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New Temporary Regulations Provide Helpful Relief for Troubled Debtor Partnerships

By: Ezra Dyckman and Lana A. Kalickstein

Last year, in an attempt to provide relief to the growing number of taxpayers struggling to repay loans, Congress enacted Internal Revenue Code Section 108(i). Section 108(i) allows the deferral of cancellation of indebtedness (COD) income generated in 2009 or 2010 in connection with certain debt transactions. Treasury's subsequent release of Revenue Procedure 2009-37 clarified the statute's application but left many crucial terms undefined, leaving many taxpayers, particularly partnerships, uncertain whether they would be eligible for deferral. Fortunately, temporary and proposed regulations issued under section 108(i) this past August rein in the statute's overly broad drafting, and provide much needed clarity to partnership borrowers.

Background

If a lender cancels all or a portion of a borrower's indebtedness, the borrower generally will have taxable income equal to the amount of the discharge. Section 108 provides various exceptions (e.g., bankruptcy, insolvency, deferral) to the general rule that COD income must be included in gross income in the year of the discharge. Under section 108(i), a taxpayer can defer certain COD income generated in 2009 or 2010 until 2014, and then recognize such COD income ratably over the five-year period beginning in 2014.

Section 108(i) applies only to COD income generated in connection with a debt instrument issued by either (1) a C corporation, or (2) any other person (including a partnership) "in connection with the conduct of a trade or business by such person." The requirement that the debt be issued "in connection with the conduct of a trade or business by such person" in the case of all non-C corporation borrowers, with no further clarification, left many borrowers unsure whether their debt would qualify. For example, if a partnership engaged in the trade or business of operating a real estate portfolio borrows money secured by a mortgage on its property in order to make distributions to its partners, is that debt "issued in connection with the conduct of a trade or business?" Will a partnership's trade or business be imputed to one of its partners in the case where the partner borrows money in order to buy a partnership interest or make a contribution to the partnership?

Thankfully, the temporary regulations issued this past August address some of these concerns. The regulations provide that for partnership borrowers, the determination of whether debt will be considered to be issued in connection with the conduct of a trade or business by the partnership will be "based on all the facts and circumstances." Moreover, the regulations provide five safe harbors, any of which, if met, deem the debt to be issued in connection with the conduct of a trade or business by the borrower partnership: (i) the gross fair market value of the trade or business assets of the partnership borrower represented at least 80 percent of the gross fair market value of that partnership's total assets on the date of issuance; (ii) the trade or business expenditures of the partnership borrower represented at least 80 percent of the partnership's total expenditures for the taxable year of issuance; (iii) at least 95 percent of interest paid or accrued on the debt instrument issued by the partnership was allocated to one or more trade or business expenditures under the interest allocation rules for the taxable year of issuance; (iv) at least 95 percent of the proceeds from the debt instrument issued by the partnership were used by the partnership to acquire one or more trades or businesses within six months from the date of issuance; or (v) the partnership issued the debt instrument to a seller of a trade or business to acquire the trade or business.

A partnership in the real estate business who borrows money to make distributions to its partners could qualify for one of the safe harbors listed above, as could a partnership who borrows money to purchase an interest in a partnership in the real estate business.

***Ezra Dyckman** is a partner in, and **Lana A. Kalickstein** is an associate of, the law firm of Roberts & Holland LLP.*

On the other hand, since the safe harbors explicitly apply only to partnership borrowers, an individual who borrows money to invest in that same partnership is not covered by the regulation, leaving the individual uncertain whether his debt qualifies under the words of the statute.

Additional Rules for Partnerships

Section 108(i) requires that the election to defer COD income be made at the *entity* level. Revenue Procedure 2009-37 clarified this rule by giving a taxpayer the ability to make a "partial" election so that the taxpayer can elect to defer all, part, or none of its eligible COD income. A taxpayer can apply a different section 108 exception (bankruptcy, insolvency, etc.) to any COD income that is not deferred and would otherwise be included in income. In the case of a partnership, the partnership must first allocate to each partner its distributive share of COD income under the partnership agreement. The partnership can then decide, on a partner-by-partner basis, how much, if any, of each partner's distributive share of COD income will be deferred under the partnership's election.

Mandatory Acceleration Events

Although deferred COD income, which is treated as ordinary income, generally will not be included in an electing taxpayer's gross income until 2014, section 108(i) lists certain events that trigger earlier inclusion: (1) the death of the taxpayer, (2) liquidation or sale of substantially all the assets of the taxpayer, (3) cessation of business by the taxpayer, or (4) in the case of a partnership or S corporation, the sale, exchange or redemption by a partner or shareholder of its interest in the partnership or S corporation.

The terms "liquidation or sale of substantially all the assets of the taxpayer" and "cessation of business by the taxpayer" were not defined in section 108(i) or the Revenue Procedure, leading to concern that many common business transactions (such as contributions to partnerships and reorganizations) would cause acceleration. Additionally, in the case where a partner sells its interest in a partnership with deferred COD income, it wasn't entirely clear under the statute and the Revenue Procedure whether such a sale accelerated *all* of the partnership's deferred COD income or just that partner's share.

The regulations clarify many of these ambiguities for partnership borrowers and their direct and indirect partners. Under the regulations, all of a partnership's deferred COD income is accelerated when the partnership (i) liquidates, (ii) sells, exchanges, transfers (including contributions and distributions), or gifts substantially all of its assets, (iii) ceases doing business, or (iv) files a petition in a Title 11 or similar case. "Substantially all" of the partnership's assets means assets representing at least 90 percent of the fair market value of the partnership's net assets and at least 70 percent of the fair market value of the partnership's gross assets, as measured immediately prior to the transfer in question.

The regulations also clarify which partner level events trigger acceleration. A direct or indirect partner's share of deferred COD income of a partnership is accelerated if: the partner (1) dies or liquidates, (2) sells, exchanges, transfers (including contributions and distributions), or gifts all or a portion of its direct or indirect interest in the partnership, (3) is completely redeemed from the partnership, or (4) abandons its interest. The shares of deferred COD income of the other direct and indirect partners are unaffected by the partner's transfer. If only a portion of a partner's interest is transferred, only a proportionate amount of the partner's share of deferred COD income is accelerated.

Exception for Non-Recognition Events

The regulations contain an exception to the acceleration rules for certain non-recognition events. Tax-free contribution transactions wholly governed by section 721 (including contributions by the partnership or by a direct or indirect partner in the partnership) and like-kind exchanges of property generally will not trigger acceleration. If the non-recognition rules do not apply to a portion of the transaction (for example, to boot received in a like-kind exchange), a proportionate amount of deferred COD income will be accelerated.

Although the regulations exempt certain transactions from acceleration, some issues remain unaddressed. For example, assume a partnership in the real estate business has made an election to defer COD income. One year later the partnership sells substantially all of its real estate portfolio and purchases a new real estate portfolio in a taxable transaction, continuing to operate a real estate business. The current rules require acceleration in these circumstances, although in substance the partnership continues to be engaged in the business of operating real estate.

Additional Rules

The regulations provide similar rules to those described above for S corporation borrowers. The regulations also come to the aid of C corporations with a narrow definition of acceleration events for C corporation borrowers with deferred COD income.

Although many issues remain unresolved, the regulations are favorable and give partnerships, S corporations and C corporations flexibility to engage in many common business transactions without losing the ability to enjoy the benefits of section 108(i). Given the impending expiration of section 108(i) at the end of this year, this guidance comes just in time and perhaps gives new meaning to the term "temporary regulations."