

Tax Considerations in Partnership Debt Workouts

by Karen A. Hayes

A FREEBORN & PETERS LLP CLIENT ALERT

A partnership (including a limited liability company taxed as a partnership) that is contemplating a workout or restructuring of the partnership's debt should consider the various tax issues that could affect the partnership and its partners. There are potential tax pitfalls that may need to be addressed, as well as possible planning opportunities. This Client Alert details how to address those pitfalls.



Discharge of Indebtedness Income: In General

When a lender reduces or cancels the amount of a partnership's debt owed, this generally causes the partnership to recognize taxable income, which flows through the partnership and is allocated among its partners.

The type of taxable income that is recognized depends on whether the partnership surrenders property in exchange for the forgiveness of debt. In the simplest scenario, a lender reduces the amount of debt the partnership owes without receiving any property in exchange. In that case, the partnership will recognize taxable income in the form of cancellation of indebtedness (COD) income equal to the amount of the reduced debt. COD income is taxed at ordinary income rates.

If, on the other hand, the partnership surrenders property to the lender in a foreclosure or similar transaction, the analysis is more complicated and the tax consequences largely depend on whether the loan is recourse or nonrecourse. In general, a loan is recourse if the borrower is personally liable for repayment of the debt; if the borrower is not personally liable, the loan is nonrecourse.

If the partnership transfers property in exchange for a reduction in recourse debt, the transaction is bifurcated and analyzed in part as a sale and in part as discharge of indebtedness. First, the partnership is treated as selling the property for an amount of the debt equal to the property's fair market value. The partnership will recognize gain or loss equal to the difference between the property's value and the partnership's adjusted tax basis in the property. In addition, to the extent the amount of debt that is cancelled exceeds the value of the property, the partnership will recognize COD income.

If property is transferred to satisfy nonrecourse debt, the results are different. The transaction is treated as a sale or exchange, and the partnership recognizes taxable gain (or loss) equal to the difference between the amount of the debt and the partnership's adjusted tax basis in the property surrendered. No COD income is recognized, even if the amount of the cancelled debt exceeds the value of the transferred property.

With advance planning, it may be advantageous to structure a debt workout in a manner that generates COD income instead of taxable gain, or vice versa, if the partners prefer to recognize one type of income instead of the other. The partners may prefer to recognize COD income if they plan to take advantage of one of the exclusions described below. Alternatively, the partners may prefer to recognize gain if they would not qualify for any COD income exclusions, but would qualify for lower rates of tax on capital gain. Whether such a structuring opportunity is available will depend on the facts and the parties involved.

Allocation of COD Income to Partners

COD income resulting from a partnership debt workout is generally allocated to the partners in accordance with the terms of the partnership agreement. A partner's allocable share of COD income increases that partner's basis in his or her partnership interest. In addition, the reduction in a partner's share of the partnership's liabilities as a result of the workout is treated as a deemed distribution to that partner. This deemed distribution may result in gain recognition if the partner has insufficient tax basis in his or her partnership interest.

Excluding COD Income

The Internal Revenue Code has special rules that permit taxpayers in the situations described below to exclude some or all of their COD income from taxable income. These exclusions apply to COD income only, and not to the taxable gain that may arise if property was exchanged for the reduction in debt.

Bankruptcy or Insolvency. COD income is generally excluded if the debt was discharged in a title 11 bankruptcy case. In the partnership context, the bankruptcy exclusion applies at the partner level. Therefore, this exclusion is only available if the partner (and not just the partnership) is a debtor in a bankruptcy case.

The Internal Revenue Code also excludes COD income to the extent the taxpayer is insolvent. Like the bankruptcy exclusion, the insolvency exclusion applies at the partner level. The amount of COD income that a partner may exclude is limited to the amount of the insolvency. For this purpose, a taxpayer is "insolvent" to the extent its liabilities exceed the fair market value of its assets. The calculation is determined based on the amount of assets and liabilities immediately prior to the debt discharge.

If a partnership is bankrupt or insolvent, but its partners are not, it may consider converting to a C corporation in order to take advantage of the COD income exclusions that would otherwise apply only at the partner level. There are several tax issues that should be evaluated before undertaking a C corporation conversion in this scenario, including whether or not the conversion would be respected for tax purposes. It is also possible that a conversion could cause other unintended tax consequences that would need to be taken into account.

Qualified Real Property Indebtedness. A partner that is not a C corporation may qualify for a COD income exclusion for the discharge of debt that constitutes qualified real property indebtedness. Debt qualifies for this exception if:

- (1) it was incurred in connection with real property used in a trade or business and is secured by the real property, and
- (2) it was incurred before January 1, 1993, or was incurred after that date to acquire, construct, reconstruct, or substantially improve the real property. The taxpayer must affirmatively make an election in order to have the exception apply.

Tax Attribute Reduction. The trade-off to excluding taxable income under these exceptions is that the taxpayer must make corresponding reductions to favorable tax attributes to the extent of the amount of the COD income that was excluded. In the case of the bankruptcy or insolvency exception, the attribute reductions are generally made to net operating losses, tax credits, capital loss carryovers, basis in assets, passive activity loss and credit carryovers, and foreign tax credit carryovers. If a taxpayer elected to apply the qualified real property indebtedness exclusion, the taxpayer must reduce its tax basis in depreciable real property. Consequently, excluding COD income under one of these exceptions often results in a deferral of tax, rather than a complete exemption from tax.

Conclusion

A partnership that is undergoing a debt restructuring or workout should consider the potential for taxable income or gain recognition that could impact its partners, as well as various COD income exclusions and other possible planning techniques that could potentially mitigate these negative tax consequences.

If you have questions, please contact Karen Hayes at khayes@freeborn.com or 312-360-6545, or another member of Freeborn's Tax Team.

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