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Client Alert

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IRS Issues Proposed Treasury Regulations Addressing Tax Treatment of Partnership Debt for Equity Exchanges

Background

As part of the American Jobs Creation Act of 2004 (the 2004 Act), Section 108(e)(8) of the Internal Revenue Code of 1986 (the Code) was amended to include discharges of partnership indebtedness. Prior to the amendment, the Code addressed the tax treatment of corporate indebtedness but not indebtedness of a partnership.

"Proposed Treasury regulations issued on October 30, 2008 provide answers to some of the questions left unanswered by the 2004 Act."

The amended provision provided much the same treatment for partnerships as it already provided for corporations. Specifically, if a debtor partnership transfers partnership equity to a creditor in satisfaction of its 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. If the fair market value is less than the amount of debt being discharged, the partners of the partnership recognize taxable income from cancellation of debt, immediately before the discharge, in the amount by which the debt being discharged exceeds the fair market value of the partnership interest used to extinguish the debt.

The 2004 Act left a number of questions unanswered, including how to determine the fair market value of the partnership interest for this purpose and the tax treatment of the creditor who exchanges debt for equity of the partnership.

New Proposed Treasury Regulations Provide Some Answers

Determining the Amount of Income from Debt Cancellation

Proposed Treasury regulations issued on October 30, 2008 provide answers to some of the questions left unanswered by the 2004 Act. First, the regulations provide that when certain requirements are satisfied, the fair market value of the partnership interest transferred in exchange for debt is the "liquidation value" of the partnership interest. For this purpose, the liquidation value is the amount of cash the creditor would receive with respect to the newly received partnership interest if the partnership sold all of its assets (including goodwill, going concern value, and any other intangibles associated with the partnership's operations) for cash equal to the fair market value of those assets and then liquidated. This rule only applies, however, if (i) the partnership maintains capital accounts in accordance with the rules set forth in the applicable

Treasury regulations; (ii) the creditor, the partnership and its partners treat the fair market value of the partnership interest as equal to the liquidation value for purposes of determining the tax consequences of the exchange; (iii) the debt for equity exchange is an arm's length transaction and (iv) subsequent to the debt-for-equity exchange, neither the partnership nor any related person purchases the partnership interest as part of a plan that has as a principal purpose the avoidance of income from debt cancellation by the partnership.

If any of these requirements is not satisfied, all relevant facts and circumstances will be considered in determining the fair market value of the partnership interest.

It should be noted that, depending on the facts, a more favorable tax result may be obtainable by electing to use the "all facts and circumstances" test.

Tax Treatment to the Creditor of the Exchange

The Treasury regulations provide that the exchange by a creditor of partnership debt for an equity interest of the partnership is a tax-free exchange in which no gain or loss is recognized. Instead, the creditor's tax basis (and holding period) in the debt becomes the tax basis (and holding period) of the partnership interest. This rule does not apply, however, to partnership equity that is used to satisfy unpaid rent, royalties or interest on indebtedness (including accrued original issue discount). The IRS has stated that the rule similarly does not apply to the disposition of an installment sale obligation.

Note that where the creditor's tax basis in the debt exceeds its value, this rule has the disadvantage of resulting in a deferral of the loss and, in some cases, a change in character from ordinary to capital.

Effective Date; Unanswered Questions

These new Treasury regulations are only proposed and are not effective unless and until finalized. These rules could change in response to public comments. In particular, the IRS has asked for comments on a number of issues not addressed in the proposed Treasury regulations, including:

- whether any special allocation rules should apply to the allocation of income from cancellation of debt where the debt was owed to a pre-existing partner;
- how the income from debt cancellation should be treated for purposes of certain technical rules concerning "minimum gain chargeback" and
- whether and how these rules should apply in the case of convertible debt.

If you have any questions about this *Client Alert*, please contact the author listed below:

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