

RECOURSE vs. NON-RECOURSE DEBT

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](mailto:linda.swartz@cwt.com) (linda.swartz@cwt.com).

Upcoming speaking engagements:

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| October 14, 2020 | <ul style="list-style-type: none">• 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 | <ul style="list-style-type: none">• 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 | <ul style="list-style-type: none">• Linda Swartz will be presenting "Distressed Corporations: Creditor and Shareholder Issues" at the 2021 University of Southern California Federal Tax Institute |
| February 8, 2021 | <ul style="list-style-type: none">• Linda Swartz will be presenting "Workouts and Debt Restructurings" at PLI's 23rd Annual Real Estate Tax Forum |
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LINDA Z. SWARTZ



Linda Z. Swartz
Chair, Tax
New York
(212) 504 6062
linda.swartz@cwt.com

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.

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).