LATHAM&WATKINS

Number 1259 November 16, 2011

Client Alert

Latham & Watkins Tax Department

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

"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."

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 address discharges of partnership indebtedness when a partnership transfers a partnership equity interest to satisfy a partnership debt. The amended provision provided much the same treatment for partnerships as was 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 immediately before the discharge recognize taxable income from cancellation of debt in the amount by which the debt being discharged exceeds the fair market value of the partnership interest used to extinguish the debt.

Proposed Treasury regulations issued on October 30, 2008 clarified the amendments to Section 108(e)(8) by providing that "fair market value" is determined either by using the "liquidation value" as defined in the proposed Treasury regulations (in certain circumstances), or based on a "facts and circumstances" test. The proposed Treasury regulations also provided that the exchange by a creditor of partnership debt for an equity interest of the partnership is generally treated as a tax-free exchange in which no gain or loss is recognized. The creditor's tax basis (and holding period) in the debt becomes the tax basis (and holding period) of the partnership interest, subject to certain exceptions.

Effective November 17, 2011, the final Treasury regulations largely adopt the approach taken in the proposed Treasury regulations, with some important clarifications and revisions.

Determining the Amount of Income from Debt Cancellation

The final Treasury regulations contain a "liquidation value" safe harbor for determining the fair market value of a partnership interest transferred in satisfaction of the partnership debt, and require considering all facts and circumstances in all instances where the safe harbor requirements are not met. For this purpose, the liquidation value is the amount of cash the creditor would receive with respect to the newly received partnership interest if, immediately after the transfer, 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. The use of liquidation value is only available if (i) 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; (ii) the debt for equity exchange has terms comparable to those that would be agreed to by unrelated parties negotiating with adverse interests; (iii) if, as part of the same overall transaction, more than one partnership interest is transferred to one or more creditors, each creditor, the partnership, and its partners treat the fair market value of each partnership interest transferred as equal to its liquidation value; and (iv) subsequent to the debt-for-equity exchange, neither the partnership nor any related person purchases the partnership interest transferred as part of a plan that has as a principal purpose the avoidance of income from debt cancellation by the partnership.

Requirement (iii), mandating consistent treatment by multiple creditors who participate in the same overall transaction, was added to the final Treasury regulations. In addition, the final Treasury regulations removed a requirement for the liquidation value safe harbor contained in the proposed Treasury regulations that the partnership maintain capital accounts in accordance with the rules set forth in the applicable Treasury regulations. Finally, the final Treasury regulations addressed tiered partnerships, noting that liquidation value for a partnership that directly or indirectly owns an interest in one or more partnerships is determined by taking into account the liquidation value of such lower-tier partnerships.

Tax Treatment to the Creditor of the Exchange

The final 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. 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 the extent that partnership equity is used to satisfy unpaid rent, royalties or interest on indebtedness (including accrued original issue discount) that accrued on or after the beginning of the creditor's holding period for the debt. If partnership equity is used to satisfy such debts, however, the partnership will not recognize any gain or loss.

Thus, where the creditor's tax basis in the debt exceeds its value, in many cases the creditor will not be entitled to a bad debt deduction. Instead, the creditor's loss is deferred and in effect becomes built into its tax basis in the partnership equity received in the exchange. Depending on the facts, however, it sometimes may be possible for the creditor to first write down the debt and take a bad debt deduction in a separate transaction, prior to exchanging the debt for an equity interest in the partnership.

Proposed Installment Sale Regulations

The IRS indicated that it will propose regulations clarifying that the disposition by a creditor of a partnership installment obligation in exchange for an equity interest in the partnership does not qualify as a tax-free exchange.

Client Alert is published by Latham & Watkins as a news reporting service to clients and other friends. The information contained in this publication should not be construed as legal advice. Should further analysis or explanation of the subject matter be required, please contact the attorney with whom you normally consult. A complete list of our *Client Alerts* can be found on our website at www.lw.com.

If you wish to update your contact details or customize the information you receive from Latham & Watkins, please visit www.lw.com/LathamMail.aspx to subscribe to our global client mailings program.

If you have any questions about this *Client Alert*, please contact one of the authors listed below or the Latham attorney with whom you normally consult:

David S. Raab
+1.212.906.1344
david.raab@lw.com
New York

Jonathan Stein*
+1.212.906.1678
jonathan.stein@lw.com
New York

* *Mr. Stein is only admitted to practice in Massachusetts.*

Abu Dhabi
Villiers Terblanche
+971.2. 495.1700

Barcelona
Jordi Domínguez
+34.93.545.5000

Beijing
Allen C. Wang
+86.10.5965.7000

Boston
David O. Kahn
+1.617.948.6000

Brussels
Howard Rosenblatt
+32.2.788.6000

Chicago
Diana S. Doyle
+1.312.876.7700

Doha
Villiers Terblanche
+974.4406.7700

Dubai
Villiers Terblanche
+971.4.704.6300

Frankfurt
Hans-Jürgen Lütt
Anders Kraft
+49.69.6062.6000

Hamburg
Tobias Klass
Götz T. Wiese
+49.40.4140.30

Hong Kong
Joseph A. Bevash
+852.2522.7886

Houston
C. Timothy Fenn
+1.713.546.5400

London
Daniel Friel
+44.20.7710.1000

Los Angeles
Orange County
Samuel R. Weiner
Pardis Zomorodi
+1.213.485.1234

Madrid
Jordi Domínguez
+34.91.791.5000

Milan
Fabio Coppola
+39.02.3046.2000

Moscow
Christopher J. Allen
+7.495.785.1234

Munich
Thomas Fox
Stefan Süss
+49.89.2080.3.8000

New York
New Jersey
David S. Raab
Lisa G. Watts
+1.212.906.1200

Paris
Olivia Rauch-Ravisé
+33.1.40.62.2000

Riyadh*
Mohammed Al-Sheikh
+966.1.207.2500

Rome
Fabio Coppola
+39.06.98.95.6700

San Diego
Laurence J. Stein
+1.619.236.1234

San Francisco
Kirt Switzer
+1.415.391.0600

Shanghai
Rowland Cheng
+86.21.6101.6000

Silicon Valley
Kirt Switzer
+1.650.328.4600

Singapore
Mark A. Nelson
+65.6536.1161

Tokyo
Hisao Hirose
+81.3.6212.7800

Washington, D.C.
Joseph D. Sullivan
Cheryl M. Coe
+1.202.637.2200

* In association with the Law Office of Mohammed A. Al-Sheikh