DC BAR Taxation Section /
Passthroughs and Real Estate Committee

Emerging from the 2008-2009 Economic Downturn – Important Tax Issues You Should Know

Debt Workouts for Partnerships

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James B. Sowell, KPMG LLP
Blake Rubin, McDermott Will & Emery (Moderator)
Christian McBurney, Nixon Peabody LLP

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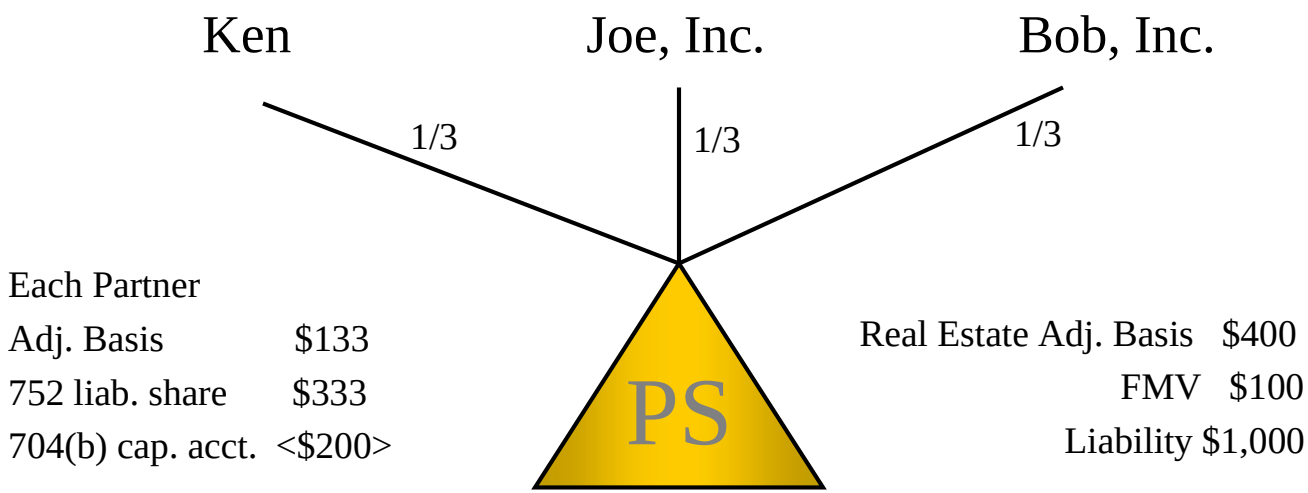
Basic Facts

Partnership Workouts – Basic Facts



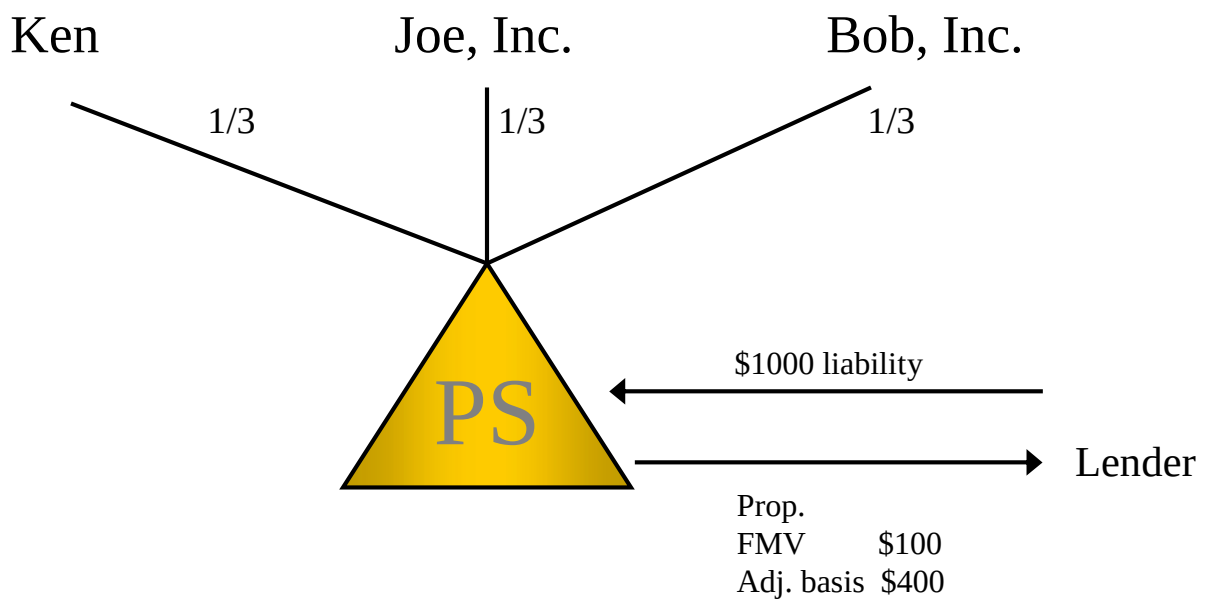
- Ken is a solvent individual.
- Joe, Inc. is a corporation that is insolvent by $100, not taking into account its investment in PS. Joe, Inc. has $300 in NOLs.
- Bob, Inc. is a corporation that is currently going through a bankruptcy reorganization under chapter 11. Bob, Inc. has $200 in NOLs that will expire next year.

Analyzing Debt Discharge Transactions

Recourse Debt

- PS is a general partnership and the debt is recourse to all of the partners.
- Lender forecloses and takes the property in complete satisfaction of the debt.
- Property is treated as sold for an amount of debt equal to the value of the property. Reg. §1.1001-2(c), ex. 8.
- To the extent that the amount of the debt exceeds the value of the property, debt relief will result in COD income. Rev. Rul. 90-16, 1990-1 C.B. 12.

Recourse Debt



Amt. real.	$100
– Adj. basis	$400
Cap. loss	<$300>

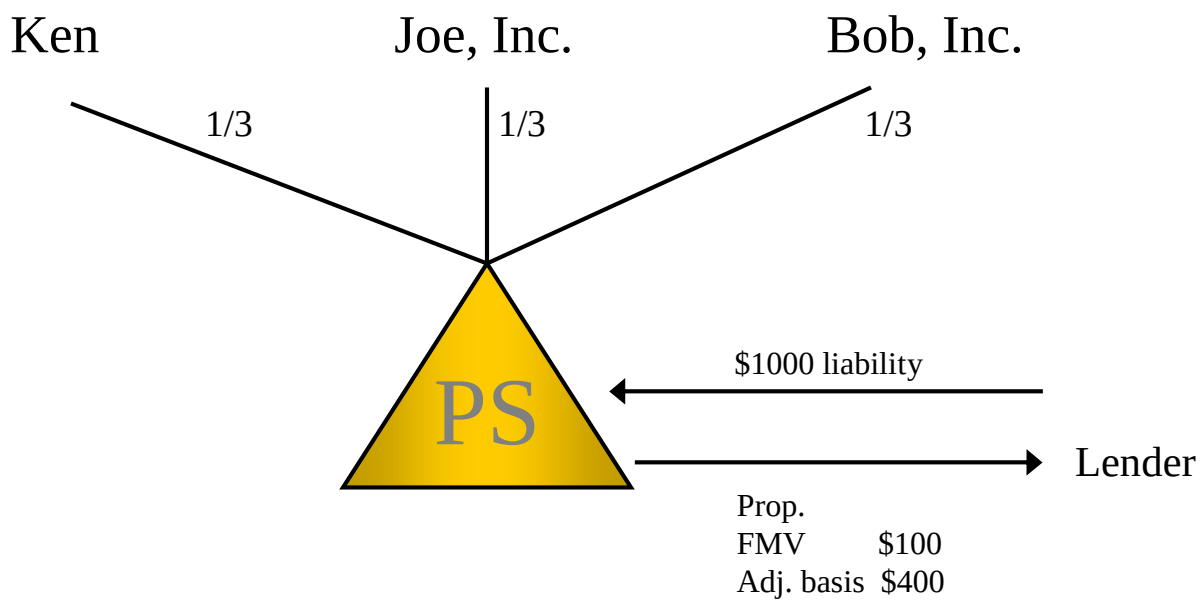
Remaining $900 of debt.

All COD income.

Nonrecourse Debt

- PS is an LLC and the debt is secured only by the property. Neither the partners nor the LLC are personally liable for the debt.
- Lender forecloses and takes the property in complete satisfaction of the debt.
- The property is treated as sold for the amount of the debt. Sales price is not limited to the value of the property. Reg. §1.1001-2(c), Ex. 7; Tufts, 461 U.S. 300 (1983).

Nonrecourse Debt



Amt. real.	$1,000
– Adj. basis	$ 400
Cap. gain	$ 600

No remaining debt.

No COD income.

Recourse or Nonrecourse Debt

- PS is an LLC and the debt is structured as a recourse debt with respect to PS (*i.e.*, the lender could reach all of the LLC's assets). The partners are not personally liable for the debt.
- Is this debt recourse or nonrecourse for purposes of analyzing the workout transaction?
  - Consider Great Plains Gasification Associates, 92 T.C.M. (CCH) 534 (2006) (general partnership where debt was secured by "all real or personal property 'now owned or herafter acquired' by the partnership"; court focused on section 752 rules in determining debt was nonrecourse)

Reduction in Debt Balance

- The lender agrees to reduce the balance of the debt to the value of the property (*i.e.*, $100). PS retains the property.
- Where a creditor reduces debt without foreclosing on the property, the debtor realizes COD income. Reg. §1.61-12(a). Accordingly, PS would have $900 of COD income.
- COD income is ordinary in character.

Nonrecourse Debt – Manipulation of Character

- Preference for COD income over capital gain?
- Could PS sell the property for cash, then transfer the cash in discharge of the indebtedness?
- If respected, this would result in PS recognizing a $300 capital loss and $900 of COD income.
- If property is sold "in connection with" the discharge of indebtedness, the result for the debtor will be as if the debtor gave the property to the lender in discharge of the debt. *Compare* 2925 Briarpark Ltd., 163 F.3d 313 (5th Cir. 1999), *with* Gershkowitz, 88 T.C. 984 (1987).
- Could PS transfer property to a third party subject to the debt, with the lender reducing the debt in connection with the transfer? *See* Reg. §1.1274-5(a) (modification of debt treated as occurring in a "separate" transaction).

Excluding COD Income

What are the Partners' Preferences?

- Assume that PS has $900 of COD income, and the income is allocated equally among the partners.
- Provisions of section 108 generally apply at the partner level. IRC §108(d)(6).
- Insolvency of PS is irrelevant to the partners. IRC §108(d)(6).

Partners' Preferences – Bob, Inc.

- Bob, Inc. is a bankrupt corporation with $200 in expiring NOLs.
- Bob, Inc. would like to exclude COD income by applying the general rules of section 108.
- Section 108 provides for the exclusion of COD income for bankrupt or insolvent taxpayers.
- Bankruptcy exclusion applies if the taxpayer is under the jurisdiction of a court in a title 11 case, and the discharge is granted by the court or is pursuant to a plan approved by the court. IRC §108(d)(2).

Partners' Preferences – Bob, Inc. – Attribute Reduction

- When a taxpayer excludes COD income under bankruptcy or insolvency exceptions, must reduce certain tax attributes. IRC §108(b)(4).
- Tax attributes generally reduced in the following order:
  - Net operating losses
  - General business credits
  - Minimum tax credits
  - Capital loss carryovers
  - Property basis
  - Passive activity loss and credit carryovers
  - Foreign tax credit carryovers
- Attribute reductions are made after taxpayer determines tax liability for the taxable year of discharge. IRC §108(b)(4).

Partners' Preferences – Bob, Inc. – Attribute Reduction

- Bob, Inc. eliminates NOL carryover of $200, then reduces basis.
- Aggregate basis reduction cannot exceed the excess of the aggregate basis of property and money held immediately after the discharge over the aggregate liabilities of the taxpayer immediately after the discharge. IRC §1017(b)(2).
- If Bob, Inc. reduces its basis in its PS interest, it does not appear that a corresponding basis reduction will be made to the assets of the partnership.
- Basis reduction creates ordinary income recapture potential. IRC §1017(d).

Partners' Preferences – Joe, Inc. – Measuring Insolvency

- Disregarding the investment in PS, the liabilities of Joe, Inc. exceed the value of its assets by $100.
- An insolvent taxpayer can exclude COD income only to the extent of its insolvency.
- A taxpayer is insolvent to the extent that the amount of its liabilities exceed the fair market value of its assets, determined immediately before the discharge. IRC §108(a)(3) and (d)(3).

Partners' Preferences – Joe, Inc. – Measuring Insolvency

- If a nonrecourse liability is being discharged, the excess of the nonrecourse liability over the value of the property will be treated as a liability in measuring insolvency to the extent that the excess is discharged. Rev. Rul. 92-53, 1992-2 C.B. 48.
- If the nonrecourse debt is not being discharged, treat the debt as a liability only to the extent of the value of the property securing the debt. Id.
- How does a partner's share of partnership liabilities affect the insolvency determination?

Partners' Preferences – Joe, Inc. – Basis Reduction First

- Assume that Joe, Inc. is insolvent by $400.
- Joe, Inc. would like to retain its $300 NOL.
- Rather than applying the general attribute reduction ordering rule, Joe, Inc. may elect first to reduce the basis of its depreciable property under section 108(b)(5).

Partners' Preferences – Joe, Inc. – Basis Reduction First

- A partner may elect to treat a partnership interest as depreciable property to the extent of the partner's share of depreciable property held by the partnership. IRC §108(b)(3)(C).
  - There are request-and-consent procedures pursuant to which the partnership will make corresponding adjustments to the basis of the property held by the partnership. Reg. §1.1017-1(g)(2)(ii).
- A taxpayer also may elect to treat real property described in section 1221(a)(1) as depreciable property. IRC §1017(b)(3)(E).

Partners' Preferences – Ken Qualified Real Property Business Indebtedness

- Ken is not bankrupt or insolvent.
- However, Ken is an individual, and thus he can take advantage of the provisions relating to qualified real property business indebtedness. IRC §108(a)(1)(D).

Partners' Preferences – Ken Qualified Real Property Business Indebtedness

- Qualified real property business indebtedness is indebtedness which:
  - was incurred or assumed by the taxpayer in connection with real property used in a trade or business and is secured by such real property;
  - was incurred or assumed before January 1, 1993, or was incurred or assumed after that date to acquire, construct, reconstruct, or substantially improve such property, and
  - with respect to which the taxpayer makes an election.
- Can debt secured by "dealer" property qualify?
- Is "Mezz Debt" secured by an interest in a disregarded entity that owns real property treated as actually "secured by" the real property?

Partners' Preferences – Ken Qualified Real Property Business Indebtedness

- When COD income is excluded with respect to qualified real property business indebtedness, the taxpayer must reduce the basis of depreciable real property.
  - As with section 108(b)(5), a partner may elect to treat its interest in a partnership as depreciable real property to the extent of the partner' share of such property held by the partnership. Request-and-consent procedures are the same for inside basis reduction. IRC §1017(b)(3)(F)(i).
  - A taxpayer may not treat section 1221(a)(1) real property as depreciable real property.

Partners' Preferences – Ken Qualified Real Property Business Indebtedness

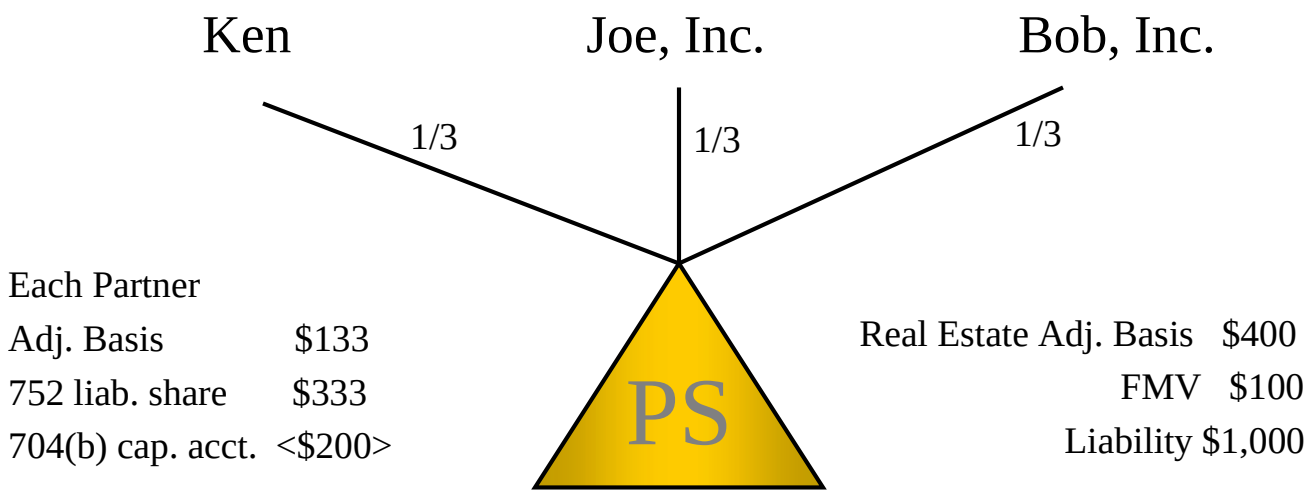
- Limitations for qualified real property business indebtedness.
  - The amount excluded cannot exceed the excess, if any, of the outstanding principal of the qualified real property business indebtedness immediately before the discharge over the net fair market value of the qualifying real property immediately before the discharge. IRC §108(c)(2)(A).
  - Excluded COD income cannot exceed total adjusted basis in depreciable real property reduced by (1) depreciation claimed with respect to such property for the year of the discharge and (2) reductions to the basis of the property pursuant to section 108(b) (the general attribute reduction provision). IRC §108(c)(2)(B).

Purchase Money Debt Reduction

- If debt of a purchaser to a seller of property that arose out of the purchase of such property is reduced, and the reduction otherwise would give rise to COD income for the debtor, then the reduction will be treated as a purchase price adjustment. IRC §108(e)(5).
- Rule is mandatory, not elective.
- Rule does not apply where debtor is bankrupt or insolvent. IRC §108(e)(5)(B).
- Rule may apply in partnership context where partnership is bankrupt or insolvent. Rev. Proc. 92-92, 1992-2 C.B. 505. (Remember, bankruptcy and insolvency exceptions apply at partner level.)

Deferring COD Income

Partner Preferences - COD Income Deferral under Section 108(i)



- What if Ken is a solvent individual, Bob, Inc. is a bankrupt corporation, and Joe, Inc. is a solvent corporation and lender agrees to reduce debt to $100 without foreclosing?

Partner Preferences - COD Income Deferral under Section 108(i)

- Under section 108(i), COD income may be deferred under certain circumstances.
- Requirements for deferral under section 108(i)
  - Taxpayer holds an “applicable debt instrument” (“ADI”).
  - There is a “reacquisition” of the ADI in 2009 or 2010.
  - The reacquisition results in COD income to the taxpayer.
  - Taxpayer elects to defer the COD income under section 108(i).

Partner Preferences - COD Income Deferral under Section 108(i)

- Deferred COD income included in gross income ratably over the 5-taxable-year period beginning with -
  - For reacquisitions in 2009 -
    - The fifth taxable year following the taxable year in which the acquisition occurs.
  - For reacquisitions in 2010 –
    - The fourth taxable year following the taxable year in which the acquisition occurs.
- Bankruptcy, insolvency, farming, and QRPBI exceptions do not apply for any year with respect to the deferred COD income.

Partner Preferences - COD Income Deferral under Section 108(i)

- An ADI is any debt instrument issued by:
  - A C corporation; or
  - Any other person (e.g., partnership) in connection with a trade or business by such person.
- A “debt instrument” is broadly defined to include any contractual arrangement constituting indebtedness under section 1275(a)(1).

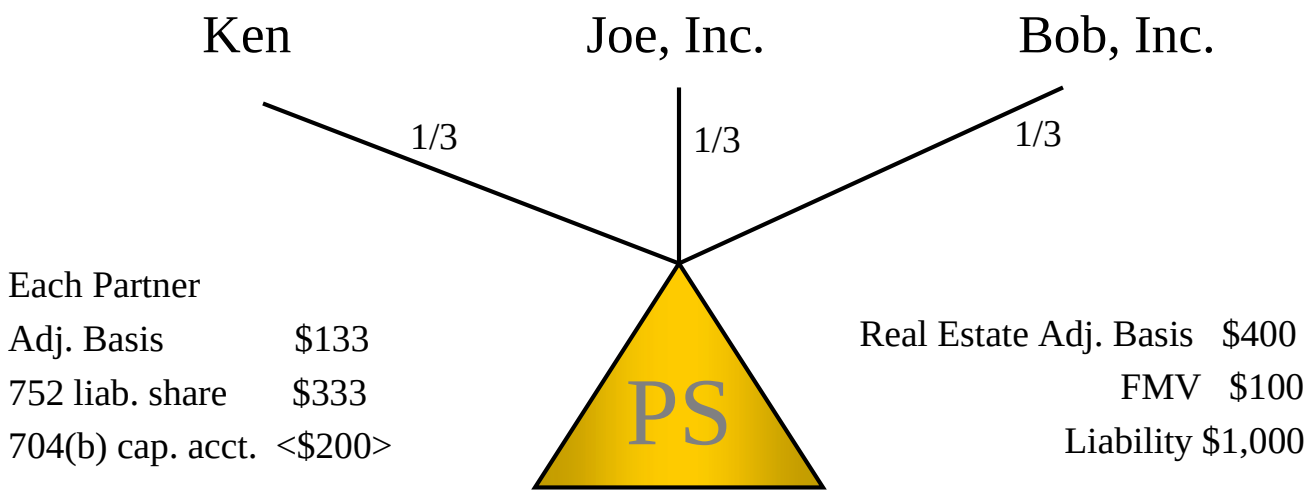
Partner Preferences - COD Income Deferral under Section 108(i)

- The term “reacquisition” means any “acquisition” of an ADI by the debtor/obligor or a related person (within the meaning of section 108(e)(4)).
- The term “acquisition” <u>includes</u> –
  - Acquisition for cash (or other property under Rev. Proc. 2009-37)
  - Exchange for another debt instrument (IRC §108(e)(10))
    - Includes modifications treated as exchanges (Reg. §1.1001-3).
  - Exchange for corporate stock or partnership interest (IRC §108(e)(8)).
  - Contribution to capital (see IRC §108(e)(6) for corporations).
  - Complete forgiveness of the instrument by the holder.

Partner Preferences - COD Income Deferral under Section 108(i)

- Pass-thru entity (e.g., partnership, S corporation) must make election (IRC §108(i)(5)(B)(iii)), but Rev. Proc. 2009-37 provides flexibility
  - A taxpayer can elect to defer COD income with respect to only a portion of a debt instrument.
  - This sets up a “deferred amount” and “included amount” with respect to a debt instrument.
  - While the partnership must allocate the total COD to the partners present immediately prior to the discharge under section 704(b), it can divide the “deferred amount” and “included amount” among the partners in the manner that it chooses.
  - A partner can still take advantage of the bankruptcy, insolvency, and QRPBI exceptions with respect to its allocated “included amount.”

Partner Preferences - COD Income Deferral under Section 108(i)



- What if the debt is recourse and the lender does foreclose?
  - Is there a difference if the partnership has other assets that it will retain?

Partner Preferences - COD Income Deferral under Section 108(i)

- The following events will cause the deferred COD income to be currently included in income:
  - Death
  - Liquidation or sale of substantially all the assets of the taxpayer (including in a title 11 or similar case).
  - Cessation of business by the taxpayer, or
  - Circumstances similar to those above.
  - In pass-thru entity case, the sale, exchange, or redemption of an entity interest.

Partner Preferences - COD Income Deferral under Section 108(i)

- Section 752(b) deemed distribution not taken into account at the time of discharge, but only to the extent it would cause gain under section 731.
  - Could result in suspended losses or gain from future distributions.
  - Deferred deemed distribution taken into account by partner "at the same time, and to the extent remaining in the same amount," as the deferred COD income under section 108(i) is recognized.
  - For tiered partnerships, Rev. Proc. 2009-37 provides reduction in deemed distribution is determined at debtor-partnership level and is not re-calculated at upper-tier partnership level
  - Partnership must know partners' adjusted bases in order to calculate the deferred deemed distribution under section 752. If partnership does not undertake reasonable efforts to determine this information, Rev. Proc. 2009-37 provides that section 108(i) election can be invalidated.

Partner Preferences - COD Income Deferral under Section 108(i)

- If OID is created in “reacquisition,” OID deductions are deferred so as to match COD income deferred under section 108(i).
- Statute provides specific regulatory authority to provide rules for the application of section 108(i) to pass-thru entities.

Partner Preferences - COD Income Deferral under Section 108(i)

- Rev. Proc. 2009-37 provides detailed rules regarding:
  - How to make the election under section 108(i); and
  - Required reporting for the partnership and partners once such an election is made
- If made section 108(i) election with a return filed prior to September 16, 2009, and election does not meet the requirements of Rev. Proc. 2009-37, need to file amended return by November 16, 2007 (that's Monday!) providing information that complies with the Rev. Proc.

Admission of Lender

Admission of Lender

- The partners may choose to admit the lender as a partner in exchange for eliminating some or all of the debt.
- Does the contribution of debt qualify under section 721?
  - What did the lender originally advance (*e.g.,* cash, services, rents, royalties)?
  - What if the contributed debt has accrued interest outstanding?

Admission of Lender

- If the lender does not receive a partnership interest with a value equal to the debt contributed, is there COD income?
  - There used to be support for the position claiming that there is a partnership debt-for-equity exception. *Cf.,* Capento Securities, 47 BTA 691 (1942), *aff'd*, 140 F.2d 382 (1st Cir. 1944).
  - But 2004 Act adopted corporate rule under section 108(e)(8) for partnerships.
  - Thus, partnership has COD income to the extent that debt amount contributed exceeds the "fair market value" of partnership interest transferred.
    - What is fair market value in this context?

Admission of Lender

- Proposed regulations provide that, for purposes of section 108(e)(8), the FMV of partnership interest is its liquidation value if –
  - Debtor partnership determines and maintains partners' capital accounts under Reg. §1.704-1(b)(2)(iv);
  - Creditor, debtor partnership, and its partners treat the FMV of the interest as the liquidation value for this purpose,
  - The exchange is an arm's-length transaction, and
  - Subsequent to the exchange, neither the partnership redeems, nor any person related to the partnership purchases, the interest as part of a plan with a principal purpose to avoid COD income.

Admission of Lender

- Liquidation value is the amount of cash the creditor would receive with respect to the interest if, immediately after the transfer, the partnership sold all its assets for cash (at FMV) and liquidated.
- Otherwise, FMV of interest is based on all the facts and circumstances.

Admission of Lender

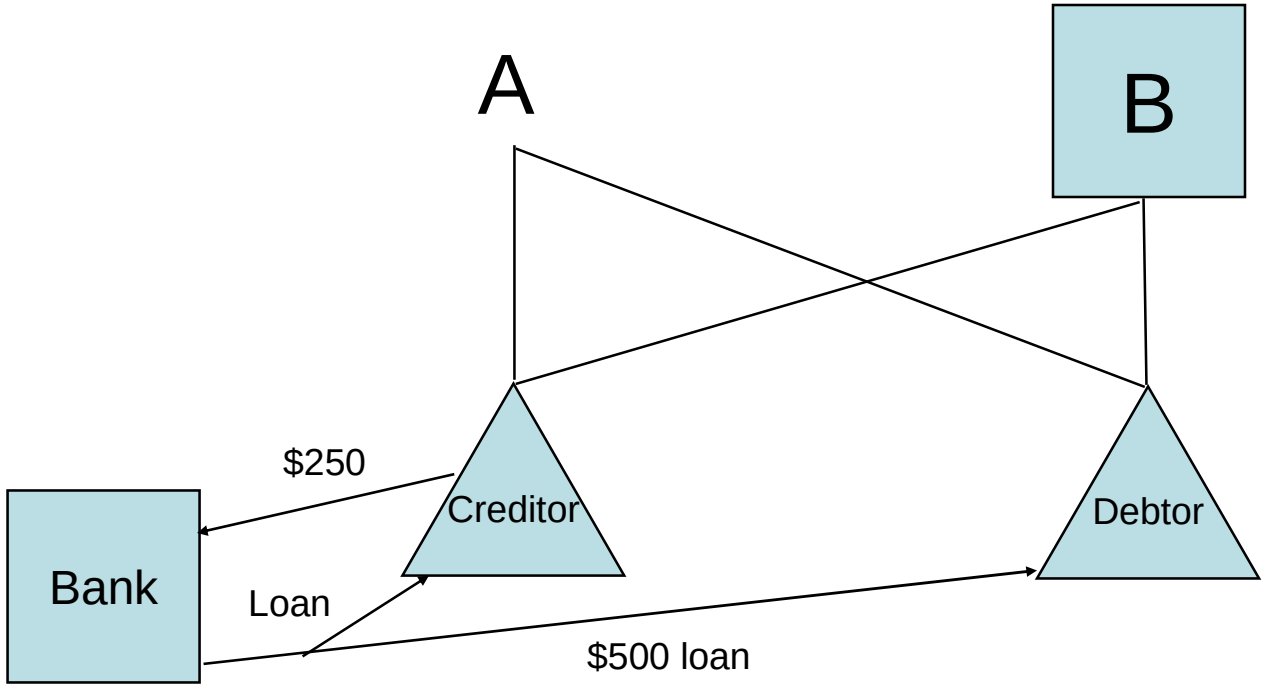
- Proposed regulations provide that the contribution is treated as a contribution under section 721 of the entire debt instrument, even though part of debt is treated as forgiven.

Third-Party Debt Acquisition

Acquisition of Debt

- Rather than discharging a liability for less than the face amount of the debt, partners may defer COD income by having a third party acquire the debt from lender.
- If the party acquiring debt is related to the debtor (or acquires debt "in anticipation of becoming related to the debtor"), the debtor will be treated as acquiring its own debt, thus triggering COD income. IRC §108(e)(4).
- If section 108(e)(4) applies, adjusted issue price of purchased debt is generally purchase price of debt
  - Stated redemption price at face amount creates significant OID
  - AHYDO rules under section 163(e)(5) can create interest disallowance for corporate partners of debtor/partnership

Acquisition of Debt



- Creditor partnership buys $500 loan from bank for $250.

- In creditor partnership's hands, loan is treated as re-issued with a $250 adjusted issue price and $500 stated redemption price at maturity, thus creating $250 of OID
- A and B have OID income accrual from creditor partnership and OID deduction accrual from debtor partnership, but a significant portion of B's deduction is disallowed under section 163(e)(5)
- 2009 legislation suspending AHYDO rules does not apply to related-party debt.

Debt Modifications

Debt Modifications

- Parties must be careful to analyze whether there is a "significant modification" of debt, thus triggering a deemed re-issuance of debt. Reg. §1.1001-3(b).
- If debt is not publicly traded within 30 days before or after the deemed re-issuance, the adjusted issue price of the new debt may be the stated redemption price at maturity or stated principal amount.
  - If party purchased debt at discount, would trigger significant gain with respect to the debt.
  - The "potentially abusive situation" rule in Reg. §1.1274-2(b)(3) could cause the adjusted issue price to equal the fair market value of the debt as of the date of re-issuance if the "recent sales transaction" rule under Reg. §1.1274-3(a)(2)(i) applies.

Debt Modifications

- If a restructuring significantly modifies existing debt, new debt/equity is deemed exchanged for old debt.
- General test is facts and circumstances.
- Specific Rules
  - Change in Yield
  - Change in Timing
  - Change of Obligors
  - Change in Security
  - Change in Nature of Debt Instrument

Debt Modifications

- Deterioration in financial condition of obligor is ignored in determining whether a significant modification has occurred <u>unless</u> there is a new obligor, or a co-obligor is added or deleted. Reg. §1.1001-3(e)(5)(i).
- If debt terms are modified so that there otherwise is a significant modification of the debt instrument, will a deterioration in the obligor's financial condition be considered in determining whether the new instrument is debt or equity?

Allocation of Debt Discharge Income and Deemed Distributions

Allocation of Discharge Income

- Substantial economic effect (IRC §704(b))
- Section 704(c) built-in gain
- Partnership minimum gain (Reg. §1.704-2)
  - A lender bears the economic burden of deductions or losses that are financed with nonrecourse debt (*i.e.*, nonrecourse deductions). These deductions are allocated in accordance with the partners' interests in the partnership.
  - To the extent that a nonrecourse liability exceeds the basis (or book value where the property has been revalued) of the partnership property that secures the liability, a disposition of the property will generate gain that is at least equal to the amount of such excess. This is partnership minimum gain.
  - Where gain is recognized or debt is reduced, minimum gain chargeback will allocate income and gain among partners to reverse nonrecourse deductions previously allocated.

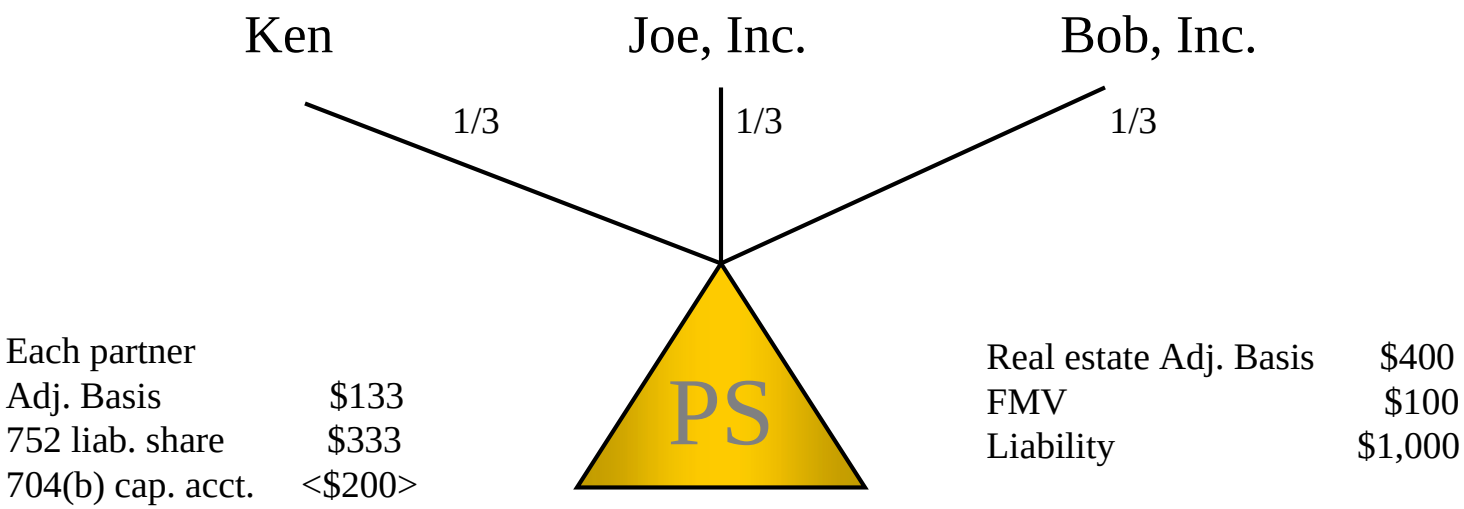
Allocation of Discharge Income

- With respect to income from a workout of recourse debt, or nonrecourse debt where minimum gain does not exist, the general rules relating to substantial economic effect will apply.
- Legislative history to 1980 Bankruptcy Tax Act assumes that COD income will be allocated among partners in the same way that the discharged liability was shared by the partners under section 752.
- Rev. Rul. 92-97, 1992-2 C.B. 124, recognizes that, in some cases, COD income may be validly allocated in a manner other than how the liability is shared.

Allocation of Discharge Income

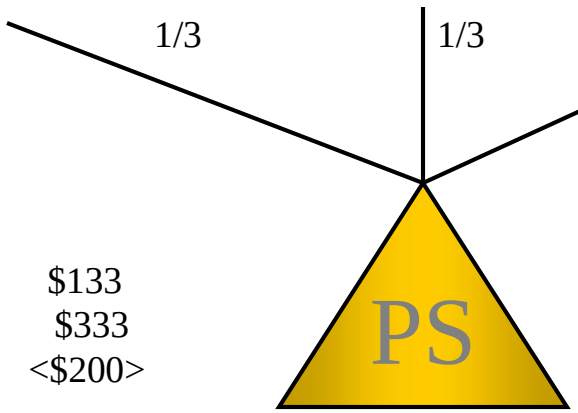
- Sale gain recognized from the discharge of indebtedness (*i.e.*, foreclosure sales) will be allocated pursuant to the terms of the partnership agreement, assuming such allocations have substantial economic effect, just as any other gain would be.
- Section 704(c) must be taken into account in allocating the gain.

Allocation of Discharge Income - Recourse Debt



- PS agreement provides for *pro rata* allocation of all income, gain, loss and deductions.
- $300 capital loss is allocated equally, $100 to each partner.
- $900 of COD income is allocated equally among partners.
- Capital account: <$200> (beginning balance) - $100 (capital loss) + $300 (COD income) = -0-

Allocation of Discharge Income - Recourse Debt



Each partner	
Adj. Basis	$133
752 liab. share	$333
704(b) cap. acct.	<$200>

Real estate Adj. Basis	$400
FMV	$100
Liability	$1,000

- PS agreement provides that all COD income will be allocated to Bob, Inc.
- $300 capital loss is allocated equally to each partner.
- $900 of COD income is allocated entirely to Bob, Inc.
- Bob, Inc. Capital Acct.: <$200> (beginning balance) - $100 (capital loss) + $900 (COD income) = $600
- Ken and Joe, Inc. Capital Accts.: <$200> (beginning balance) - $100 (capital loss) = <$300>

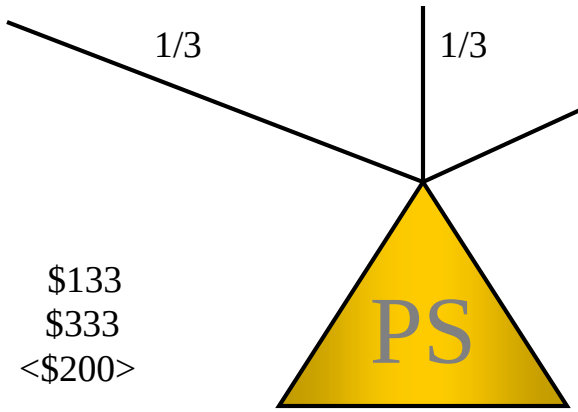
Allocation of Discharge Income – Recourse Debt

- Do Ken and Joe, Inc. have deficit restoration obligations that remain in effect after discharge of debt?
- Rev. Rul. 99-43, 1999-2 C.B. 506, provides that a special allocation of COD income to an insolvent partner will not be respected where the partnership agreement is amended after the COD income has been realized.

Allocation of Discharge Income

- Where minimum gain exists with respect to the discharged liability, the minimum gain chargeback rules must be considered.
- Reduction or elimination of debt will reduce minimum gain, thus triggering a chargeback.
- Income and gain are allocated pursuant to a chargeback of minimum gain in the following order:
  - first, gain from the disposition of property subject to the nonrecourse debt;
  - second, as a *pro rata* portion of the partnership's other items of income and gain for that year.

Allocation of Discharge Income - Nonrecourse Debt



Each partner

Adj. Basis	$133
752 liab. share	$333
704(b) cap. acct.	<$200>

Real estate Adj. Basis	$400
FMV	$100
Liability	$1,000

- PS agreement provides that sale gain is allocated to Bob, Inc.
- Partnership minimum gain is equal to $600. Each partner has been allocated $200 in nonrecourse deductions so each partner's share of partnership minimum gain equals $200.
- By virtue of eliminating debt, partnership minimum gain is reduced to -0-.
- $600 of capital gain must be allocated to chargeback minimum gain; $200 will be allocated to each partner.
- Capital acct.: <$200> (beginning balance) + $200 (capital gain) = -0-.

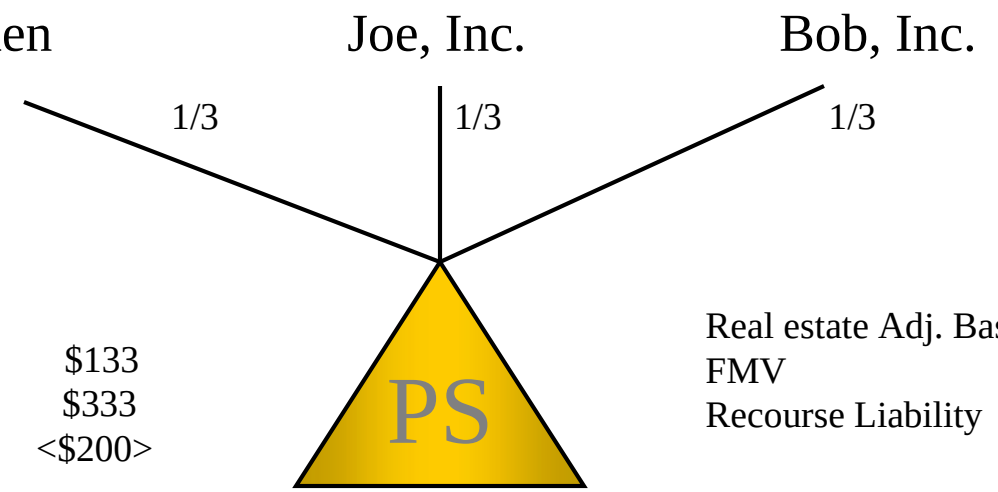
Gain from Liability Reduction

- Reduction in liability results in a deemed distribution to partners under section 752(b).
- Distribution in excess of a partner's basis in its partnership interest will cause the partner to recognize gain under section 731.
- COD income increases a partner's basis in its partnership interest, even if the income is excluded under section 108. PLR 9739002.

Gain from Liability Reduction

- Rev. Ruls. 92-97 and 94-4 both treat a deemed distribution to a partner resulting from debt cancellation as an advance or drawing against a partner's share of income, so that the distribution is deemed to be made on the last day of the partnership's taxable year.
- Thus, if the partnership allocates COD income consistent with its allocation of liabilities, the deemed distribution should not trigger gain.

Gain from Liability Reduction



Each partner

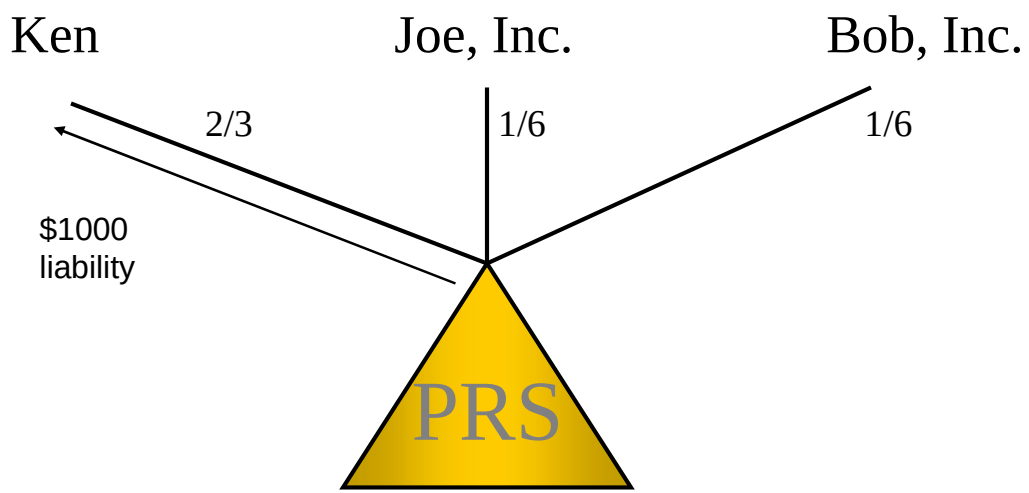
Adj. Basis	$133
752 liab. share	$333
704(b) cap. acct.	<$200>

Real estate Adj. Basis	$400
FMV	$100
Recourse Liability	$1,000

- PS agreement provides that all COD income will be allocated to Bob, Inc. Ken and Joe, Inc. each have a deficit restoration obligation.
- Bank forecloses. $300 capital loss is allocated equally among the partners, and all $900 of the COD income is allocated to Bob, Inc.
- Results for Ken and Joe, Inc.: $133 (beginning adj. basis) - $100 (capital loss) - $333 (752(b) deemed dist.) = $300 dist. in excess of basis.

Partner/Creditor Issues

Partner/Creditor Issues



- PRS holds real property with a value of $500.
- Ken has loaned money to PRS ("Creditor Partner").
- *Bona fide* indebtedness (i.e., not equity)?

Foreclosure – Creditor Partner Considerations

- Ken forecloses on property in full satisfaction of debt owed by PRS.
- Ken may realize section 1271/165 loss on satisfaction of loan with the property.
  - Section 1271/165 losses may be subject to disallowance in this situation under section 707(b)(1), as Ken owns more than 50% of PRS.
  - Might Reg. §1.166-6(a) provide for a bad debt deduction?

Alternatives to Consider

- Ken should consider potential alternatives in anticipation of a workout.
  - Can Ken take a partial charge-off of the loan?
    - PRS remains liable for full amount of the loan.
  - Is contribution of the loan to the equity of the partnership desirable?

Partial Charge-off of Loan

- Ken may be able to take a section 165 (capital loss) or 166 (ordinary) loss on any charged off loan receivable.
  - Rules depend on type of partner and type of debt

Partial Charge-off of Loan

- If “business bad debt” as to the Creditor Partner
  - Ordinary section 166 deduction.
  - May be a complete deduction in year that debt becomes wholly worthless, or partial deduction to extent of A/B of debt charged off.
  - Not subject to disallowance under sections 707(b)(1) and 267 because is not an exchange loss.
- If non-business bad debt:
  - Section 165 STCL in year that debt becomes wholly worthless.
  - No deduction for partial worthlessness. Reg. §1.166-5(a)(2).
  - Deemed exchange loss but query whether could be subject to disallowance under sections 707(b)(1) and 267?

Partial Charge-off of Loan

- Determining if debt is “business bad debt”
  - Corporate Creditor Partner
    - Business bad debt deduction rules always apply.
  - Non-corporate creditor partner
    - Must determine if debt is properly classified as “business.” *See* IRC §166(d)(2); Reg. §1.166-5(b).
  - Pass-thru Creditor Partner that has only corporate partners?
    - Unclear whether proper to apply the “Corporate Creditor Partner” rules above.

Contribution of Loan to Equity of PRS?

- Ken may consider contributing all or a portion of the loan receivable to PRS in exchange for an equity interest.
- Proposed regulations provide that the contribution is treated as a contribution under section 721 of the entire debt instrument, even though part of debt is treated as forgiven.
- Ken increases his basis in its partnership interest by the full basis in the debt contributed.

Presenters' contact details

James B. Sowell
KPMG LLP
(202) 533-5170
jsowell@kpmg.com

Blake D. Rubin
McDermott Will & Emery LLP
(202) 756-8424
brubin@mwe.com

Christian M. McBurney
Nixon Peabody LLP
(202) 585-8358
cmcburney@nixonpeabody.com