Partnership Debt-for-Equity Exchanges

IRS Issues Final Regulations on Cancellation of Indebtedness Income and Other Consequences of an Exchange of Partnership Debt for Partnership Equity

SUMMARY

The Internal Revenue Service (the “IRS”) recently released final regulations (the “Final Regulations”) relating the federal income tax consequences of the transfer of a partnership interest by a partnership to a creditor in satisfaction of the partnership’s indebtedness. The Final Regulations modify and expand upon the proposed regulations that the IRS issued on this topic in October 2008 (the “Proposed Regulations”). Similar to the Proposed Regulations, the Final Regulations permit a debtor partnership and its creditor to use the liquidation value of the transferred partnership interest as its fair market value for purposes of calculating the partnership’s cancellation of indebtedness income, but the Final Regulations modify the requirements for this treatment as compared to the Proposed Regulations. The Final Regulations, similar to the Proposed Regulations, generally do not permit or require a creditor to recognize gain or loss on the transfer, but instead require the creditor to carryover its basis and holding period in the indebtedness to its partnership interest. The Final Regulations apply to debt-for-equity exchanges occurring on or after November 17, 2011.

BACKGROUND

Generally, a partnership that transfers a partnership interest to a creditor in satisfaction of a partnership’s indebtedness (i.e., in a debt-for-equity exchange) is treated as having satisfied the indebtedness for the fair market value of the partnership interest transferred to the creditor. The partnership generally recognizes cancellation of indebtedness income equal to the excess of the amount of the indebtedness over the fair market value of the transferred partnership interest. This cancellation of indebtedness income is taken into account in determining the distributive shares of partnership income of the partners immediately before discharge.
THE FINAL REGULATIONS

Amount of Cancellation of Indebtedness Income

Subject to the conditions described below, the Final Regulations allow the partnership and creditor to treat the “liquidation value” of the transferred partnership interest as its fair market value. The liquidation value of the transferred interest is the amount of cash that the creditor would receive if, immediately after the transfer, the partnership sold all of its assets (including goodwill and other intangibles) for cash equal to their fair market value, repaid its other liabilities and distributed the cash in liquidation.4

The Final Regulations allow liquidation value to be used as a measure of fair market value only if:

1. the creditor, the partnership and the partners all treat the fair market value as being equal to the liquidation value;
2. the partnership applies a consistent valuation methodology to all equity issued in any debt-for-equity exchange that is part of the same overall transaction;
3. the terms of the debt-for-equity exchange are comparable to terms that would be agreed to by unrelated parties negotiating with adverse interests; and
4. there are no subsequent redemptions or related-party5 sales of a partnership interest as part of a plan which has a principal purpose of avoiding cancellation of indebtedness income.

The Final Regulations do not require that the debtor partnership determines and maintains capital accounts in accordance with prescribed capital account rules under Treas. Reg. § 1.704-1(b)(2)(iv). The Final Regulations further clarify that these rules can apply to a partnership acquiring debt from a creditor that is an existing partner.

In addition, the Final Regulations provide that, with respect to interests held in one or more lower-tier partnerships, the liquidation value of an interest in an upper-tier partnership is determined by taking into account the liquidation value of the lower-tier partnership interests. The Final Regulations further provide that cancellation of indebtedness income arising from a discharge of a partnership or partner nonrecourse indebtedness is treated as a first-tier item for minimum gain chargeback purposes.6

The preamble to the Final Regulations states that existing guidance7 provides a framework for allocating cancellation of indebtedness income, and the Final Regulations therefore do not adopt additional guidance regarding the allocation of cancellation of indebtedness income where a partnership indebtedness owed to a preexisting partner is satisfied with the transfer of a partnership interest.

Treatment of Creditors

The Final Regulations provide that, when a creditor receives a partnership interest in satisfaction of indebtedness, no gain or loss is recognized by the creditor. Thus, the creditor’s gain or loss is reflected in
the basis in the partnership interest. This treatment does not apply to the satisfaction of unpaid rent, royalties or interest on indebtedness (including accrued original issue discount) that accrue on or after the beginning of the creditor’s holding period for the indebtedness. The holding period of the new interest includes the creditor’s holding period in the indebtedness.\textsuperscript{8}

The preamble to the Final Regulations allows for the possibility that a creditor may validly take a bad debt deduction prior to the debt-for-equity exchange in a transaction independent of and separate from the debt-for-equity exchange.

The preamble to the Final Regulations states that proposed regulations under Section 453B are forthcoming to clarify that if a creditor contributes an installment obligation to the debtor partnership, the creditor must recognize any deferred gain or loss, even if the transaction otherwise qualifies as a Section 721 contribution. This treatment would be consistent with treatment of a creditor of a corporation that contributes an installment obligation to the debtor corporation.

The Final Regulations were published in the Federal Register on November 17, 2011, and are effective for debt-for-equity exchanges occurring on or after that date.

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ENDNOTES


2 The Proposed Regulations are described in the Sullivan & Cromwell LLP publication entitled “Partnership Debt-for-Equity Exchanges – IRS Issued Proposed Regulations On Cancellation of Indebtedness Income and Other Consequences of an Exchange of Partnership Debt for Partnership Equity” (November 3, 2008), which may be obtained by following the instructions at the end of this publication.

3 Section 108(e)(8).

4 In an example in the Final Regulations, a partnership has debt to C of $1,000, issues a partnership interest to C in exchange for the debt, and the liquidation value of the partnership interest is $700 at the time of the exchange. The conditions to the use of liquidation value as the fair market value of the partnership interest are assumed to be satisfied and, accordingly, the partnership’s cancellation of indebtedness income is $300.

5 Related parties in this context are defined by reference to Sections 267(b) and 707(b).

6 The minimum gain chargeback requirement is a requirement to specifically allocate income in order to offset non-economic deductions (i.e., deductions for items that are not economically borne by the partnership or a partner but are instead borne by, for example, a non-recourse lender). For the new regulations, see Treas. Reg. §§ 1.704-2(f)(6), 1.704-2(j)(2)(i)(A) and 1.704-2(j)(2)(ii)(A), providing that any minimum gain chargeback required for a partnership taxable year consists first of certain gains recognized from the disposition of partnership property subject to one or more partnership nonrecourse liabilities and then, if necessary, of a pro rata portion of the partnership’s other item of income and gain for that year.


8 See Sections 722 and 1223(1).
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