December 28, 2011

Still Stressing Over Distressed Debt

By: Ezra Dyckman and Lana A. Kalickstein

In the current market, many real estate owners continue to struggle as the maturity date approaches for loans on distressed real estate. In one common workout scenario, the lender contributes all or a portion of the outstanding debt to the borrower in exchange for an equity interest in the property. On its face, this transaction might appear to be a simple tax-free contribution to a partnership in exchange for a partnership interest. Unfortunately, this transaction is far from simple, and in many cases will not be tax-free. In November, the Internal Revenue Service issued final regulations that provide guidance on (1) the determination of cancellation of indebtedness income of a partnership borrower that issues a partnership interest to its lender in satisfaction of the partnership's debt, and (2) the tax consequences to the lender. These regulations substantially incorporate proposed regulations issued in 2008, with some helpful modifications, and clarify the tax treatment of this common transaction.

Background

When 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 (cancellation of indebtedness income, or "COD" income). This is generally true whether the borrower satisfies any reduced amount of debt with cash, or with property. However, prior to 2004, there had 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 in cases where the partnership interest was worth less than the face amount of the debt.

Case law in existence prior to 1980 held that a corporation had no COD income when it transferred stock to a lender in exchange for its debt, no matter what the value of the stock transferred (the "debt-for-equity exception"). Many believed that the debt-for-equity exception also applied to partnerships.

A 1984 amendment to Section 108 of the Internal Revenue Code changed this result for corporations (other than those that were insolvent or bankrupt), providing that, in a debt-for-equity exchange, a debtor corporation had to recognize COD income in the amount that the debt exchanged by the lender exceeded the value of the stock transferred to the lender. Since this statutory change dealt only with *corporate* borrowers, many continued to believe that this debt-for-equity exception continued to apply to partnerships.

In 2004, Congress ended the uncertainty, and amended Section 108 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. Any 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. The amended statute does not provide any guidance on how to determine the fair market value of the partnership interest issued.

Regulations

On October 30, 2008, the IRS issued proposed regulations, which provided a favorable 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.

Last month, the IRS issued final regulations, which kept substantially the same form as the proposed regulations, but include a few helpful modifications. 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 into account valuation factors such as illiquidity or minority discounts, which could lower the value. The final 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

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

the partnership's operations) for cash equal to their fair market value, and then liquidated.

Under the final regulations, this definition of "fair market value" can be used only if four requirements are met: (i) 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., all of the parties report consistently for tax purposes); (ii) 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; (iii) the debt-for-equity exchange is an arm's-length transaction (the final regulations clarify that transactions between a partnership and an existing partner or other related party with arm's length terms can qualify); and (iv) subsequent to the exchange, neither the partnership redeems, nor any person related to the partnership or any partner 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.

The final regulations clarify the proposed regulations by adopting a definition for "related" parties for purposes of the safe harbor (a "more than 50%" common ownership standard). The final regulations also remove from the proposed regulations the potentially troublesome requirement that the partnership maintain capital accounts in accordance with accounting rules set out in Treasury Regulations. On its face, this requirement seemed to dictate how the partnership kept its books, but did not require that those books have any impact on the partners' economic entitlements. In other words, while requiring capital accounts to be maintained, the proposed regulation seemed to contain no requirement that the partnership make liquidating distributions in accordance with the partners' capital account balances. Today, most partnership agreements direct that the partnership liquidate in accordance with stated percentages or a "waterfall," rather than in accordance with the partners' capital account balances. Along with the removal of the requirement, the Preamble to the final regulations explicitly states that "maintenance of capital accounts is not necessary to the determination of the liquidation value of the partner's interest."

The final regulations provide that 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. This raises the specter of IRS auditors applying steep discounts to value (for illiquidity and/or lack of control), resulting in larger amounts of COD income for partnerships that do not meet the safe harbor.

The final regulations also add some helpful guidance regarding tiered partnerships. Under the regulations, the "liquidation value" of an interest in an upper-tier partnership is determined by taking into account the "liquidation value" of the interest held in a lower-tier partnership.

Example

Partnership P has $1,000 of outstanding indebtedness owed to creditor C. In an arm's-length transaction, C agrees to contribute the debt to P, in exchange for an interest in P. If P sold all of its assets for cash equal to fair market value, and liquidated, the amount of cash C would receive with respect to the partnership interest issued to C is $700.

Assuming all of the safe harbor requirements are met, P can value the interest issued to C at its liquidation value. Thus, the fair market value of the partnership interest issued to C is deemed to be $700. P is treated as satisfying the $1,000 indebtedness with $700, and P will have $300 of COD income. The $300 of COD income must be included in the distributive shares of the persons who were partners in P immediately before the exchange.

Tax Consequences to the Lender

Additionally, the final regulations, consistent with the proposed regulations, amend the regulations under Section 721 of the Code, generally resulting in unfavorable tax consequences to a lender in a debt-for-equity exchange with a partnership borrower.

Background

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 final 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.

In the above Example, Section 721 would preclude C from recognizing a loss on its contribution. However, since C's basis in its partnership interest will be equal to C's adjusted basis in the contributed debt, C may recognize its loss either when it sells its partnership interest or when its interest is liquidated.

Tax Treatment of Contribution of Accrued Interest Obligations

The final regulations, similar to the proposed regulations, include an exception to Section 721 tax-free treatment for contributions to the partnership debtor of indebtedness for unpaid rent, royalties, or interest on indebtedness (including accrued original issue discount (OID)). In other words, a lender may have to recognize ordinary income to the extent that part of the debt contributed relates to such accrued interest. The final regulations generously narrow the exception provided in the proposed regulations. As proposed, the exception to tax-free treatment applied to all indebtedness for unpaid rent, royalties, or interest on indebtedness (including accrued original issue discount (OID)). However, under the final regulations, the exception applies only where the indebtedness accrued on or after the beginning of the creditor's holding period for the indebtedness.

Prior to 1980, if a lender contributed a corporation's accrued interest obligation to the corporation, in exchange for stock of the corporation, the lender was potentially eligible for tax-free treatment under Section 351 with respect to stock received in satisfaction of its claim for any accrued interest (if all the other requirements of Section 351 were met), even if the lender had not yet reported the accrued interest income. In 1980, Congress amended Section 351 so that tax-free treatment was no longer available in such a case. Thus, a cash-basis lender must recognize gain upon a contribution of an interest obligation to a debtor corporation. No parallel change was made in 1980 to the rules governing tax-free contributions to partnerships, with the result that a lender's contribution of a partnership's accrued interest obligation to the partnership, in exchange for a partnership interest, was believed by some to be tax free under Section 721. The final regulations resolve this issue; under these regulations a cash-basis lender must recognize taxable income on such a contribution to a partnership, to the extent the obligation accrued on or after the beginning of the creditor's holding period for the indebtedness. The regulations also clarify that the debtor partnership recognizes no gain or loss on this contribution.

The final regulations to Section 721 also provide that, for purposes of determining the respective portions of a partnership interest issued to a lender that are considered to be in exchange for principal indebtedness, interest, or OID, very specific ordering rules apply, under which payments of indebtedness are generally allocated first to accrued interest, and then to principal. For example, assume that creditor C, a cash-basis taxpayer, contributes indebtedness with (a) a principal amount of $1,000 (and an adjusted basis of $1,000), and (b) an accrued interest obligation of $200, to partnership P, in exchange for a partnership interest in P with a fair market value of $250. Under the ordering rules described above, the partnership interest would be applied first to the accrued interest obligation, and then to the principal obligation. Section 721 would then apply *only* to C's exchange of the principal indebtedness for a partnership interest; it would not apply to C's exchange of the interest obligation for a partnership interest. Therefore, C would have to report $200 of interest income, as a result of the satisfaction of the interest obligation with a partnership interest with a value of $200. The remaining partnership interest issued by P, valued at $50, would be transferred by P to C in exchange for the $1,000 principal obligation, resulting in no loss recognized by C, and a high carryover basis to C in its low-value partnership interest, equal to C's adjusted basis of $1,000 in the principal amount of debt contributed. These ordering rules clearly produce unfavorable results to C.

Installment Obligations

Proposed regulations are also expected to be issued soon that will clarify the tax consequences of a contribution of an installment obligation by a lender to a debtor partnership in exchange for a partnership interest.

Effective Date

The final regulations apply to debt-for-equity exchanges occurring on or after November 17, 2011.

Conclusion

The final regulations come at an opportune time and provide a favorable safe harbor for partnership borrowers looking to satisfy all or a portion of their debt with partnership interests granted to their lenders. The regulations provide clarity for both the borrower partnership and the lender in a debt-for-equity exchange. Unfortunately, however, the regulations confirm some unfavorable consequences to lenders by preventing lenders from recognizing gain or loss upon the exchange while requiring the partnership borrowers' current recognition of COD income. Additionally, many other unresolved COD issues that have become increasingly relevant in the current economic climate remain unaddressed, and we hope to see these issues resolved in future guidance.