

# **PARTNER ISSUES IN PARTNERSHIP DEBT RESTRUCTURINGS**

# INTRODUCTION

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

## Upcoming speaking engagements:

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| <b>October 14, 2020</b> | <ul style="list-style-type: none"><li>• <b>Linda Swartz</b> will be presenting "Tax Strategies for Financially Troubled Businesses and Other Loss Companies" at PLI's <a href="#">Tax Strategies for Corporate Acquisitions, Dispositions, Spin-Offs, Joint Ventures, Financings, Reorganizations &amp; Restructurings 2020</a></li></ul> |
| <b>November 5, 2020</b> | <ul style="list-style-type: none"><li>• <b>Linda Swartz</b> will be presenting "A Cause for Distress? The Ways the Federal Income Tax Pushes Taxpayers into Bankruptcy" at <a href="#">The University of Chicago Tax Conference</a></li></ul>   |
| <b>January 25, 2021</b> | <ul style="list-style-type: none"><li>• <b>Linda Swartz</b> will be presenting "Distressed Corporations: Creditor and Shareholder Issues" at the <a href="#">2021 University of Southern California Federal Tax Institute</a></li></ul>   |
| <b>February 8, 2021</b> | <ul style="list-style-type: none"><li>• <b>Linda Swartz</b> will be presenting "Workouts and Debt Restructurings" at PLI's <a href="#">23rd Annual Real Estate Tax Forum</a></li></ul>  |
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# LINDA Z. SWARTZ

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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.

# PARTNERSHIP GLOSS ON COD RULES

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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.

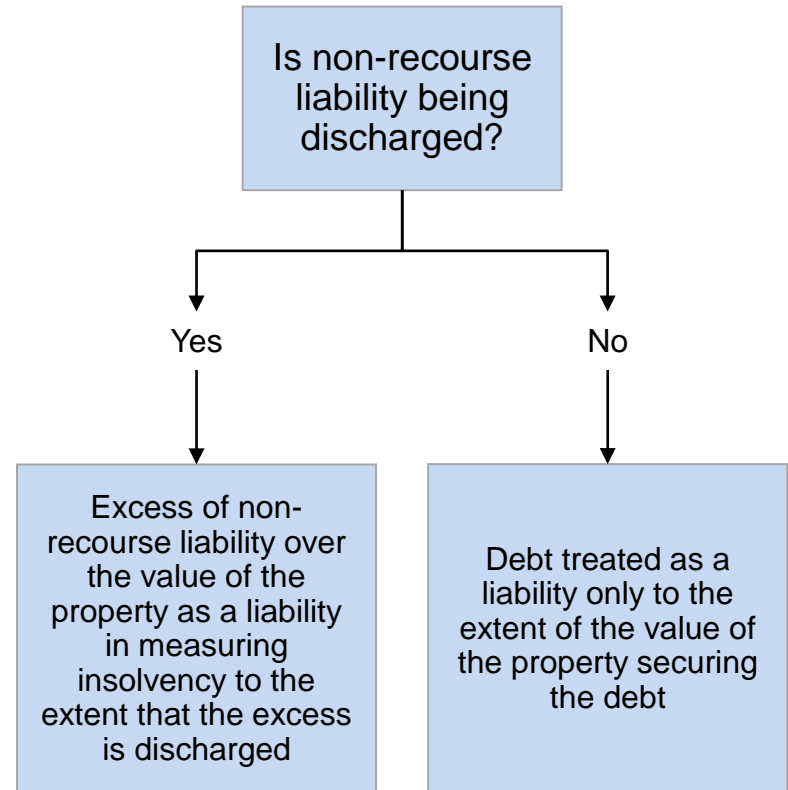
- **Treatment of Partnership / Partners:** Availability of bankruptcy and insolvency exceptions is determined at the partner level.
  - Accordingly, a partner of a partnership is allocated its distributive share of partnership COD income, whether or not the partnership is in bankruptcy.
  - The IRS views 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

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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 a 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

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**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

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**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

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**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

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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

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**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

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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

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## 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

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## 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.