Reproduced with permission from Daily Tax Report, 136 DTR G-5 (July 16, 2013). Copyright 2013 by The Bureau of National Affairs, Inc. (800-372-1033) http://www.bna.com

Bloomberg BNA

Daily Tax Report®

NUMBER 136 JULY 16, 2013

Passthrough Entities

Final Rules on Deferred COD Income Clarify Partnership Accounting, But Pitfalls Remain

Final rules on the deferral of cancellation of debt income issued July 2 provided helpful clarification and relatively beneficial terms in their final form to passthrough entities, but contain some areas that may catch the unwary off-guard, practitioners told BNA recently.

T.D. 9623 provides guidance under tax code Section 108(i) on COD income and original issue discount deductions by a partnership or an S corporation with respect to reacquisitions of applicable debt instruments. The guidance applies only to a limited period during the height of the economic recession, when entities were allowed to make the election for debt discharged in 2009 or 2010.

Section 108(i) ''does a better job than other code sections addressing partnership issues with some specificity,'' Michael Grace, counsel at Whiteford, Taylor & Preston LLP, says.

The final rules ''should prove to be music to a tax accountant's ear, without any atonality or dissonance,'' Michael Grace, counsel at Whiteford, Taylor & Preston LLP, told BNA July 5. This is in part because Section 108(i) ''does a better job than other code sections addressing partnership issues with some specificity,'' Grace said.

These include the relationship between COD income discharge events and the allocation of partnership liabilities, he said. Other situations arise under Section 108 wherein debt is discharged with collateral effects on Subchapter K issues, but ''other parts of Section 108 do not address those coordinations with much specificity, if at all,'' Grace said.

By contrast, T.D. 9623 coordinates the various partnership or passthrough-associated adjustments so that they properly occur at the same time, Grace said.

Section 752. This is particularly true of how the deferred Section 752(b) basis reduction is recognized as the deferred COD is recognized, Steven Schneider, partner, Goulston & Storrs, told BNA July 7.

''In the partnership context, the Section 108(i) rules necessarily took complexity to a whole new level,'' with regards to the treatment of partnership liabilities, Schneider said in emailed comments. ''Early on the IRS thankfully allowed partners to elect out of a partnership's Section 108(i) election, enabling the partnership to avoid forcing the election on partners who would otherwise be harmed by the election,'' he noted.

The Internal Revenue Service also recognized that deferring COD alone was insufficient for partnerships if the disappearing debt was at the same time supporting a partner's negative tax capital account, Schneider said. In such a situation, relief of the debt could trigger a deemed distribution under Section 752(b) and create a partner-level gain under Section 731(a), he explained.

The statute and temporary regulations sought to resolve this issue by allowing for the deferred recognition of a partner's basis reduction under Section 752 to the extent necessary to avoid indirectly recognizing the deferred COD income, Schneider said. This income was to be taken into account at the same time, and to the extent remaining in the same amount, as income deferred under the subsection is recognized, the statute stated.

The final rules went a step further in clarifying that the mechanics of this inclusion rule when the deferred Section 752 amount was less than the deferred Section 108(i) amount, Schneider said. The rules required a deferred Section 752 amount to be front loaded, ''minimizing the duration of the basis reduction deferral,'' Schneider said.

This is a reasonable interpretation of the statute, but ''it is possible that some taxpayers may view this as a substantive change'' in their planned accounting, Schneider said. Some taxpayers may have been counting on the ability to defer recognition on a pro rata or back-end approach, prior to the final rules' clarifications, he said. Some taxpayers may not have gotten as good a deal under Section 108(i) as they had originally thought, Schneider said.

Section 465 Coordination. The rules provide for a similar mechanism to coordinate Section 108(i) and Section 465, on at-risk limitations, Grace explained. As a debt at the partnership level is reduced, then the partners' at-risk amounts are also collectively reduced by an equal amount. ''Unless you had a rule to address that,

COPYRIGHT © 2013 BY THE BUREAU OF NATIONAL AFFAIRS, INC. ISSN 0092-6884

you could have a situation where, because of the election, partners would be able to defer recognizing [COD] income but not to take the hit from amounts at-risk going down'' by an equivalent amount,'' Grace said. The regulations make it clear that such a situation would not be appropriate, he said.

Timing Differences. The timing difference between the adjustment of Section 704 capital accounts and the adjustment of a partner's basis in a partnership could easily be overlooked in the rules, Grace noted.

The difference occurs where partners of a partnership electing to defer COD income has to adjust the basis in the partnership once the deferred amounts start to be recognized in 2014, Grace explained. By contrast, Section 704(b) rules require partner capital accounts to be adjusted in the year in which the COD income arose.

This second rule basically ignores the partnership's deferral election under Section 108(i), but still appears correct, Grace explained. ''I think it is correct to say, 'adjust the capital accounts right away, although income [is] deferred, because the capital accounts are supposed to reflect the economic arrangement among the partners,'' and not tax consequences, Grace said.

This timing difference, coupled with the confusion in the partnership realm around using book, tax, basis, and capital accounting and in preparing partnership tax returns could lay a trap for some practitioners, Grace said. ''It would be very easy for someone to get confused about when the different categories of these amounts should be adjusted,'' he explained.

Trade or Business Limitations. The vagueness of the term ''trade or business'' as related to the issuance of debt in the Section 108(i) context comes to the fore in the final rules where IRS rejected a comment requesting a safe harbor for real estate, Schneider noted.

''The term 'trade or business' is a complex concept, as has recently been highlighted by the proposed Section 1411 regulations where this determination is critical and yet undefined,'' Schneider said. In the Section 108(i) context, IRS chose not to provide a safe harbor to provide that a real estate trade or business existed when the debt was used by a partnership to acquire of improve rental real property if at least 30 percent of the new tax basis was depreciable, Schneider said.

''There's always been a lack of guidance in tiered partnerships,'' Steven Schneider, partner, Goulston & Storrs, says. The issue ''comes up all the time, in all different sets of rules, but they rarely issue claritive guidance.''

''In declining to add the safe harbor, the IRS noted that the mere existence of depreciable property was insufficient to establish that rental property was held in a trade or business,'' he said.

Refusal to Address Tiered Partnerships. IRS also rejected a comment to specifically look through lower-tier partnerships for applying the existing trade or business safe harbor applicable if 80 percent of an entity's gross assets are trade or business assets, Schneider said.

IRS chose not to address the issue to avoid adding ''undue complexity to the trade or business safe harbors,'' it said in the final rules. However, the final regulations contain other rules regarding tiered partnerships that seem just as complex, Grace noted.

It would have been helpful for IRS to have addressed the issue, Schneider said in a July 8 phone interview. ''There's always been a lack of guidance in tiered partnerships,'' Schneider said. The issue ''comes up all the time, in all different sets of rules, but they rarely issue claritive guidance,'' Schneider said.

Revenue Procedure Incorporation. Another area IRS might have chosen to help clarify would have been the incorporation of reporting requirements from the Section 108(i) Revenue Procedure 2009-37 into the final rules, Grace said (157 DTR G-2, 8/18/09).

''For the sake of avoiding fragmentation and trying to make these partnership tax reporting rules more user friendly, I don't think it would've hurt to 'cut and paste' [those] procedures into the final regulations so that less sophisticated practitioners wouldn't have to scrounge to find the additional paper and reconcile the rules'' with the reporting requirements, Grace said.

The issue goes beyond mere convenience for the tax practitioner, he said. The revenue procedure describes not only how to make the election, but also how to file annual information statements with the subsequent years' returns, Grace explained. That information cannot be drawn out of the final regulations themselves, Grace said. ''I would have to know about them by knowing about the revenue procedure,'' he said. ''It's a potential trap for the unwary due to lack of knowledge of the requirements,'' he added.

By Lydia Beyoud

To request permission to reuse or share this document, please contact permissions@bna.com. In your request, be sure to include the following information: (1) your name, company, mailing address, email and telephone number; (2) name of the document and/or a link to the document PDF; (3) reason for request (what you want to do with the document); and (4) the approximate number of copies to be made or URL address (if posting to a website).

 COPYRIGHT © 2013 BY THE BUREAU OF NATIONAL AFFAIRS, INC. ISSN 0092-6884