

Vinson&Elkins

Partnership Debt Workouts: What We Know, What We Think We Know, and What We Don't Know

Slides for November 2020 Webinar
Houston Bar Association's Tax Section

V&E Speaker Bios



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Gary's practice focuses on domestic and international tax planning, tax transactions, and litigation, with an emphasis on partnerships, financial products and natural resources. For more than 30 years, Gary has advised major multinational corporations, including some of the world's largest banks and oil and gas exploration and production companies, on inbound and outbound cross-border transactions. He has a depth of experience handling the tax aspects of structuring and raising capital for master limited partnerships (MLPs). Gary has led major corporate acquisitions, dispositions, and spin-off transactions, and has structured countless strategic alliances and joint ventures around the globe.

Gary has taught advanced partnership taxation for more than 15 years at Georgetown University Law Center's LLM program. He is also a co-author of the treatise *Federal Taxation of Partnerships and Partners (4th ed.)*.



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Christine's practice focuses on the U.S. federal income tax aspects of domestic and international business transactions, primarily within the energy sector. Christine has experience with the taxation of publicly traded partnerships (master limited partnerships or MLPs), mergers and acquisitions, joint venture transactions, private equity transactions, Up-C structures, special purpose acquisition companies, reorganizations, and capital markets transactions.

General Rule: § 61(a)(11) – Income from Discharge of Indebtedness

- **§ 61(a)(11)** – Except as otherwise provided in this subtitle, gross income means all income from whatever source derived, including (but not limited to) income from... discharge of indebtedness (“CODI”).

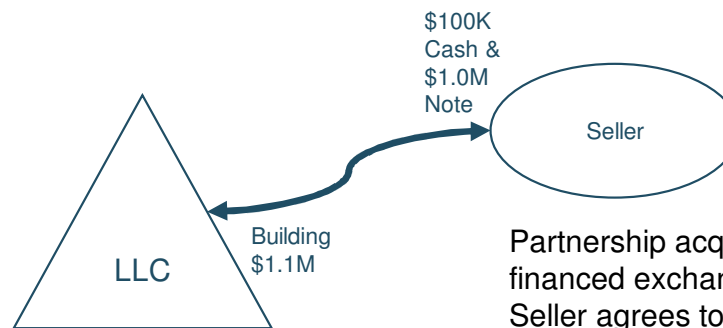
Exceptions to § 61(a)(11): Disputed Liabilities

- Neither the Code nor the Treasury Regulations define the term “indebtedness” for purposes of § 61(a)(11).
- However, the Courts have effectively adopted the following definition from Treas. Reg. § 1.108(b)-1(c):
“an obligation, absolute and not contingent, to pay on demand or within a given time, in cash or another medium, a fixed amount.”
- A genuinely disputed amount is not indebtedness for CODI purposes.
- Example:
 - After a hurricane, Lina’s roof needs repairs and she hires David, a roofer, who quotes her \$5,000 to perform the work. After the repairs are complete, David sends Lina a bill for \$10,000. Lina refuses to pay, believing she was overcharged for the work performed. After discussing with David, the parties agree that \$7,000 is a fair price. The \$3,000 (\$10,000 – \$7,000) decrease in price is not CODI.

Exceptions to § 61(a)(11): Purchase Price Adjustments

- § 108(e)(5) treats the reduction of the debt of a purchaser of property to the seller of such property which arose out of the purchase of such property as a purchase price adjustment, not CODI.
- Even though § 108 exceptions to CODI generally apply at the partner level (see § 108(d)(6)), the IRS applies the purchase price adjustment rule of § 108(e)(5) at the partnership level.
- § 108(e)(5) technically does not apply when the taxpayer that owns the subject property is bankrupt or insolvent. However, the IRS will not challenge the treatment of a reduction of debt of a bankrupt or insolvent partnership as a purchase price adjustment if the transaction would have qualified under § 108(e)(5) but for the partnership's bankruptcy or insolvency.
 - See Rev. Proc. 92-92; TAM 8429001

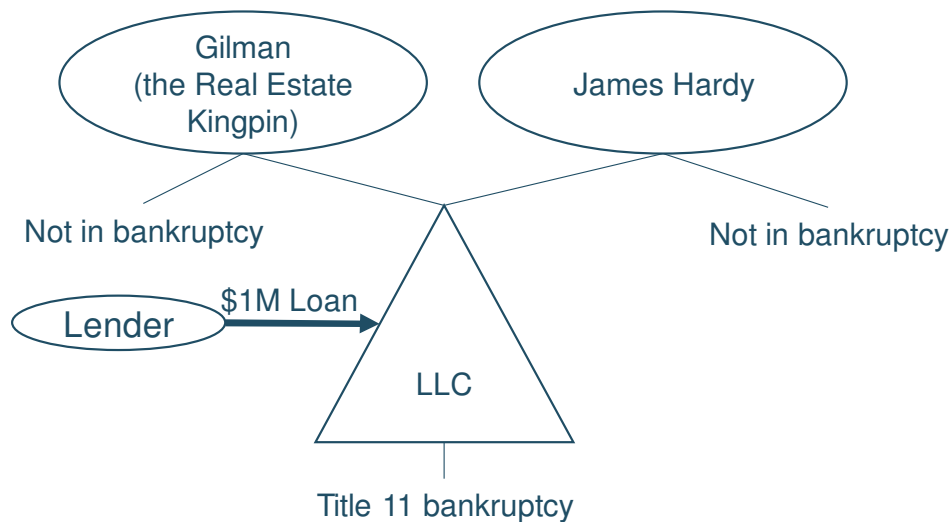
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Partnership acquires Building from Seller, in a Seller financed exchange. Partnership enters bankruptcy. Seller agrees to reduce the amount owed from \$1.0M to \$825k. The \$175k reduction is not CODI, but a purchase price adjustment. Partnership reduces its basis in the Building from \$1.1M to \$925k.

Exceptions to § 61(a)(11): Title 11 (Bankruptcy) Case

- CODI is excluded to the extent of any indebtedness that is discharged in a Title 11 (bankruptcy) case.
 - See § 108(a)(1)(A)
- In the case of a partnership, § 108(a)(1)(A) applies at the partner level.
 - See § 108(d)(6)



Gilman and James Hardy's partnership has not worked out as well as they had hoped. Now their partnership is in bankruptcy (Title 11 case). Lender's \$1M loan to the partnership is discharged in the partnership's Title 11 bankruptcy case, triggering \$1M of CODI. The partnership cannot take advantage of § 108(a)(1)(A) and the full \$1M of CODI is allocated to Gilman and James, and each applies the § 108 rules with reference to his own circumstances.



Partner Level

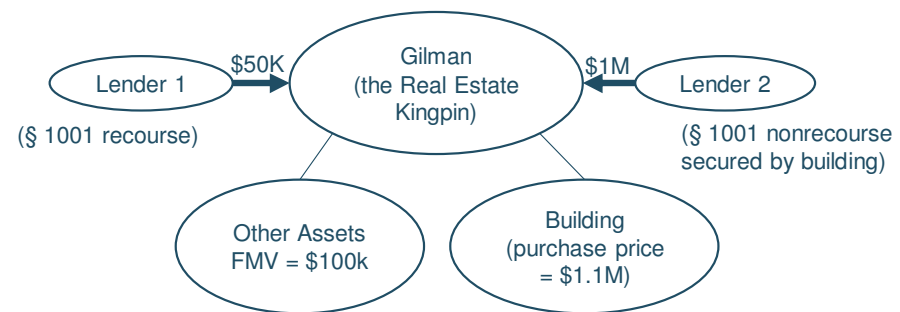


Partnership Level

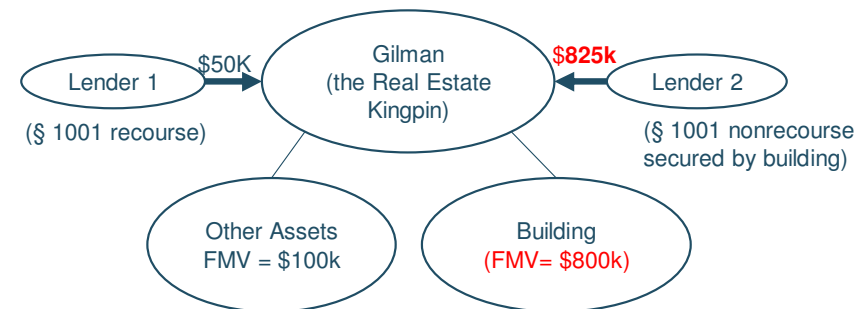
Exceptions to § 61(a)(11): § 108(a)(1)(B) Insolvency

- CODI is excluded to the extent a taxpayer is “insolvent.”
 - § 108(a)(1)(B), § 108(a)(3)
- A taxpayer is insolvent to the extent the taxpayer’s liabilities exceed the FMV of its assets immediately before a CODI event.
 - § 108(d)(3)
- Assume the FMV of Building drops to \$800k, and Lender 2 reduces its debt to \$825k, triggering \$175k of CODI. How is Gilman’s insolvency measured?
- § 1001 nonrecourse debt in excess of the FMV of burdened property is treated as a liability for § 108(d)(3) purposes **only** to the extent of CODI from a reduction of the debt.
 - See Rev. Rul. 93-53
- Thus, Gilman is “insolvent” in the amount of \$125k (\$1.025M in liabilities - \$900k FMV assets). Gilman can exclude \$125k of \$175k CODI.

Gilman’s Assets and Liabilities

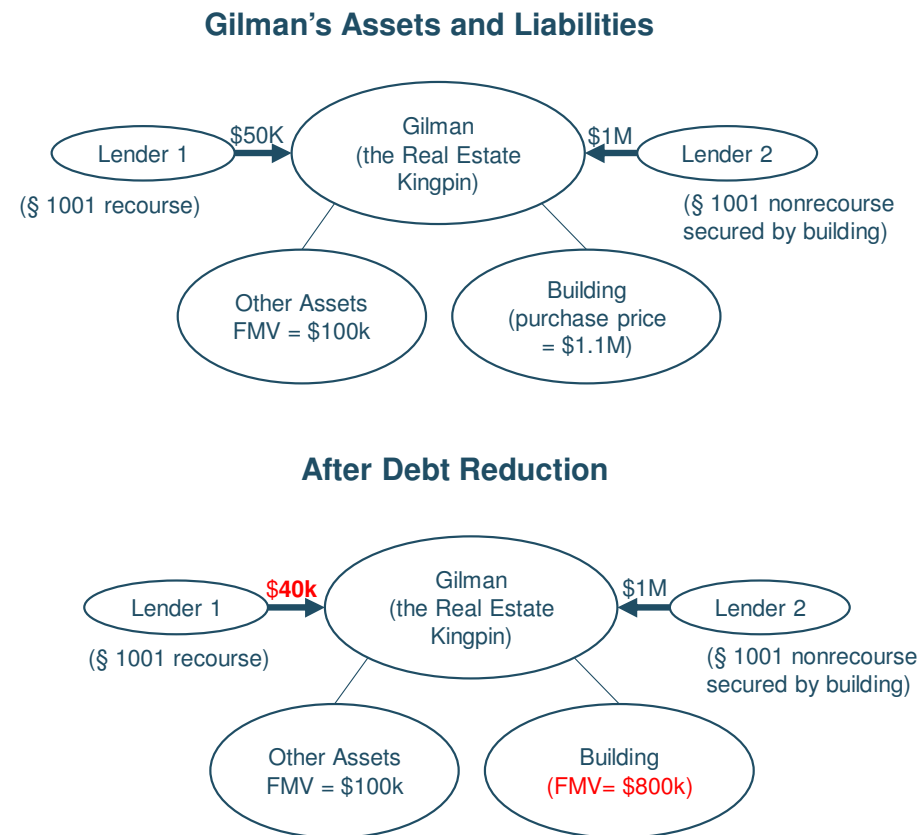


After Debt Reduction

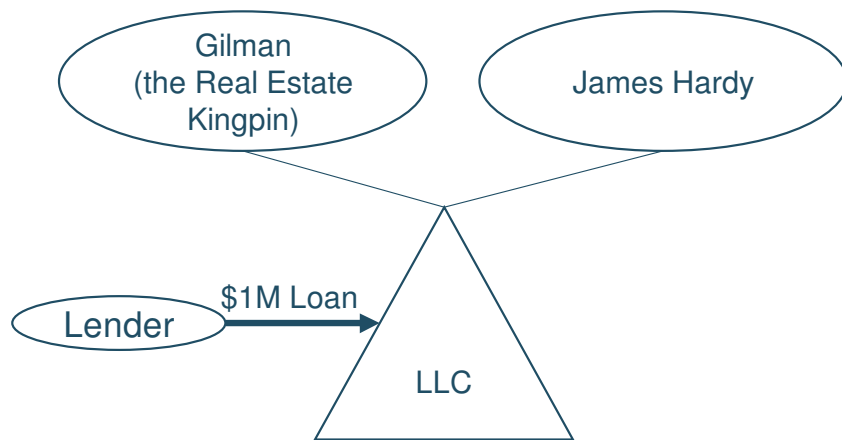


Exceptions to Section 61(a)(11): § 108(a)(1)(B) Insolvency

- § 1001 nonrecourse debt in excess of the FMV of burdened property is treated as a liability for § 108(d)(3) purposes **only** to the extent of CODI from a reduction of the debt.
 - Rev. Rul. 93-53
- Now assume the FMV of Building drops to \$800k, but Lender 2 does not reduce its debt. However, Gilman was unable to make his payments on trade payables he owed to Lender 1. Lender 1 reduces the debt by \$10k, triggering \$10k of CODI. How is Gilman’s insolvency measured?
- Gilman cannot take any of the excess of the \$1M nonrecourse debt into account, because the debt was not reduced (and no CODI was incurred)
- Thus, Gilman is **not** “insolvent” and cannot exclude any of the \$10k CODI from Lender 1’s reduction. Gilman is treated as having \$850k of liabilities (\$800k of nonrecourse debt + \$50k of recourse debt) and \$900k of assets (\$800k FMV of Building + \$100k in other assets).



Exceptions to Section 61(a)(11): § 108(a)(1)(B) Insolvency



- Assume FMV of Building drops to \$800k, and Lender writes debt down to \$825k, triggering \$175k of CODI allocated equally to Gilman and James Hardy. How much can each exclude under § 108(a)(1)(B)?
- § 108(d)(6) requires application of §108(a)(1)(B) at the partner level
- § 752 nonrecourse debt in excess of FMV of burdened partnership assets is taken into account by a partner only to extent of its § 704(b) share of partnership CODI
 - See Rev. Rul. 2012-14
- Thus, if Gilman and James Hardy have no other assets or liabilities, each is insolvent by \$87.5k (\$87.5k share of CODI – zero value of partnership interest), and each can exclude all \$87.5k of allocated CODI

Balance Sheet (Pre-CODI)						
	<u>Assets</u>			<u>Liab. & Equity</u>		
	<u>Book</u>	<u>Tax</u>		<u>Book</u>	<u>Tax</u>	<u>O/B</u>
Building	1,100,000	1,100,000	Debt	1,000,000	1,000,000	0
			Gilman	50,000	50,000	550,000
	_____	_____	James	<u>50,000</u>	<u>50,000</u>	<u>550,000</u>
	1,100,000	1,100,000		1,100,000	1,100,000	1,100,000

Balance Sheet (Post-CODI)						
	<u>Assets</u>			<u>Liab. & Equity</u>		
	<u>Book</u>	<u>Tax</u>		<u>Book</u>	<u>Tax</u>	<u>O/B</u>
Building	1,100,000	1,100,000	\$752 N/R Debt	825,000	825,000	0
			Gilman	137,500	137,500	550,000
	_____	_____	James	<u>137,500</u>	<u>137,500</u>	<u>550,000</u>
	1,100,000	1,100,000		1,100,000	1,100,000	1,100,000

The § 108(b) Toll Charge: Attribute Reduction

- If a taxpayer excludes CODI from gross income under either the bankruptcy or insolvency exception, § 108(b) requires a corresponding reduction in the following tax attributes (in order):
 - NOLs
 - General Business Credits
 - Minimum Tax Credits
 - Capital Loss Carryovers
 - Basis of Assets (in the order supplied by § 1017)
 - Passive Activity Loss and Credit Carryovers
 - Foreign Tax Credit Carryovers
- § 108(b)(5) provides an election permitting reduction first to the tax basis of depreciable property

<input checked="" type="checkbox"/>	Partner Level
<input type="checkbox"/>	Partnership Level

Treatment of Partnership Interests Under § 1017: No § 108(b)(5) Election

- If no § 108(b)(5) election is made, § 1017 basis reductions are made in the following order:
 - Real property used in a trade or business that secured the discharged debt
 - Personal property used in a trade or business or held for investment that secured the discharged debt
 - ❖ This includes a partnership interest to the extent of a partner's share of partnership CODI excluded from income or if the partnership interest was collateral for the discharged debt.
 - See Treas. Reg. § 1.1017-1(g)(1).
 - Remaining property used in a trade or business or held for investment
 - ❖ This includes a partnership interest if the excluded CODI is not a distributive share of excluded partnership CODI or the partnership interest does not secure other debt giving rise to the CODI
 - Inventory, accounts receivable, notes receivable and § 1221(a) real property
 - Property not used in a trade or business held for investment

Treatment of Partnership Interests Under § 1017: With § 108(b)(5) Election

- If a § 108(b)(5) election is made, a partnership interest is treated as depreciable property to the extent of the partner's proportionate interest in the depreciable property held by the partnership, if the partnership consents to a corresponding reduction in the partnership's basis in depreciable property with respect to such partner.
- The basis reduction is a quasi-§ 743(b) adjustment for the partner, it does not affect common basis.

Assume the same facts as Slide 9 and assume Gilman is insolvent but James is not. Gilman makes a § 108(b)(5) election, which the partnership agrees to.



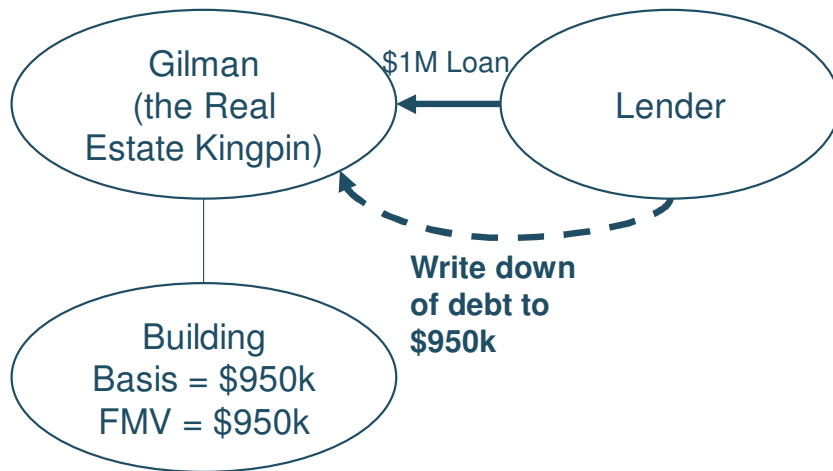
Partner Level



Partnership Level

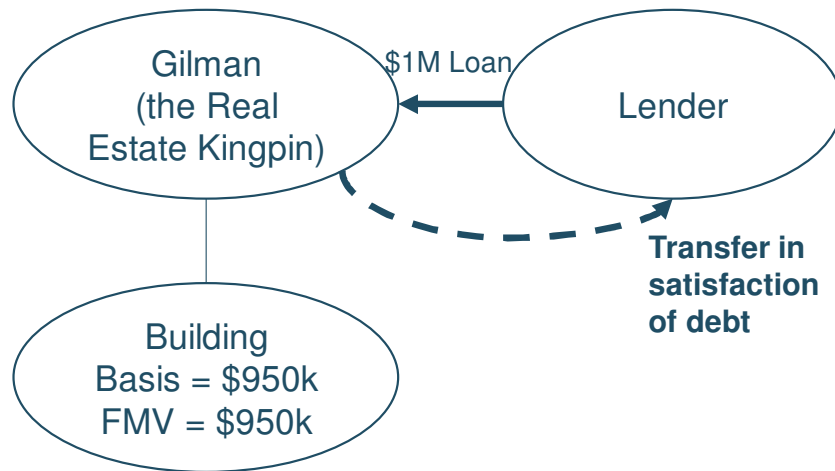
Resulting Balance Sheet							
	<u>Assets</u>				<u>Liab. & Equity</u>		
	<u>Book</u>	<u>Tax</u>	<u>Quasi- §743(b)</u>		<u>Book</u>	<u>Tax</u>	<u>O/B</u>
Building	1,100,000	1,100,000	(87,500)	752 N/R Debt	825,000	825,000	0
				Gilman	137,500	137,500	462,500
	_____	_____	_____	James	<u>137,500</u>	<u>137,500</u>	<u>550,000</u>
	1,100,000	1,100,000	(87,500)		1,100,000	1,100,000	1,012,500

Measurement and Character Issues: § 1001 Gain / Loss vs. CODI



- What result if Lender simply agrees to reduce the debt from \$1M to \$950k?
 - Gilman has \$50k of CODI
 - Status of debt as § 1001 “recourse” or “nonrecourse” does not matter.

Measurement and Character Issues: § 1001 Gain / Loss vs. CODI



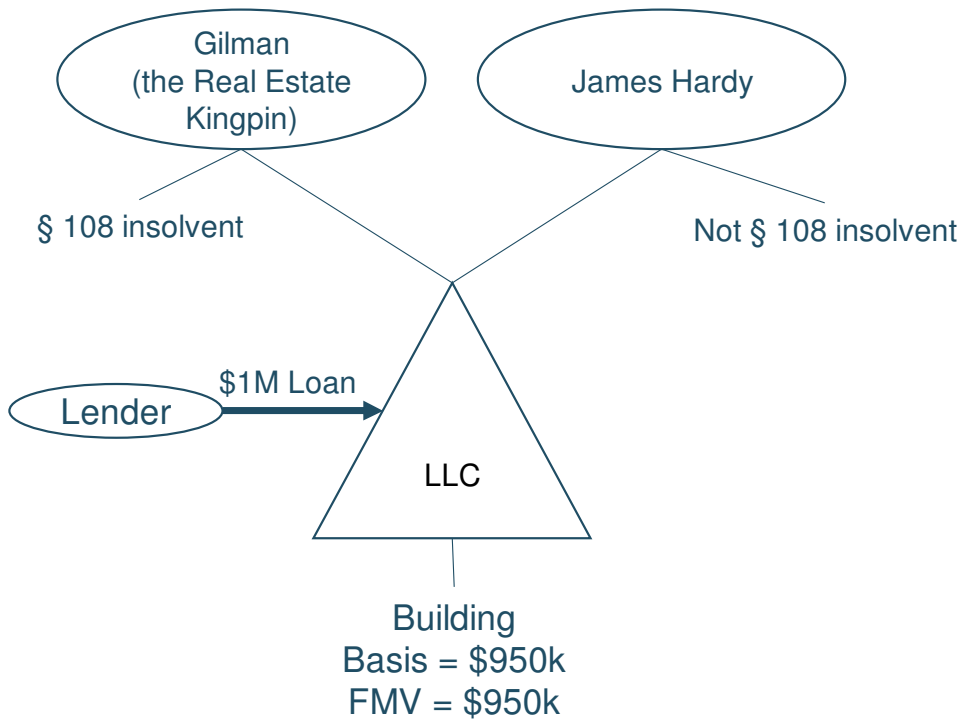
* Ignores § 1250 potential

- What if Lender accepts a transfer of the building in full satisfaction of the \$1M liability?
- **If § 1001 Nonrecourse Liability:**
 - § 1231 gain* = \$1,000,000 (amount realized)

$$\begin{array}{r} - 950,000 \text{ (basis)} \\ \hline \$50,000 \end{array}$$
 - See Treas. Reg. §1.1001-2(c), Ex. 7; *Commissioner v. Tufts*.
- **If § 1001 Recourse Liability:**
 - § 1231 gain* = \$950,000 (amount realized)

$$\begin{array}{r} - 950,000 \text{ (basis)} \\ \hline \$0 \end{array}$$
 - CODI = \$50,000
 - See Treas. Reg. §1.1001-2(c), Ex. 8; Rev. Rul 90-16.
- Can Gilman receive CODI by selling Building to a 3rd party for \$950,000 (free of debt) then paying Lender the \$950,000 pursuant to a pre-arranged plan? See *Briarpark*

Measurement and Character Issues: § 1001 Gain / Loss vs. CODI



	<u>Assets</u>			<u>Liab. & Equity</u>		
	<u>Book</u>	<u>Tax</u>			<u>Book</u>	<u>Tax</u>
Building	950,000	950,000	Debt	1,000,000	1,000,000	0
			Gilman	(25,000)	(25,000)	475,000
	_____	_____	James	<u>(25,000)</u>	<u>(25,000)</u>	<u>475,000</u>
	950,000	950,000		950,000	950,000	950,000

Measurement and Character Issues: § 1001 Gain / Loss vs. CODI

- **Alternative 1:** Lender writes debt down to \$950k (whether §1001 recourse or § 1001 nonrecourse)
 - LLC recognizes \$50k of CODI

Resulting Balance Sheet							
	<u>Assets</u>			<u>Liab. & Equity</u>			
	<u>Book</u>	<u>Tax</u>		<u>Book</u>	<u>Tax</u>	<u>O/B</u>	
Building	950,000	950,000		Debt	950,000	950,000	0
				Gilman	0	0	475,000
	_____	_____		James	<u>0</u>	<u>0</u>	<u>475,000</u>
	950,000	950,000			950,000	950,000	950,000

Observations

- Gilman can exclude \$25,000 of CODI, but James cannot.
- This may give rise to negotiations among the partners regarding the course of action.

Measurement and Character Issues: § 1001 Gain / Loss vs. CODI

- **Alternative 2:** LLC transfers Building to Lender in satisfaction of its § 1001 nonrecourse debt
 - LLC recognizes \$50k of § 1231 gain
 - \$1,000,000 debt
 - 950,000 basis
 - \$50,000

Resulting Balance Sheet							
	<u>Assets</u>			<u>Liab. & Equity</u>			
	<u>Book</u>	<u>Tax</u>		<u>Book</u>	<u>Tax</u>	<u>O/B</u>	
Building	0	0		Debt	0	0	0
				Gilman	0	0	0
	_____	_____		James	<u>0</u>	<u>0</u>	<u>0</u>
	0	0			0	0	0

Observations

- Neither Gilman nor James can exclude his \$25k share of § 1231 gain from income.
- Gilman and James each have:
 - \$25k of § 1231 gain
 - Outside Basis
 - Increase by \$25 for § 1231 gain
 - Decrease by \$500k under § 752(b)
 - No § 731 Gain or loss

Measurement and Character Issues: § 1001 Gain / Loss vs. CODI

- **Alternative 3:** Lender contributes debt to LLC in exchange for equity interests in LLC. Gilman and James remain partners with profits interests in LLC.
 - See following slides for discussion of § 108(e)(8)

Resulting Balance Sheet						
	<u>Assets</u>			<u>Liab. & Equity</u>		
	<u>Book</u>	<u>Tax</u>		<u>Book</u>	<u>Tax</u>	<u>O/B</u>
Building	950,000	950,000		Debt	0	0
				Gilman	0	0
				James	0	0
	_____	_____		Lender	<u>950,000</u>	<u>1,000,000</u>
	950,000	950,000			950,000	1,000,000

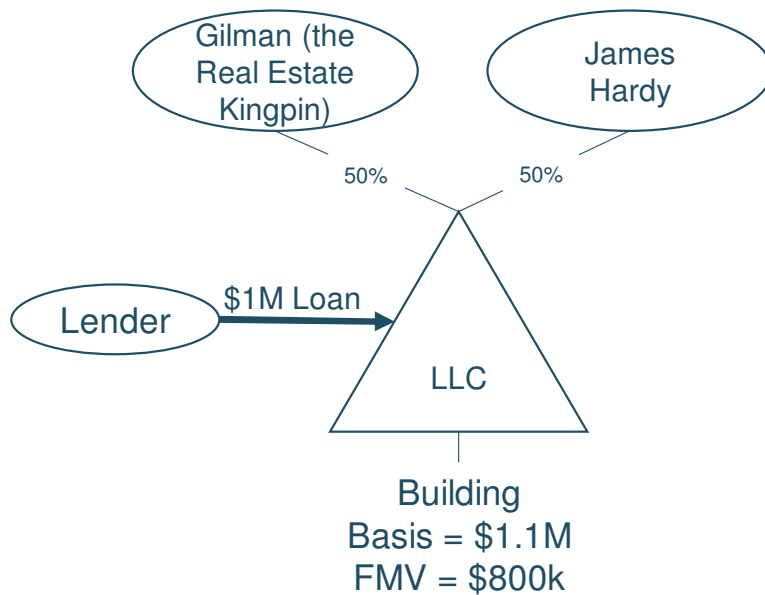
Observations

- LLC recognizes \$50k of CODI under § 108(e)(8) without regard to whether debt is recourse or nonrecourse
- Gilman can exclude \$25k of CODI but James cannot.
- Gilman and James each have:
 - \$25K of CODI
 - Outside Basis:
 - Increase by \$25k for CODI
 - Decrease by \$500k under § 752(b)
 - No § 731 gain or loss

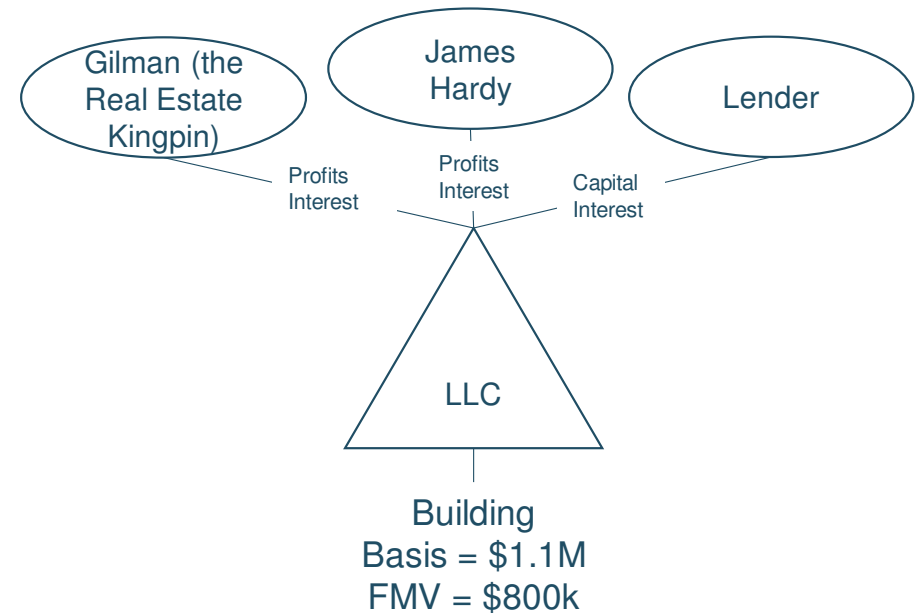
§ 108(e)(8) Debt for Equity Exchange

- When a partnership transfers a capital or profits interest in the partnership to a creditor in satisfaction of a partnership debt, the partnership recognizes CODI income as if the debt had been satisfied with cash equal to the value of the partnership interest. See § 108(e)(8).
 - CODI is allocated to the partners of the partnership immediately prior to the satisfaction of the debt for equity exchange

Beginning Structure



Resulting Structure



§ 108(e)(8) Debt for Equity Exchange: Valuing the Extinguished Debt

- All facts and circumstances are considered in determining the fair market value of the debt extinguished in the exchange
- Treas. Reg. § 1.108-8(b)(2) allows the parties to treat the fair market value of the debt extinguished in the exchange as equal to the liquidation value of the partnership interest transferred to the Lender in the debt-for-equity exchange

Assume that the partnership liquidates in accordance with 704(b) capital accounts

FMV of Debt: \$800,000

CODI: \$1,000,000 – 800,000 = \$200,000

Pre-Exchange Balance Sheet							
	<u>Assets</u>				<u>Liab. & Equity</u>		
	<u>FMV</u>	<u>Book</u>	<u>Tax</u>		<u>Book</u>	<u>Tax</u>	<u>O/B</u>
Building	800,000	1,100,000	1,100,000	Debt	1,000,000	1,000,000	0
				Gilman	50,000	50,000	550,000
	_____	_____	_____	James	<u>50,000</u>	<u>50,000</u>	<u>550,000</u>
	800,000	1,100,000	1,100,000		1,100,000	1,100,000	1,100,000

§ 108(e)(8) Debt for Equity Exchange: Valuing the Extinguished Debt

Post-Exchange Balance Sheet							
	<u>Assets</u>				<u>Liab. & Equity</u>		
	<u>FMV</u>	<u>Book</u>	<u>Tax</u>		<u>Book</u>	<u>Tax</u>	<u>O/B</u>
Building	800,000	800,000	1,100,000		Debt	0	0
					Gilman	0	150,000
					James	0	150,000
	_____	_____	_____		Lender	<u>800,000</u>	<u>1,000,000</u>
	800,000	800,000	1,100,000			800,000	1,300,000

§ 1001 Recourse Debt vs. Nonrecourse Debt

- **Recourse Debt**

- Borrower is personally liable for the debt.
- Where recourse debt is discharged in connection with the transfer of property to lender, the amount realized does not reflect the amount of recourse debt.
 - Gain/loss = amount realized (FMV) less taxpayer's tax basis in the assets
- However, taxpayer has CODI to the extent the amount of debt exceeds FMV.
- See Treas. Reg. §1.1001-2(c), Ex. 8; Rev. Rul 90-16.

- **Nonrecourse Debt**

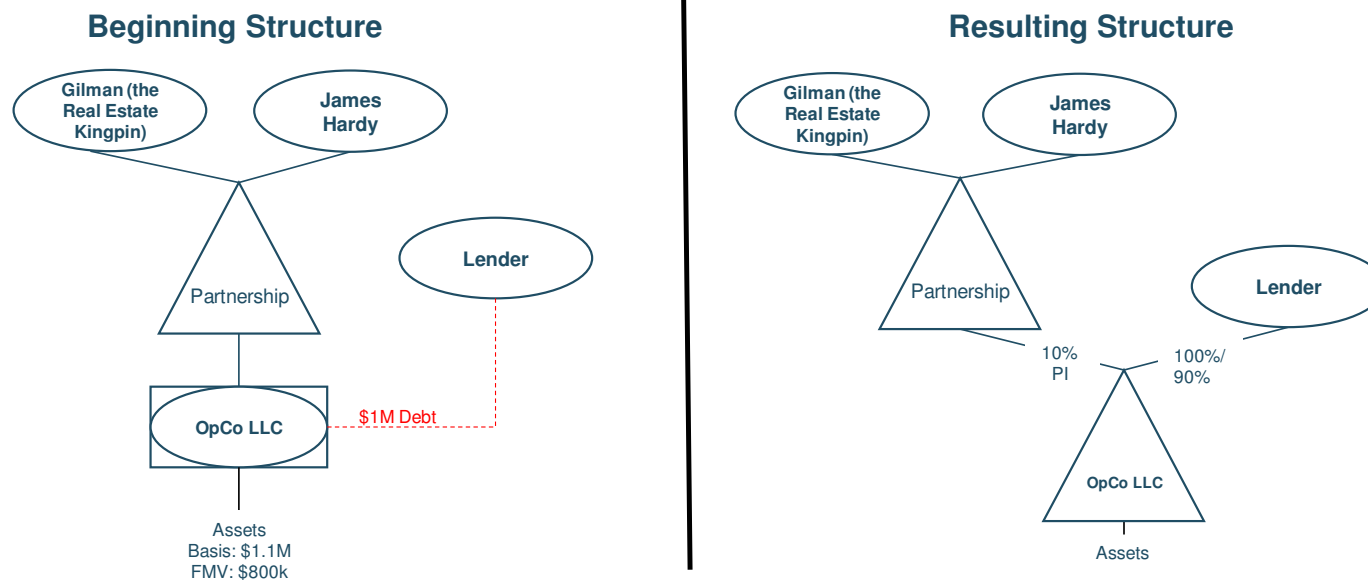
- Borrower is not personally liable for the debt and the creditor's recourse is limited to secured assets.
- Where nonrecourse debt is discharged in connection with the transfer of property to lender, the amount realized is no less than the amount of nonrecourse debt.
 - Gain/Loss = amount realized (greater of FMV or debt) less taxpayer's tax basis in the assets.
- Taxpayer does not have CODI.
- See Treas. Reg. §1.1001-2(c), Ex. 7; *Commissioner v. Tufts*.

- **Relevant facts**

- The question of whether debt is recourse or non-recourse becomes more difficult when examining debt held by a wholly-owned, disregarded subsidiary of the taxpayer (a "DRE")
- Debt that is recourse to a DRE may be considered § 1001 recourse to taxpayer if DRE holds all assets of the taxpayer.
- However, if the taxpayer owns significant assets, but only a single project/asset through DRE, the DRE debt is likely nonrecourse to the taxpayer.
 - See *Great Plains Gasification v. Comm'r*.
 - If the DRE holds an actual business with inventory and working capital that turns over, the debt looks more like recourse to the taxpayer.
- It is more difficult to characterize debt that is legally recourse against a disregarded tax entity as nonrecourse debt for § 1001 purposes.
- Debt can be considered nonrecourse for § 1001 purposes in spite of legal recourse if in substance the lender has no meaningful recourse beyond foreclosure on the property securing the debt.
 - See *Great Plains*; CCA 201525010.

OpCo Borrowers: CODI, §1001 Gain or Loss and Rev. Rul. 99-5

- Partnership wholly owns OpCo LLC, a disregarded entity for U.S. federal income tax purposes.
- OpCo LLC is the borrower in Lender's credit facility.
- OpCo LLC owns assets used in a trade or business, which secure OpCo LLC's debt, but Lender's recourse is not limited to specific OpCo LLC assets.
- Lender acquires a 100% capital and a 90% profits interest in OpCo LLC in exchange for debt relinquishment.
- Partnership retains a 10% profits interest in OpCo LLC.



OpCo Borrowers: CODI, §1001 Gain or Loss and Rev. Rul. 99-5

- Rev. Rul. 99-5 generally holds that form dictates tax consequences when a DRE becomes a partnership.
 - In Situation 1, a transfer across the top of a 50% interest in the DRE is treated as a deemed sale of 50% of the DRE's assets. Following the sale, the parties are treated as contributing their 50% shares of the assets to the DRE.
 - In Situation 2, a contribution of cash for a 50% interest in the DRE is treated as a contribution by both parties to a new partnership in exchange for partnership interests.

ISSUE

- Whether a § 1001 gain or loss or CODI is triggered depends on whether, (1) for tax purposes, the cancellation of the debt in exchange for a partnership interest in OpCo LLC is a deemed contribution to OpCo LLC or a deemed sale of OpCo LLC's assets by Partnership to Lender, and (2) whether the OpCo LLC debt is § 1001 recourse or § 1001 nonrecourse.
 - If the debt cancellation is a deemed contribution, then Partnership is deemed to have contributed the assets of OpCo LLC to a new partnership and Lender is deemed to have contributed its creditor position to the new partnership in an amount equal to the cancelled debt. Partnership receives a § 752 distribution equal to the amount of debt relinquished (and possibly CODI).
 - If the debt cancellation is deemed consideration in an asset sale, then our facts are analogous to those in Rev. Rul. 99-5 Situation 1, and there should be a recognized gain/loss under § 1001 if the debt of OpCo LLC is § 1001 nonrecourse debt, or § 1001 gain or loss (and possibly CODI) if it is § 1001 recourse debt.

OpCo Borrowers: CODI, §1001 Gain or Loss and Rev. Rul. 99-5

Debt cancellation is Rev. Rul. 99-5, Situation 1:

- If Debt is § 1001 Nonrecourse:
 - Partnership has § 1231 loss = \$100k (\$1M amount realized - \$1.1M basis)
 - Lender has a loss of \$200k and basis in assets of \$800k
- If Debt is § 1001 Recourse
 - Partnership has § 1231 loss of \$200k and CODI of \$100K
 - Lender has loss of \$200k and basis in assets of \$800K

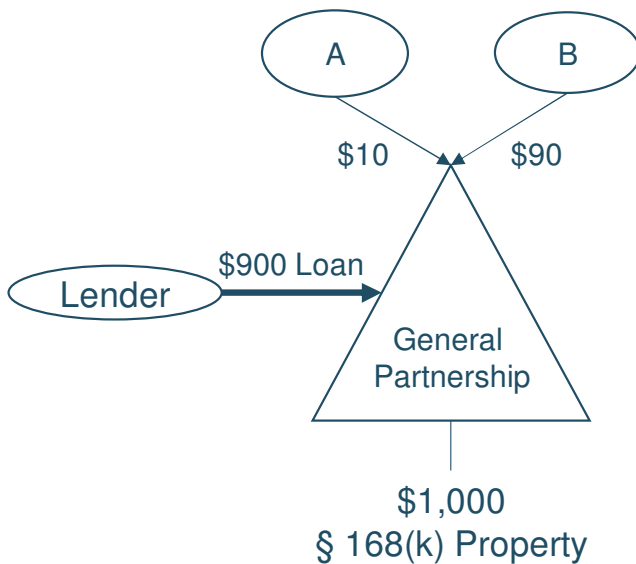
OpCo LLC: Post-Transaction Balance Sheet						
	Assets			Liab. & Equity		
	Book	Tax		Book	Tax	O/B
Assets	800,000	800,000	Debt	0	0	0
			Partnership	0	0	0
	_____	_____	Lender	<u>800,000</u>	<u>800,000</u>	<u>800,000</u>
	800,000	800,000		800,000	800,000	800,000

Debt cancellation is Rev. Rul. 99-5, Situation 2:

- FMV of Assets Contributed: \$800k
- FMV of Debt Contributed: \$800k
- CODI: \$1M - \$800k = \$200k (without regard to § 1001 status of debt)
- Lender's Basis: \$1M
- Partnership's Basis: \$1.1M + 200k CODI - \$1M § 752(b) debt relief = \$300k

OpCo LLC: Post-Transaction Balance Sheet						
	Assets			Liab. & Equity		
	Book	Tax		Book	Tax	O/B
Assets	800,000	1,100,000	Debt	0	0	0
			Partnership	0	300,000	300,000
	_____	_____	Lender	<u>800,000</u>	<u>1,000,000</u>	<u>1,000,000</u>
	800,000	1,100,000		800,000	1,300,000	1,300,000

Rev. Rul. 92-97: Mismatched CODI & §752(b) Allocations



- General Partnership purchases property for \$1,000 and deducts 100% under § 168(k)
- Partnership Agreement provides:
 - All losses 10% to A, 90% to B
 - All income 50% to A, 50% to B
 - A and B have DROs

Resulting Balance Sheet						
	<u>Assets</u>			<u>Liab. & Equity</u>		
	<u>Book</u>	<u>Tax</u>		<u>Book</u>	<u>Tax</u>	<u>O/B</u>
§168(k) Property	0	0	Debt	900	900	0
			A	(90)	(90)	0
	_____	_____	B	<u>(810)</u>	<u>(810)</u>	<u>0</u>
	0	0		0	0	0

Rev. Rul. 92-97: Mismatched CODI & §752(b) Allocations

- In Year 2, § 168(k) property value falls to \$500
- Lender reduces debt from \$900 to \$500, generating \$400 of CODI
- CODI is allocated \$200 to A and \$200 to B

Resulting Balance Sheet						
	<u>Assets</u>			<u>Liab. & Equity</u>		
	<u>Book</u>	<u>Tax</u>			<u>Book</u>	<u>Tax</u>
§168(k) Property	0	0*	Debt	500	500	0
			A	110	110	110
	_____	_____	B	(610)	(610)	0
	0	0		0	0	110

* Assumes no § 734(b) step-up for B's § 731(a) gain

Observations

- A has \$200 of CODI, which A can exclude if A is insolvent
- A's share of debt is reduced from \$90 to \$0
- B has \$200 of CODI, which B can exclude if B is insolvent
- B has \$100 of § 731(a) gain
(0 + \$200 CODI – \$310 § 752(b) distribution)
 - The \$110 of § 731(a) gain cannot be excluded from income.
 - See Rev. Rul. 95-21; § 108(d)(6)
- B was very poorly represented
 - Reverse losses with income; or
 - Allocate CODI in proportion to § 752(b) deemed distributions

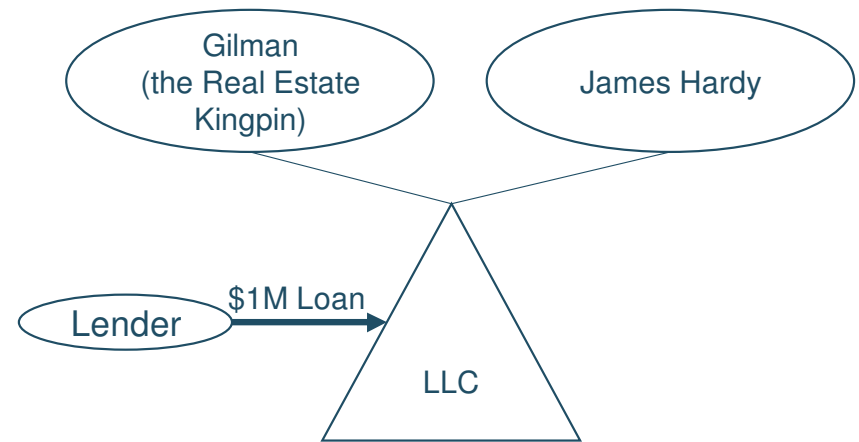
Avoiding CODI: Partnership Incorporations

Assumptions

- Lender will write debt down to \$500
- Neither Gilman nor James is insolvent
- LLC will incorporate before Lender reduces the debt

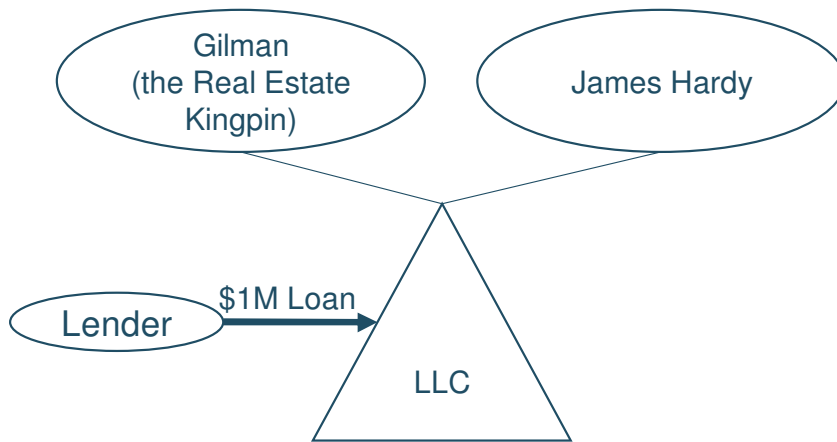
Issue

- Does § 351 apply to the incorporation of LLC?
- If § 351 does apply, which is better?
 - LLC checks closed?
 - Gilman and James contribute LLC interests to NewCo?



Balance Sheet									
	<u>Assets</u>				<u>Liab. & Equity</u>				
	<u>FMV</u>	<u>Book</u>	<u>Tax</u>		<u>FMV</u>	<u>Book</u>	<u>Tax</u>	<u>O/B</u>	
Property	500	700	700		Debt	500	800	800	0
					Gilman	0	(50)	(50)	350
					James	0	(50)	(50)	350
	500	700	700			500	700	700	700

Avoiding CODI: Partnership Incorporations (CTB Election)



Balance Sheet								
	Assets				Liab. & Equity			
	FMV	Book	Tax		FMV	Book	Tax	O/B
Property	500	700	700		Debt	500	800	0
					Gilman	0	(50)	350
					James	0	(50)	350
	500	700	700			500	700	700

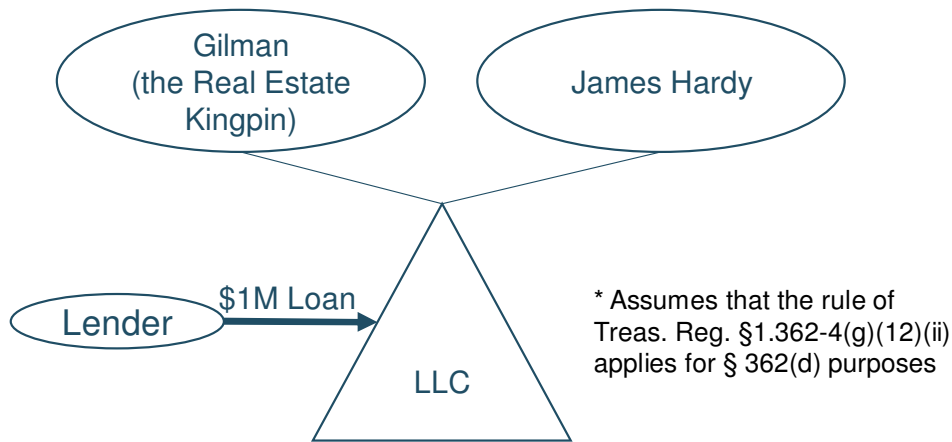
Assumptions

- LLC checks closed
- § 351 does apply

Results

- Gilman and James:
 - LLC recognizes \$100 of § 357(c) gain
 - Allocates \$50 to each partner
 - Gilman and James each take \$0 basis in LLC stock
 - See § 358, § 732
- NewCo:
 - NewCo is insolvent by \$300, so all \$300 of CODI is excluded
 - Asset Basis:
 - \$700 (§ 362(a))
 - + 0 (§ 362(a), § 362(d))
 - 200 (§ 362(e)(2))
 - 0 (§ 108(b)(1)(E), § 1017(b)(2))
 - \$500**

Avoiding CODI: Partnership Incorporations (NewCo)



Balance Sheet								
	Assets				Liab. & Equity			
	FMV	Book	Tax		FMV	Book	Tax	O/B
Property	500	700	700	Debt	500	800	800	0
				Gilman	0	(50)	(50)	350
				James	0	(50)	(50)	350
	500	700	700		500	700	700	700

Assumptions

- Gilman and James form NewCo and contribute their interests in LLC to NewCo
- § 351 does apply
- Rev. Rul. 84-111 (not Rev. Rul. 99-6) applies

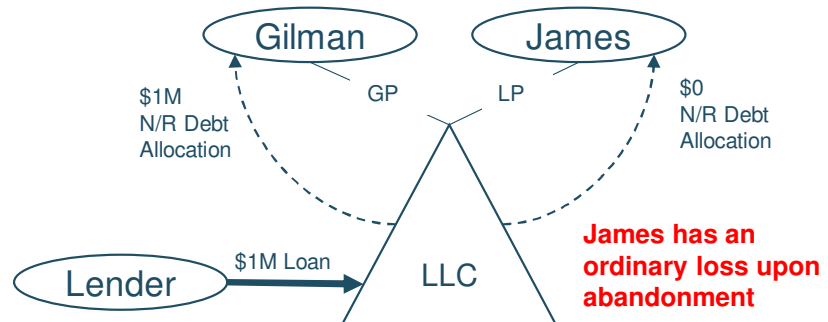
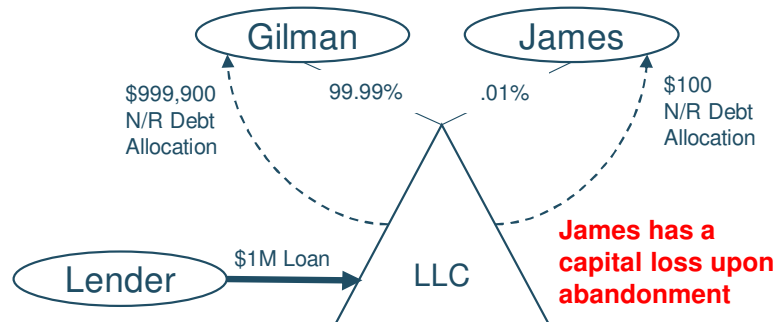
Results

- Gilman and James:
 - Gilman and James each recognize \$50 of § 357(c) gain
 - Gilman and James each take \$0 basis in NewCo stock
 - See § 358
- NewCo:
 - NewCo is insolvent by \$300, so all \$300 of CODI is excluded
 - Momentary Basis in Partnership Interest:
 - \$700 (§ 362(a))
 - + 100 (§ 362(a), § 362(d))
 - 0 (§ 362(e)(2), § 1.362-4(g)(12)(ii))*
 - \$800****
 - Asset Basis:
 - \$800 (§ 732(b))
 - 300 (§ 108(b), § 1017(b)(2))
 - \$500**

** Note the timing difference on basis reduction

Avoiding CODI: Abandoning the Partnership Interest

- A partner may avoid CODI by abandoning its partnership interest.
 - Requires (1) an intent to abandon and (2) an affirmative act demonstrating that abandonment has occurred.
- The partner should receive a loss equal to its basis in the partnership interest at the time of abandonment. A loss will only be considered an ordinary loss if sale or exchange treatment does not apply.
 - See Rev. Rul. 93-80; *Echols v. Commissioner*; *Pilgrim's Pride Corp. v. Commissioner*.
 - If there is an actual or deemed distribution (including a § 752 distribution) to the partner, a sale or exchange is considered to exist, and the partner's loss is capital.
- Thus, if a partner is allocated even \$1 of the partnership's nonrecourse liabilities, the loss upon abandonment will be a capital loss.
- Ordinary loss may be a miscellaneous itemized deduction, not deductible by an individual.
- Consider impact of abandonment on CODI of remaining partners.



Avoiding CODI: Declaring the Partnership Interest Worthless

- § 165(a) provides that there shall be allowed as a deduction any loss sustained during the taxable year and not compensated for by insurance or otherwise.
 - A partnership interest is not a security under § 165(g) (worthless security deduction).
- A loss is only available “during the taxable year in which the loss occurs as evidenced by closed and completed transactions and as fixed by identifying events occurring in such taxable year.”
 - See Treas. Reg. § 1.165-1(d)
 - Issues may arise where a partnership interest became worthless in a year before the taxpayer abandoned it, and the taxpayer takes the loss in the year of abandonment.
- The deduction for a worthless partnership interest should be equal to the partner’s basis in its partnership interest and is generally considered an ordinary loss if sale or exchange treatment does not apply
 - See Rev. Rul. 93-80
 - Query whether a deemed distribution arises where the partner has not abandoned her partnership interest

THANK YOU

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