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Cancellation of Indebtedness Income From Partnerships

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Many partners in real estate partnerships are lucky enough to receive distributions of cash flow without a corresponding amount of taxable income, due to depreciation and other noncash deductions. Less fortunate partners are allocated taxable income without cash distributions (so-called “phantom income”). A prime example of phantom income is cancellation of debt income (“COD income”) arising from debt discharges. There are several ways for COD income to be excluded from a taxpayer’s gross income, such as if the taxpayer was insolvent at the time of the discharge. The Internal Revenue Service recently issued a new revenue ruling with special tax rules for partnerships that recognize COD income and allocate the income to their partners who are insolvent.

Background

A discharge of indebtedness generally creates COD income that is taxed at ordinary income rates. For example, two partners may each invest \$100 in a 50-50 partnership that borrows \$800 to acquire land worth \$1,000. If the land declines in value and the lender agrees to reduce the \$800 of debt to \$500 of principal, the partnership recognizes \$300 of COD income, and each partner must recognize \$150 of ordinary taxable income, unless an exception applies. It is a small consolation that a partner could recognize a \$150 loss when he ultimately disposes of his in-

terest in the partnership, because the sale may occur many years later and the loss might be a capital loss.

Insolvency Exclusion

To alleviate the hardships arising from taxpayers being taxed on income without cash, section 108 of the Internal Revenue Code provides several instances in which COD income may be excluded from gross income. One example is if the taxpayer is insolvent immediately before the discharge. An insolvent taxpayer can exclude COD income from his gross income, but only to the extent of his insolvency immediately before the discharge. The mathematically equivalent result generally is that the insolvent taxpayer has taxable COD income to the extent that he is *solvent after the discharge*, i.e., the extent that the value of his assets exceeds his liabilities after the discharge. For example, assume that a taxpayer has only one asset worth \$500 subject to \$800 of recourse liabilities. If \$400 of the liabilities are discharged, he has \$400 of COD income. Since he is insolvent by \$300 before the discharge, \$300 of the COD income is excluded from his gross income and he has only \$100 of taxable COD income. The \$100 of taxable income is also equal to the extent of his solvency after the discharge (\$500 in value of assets subject to \$400 of liabilities).

Generally, a taxpayer who has excluded COD income must reduce various tax attributes, including net operating loss carryovers, business tax credit carryovers, capital loss carryovers, tax basis in his assets, passive activity loss carryovers, and foreign tax credit carryovers, in that

order. For example, if the taxpayer in the above example has no other tax attributes, he must reduce his tax basis in his asset by \$300. However, if the COD income is excluded due to the taxpayer’s insolvency, the taxpayer is not required to reduce tax basis in his assets below the amount of liabilities after the debt discharge.¹ Thus, his asset’s tax basis cannot be reduced below \$400 in the above example. To the extent of the basis reduction, the excluded COD income is ‘recaptured’ when the taxpayer eventually sells the property at a gain (some or all of the recaptured gain may be taxed as ordinary income, even if the asset is a capital asset).

The insolvency analysis becomes trickier when the taxpayer owns property subject to nonrecourse debt in excess of the property’s value (“excess nonrecourse debt”). Since the taxpayer might never have to pay the excess nonrecourse debt, it seems unfair for him to get the full benefit of the excess nonrecourse debt in determining his insolvency. For example, assume that a taxpayer owns property A worth \$500 subject to \$700 of recourse liabilities, and property B worth \$100 subject to \$600 of nonrecourse liabilities. The general rule is that nonrecourse debt is considered a liability of the taxpayer only up to the value of the encumbered property, and any excess nonrecourse debt is taken into account only if the excess nonrecourse debt is being discharged.² Thus, if only property A’s debt is being reduced from \$700 to \$400, the taxpayer is taxed on \$100 of COD income and can exclude only \$200 of COD income from gross income because he was insolvent by only \$200 before the discharge (he owned

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property A worth \$500 subject to \$700 of debt, and property B worth \$100 subject to the \$100 of nonrecourse debt that was not in excess of property B's value). On the other hand, if property B's debt were reduced instead, the amount of the excess nonrecourse debt that is cancelled is taken into account in determining his insolvency. For example, if the taxpayer keeps property B while its debt is reduced from \$600 to \$200, he was insolvent by \$600 prior to the discharge (he owned property A worth \$500 subject to \$700 of debt and property B worth \$100 subject to \$500 of debt, which included the \$400 discharged portion of the \$500 excess nonrecourse debt), so all of his \$400 of COD income is excluded from gross income.

Application to Partnerships

When a partnership recognizes COD income, the insolvency exclusion is determined only at the partner level. Thus insolvent partners may exclude the COD income in whole or in part, while solvent partners would be fully taxable on their allocable share of COD income, unless they can use another exclusion under section 108.

On May 25, 2012, the Internal Revenue Service issued Revenue Ruling 2012-14, which contains rules for determining the insolvency of partners who own interests in partnerships with assets subject to nonrecourse liabilities. Since a partnership or limited liability company may provide the equivalent protection for the partners that nonrecourse debt terms provide for a borrower, even if the debt is recourse to the partnership itself, it was previously unclear whether such partnership liabilities should be treated as nonrecourse debt and be subject to the same insolvency rules that apply to non-partnership excess nonrecourse debt.

The Revenue Ruling notes that in the partnership context, a liability is a "nonrecourse liability" to the extent that no partner or related person bears economic risk of loss.³ If a liability is recourse to the partnership, but no partner (or related person) bears personal liability for the

note, such as if the entity is a limited liability company treated as a partnership for tax purposes, the liability is considered a nonrecourse liability. The Revenue Ruling provides that this definition of nonrecourse liability applies for purposes of the insolvency rules.

As one might expect, the Revenue Ruling provides that if the partnership owns assets with liabilities in excess of the assets' value, the excess nonrecourse debt is normally not taken into account in determining the partners' insolvency. The partners' shares of the partnership's excess nonrecourse debt are only taken into account if excess nonrecourse debt is being discharged. For purposes of computing insolvency, the partnership must allocate its liabilities among the partners in the same manner that the COD income is allocated, so that each partner has matching items of COD income and shares of the discharged liability. This partnership liability allocation for section 108 insolvency purposes is not necessarily the same as the liability allocations on the partners' Schedule K-1's and for other tax purposes.⁴

The Revenue Ruling's example is illustrative. A two-partner partnership borrows \$1,000,000 to acquire real property. The partnership's \$1,000,000 note is secured by the real property. Neither the partnership nor the partners bear personal liability on the note, so the liability is considered a nonrecourse liability. The property value later declines to \$800,000, so the lender agrees to reduce the partnership's principal indebtedness to \$825,000. The partnership recognizes \$175,000 of COD income, which it allocates equally to the two partners, or \$87,500 of COD income to each partner. The ruling concludes that for purposes of measuring each partner's insolvency, each partner treats as a liability its share of the partnership's discharged excess nonrecourse debt based upon the COD income allocation, i.e., half of the \$175,000 of discharged excess nonrecourse debt. If a partner has no other assets or liabilities,

the partner immediately before the debt discharge would have liabilities in excess of the value of its partnership interest by \$87,500 (not \$100,000, because only the *discharged* excess nonrecourse debt is taken into account). Therefore, the partner would be insolvent to the extent of \$87,500 and may exclude \$87,500 of COD income.

If one partner is insolvent or otherwise able to exclude COD income, a partnership might be tempted to allocate COD income disproportionately to that partner, while allocating other income (such as ordinary income from operations) to the other partner(s). This tax-saving maneuver is foreclosed by Revenue Ruling 99-43, which provides that such allocations generally will not be respected because they do not have "substantial economic effect."

Although Revenue Ruling 2012-14 provides some helpful guidance, it comes as no surprise. When a partnership allocates COD income to a partner, that is effectively equivalent to the partner having that share of the partnership's liabilities and discharging that liability. If there were no partnership, excess nonrecourse debt would be taken into account in determining the partner's insolvency only when the debt is being discharged, and the result should be the same in partnership form. We have now seen a good amount of Internal Revenue Service guidance on "recession topics" like cancellation of indebtedness; the economy hopefully will improve to the point that future guidance will deal with more upbeat issues.

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¹ COD income that is excluded from gross income without any offsetting tax basis or attribute reduction is sometimes known as "black-hole" COD income, because the income will never be taxable in the present or in the future (even if the taxpayer acquires more assets in the future).

² Revenue Ruling 92-53.

³ Treas. Reg. § 1.752-1(a)(2).

⁴ See Revenue Ruling 92-97.