property.

In addition to the second deed of trust, Second Lender held:

- a general assignment of both the LLC's rights, title, and interest to the property and the LLC members' rights, title, and interest to the property, and
- pledges of the LLC membership interests, and member guarantees.

Notes held by Second Lender did not expressly address the (non)recourse nature of the notes or (un)conditional LLC liability.

LLC DEBT: RECOURSE OR NON-RECOURSE (cont'd)

LLC argued that debt was recourse on the basis of the section 752 regulations and *Great Plains Gasification*.

The insolvent LLC members preferred recourse treatment, which would permit them to realize COD income from the portion of the debt in excess of the property value, which they argued was supported by the section 752 regulations and *Great Plains Gasification.*

IRS disagreed and argued:

- Section 752 regulations are not determinative, as they apply only "for purposes of section 752."
- Treasury Regulation section 1.704-2(b)(4), addressing non-recourse deductions and minimum gain, specifically recognizes the possibility that debt guaranteed by a partner may be non-recourse under section 1001, which is termed a "partner non-recourse liability."
- The taxpayer's reliance on footnote 35 of *Great Plains Gasification* is misplaced. The footnote cannot properly be read to provide that the recourse/non-recourse determination is made by reference to section 752, and any implication in the case that such analysis should apply is erroneous.

LLC DEBT: RECOURSE OR NON-RECOURSE (cont'd)

The ruling ultimately did not determine the status of LLC debt owed to Second Lender.

The CCA discusses two countervailing theories:

- LLC's status as an SPE expressly limited LLC's assets to those related to the property.
    - The loan documents stopped short of imposing full unconditional liability on the LLC, and so the Second Lender's recourse was limited to property-related assets.
- Because the assets that the LLC could hold as an SPE were strictly limited, Second Lender could reach all assets that LLC would ever own.
    - In addition, the members' pledge of their LLC interests effectively provided that the Second Lender could acquire all of the LLC's assets.
    - Query whether these facts should be sufficient to treat the LLC debt as recourse.

DRE DEBT: RECOURSE OR NON-RECOURSE

IRS Field Attorney Advice 20150301F analyzed whether debt owed by a disregarded LLC whose owner had no personal liability should be treated as recourse or non-recourse for purposes of section 1001 and the determination of COD income or gain or loss on sale.

- Citing Regulation section 1.465-27(b)(6), Ex. 6, the FAA states that "where the disregarded entity is personally liable on the debt, but its sole member is not (*i.e.*, the creditor may proceed only against the disregarded entity's assets), the debt is treated as non-recourse with respect to the sole member."
- The sole member, as the taxpayer, was required to treat the full amount of debt owed by disregarded LLC as amount realized upon the transfer of property in satisfaction of debt.

In PLR 201644018, the IRS also concluded that debt owed by a disregarded entity for which its regarded owner is not personally liable would be treated as a non-recourse liability of the regarded owner of the disregarded entity.

- As a result, the entire amount of debt cancelled was treated as gain rather than COD income recognized in connection with the transfer of property in satisfaction of the debt.

CAN NON-RECOURSE DEBT BE TRANSFORMED INTO RECOURSE DEBT

Insolvent and bankrupt debtors often seek to create COD income that they can exclude rather than capital gain.

- The creditor can reduce the principal amount of non-recourse debt, without foreclosing on the property, in which case the debtor realizes COD income. Reg. § 1.61-12(a).
- However, if property is sold "in connection with" the discharge of indebtedness, the debtor will be treated as delivering the property to the lender in discharge of the debt, which will produce capital gain on the deemed sale. *Compare* 2925 Briarpark Ltd., 163 F.3d 313 (5th Cir. 1999), *with* Gershkowitz, 88 T.C. 984 (1987).
- If a debtor transfers property to a third party subject to the debt, and the lender reduces the debt in connection with the transfer, could the reduction be treated as a separate transaction that produces COD rather than capital gain? What are the timing constraints? *See* Treas. Reg. § 1.1274-5(b)(1) (modification of debt treated as occurring in a "separate" transaction).

SIGNIFICANT MODIFICATIONS OF DEBT

RETESTING DEBT AS EQUITY

All debt that is modified must be retested to determine whether it qualifies as debt for tax purposes. A significant modification occurs if the resulting instrument is equity.

Long running debate regarding scope of debt-equity retesting under preamble and regulations.

- Broad view - deterioration in financial condition of issuer may be disregarded for purposes of all regulatory tests if no change in obligor or co-obligor.
  - Query why change of obligor on non-recourse debt should trigger retesting.

Regulations amended to adopt a broader view.

1001–3 DEBT vs. EQUITY TEST

Preamble

A number of commentators raised questions regarding the circumstances under which the modification of a debt instrument will require a determination of whether the modified instrument is debt or equity. Many expressed concern that a deterioration in the financial condition of the issuer between the date of original issuance and the date of the modification could lead to a determination that the modified instrument is not debt for tax purposes. **The final regulations address this concern by providing a rule that for purposes of this regulation, unless there is a substitution of a new obligor, any deterioration in the financial condition of the issuer is not considered in determining whether the modified instrument is properly characterized as debt.**

Regulation Text

(5) Changes in the nature of a debt instrument – (i) Property that is not debt. A modification of a debt instrument that results in an instrument or property right that is not debt for federal income tax purposes is a significant modification.

For purposes of this paragraph (e)(5)(i), any deterioration in the financial condition of the obligor between the issue date of the unmodified instrument and the date of modification (as it relates to the obligor's ability to repay the debt) is not taken into account unless, in connection with the modification, there is a substitution of a new obligor or the addition or deletion of a co-obligor.

DEEMED EQUITY QUESTIONS

- What portion of an issuer's equity is a lender deemed to receive?
- Is new "equity" of corporate issuers nonqualified preferred stock? Participating preferred stock? section 305(c) preferred stock?
- Could deconsolidation result, triggering deferred intercompany gains and excess loss accounts, and limiting future use of issuer's NOLs against other group members' income?
- Will new "equity" of LLC issuers trigger liability shifts and minimum gain chargebacks under section 752? Could it cause the liquidation of an LLC or partnership?
- Is new "equity's" (low) fair market value used to measure COD income? Compare (high) stated redemption price at maturity used to calculate COD in case of new privately held debt with adequate interest.
  - Corresponding loss to holders receiving deemed equity in a taxable exchange, *but see* Prop. Reg. Section 1.721-1(d)(1).
- Will "equity" represent newly issued stock for section 382 purposes that could cause an ownership change?
- Could issuers avoid future equity recharacterization by building in equity conversion features contingent on financial covenant defaults at issuance? Could these features cause the debt to be recast as equity upon issuance?

DEBT MODIFICATIONS

Whenever restructuring debt causes a "significant modification" of the debt, new debt (or equity, if new debt is recast as equity) is deemed exchanged for old debt.

- General test is facts and circumstances.
- Specific Rules regarding significant modifications:
  - Change in Yield
  - Change in Timing
  - Change of Obligors
  - Change in Security
  - Change in Nature of Debt Instrument

Whenever new debt deemed to be exchanged for old debt, COD is realized equal to any excess of the Adjusted Issue Price of the old debt over the Issue Price of the new debt.

- The "adjusted issue price" of the new debt instrument generally depends on whether the debt is "publicly traded."

PUBLIC TRADING & ISSUE PRICE

If debt is "Publicly Traded"

Issue Price = Fair Market Value of Instrument

If debt is not "Publicly Traded"

Issue Price = Stated Redemption Price at Maturity*

*so long as the debt bears adequate stated interest (determined by reference to AFR)

PUBLIC TRADING TESTS

Whether old or new debt is "publicly traded" is determined under the 15 before / 15 after rule (*i.e.*, 31-day period ending 15 days after the issue date).

Three ways for debt to be "publicly traded":

"Reasonably Available" Sales Price

Sales price for executed purchase or sale occurring within the 31-day period ending 15 days after the issue date is "reasonably available" within a reasonable period of time after the sale:

- "appears in a medium that is made available to" issuers of debt instruments, regular purchasers or sellers, or brokers;
- proposed regulation preamble: "pricing services and trading platforms that report prices of executed sales on a general basis or to subscribers"; and
- proposed regulation preamble: TRACE reporting = public trading.

Firm Quote

Price quote from at least one broker, dealer, or pricing service that is "substantially the same as the price for which the person receiving the quote could purchase or sell the property."

Indicative Quote

Price quote other than firm quote provided by at least one broker, dealer, or pricing service.

POTENTIALLY ABUSIVE EXCHANGES

Issue price of deemed exchanged private debt is FMV if the situation is "potentially abusive," which may be the case if:

- some or all of the exchanged debt has been acquired recently, and
- there is not a deemed or actual exchange of non-recourse debt for non-recourse debt.

Taxpayers and the IRS can each invoke the exception.

- An issuer's determination binds all holders, unless a holder explicitly discloses an inconsistent position on a statement attached to holder's tax return. Treas. Reg. § 1.1274-3(d).

The contours of the "potentially abusive" exception are not clear.

CONSEQUENCES OF DEBT EXCHANGES

CONSEQUENCES OF DEEMED EXCHANGES

Issuer Consequences of Deemed Exchanges

Issuer realizes COD to extent issue price of new debt is less than issue price of old debt.

- **Publicly Traded Debt**. COD income if trading price of new debt is less than adjusted issue price of old debt, including, for example, for a borrower seeking a loan modification despite no change in the amount or timing of principal due, e.g., a yield change.
- **Other Debt**. If new debt has adequate stated interest, COD income is only realized if principal is reduced.

Holder Consequences of Deemed Exchanges

Holders generally recognize taxable gain or loss.

- **Publicly Traded Debt.** If either old debt or new debt is "publicly traded," measure gain or loss by FMV of debt over holder's adjusted tax basis. Market discount is transformed into OID.
- **Other Debt.** No gain or loss to original holder if new fixed rate debt bears "adequate stated interest," and principal amount is not reduced. If new debt lacks "adequate stated interest," gain or loss is measured by FMV of new debt over adjusted tax basis. Secondary purchasers recapture market discount as ordinary income.

If a deemed exchange is a recapitalization, no gain or loss to holders.

HOLDER CONSEQUENCES

Holder Consequences of All Deemed Exchanges

Whether or not a taxable exchange, a deemed issuance of new debt raises holder issues.

- Market discount becomes OID, requiring current income accruals going forward.
- New participating debt may not qualify for the portfolio interest exception and may subject foreign holders to FIRPTA.
- New debt may constitute an AHYDO, which would limit the issuer's deductions for substantial OID and raise cash flow issues.
- Requires retest of debt/equity; significant issues if new debt is equity.

Holder Consequences of Tax-Free Deemed Exchanges

Tax-free recapitalization – corporations only.

- Must exchange tax securities for tax securities.
- Most important tax security characteristic is the debt's original term to maturity.
- Historically, term of 5 years or less was not a security, 5 to 10 year term was uncertain, and a 10 year term was a security. However, the IRS has tacked the original maturity of exchanged debt, allowing recap treatment for new short maturity debt issued in a workout. *See* Rev. Rul. 2004-78.

Tax-free partnership debt for equity exchanges are governed by separate rules. *See* Prop. Reg. §§ 1.108-8; 1.721-1.

Matching Deferred COD and OID

- Gain/loss equals difference between holder's basis in old debt and issue price of new debt.
- If either old or new debt is publicly traded, issue price of new debt is the FMV of the traded debt.
- Exchange of publicly traded debt may result in capital loss and OID income on new debt for holders.
- If neither debt is publicly traded and the new debt bears adequate interest, issue price generally equals the new debt's principal amount.
- Exchange of nonpublicly traded debt can result in significant noneconomic gain for distressed debt buyers because issue price equals principal amount if tax basis is low due to recent purchase.

CONSEQUENCES OF DEBT EXCHANGES FOR DIFFERENT TYPES OF HOLDERS

For U.S. Banks

Banks can claim bad debt deductions with or without exchange, so generally indifferent to exchanges.

- Conformity election for bad debts.
- All gain and loss is ordinary.
- Deemed charge off if debt exchange creates phantom gain.

For REITs and RICs

- Income on taxable exchanges may affect distribution requirements, as amended by the CARES Act.
- RICs may not receive good income if debt is recharacterized as partnership equity.
- REITs need to confirm that any rents received, and interest on participating debt, will qualify as good income under REIT rules.

For Foreign Holders

Exchange is not taxable unless old debt is held in connection with a U.S. trade or business, or FIRPTA applies.

- Foreign funds that buy and sell distressed debt slated for workouts may be treated as engaged in a U.S. trade or business unless strict guidelines are satisfied.
- If new debt is participating debt, portfolio interest exception will not be available and FIRPTA may apply.
- If new debt is partnership equity, future income on debt, and other lender income, may be ECI. FIRPTA may also apply to sales of deemed partnership equity interests.

For U.S. Tax-Exempt Holders

Unless old debt was debt financed, exchange is not taxable.

If new debt is partnership equity, need to consider UBTI.

- For rents to qualify under section 512(b)(3):
  - No non-customary services;
  - No participation other than a fixed percentage of receipts or sales; and
  - Not too much personal property.
- If there is underlying debt, section 514(c)(9) should be investigated.

CHOICE OF CREDITOR INVESTMENT VEHICLE

FORECLOSURE CONSEQUENCES

Creditor gain/loss on foreclosure equals difference between FMV of asset and tax basis in debt.

Choice of foreclosure vehicle – often creates significant intercreditor friction.

- Using tax partnership to hold asset presents issues for REITs, RICs, tax exempts, and foreign holders.
- A corporation avoids most of these problems (though it may be a USRPHC for FIRPTA purposes), but subjects U.S. taxables to two levels of taxes.
- Selective use of blockers by creditors is common.

INDIRECT FORECLOSURES: CHOICES AND QUESTIONS

Affiliated entity, *e.g.*, LLC, acquires asset for nominal amount of cash or debt, leaving most or all of the debt outstanding.

- Allows asset liens to be preserved.
- If structure is respected, tax exempts and foreigners retain advantages of holding debt (portfolio interest; no UBTI, ECI, or FIRPTA) and would only need to hold equity through blocker corporations.
    - Cautious investors may also choose to hold debt through blocker corporations to avoid equity recast risk.

Will indirect foreclosure be respected?

- Once debt always debt.
- Change of obligor should not matter for non-recourse debt.
- Substance over form concerns.

Stronger arguments for debt treatment if reduce principal amount of loan to collateral FMV?

- Or reduce loan to 80% of FMV of collateral?
- And/or subordinate a portion of the loan to protect the senior piece?

INDIRECT FORECLOSURES: ADDITIONAL ISSUES

Can PTP risk be avoided by restricting trading in equity of LLC holding assets, or must debt trading also be restricted?

Should foreigners and tax exempts hold only equity positions, or also their debt, through blocker corporations?

Should debt and equity be stapled or can they trade separately?

- Stapling increases risk that debt will be recast as equity.
- LLC debt is initially partner debt if creditors receive proportionate LLC debt and equity stakes. Trading debt and equity separately may create tax issues, including minimum gain chargebacks and deemed cash distributions in excess of basis.

POTENTIAL CREDITOR EXIT STRATEGIES

Sale of Debt or Equity of Equity LLC

Holder's gain/loss on sale equals amount realized less its tax basis in debt. Holder must allocate tax basis between equity and debt and, if relevant, among tranches of debt.

REMICs must sell foreclosed-upon properties within three years, and grantor trust must sell such properties "expeditiously."

- During the 2008 downturn, participants in mortgage securitization industry asked IRS to permit a REMIC to provide seller financing to buyer of foreclosed property. Currently, such a loan would not be a qualified mortgage for a REMIC.

Third Party Refinancings of Equity LLC

Generally requires cancellation of existing debt and release of liens, or increase in collateral value.

If foreclosure vehicle is an LLC, distribution of debt refinancing proceeds is often tax-free under sections 731 and 752.

- To avoid creating partner debt issues, equity holders may be prohibited from directly participating in the financing or buying the third party debt.
- While a lender actively engaged in the business of lending may own 10% or less of the equity interest in an LLC without creating partner debt, it is unclear whether hedge funds so qualify.

New Debt Distributions to Equity Holders

Alternative to third party refinancing to create liquidity and keep upside.

Can LLC create new tradable debt by distributing debt to its members?

- Tax character of distributed debt is unclear.
- Section 704(b) rules suggest that distributed debt is "debt" only if it is readily tradable on an established securities market or once it is transferred in a taxable exchange.
- McKee views the debt as an equity-like promise by LLC to make later distributions.

If distributed debt is equity, PTP, UBTI, ECI, FIRPTA, REIT, and RIC issues discussed earlier may apply.

SALES OF EQUITY AND SALES OF BLOCKERS

If tax-exempts or foreigners hold equity stakes through blockers, can they sell the blockers?

- Tax-exempt holders will prefer to sell blockers if assets are subject to debt to avoid UBTI, although *pro rata* holdings of debt and equity by tax-exempt holders may not create debt financed UBTI.
- Foreign holders will prefer to sell blockers unless blocker is a USRPHC.

Buyers prefer to buy assets to step up asset basis.

- Will buyers be willing to buy part assets, part blockers?

PARTNER ISSUES IN PARTNERSHIP DEBT RESTRUCTURINGS

PARTNERSHIP GLOSS ON COD RULES

Gross income includes income from the cancellation of debt unless the debtor is bankrupt or insolvent (to the extent of insolvency). These exceptions are determined at the partner level.

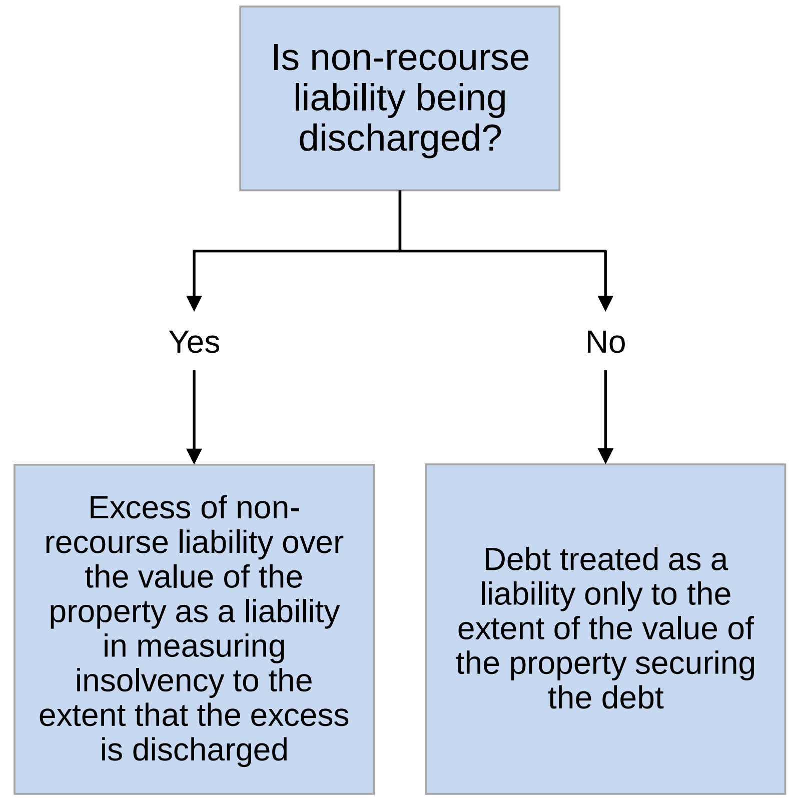
- **Treatment of Partnership / Partners**: Availability of bankruptcy and insolvency exceptions is determined at the partner level.
  - Accordingly, a partner of a partnership is allocated its distributive share of partnership COD income, whether or not the partnership is in bankruptcy.
  - The IRS views the application of the bankruptcy exception to a partner as depending on whether the partner itself is “under the jurisdiction of the [bankruptcy] court” and whether the discharge is “granted by the court.” §§108(a)(1)(A), (d)(2).

MEASURING PARTNERS' INSOLVENCY

The excess of a non-recourse liability discharged over the value of the property securing it will be treated as a liability in measuring insolvency. If the non-recourse debt is not being discharged, the debt constitutes a liability only to the extent of the value of the property securing the debt. Rev. Rul. 92-53, 1992-2 C.B. 48.

Preamble to final regulations relating to disregarded entities and the application of the bankruptcy and insolvency exceptions indicates that debt of a disregarded LLC generally will be treated as non-recourse for purposes of measuring insolvency absent a guarantee or other credit support by the regarded owner. T.D. 9771 (preamble).

A partnership's discharged excess non-recourse debt should be allocated among the partners in the same ratio as COD from the debt would be allocated among the partners under section 704(b). Rev. Rul. 2012-14.



COD ON PARTNERSHIP DEBT / EQUITY EXCHANGES

Partnership debt for equity exchanges may create COD income under section 108(e)(8).

- The partnership realizes COD income on transfers of a partnership capital or profits interest in exchange for a recourse or non-recourse debt of the partnership in the amount of benefit that it would have if the debt were satisfied for an amount of money equal to the fair market value of the interest.
  - The COD income must be allocated to the partners immediately before the exchange.
- Regulatory safe harbor permits the parties to treat a partnership interest's "liquidation value" as its FMV, provided that:
  - The partnership, its partners, and its creditor all treat the fair market value of the debt exchanged as equal to the liquidation value of the partnership interest transferred,
  - The debt-for-equity exchange has terms comparable to an arm's-length transaction,
  - Neither the partnership nor any related person later purchases the partnership interest transferred pursuant to a plan that exists when the debt-for-equity exchange occurs and has as <u>a</u> principal purpose avoiding partnership COD income, and
  - If the partnership engages in debt-for-equity exchanges with multiple creditors, all parties to each exchange; *i.e.*, each creditor, the partnership, and its partners, treat the fair market value of each partnership interest exchanged as equal to its liquidation value.

COD EXCLUSION AND ATTRIBUTE REDUCTION

Taxpayers that exclude COD income under bankruptcy or insolvency exceptions must reduce certain tax attributes after determination of tax liability for the taxable year of discharge.

Tax attributes are generally reduced in the following order:

- Net operating losses
- General business credits
- Minimum tax credits
- Capital loss carryovers
- Property basis
- Passive activity loss and credit carryovers
- Foreign tax credit carryovers

PARTNERSHIP-SPECIFIC COD RULES

A partner may elect to treat a partnership interest as depreciable property to the extent of the partner's share of depreciable property held by the partnership.

- Request-and-consent procedures must be followed for the partnership to make corresponding adjustments to the basis of the property held by the partnership. Treas. Reg. § 1.1017-1(g)(2)(ii).
- A taxpayer also may elect to treat real property described in section 1221(a)(1) as depreciable property. IRC § 1017(b)(3)(E).

If debt of a purchaser to a seller of property that arose out of the purchase of such property is reduced, and the reduction otherwise would give rise to COD income for the debtor, the reduction will be treated as a purchase price adjustment. IRC § 108(e)(5).

- Rule is mandatory, not elective.
- Rule does not apply where debtor is bankrupt or insolvent. IRC § 108(e)(5)(B).
- Rule may apply in partnership context where partnership is bankrupt or insolvent because bankruptcy and insolvency exceptions apply at partner level. Rev. Proc. 92-92, 1992-2 C.B. 505.

ALLOCATION OF DISCHARGE INCOME

COD income generally will be allocated consistent with the terms of the partnership agreement.

The result may vary, however, where a partner has a negative capital account and no deficit restoration obligation. Rev. Rul. 92-97, 1992-2 C.B. 124.

Elimination of partnership debt will give rise to a deemed distribution under section 752.

- This deemed distribution will be considered an "advance" against the COD income and thus will not occur until the end of the taxable year after the COD income has been allocated and increased a partner's basis in its interest. Rev. Rul. 92-97; Rev. Rul. 94-4, 1994-1 C.B. 196.

A special allocation of COD income to an insolvent partner will not be respected where the partnership agreement is amended after COD income is realized. Rev. Rul. 99-43, 1999-2 C.B. 506.

COD AS QUALIFYING INCOME FOR PTPs

The IRS generally will not challenge a PTP's determination that COD income is qualifying income if the COD income is attributable to debt incurred in direct connection with PTP activities that generate qualifying income.

- According to Revenue Procedure 2012-28, the PTP may demonstrate that COD income is attributable to debt incurred in direct connection with the PTP's qualifying activities by any reasonable method.
- One reasonable method for demonstrating that COD income is attributable to debt incurred in direct connection with the PTP's qualifying activities is to trace the proceeds of the debt generating COD income to qualifying activities under an approach similar to the one used in Treasury Regulation section 1.163-8T.
  - Ordinarily, an allocation of COD income based solely on the ratio of qualifying gross income to total gross income will not be considered reasonable.
  - The IRS may consider ruling privately on whether a method is reasonable.

ACQUISITION OF DEBT

Rather than discharging a liability for less than the face amount of the debt, partners may seek to defer COD income by having a third party acquire the debt from lender.

If the party acquiring debt is related to the debtor (or acquires debt “in anticipation of becoming related to the debtor”), the debtor will be treated as acquiring its own debt, thus triggering COD income under section 108(e)(4).

If section 108(e)(4) applies, adjusted issue price of purchased debt is generally purchase price of debt.

- Stated redemption price at face amount creates significant OID.
- AHYDO rules under section 163(e)(5) can disallow interest for corporate partners of debtor partnership.

WORKOUT ON THE HORIZON

When a debt workout is on the horizon, partners may consider taking action to limit COD income.

Concerns arise most often where restructuring will result in:

- Current COD income and capital loss
- Current COD income and no current loss

Actions often proposed:

- Incorporate partnership
- Abandon partnership interest

RESTRUCTURING IN ADVANCE OF A WORKOUT

Incorporation of Insolvent Partnership

- If respected, former partners are not allocated COD income, and insolvent corporation excludes COD income.

Issues to Consider

The IRS might seek to disregard incorporation:

- "Born to die/transitory entity" risk where entity will be liquidated soon after conversion to a corporation. *Cf.* 1994 FSA Lexis 20 (Aug. 5, 1994).
- Courts may disallow if value of estate is affected. *Prudential Lines*, 928 F.2d 565; *see also In re Majestic Star Casino, LLC*, 716 F.3d 736 (3rd Cir. 2013).
- Section 269.
- Section 482; Treas. Reg. §1.482-1(f)(1)(iii); *National Securities*,137 F.2d 600 (3rd Cir. 1943).
- Section 351; possible loss disallowance if don't qualify; application of section 357(c) if do qualify.
- Section 7701(o) and economic substance.

ABANDONMENT BEFORE A WORKOUT

Abandonment of Partnership Interest

Analogous authority is generally favorable with respect to respecting abandonments.

- *Echols*, 950 F.2d 209 (abandonment respected following partnership default on debt); Rev. Rul. 93-80, 1993-2 C.B. 239 (abandonment effective in year partnership became insolvent).
- Ensure that contractual limitations on disposition in partnership agreement do not prohibit abandonment.
- *Cottle*, 89 TC 467, is helpful on "assignment of income."

If partner has share of partnership liabilities, loss on abandonment generally will be capital.

- Rev. Rul. 93-80 concludes that abandonment loss is ordinary only if partner has no share of liabilities.
- *Pilgrim's Pride* may signal that a capital loss on abandonment is not possible even in the absence of liabilities, as the Tax Court implied in its opinion that section 1234A impacted the liability-related holding in Rev. Rul. 93-80. On appeal, the Fifth Circuit limited the Tax Court's holding significantly.

Partners may also consider selling partnership interests for nominal consideration rather than abandoning them.