Pass-Through Entities and COD Income:
Sheltering Solvent Entity Owners From Insolvent Entity Taxable COD Income

WEDNESDAY, JANUARY 28, 2015

1pm Eastern | 12pm Central | 11am Mountain | 10am Pacific

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Pass-Through Entities and COD Income: Sheltering Solvent Entity Owners From Insolvent Entity Taxable COD Income
January 28, 2015

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Cancellation of Indebtedness Income ("COD Income") Overview

- Arises on:
  - Cancellation of Debt by Lender
  - Cancellation of Debt by Operation of Law
  - Substantial Modification of Debt
  - Acquisition of Debt by related party

- COD Income is included in gross income under Section 61(a)(2) unless an exception applies.

- Section 108 contains a myriad of exceptions to the inclusion of COD Income in income.
Cancellation of Indebtedness Income

Cancellation of an Entity’s Debt

- Pass-through vs. corporate treatment
- COD Income and applicability of exceptions determined at partner level. Section 108(d)(6)
  - In the case of a partnership, sections (a), (b), (c), and (g) shall be applied at the partner level.
  - This legislatively overrules a prior case, Stackhouse v. Commissioner, 441 F.2d 465 (9th Cir. 1971), which treated COD Income of a partnership as a reduction of liabilities under Section 752.
  - A partnership may be insolvent but some or all partners may be solvent, in such an instance the insolvency of the partnership is not relevant to the insolvency exclusion.

- COD Income and special rules for “S” corporations. Section 108(d)(7).
  - In the case of an S corporation, subsections (a), (b), (c), and (g) shall be applied at the corporate level, including by not taking into account under section 1366(a) any amount excluded under subsection (a) of this section. Section 108(d)(7)(A)
  - Because insolvency is determined at the entity level, if an insolvent “S” corp has COD Income, it can be excluded.
COD Income of a Partnership

- Income passes through to partners. Section 702(a)(8). See, also Rev. Rul. 92-97 later in presentation re allocation rules.

- Partner’s basis in the partnership interest is increased by partner’s share of COD Income. Section 705(a)(1).

- Partner’s decrease in share of partnership liabilities is treated as a distribution of money to the partner. Section 752(a).

- Applicability of any exclusion of COD income is determined at the partner level. Section 108(d)(6).
COD Income of an S corporation

- Income passes through to shareholders. Section 1366(a)

- Unlike a partnership, the existence of any exclusions is determined at the S corporation level. Section 108(d)(7). Any COD income excluded as the result of an exception applied at the corporate level does not pass through to shareholders. Section 108(d)(7)(A).

- What about basis?

  - However, The Job Creation and Worker Assistance Act of 2002 legislatively overrules Gitlitz amended Section 108(d)(7)(A) to provide that any excluded income does not pass through to the shareholders. This applies to any COD income after 3/1/2002 and any plan of reorganization filed with bankruptcy court after 10/11/2001.
Cancellation of Indebtedness Income ("COD Income") Upon Outright Cancellation of a Debt.

- The amount of COD Income is the excess of the principal amount of the debt over the fair market value of any consideration paid in exchange for the debt.
- Classic example is real property mortgage
- Significance of whether mortgage is recourse or non-recourse.
Cancellation of Indebtedness Income

➢ Treatment of Nonrecourse Debt.

   - **Tufts v. Commissioner, 461 U.S. 300 (1983)**
     
     Tufts was a general partner in a partnership which financed a property with $1,851,500 of nonrecourse debt. The property was depreciated, with the adjusted basis being decreased to $1,455,740. The FMV on the date the property was transferred was $1,400,000. The partnership conveyed the property and the buyer assumed the mortgage. The partners claimed a loss of $55,740 (the FMV of $1,400,000 – the adjusted basis of $1,455,740).
     
     The IRS asserted that there was a gain of $395,760 (the amount of the debt, $1,851,500 – the adjusted basis of the property, $1,455,740). A portion of this amount was capital gain and a portion was taxed at recapture rates.
     
     The taxpayer lost at the Tax Court level, but won a reversal at the Fifth Circuit.
     
     The Supreme Court decided the case, and held that the transaction should be “collapsed” rather than “bifurcated” into two transactions.
     
     The Supreme Court held that where a property subject to nonrecourse debt is conveyed to the lender in satisfaction of debt, the amount of the non-recourse obligation is considered to be the “sale” price of the property for purposes of computing gain or loss.
     
     Because the steps are collapsed there is no COD income.

   - See, also, Treas. Reg. Section 1.1001-2(a), 1.1001-2(c), Example 7
Cancellation of Indebtedness Income

- Treatment of Nonrecourse Debt (cont.)


  - Where the property is retained, there is COD Income (potentially), but no gain or loss

  - In example above, if property is retained and non-recourse debt of 300 is reduced to 200 (the FMV of the property), there is 100 COD Income.
Cancellation of Indebtedness Income

Treatment of Recourse Debt.

- The transfer of property in satisfaction of recourse debt is split into two transactions.

- There is gain or loss measured by the FMV of the property and adjusted basis of the property. Section 1001.

- If the debt cancelled is greater than the FMV of the property, the difference may be COD Income.

- Property with Debt of 200, FMV of 100 and AB of 75 is transferred in satisfaction of debt. Gain is 100 – 75. COD Income is 100.
Cancellation of Indebtedness Income

Cancellation of Indebtedness Income (“COD Income”) Upon Modification of Debt.

- **Significant Modification or Deemed Debt Exchange**
  - **Significant Modification.**
    - Treas. Reg. Section 1.1001-3(a)
    - General Rule: Modification is “significant” if, under all the facts and circumstances, legal rights or obligations are altered and the degree to which they are altered are economically significant. Treas. Reg. Section 1.1001-3(d).
    - Specific Rules:
      - Change in yield. A change of 0.25% or 5% of the annual yield or more is considered significant. Treas. Reg. Section 1.1001-3(e)(2).
      - Change in timing of payments. A change in timing of payments is a significant modification if it results in a “material deferral” of scheduled payments. A deferral of payments is not material if the deferral is within the safe harbor period that begins on the original due date of the first payment that is deferred and extends for a period of the lesser of five years or 50% of the original term of the debt instrument. Treas. Reg. Section 1.1001-3(e)(3)(ii).
      - Change in obligation or security.
      - Change in the nature of the debt instrument. Converting debt into equity for example. Treas. Reg. Section 1.1001-3(e)(5)
      - Accounting or financial covenants. Altering these. Treas. Reg. Section 1.1001-3(e)(6).
  - **Result of Significant Modification**
    - New debt is treated as having been exchanged for the old debt.
    - Discussed in more detail in later portion of presentation.
Cancellation of Indebtedness Income

Acquisition of Debt by Related Party.

- Section 108(e)(4), Kirby Lumber v. Commissioner, 284 U.S. 1 (1931).

- What is a “related party?”
  - Sections 267(b), 707(b)(1) and 414 apply
  - Generally a greater than 50% direct or indirect common ownership

- Mechanics:
  - The debtor is treated as having paid an amount equal to the related party’s basis in the debt instrument.
  - In certain circumstances, the amount deemed paid will be the FMV of the debt instrument rather than what the related party paid, if the instrument is acquired more than 6 months before the parties become related, if the instrument was acquired in a carryover basis transaction, or if the purchase had a principal purpose of tax avoidance.
Cancellation of Indebtedness Income

Cancellation of an Entity’s Debt

- Contribution of Debt to Corporation
  - Under Section 108(e)(6) the corporation is treated as satisfying the debt with an amount of money equal to the shareholder’s basis in the debt.
  - If the shareholder had originally loaned the money to the corporation, the basis is generally the amount loaned.
  - If the shareholder’s debt is related to services and the shareholder is a cash method taxpayer, the basis is generally zero, so there would be COD Income on contribution of the debt.

- Stock for Debt Exception
  - If a corporation transfers stock to a lender in satisfaction of debt, the corporation is generally treated as having satisfied the debt with an amount equal to the FMV of the stock. Section 108(e)(8)(A).
  - Thus, there is COD Income if the amount of debt satisfied is greater than the FMV of the stock. Note: This rule differs from the contribution of debt, without the issuance of stock.

- Partnership Interest for Debt Exception
  - If a partnership transfers a partnership interest to a lender in satisfaction of debt, the partnership is treated as having satisfied the debt with an amount equal to the FMV of the partnership interest. Section 108(e)(8)(B).
  - This is the partnership analog to the rule above.
  - Thus, there is COD Income if the amount of the debt discharged exceeds the FMV of the partnership interest. Any such COD Income is included in the distributive shares of the partners who were partners immediately before the issuance of the interest to the lender.
Cancellation of an Entity’s Debt

- Consolidated Returns. Debt Between Members
  - The consolidated return rules are very complex, but, in general, for a debt between members of the group there is no net income tax consequence to the group.
  - For debt between members of the group, the exceptions (such as insolvency) do not apply and attributes are not reduced.
  - See Treas. Reg. Section 1.1502-13(g)(7)(ii), Example 3

- Consolidated Returns. Debt Outside of Group
  - The normal rules apply.
  - In determining if the insolvency exception is met, only the solvency of the particular group member is considered, but its assets include any shares it holds in other members.
Cancellation of Indebtedness Income

Exceptions to COD Income

- Lost Deduction
- Purchase Price Modification
- Bankruptcy
- Insolvency
- Real Property Business Debt
- Qualified Farm Debt
Cancellation of Indebtedness Income

Exceptions to COD Income: Lost Deduction
Section 108(e)(2)

- The concept is that the item would have been deductible had it been paid, so imputing income and then permitting a deemed deduction would be circular.
- The classic example is business related income due from a cash method taxpayer (that is the deduction for the interest has not already been accrued).
Exceptions to COD Income: Purchase Price Modification

- Limited to certain modifications by sellers (discussed in later slides).
- Section 108(e)(5).
Cancellation of Indebtedness Income

Exceptions to COD Income: Bankruptcy

- One of the most useful and certain of the exceptions.
- Either a taxpayer is in bankruptcy or not, vs insolvency which can be subject to debate
- Important point is that in attribute reduction NOLs are only reduced after the NOL for the year is used
- Also, any COD Income in excess of the NOL is excluded/written off. This is “black hole” COD Income.
- Section 108(a)(1)(A).
Cancellation of Indebtedness Income

Exceptions to COD Income: Insolvency

- Requires a solvency analysis of taxpayer.
- Insolvency is defined as the excess of the taxpayers’ liabilities over the fair market value of the taxpayer’s assets. Section 108(d)(3).
- Goodwill and going concern value must be considered “assets” in this analysis. J.A. Mauer, Inc. v. Commissioner, 30 T.C. 1273 (1958) (goodwill); Conestoga Transp. Co. v. Commissioner, 17 T.C. 506 (1951) (going concern value).
- Section 108(a)(1)(B).
Cancellation of Indebtedness Income

Exceptions to COD Income: Qualified Real Property Business Indebtedness

- Only applies to debt incurred in connection with and secured by real property used in a trade or business. Section 108(c)(3).
- The exclusion is limited to the amount by which the qualified real property indebtedness exceeds the FMV of the property securing the debt. Section 108(c)(2)(A).
- Sections 108(a)(1)(D); 108(c)
- If this exclusion is used, the basis of the depreciable property must be reduced by the amount of income excluded.
Cancellation of Indebtedness Income

Exceptions to COD Income: Qualified Farm Indebtedness

- Similar to the Qualified Real Property Business Debt but if the taxpayer is engaged in farming the qualified farm indebtedness exception applies.
- 50% or more of the taxpayer’s gross receipts must be from farming in the three years prior to the year in which the debt is cancelled. Sections 108(a)(1)(C); 108(g).
- Debt must be owed to a “qualified person” – a person actively and regularly engaged in lending money, a person from whom the taxpayer acquired the property, or a person who earns a fee with respect to the taxpayer’s investment in the property (all of whom must be unrelated to the taxpayer). Section 108(g)(1).
- Amount excluded must not exceed: (i) the taxpayer’s adjusted tax attributes, plus (ii) the taxpayer’s aggregate adjusted basis in “qualified property” – which is property used in the active trade or business in the year following the year of the exclusion. Section 108(g)(3).
Cancellation of Indebtedness Income

Exceptions to COD Income – Attribute Reduction

- **How it works**
  - For partnerships, attribute reduction occurs at the partner level. For S corporations, attribute reduction occurs at the corporate level.
  - Planning using this difference is discussed later in the presentation.

- **Timing**
  - Any NOL is reduced only after it is used for the year at issue.
  - This can be important in planning because excluded COD income in year 1 will not reduce the usable NOL in year 1, it will only reduce or eliminate the NOL that can be carried forward and used in year 2.

- **Planning**
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Right to Terminate a Pass-Through Election in Bankruptcy

S Elections as a Property Right in Bankruptcy

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Tax Assets in Bankruptcy

• Are tax attributes assets in bankruptcy?
• Entering into bankruptcy does not terminate S election. Mourad v. Commissioner, 387 F3d 27 (1st Cir. 2004).
• Gain (and loss to the extent not limited) continues to pass through – particularly amount realized from disposition of assets.
Example – How the Issue Arises

- Company enters bankruptcy
- Has equipment
  - Basis $0
  - Value $40 million
  - Debt secured by equipment $60 million
- Ordinary gain (recapture) - $40 million
- Cancellation of indebtedness income $20 million
Cancellation of Debt

- No tax at S corporation level
- Increases the shareholder’s basis and AAA (if not excluded at corporate level)
- Exclusions are generally tested at corp level
  - Title 11 case exclusion
  - Insolvency
  - QRPBI
- Attribute reduction
Treatment of Shareholders

- Mitigating factors
  - Prior use of deductions
  - Suspended losses
- Cancellation of debt
  - Bankruptcy exclusion
  - Insolvency exclusion
  - Other exclusions
Segal v. Rochelle, 382 U.S. 375 (1966)
- Justice Harlan – said it was a difficult question
- 1st & 4th Cir. held carryback was not property
- The Court held *carrybacks* are property
- Carryovers – not decided by court
- Can carrybacks be transferred (claim against U.S.)? Yes
Other Precedents

• In re Prudential Lines, Inc., 930 F.2d 759 (2d Cir 1991) - parent corp was enjoined from taking worthless stock deduction.

• In re Feiler, 230 B.R. 164 (1999 BR) - election to carry forward NOLs and forego carryback was a voidable transfer under Section 548.

• Cumberland Farms, Inc., 162 B.R. 62 (1993 BR) – suspended shareholder loss is an asset of the estate.
Cases Holding S Election is Property

• In re Trans-Lines West, Inc., 203 BR 653 (1996). Court held it would not rule that revocation of S election as a matter of law was not a fraudulent conveyance.

• Walterman Implement, 97 A.F.T.R.2d 2006-2626. S election was property of the bankruptcy estate and revocation violated the automatic stay.
In re Bakersfield Westar, 226 B.R. 227

- Shareholder revoked S election and corporation filed voluntary chapter 7 several weeks later.
- Alleged – transfer to hinder or delay, etc.
- Shareholder fairness argument – tax with no say over asset disposition.
- Property is "all legal or equitable interests."
- No congressional definition of property.
- Held: Fraudulent, and S election was transferred to ... the IRS.
Majestic Star Casino LLC

- 2012-1 U.S.T.C. ¶50,175.
- After filing, Barden revoked S election (effective to Jan 1).
- No authorization from court - stealth revocation.
- $2.26 million estimated state tax bill!
Majestic Star – Bankruptcy Case

- Debtor summary judgment motion to avoid transfer.
- Numerous federal courts held S status is property of the estate.
- S election is property – like an NOL.
- If there is value, there is property.
- Shareholders already received "enormous tax benefit" from the loss pass-through.
Majestic Star – Bankruptcy Case

- Revocation was an effort to "manipulate the bankruptcy system."

- Now, shareholder must "bear the burden" of post petition tax liabilities.

- Despite that QSub status is dependent on non-debtor S election, QSub has a property right in its tax status (In re Prudential Lines, Inc.).

- Result: Violation of automatic stay.
• 2013-1 U.S.T.C. ¶50,338
• Question of first impression in Courts of Appeals.
• Do debtors have standing to challenge the revocation?
• Trustee has no greater property rights than does the debtor.
• Corp is asserting the rights of the shareholders.
• Under § 362, § 549 and § 550, the question is whether QSub status is (1) property (2) of the bankruptcy estate (3) that has been transferred.
• QSub status as property.
Majestic – 3rd Cir.

- Extension of NOL as property to S election as property is "untenable."
- S elections are not "forever" and can be lost any number of different ways.
- Disagrees with conclusion that because there is value, there is property.
- S election is not a property right.
- QSub status is even more so not a property right.
Majestic – 3rd Cir.

• Section 541 not intended to expand debtor’s rights against others more than they exist at commencement of the case.

• E.g., S corp NOLs pass thru, and aren’t property of the estate – same for S election.

• QSub election not "owned" by the by the QSub even if it were property.

• Can’t restrict the parent this way.
Suspended Losses

- Shareholders may have suspended losses.
- What happens when suspended losses are not proportionate to stock ownership?
- May shareholders transfer shares to equalize ownership with suspended losses?
- What if shares have no value (other than their losses)?
Timing Issues

• Revoking the S election –
  - File revocation – majority of stock.
  - Cease to be small business corporation by transferring shares to a disqualified shareholder.

• Date of termination –
  - If revoked, may specify a prospective date, otherwise retroactive within 2 ½ months after year or as of end of year.
  - Date ceases to be a small business corporation.
Timing Issues

- Year of termination is an S termination year.
- General rule – pro rata allocation.
- Closing of the books –
  - By agreement of all persons who were shareholders during S short year and at the beginning of the C short year
  - Sale or exchange of 50% or more of the stock at any time during the S termination year. Meaning of “exchange.”
Controlling Gain Recognition

• Repossession by creditor or sale.
• Transfer assets to C corporation subsidiary with liability in excess of basis. Caution: Section 357(b).
• Limiting gain recognition before the termination of the S election.
• Tax avoidance, substance over form and Section 269.
• S corporation attribute reduction.
Questions/Observations

• Shareholder has suspended losses – are shares non-transferrable?

• Can LLC file a check-the-box election?

• Like Majestic Star - suppose there were multiple Q subs, only one of which were in bankruptcy.

• Solyndra Case – NOL preservation and stuffing strategy.
Treatment of COD Income by Partnerships

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January 28, 2015
COD income is allocated to those partners who are partners immediately before the debt is discharged in accordance with the provisions of the partnership agreement and Section 704(b).

- Normally, the allocation of COD income under Section 704(b) and the partnership agreement will follow the allocation of partnership liabilities under Section 752 (See, for example, Revenue Ruling 2012-14, 2012-24 IRB 1012).

- The allocation of COD under the partnership agreement may differ from the allocation of liabilities under Section 752(b).

- The allocation of COD income must have substantial economic effect.

The treatment of the allocated COD income under Section 108 is determined at the partner level under Section 108(d)(6). This is discussed separately in more detail.
Revenue Ruling 92-97, 1992-2 CB 124, addresses the allocation of COD income in 2 different factual situations involving the existence or absence of a deficit restoration obligation.

- In situation 1, the 2 partners form a general partnership with A contributing 10K and B contributes $90K. They share losses 10 percent and 90 percent respectively but they share income 50 percent each. They do not have a deficit restoration obligation but meet the requirements of the alternative test under Treasury Regulations Section 1.704-1(b)(2)(i)(ii)(d) with a qualified income offset provision.

- In situation 1, the partnership buys property for $1 million and pays $100K in cash and borrows $900K. Under the loss allocation provisions, A bears $90K of the economic risk of loss and B bears $810K. The property generates $200K of depreciation and a net loss for each of the first 5 years reducing A’s capital account to negative $90 ($10K - $100K) and B’s capital account to negative $810 ($90K - $900K).
At the beginning of year 6 the property has declined in value and the lender cancels the loan as part of a work-out.

Under the partnership agreement the COD income of $1 million would be allocated 50% to each partner so that A’s capital amount would equal to $360K (- $90K + $450K) and B’s capital account would equal negative $360K (- $810K + $450K). However, this allocation cannot have economic effect even though the partners maintain capital accounts and liquidate in accordance with positive capital accounts.

Since neither partner has an independent deficit restoration obligation that could be involved to satisfy the other partner’s positive capital account, A cannot enjoy an economic benefit of an allocation of COD income exceeding $90K or bear the economic burden of COD income of less than $90K. Similarly, B cannot bear the economic burden of COD income of less than $810K.

Accordingly, the allocation of COD income under the partnership agreement does not have economic effect and the COD income will be allocated $90K to A and $810K to B.
As a result of the proper allocation of COD income, the outside bases of A and B are increased under Section 705(a)(1)(A) by $90K and $810K respectively. Under Section 108(d)(6), A and B individually determine if any of the COD income can be excluded from gross income under Section 108.

The decrease in debt results in a deemed distribution of cash under Section 752(b) of $90K and $810K to A and B respectively. However, A and B recognize no gain under Section 731 in year 6 because the distribution shares of COD income increase the bases of each partner to cover the deemed distribution of cash under Section 752(b).
In situation 2, the facts are the same except that A and B agree to an unconditional deficit restoration obligation as described in Treasury Regulations Section 1.704-1(b)(2)(ii)(b)(3) in which A and B agree to satisfy the other partner’s positive capital account balance on liquidation.

- Under the partnership allocation 50% of $450K is allocated to both A and B so that A has a capital account of $360K (- $90K + $450K) and B has a negative $360K capital account (- $810K - $450K).
Since B is required to restore A’s positive capital account by contributing $360K, the allocation of COD income under the partnership agreement has economic effect.

- The outside bases of A and B are increased by $450K and under Section 108(d)(b); A and B individually determine if any purpose of the allocation of COD income is excludable under Section 108.

- Although B’s basis is increased by $450K, the $810K deemed distribution of cash under Section 752(b) results in gain recognition by B of $360K ($810K - $450K) under Section 731. A does not recognize any gain under Section 731 because A’s basis is increased by $450K and the deemed distribution under Section 752(b) is $90K. After the cancellation A’s basis in its partnership interest is $360K ($450K - $90K).
When COD income is anticipated, partners may attempt to amend the partnership agreement to specially allocate the COD income in the most tax efficient manner. However, there are limitations on their ability to do so once the COD income has occurred.


In Revenue Ruling 99-43, A and B form PRS a general partnership and each contribute $1,000 and agree to share all partnership items on a 50 percent basis. PRS acquires non depreciable property for $10,000 for $2,000 cash and $8,000 borrowed from a bank. The $8,000 loan is a nonrecourse to A and B and is secured only by the property. When the fair market value of the property declines from $10,000 to $8,000, the bank reduces the principal amount of the loan by $2,000, to $6,000 and A contributes $500 to cover deductible expenses of the workout.
At the time of the workout, B was insolvent within the meaning of Section 108(a)(1)(B), and the partnership agreement is amended so that PRS profits and losses are allocated 60% to A and 40% to B.

- As a result of the $500 contribution, PRS was required to revalue its property to reflect its fair market value in A and B’s capital accounts.

- A and B further amend the PRS agreement to allocate $3,000 of the $4,000 book loss from the revaluation of the property to B and all of the $2,000 COD income. A is allocated $1,000 of the book loss from the revaluation but none of the COD income. Thus, after the revaluation and special allocation in the amended PRS agreement, the capital accounts of both A and B are zero.

- Absent the amendments, A and B would have shared the partnership items equally so that A and B would each be allocated $1,000 of COD and $2,000 of loss from the revaluation of the property. In that case the capital accounts of both A and B would also be zero ($1,000 - $2,000 book loss + $1,000 COD).
The allocation of the book loss does not immediately result in a tax loss to A or B, but the allocation of the $2,000 COD income to B who is insolvent by that amount and can therefore exclude such amount results in an overall tax savings to the partners.

- For an allocation of profits and losses to be respected it must not only satisfy the economic effect test of Treasury Regulations Section 1.704-1(b)(2)(ii) but must also satisfy the substantiality test of Treasury Regulations Section 1.704-1(b)(2)(iii) so that the allocation has substantial economic effect.

- The economic effect of an allocation will not be substantial if at the time it becomes part of the partnership agreement unless it satisfies 2 tests under Treasury Regulations Section 1.704-1(b)(2)(iii)(a)-(b) and the allocation cannot be transitory under Treasury Regulations Section 1.704-(b)(2)(iii)(c).
Revenue Ruling 99-43

- Under the first test, the allocation is substantial if there is a reasonable possibility that the allocation or allocations will substantially affect the dollar amounts to be received by the partners independent from the tax consequences.

- Under the second test, the allocation is not substantial if the allocation results in shifting tax consequences. Shifting tax consequences result when there is a strong likelihood that (1) the net increases and decreases recorded in the partners’ respective capital accounts for the taxable year will not differ substantially from the net increases or decreases in the capital accounts for the year if the allocations were not made and (2) the total tax liability of the partners for the tax year will be less than it would be if the allocations were not made.

- Finally, an allocation will not be substantial if the allocation is transitory. An allocation is transitory if it is expected to be reversed by other allocations. If the offsetting allocations are not expected to occur for 5 years such allocations may not be treated as offsetting.
Revenue Ruling 99-43 concludes that the allocations in the amended PRS agreement violated each of the substantiality requirements of the Section 704(b) regulations and that the “value equals basis” rule in Treasury Ruling Section 1.704-1(b)(2)(iii)(c)(2) will not apply to protect the allocations. Under that rule a special allocation of book gain or loss from a revaluation would not be viewed as transitory.

The allocation of the COD income to B fails the first substantiality test because it will not affect the dollar amounts to be received by the partners independent of tax consequences because B can exclude the COD income under Section 108(a)(1)(B) but there is no distribution of cash.

The allocation of the $2,000 of COD income coupled with the allocation of $3,000 of the loss from revaluation of the property to B reduces B’s capital account to zero. If the original allocations had been followed the capital accounts of A and B would each still be equal at zero and the overall tax liability of the partners would be reduced because A would not have any COD income to include.

The allocations will also be transitory because the $2,000 of COD income is offset by $3,000 of book loss from the revaluation of the property because the “value equal basis” rule does not apply.
Section 108 Strategies by Partners for COD Income

- Certain types of COD income can be excluded by a taxpayer from its gross income under the bankruptcy exception of Section 108(a)(1)(A), the insolvency exception 108(a)(1)(B), and partnerships and other non-corporations can exclude COD income from qualified real property business indebtedness (“QRPBI”) under Section 108(a)(1)(D).

- Under Section 108(d)(6) and Proposed Treasury Regulations Section 1.108-9(b), Sections 108(a), (b), (c) and (g) which include the bankruptcy, insolvency and QRPBI exceptions, apply at the partner level and not the partnership level.

- In the case of QRPBI, its qualification is determined at the partnership level but its exclusion is determined at the partner level.
Section 108 Strategies by Partners for COD Income

- For purposes of those provisions the taxpayer is the partner so that the partner must be in a title 11 case or insolvent for the Sections 108(a)(1)(A) or (B) exceptions to apply.

- The same rules apply to disregarded entities and grantor trust under Proposed Treasury Regulations Section 1.108-9(a) so that the owner of the disregarded entity or grantor trust must be in a title 11 proceeding of itself insolvent for the COD exclusion rules of 108(a)(1)(A) – (B) to apply.

- Under Section 108(d)(3) insolvency is defined as the excess of liabilities over the fair market value of assets. Thus, the exclusion under Section 108(a)(1)(B) only applies to the extent of the insolvency of the partner.

- Similarly, the bankruptcy exception of Section 108(a)(1)(A) requires that the partner be under the jurisdiction of a court under title 11 and the discharge is granted by the court or pursuant to a plan approved by the court.
Insolvency Exception

- Under Section 108(d)(3) a taxpayer-partner is insolvent only to the extent its liabilities exceed the fair market value of its assets. The term “liabilities” is not defined.
  - Revenue Ruling 92-53, 1992-2 CB 48, addresses the effect of nonrecourse debt on the determination of whether a taxpayer is insolvent for purposes of Section 108(d)(3).

- Revenue Ruling 92-53 analyzes 3 different situations in determining the amount of nonrecourse debt which is taken into account in determining the insolvency of the taxpayer.
  - The facts of Revenue Ruling 92-53 involve an individual taxpayer who borrowed $1 million on a nonrecourse basis. When the value of the building declined to $800K and the outstanding balance on the note was $1 million, the lender agreed to reduce the principal amount of the note to $825K. The taxpayer’s other assets had a fair market value of $100K and the taxpayer was indebted to another person in the amount of $50K with personal liability.
Insolvency Exception

– In situation 1, Revenue Ruling 92-53 concludes that $175K of the taxpayer’s $200K excess nonrecourse debt ($1 million - $800K building) was discharged and only that amount is taken into account in computing the individual’s liabilities. Thus, for purposes of Section 108(d)(3), the taxpayer’s liabilities were $1,025,000 consisting of $50K for which he was personally liable plus the sum of the $800K fair market value of the building and the $175K of the nonrecourse liability that was discharged ($50K + $800K + $175K).

– The excess of the liabilities of $1,025,000 over 900 fair market of assets ($800K + $100K) was $125K. Accordingly, the taxpayer was insolvent to the extent of $125 which is excluded under Section 108(a)(1)(B) and $50K of the $175K was COD income.
In situation 2, the facts are the same but except the $50K note with personal liability was discharged for a transfer of property with a fair market value and basis of $40K, and the lender did not reduce the $1 million nonrecourse mortgage.

In situation 2, Revenue Ruling 92-53 concludes that since no portion of the excess nonrecourse debt was discharged no portion of such debt is treated as a liability for purposes of the insolvency exception. Thus, the taxpayer was solvent when the $40K was discharged because the fair market value of his assets of $900K ($800K building - $100K) exceed his liabilities ($800K + $50K).

In situation 3, under a pre-arranged plan, $10K of the recourse debt of the taxpayer is cancelled and thereafter $175K of the nonrecourse mortgage is discharged. The two transactions are stepped together and treated as one transaction.

Revenue Ruling 92-53 concludes in situation 3 that the individual recognizes $50K of the $175K excess nonrecourse debt plus 10K of the recourse debt discharged.
Revenue Ruling 92-53 ignores nonrecourse debt in excess of the fair market value of the secured property unless it is discharged. It counts as a liability for tax purposes only debt for which the person is personally liable, the fair market value of the property and the discharged nonrecourse debt.

The conclusion of Revenue Ruling 92-53 seems consistent with the treatment of the discharge of recourse liabilities under Treasury Regulations Section 1.1001-2(a)(2) in which the excess of the fair market value of the secured property is treated as COD income. Under Treasury Regulations Section 1.1001-2(a)(4), the discharge of nonrecourse debt in a foreclosure transaction does not result in COD income but is treated as a sale or exchange.
Insolvency Exception for Partners

- Revenue Ruling 2012-14, 2012-24 IRB 1012, illustrates how partner’s should treat the partnership’s discharged excess nonrecourse debt in measuring insolvency under Section 108(d)(3).
  - X investor other than a partnership and Holdco, a corporation are equal partners in PRS, a partnership which borrows $1 million from bank. The note is used to purchase real estate valued in excess of $1 million which secures the note which is nonrecourse under the applicable Treasury regulations.
  - Bank cancels $175K of PRS’s $200K excess nonrecourse debt thereby generating $175K of COD income. The COD income is allocated equally between X and Holdco under Section 704(b). For purposes of measuring the insolvency of the partners, PRS’s discharged excess nonrecourse is treated as a liability of its partners based on the COD income allocation.
  - X and Holdco each treat $87,500 ($175K x 50%) as their own liabilities in determining whether and to what extent they are insolvent. The bankruptcy exception of Section 108(a)(1)(A) is not applicable.
Insolvency Exception for Partners

- Revenue Ruling 2012-14 reasons that the partnership discharged excess nonrecourse debt should be associated with the partner who in the absence of the insolvency or other Section 108 exclusion would be required to pay the tax liability arising from the discharge of the debt. Thus, a partner’s share of the partnership’s excess non-recourse debt is allocated based on how COD income with respect to that portion of the debt is allocated under Section 704(b).

  - The note is a nonrecourse liability within the meaning of Treasury Regulations Section 1.752-1(a)(2). When the value of the real estate has declined to $800K, bank reduces the principal amount of the note to $825K.

  - PRS has no partnership minimum gain with respect to the note under Treasury Regulations Section 1.704-2(d)(1) which would provide a special rule not here relevant.
The PRS agreement allocates income equally to X and Holdco, and X and Holdco share PRS nonrecourse liabilities equally under Treasury Regulations Section 1.752-3. At the time of the modification, X and Holdco have no assets or liabilities other than their PRS interests.

Since X and Holdco have no assets other than their interests in PRS, the fair market value of their assets is zero.

Immediately prior to the discharge of the nonrecourse indebtedness, X’s liability exceeds the value of its PRS interest by $87,500 and similarly for Holdco.

Each of X and Holdco are insolvent to the extent of $87,500 under Section 108(d)(3) and exclude such COD income under Section 108(a)(1)(B).

They key point of Revenue Ruling 2012-2014 is that the excess nonrecourse liabilities are determined in accordance with the allocation of COD income under Section 704 and that the computation of the total amount of excess nonrecourse liabilities is determined at the partnership level.
Section 108 Reduction of Tax Attributes

- Under Section 108(b), reduction of tax attributes of the partner is required for the amount of COD income excluded under Sections 108(a)(1)(A), (B) and (D) relating to bankruptcy, insolvency and qualified real property business indebtedness (QRPBI).

- All of the reduction provisions of Section 108(b) apply at the partner or owner level.

- Partnership interests can be treated as depreciable assets for purposes of the basis reduction provision.
The relevant tax attributes of the tax payer and their order of reduction is set forth in Section 108(b)(2) as follows:

- Net operating losses
- Capital loss carryovers
- Bases reduction for depreciable assets
- Passive activity loss and credit carryover
- Foreign tax credit carryover
Qualified Real Property Business Indebtedness ("QRPBI")

- Section 108(a)(1)(D) provides for the exclusion of COD income for QRPBI.
  - In the case of partnerships, disregarded entities and grantor trusts, the exclusion applies at the partner or owner level under Section 108(d)(6) and Proposed Treasury Regulations Section 1.108-9.
  - The determination whether the indebtedness is QRPBI is made at the partnership level even though the eligibility for the QRPBI and the election is made at the partner level.
Qualified Real Property Business Indebtedness ("QRPBI")

- Section 108(c) sets forth the requirements for indebtedness to qualify as QRPBI. PLR 9840026 illustrates the qualification and calculation of QRPBI in a partnership context.
  - The real property must be real property used in a trade or business by the partnership. The real property must be held by the partnership in connection with a trade or business by the partnership and a rental arrangement under a triple net lease may not qualify as a trade or business.
  - The partner must make a timely election to have Section 108(c) apply.
  - The indebtedness was incurred or assumed to acquire, construct, reconstruct or substantially improve the real property.
Qualified Real Property Business Indebtedness ("QRPBI")

− The bases of the partners interest in their partnership interests is reduced by the amount of COD income excluded to the extent the partnership interest is treated as a depreciable asset for purposes of Section 108(c)(1) and under Section 1017(b)(3)(C) and a corresponding reduction in bases by the partnership in its assets.

− The amount of COD income from QRPBI will be determined at the partnership level and is limited to the excess of the outstanding principal amount of the indebtedness immediately prior to the discharge over the fair market value of the real property reduced by the outstanding principal amount of any other QRPBI secured by such property.

− The amount of COD income allocated to a partner will depend on the general allocation under Treasury Regulations Section 704(b) as previously discussed.
Section 108(e)(5) provides an exception to COD income if debt issued by a purchaser of property to the seller is reduced. The debt reduction will be treated as a purchase price adjustment if 2 requirements are met.

- The first requirement is that the purchaser is not in a title 11 bankruptcy case or is insolvent.

- The second requirement is that the reduction would result in COD income but for Section 108(e)(5) treatment.

- In Revenue Procedure 92-92, 1992-2 C.B. 505, the Internal Revenue Service ruled that it would not challenge a partnership’s treatment of a reduction of an indebtedness owed by such partnership as a purchase price adjustment, provided that the purchase price adjustment would otherwise qualify as a purchase price adjustment under Section 108(e)(5) but for the bankruptcy or insolvency of the partnership.
Purchase Price Adjustment

- Section 108(e)(5) only applies to a reduction of a debt obligation of the purchaser issued to the seller with respect to the purchase of property.

- The reasoning of Revenue Procedure 92-92 is that the Section 108(a) exclusions for bankruptcy and insolvency apply at the partner level so that the bankruptcy or insolvency of the partnership should be irrelevant for the application of the purchase price adjustment under Section 108(e)(5).

- Revenue Procedure 92-92 will not apply if any partner of the partnership adopts a Federal income tax reporting position with respect to the debt discharge that is inconsistent with that of the partnership.
Restructuring of Partnership Debt to Avoid COD Income or Gain Recognition

- There are several strategies to restructure, modify or eliminate partnership liabilities which can reduce the adverse Federal income tax consequences of the workout. In some cases, COD income may be preferable depending on whether the partners can qualify for an exclusion under Section 108.

- Foreclosure on a partnership debt obligation secured by a mortgage can produce very different tax consequences depending on whether the debt obligation is treated as a non-recourse or recourse debt obligation.
  - The sale or disposition of property that secures a non-recourse liability is treated as the sale or exchange of the property for the principal amount of the liability. The fair market value of the property is irrelevant so that there is no COD income. See Treasury Regulations Section 1.1001-2(a)(4)(i) and -2(b). Thus, the foreclosure on a mortgage that secures a non-recourse liability will result in the recognition of gain or loss but not COD income.
Restructuring of Partnership Debt to Avoid COD Income or Gain Recognition

- This result may be helpful in cases in which the partners cannot qualify for a COD income exclusion.

- A partner in a partnership will recognize gain or loss with respect to its share of partnership liabilities on the sale or exchange of its partnership interest or if the partnership property that secures a non-recourse partnership liability is sold or exchanged to satisfy that liability. Note that under Revenue Rule 91-31, this result does not obtain if the lender cancels or forgives all or a portion of a liability which results in COD income.

- The sale or disposition of property that secures a recourse debt obligation will be treated as a sale or exchange only to the extent of the fair market value of the property and result in COD income only to the extent the principal amount of the debt exceeds the fair market value of the property. See Treasury Regulations Section 1.1001-2(a)(2) and example 8 of Treasury Regulations Section 1.1001-4(c).

- Thus, if partners are in a title 11 case or are insolvent, it may be preferable for the debt obligation to be structured as a recourse obligation.
Restructuring of Partnership Debt to Avoid COD Income or Gain Recognition

- Partner guarantees of partnership liabilities, especially bottom-tier guarantees, may permit the partner to avoid COD income or gain from a reduction of partnership debt under Section 752(b).

  - Note that Proposed Treasury regulations under Section 752 would substantially reduce the efficacy of bottom-tier guarantees. Those Treasury regulations will be generally effective when those Treasury regulations become final.

  - Under the current Treasury Regulations Section 1.752-2, a partner may guarantee a bottom tier portion of a partnership liability which will be allocated to him under Section 752 as a recourse partnership liability.

  - Thus, a reduction of a partnership liability would not be treated as COD income or a distribution under Section 752(d) to the extent the partner guaranteed that portion of the liability that was not reduced or cancelled.
Restructuring of Partnership Debt to Avoid COD Income or Gain Recognition

- Transfer of a partnership interest by debtor partnership to a creditor in exchange for partnership debt may be a viable method to reduce partnership debt.

- Transfer by a debtor partnership of a capital or profits interest in satisfaction of its recourse or nonrecourse indebtedness is treated under Section 108(e)(8)(B) as having satisfied the indebtedness with an amount of money equal to the fair market value of the partnership interest.

  - If the fair market value of the partnership interest is less than the outstanding principal amount, the partnership will recognize COD income.

  - Taxpayers which were partners immediately prior to the transfer will include the COD income as provided in the partnership agreement and Section 704(b).
Exchange of Partnership Interest for Debt

- Treasury Regulations Section 1.108-8(b)(2) provides a special safe-harbor rule for determining the fair market value of the partnership interest transferred to a creditor.
  - The safe harbor provision allows the fair market value to be deemed to be equal to the liquidation value that the creditor would receive. The liquidation value equals the amount of cash the creditor would receive with respect to the interest if the partnership sold all of its assets for cash (including goodwill and intangibles) for cash equal to the fair market value of those assets and liquidated.
  - The safe harbor provides a significant amount of flexibility to the partnership and its creditors to craft a partnership interest with a value which may mitigate or eliminate COD income.
Exchange of Partnership Interest for Debt

- Note that the terms of the exchanged interest must be comparable to terms that would be agreed to by unrelated parties with adverse interests. However, this generally should not be a problem with an unrelated lender.

- An example illustrates the safe harbor. AB partnership exchanges outstanding debt for an interest in the partnership. The liquidation value is agreed upon as being $700 so that AB partnership is treated as satisfying the $1,000 debt for $700 and recognizes $300 of COD income.
Sale of Partnership Debt

- Since the related person and constructive ownership rules are generally strictly construed, planning opportunities exist to cause unrelated persons to acquire partnership debt without causing the partnership to recognize COD income as long as the acquirer does not anticipate becoming a related person to the partnership under Section 267(b) or 707(b)(1).

  - Section 267(b) provides a detailed list of related persons and Sections 267(c) applies constructive ownership rules which are expanded by Section 108(e)(4)(B). For example, the family of an individual partner of a partnership is deemed to consist of the spouse, children, grandchildren, parents, and any spouse of the individual's children or grandchildren.

  - Thus, the acquisition by any of those individuals of partnership debt from an unrelated person to the partnership would result in COD to the partnership if the purchase price was less than the outstanding principal amount.
Sale of Partnership Debt

- Section 707(b)(1) treats a person owning more than 50 percent of the partnership’s capital or profits as a related person as well as 2 partnerships in which the same persons own directly or indirectly more than 50 percent of the capital or profits interest in both partnerships. Similar to Section 267(b), expanded constructive ownership rules apply.

- Treasury Regulations Section 1.08-2 provides detailed rules to avoid abuses such as acquisition of debt by a holder which subsequently becomes related to the debtor.

- Treasury Regulations Section 1.108-2(c)(4) requires disclosure when indebtedness is acquired by a holder within 6 to 24 months of the holder becoming a related person. Failure to file the disclosure statement results in a presumption that the debt was acquired in anticipation of becoming a related person.
Sale of Partnership Debt

- Treasury Regulations Section 1.108-2(c)(3) provides a presumption that the acquirer intended to become a related person if the debt is acquired within 6 months of the holder becoming related to the debtor partnership. In that case, COD income will result if the acquisition price of the debt is less than its outstanding principal amount.

- Debt acquired by a holder which becomes a related person to the partnership after 24 months is generally presumed not to have been acquired by the holder in anticipation of becoming a related person.
Significant Modification of Partnership Debt

- Rather than cancel or forgive the debt of the partnership, a lender may seek to modify the debt in a manner which would not result in COD income to the partnership.

  - Treasury Regulations Section 1.1001-3 provides that a significant modification of a debt instrument will be treated as a deemed exchange of the “old” debt for a “new” debt instrument in which gain or loss may be recognized based on the difference between the basis of the old debt instrument and the adjusted issue price of the modified debt instrument.

- Significant modifications may include, among other things, under Treasury Regulations Section 1.1001-3(e), a change in yield, obligor, security or payment dates. Thus, a partnership may avoid COD by negotiating modification of its debt with its lenders.
Significant Modification of Partnership Debt

- However, if the lenders have acquired the debt instrument at a discount, the exchange could result in the recognition of gain because the adjusted issue price is likely to be equal to its stated redemption prices under Treasury Regulations Section 1.1273-2(d), unless the debt is publically traded or is treated as traded on an established market under Treasury Regulations Section 1.1273-2(f).

- By combining the significant modification rules with the exceptions to the Section 108(e)(4) rule for debt acquisitions by unrelated persons, there may be planning opportunities to avoid gain on the significant modification and to cause the debt obligation to be held by an unrelated sympathetic lender and avoid COD income.

- A lender, such as a financial institution, may not wish to retain the debt of a financially distressed partnership and may be eager to dispose of such instrument to a willing buyer and claim a bad debt loss.
Significant Modification of Partnership Debt

– Prior to disposing of the partnership debt, the original lender agrees with the partnership to modify the debt instrument by, for example, extending the maturity date and reducing the interest rate so that the distressed partnership can comply with the modified debt instrument provisions.
Significant Modification of Partnership Debt

- Under the debt modification provisions of Treasury Regulations Section 1.1001-3, the original lender should not recognize any gain from the deemed exchange of the old instrument for the modified instrument because its bases should be equal to its stated principal amount. The subsequent sale by the original lender to the new lender would presumably result in a loss for Federal income tax purposes.

- After the debt instrument has been modified, the lender may sell the modified debt instrument to a person which is not related to the partnership. It is likely that the purchase price for the modified debt instrument would be at a significant discount to its principal amount.

- Normally, the new lender would view the modified debt instrument as a long-term investment.
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