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Is It the End or Just the Beginning: Planning with The Final Partnership Debt-for-Equity Regulations

by Steven R. Schneider & Brian J. O'Connor[1]

INTRODUCTION

The development of law for partnerships frequently lags behind that for corporations.[2] Contributions of debt for equity are no exception. In this case, being the last person to the table was a good place to be. For years taxpayers had argued that a ''partnership debt-for-equity'' exception to cancellation of debt (COD) income lurked in the far corners of the tax rules. That argument was abruptly taken off the table on October 22, 2004. That's when Congress added partnerships to the scope of §108(e)(8),[3] confirming that partnerships have COD income when using partnership equity to pay off debt at a discount. Congress then passed the baton to the IRS and Treasury (IRS) to clarify the details. Now, seven years later, the IRS finalized §108(e)(8) regulations (the ''Final Regulations'') and officially passed the baton to taxpayers.[4] Taxpayers now must figure out how to structure transactions in light of the Final Regulations to minimize the significant risks for phantom income, deferred lender losses, and negative tax-character conversions. Thus, for taxpayers and their advisors, this is just the beginning of a trip down the new road of debt-for-equity planning.

The purposes of this article are to explain the Final Regulations and to suggest potential tax structuring alternatives in light of the new rules. The Final Regulations are taxpayer-favorable in that they provide procedures for valuing partnership equity at liquidation value for COD calculation purposes and they clarify that a partnership itself will not recognize taxable gain to the extent it uses its equity to pay ordinary income items, such as accrued interest. However, the Final Regulations generally deny lenders an immediate tax loss on any discount of their debt, favor accelerated lender income by assuming the value of the equity received first pays for accrued but unpaid interest, and include potential foot-faults that may prevent taxpayers from receiving the benefit of the liquidation valuation rule. In the end, the Final Regulations are a welcome addition to the law on the topic, but now it's up to taxpayers to turn the few unwanted lemons into lemonade.

HOW SECTION 108(e)(8) CHANGED THE GAME

In 1993, when Congress eliminated the corporate stock-for-debt exception to COD income by amending §108(e)(8),[5] many partnership tax practitioners took comfort in their understanding (or their hope) that a common law partnership debt-for-equity exception to COD income continued to survive. Under a view held by many at the time, certain debtor partnerships issuing partnership interests to creditors to satisfy partnership debt could qualify such transactions as tax-free exchanges under §721 *and* avoid COD income re-

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[2] This article uses the tax definition of partnerships, as defined in Regs. §301.7701-2(c), which includes limited liability companies taxed as partnerships.

[3] All Section references are to the Internal Revenue Code of 1986, as amended (the ''Code''), or the Treasury Regulations promulgated under the Code.

[4] T.D. 9557, 76 Fed. Reg. 71255 (11/17/11).

[5] Omnibus Budget Reconciliation Act of 1993 (P.L. 103-66).

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gardless of the value of partnership assets. The IRS never officially blessed this taxpayer-favorable position. In fact, unofficially, IRS personnel often reached contrary conclusions. Nevertheless, because at the time newly amended §108(e)(8) addressed only corporate stock-for-debt, many partnership tax practitioners found additional support for a common law partnership debt-for-equity exception in what Congress did not say in 1993.[6]

As mentioned above, Congress dashed all dreams of a partnership debt-for-equity exception to COD income when it once again amended §108(e)(8) as part of the American Jobs Creation Act of 2004 (the ''2004 Act'').[7] As amended by the 2004 Act, §108(e)(8) now reads as follows:

> (8) **Indebtedness satisfied by corporate stock or partnership interest.** For purposes of determining income of a debtor from discharge of indebtedness, if —
>
> > (A) a debtor corporation transfers stock, or
> >
> > (B) a debtor partnership transfers a capital or profits interest in such partnership,
>
> to a creditor in satisfaction of its recourse or nonrecourse indebtedness, such corporation or partnership shall be treated as having satisfied the indebtedness with an amount of money equal to the fair market value of the stock or interest. In the case of any partnership, any discharge of indebtedness income recognized under this paragraph shall be included in the distributive shares of taxpayers which were the partners in the partnership immediately before such discharge.

Unlike prior versions of §108(e)(8), this newly expanded version of §108(e)(8) specifically includes partnerships. As a result, debtor partnerships issuing capital or profits interests to creditors to satisfy partnership debt are now clearly treated as satisfying their debts with the fair market value of their newly issued interests for purposes of calculating COD income. Debtor partnerships with little or no value in their assets, as a result, no longer can contend that they avoid COD income when they issue partnership interests to creditors in satisfaction of partnership debt. Instead, under the newly expanded §108(e)(8), these partnerships would recognize COD income on the discount and allocate the income to taxpayers who were partners immediately before the discharge of partnership debt.

While the 2004 Act certainly eliminated any uncertainty as to the validity of a partnership debt-for-equity exception, the Act left many other questions unanswered. For example, how must debtor partnerships determine the fair market value of the interests they issue to creditors? Can debtor partnerships apply liquidation value or must they hire appraisers to determine fair market value? How should taxpayers be treated when partnership interests are issued to satisfy accrued ordinary income items such as unpaid rent, royalties or interest? Under what circumstances may creditors recognize losses when they exchange debt instruments for partnership interests? To answer these questions, the IRS and Treasury started by issuing proposed regulations under §§108(e)(8) and 721.

THE PROPOSED REGULATIONS

COD Income for the Discount

The IRS issued proposed regulations under §§108(e)(8) and 721 (the ''Proposed Regulations'') in 2008.[8] The Proposed Regulations provided that, when a debtor partnership transfers a capital or profits interest in satisfaction of a recourse or nonrecourse debt, the partnership is treated as having satisfied the debt with an amount of money equal to the fair market value of the partnership interest transferred. In other words, any discount is treated as COD income.

Example 1 — Measuring COD Income

Facts: In year 1, A and B each contributed $100 of cash to form the PRS partnership. PRS bought Building for $1,000, financed with its $200 of equity and an $800, interest-only Note from Lender. At the end of year 5, PRS's sole asset is Building, which has declined in value to $500, and remains encumbered by the $800 Note. PRS issues a PRS interest with a $500 fair market value to Lender in satisfaction of the Note.

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[6] After the fact, practitioners found additional support for these arguments in the prospective nature of the 2004 change to §108(e)(8) and the following helpful language in the Joint Committee on Taxation description of ''present law'':

> In the case of a partnership that transfers to a creditor a capital or profits interest in the partnership in satisfaction of its debt, no Code provision expressly requires the partnership to realize cancellation of indebtedness income. Thus, it is unclear whether the partnership is required to recognize cancellation of indebtedness income under either the case law that established the stock-for-debt exception or the present-law statutory repeal of the stock-for-debt exception.

JCX-85-03 (10/1/03).

[7] P.L. 108-357, §896(a).

[8] REG-164370-05, 73 Fed. Reg. 64903 (10/31/08).

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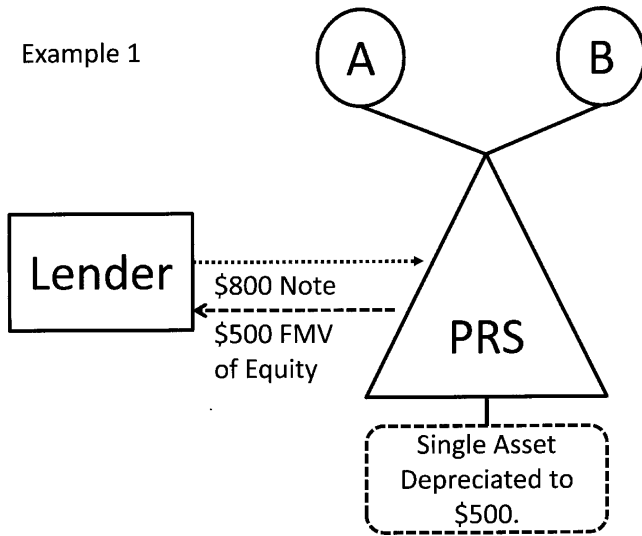

Result: PRS has $300 of COD income for the discount between the value of the equity issued and the amount owed on the Note.

Valuation Safe Harbor

Under the Proposed Regulations, the fair market value of any partnership interest issued to a creditor in satisfaction of partnership debt would equal the liquidation value of the issued interest as long as the partnership satisfied certain requirements (hereinafter, the ''Liquidation Value Safe Harbor'' or simply the ''Safe Harbor''). For this purpose, liquidation value would equal the amount of cash that the creditor would receive if the partnership sold all of its assets for cash equal to their fair market values immediately after the creditor received the interest and then liquidated (hereinafter, the ''Liquidation Value''). To qualify under the Safe Harbor: (i) the debtor partnership needed to determine and maintain capital accounts in accordance with the §704(b) regulations; (ii) the creditor, the debtor partnership, and all of the debtor partnership's partners needed to treat the fair market value of the issued interest as equal to its liquidation value for purposes of determining the tax consequences of the debt-for-equity exchange; (iii) the debt-for-equity exchange needed to be an arm's-length transaction; and (iv) after the debt-for-equity exchange, the partnership could not redeem, nor could any person related to the partnership purchase, the issued interest as part of a plan to avoid COD income.

For partnerships unable or unwilling to satisfy the requirements necessary to meet the Safe Harbor, the Proposed Regulations provided that all facts and circumstances would be considered in determining the fair market value of the interest issued to the creditor. In other words, the Proposed Regulations would apply a willing buyer/willing seller analysis in determining the fair market value of an issued interest that falls outside the Safe Harbor.

Example 2 — Applying Liquidation Valuate Safe Harbor

Facts: Same as Example 1 except that PRS issues a PRS interest to Lender with a right to a $450 Liquidation Value and an 80% share of future appreciation in Building over its current $500 value. PRS elects the Liquidation Value Safe Harbor.

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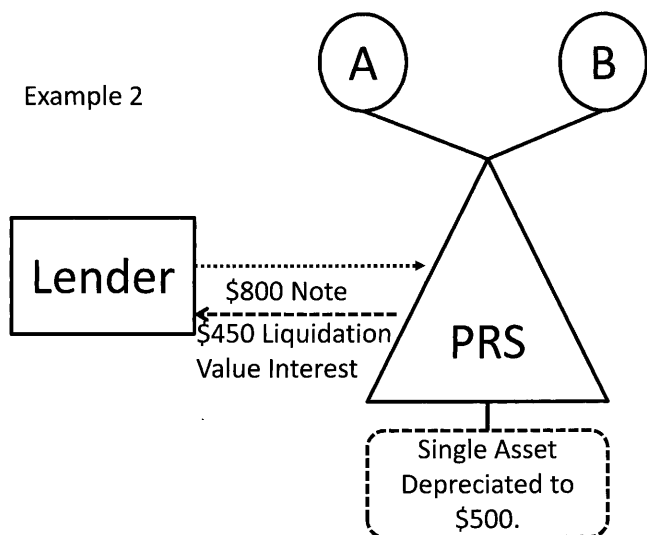


Result: PRS has $350 of COD income for the discount between the Liquidation Value of the equity issued and the amount owed on the Note.

Section 721 Treatment — Except for Accrued Income Items

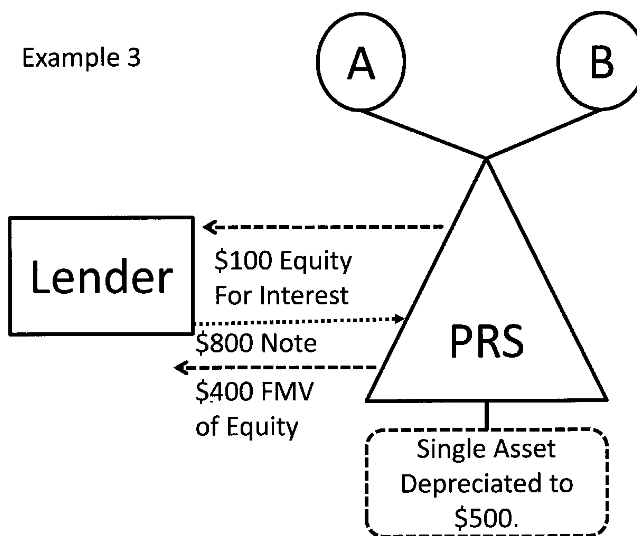
The Proposed Regulations also applied §721 to contributions by creditors of recourse or nonrecourse debt to debtor partnerships for partnership equity unless the debtor partnerships issued such equity for unpaid rent, royalties or interest (including accrued original issue discount). In so doing, the Proposed Regulations denied creditors immediate losses or bad debt deductions as part of a debt-for-equity exchange.

In many cases throughout the tax law, creditors recognize losses or bad debt expenses when debtors recognize COD income. Not so under the Proposed Regulations. Instead, under the Proposed Regulations, contributing creditors would receive only an increased basis in their partnership interests as a result of the debt-for-equity exchange. This increased basis ultimately may lead to losses when the creditors dispose of their interests. Such losses, however, may be capital in nature whereas any bad debt deduction may have been ordinary. As a result, by taking the position that §721 generally would apply to contributions by creditors in debt-for-equity exchanges, the Proposed Regulations clearly took an unpopular position with taxpayers.[9] In fact, the issue of whether creditors could claim losses or bad debt deductions upon a debt-for-equity partnership exchange was undoubtedly the most controversial element of the Proposed Regulations.

The Proposed Regulations did not apply a §721 approach to equity paid in exchange for partnership indebtedness related to unpaid rent, royalties, or interest.

Example 3 — Applying §721

Facts: Same as Example 1 except that in addition to the $800 of principal amount on the Note, the cash-basis Lender has $100 of accrued but unpaid interest on the Note.



Result: Lender is treated as receiving the first $100 of partnership equity as a payment of the $100 of accrued interest and recognizes ordinary income for that amount. PRS is treated as satisfying the remaining $800 of debt with the remaining $400 of equity (after reduction for the $100 deemed to pay off the accrued interest). PRS has $400 of COD income. Lender is treated as transferring its Note with an $800 tax basis to PRS in a §721 transaction in exchange for the remaining $400 of PRS equity. Lender's §704(c) built-in loss asset "disappears," and Lender is left with its loss deferred in its outside tax basis in PRS of $900 ($800 carryover basis from the contributed Note and $100 of basis from the equity received for accrued interest).

THE FINAL REGULATIONS

The Final Regulations keep the general concepts from the Proposed Regulations described above, but address certain issues and make the clarifications described below.[10]

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[9] *See* AICPA Comments on Proposed Regs on Discharge of Partnership Indebtedness Income, 2009 *TNT* 88-113 (4/22/09) and ABA Members Comment on Proposed Rules on Partnership Cancellation of Debt Income, 2009 *TNT* 85-13 (5/4/09).

[10] The changes in the Final Regulations primarily addressed comments and questions from various commentators. *See generally* AICPA Comments on Proposed Regs on Discharge of Partnership Indebtedness Income, 2009 *TNT* 88-113 (4/22/09); ABA Members Comment on Proposed Rules on Partnership Cancellation of Debt Income, 2009 *TNT* 85-13 (5/4/09); and NYSBA

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The Liquidation Value Safe Harbor

The Final Regulations modify the four requirements for a taxpayer to rely on the Liquidation Valuation Safe Harbor.[11] First, the Final Regulations eliminate the requirement that regulatory §704(b) capital accounts be maintained, acknowledging that the IRS did not intend to limit the rule to partnerships that liquidate in accordance with §704(b) capital accounts.[12] Second, the Final Regulations confirm that tax reporting using the Liquidation Value formula must be used consistently by the lender, the partnership, and *all of the partners* — thus putting partnerships at risk of a recalcitrant partner filing an inconsistent tax return to undo the agreement between the partnership and the lender.[13] Third, the Final Regulations clarify that the ''arm's-length'' dealing requirement in the Proposed Regulations can be satisfied even if the debtor and creditor are related parties, but only if the terms are comparable to what would be agreed to by unrelated parties negotiating with adverse interests. Fourth, the Final Regulations expand the requirement that the creditor cannot be redeemed as part of a COD income avoidance plan by also restricting pre-planned creditor interest purchases by partners or persons related to partners. Lastly, the Final Regulations clarify that in determining the Liquidation Value, if the partnership owns an interest in a lower-tier partnership, the same Liquidation Value rule should apply to its interest in the lower-tier partnership.[14]

Members Comment on Proposed Regs on Discharge of Partnership Indebtedness Income, 2009 *TNT* 122-75 (6/26/09). Others have also informally commented on the Proposed Regulations in articles. *See* Rubin et al., ''New Partnership Debt-for-Equity Regulations Deny Lender's Losses,'' 121 *Tax Notes* 1281 (12/15/08); Lipton, ''Prop. Regs. on Contributions of Partnership Debt Do Not Answer the Hard Questions,'' 110 *J. Tax'n* 79 (Feb. 2009); and Schippel, ''Coping with CODI Under Prop. Regs. §1.108-8 and Code §108(i),'' 25 *Tax Mgmt. Real Est. J.* 175 (8/5/09).

[11] Regs. §1.108-8(b)(2)(i).

[12] For a full discussion of the trend to not liquidate in accordance with capital accounts see O'Connor and Schneider, ''Capital-Account-Based Liquidations: Gone With the Wind or Here to Stay?'' 102 *J. Tax'n* 21 (Jan. 2005).

[13] Many partnership agreements contain provisions that require the partners to file consistently with the information reported on their Form K-1 received from the partnership. Such careful partnership agreement drafting may prove valuable in a subsequent debt-for-equity conversion. For a discussion of drafting techniques in partnership agreements, see Schneider & O'Connor, ''Partnership and LLC Agreements: Learning to Read and Write Again,'' *Tax Notes* (12/21/09).

[14] Regs. §1.108-8(b)(2)(ii).

The Elephant in the Room — Lender's Disappearing Loss

The Final Regulations confirm the Proposed Regulation's denial of a tax loss to the lender for the discount, even though the debtor partnership recognizes offsetting COD income. The IRS held to its ''Section 721'' treatment, such that the lender's built-in loss in the note carries over into its partnership interest, following the general rules for contributions of property to partnerships. The stark difference between this case and a ''normal'' contribution transaction is that (1) the partnership does not have the same tax-free treatment and recognizes COD on the transaction; and (2) because the contributed note disappears after the contribution, the lender does not have a partnership asset on which it would eventually recover its built-in loss. The net result at the end of the day is that the transaction creates income to the borrower but indefinitely traps the lender's loss in its outside basis in the partnership. The Preamble to Final Regulations acknowledges that many commentators found this unfair, but also notes that one commentator found that bifurcating the transaction to separate out the lender's loss is not consistent with §721 or case law.[15] Ultimately, the Final Regulations deny the bifurcation approach, arguing that it would be inconsistent with corporate tax authorities. However, in an attempt to show compassion, the Preamble to the Final Regulations acknowledges that, for lenders in the trade or business of lending, a §166 deduction for partial worthlessness might be available ''prior to the debt-for-equity exchange in a transaction independent of and separate from the debt-for-equity exchange.''

Equity for Accrued Ordinary Income Items

The Final Regulations made some clarifying changes to the proposed rule that the §721 approach does not apply to equity paid in exchange for unpaid rent, royalties or interest on the partnership's indebtedness. First, the Final Regulations refine the rule to limit its application to such items that accrued after the lender acquired the note. Thus, if a lender purchases a pre-existing debt, the refinement means that there is the potential for ordinary income only to the extent of the items that accrued after purchase. Second, the Final Regulations address the question of

[15] *See generally* NYSBA Members Comment on Proposed Regs on Discharge of Partnership Indebtedness Income, 2009 *TNT* 122-75 (6/26/09) (''We believe that serious concerns about statutory authority exist with respect to an approach that would deem a debt instrument to be bifurcated in connection with a transaction that otherwise would be considered an exchange under Section 721 (or Sections 351, 354 or 1271).'').

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whether the partnership might recognize gain or loss, based on an aggregate treatment of partnerships, through treating the partnership as satisfying its accrued income obligation with a pro rata share of its underlying assets. Although not stating the specific theory, the Final Regulations appear to have taken the ''deemed cash payment approach'' to avoid gain to the partnership on this transaction.[16] Finally, to the dismay of many taxpayers, the Final Regulations keep the proposed approach of treating 100% of the equity as first being used to satisfy accrued interest, citing Regs. §§1.446-2 and 1.1275-2, despite taxpayer pleas to prorate the payment between the value of the relative obligations being cancelled.[17] The effect of the IRS approach is to increase the potential ordinary income to the lender, at the expense of a trapped loss in the lender's partnership interest.

Housekeeping Changes

COD Income as a First-Tier Minimum Gain Chargeback Item

When a partnership borrows money on a nonrecourse basis, there is the potential for ''minimum gain'' to the extent that tax deductions exceed the equity in the property. For example, if PRS borrowed $100 on a nonrecourse basis and bought property for $120, once tax deductions exceed the initial $20 of equity and reduce the book value of the property to the amount of nonrecourse debt, the next deductions create minimum gain. The partners who receive these next deductions, referred to as ''debt-sourced deductions,'' are the partners who will later be ''charged back'' gross income upon certain future chargeback events. The termination of the debt is one of those events. Thus, if the lender later contributes the debt for partnership equity, there is a minimum gain chargeback for any debt-sourced deductions. The historical §704(b) regulations provided that gain from the sale of the underlying property was a ''first-tier'' item of gross income to allocate to satisfy this minimum gain chargeback, and if insufficient, then a pro rata share of all other partnership income or gain items for the year was to be used. The Final Regulations take the next logical step and include the COD income as an additional ''first-tier'' item to satisfy this chargeback requirement so that there will be a better matching of the COD income allocation to the partners who previously took the deductions sourced to the forgiven debt.[18]

A Warning About Disguised Payments

The Final Regulations leave taxpayers with a warning — do not try to sneak in any disguised payments for services or otherwise and try to get §721 treatment. Specifically, the regulations say that all the facts and circumstances are considered in determining the fair market value of a partnership interest transferred as compared to the fair market value of the note. If the values differ, general tax principles, such as the §707(a)(2)(A) disguised payments for services rules, could apply to recast the tax treatment to the extent of that difference.[19]

THE LONG ROAD AHEAD — WHAT'S A TAXPAYER TO DO?

Taxpayers are left with two primary issues in a partnership debt-for-equity exchange, how to minimize COD income and how to trigger the lender's loss. The first is the goal of the partnership and the second the goal of the lender. Luckily, as discussed below, the two goals are not necessarily mutually exclusive.

Minimizing COD Taxable Income

Liquidation Value Safe Harbor — Can You Qualify and Should You Do It?

The Liquidation Value Safe Harbor minimizes COD income only if the Liquidation Value is more than the fair market value of the issued equity. Thus, assuming that the parties wish to minimize COD income,[20] the Safe Harbor makes sense to rely on[21] if the Liquidation Value of the partnership equity issued

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[16] This same approach was taken by the IRS in the proposed regulations addressing noncompensatory partnership options. *See* REG-103580-02 (1/21/03). The IRS once again took a similar approach in the proposed compensatory option regulations. See Schneider and O'Connor, ''Proposed Rules Substantially Change the Treatment of Compensatory Partnership Interest: Are You Ready?'' 8 *J. Passthrough Entities* 35 (Sept.-Oct. 2005), for a full discussion of the compensatory option regulation. For a more complete discussion of the overall issue of partnership capital shifts, see Schneider and O'Connor, ''LLC Capital Shifts: Avoiding Problems When Applying Corporate Principles,'' 92 *J. Tax'n* 13 (2000).

[17] For a good analysis of why the ''interest first'' rule should not apply to a payment in termination of a loan, see ''NYSBA Members Comment on Proposed Regs on Discharge of Partnership Indebtedness Income,'' 2009 *TNT* 122-75 (6/26/09).

[18] Regs. §1.704-2(f)(6).

[19] Regs. §1.108-8(b)(1).

[20] Certain §108 exceptions to COD income, such as insolvency or bankruptcy, make some partners less adverse to COD income. In some other contexts, where the COD income can be excluded, taxpayers may prefer more COD income in exchange for less gain upon the disposition of the underlying property. For an example of a taxpayer unsuccessfully trying to achieve greater COD income and less gain on sale of the property, see 2925 *Briarpark, Ltd. v. Comr.*, 163 F.3d 313 (5th Cir. 1999). However, in the con-

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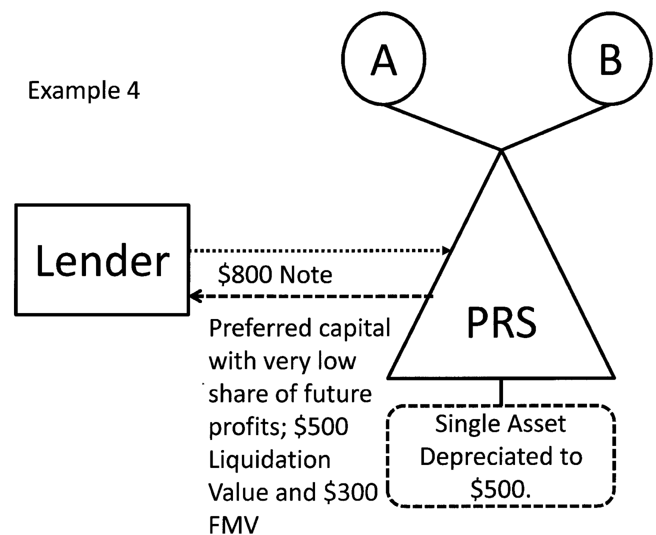
to the lender is equal to or higher than the fair market value of such partnership equity. The lender is arguably indifferent on whether the parties use the Safe Harbor since it does not affect the lender's tax basis or loss recognized. The Liquidation Value approach also arguably creates more certainty when the true value of the lender's equity interest is difficult to value.[22] The following examples illustrate the above points.

Example 4 — Electing Liquidation Value to Minimize COD Income

Facts: Same as Example 1 ($800 Note contributed for PRS equity) except that the equity received in return has a $500 Liquidation Value with a low share of future profits and other restrictions that make the true fair market value of the equity only $300. Because the Liquidation Value exceeds the fair market value, the parties agree to use the Liquidation Value Safe Harbor to minimize COD income.



Result: PRS has $300 of COD income. Lender is treated as transferring its Note with an $800 tax basis to PRS in a §721 transaction in exchange for $500 of PRS equity. Lender's §704(c) built-in loss asset "disappears" and Lender is left with its loss indefinitely deferred in its $800 outside tax basis in PRS. Because Lender's partnership interest is worth only $300, the Safe Harbor saves $200 of COD income to the partnership and does not affect either the Lender's $500 built-in loss in its partnership interest ($800 basis less $300 value) or the partnership's inside basis.

Example 5 — Fair Market Value Higher Than Liquidation Value

Facts: Same as Example 1 ($800 Note contributed for PRS equity) except that the Lender receives only a share of future profits with a value of $200 and a zero Liquidation Value. This could occur, for example, if the Lender's loan was junior to a senior loan that would receive 100% of the underlying PRS assets if PRS were liquidated. In this case the Safe Harbor would actually produce a higher amount of COD income.

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text of §108(e)(8), the additional COD income does not reduce other taxable gain. Thus, we presume that taxpayers will almost universally prefer less COD income in the §108(e)(8) context.

[21] The Final Regulations provide that the general rule for valuing the equity is based on all facts and circumstances, but if four specified requirements are satisfied, the value is deemed to equal the Liquidation Value. One such requirement is that the parties consistently treat the value as equal to the Liquidation Value, effectively making the Safe Harbor elective since the parties can simply not treat the value as equal to the Liquidation Value and the Safe Harbor would then not apply. Although as a practical matter the Safe Harbor is elective, no formal tax election is required. *See generally* Regs. §1.108-8(b).

[22] For example, a willing-buyer willing-seller valuation may include significant discounts for lack of transferability and minority ownership, thus increasing the potential COD income as compared to the Liquidation Value approach.

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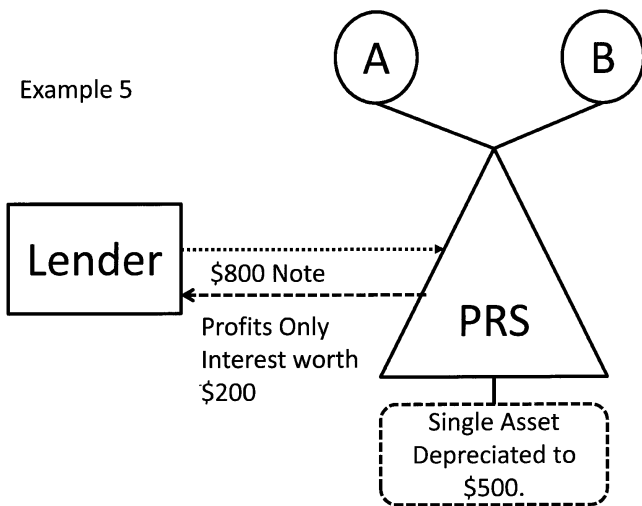

Result: PRS has $600 of COD income provided it does not elect the Liquidation Value Safe Harbor. Lender is treated as transferring its Note with an $800 tax basis to PRS in a §721 transaction in exchange for $200 of PRS equity. Lender's §704(c) built-in loss asset "disappears," and Lender is left with an outside tax basis in PRS of $800. Because the Liquidation Value was zero, using the general fair market value approach saves $200 of COD income to the partnership.

Similar to Example 4, Lender is indifferent because its tax treatment is not affected by whether the Liquidation Value Safe Harbor is used.[23] Although the fair market value approach may appear better in this example, if the example is modified to include a first mortgage lender, PRS also needs to evaluate whether it will also issue equity to the first mortgage lender as part of the same overall transaction. The Final Regulations do not allow PRS to use the Safe Harbor for some, but not all, of the debts converted as part of the same overall transaction.[24] Therefore PRS needs to either separate the two transactions or determine whether the fair market value or Liquidation Value creates the best overall answer for the two loan conversions combined.

[23] The Final Regulations do not address what the §704(b) capital account should be in this example where the fair market value differs from the Lender's Liquidation Value. To the contrary, the Preamble to the Final Regulations notes how these rules do not require §704(b) capital account maintenance. Query whether the Lender or the other partners might be concerned that the Lender's capital account must equal the Liquidation Value and the partnership might be forced to allocate gross income items to create this balance. *See, e.g.,* "NYSBA Members Comment on Proposed Regs on Discharge of Partnership Indebtedness Income," 2009 *TNT* 122-75 (6/26/09) (noting that this disparity "may require inappropriate and unfair corrective allocations of gross income to the former creditor (or other similar mechanics) to eliminate such disparity").

[24] Regs. §1.108-8(b)(2)(i)(B).

Liquidation Value Safe Harbor — Making it Work

The Liquidation Value Safe Harbor includes specific regulatory requirements, but the practical aspects of meeting these may require some effort. Some of the practicalities are discussed below.

- *Ensuring Consistent Treatment.* One of the requirements of the Safe Harbor is that the lender, the partnership, and the partners use the Liquidation Value. The contribution agreement with the lender should include a statement that the Liquidation Value is used and, because the partnership agreement will require amendment to create the lender's new equity, this amendment should also state that all of the partners will use the Liquidation Value approach in reporting their COD income. This will at least minimize the risks of a recalcitrant partner not following the Liquidation Value in computing COD income.
- *Determining the Liquidation Value.* The Liquidation Value Safe Harbor contemplates that the partners and the lender actually know the value the lender would receive on liquidation, which is not always the case. For example, if the partnership simply gives the lender a pro rata "common" interest in the partnership, the parties may not have otherwise needed to value the underlying asset and might have different views on asset values. A similar conundrum can occur if the lender receives a preferred interest with a right to 100% of the liquidation proceeds up to a dollar amount clearly above the value of the property.[25] Presumably to meet the consistency requirement in the regulations, the IRS would want the parties to not only agree on using the Liquidation Value Safe Harbor, but to agree on the specific amount of the Liquidation Value.[26] Thus, a taxpayer would be well advised to specify in the transaction documentation the specific dollar amount of Liquidation Value agreed to by the partners. Although the lender may be tax-indifferent because it does not directly affect the lender's tax treatment, the lender may be sensitive from a business standpoint. Further, the value placed on the underlying assets could affect both the lender and the histori-

[25] For example, if the note is $1,000 and the property is worth somewhere in the range of $400 to $500, the lender may insist on the first $600 of distributions from the partnership, with some smaller residual sharing of profits above $600.

[26] Interestingly, the regulations are silent on this point. Regs. §1.108-8(b)(2)(i)(A). However, they appear to be based on the underlying assumption that the consistent use of the Liquidation Value means the parties agree on the same number for Liquidation Value.

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cal partners when applying future §704(b) and (c) income allocation rules.[27]

- *Restriction on Future Lender Buy-out/ Redemption.* The Safe Harbor requires that there be no pre-existing tax plan by the partnership, other partners, or related parties to redeem or buy-out the lender if there is a principal purpose of avoiding COD income. An example would be a modification of Example 4 above, where the lender has an $800 note and the partnership issued equity with a $500 Liquidation Value and $300 fair market value, only to redeem the lender for $300 shortly thereafter. If this redemption were part of a "plan," then the IRS would disallow the Liquidation Value Safe Harbor and compute the COD on the $300 fair market value paid and not the $500 Liquidation Value. Because this restriction applies even to purchases by partners or persons related to a partner, the transaction documentation might include restrictions on such sales to partners or related persons for some minimum period to avoid the risk of the IRS arguing that such a plan existed. For example, the lender could have pre-arranged a transaction with a recalcitrant partner to buy out the lender's partnership interest absent the documents prohibiting this.[28]

Realizing the Lender's Loss

As discussed above, the most common objection to the Proposed Regulations was the rollover of the lender tax loss into the outside basis of its new partnership interest. Commentators noted the inherent unfairness in applying §721 to deny the *lender's* immediate loss when the statute does not allow the *borrower* to take advantage of §721 to avoid COD income — a true "heads I win, tails you lose" situation. However, this is where tax advisors can add value. Some strategic tax planning is discussed below.

The §166 Partial Worthlessness Deduction

The Final Regulations hint at the ability to take a partial worthlessness deduction under §166 if done in a transaction that is "independent of and separate from the debt-for-equity exchange."[29] Not only does the §166 deduction avoid the deferral of the lender's loss but it also ensures that the loss is "ordinary" and does not get converted into a potential future capital loss in the partnership equity received. This is a welcome informal acknowledgement that §166 allows either corporate lenders or non-corporate lenders in the regular trade or business of lending, to take a "partial worthless" deduction up to the amount "charged off" on the taxpayer's books and records within the taxable year.[30] Although it is helpful that the IRS acknowledged this existing rule, the Preamble creates a clear hurdle that the charge-off and related §166 deduction be independent from the equity conversion. Further, many of the lenders that are willing to accept equity are likely non-bank types who may not qualify for this exception.

Loss Under §1001 / §165 for Partial Debt Forgiveness

If §166 is not available, all hope may not be lost if the lender can actually write down the debt in an independent transaction and receive a deduction under §165.[31] For a non-trade/business lender, this loss is not nearly as favorable as a §166 loss, for at least two reasons.[32] First, the loss under §165, for a non-trade/business lender, is going to be a capital loss.[33] Second, to receive a loss under §165, the lender must actually forgive that portion of the loan,[34] undoing the leverage the lender may have over the borrower to collect the additional moneys and accelerating the COD income for the borrower on the forgiven portion

[27] The issuance of equity to the lender would be a revaluation event under Regs. §1.704-1(b)(2)(iv)(*f*), and the asset values are relevant for determining the §704(b) value to revalue the property. This revaluation would create a "reverse §704(c)" layer and raise an issue for negotiation as to the appropriate §704(c) method.

[28] Note, most partnership agreements include extensive restrictions on sales by partners so this modification should be a relatively easy addition/clarification to these pre-existing restrictions.

[29] The Preamble to the regulations implies that the denial of the "bifurcation approach" to allow the lender's loss may not be that harsh. Specifically, the regulations state that "[f]urther, comments in favor of the bifurcation approach assume a creditor has not validly taken a bad debt deduction under §166 prior to the debt-for-equity exchange in a transaction independent of and separate from the debt-for-equity exchange." T.D. 9557, 76 Fed. Reg. 71255 (11/17/11).

[30] §166(a), (d). *See also* Bittker & Lokken: *Federal Taxation of Income, Estates, and Gifts*, ¶33.4. Partial Worthlessness ("deductions for partial worthlessness are elective with the taxpayer and are conditioned on a charge-off of the uncollectible amount on the taxpayer's books and records").

[31] *See generally* Regs. §1.1001-3 for significant modifications that create a deemed exchange of the old debt for the new debt. *See also* Regs. §1.1001-3(g), *Ex. 3*, for an example showing how the reduction in loan principal can create enough of a change in loan yield to create a significant modification.

[32] For a discussion of the overlap of §165 and §166, see Cummings, Jr., "Bad Debt or Loss?" 123 *Tax Notes* 111 (4/6/09).

[33] The new written down debt would likely be a "significant modification" of the prior debt under Regs. §1.1001-3, thus creating a taxable exchange by the lender of the old loan for the new loan with a lesser face value. If the asset is a capital asset in the hands of the lender, the loss would be a capital loss. *See also* §166(d).

[34] Section 165(a) requires that the loss be "sustained" during the tax year. Regs. §1.165-1(b) further requires that "a loss must be evidenced by closed and completed transactions, fixed by identifiable events."

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of the loan. Further, there is also a high bar for the taxpayer to prove that the loan write down should be respected as having independent economic significance if it is soon followed by a conversion of the debt for equity.[35]

Future Lender Interest Transfers

Although a lender is not allowed a pre-planned redemption/sale to certain related parties, this still leaves open (1) a taxable sale to an unrelated party; or (2) a tax-free contribution of the equity to a lower-tier entity, such as a partnership or a corporation, combined with a §754 election to adjust the inside basis of partnership assets under §743(b).

On the taxable sale alternative, the lender simply sells its equity to an unrelated third party. Although this allows the lender's loss, it would be a capital loss, so the lender should make sure it's able to use a capital loss on its tax return. Further, if the lender had wanted to exit the position entirely, it probably would not have agreed to the debt-for-equity transaction in the first place and would have instead simply sold its debt position to a new investor, and recognized the loss on that sale. Thereafter, the new investor could agree to the debt-for-equity conversion without the same built-in tax loss issue.

On the tax-free contribution alternative, the lender keeps an indirect economic position in the underlying partnership, although now holds it through another tier. A transfer of a partnership interest to a corporation or another partnership is an ''exchange'' for §743(b) purposes, even if there is no taxable gain recognized on the transfer.[36] In evaluating these future transfers, general common law and statutory economic substance principals should be examined as well as §§267 and 707 related-party loss-disallowance rules.[37] It is also important to ensure that this transfer is not within the realm of the forbidden pre-planned lender redemptions/sales that would run avoid of the Liquidation Value Safe Harbor discussed earlier.[38] For non-trade or business lenders who would otherwise have sustained only a capital loss on the loan, acquiring the deduction over time through amortization of a §743(b) special basis adjustment may actually be preferable. However, because of the unusual nature of the §755 rules for allocating §743(b) adjustments, a careful ''running of the numbers'' and some additional planning may be necessary.[39]

Example 6 — Effect of Section 743(b)

Facts: Same as Example 4 ($800 Note contributed for PRS equity with $500 liquidation value and $300 fair market value). PRS owns a single asset with a tax basis and value of $500. Two years later, when the asset has appreciated, for independent business reasons lender transfers its partnership interest to Lower-Tier in an unrelated tax-free transaction (e.g., under §351 or §721) and PRS makes a §754 election.[40]

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[35] For a discussion of a court stepping together related transactions in the COD context, see *2925 Briarpark, Ltd. v. Comr.*, 163 F.3d 313 (5th Cir. 1999).

[36] Section 743(b) applies to ''transfers'' of partnership interest, which includes both ''sales'' and ''exchanges.'' §743(b). *See also* McKee, Nelson & Whitmire, *Federal Taxation of Partnerships and Partners*, ¶16.07[1] (4th Edition) (''Section 743(b) is applicable [in a section 351 transaction] even though the transferor-shareholder recognizes no income on the exchange. This section generates a basis adjustment to the corporation whenever the carryover basis of the transferred interest differs from the transferor's share of the basis of partnership assets.'').

[37] This transfer should be undertaken as part of an independent business transaction in light of the many ''anti-abuse'' rules including the recently codified economic substance doctrine under §7701(o). Further, additional anti-loss trafficking rules should be considered, such as §§362(e) and 704(c)(1)(C). A full discussion of these rules is beyond the scope of this article.

[38] Regs. §1.108-8(b)(2)(D) prohibits pre-planned redemptions or sales that were done with a principal purpose of reducing the borrower's COD income. This transaction is not relevant to the amount of COD income to the borrower and further is merely a transfer and not a sale or redemption that is prohibited by the regulations.

[39] For a thoughtful discussion of this approach, see Blumenreich, ''Proposed Regulations on Partnership Debt for Equity Exchanges — IRS Addresses Certain Outstanding Questions But Defers on Others,'' *Tax Mgmt. Real Est. J.* 83 (5/6/09) (discussing the potential need to ensure some built-in gain assets inside the partnership to allow allocation of the §743(b) adjustment to partnership assets under Regs. §1.755-1(b)(5)(iii)(A)).

[40] Note that PRS may already have a §754 election in place, especially if the partnership elected to adjust the inside basis in the partnership under §734(b) for any §731(a) gain that may have been recognized by the historical partner from the termination of the debt. If such an election is not in place, the Lender would be well advised to make sure the partnership agreement allows it to cause the partnership to make a §754 election.

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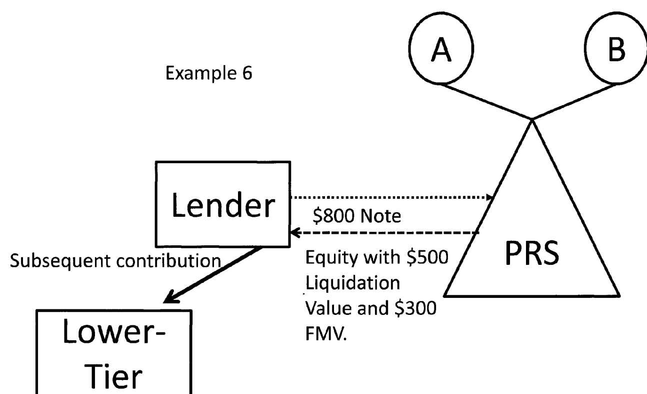

Result: As in Example 4, if the partnership uses the Liquidation Value Safe Harbor, the partnership will recognize COD income of $300 (the difference between the $800 note and the $500 Liquidation Value). The Lender has an outside basis in its partnership interest of $800, even though the partnership has only $500 of tax basis in its assets. Two years later, on the transfer to Lower-Tier, the partnership makes a §754 election and Lower-Tier computes a §743(b) adjustment of $300.[41] This basis adjustment is then allocated among the partnership assets under the §755 regulations to partnership's single asset.[42] Lower-Tier will then receive amortization of this special basis adjustment based on the tax life of this asset.[43]

CONCLUSION

The Final Regulations are welcome guidance in many important areas and allow taxpayers more certainty on the treatment of partnership debt-for-equity transactions. Taxpayers now have a roadmap to plan to minimize COD income, which mainly involves determining whether to take advantage of the Liquidation Value Safe Harbor. Taxpayers also have a few options to help the lender plan to avoid trapping its loss inside its partnership interest. The best plan, if the facts allow for it, is for eligible lenders to take advantage of the §166 partial-worthlessness deduction. If this isn't an option, there are still a few planning alternatives that may be available. As with most of tax, ''[i]t pays to plan ahead. It wasn't raining when Noah built the ark.''[44]

[41] *See generally* Regs. §1.743-1 for computation of the §743(b) adjustment.

[42] *See* Regs. §1.755-1(b)(5). Note that the example assumes subsequent appreciation in the asset to overcome the technical basis allocation issue discussed in footnote 39.

[43] Regs. §1.743-1(j)(4)(i)(B)(1) (step-up taken into account as if it were newly purchased recovery property placed in service when transfer occurs).

[44] Quote attributed to Peter F. Drucker.

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