WITHUM SMITH+BROWN TAX BRIEF

IRS Clarifies Cancellation of Partnership Indebtedness

FEBRUARY 5, 2009

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Executive Summary

The Internal Revenue Service has issued proposed regulations that provide guidance on the determination of cancellation of indebtedness income of a partnership that issues a partnership interest to its lender in satisfaction of the partnership's debt and the tax consequences to the lender. As long as certain requirements are met, taxpayers can use the "liquidation value" of the partnership interest as its fair market value, and do not have to take other factors into account. Under the proposed regulations, a contribution of debt by a lender to a partnership, in exchange for a capital or profits interest in the partnership, will generally be treated as tax free to the lender under Section 721 and no loss will be recognized by the lender at the time of the contribution of the debt, even if the partnership recognizes COD income.

The Law Prior to the Proposed Regulations

When a lender cancels any or all of a borrower's indebtedness, the borrower generally will have taxable income equal to the amount of the discharge (cancellation of indebtedness income, or "COD" income). There has been a question as to whether a borrower partnership's issuance of an interest in the partnership in exchange for satisfaction of its debt was tax free to the partnership, where the partnership interest was worth less than the face amount of the debt.

In 2004, Section 108 of the Internal Revenue Code was amended to state that discharges of indebtedness of a partnership, in exchange for a capital or profits interest in the partnership, result in COD income in the amount that the debt exceeds the fair market value of the partnership interest. Such COD income of the partnership will be included in the distributive shares of the taxpayers that were partners in the partnership immediately before the discharge. However, the amended statute does not state how to determine the fair market value of the partnership interest issued.

IN TODAY'S ECONOMIC CLIMATE, TAXPAYERS ARE STRUGGLING TO REPAY LOANS, AND MUST NEGOTIATE WITH LENDERS FOR ALTERNATIVES. THE TAX IMPLICATIONS ARE IMIMPORTANT.

Questions or comments?

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New Proposed Regulations-Borrower's Tax Consequences

On October 28, 2008, the IRS issued proposed regulations, which provide a safe harbor for valuing a partnership interest issued by a partnership to a lender in a debt-for-equity exchange, for purposes of determining COD income. As long as certain requirements are met, taxpayers can use the "liquidation value" of the partnership interest as its fair market value, and do not have to take other factors into account. The proposed regulations define "liquidation value" as the amount of cash that the lender would receive with respect to the interest if, immediately after the transfer, the partnership sold all of its' assets (including good will, going concern value, and any other intangibles associated with the partnership's operations) for cash equal to their fair market value, and liquidated.

Under the proposed regulations, this definition of "fair market value" can be used only if four requirements are met: (i) the partnership maintains capital accounts in accordance with accounting rules set out in Treasury Regulations, (ii) the lender, partnership, and its partners treat the fair market value of the indebtedness as being equal to the liquidation value of the partnership interest (i.e., the parties report consistently for tax purposes); (iii) the debt-for-equity exchange is an arm's length transaction; and (iv) subsequent to the exchange, neither the partnership redeems, nor any person related to the partnership purchases, the lender's interest as part of a plan at the time of the exchange which has as a principal purpose the avoidance of COD income by the partnership.

If the safe harbor requirements are not met, all facts and circumstances will be considered in determining the fair market value of the partnership interest.

New Proposed Regulations-Lender's Tax Consequences

The proposed regulations issued on October 30, 2008 also amend the regulations under Section 721, generally resulting in unfavorable tax consequences to a lender in debt-for-equity exchange with a partnership borrower.

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Section 721 of the Code provides generally that a person who contributes property to a partnership in exchange for a partnership interest, recognizes no gain or loss on the contribution. Under the proposed regulations, a contribution of debt by a lender to a partnership, in exchange for a capital or profits interest in the partnership, will generally be treated as tax free to the lender under Section 721. The lender's basis in its partnership interest will be equal to the lender's adjusted basis in the debt contributed. No loss will be recognized by the lender at the time of the contribution of the debt, even if the partnership recognizes COD income.

Questions or comments?

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If you have any questions, please contact the WS+B tax department. # 302

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