



Final Treasury Regulations Address Tax Treatment of Partnership Debt-for-Partnership Interest Exchanges

The Treasury Department has issued Final Treasury Regulations (the “Final Regulations”) providing guidance regarding the determination of discharge of indebtedness income (“COD income”) of a partnership that transfers a partnership interest to a creditor in satisfaction of the partnership’s indebtedness (a “debt-for-equity exchange”). The Final Regulations also address the treatment of the creditor in such a debt-for-equity exchange. These Final Regulations modify and replace Proposed Treasury Regulations promulgated in 2008 addressing the same topic.

Determination of COD Income

Internal Revenue Code Section 108(e)(8) provides, in part, that for purposes of determining income of a debtor from COD income, if a debtor partnership transfers a capital or profits interest in the partnership to a creditor in satisfaction of its recourse or nonrecourse indebtedness, the partnership is treated as having satisfied the indebtedness with an amount of money equal to the fair market value (“FMV”) of the partnership interest. Any COD income (that is, the amount by which the indebtedness exceeds such FMV) recognized by the partnership is included in the distributive shares of taxpayers which were the partners in the partnership immediately before such exchange. If the debt discharged is nonrecourse, the COD income is first to be allocated in the same manner that any gain realized in a foreclosure (that is, the amount of the debt that exceeds the basis of the property) would have been allocated. The Final Regulations do not provide further guidance on the allocation of the COD income among such partners, referring to the existing guidance as an “appropriate framework” for that purpose.

Generally, all the facts and circumstances are considered in determining the FMV of the partnership interest transferred in exchange for the satisfaction of the partnership debt (the “Debt-for-Equity Interest”). The Final Regulations, however, do provide a safe harbor (the “Liquidation Value Safe Harbor”) stating that the FMV of the Debt-for-Equity Interest will be equal to the liquidation value of the Debt-for-Equity Interest if certain conditions are met. The liquidation value of a Debt-for-Equity Interest equals that amount of cash that the creditor would receive with respect to the Debt-for-Equity Interest if, immediately after the transfer, the partnership sold all of its assets (including goodwill, going concern value and any other intangibles) for cash equal to the FMV of those assets, then liquidated. In the situation where there are tiered partnerships, the liquidation value of a Debt-for-Equity Interest in an upper-tier partnership is determined by taking into account the liquidation value of all lower-tier partnership interests.

Liquidation Value Safe Harbor Conditions

1. *Consistency* – The creditor, partnership and all partners must treat the FMV of the indebtedness as being equal to the liquidation value of the Debt-for-Equity Interest for all tax purposes. If, as part of the same overall transaction, a partnership transfers more than one Debt-for-Equity Interest to one or more creditors, then each creditor, the partnership and all partners must treat the FMV of each Debt-for-Equity Interest transferred to such creditors as equal to its liquidation value.
2. *Arms' Length* – The terms of the debt-for-equity exchange must be comparable to the terms that would be agreed to by unrelated parties negotiating with adverse interests.
3. *Anti-Abuse* – After the debt-for-equity exchange, the partnership cannot redeem the Debt-for-Equity Interest and no person related to the partnership (within the meaning of Code Section 267(b) or 707(b)) can purchase the Debt-for-Equity Interest as part of a plan at the time of the debt-for-equity exchange that has the principal purpose of avoiding COD income. This anti-abuse rule is intended to prevent a partnership from asserting a relatively high liquidation value, thereby minimizing its COD income, and then as part of a plan redeeming or having the partnership or a related partner purchase the partnership interest from the (former) creditor at a fair market value price lower than the asserted liquidation value. If a related partner or the partnership had bought the debt directly from the creditor at that fair market value price, without any intervening debt-for-equity exchange, the partnership would recognize COD income.

Contribution to Partnership (Code Section 721)

Despite criticism of the application of Code Section 721 to debt-for-equity exchanges in the Proposed Treasury Regulations, the Final Regulations confirm that in general under Code Section 721, no gain or loss will be recognized by the creditor or the partnership on a creditor's contribution of a partnership's indebtedness to the partnership in exchange for a capital or profits interest in the partnership, except as otherwise provided by the Code or Treasury Regulations. For example, if a partnership that borrowed \$100 from a creditor satisfies that indebtedness with a partnership interest that has a liquidation value of \$80, the partnership will have \$20 of COD income and the creditor will have a partnership interest with an initial basis of \$100. However, gain or loss may be recognized by the creditor (but not the partnership) to the extent the Debt-for-Equity Interest is exchanged for the partnership's indebtedness for unpaid rent, royalties or interest (including accrued original issue discount) that accrued on or after the beginning of the creditor's holding period for the indebtedness. Accordingly, as to creditors that under their general method of accounting report income only as payments are received, the receipt of a partnership interest in satisfaction or partial satisfaction of the related liability will be treated as payment and therefore income.

As to taxpayers that have previously accrued interest income and original issue discount, however, the Final Regulations refer to other regulations that specify that when partial payments are received on a debt instrument, they are applied first to interest and original issue discount, then to principal. Consequently, if the value of the partnership interest received equals or exceeds the amount of interest and original issue discount previously accrued as income by the creditor, the creditor will not recognize any loss on the exchange, because the interest or original issue discount will have been "paid", and the general nonrecognition rule of Code Section 721 will apply to the principal amount of the exchanged debt. Creditors owning debt attributable to other types of previously accrued income items (such as rent or royalties) will not be barred from recognizing loss under Code Section 721.

With the exception of losses potentially recognized with respect to previously accrued income items, the creditor will not be able to take a loss on the exchange, but will have a basis in its partnership interest equal to its adjusted basis in the debt. Any loss would be deferred, a deferral that could extend until a redemption or other disposition of the partnership interest. Furthermore, because a partnership interest is generally treated as a capital asset, any loss upon a liquidation or other disposition of such creditor's partnership interest would generally be characterized as a capital loss rather than an ordinary loss. This reemphasizes that creditors should periodically review their portfolios for loans that should be charged off as partially worthless, to determine whether an ordinary bad debt deduction under Code Section

166 is available. To enable the creditor to claim the bad debt deduction, any such charge-off should be well in advance of a debt-for-equity exchange, in order for it not to be part of that exchange and subject to the deferral and capital loss treatment described above.

Effective Date

The Final Regulations apply to debt-for-equity exchanges occurring on or after November 17, 2011.

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