Partnership Debt-for-Equity Exchanges

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

SUMMARY
On October 31, the IRS issued proposed regulations (the “proposed regulations”) on the consequences of the transfer of a partnership interest by a partnership to a creditor in satisfaction of the partnership’s indebtedness. Under the proposed regulations, the partnership and the creditor may treat the liquidation value of the transferred partnership interest as its fair market value for the purposes of calculating the partnership’s cancellation of indebtedness income. In addition, the creditor will generally not recognize gain or loss on the transfer, but instead the basis of the indebtedness will carry over to the creditor’s partnership interest, and the holding period of the partnership interest will include the creditor’s holding period for the indebtedness.

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 partnership interest transferred. This cancellation of indebtedness income is taken into account in determining the distributive shares of partnership income of the partners immediately before discharge. The proposed regulations address two principal issues – (1) the determination of the amount of cancellation of indebtedness income of the partnership and (2) the treatment by the creditor of the creditor’s receipt of the partnership interest.
THE PROPOSED REGULATIONS

Amount of Cancellation of Indebtedness Income

Subject to the conditions described below, the proposed regulations allow the partnership and creditor to treat the fair market value of the transferred partnership interest as its “liquidation 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 and distributed the cash in liquidation. If the partnership maintains capital accounts in accordance with the capital accounting rules set forth in Treasury Regulations, the partnership will be treated as satisfying the debt in exchange for the capital account the creditor receives as a result of the debt-for-equity exchange.

The proposed regulations allow liquidation value to be used as a measure of fair market value only if (1) the debtor partnership determines and maintains capital accounts in accordance with prescribed capital account rules, (2) the creditor, the partnership, and the partners all treat the fair market value as being equal to the liquidation value, (3) the exchange is an arm’s length transaction, and (4) there are no subsequent redemptions of a partnership interest as part of a plan which has a principal purpose of avoiding cancellation of indebtedness income.

Treatment of Creditors

The proposed regulations provide that, when a creditor receives a partnership interest in satisfaction of indebtedness, no gain or loss will be recognized by the creditor. Thus, the creditor’s gain or loss will be reflected in the basis in the partnership interest. This treatment will not apply to the satisfaction of unpaid rent, royalties, interest on indebtedness (including original issue discount), or installment obligations.

The holding period of the new interest will include the creditor’s holding period in the indebtedness.

The IRS and the Treasury Department request comments on the proposed regulations, and specifically the treatment of the satisfaction of indebtedness owed to a pre-existing partner with an additional partnership interest and whether the creditor’s loss should not be recognized in a debt-for-equity exchange. Additionally, the IRS and the Treasury Department are interested in the interaction of the non-compensatory partnership options rules relating to convertible debt with the proposed regulations.

The proposed regulations are proposed to apply to debt-for-equity exchanges occurring on or after the date these regulations are published as final regulations in the Federal Register.
ENDNOTES

1  Federal Register Document 2008-25851 (Filed October 30, 2008; publication date October 31, 2008).
2  Section 108(e)(8).
3  In an example in the proposed 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 and C’s capital account is increased by $700.
6  Separate guidance addresses a transfer in connection with performance of services.
7  See Sections 722, 1223(1).
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