DEBT WORKOUTS: THE PARTNERSHIP AND THE PARTNERS

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This outline is based, in part, on an article entitled Partnership Workouts: Is It That Time Again? that previously was published at 42 Tax Mgmt. Memo. (BNA) 414 (Sept. 10, 2001). That article was then expanded upon in Troubled Partnerships: Debt Workouts and Other Issues, 62 NYU Inst. on Fed. Tax’n 12-1 (2004). Although this author has published various outlines in a number of venues since the publication of those articles that rely, in part, on those materials, this outline was independently developed in July 2007 by going back to Troubled Partnerships: Debt Workouts and Other Issues, and bringing the materials in that article up-to-date. This outline has been updated since that time. This outline is published with the permission of both BNA and Matthew Bender.

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TABLE OF CONTENTS

I. Introduction ......................................................................................................... 1

II. Income From Discharge Of Indebtedness ............................................................ 1
   A. Transfers of Properties in Satisfaction of Recourse Liabilities .......................... 2
   B. Transfers of Properties in Satisfaction of Nonrecourse Liabilities ................. 3
      1. In General ............................................................................................ 3
      2. Planning for COD Income or Sale Gain ................................................ 4
   C. Transfer of Properties in Satisfaction of Partially Recourse Liabilities .......... 6
      1. Top Guarantee ...................................................................................... 6
      2. Bottom Guarantee ................................................................................ 7
   D. Release of a Guarantee ................................................................................ 8
   E. Treatment of LLC Debt ............................................................................. 9

III. Discharge of Partnership Liabilities ................................................................... 12
   A. Allocation of Partnership Liabilities.......................................................... 12
      1. Recourse Liabilities ............................................................................ 13
      2. Nonrecourse Liabilities ...................................................................... 14
   B. Allocation of Partnership Income in a Workout ........................................ 14
      1. Substantial Economic Effect .............................................................. 15
      2. Partnership Minimum Gain ................................................................ 15
      3. Partner Minimum Gain ...................................................................... 16
      4. COD Income and Minimum Gain ...................................................... 16
      5. COD Income and Economic Effect .................................................... 17
      6. COD Income and Substantiality ......................................................... 22
      7. Sale Gain and Section 704(c) ............................................................. 22
   C. Deemed Distributions and Gain Recognition ............................................ 23
      1. Deemed Distributions ......................................................................... 23
      2. Basis Increase for COD Income ......................................................... 23
      3. Timing of Deemed Distribution ......................................................... 23

IV. Exclusion or Deferral of COD Income Realized by a Partnership ..................... 24
   A. Bankruptcy and Insolvency ....................................................................... 24
      1. Exclusion ........................................................................................... 24
         a. In General ....................................................................................... 24
         b. Bankruptcy ..................................................................................... 25
         c. Insolvency ...................................................................................... 26
      2. Reduction of Tax Attributes ................................................................ 31
         a. General Attribute Reduction ........................................................... 31
         b. Rules Applying to Basis Reduction ................................................ 32
         c. Election to Reduce Basis First Under Section 108(b)(5) .................... 33
   B. Qualified Real Property Business Indebtedness ........................................ 35
      1. Exclusion ........................................................................................... 35
         a. In General ....................................................................................... 35
         b. Equity Limitation .......................................................................... 36
         c. Basis Limitation ............................................................................ 37
         d. Identifying the Qualifying Portion of a Debt .................................. 37
         e. “Secured By” Real Property ........................................................ 38
2. Basis Reduction .......................................................................................... 40
C. Temporary Deferral of COD Income in Debt “Reacquisitions” ................ 41
D. Purchase Money Debt Reduction .............................................................. 58
E. Exclusion of Lost Deductions ................................................................. 59

V. Other Approaches...................................................................................... 59
A. Acquisition of Debt by a Third Party ....................................................... 60
   1. In General .......................................................................................... 60
   2. Related Party Acquisition of Indebtedness ......................................... 60
   3. Significant Modifications and Deemed Reissuance of Debt.............. 62
   4. Acquisition of Debt by an Agent ....................................................... 65
B. Admission of a New Partner ................................................................. 65
   1. Admission of a Third Party as a Partner .......................................... 65
      a. Direct Admission to the Debtor Partnership ............................... 65
      b. Admission to a Subpartnership .................................................. 67
   2. Admission of Lender as a Partner ..................................................... 68
      a. Application of Section 721 ......................................................... 68
      b. Partnership Debt-for-Equity Exchange ................................... 72
      c. Liability Shifts and Gain Recognition ....................................... 75
C. Elimination of Partner Debt ..................................................................... 77

VI. Passive Activity Rules.............................................................................. 78
VII. At-Risk Rules .......................................................................................... 79
VIII. Partner-Specific Issues .......................................................................... 79
A. Debt Owed by the Partnership to a Partner .......................................... 80
   1. Debt is Wholly Worthless ............................................................... 80
   2. Debt is Partially Worthless .............................................................. 84
   3. Some Examples .............................................................................. 87
      a. Writing Off Wholly-Worthless Debt in the Year of Forgiveness .... 87
      b. Contributing Wholly-Worthless Debt to Partnership Capital .... 88
      c. Deduction for Worthless Debt in a Year Prior to Forgiveness ...... 88
B. Abandonment Loss ............................................................................... 92
C. Worthlessness ......................................................................................... 103
DEBT WORKOUTS: THE PARTNERSHIP AND THE PARTNERS

I. Introduction

This outline is intended to provide a roadmap to issues, from the debtor partnership’s and the partner’s perspective, that one must address in undertaking a partnership workout. The outline begins by setting forth the general rules relating to income recognition in cases where liabilities are discharged. The outline then discusses how a partnership may allocate income from discharge of indebtedness and highlights other ways that a partner may recognize income when partnership debt is forgiven. The outline follows with a summary of the various rules that provide for the exclusion or deferral of cancellation of indebtedness (COD) income and discusses the ramifications that follow from excluding such income. The outline then discusses certain strategies that may provide favorable results in certain partnership workouts. The outline follows with a brief description of the results that follow under the at-risk and passive loss rules where a partner has COD income. Finally, the outline concludes with a discussion of various ways that a partner may recognize a loss with respect to its investment in a troubled partnership.

II. Income From Discharge Of Indebtedness

Partnership workouts generally involve one of two scenarios. In one scenario, the partnership keeps the property that secures the debt. In the other, it does not. Where the creditor reduces the amount due with respect to an indebtedness without actually receiving the property that secures the debt, the partnership will have

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2 One set of issues not addressed in this article is the ramifications that follow from the creation of a bankruptcy estate separate from a partnership or partner that is the subject of a Chapter 7 or 11 bankruptcy proceeding. For a discussion of these issues, see L. Swartz, Partnership Bankruptcy Tax Issues, 13 Tax Planning for Domestic & Foreign Partnerships, LLCs, Joint Ventures & Other Strategic Alliances (PLI) 235-1 (2010); A. Purintin, Partnerships and Partners in Bankruptcy, 11 J. of P-ship Tax’n 342 (1995).
cancellation of indebtedness income in an amount equal to the reduction in the liability.³ Where the debtor surrenders property for reduction or cancellation of the liability, the situation is somewhat more complicated. Some of the complexities in this area relate to differences in the results achieved by using property transfers to satisfy recourse and nonrecourse liabilities.

A. Transfers of Properties in Satisfaction of Recourse Liabilities

Where a creditor agrees to discharge a debtor from responsibility for a recourse liability in exchange for the transfer of property, the debtor will be treated as if it sold the property in exchange for an amount equal to the fair market value of such property.⁴ Accordingly, the debtor will recognize gain or loss on such transaction in the same manner as if it had actually sold the property. To the extent that the amount of the debt cancelled exceeds the value of the property transferred, the debtor will have COD income.⁵

The bifurcation provided for under current law is logical. The transfer of the property essentially serves as a payment on the debt. Because the debt is recourse, the debtor technically remains liable for the balance of the debt that exists after the payment. If the creditor chooses to forgive that amount of the debt, the debtor should have COD income.

It should be noted that certain cases indicate that, even where debt is recourse, if the entire debt is eliminated in connection with the foreclosure transaction (or in a transaction closely related to the foreclosure transaction), the entire amount of the debt should be treated as an amount realized, regardless of the fair market value of the property transferred.⁶ These cases seem to be at odds with the result in example 8 of

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³ Treas. Reg. §1.61-12(a). Often, the debtor will provide additional security or will personally guarantee the remaining debt for exchange for a reduction in the principal amount of the indebtedness. See infra notes 295-305 and accompanying text regarding significant modifications and deemed exchanges of debt instruments.

⁴ Treas. Reg. §1.1001-2(c), Ex. 8; Rev. Rul 90-16, 1990-1 C.B. 12; 1998 FSA Lexis 581 (Nov. 13, 1998). Note that the amount of the debt that is bid at the foreclosure sale generally will determine the fair market value of the property. Carlson v. Commissioner, 116 T.C. 87 (2001). However, where a taxpayer can show, by clear and convincing evidence, that an alternative value is more appropriate, such alternative valuation will determine the fair market value of the property. Frazier v. Commissioner, 111 T.C. 243, 247 (1998); see generally D. Sher, Frazier: Revenue Rulings Should Have Some Fair Market Value, 98 Tax Notes Today 219-9 (Nov. 13, 1998).


⁶ Chilingirian v. Commissioner, 918 F.2d 1251 (6th Cir. 1990); In re: A.J. Lane & Co., Inc., 133 B.R. 264 (1991). Cf Aizawa v. Commissioner, 99 T.C. 197 (1992) (“The key to resolution of the issue before us lies in the recognition that, in this case, there is clear separation between the foreclosure sale and the unpaid recourse liability for mortgage principal which survives as part of the deficiency judgment), aff’d, 1994 U.S. App. Lexis 18330 (9th Cir. 1994); Wicker v. Commissioner, 66 T.C.M. (CCH) 757 (1993) (describing, in dicta, result reached in Chilingirian as a conclusion reached by courts “in some cases,” but such rule was not relevant in the instant case since the record did not indicate that the unsatisfied debt
Treas. Reg. §1.1001-2(c) and the position of the Internal Revenue Service (the “Service”) as set forth in Rev. Rul. 90-16. Commentators, while recognizing the cases treating the entire amount of the recourse debt as amount realized in the circumstances described, have referred to the bifurcation approach as the “correct approach” where the deficiency judgment is reduced or eliminated through negotiations with the lender. Nonetheless, consideration should be given to this case law in analyzing recourse debt foreclosures where the deficiency judgment is eliminated as part of the foreclosure proceeding.

B. Transfers of Properties in Satisfaction of Nonrecourse Liabilities

1. In General

The treatment of a nonrecourse debtor upon the transfer of property in relief of indebtedness differs significantly from the treatment of a recourse debtor. Where nonrecourse debt is forgiven in exchange for the transfer of the collateral, the debtor must recognize gain or loss from the sale or exchange of the property measured by the difference between the amount of the debt forgiven and the adjusted basis of the property transferred. This is the case even where the amount of the liability exceeds the fair market value of the property.  

7 1990-1 C.B. 12.

8 A. Cardinali & D. Miller, Tax Aspects of Non-Corporate Single Asset Bankruptcies and Workouts, 1 Am. Bankr. Inst. L. Rev. 87 (1993); see also D. Garlock, etal, Federal Income Taxation of Debt Instruments, ¶1501.04, n. 161 (5th ed. CCH 2006) (hereafter referred to as “Debt Instruments”) (referencing Chilingirian as a “but see” citation, contrasting the result in that case with the generally understood rule with respect to the discharge of recourse debt).

9 These cases might have some application, for instance, where debt that is recourse to a single-asset LLC, but not to the partners, is eliminated in connection with a foreclosure proceeding. See infra notes 36-49.

10 Treas. Reg. §1.1001-2(c), Ex. 7; Commissioner v. Tufts, 461 U.S. 300 (1983); cf. Priv. Ltr. Rul. 9251023 (Sept. 18, 1992) (allowed bifurcation of nonrecourse debt among multiple properties where some property was transferred in relief of indebtedness while other property was released as security for the indebtedness; portion of debt attributable to property transferred to creditor was treated as sales proceeds while the remaining portion of the debt written off generated COD income).

11 Treas. Reg. §1.1001-2(c), Ex. 7; Commissioner v. Tufts, 461 U.S. 300 (1983). Because the debtor cannot be held liable for any deficiency judgment with respect to nonrecourse debt, it is appropriate that there is no COD income. After the collateral is transferred, the debtor has no remaining obligation to pay anything to the lender. Accordingly, no debt is “forgiven.”
2. **Planning for COD Income or Sale Gain**

In some situations, the recognition of gain by a debtor will be preferable to receiving COD income, given that sale gain may qualify for favorable capital gains rates while COD income is ordinary in character. However, where the debtor can qualify for exclusion of the COD income,\(^\text{12}\) sale treatment may produce a less favorable result.\(^\text{13}\) Accordingly, in some situations, a debtor may wish to avoid this treatment when negotiating the discharge of nonrecourse liabilities.

Because a reduction in a nonrecourse liability without surrendering the underlying collateral gives rise to COD income,\(^\text{14}\) one may ask, “can a debtor negotiate a reduction in the amount of the indebtedness prior to foreclosure so as to avoid sale gain on the amount by which the debt exceeds the fair market value of the property?” Alternatively, “can a debtor transfer cash in an amount equal to the value of the collateral, rather than actually transferring the collateral, and recognize COD income rather than sale gain?” Even better, “to generate COD income in connection with the disposition of encumbered property in satisfaction of a nonrecourse liability, can a debtor sell the collateral and transfer the proceeds to the lender, recognizing gain or loss from disposition of the property based upon the sales proceeds over the basis of the property, and then recognizing COD income based upon the amount by which the liability exceeds the payment to the lender?”

While not necessarily easy to accomplish, these results may be possible through careful planning. In *Gershkowitz v. Commissioner*,\(^\text{15}\) the Tax Court appeared to allow something akin to the above-listed results, although the opinion in the case is so confusing, it has been hard to derive any real comfort from the decision. A more recent case, *2925 Briarpark, Ltd. v. Commissioner*,\(^\text{16}\) sheds important light on how the desired results may be accomplished. In that case, the debtor held property with a value that was significantly less than the balance due on the nonrecourse debt that the property secured. The lender agreed to release the underlying property from all liens if the debtor sold the property for a minimum gross sales price and assigned the net sales

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12 See infra notes 108-181 and 277-283 and accompanying text.


14 *Gershkowitz v. Commissioner*, 88 T.C. 984 (1987); Rev. Rul. 91-31, 1991-1 C.B. 19. Some argue, under *Fulton Gold Corp. v. Commissioner*, 31 B.T.A. 519 (1934), that such a reduction of a nonrecourse liability should not lead to COD income, but instead, should result only in a reduction of the basis of the property securing the debt. This line of reasoning has been largely eroded by the decisions in *Tufts* and *Gershkowitz*.


proceeds to the bank. The Fifth Circuit Court of Appeals, in affirming the Tax Court, held that where the sale of the property and cancellation of the indebtedness are closely intertwined so as to effectively be one transaction, the debtor will recognize sale gain rather than COD income.\(^{17}\)

The court in 2925 Briarpark distinguished Gershkowitz by emphasizing that, in Gershkowitz, the debts were not discharged in connection with the disposition of the property.\(^{18}\) Instead, in Gershkowitz, the property that had secured the debt was disposed of approximately three months after the debt was discharged.\(^{19}\)

Based upon the holdings in Gershkowitz and 2925 Briarpark, it would appear that any pre-discharge write-down of the debt or sale of the property must not be undertaken “in connection with” the actual discharge of the indebtedness. Taking this standard into consideration, if the debtor can reach an agreement with the lender as to the fair market value of the collateral and then come up with funds equal to such amount to satisfy the lender, the debtor should realize COD income, rather than sale gain, even if the debtor subsequently disposes of the property.\(^{20}\)

It probably will be more difficult to sell the property prior to the settlement of the debt in a transaction that would be respected as separate from the discharge of the liability under the standards set forth in 2925 Briarpark. In most cases, the lender will be unwilling to release the property as security to permit the sale. However, a lender may agree to release the property and reduce the balance of the debt to the fair market value of the current security where the debtor agrees to provide additional or substitute security to ensure that the lender will not risk losing even more with respect to its loan. The borrower then, at some point following the sale of the property, may be able to take the sales proceeds of the original collateral and pay off the reduced amount of the debt in a separate transaction that would not implicate the decision in 2925 Briarpark.\(^{21}\)

\(^{17}\) 163 F.3d at 318.

\(^{18}\) The Fifth Circuit stated that “[s]ince there was no disposition of property upon the discharge of the debts, the Tax Court [in Gershkowitz] held that there was no amount realized upon disposition that could be regarded as flowing from the discharge of indebtedness, and hence, no gain or loss on disposition to be computed.” Id.

\(^{19}\) In FSA 200135002 (Aug. 31, 2001), the Service appeared to follow the Fifth Circuit’s rationale in 2925 Briarpark in a similar factual situation. A similar analysis was followed by the Tax Court in Sands v. Commissioner, 73 T.C.M. (CCH) 2398 (1997), aff’d by, sub nominee, Murphy v. Commissioner, 163 F.3d 618 (2d Cir. 1998).

\(^{20}\) Query the result if the debtor borrows money to pay off the current lender, and the new lender conditions the loan on the borrower’s commitment to dispose of the property and transfer the proceeds to the lender in a short period of time (such as three months).

\(^{21}\) For a discussion of the opportunities for restructuring prior to 2925 Briarpark, see W Raby, Bifurcation and Excess Debt, 94 Tax Notes Today 3-47 (Jan. 5, 1994).
Interestingly, while 2925 Briarpark appears to collapse a pre-arranged sale of property to a third party and payment of the sales proceeds to the lender in cancellation of debt into a single foreclosure transaction, a different result would seem to follow where property is sold to a third party subject to debt and the debt is modified (including a reduction in principal) in connection with the transfer. That is, where a liability is assumed in connection with a sale or exchange of property, or where property is transferred subject to debt, Treas. Reg. §1.1274-5(b)(1) treats a modification of the debt instrument undertaken in connection with the sale or exchange as occurring in a transaction that is separate from the sale or exchange. Accordingly, where parties desire to recognize COD income with respect to nonrecourse debt, it may be advisable to negotiate with the lender to permit a transfer of the property to a third party subject to some reduced portion of the debt. In such a transaction, it would appear that the lender could still obtain proceeds from the sale as a payment in reduction of the original debt, as was done in 2925 Briarpark, so long as some meaningful portion of the original debt remains outstanding following the sale.

C. Transfer of Properties in Satisfaction of Partially Recourse Liabilities

A liability may be partially recourse and partially nonrecourse where the debtor agrees to bear personal responsibility for a portion of the indebtedness. A partial guarantee is probably the most common situation giving rise to partially recourse debt.

1. Top Guarantee

The authority addressing the treatment of partially recourse liabilities is limited. However, the Service has held, in at least one private letter ruling, that payments in settlement of partially recourse debt should be allocated first to the nonrecourse portion of the debt. According to the Service, “a debtor should not be able to impair his

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22 These rules apply where the modification of the debt instrument gives rise to an exchange of the debt instrument under section 1001. Treas. Reg. §1.1274-5(b)(1). See infra notes 296-306 and accompanying text.

23 See generally J. Schmalz, M. Brumbaugh, and R. Pillow, Debt Reductions in Connection with the Disposition of Property, 25 J. of Real Est. Tax’n 197 (1998); D Friedline, Bifurcation of Nonrecourse Debt: Application of Reg. §1.1274-5 to Transactions that are the Functional Equivalent of a Foreclosure, 9 J of Tax’n of Fin. Prod. 17 (2011); Debt Instruments, supra note 8, at ¶310.02; see also 1995 FSA Lexis 437 (Sept. 29, 1995) (distinguishing a “short sale”, where debt is eliminated in connection with a sale of property, from a modification in connection with an assumption of debt as part of a sale, as in Treas. Reg. §1.1274-5). The modification generally will be treated as occurring immediately before the sale or exchange so long as the seller knew or had reason to know of the modification. Treas. Reg. §1.1274-5(b)(1). The buyer and seller may, however, jointly elect to have the modification treated as occurring immediately after the sale or exchange, so that the tax ramifications of the modification will be reflected on the purchaser’s tax return. Treas. Reg. §1.1274-5(b)(2).

24 A reduction in the principal balance due under the debt instrument generally will give rise to a significant modification that triggers an exchange of the debt instrument. Treas. Reg. §1.1001-3(g), Ex. 3.


creditor’s rights by asserting that a settlement must first be applied against the recourse portion of a debt. This view attempts to harmonize the treatment of the transaction under federal income tax law and local law.

The rule asserted by the Service makes it more likely that a debtor will have COD income rather than sale gain in connection with the workout of a partially recourse debt. Consider the following example: A borrows $100 and personally guarantees $70 of the debt. The debt is secured by land with a basis of $30 and fair market value of $100. The value of the land falls to $60, and the lender chooses to foreclose. The basis of the property is still $30 at the time of the foreclosure. Presumably, half of the property will be treated as being transferred in exchange for the nonrecourse portion of the debt. This would cause the debtor to recognize $15 of sale gain ($30 value - $15 basis). The other half of the property would be treated as transferred in satisfaction of $30 of the recourse portion of the liability, thus causing the debtor to recognize an additional $15 of sale gain. The remaining $40 of recourse debt that is discharged in connection with the transaction would give rise to COD income for the debtor.

2. Bottom Guarantee

Query whether the analysis applied by the Service is appropriate where the debtor has undertaken a “bottom” guarantee. For example, if the principal amount of the liability is $100, the debtor might guarantee $20 of the debt under terms that will only require the debtor to honor the guarantee if the collateral cannot be sold for at least $20. If the recourse obligation is eliminated by the first dollars collected on the indebtedness, it seems that, under the Service’s rationale, the recourse portion of the debt should be treated as being satisfied first. Following this theory, and assuming again that the property is worth $60 at the time of foreclosure, arguably, one-third of the property (i.e., a portion of the property worth $20) would be treated as being transferred in satisfaction of the recourse portion of the debt, with the remaining two-thirds (i.e., a portion of the property worth $20) being transferred in satisfaction of the $80 nonrecourse portion of the debt. Note that this could result in a loss being recognized on the foreclosure of the recourse portion of the debt and gain on the nonrecourse portion. Alternatively, if the property were spread proportionately to both parts of the

27 Id.
28 A portion of the property worth $30 would be treated as transferred in satisfaction of the $30 nonrecourse portion of the debt, with the remaining $30 portion of the property being treated as satisfying $30 of the recourse portion of the debt.
29 Cf. Treas. Reg. §1.704-2(m), Ex. 1(vii).
30 For instance, suppose the adjusted basis of the property was $90 at the time of foreclosure. The one-third portion of the property transferred in satisfaction of the $20 recourse portion of the property would have an adjusted basis of $30 and the two-thirds portion of the property transferred in satisfaction of the $80 nonrecourse portion of the property would have an adjusted basis of $60.
debt and the guaranteed portion was respected as recourse, it seems that COD income could result with respect to the recourse portion of the debt.\textsuperscript{31}

D. Release of a Guarantee

Where a lender releases a partner from its obligation under a guarantee of partnership debt, the partner/guarantor generally will not recognize income.\textsuperscript{32} The Service long ago implied that this result may not follow where a partner has become primarily liable for the debt as a result of the partner’s guarantee, although this position generally seems to have been settled to the contrary.\textsuperscript{33} Certain authority would support treating a guarantor/partner as assuming the guaranteed portion of the liability from a partnership upon termination of the partnership, rather than treating the debt as discharged at the partnership level when the partnership ceases to exist (\textit{e.g.}, because all property of the partnership has been foreclosed upon).\textsuperscript{34} Under this view of the transaction, it would appear to follow that a discharge of such indebtedness would not be treated as occurring at the partnership level, but instead would be treated as occurring at the partner level when the guarantee is finally settled. Results may vary depending on whether the debt is recourse or nonrecourse for purposes of section 1001, and whether or not the partnership remains in existence as the primary obligor on the debt.\textsuperscript{35}

\textsuperscript{31} If 20 percent of the property (with a value of $12) were treated as being transferred in satisfaction of $20 of recourse debt, the debtor would recognize $8 of COD income.

\textsuperscript{32} \textit{Brickman v. Commissioner}, 76 T.C.M. (CCH) 506 (1998).

\textsuperscript{33} Tech. Adv. Mem. 7953004 (Sept. 7, 1979). This position would seem to be undermined by the recent decision in \textit{Mylander v. Commissioner}, 108 T.C.M. (CCH) 310 (2014). In that case, the court stated: Unlike a debtor who borrows funds, a guarantor who assumes a contingent liability does not receive an untaxed accretion of assets which is accompanied by an offsetting obligation to pay. This remains the case even after the guarantor becomes a primary obligor because of the debtor’s default. Regardless of whether the guarantor is a secondary obligor or has become a primary obligor, when the debt is discharged the guarantor’s net worth is not ‘increased over what it would have been if the original transaction had never occurred.’”

\textsuperscript{34} Marcaccio v. Commissioner, 69 T.C.M. (CCH) 2420 (1995); FSA 200028019 (Apr. 14, 2000); but see Brickman v. Commissioner, 76 T.C.M. (CCH) 506 (1998).

\textsuperscript{35} Marcaccio v. Commissioner, 69 T.C.M. (CCH) 2420 (1995). \textit{Compare Great Plains Gasification Assoc. v. Commissioner}, 92 T.C.M. (CCH) 534 (2006) (court analyzed debt discharged in foreclosure as nonrecourse debt and thus treated the entire balance of the debt as discharged at the partnership level, even though a partner had pledged property outside the partnership and the creditor ultimately realized value from the pledged property in partial satisfaction of the deficiency judgment relating to the debt; although not analyzed, it would seem appropriate for the partner who surrendered the pledged property to have received a bad debt deduction for the value of such property under Treas. Reg. §1.166-8). For a more detailed discussion of the impact of partner guarantees in debt workouts, see J. Sowell, \textit{Partner Guarantees in Debt Workouts}, 61 U.S.C. Law School Inst. on Major Tax Planning 8-1 (2009).
E. Treatment of LLC Debt

As this discussion shows, it is important to distinguish between recourse and nonrecourse debt in characterizing income from the discharge of such indebtedness. But this distinction becomes blurred in evaluating the debt of LLCs and other entities treated as partnerships for federal tax purposes that provide limited liability for their members. What is the proper treatment where a lender forecloses on debt that is recourse to all of the assets of an LLC, but none of the members are personally liable for the debt (i.e., exculpatory debt)?

As discussed in the next section, the regulations under section 752 provide that a partnership liability is a “nonrecourse liability” to the extent that no partner or related person bears the economic risk of loss for that liability. Likewise, in determining whether debt is “qualified nonrecourse financing” under the “at-risk” rules, the personal liability of a partnership for repayment of a financing is disregarded.

Nonetheless, these rules technically apply only for purposes of classifying partnership debt at the partner level. Although the section 108 exclusions generally apply at the partner level, the discharge of indebtedness is a partnership level event the effects of which are evaluated under Treas. Reg. §1.1001-2. The discharge gives rise to income at the partnership level which then passes through to the partners under section 702.

Historically, there has been significant debate regarding whether the recourse or nonrecourse nature of the debt should be determined by reference to the liability of the

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36 See generally L. Sheppard, Walk Away: Forgiveness of Nonrecourse Debt and Other Problems, 92 Tax Notes Today 34-5 (Feb. 14, 1992) (“[t]he tax law needs to decide whether section 1001 justifies looking through to the partners to determine whether the liability is recourse or not”). The preamble to the final regulations under Treas. Reg. §1.704-2 discusses exculpatory debt (i.e., debt that is recourse to the assets of the partnership but that is not recourse to any partner) in the context of applying the partnership minimum gain rules. While the preamble states that exculpatory debt is nonrecourse debt pursuant to the definition provided in the regulations under section 752, the preamble also acknowledges special concerns regarding exculpatory liabilities and recognizes that the regulations relating to partnership minimum gain do not prescribe precise rules addressing the allocation of income and loss attributable to exculpatory liabilities. The Service requested comments regarding allocations attributable to exculpatory liabilities but never published any further guidance. T.D. 8385 (preamble).

37 Treas. Reg. §1.752-1(a)(2).


39 See infra notes 110 and 163 and accompanying text.

40 Cf. Priv. Ltr. Rul. 9619002 (Jan. 31, 1996) (discharge in bankruptcy of a partner for his share of a partnership’s recourse debt was not a COD event; the debt was a primary obligation of the partnership, and because the partnership was not relieved of a liability, no COD income resulted; the partner recognized gain under section 731 as a result of a liability shift under section 752).

partnership or the partners. Some argue that the determination should be made at the partnership level by reference to the rights and obligations related to the debt under the laws of the applicable jurisdiction as between the lender and the partnership.\footnote{See S. Starr, E. Case, K. Garre-Lohnes, J. Rosenberg, and J. Schmalz, \textit{Limited Liability Companies, 725-2nd Tax Management Portfolio (BNA) A-45 – A-46 (2003) (hereafter referred to as “LLCs”)}; K Burke, \textit{Exculpatory Liabilities and Partnership Nonrecourse Allocations, 57 Tax Law. 33, 37 (2003) (“Notwithstanding the nonrecourse characterization under the section 704(b)/752 regulations, most commentators agree that an exculpatory liability should be treated as recourse for purposes of section 1001.”); B. Rubin, A. Whiteway, and J. Finkelstein, \textit{Recourse or Nonrecourse: Liability Treatment for COD, Other Purposes, 2010 Tax Notes Today 177-9 (Sept. 14, 2010); Cf B. Rice, Does Regulation Section 1.704-2 Permit Special Allocations of Nonrecourse Deductions Attributable to Exculpatory Liabilities, 56 Tax Law. 155 (2002); D. Bennett, “To Be or Not to Be, That is the Question”: Disregarded Entities and Debt Modification, 81 Taxes 9 (Dec. 2003).} Under this view, so long as the creditor may proceed against all of the LLC’s assets in satisfaction of the LLC’s obligations, the debt should be treated as recourse for purposes of determining the character of income from discharge of the liability even though the liability may be treated as nonrecourse debt at the partner level.\footnote{Query whether there should be a different result for an LLC that owns only assets acquired with proceeds of the debt. In such a situation, the lender can reach only those assets of the LLC that would naturally secure the debt; thus, the “recourse” nature of the obligation may be illusory. Separately, following from the view that the recourse nature of the debt should be determined at the partnership level, query how this analysis should apply where debt is nonrecourse to an LLC, but the debt is guaranteed by one or more members of the LLC. Although the guarantee would cause the debt to become recourse to the partner under section 752, such a conclusion would not be relevant to the character of the cancellation of indebtedness income. \textit{Cf} Treas. Reg. §1.704-2(b)(4) (partnership liability treated as a “partner nonrecourse debt” to the extent that the liability is nonrecourse for purposes of Treas. Reg. §1.1001-2, and a partner or related person bears the economic risk of loss under Treas. Reg. §1.752-2 because, for example, the partner or related person is the creditor or a guarantor). A member’s guarantee does not put any additional LLC assets at risk for repayment of the indebtedness. So if the recourse/nonrecourse determination is made at the partnership level, a partner guarantee seemingly would be disregarded in characterizing income from the discharge of LLC debt. \textit{LLCs, supra note 42, at A-46. This conclusion would seem consistent with the holding in 2925 Briarpark, Ltd. v. U.S., 163 F.3d 313 (5th Cir. 1999). Although not often focused upon, factually, that case involved a debt of slightly more than $25 million that was nonrecourse to a limited partnership (from a commercial perspective) but that was guaranteed to the extent of $5 million by the general partner. Without any analysis of the guarantee, the court concluded that the debt should be treated as nonrecourse for purposes of section 1001.\footnote{92 T.C.M. (CCH) 534 (2006).}}

The other view historically offered by some practitioners has been that the section 752 rules should determine the recourse/nonrecourse characterization of the debt for purposes of the discharge of indebtedness rules. Under those rules, the recourse/nonrecourse nature of the debt would be determined at the partner level.

This latter position was bolstered somewhat by the Tax Court’s 2006 decision in \textit{Great Plains Gasification Associates v. Commissioner}.\footnote{92 T.C.M. (CCH) 534 (2006).} In this case, the lender foreclosed on property owned by a general partnership. Under the terms of the debt, the creditor could not reach the assets of any partner. The available collateral, however, did include “all real or personal property ‘now owned or hereafter acquired by’ the
partnership."45 It is difficult to distinguish this situation from exculpatory debt of an LLC because the creditor could reach all of the partnership’s assets to satisfy the liability but was not entitled to look to any of the assets of a partner.

In determining the characterization of the debt as recourse or nonrecourse, the court started its analysis by indicating that the determination should be made at the partnership level. In a somewhat contradictory shift in analysis, however, the court ultimately seemed to focus on the section 752 regulations in deciding that the debt was nonrecourse. In this regard, the court cited Treas. Reg. §1.752-1(e). That provision states that a nonrecourse liability is one in which “none of the partners have any personal liability.”

In Great Plains Gasification, the applicable indenture specifically limited the collateral available to the creditor so as to prevent the creditor from reaching the assets of the general partners. The limitation provided by the indenture does make the debt seem more nonrecourse than traditional exculpatory debt of an LLC, and the court did appear to give some significance to the limiting nature of the indenture.46 While this fact may provide some justification for distinguishing the situation considered in the case from exculpatory debt of an LLC, the court’s seeming reliance on the regulations under section 752 implies that the foundation of the decision was the lack of personal liability for the partners.

One further point bears mentioning in connection with the treatment of foreclosure transactions with respect to property held by an LLC. If the debt is considered to be recourse for purposes of analyzing the results of the foreclosure transaction, the lender may have no further assets to look to following the foreclosure transaction. If this is the case, the authorities discussed above treating the full amount of recourse debt eliminated as part of a foreclosure transaction as amount realized could be relevant.47 Practitioners may argue regarding whether the result espoused in these cases is correct, and the result does appear to be inconsistent with the Service’s general position relating to recourse debt.48 Nonetheless, this case law should not be ignored,

45 The opinion described the collateral arrangement as follows: “[T]he collateral for the debt included all project assets, including all real or personal property ‘now owned or hereafter acquired’ by the partnership. Insofar as the record reveals, the partnership had no significant assets apart from the project assets that were foreclosed upon. Indeed, pursuant to the partnership agreement and loan guarantee agreement, the partnership was not authorized to acquire nonproject assets or to engage in any business other than the project. After DOE took control of the project and acquired the project assets, there was no realistic possibility that the partnership was going to acquire additional assets.”

46 The court stated as follows: “In these circumstances, the partnership’s liability on the debt was effectively limited to the project assets that collateralized the indebtedness, and the partners’ liabilities were effectively limited to their interests in those project assets. In these circumstances, the debt was in substance nonrecourse against the partnership and the partners.”

47 See supra note 6.

48 See supra notes 7-8 and accompanying text.
particularly if treating the full amount of the recourse debt as amount realized might provide the taxpayer with a better result.

The treatment of debt that is recourse to an LLC taxed as a partnership is distinguishable from debt that is recourse to an LLC that is a disregarded entity owned by an entity taxed as a partnership. In the latter situation, the disregarded LLC generally will limit the recourse of the creditor to the assets held by the disregarded LLC and will shield the regarded partnership from any further liability. Where this is the case, the debt is, in substance, nonrecourse to the assets of the regarded taxpayer and seemingly should be treated as nonrecourse for purposes of Treas. Reg. §1.1001-2. One can imagine numerous scenarios, however, where the result might not be so clear. For instance, if the regarded partnership acts as a guarantor of the disregarded LLC’s obligation, the creditor ultimately would have access to all of the taxpayer’s assets for satisfaction of the debt, which arguably would make the debt recourse. As another example, consider a regarded partnership that is contractually prohibited from holding any assets other than the interest in the disregarded LLC. Under the terms of the arrangement, if the regarded partnership does acquire other assets such that it is in violation of its covenant, the debt will become recourse to the partnership. In substance, the creditor will have access to all assets of the regarded partnership because either the partnership will hold only the disregarded entity interest or, if the partnership does hold other assets, the creditor would gain access to such assets by virtue of the covenant violation.

III. Discharge of Partnership Liabilities

Special issues must be confronted in the context of partnership workouts. In addition to determining how to treat the transaction in which the liability relief occurs, the partnership must allocate the related income among the partners, and the partners must determine the effect of the deemed distributions that follow from the reduction in their shares of partnership liabilities, as determined pursuant to the regulations under section 752.

A. Allocation of Partnership Liabilities

In analyzing the income tax ramifications from a discharge of partnership indebtedness, it is necessary to determine how the partnership’s liabilities are allocated

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49 Cf. Treas. Reg. §1.465-27(b)(6), Ex. 6 (debt that is recourse to disregarded LLC treated as qualified nonrecourse financing with respect to regarded owner of LLC); M. Teitelbaum, A Disregarded Entity Must be Taken Into Account, 2002 Tax Notes Today 232-47 (Dec. 3, 2002); T. Cuff, Indebtedness of a Disregarded Entity, 81 Taxes 303 (Mar. 2003); Cf. also Treas. Reg. §1.108-9(a) (for purposes of bankruptcy and insolvency exceptions under section 108, neither a grantor trust nor a disregarded entity is treated as the “taxpayer” to which the exception applies); Treas. Reg. §1.752-2(k) (in determining economic risk of loss for a partnership liability, an obligation of a disregarded entity is taken into account only to the extent of the net value of the disregarded entity).
among the partners. The rules for allocating partnership liabilities differ depending upon whether the liabilities are recourse or nonrecourse.

1. **Recourse Liabilities**

For purposes of section 752, a partnership liability is a recourse liability to the extent that any partner or related person bears the economic risk of loss for that liability under Treas. Reg. §1.752-2. A partner’s share of a recourse liability is equal to the portion of the liability, if any, for which the partner (or related person) bears the economic risk of loss. Generally, a partner will be considered to bear the economic risk of loss for a partnership liability to the extent that, if the partnership constructively liquidated (after disposing of all of its assets in a fully taxable transaction for no consideration), the partner (or related person) would be obligated to make a payment to any person (or a contribution to the partnership) because the liability comes due and the partner (or related person) would not be entitled to reimbursement from another partner (or person related to another partner). In determining whether a partner bears the risk of loss with respect to a liability, all statutory and contractual obligations relating to the partnership liability are taken into account. This includes obligations such as guarantees, reimbursement agreements, and indemnification agreements, as well as capital contribution obligations and deficit restoration obligations. A partner also will be considered to bear the economic risk of loss for a partnership liability to the extent that the partner (or a related person) makes a nonrecourse loan to the partnership and no other partner bears the economic risk of loss for the liability.

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50 Treas. Reg. §1.752-1(a)(1).
51 Treas. Reg. §1.752-2(a).
52 An exception to the “no consideration” rule is provided with respect to assets securing nonrecourse debt. Treas. Reg. §1.752-2(b)(1)(iii).
53 Treas. Reg. §1.752-2(b)(1) & (2).
54 Treas. Reg. §1.752-2(b)(3).
55 Id. This rule will not apply where a partner (or related person) who has a 10-percent or less interest in each partnership item guarantees debt that otherwise would constitute qualified nonrecourse financing within the meaning of section 465(b)(6) (without regard to the type of activity financed). Treas. Reg. §1.752-2(d)(2).
56 Treas. Reg. §1.752-2(c)(1). This rule will not apply where a partner (or related person) who has a 10-percent or less interest in each partnership item makes a loan to a partnership that otherwise would constitute qualified nonrecourse financing within the meaning of section 465(b)(6) (without regard to the type of activity financed). Treas. Reg. §1.752-2(d)(1).
2. **Nonrecourse Liabilities**

In contrast to recourse liabilities, no partner bears the economic risk of loss with respect to a nonrecourse liability.\(^{57}\) Accordingly, the regulations generally endeavor to allocate such liabilities in a way that corresponds to how income or gain attributable to the property securing the debt would be allocated among the partners. The regulations utilize a three-tier method for allocating nonrecourse liabilities. Liabilities will be allocated first among the partners to the extent of each partner’s share of partnership minimum gain\(^{58}\) (i.e., the amount by which a nonrecourse liability exceeds the section 704(b) book value of property securing the liability).\(^{59}\) To the extent that a liability is not allocated under the first tier, the liability will be allocated to a partner in an amount equal to the section 704(c) minimum gain allocable to such partner.\(^{60}\) Section 704(c) minimum gain is the taxable gain that would be allocated to a partner under section 704(c) (or in the same manner as section 704(c) in connection with a revaluation of partnership property) if the partnership disposed of all partnership property subject to one or more nonrecourse liabilities of the partnership in full satisfaction of the liabilities (and for no other consideration).\(^{61}\) The third tier provides significant flexibility for allocating the portion of a nonrecourse liability that is not allocated pursuant to the first two tiers. Nonrecourse liabilities may be allocated under this tier in accordance with the partner’s share of partnership profits.\(^{62}\) Alternatively, nonrecourse liabilities may be allocated under this tier in accordance with the manner in which it is reasonably expected that the deductions attributable to such liabilities will be allocated.\(^{63}\) Finally, a nonrecourse liability may be allocated under the third tier in accordance with a partner’s share of excess section 704(c) gain (i.e., section 704(c) gain not taken into account under the second tier) that relates to the property secured by the liability up to the full amount of the excess section 704(c) gain.

**B. Allocation of Partnership Income in a Workout**

The rules for allocating partnership income in a debt workout can be quite complicated. A brief review of the general partnership allocation rules is useful prior to layering on the specific rules relating to discharge of indebtedness.

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\(^{57}\) Treas. Reg. §1.752-1(a)(2). For purposes of section 752, a partnership liability is a nonrecourse liability to the extent that no partner bears the economic risk of loss for that liability under Treas. Reg. §1.752-2.

\(^{58}\) Treas. Reg. §1.752-3(a)(1).

\(^{59}\) Treas. Reg. §1.704-2(d).

\(^{60}\) Treas. Reg. §1.752-3(a)(2).

\(^{61}\) Id.

\(^{62}\) Treas. Reg. §1.752-3(a)(3). The partnership agreement may specify the partners’ interests in partnership profits for purposes of allocating nonrecourse liabilities provided that the specified interests are reasonably consistent with allocations (having substantial economic effect) of some other significant item of partnership income or gain. Id.

\(^{63}\) Id.
1. **Substantial Economic Effect**

Under section 704(b), allocations of partnership income, gain, loss, deduction, or credit provided for in the partnership agreement will be respected if the allocations have substantial economic effect. Allocations that do not have substantial economic effect are reallocated in accordance with the partners’ interests in the partnership.64

In order for the allocation of an item to have economic effect, it must be consistent with the underlying economic arrangement of the partners.65 A partner who is allocated a share of income should enjoy the corresponding economic benefit of such income, and a partner who is allocated a share of loss should bear the corresponding economic burden of such loss.66

The economic effect of an allocation will not be substantial if, at the time the allocation becomes part of the partnership agreement, (1) the after-tax economic consequences of at least one partner may, in present value terms, be enhanced compared to the consequences if the allocation (or allocations) were not contained in the partnership agreement, and (2) there is a strong likelihood that the after-tax consequences of no partner will, in present value terms, be substantially diminished compared to the consequences if the allocation (or allocations) were not contained in the partnership agreement.67 The substantiality requirement is aimed largely at preventing a taxpayer from making a tax-advantaged allocation with economic effect where there is a strong likelihood that another allocation will offset the impact of the original special allocation.68

2. **Partnership Minimum Gain**

Because a lender will bear the economic burden of deductions or losses that are financed with nonrecourse debt (“nonrecourse deductions”),69 such items cannot have economic effect.70 As a result, the regulations provide that such allocations must be made in accordance with the partners’ interests in the partnership.71 To the extent that a nonrecourse liability exceeds the basis (or book value in situations where the property

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64 Treas. Reg. §1.704-1(b)(1)(i) and (b)(3).
66 Id.
68 See Treas. Reg. §1.704-1(b)(2)(iii)(b) and (c) (providing rules for “shifting” and “transitory” allocations).
70 Id. To the extent that the value of the property securing the debt falls below the amount of the debt, the lender will not be repaid. Accordingly, the lender rather than the partner bears the risk with respect to depreciation in the value of the property below the amount of the debt.
71 Id.
has been contributed or revalued)\textsuperscript{72} 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.\textsuperscript{73} This excess is referred to as “partnership minimum gain.”\textsuperscript{74} Partnership minimum gain often arises (or increases) as a result of depreciation deductions taken with respect to the collateral property.\textsuperscript{75} Partnership minimum gain will be reduced where the amount of the debt is reduced\textsuperscript{76} and generally will be eliminated when the property securing the debt is disposed of. The minimum gain chargeback requirement in the regulations generally requires that each partner must be allocated items of partnership income and gain equal to the partner’s share of the net decrease in partnership minimum gain in the year that such a decrease occurs.\textsuperscript{77}

3. **Partner Minimum Gain**

Where one or more partners bear the economic risk of loss with respect to a nonrecourse liability (either because the partner lent the money to the partnership or guaranteed the otherwise nonrecourse liability), losses or deductions attributable to the partner nonrecourse liability (partner nonrecourse deductions) must be allocated to the partner that bears the risk of loss for the liability.\textsuperscript{78} Where more than one partner bears the economic risk of loss for a partner nonrecourse liability, partner nonrecourse deductions attributable to the liability must be allocated among the partners according to the ratio in which they bear the risk of loss.\textsuperscript{79} The regulations also contain rules for determining partner nonrecourse debt minimum gain and providing for the chargeback of such gain in a manner similar to the rules for partnership minimum gain.\textsuperscript{80}

4. **COD Income and Minimum Gain**

Where a nonrecourse liability (as defined for purposes of section 752) is reduced or eliminated in connection with a workout, and there is partnership minimum gain or partner nonrecourse debt minimum gain, income from the discharge (to the extent of the

\textsuperscript{72} Treas. Reg. §1.704-2(d)(4).
\textsuperscript{73} Treas. Reg. §1.704-2(b)(2). The partnership agreement generally should provide for the allocation of nonrecourse deductions in a manner that is reasonably consistent with allocations that have substantial economic effect of some other significant item attributable to the property securing the debt. Treas. Reg. §1.704-2(e)(2).
\textsuperscript{74} Treas. Reg. §1.704-2(b)(2).
\textsuperscript{75} Id.
\textsuperscript{76} Id.
\textsuperscript{77} Treas. Reg. §1.704-2(f)(1).
\textsuperscript{78} Treas. Reg. §1.704-2(i)(1).
\textsuperscript{79} Id. If partners bear the economic risk of loss for different portions of a liability, each portion is treated as a separate partner nonrecourse liability. Id.
\textsuperscript{80} Treas. Reg. §1.704-2(i)(2) - (4).
reduction in minimum gain) must be allocated in accordance with the relevant chargeback provision.81 Specifically, as amended in 2011, the regulations provide that any minimum gain chargeback required for the taxable year of a partnership will consist first of a pro rata portion of gain recognized from the disposition of property subject to the nonrecourse liabilities and COD income relating to nonrecourse liabilities to which the property is subject.82 After such items are exhausted, the chargeback will consist of a pro rata portion of the partnership’s other items of income and gain for that year.83

5. COD Income and Economic Effect

With respect to income from a workout of recourse debt, or nonrecourse debt where minimum gain does not exist (or the related income is greater than the amount of minimum gain), the general rules regarding substantial economic effect will apply. The legislative history to the Bankruptcy Tax Act of 1980 (the “1980 Act”) assumes that income from the discharge of indebtedness will be allocated among the partners in the same manner in which the discharged liability was shared by the partners under section 752.84 Rev. Rul. 92-97,85 however, recognizes that this will not always be the case. The revenue ruling sets forth an analysis of the economic effect requirement where the partnership agreement allocates COD income in a manner that is different from how the partners share the debt.86

Rev. Rul. 92-97 analyzes two factual situations. Under the first scenario, two partners, A and B, had contributed $90 and $10 respectively on the formation of a general partnership. The partnership borrowed an additional $900 on a recourse basis to acquire property. A bore the risk of loss for $810 of the debt and B bore the risk of loss for $90 of the debt, and the liability was allocated among the partners accordingly under section 752. The partnership allocated deductions and losses 90-10 among its two partners but allocated income and gain among such partners 50-50. The $900 debt obligation was discharged as part of a workout at a time when the property was fully depreciated. As a result, A’s capital account was negative by $810 and B’s was negative by $90 at the time of the discharge. The partners were obligated to restore deficit capital accounts only to the extent necessary to pay creditors, so the deficit restoration obligations of A and B were eliminated when the partnership’s liability was discharged.

If the income from the discharge of the liability had been allocated 50-50 pursuant to the terms of the partnership agreement, A would have wound up with a negative capital account balance equal to $360 (($810) + $450), and B would have had a positive capital account equal to $360 (($90) + $450). However, because A had no obligation to fund B’s capital account by restoring A’s capital account deficit, such an allocation would not have had economic effect. Accordingly, the revenue ruling holds that the only allocation that would have had economic effect would have been an allocation in accordance with how the partners had shared the liability; that is, $810 to A and $90 to B. Such an allocation would have left each partner with a capital account balance of $0.

Under the second scenario considered in Rev. Rul. 92-97, the facts are exactly the same, except that A and B both had unlimited deficit restoration obligations. Under this scenario, the Service held that a 50-50 allocation of the COD income between A and B did have economic effect because A would be required to fund B’s positive capital account. In other words, there were real economic ramifications to the allocation.

In analyzing the results in Rev. Rul. 92-97, it is important to recognize that the property acquired with the proceeds of the recourse debt had been fully depreciated, and the losses from the property attributable to the depreciation had been allocated among the partners. In the first scenario, by reflecting the losses attributable to the debt in each partner’s capital account in a situation where the deficit restoration obligations of the partners ultimately were not effective to force satisfaction of the negative capital accounts, the debt effectively became akin to nonrecourse debt where significant partnership minimum gain existed. That is, the partners had taken deductions that were funded by a creditor to whom the partners ultimately were not required to make a payment. Allocating the COD income in the same manner that the debt was allocated under section 752 (i.e., how the parties had agreed to share responsibility for the debt, and hence risk of loss for property funded by the debt) operated to reverse the prior benefit of the deductions for which the partners never had to bear the cost. The result is similar to that which would have been obtained under the rules providing for chargeback of partnership minimum gain had the debt been nonrecourse.

There would appear to be greater flexibility in allocating COD income where the partners still have positive section 704(b) capital accounts, even where the partners do

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87 See J. Avakian-Martin, Partnership Ruling May be More Than Meets the Eye, IRS Official Says, 92 Tax Notes Today 235-2 (Nov. 24, 1992). This article reports Susan Pace Hamill, then an attorney adviser in the IRS Office of Chief Counsel (Passthroughs and Special Industries), as stating that Rev. Rul. 92-97 was “the first step in dealing with the problem of income allocation, [or] restoring . . . a deficit capital account because the deficit capital account is no longer covered by a deficit restoration obligation.”

88 See Treas. Reg. §§1.704-2(b)(2), (c), (d), and (f).
not have deficit restoration obligations. Where the partners still have positive section 704(b) capital accounts prior to discharge of the debt, the elimination of the debt will actually free up positive section 704(b) capital for the partners. The allocation of that COD income attributable to the discharge of the debt will economically benefit the partner to whom the COD income is allocated by increasing that partner’s section 704(b) capital account in a situation where capital actually exists in the partnership to support that capital account.

Consider the following example: A and B are general partners in a partnership that liquidates in accordance with positive capital accounts. A and B are equal partners in all respects, except that the partnership agreement provides that all COD income will be allocated to A. A and B each contributed $400x to the partnership. A bank provides an additional $800x to the partnership, with interest payable quarterly and all principal due in ten years. The partnership acquires property with $1,000x and retains the additional $600x in liquid assets. The partners share the debt equally under section 752, as they will equally bear the risk of loss with respect to the debt as general partners. Neither partner, however, has a deficit restoration obligation that would force it to make a payment to satisfy the positive capital account of another partner. Soon after the loan is made, at a time when the property is still worth $1,000x and each partner’s section 704(b) capital account is still $400x, the lender experiences severe liquidity problems and agrees to accept $600x in immediate repayment of the $800x debt. The elimination of the $800x debt for $600x creates an additional $200x of positive section 704(b) capital in the partnership, as the partnership now owns property worth $1,000x and is liable for no debt. The allocation of the $200x COD income to A increases A’s section 704(b) capital account to $600x and effectively isolates the partnership’s increased capital for the benefit of A. Such allocation should have economic effect even though the COD income is not allocated consistently with the section 752 sharing of the liability and even though A does not have a deficit restoration obligation.

A somewhat different situation is posed where the partners still have positive section 704(b) capital accounts, but the property securing the debt has fallen significantly in value, so that the section 704(b) capital accounts no longer represent the true fair market value of the property. The following example illustrates the issues raised in this situation. A and B are members of an LLC. A and B each contribute $100x to the LLC, and the membership agreement provides that they share equally in all income, gain, loss, and deductions. A bank lends an additional $800x to the LLC. The debt is recourse to all of the assets of the LLC, and A guarantees the loan. Accordingly, under section 752, the entire loan is allocated to A. The LLC acquires property for $1,000x. Neither member has a deficit restoration obligation that would force it to make a payment to satisfy the positive capital account of another partner. Soon after acquisition, the value of the property falls to $500x, and the lender agrees to reduce the balance of the debt owed to $500x.

See generally J. Sowell, Allocation of COD Income in Partnership Workouts, 26 Tax Mgmt. Real Est. J. 23 (2010); cf FSA 200043004 (July 11, 2000) (recognizing that COD income under consideration was allocated differently from liability allocations under section 752).
In determining how to allocate the $300x COD income, presumably the allocations provided in the membership agreement would serve as the starting point. Under the membership agreement, the COD income would be allocated $150x to A and B even though the debt was allocated entirely to A under section 752. Such an allocation would seem permissible by reference to the standards of economic effect. Unlike the first situation considered in Rev. Rul. 92-97, an allocation of COD income consistent with how the members agree to share the risk of loss for the debt would not seem necessary. No portion of the loss attributable to the debt has been reflected in the capital accounts of A and B, and by forgiving $300x of the debt, the lender has provided that A, in fact, will not have to bear the risk of loss for that portion of the debt. By allocating the COD income equally to A and B, each party’s capital account would increase to $250. If the property was then sold for its $500x fair market value, the $500x loss would be allocated consistent with the membership agreement, $250x to each member. Each member’s capital account would be $0, which would be consistent with their economic deal.90

Arguably, this result would apply even if the bank foreclosed on the property and agreed in connection with the foreclosure not to pursue A on A’s guarantee or to otherwise pursue any deficiency judgment.91 In this situation, the loss with respect to the property would be triggered at the same time that the debt is forgiven, and the items with respect to both events would be allocated as part of the LLC’s net or “bottom line” income or loss allocation92 as of the end of the taxable year. Because A’s economic exposure for that loss is eliminated as part of the same transaction, the justification for

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90 It should be noted that Rev. Rul. 92-97 states:

An allocation to a partner of a share of the partnership's cancellation of indebtedness income that differs from the partner's share of the cancelled debt under section 752(b) has substantial economic effect under section 704(b) if (1) the deficit restoration obligations covering any negative capital account balances resulting from the COD income allocations can be invoked to satisfy other partners’ positive capital account balances, (2) the requirements of the economic effect test are otherwise met, and (3) substantiality is independently established.


The statement in subparagraph (1), taken in isolation, could be read to imply that, in order to allocate COD income in a manner that is different from a partner’s share of the forgiven liability under section 752, a partner must have a deficit restoration obligation to satisfy any negative capital account that might occur following an allocation of COD income that is different from the 752 debt share. Taken in the context of the ruling facts, however, it would appear that this language is better read to deal with a situation where the partner would actually wind up with a negative capital account as a result of a special COD income allocation. The statement would not seem applicable where no partner will have a negative capital account following the forgiveness of the indebtedness.

91 Given that the debt in the example is both recourse to the LLC and guaranteed by a partner, it seems that such debt would properly be treated as recourse for purposes of determining COD income in a foreclosure transaction.

specially allocating that loss (and offsetting COD income) to A would seem to be eliminated as well.

The rules relating to allocations with respect to partner nonrecourse debt minimum gain arguably support this analysis. Where debt is nonrecourse to a partnership but is guaranteed by a partner, the deductions funded by that debt would be treated as partner nonrecourse deductions under Treas. Reg. §1.704-2(b)(4) and would be allocated to the partner who bears the risk of loss for the debt. While the debt under consideration in the example is exculpatory debt (i.e., debt that is recourse to the assets of the entity, but that would not be recourse to a partner absent the contractual guarantee) and thus technically is not “nonrecourse” debt for these purposes, the situation is analogous to partner nonrecourse debt, so that an analysis of the minimum gain rules is instructive.93

In the example above, at end of the prior taxable year, there would be no partner nonrecourse debt minimum gain, since the section 704(b) book value of the property exceeds the debt (i.e., losses attributable to the debt have not yet been reflected in capital accounts). At the end of the current taxable year, there also would be no partner nonrecourse debt minimum gain, as the debt and section 704(b) book value of the property both would have been reduced (actually, eliminated), such that the debt still does not exceed the section 704(b) book value of the property. The regulations provide for the allocation of nonrecourse deductions to the partner who bears the risk of loss for the debt to the extent that there is an increase in minimum gain during the taxable year under Treas. Reg. §1.704-2(c). Partner nonrecourse debt minimum gain is calculated for these purposes by comparing minimum gain at the end of the prior year to minimum gain at the end of the current year.94 Because, under the example above, there would be no minimum gain at either of the relevant times, there would be no nonrecourse deductions and seemingly no justification for specially allocating the loss items under the regulatory provisions.95 Thus, applying the principles relating to partner nonrecourse debt minimum gain to the example above, the section 704(b) book (and tax) loss and COD income would simply be allocated consistent with the membership agreement as part of the bottom line profit or loss for the taxable year.

93 The preamble accompanying publication of Treas. Reg. §1.704-2 recognizes that difficult issues can arise in allocating deductions attributable to exculpatory liabilities and states that taxpayers “are left to treat allocations attributable to these liabilities in a manner that reasonably reflects the principles of section 704(b).” T.D. 8385 (preamble).


6. COD Income and Substantiality

In 1999, the Service published an additional ruling regarding the substantiality of COD income allocations. In Rev. Rul. 99-43,\textsuperscript{96} partners amended the allocation provisions of their partnership agreement after the lender reduced the balance due on partnership debt to specially allocate the resulting COD income to an insolvent partner who was eligible to exclude such income. The book loss attributable to the property (resulting from a revaluation) that secured the debt also was specially allocated among the partners so as to exactly offset the special allocation of COD income. The ruling held that the special allocations did not satisfy the substantial economic effect requirement. According to the ruling, “partnership special allocations lack substantiality when the partners amend the partnership agreement to specially allocate COD income and book items from a related revaluation after the events creating such items have occurred if the overall economic effect of the special allocations on the partners’ capital accounts does not differ substantially from the economic effect of the original allocations in the partnership agreement.”\textsuperscript{97} The ruling also provided that close scrutiny would be required if the allocations were altered in anticipation of a COD event that was likely to occur. It is not clear from the ruling how “likely” the COD event must be to invoke close scrutiny.

7. Sale Gain and Section 704(c)

Finally, it is important to note that the substantial economic effect rules apply only with respect to the allocation of book income.\textsuperscript{98} Taxable income generally will be allocated to match book income if the taxable income relating to the item is the same as book income (e.g., COD income). However, to the extent that sale gain or loss is recognized in a debt discharge scenario with respect to section 704(c) property (i.e., built-in gain or loss property previously contributed to the partnership), some or all of the gain or loss will be allocated to the partner who contributed the property (or the successor of the contributing partner) as required by section 704(c).\textsuperscript{99}

\textsuperscript{96} 1999-2 C.B. 506.

\textsuperscript{97} Id.

\textsuperscript{98} Treas. Reg. §1.704-1(b)(1)(vi).

\textsuperscript{99} See Treas. Reg. §1.704-3. For purposes of maintaining capital accounts, property is recorded on the books of a partnership at fair market value, determined as of the date of the contribution. Treas. Reg. §1.704-1(b)(2)(iv)(b)(2). Because section 704(c) gain or loss is equal to the precontribution gain or loss inherent in contributed property, there is no book income or loss to match section 704(c) gain. The same analysis will apply for reverse section 704(c) gain or loss with respect to property that has been the subject of a revaluation under Treas. Reg. §1.704-1(b)(2)(iv)(f).
C. Deemed Distributions and Gain Recognition

1. Deemed Distributions

While practitioners tend to focus on whether a partnership has sale gain or COD income in a workout and how such gain or income will be allocated among the partners, it is important to remember that partners also may recognize gain from the deemed distribution that results from the reduction or elimination of the liability. A partner will recognize gain under section 731(a) to the extent that the partner receives a distribution of cash in excess of the basis of the partner’s interest. To the extent that a partner’s share of partnership liabilities is reduced, that partner will be treated as receiving a distribution of cash that may cause such recognition of gain.

2. Basis Increase for COD Income

If an allocation of sale gain or COD income is made to a partner, that partner’s basis in its partnership interest is increased under section 705(a)(1)(A). Such an increase occurs even if the partner excludes COD income under section 108(a).

3. Timing of Deemed Distribution

For purposes of sections 705 and 731, advances or drawings of cash against a partner’s distributive share of income are treated as current distributions made on the last day of the partnership taxable year with respect to that partner. Rev. Rul. 92-97 and Rev. Rul. 94-4 both treat a deemed distribution of money to a partner resulting from the cancellation of debt as an advance or drawing against income for this purpose.
purpose. Accordingly, a partner’s basis in its partnership interest will be increased for COD income allocated to such partner prior to the deemed distribution that results from the liability relief. This will allow partners to avoid recognition of gain from the deemed distribution so long as the COD income is allocated in the same manner that the partners allocated the debt that was cancelled.106 If COD income is allocated other than in the manner that the discharged debt was allocated, the partners must be careful to ensure that gain is not triggered as a result of the deemed distribution.107

IV. Exclusion or Deferral of COD Income Realized by a Partnership

The mere fact that a partnership realizes COD income does not necessarily mean that anyone will have to pay tax with respect to such income. Section 108 contains numerous provisions that allow taxpayers to exclude or defer COD income.

Here, it is important to recognize the difference between sale gain and COD income. As discussed above,108 in a debt workout, some or all of the income may be sale gain rather than COD income. The exclusions in section 108 apply only with respect to COD income; they do not apply to sale gain even when such gain is recognized in connection with a debt workout.109 Accordingly, in many situations, it can be advantageous to structure the workout so as to increase COD income and reduce sale gain. (Of course, if none of the section 108 exclusions apply, sale gain would be more attractive to the extent that more favorable capital gains rates apply.)

A. Bankruptcy and Insolvency

1. Exclusion

   a. In General

   Section 108(a)(1)(A) and (B) exclude from gross income any amount of income from discharge of indebtedness if the discharge occurs in a title 11 (bankruptcy) case or when the taxpayer is insolvent. Both of these provisions are applied at the partner level110 so that, in the context of the discharge of partnership debt, the bankruptcy or insolvency of the partnership is not directly relevant.

108 See supra notes 3-24 and accompanying text.
109 See supra note 13.
b. **Bankruptcy**

The bankruptcy exclusion generally applies if the taxpayer is under the jurisdiction of the court in a case under title 11 of the U.S. Code, and the discharge of indebtedness is granted by the court or is pursuant to a plan approved by the court.\(^{111}\) Given that the exclusion is applied, in the partnership context, at the partner level, some confusion arises where the partner is not under the jurisdiction of the bankruptcy court in connection with the discharge of the partnership’s debt, but is otherwise the subject of a bankruptcy proceeding. The legislative history seems to assume that the bankruptcy exclusion will apply with respect to the discharge of partnership debt so long as the partner is the subject of a bankruptcy case, regardless of whether the partner is under the jurisdiction of the court involved in the partnership’s proceeding or whether the partnership is even involved in a bankruptcy proceeding.\(^{112}\)

The Tax Court has permitted a general partner to utilize the bankruptcy exclusion to avoid COD income where the general partner was discharged from liability for partnership debts in connection with bankruptcy proceedings relating to the partnership.\(^{113}\) In this case, the general partner’s share of COD income was in excess of the amount by which such partner was insolvent. By invoking the bankruptcy exclusion in these circumstances, the general partner actually excluded more COD income than it could have under the insolvency exclusion.\(^{114}\)

\(^{111}\) I.R.C. §108(d)(2). For an excellent discussion of the policy issues relating to the bankruptcy exception in the context of partnerships, see D. Levy & M. Hofheimer, Bankrupt Partnerships and Disregarded Entities, 2010 Tax Notes Today 109-5 (June 8, 2010).

\(^{112}\) S. Rep. No. 96-1035, at 21 (1980). This conclusion would seem to be bolstered by proposed regulations relating to bankrupt disregarded entities. Under those regulations, for purposes of applying the bankruptcy exception, neither a grantor trust nor a disregarded entity will be considered to be the “taxpayer” and, instead, the “owner” generally will be treated as the taxpayer to whom the bankruptcy exception will apply. Prop. Reg. §1.108-9(a). Under the general rule, where the debt of a disregarded entity is discharged in a Title 11 case, the bankruptcy exception will apply only if the owner is also the subject of a Title 11 action. Id. Where, however, the regarded owner is a partnership, the general rule will apply by reference to the partners of the partnership to whom the COD income is allocable. Prop. Reg. §1.108-9(b).


\(^{114}\) The Tax Court stated: “Giving due regard to principles of judicial comity, we discern no reason to second guess the bankruptcy court’s assertion of jurisdiction over petitioner in the partnership’s chapter 11 bankruptcy case. We conclude that petitioner’s debts in question were discharged ‘in a title 11 case’ within the meaning of section 108(d)(2). Accordingly, we hold that petitioner’s discharge of indebtedness income is excludable from gross income pursuant to section 108(d)(1)(A).” Id.
c. **Insolvency**

While a taxpayer in bankruptcy may exclude all COD income that arises in such a case, an insolvent taxpayer may exclude COD income only to the extent that the taxpayer is insolvent.\(^{115}\) For purposes of the insolvency exclusion, the term “insolvent” is defined as the excess of liabilities over the fair market value of assets.\(^{116}\) A taxpayer’s insolvency is determined based upon the taxpayer’s assets and liabilities immediately before the discharge.\(^{117}\)

1. **Includible Assets**

Traditionally, assets that were unavailable to creditors were excluded in measuring insolvency.\(^{118}\) However, subsequent to the Bankruptcy Tax Act of 1980, it appears that all of a taxpayer’s assets will be included in measuring insolvency, regardless of whether some of the assets are exempt from the claims of creditors.\(^{119}\)

2. **Contingent Liabilities**

There is significant uncertainty regarding the appropriate treatment of contingent liabilities in measuring a taxpayer’s insolvency. In a recent case, the Ninth Circuit Court of Appeals, in affirming the Tax Court, held that “a taxpayer claiming to be insolvent for purposes of §108(a)(1)(B) and challenging the Commissioner’s determination of deficiency must prove by a preponderance of the evidence that he or she will be called upon to pay an obligation claimed to be a liability and that the total amount of liabilities so proved exceed the fair market value of his or her assets.”\(^{120}\) There, the majority of the Ninth Circuit rejected the dissent’s argument that the term liability should include all liabilities, discounted by the probability of their occurrence. Instead, the inclusion of a liability appears to be an “all or nothing” proposition. If there is a greater than 50-percent chance that a taxpayer will have to pay an obligation, the

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\(^{116}\) I.R.C. §108(d)(3).

\(^{117}\) Id.


\(^{120}\) Merkel v. Commissioner, 192 F.3d 844 (9th Cir. 1999).
entire obligation will be included in determining a taxpayer’s insolvency. Otherwise, the liability will be excluded.

(3) **Nonrecourse Liabilities**

While the impact of recourse liabilities on a taxpayer’s insolvency is relatively straightforward, the treatment of nonrecourse liabilities historically was less clear. Although a nonrecourse liability technically is a liability of a taxpayer, a nonrecourse liability does not affect a taxpayer’s economic well-being in the same way as a recourse liability. Specifically, where a nonrecourse liability exceeds the fair market value of assets that secure the liability, the borrower will not feel the full brunt of the liability since the lender cannot recover any more than the value of the collateral in satisfaction of the debt. For example, if a taxpayer holds two assets, one of which has a value of $100 and is secured by a $200 nonrecourse liability, and one of which has a value of $99 and is unencumbered, the taxpayer actually holds $99 of assets that the lender cannot reach. Thus, even though the total liabilities of the taxpayer exceed its total assets, the taxpayer does not feel like it is insolvent.

Rev. Rul. 92-53\(^{122}\) represented the first step by Treasury and the Service in interpreting the impact of nonrecourse liabilities on a taxpayer’s insolvency. In Rev. Rul. 92-53, Treasury and the Service held that the amount by which a nonrecourse liability exceeds the fair market value of the property securing the debt ("excess nonrecourse debt") should be treated as a liability for purposes of determining insolvency to the extent that the excess nonrecourse debt is discharged. If, however, the nonrecourse debt is not being discharged, the debt should be treated as a liability in determining insolvency only to the extent of the fair market value of the property securing such debt.

In so holding, Treasury and the Service may have believed that, once a liability is actually forgiven so that the discharged portion gives rise to COD income, it is hard to ignore the status of the debt as a “liability” for purposes of section 108. As the explicit rationale for its conclusion that discharged debt should be included in determining a taxpayer’s insolvency, however, Treasury and the Service cited Congress’ desire in providing for the insolvency exclusion that insolvent taxpayers should have a “fresh start” following the workout of their debt.\(^{123}\) If the discharged nonrecourse debt was not included in determining a taxpayer’s insolvency, the taxpayer would have to pay tax to the federal government in a situation where the taxpayer may not have adequate assets to pay the tax. In other words, the workout that was intended to give the taxpayer a fresh start could put the taxpayer right back in the hole with its creditors (this time, including the federal government).

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Partnership Interests as Assets or Liabilities

Finally, the effect of a partner’s interest in a partnership on such a partner’s insolvency raises a host of difficult issues that are not addressed by any definitive authorities. Section 752 provides for the allocation of liabilities among partners, but should a partner’s allocable share of liabilities for those purposes also be treated as liabilities of the taxpayer in determining insolvency? Such an approach would not seem appropriate, given that the insolvency determination is intended to take stock of a taxpayer’s true economic situation, and the rules under section 752 do not always reflect how the responsibility for partnership liabilities ultimately will be shared.

One commentator has recommended what seems to be a reasonable method for accounting for partnership interests in measuring insolvency. Under this proposal, if a partnership is solvent and has a net positive value, the taxpayer’s interest should be included as an asset at its fair market value. According to the commentator, the value of the interest should be determined by reference to the balance of the partner’s capital account, measured after a hypothetical disposition of all of the partnership’s assets at fair market value and satisfaction of the partnership’s liabilities. If the partner would have a negative capital account after the partnership’s hypothetical sale and satisfaction of creditors, then the partner’s interest in the partnership would be treated as a liability to the extent that the partner would be obligated to restore his or her negative capital account.

Under the proposed approach, nonrecourse debt effectively would not be taken into account to the extent that such liabilities exceed the value of the assets that are security for the debt. This result is logical in many situations because the lender will bear the loss to the extent that the debt exceeds the value of the property.

An exception to this general treatment seemingly should apply, however, where the nonrecourse debt under consideration is being discharged. Although Rev. Rul. 92-53 did not directly address a situation involving the forgiveness of partnership debt, with Rev. Rul. 2012-14, Treasury and the Service expanded the rationale of Rev. Rul. 92-53 to the partnership context.

Under the facts of Rev. Rul. 2012-14, the partnership borrows $1,000,000 from a commercial lender. The note is secured by real estate that the partnership acquired.

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124 See Livsey, Determining if a Taxpayer is Insolvent for Purposes of the COD Exclusion, 76 J. Tax’n 224 (1992).

125 Under the proposal, the taxpayer would reduce the fair market value of the partnership interest by the cost of disposal and also could discount the value, in appropriate circumstances for lack of control and liquidity. Id.

126 Id. Again, according to the commentator, the value should be reduced by the cost of disposal and any applicable minority or liquidity discounts.

127 Id.
from a third party, in part, with the proceeds of the loan. The ruling states that, at the
time the loan is made, the value of the real estate exceeds the $1,000,000 balance of the
note. The ruling makes clear that the note is a nonrecourse liability within the meaning
of Treas. Reg. § 1.752-1(a)(2), and neither the partnership nor its partners are personally
liable on the note.128

In the year following when the liability was incurred, the value of the real estate
has fallen to $800,000. The outstanding principal on the note is still $1,000,000, and
the bank agrees to modify the terms of the note by reducing the note's principal amount
to $825,000.129

The partners, described as X and Holdco, share equally in the nonrecourse liabilities
of the partnership under Treas. Reg. §1.752-3. The ruling provides that, at the time of
the modification of the note, X and Holdco have no assets or liabilities other than their
partnership interests. The partnership’s sole asset is the real estate subject to the note,
and the partnership’s sole liability is the note.130 According to the ruling, the COD income
attributable to the discharged debt would be allocated equally between X and Holdco.

In Rev. Rul. 2012-14, the analysis begins with the following statements:

In order to properly apply Rev. Rul. 92-53 in a
partnership context, the partnership's discharged excess
nonrecourse debt should be associated with the partner
who in the absence of the insolvency or other § 108
exclusion would be required to pay the tax liability arising
from the discharge of that debt. Therefore, a

128 Although the ruling does not specifically state that the debt is nonrecourse for purposes of section
1001, the facts clearly indicate that this is the case. The question thus becomes, should the fact that the
debt is nonrecourse for purposes of section 1001 matter for purposes of the analysis under Rev. Rul.
2012-14, or instead should the analysis more properly turn on whether the partners are personally liable
for the debt? The determination as to whether debt is recourse or nonrecourse to the partnership for
purposes of section 1001 seemingly should be irrelevant to the issue considered in Rev. Rul. 2012-14. So
long as the partners have no personal liability for the debt of the partnership, strong arguments can be
made that the analysis in Rev. Rul. 2012-14 should apply. As with debt that clearly is nonrecourse debt
of a partnership for purposes of section 1001, debt that is recourse to the partnership but not to the partner
will not affect the economic well-being of a partner beyond the debt’s effect on the value of the
partnership interest. The discharge of such debt, however, can create a tax liability for the partner that the
partner may be unable to satisfy, depending on the other assets and liabilities of the partner. The “fresh
start” policy that justifies the specific holding in Rev. Rul. 2012-14 is equally at play if the debt is
considered recourse to the partnership for purposes of section 1001 but nonrecourse to the partners under
Treas. Reg. §1.752-1(a)(2). Accordingly, it seems that the analysis in Rev. Rul. 2012-14 should apply
equally in this situation. In this situation, “excess” liabilities (akin to excess nonrecourse liabilities in
Rev. Rul. 2012-14) would represent the recourse liabilities in excess of the total value of the assets of the
partnership. See generally J. Sowell, Good News Regarding Partnership Debt and Partner Insolvency,

129 At the time that the lender reduces the note’s principal amount, the partnership has no partnership
minimum gain with respect to the note under Treas. Reg. §1.704-2(d)(1).

130 The ruling states that the bankruptcy exclusion under section 108(a)(1)(A) does not apply in this case.
partnership’s discharged excess nonrecourse debt is treated as a liability of the partners for purposes of measuring the partners’ insolvency under § 108(d)(3) based upon how the COD income with respect to that portion of the debt is allocated among the partners under § 704(b) and the regulations thereunder.131

In the ruling, the partnership’s $175,000 of COD income attributable to the excess nonrecourse liability is allocated equally between X and Holdco. Accordingly, for purposes of measuring the insolvency of the partners, the partnership’s discharged excess nonrecourse debt is treated as a liability of its partners based upon the COD income allocation. More specifically, the ruling provides that X should treat $87,500 of the partnership’s debt as a liability of X, and Holdco should treat $87,500 of the partnership’s debt as a liability of Holdco. It then follows that X and Holdco treat their shares of the cancelled partnership excess nonrecourse debt as their own liabilities in determining whether, and to what extent, each is insolvent within the meaning of section 108(d)(3).

As previously stated, X and Holdco have no assets or liabilities other than their interests in the partnership. Based upon the assets and liabilities of the partnership, the ruling provides that the value of X’s and Holdco’s partnership interests is zero. As a result, the ruling concludes that, immediately before the lender discharges the indebtedness, X’s liability exceeds the value of X’s partnership interest by $87,500, and Holdco’s liability exceeds the value of Holdco’s partnership interest by $87,500.132 The ruling further concludes that X and Holdco each are insolvent to the extent of $87,500 under section 108(d)(3) and thus may exclude their $87,500 amount of COD income under section 108(a)(1)(B).133


132 Note that, in evaluating the insolvency of the partners in Rev. Rul. 2012-14, the ruling states as a fact that the taxpayers’ liabilities (i.e., the excess nonrecourse partnership liabilities that are discharged) exceed the value of the partnership interest held by the taxpayers (which constitute each taxpayer’s only asset). That is, each taxpayer was considered to owe $87,500 on a direct liability and otherwise to own a partnership interest with a value of $0. The analysis is a blend of entity and aggregate principles with respect to the partnership. That is, the revenue ruling takes an aggregate approach by attributing the discharged excess nonrecourse liability to the partner and treating such liability as if it was directly incurred by the partner. But the ruling otherwise applies an entity analysis for purposes of accounting for the partnership interest on the asset side of the insolvency analysis. While the blend of entity and aggregate principles might appear a bit odd, this analysis would seem to be more logical in the context of the facts considered in the ruling (i.e., a single-asset partnership). For a partner, an analysis of the net value of the partner’s economic interest in the property held by the partnership can be made more easily by reference to the partnership interest than by attributing a share of assets and nonrecourse liabilities from the partnership to the partner and undertaking a separate analysis of assets and liabilities on that basis. See Good News, supra note 128. The issues grow more complicated where the partnership holds multiple assets and only certain of the assets are secured by the nonrecourse debt being discharged. It is less clear that the entity approach applied in Rev. Rul. 2012-14 referencing the value of the partnership interest will provide the proper results in this context.

133 Rev. Rul. 2012-14 does not consider a situation involving debt that is nonrecourse to the partnership and that is owed to a partner. While one might view such debt to constitute a “liability” for purposes of
In a field service advice, the Service held that, where assets were contributed to an entity in a transaction that was simultaneous with the discharge of indebtedness of the entity, the contributed assets should be disregarded in determining whether the entity was insolvent “immediately before” the discharge.

2. Reduction of Tax Attributes

a. General Attribute Reduction

The exclusion of COD income pursuant to the bankruptcy or insolvency provisions generally carries with it some cost. When a taxpayer excludes COD income pursuant to these provisions, the taxpayer must reduce certain tax attributes. The reductions generally apply to the following tax attributes in the following order: (1) net operating losses, (2) general business credits (under section 38), (3) minimum tax credits (under section 53), (4) capital loss carryovers, (5) basis of the taxpayer’s property, (6) passive activity loss and credit and carryovers, and (7) foreign tax credit carryovers. These reductions are made after the taxpayer determines his or her tax liability for the taxable year of the discharge and thus do not impact upon the taxpayer’s tax liability for such year.

determining insolvency based on the simple fact that such debt is giving rise to COD income, it is important to recognize that the policy reasons that explicitly justify the result in the ruling may not apply as clearly where the debt is owed to a partner. As previously discussed, the “fresh start” concern that justifies allowing the partners to consider the discharged excess nonrecourse debt as a direct obligation for purposes of measuring insolvency is based upon the tax liability that would follow from the COD income generated by the forgiveness of the liability. If the partner also is the creditor, that partner may be permitted to take a bad debt deduction with respect to the debt that would effectively offset any COD income. If the partner is a corporation or the debt is otherwise “business” debt deductible under section 166(a) to the extent of the worthlessness of such debt, the partner could take an ordinary deduction that would eliminate that tax liability resulting from the COD income. It is important to recognize that the issues with respect to debt advanced by a partner are complicated, and the policy concerns may be different than with respect to the facts addressed in Rev. Rul. 2012-14. See Good News, supra note 128.

A member of the IRS National Office initially expressed concern in applying Rev. Rul. 2012-14 in the context of debt issued to a partner, although that same representative subsequently indicated that, upon further consideration, “it may be that the better answer is that the principles do apply” in such a situation. Compare A. Elliott, Recent Share-of-Liability Guidance Doesn’t Extend to Partner Lender, IRS Says, 2013 Tax Notes Today 2013 Tax Notes Today 86-1 (May 3, 2013) (reporting on comments of Beverly Katz, Special Counsel, IRS Office of Associate Chief Counsel (Passthroughs and Special Industries)), with A. Elliott, ABA Meeting: Recent Share-of-Liability Guidance May Extend to Partner Lender, 2013 Tax Notes Today 92-6 (May 13, 2013) (same).


I.R.C. §108(b)(1).


b. **Rules Applying to Basis Reduction**

Section 1017 provides special rules for determining the reduction in basis of property held by a taxpayer. First, the amount of any basis reduction for bankrupt or insolvent taxpayers cannot exceed the excess of the aggregate adjusted basis of property and money held immediately after the discharge over the aggregate liabilities of the taxpayer immediately after the discharge.\(^{138}\) Second, where COD income is excluded in connection with a bankruptcy case, no reduction is made to the basis of property treated as exempt property in the bankruptcy case.\(^{139}\) Finally, where the basis of property is reduced as a result of excluding COD income, such reduction creates recapture potential with respect to the property regardless of whether the property is section 1245 or 1250 property.\(^{140}\)

The regulations under section 1017 provide rules for determining the order in which property basis will be reduced. A reduction will apply in the following order: (1) real property used in a trade or business or held for investment (other than real property described in section 1221(a)(1)) that is secured by the discharged debt immediately before the discharge; (2) personal property used in a trade or business or held for investment (other than inventory, accounts receivable, and notes receivable) that is secured by the discharged debt immediately before the discharge; (3) remaining property used in a trade or business or held for investment (other than inventory, accounts receivable, notes receivable, and real property described in section 1221(a)(1)); (4) inventory, accounts receivable, notes receivable, and real property described in section 1221(a)(1); and (5) property not used in a trade or business nor held for investment.\(^{141}\) For purposes of applying this ordering rule, a taxpayer must treat a distributive share of a partnership’s COD income as attributable to a discharged indebtedness secured by the taxpayer’s interest in that partnership.\(^{142}\) If property is added to or eliminated as security for debt during the one-year period prior to the discharge of the indebtedness, such addition or elimination will be disregarded where a principal purpose of the change is to affect the taxpayer’s basis reductions under section 1017.\(^{143}\)

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\(^{138}\) I.R.C. §1017(b)(2); Treas. Reg. §1.1017-1(b)(3). Where assets are contributed to an entity simultaneously with a discharge of the entity’s indebtedness, the Service apparently will count the newly-contributed assets in determining the amount of this limitation. FSA 200135002 (Aug. 31, 2001).

\(^{139}\) I.R.C. §1017(c)(1).

\(^{140}\) I.R.C. §1017(d).

\(^{141}\) Treas. Reg. §1.1017-1(a).

\(^{142}\) Treas. Reg. §1.1017-1(g)(1).

\(^{143}\) Treas. Reg. §1.1017-1(d).
c. **Election to Reduce Basis First Under Section 108(b)(5)**

Rather than reduce attributes in the order described above, a taxpayer may elect under section 108(b)(5) to apply such reduction first to the basis of the taxpayer’s depreciable property. Such an election often will be beneficial, given that, in many situations, depreciation expenses spread out over the life of property will be less valuable than a net operating loss or credit that would be immediately available.

A taxpayer is limited in the amount of depreciable basis that may be reduced under section 108(b)(5). The reduction may not exceed the aggregate adjusted bases of the depreciable property held by the taxpayer as of the beginning of the taxable year following the year when the discharge occurs. If the basis reduction under section 108(b)(5) is less than the amount of the excluded COD income, the taxpayer must reduce the balance of his or her tax attributes to the extent of the remaining COD income in the order described above. A taxpayer may utilize the election under section 108(b)(5) to the extent desired. In making an election under section 108(b)(5), a taxpayer is not bound to reduce the basis of depreciable property up to the full amount of COD income, but instead, may choose to only partially reduce depreciable basis, and then reduce other attributes to the extent of the excess COD income.

In some cases, a partner may treat an interest in a partnership as depreciable property to the extent of the partner’s proportionate interest in the depreciable property held by such partnership. A partner’s share of partnership basis in depreciable property is equal to the sum of the partner’s section 743(b) basis adjustments to items of partnership property and the common basis depreciation deductions (not including remedial allocations) that are reasonably expected to be allocated to the partner over the property’s remaining useful life (determined under the partnership agreement effective for the taxable year when the discharge occurs).

In order to treat a partnership interest as depreciable real property, the partner must request that the partnership make a corresponding reduction in the partnership’s basis in depreciable property with respect to such partner. The partner generally has

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144 I.R.C. §108(b)(5); cf. Priv. Ltr. Rul. 200234023 (May 14, 2002) (taxpayer granted 9100 relief to make a late election under section 108(b)(5)).

145 I.R.C. §108(b)(5)(B). In applying the basis adjustment limitation under section 1017(b)(2), a taxpayer must use the aggregate remaining adjusted basis after reducing the basis of depreciable property under section 108(b)(5). Treas. Reg. §1.1017-1(c)(3).

146 Treas. Reg. §1.1017-1(c)(2). The general ordering rules for basis reduction are modified for purposes of section 108(b)(5) to apply only to property that is subject to section 108(b)(5). Treas. Reg. §1.1017-1(c)(1).

147 Id.


149 Treas. Reg. §1.1017-1(g)(2)(iv).

the option to request that the partnership make such an adjustment, and similarly, the
partnership generally is free to accept or reject the request. In certain situations,
however, the partner will be required to request consent, and in some situations, the
partnership will be required to consent to adjust the basis of partnership property.

The regulations regarding mandatory request and consent generally are written
with an eye to preventing taxpayers from contributing depreciable property to a
partnership and then not making an election with respect to the partnership interest in
order to block a basis adjustment with respect to the contributed property. Pursuant
to these regulations, a taxpayer must request a partnership’s consent to reduce basis if,
at the time of the discharge, the taxpayer owns (directly or indirectly) a greater than
50-percent interest in the capital and profits of the partnership or if the reductions to the
basis of depreciable property are being made with respect to the taxpayer’s distributive
share of COD income of the partnership. A partnership must consent to reduce a
requesting partner’s share of inside basis with respect to a discharged indebtedness if
consent is requested with respect to such debt by partners owning (directly or indirectly)
an aggregate of more than 80 percent of the capital and profits interests of the
partnership or five or fewer partners owning (directly or indirectly) an aggregate of
more than 50 percent of the capital and profits interests in the partnership.

A taxpayer may elect to treat real property described in section 1221(a)(1) (i.e.,
real property held primarily for sale to customers in the ordinary course of the
taxpayer’s trade or business) as depreciable property. Where a taxpayer has made
elections to treat both section 1221(a)(1) real property and partnership interests as
depreciable property, it appears that the partnership interest should be treated as
depreciable property to the extent that the partnership holds real property described in
section 1221(a)(1).

A reduction in the basis of partnership property resulting from an election under
section 108(b)(5) is partner-specific and does not reduce the common basis of a
partnership’s assets. Such basis adjustments are treated in the same manner and have
the same effect as basis adjustments under section 743(b).

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152 T.D. 8787 (preamble).
154 Treas. Reg. §1.1017-1(g)(2)(ii)(C).
155 I.R.C. §1017(b)(3)(E); Treas. Reg. §1.1017-1(f).
158 Treas. Reg. §1.1017-1(g)(2)(v)(C).
B. Qualified Real Property Business Indebtedness

1. Exclusion

   a. In General

Taxpayers other than C corporations may elect to exclude COD income derived from the discharge of “qualified real property business indebtedness.”159 “Qualified real property business indebtedness” is defined as indebtedness which (1) was incurred or assumed by the taxpayer in connection with real property used in a trade or business160 and is secured by such real property, (2) was incurred or assumed before January 1, 1993, or was incurred or assumed after such date to acquire, construct, reconstruct, or substantially improve such property, and (3) with respect to which the taxpayer makes an election.161

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159 I.R.C. §108(a)(1)(D).

160 The phrase “real property used in a trade or business” is not defined in section 108(c) or the related regulations. In a different context, section 1231(b)(1) defines the same term to exclude “dealer” property and property held for one year or less. Section 108(c) does not explicitly incorporate such limitations; thus, it seems that the phrase under section 108(c) should not be limited in the same way as in section 1231(b)(1). In addition, in describing the ordering rule for basis reduction under section 1017, the regulations use the phrase “real property used in a trade or business, other than real property described in section 1221(1)” Treas. Reg. §1.1017-1(a)(1) (emphasis added). By describing the broad term “real property used in a trade or business” and then specifically carving out “real property described in section 1221(1)” from that broader definition, the Government would seem to be recognizing that it is at least possible for “dealer” property to be treated as “real property used in a trade or business.” See generally D.C. Bar Tax Section Comments on Cancellation of Qualified Real Property Business Indebtedness, 94 Tax Notes Today 157-36 (Aug. 11, 1994); S. Aaron, Clear as Mud: The Treatment of the Discharge of Qualified Real Property Business Indebtedness, 25 J. of Real Est. Tax’n 138 (1998). Note, however, that Treasury and the Service have proposed, as part of the 2013-2014 Priority Guidance Plan, to issue a “Revenue Ruling under §108 regarding the application of the qualified real property business indebtedness exclusion for real estate developers”, so it is possible that formal guidance on this issue will be forthcoming. IRS, Treasury Release 2013-2014 Priority Guidance Plan, 2013 Tax Notes Today 155-40 (Aug. 12, 2013) (hereafter referred to as the “2013-2014 Priority Guidance Plan”). As a separate point, there also is some question as to the proper time for determining whether the real property is used in a trade or business. Priv. Ltr. Rul. 200953003 states that this determination must be made at the time that the debt was incurred or assumed.

161 I.R.C. §108(c)(3) and (4). The Service has ruled privately that pre-1993 debt of a partnership was incurred “in connection with” real property used in the partnership’s trade or business where, at the time that the debt was incurred, real property used in the partnership’s trade or business was pledged to secure such indebtedness. Tech. Adv. Mem. 200014007 (Dec. 13, 1999). Qualification of debt having no greater connection than being secured by real property used in a trade or business at the time incurred and as of January 1, 1993, seemingly contradicts certain language contained in the preamble to the final regulations. That language states that “[t]he IRS and Treasury Department do not believe that [section 108(c)(3)(A)] should be interpreted to mean only that the debt must be secured by real property used in a trade or business as of January 1, 1993.” T.D. 8787 (1998) (preamble). The Service distinguished the preamble language on the basis that the debt also was secured by business real property at the time that the debt was incurred, even though such debt did not relate to the acquisition of the property. Reasonable
Like the exclusions for bankrupt or insolvent taxpayers, the exclusion for qualified real property business indebtedness applies at the partner, rather than the partnership, level.\textsuperscript{162}

\subsection*{b. Equity Limitation}

Taxpayers are subject to dual limitations as to the amount of COD income that they can exclude with respect to qualified real property business indebtedness. The first limitation relates to the security for the specific indebtedness being discharged and is intended to prohibit taxpayers from excluding COD income related to qualified real property business indebtedness to the extent that the discharge will create equity in the secured property.\textsuperscript{163} Under this limitation, 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.\textsuperscript{164}

For purposes of the first limitation, net fair market value is defined as the fair market value of the qualifying real property, reduced by the outstanding principal amount of any qualified real property business indebtedness (other than the discharged indebtedness) that is secured by such property immediately before and after the discharge.\textsuperscript{165} The outstanding principal amount of qualified real property business indebtedness referred to in the limitation is not necessarily the stated principal amount of the liability. For purposes of this provision, “outstanding principal amount” means the principal amount of indebtedness together with additional amounts that, immediately before the discharge, are equivalent to principal, in that interest on such amounts would accrue and compound in the future.\textsuperscript{166} Accordingly, if interest will further accrue with respect to interest that is not paid, such accrued interest will be treated as outstanding principal. In addition, any portion of the indebtedness the payment of which would give rise to a deduction under section 108(e)(2) will not be considered part of the outstanding principal amount.\textsuperscript{167} This provision will exclude accrued but unpaid interest with respect to a cash basis taxpayer and may exclude minds may differ as to whether this is a justifiable distinction. Separately, the Service has granted section 9100 relief to make a late election under section 108(c)(3)(C) excluding COD income with respect to qualified real property business indebtedness. See Priv. Ltr. Rul. 201316009 (Jan. 18, 2013); Priv. Ltr. Rul. 201325004 (Mar. 18, 2013).

\textsuperscript{162} I.R.C. §108(d)(6).


\textsuperscript{164} I.R.C. §108(c)(2)(a); Treas. Reg. §1.108-6(a).

\textsuperscript{165} Treas. Reg. §1.108-6(a). The net fair market value computation does not take into account section 7701(g). \textsuperscript{Id} “Qualifying real property” is defined as real property with respect to which indebtedness is qualified real property business indebtedness with the meaning of section 108(c)(3). Treas. Reg. §1.1017-1(c)(1).

\textsuperscript{166} Treas. Reg. §1.108-6(a).

\textsuperscript{167} \textsuperscript{Id}. 

225-44
interest owed by an accrual basis taxpayer who has stopped deducting interest due to the substantial likelihood that the accrued interest will never be paid.\textsuperscript{168} Finally, the outstanding principal amount must be adjusted to account for unamortized premium and discount consistent with section 108(e)(3).\textsuperscript{169}

c. Basis Limitation

The second limitation, referred to as the overall limitation, is intended to ensure that a taxpayer incurs some tax detriment (through basis reduction) to offset the benefit of excluding COD income. This limitation provides that the amount of COD income excluded with respect to qualified real property business indebtedness may not exceed the aggregate adjusted basis of all depreciable real property held by the taxpayer immediately before the discharge reduced by the sum of (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 of section 108.\textsuperscript{170} Depreciable real property acquired in contemplation of the discharge may not be considered for purposes of this calculation.\textsuperscript{171}

d. Identifying the Qualifying Portion of a Debt

It is possible, and will often be the case, that only a portion of a debt instrument will be treated as qualified real property business indebtedness.\textsuperscript{172} This raises a question as to how taxpayers should identify the portion of a debt that is forgiven as qualified real property business indebtedness or not.

An example is helpful in illustrating this point. Assume that a partnership initially incurred $50 million of debt in order to acquire an office building. Assume that this debt is treated entirely as qualified real property business indebtedness. At a later date, when the property has appreciated significantly, the partnership refinances the property, incurring an additional $50 million of debt for a total of $100 million of debt secured by the property. The partnership distributes all $50 million of the additional debt proceeds to its partners, so no portion of the additional borrowing can be treated as qualified real property business indebtedness. Afterwards, the property falls in value to

\textsuperscript{168} Cf. Kellogg v. U.S., 82 F.3d 413 (5th Cir. 1996) (deduction denied for accrued interest where debtor was hopelessly insolvent); Tampa & Gulf Coast RR Co. v. Commissioner, 469 F.2d 263 (5th Cir. 1972) (subsidiary could not accrue deduction on debt owed to parent where parent had ceased to accrue income due to remote likelihood of collection); but see Zimmerman Steel Co. v. Commissioner, 130 F.2d 1011 (8th Cir. 1942) (allowing deduction for interest although eventual payment was unlikely).

\textsuperscript{169} Treas. Reg. §1.108-6(a).

\textsuperscript{170} I.R.C. §108(c)(2)(B); Treas. Reg. §1.108-6(b). Reductions to basis for qualified farm indebtedness under section 108(g) also must be excluded.

\textsuperscript{171} I.R.C. §108(c)(2)(B); Treas. Reg. §1.108-6(b).

\textsuperscript{172} Priv. Ltr. Rul. 200953005 (Sept. 23, 2009) confirms that the entire debt need not constitute qualified real property business indebtedness in order to rely on section 108(c) with respect to a portion of the indebtedness.
$50 million, and the lender agrees to forgive $50 million of the $100 million owed. Is any portion of the $50 million COD income excludible under section 108(c)?

In one private letter ruling, the Service has indicated that taxpayers must use a “reasonable allocation method” in determining the portion of a debt instrument that is qualified real property business indebtedness and the portion that is not. This language may imply some flexibility in determining whether the discharged portion of a debt qualifies for exclusion under section 108(c). It is not clear, however, whether the statement in the ruling is directed at determining the portion of the discharged debt that is qualified real property business indebtedness or instead, is simply aimed at measuring the qualifying and non-qualifying portions of the overall debt instrument.

In any event, the impact of the equity limitation under section 108(c)(2)(A) in this instance would seem to make the allocation issue irrelevant. As previously discussed, a taxpayer may exclude COD income only to the extent that the outstanding principal of the qualified real property business indebtedness immediately before the discharge exceeds the net fair market value of the qualifying property immediately before the discharge. In the example set forth above, the amount of qualified real property business indebtedness is $50 million and the value of the underlying property also is $50 million. Accordingly, under these facts (and many other situations that raise the issue of identifying the qualifying portion of a debt), it appears that no portion of the COD income would be excludible under section 108(c) regardless of what portion of the forgiven debt was treated as qualified real property business indebtedness.

e. **“Secured By” Real Property**

In many situations, junior debt with respect to real property is “structurally” subordinated rather than “legally” subordinated, meaning that the junior loan is secured by an interest in a disregarded entity that owns the real property (or possibly a higher-tier disregarded entity, depending on the levels of subordinated debt). Practitioners have argued over whether debt secured by an interest in a disregarded entity can meet the “secured by” requirement contained in section 108(c).

Recently, the Service issued a “safe harbor” revenue procedure indicating that, under certain circumstances, such debt can satisfy the “secured by” requirement in this context. More specifically, Rev. Proc. 2014-20 provides that, if the following five requirements are satisfied, debt secured by a 100-percent ownership interest in a disregarded entity holding real property will be treated as indebtedness that is “secured by” real property for purposes of section 108(c)(3)(A).

1. The taxpayer or a wholly owned disregarded entity of the taxpayer (“Borrower”) incurs indebtedness.

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(2) Borrower directly or indirectly owns 100% of the ownership interest in a separate disregarded entity owning real property ("Property Owner"). Borrower is not the same entity as Property Owner.

(3) Borrower pledges to the lender a first priority security interest in Borrower's ownership interest in Property Owner. Any further encumbrance on the pledged ownership interest must be subordinate to the lender's security interest in Property Owner.

(4) At least 90 percent of the fair market value of the total assets (immediately before the discharge) directly owned by Property Owner must be real property used in a trade or business and any other assets held by Property Owner must be incidental to Property Owner's acquisition, ownership, and operation of the real property.

(5) Upon default and foreclosure on the indebtedness, the lender will replace Borrower as the sole member of Property Owner.174

In the context of large real property acquisitions, it is not at all unusual to see multiple tranches of structurally subordinated junior debt, with each more junior tranche secured by a disregarded entity interest that is directly above the next more senior tranche. Unfortunately, the revenue procedure is very limited in that it appears only to allow for one level of debt to be “secured by” a disregarded entity interest. Although the second requirement contains “direct or indirect” language seemingly implying that multiple layers of security interests may be permitted, the limitation in the fifth

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174 Rev. Proc. 2014-20, 2014 I.R.B. Lexis 83; see also Priv. Ltr. Rul. 200953005 (Sept. 23, 2009). Beyond the revenue procedure, there are certain analogous authorities that advisors previously have considered in analyzing this issue. For real estate investment trusts ("REITs"), Rev. Proc. 2003-65, 2003-2 C.B. 336, provides that, where certain requirements are met, a loan that provides for a security interest in a partnership or disregarded entity that owns real property will be treated as “secured by” real property or an interest in real property. Although helpful, certain distinctions exist under the REIT rules (e.g., rules also apply to an “interest in real property” as defined under section 856(d)(5)(C) and Treas. Reg. §1.856-3(g) generally provides look-through treatment for partnership interests) which make it difficult to rely on this authority in the context of section 108(c). Structural subordination was not utilized in any significant way at the time that section 108(c) was enacted, so it is not surprising that the legislation and legislative history do not address the issue. Such arrangements have been dealt with favorably under Treas. Reg. §1.465-27 in the context of defining qualified nonrecourse financing for purposes of the “at-risk” rules. Treas. Reg. §1.1038-1(a)(2) also would appear to be helpful in providing that “[a]n indebtedness of the seller is secured by the real property for purposes of this section whenever the seller has the right to take title or possession of the property or both if there is a default with respect to such indebtedness.” A lender of structurally subordinated debt generally will be able to obtain possession of the property as a remedy upon default, although not title. The rules relating to “qualified residence indebtedness” under Treas. Reg. §1.163-8T(o) apply a stricter “security” requirement and must be considered by analogy.
requirement providing that, upon default, “the lender will replace Borrower as the sole member of Property Owner” makes clear that only one level of security interest will be permitted. No more senior lender whose debt is secured by a disregarded entity interest would permit a more junior lender to become the sole member of the property-owning disregarded entity.

Rev. Proc. 2014-20 does provide that, if a taxpayer fails to meet the requirements of the safe harbor, it will not be precluded from arguing, based on facts and circumstances, that its debt satisfies the “secured by” requirement in section 108(c)(3)(A). Accordingly, it may still be possible to meet the “secured by” requirement when multiple tranches of structurally subordinated security interests exist.

2. Basis Reduction

A taxpayer is required to reduce the basis of depreciable real property to the extent that COD income is excluded with respect to qualified real property business indebtedness.\footnote{I.R.C. §108(c)(1)(A). The general ordering rule for basis reduction under Treas. Reg. §1.1017-1(a) is appropriately modified for qualified real property business indebtedness so that only the basis of depreciable real property will be reduced. Treas. Reg. §1.1017-1(c)(1).} A taxpayer must first reduce the basis of qualifying real property (generally depreciable real property that secures the qualifying real property business indebtedness)\footnote{See Treas. Reg. §1.1017-1(c)(1).} before reducing the basis of other depreciable real property.\footnote{Id.}

As with elections to reduce the basis of depreciable property under section 108(b)(5), a taxpayer may (and in some situations must) treat an interest in a partnership as an interest in depreciable real property to the extent of the partner’s proportionate share of depreciable real property held by the partnership.\footnote{I.R.C. §1017(b)(3)(F)(i).} The rules with respect to partnerships and qualified real property business indebtedness essentially mirror those that are provided for purposes of section 108(b)(5).\footnote{See supra notes 148-154 and accompanying text.}

Unlike the basis reduction rules for section 108(b)(5), a taxpayer may not elect to treat real property described in section 1221(a)(1) as depreciable real property for purposes of the qualified real property business indebtedness provisions.\footnote{I.R.C. §1017(b)(3)(F)(ii); Treas. Reg. §1.1017-1(f). If debt of a developer with respect to “dealer” property is treated as qualified real property business indebtedness (see supra note 160), it is important to recognize that the developer must still have depreciable real property with sufficient basis to support exclusion of the COD income.} In addition, contrary to the general rule providing that basis reductions attributable to the exclusion of COD income must occur at the beginning of the taxable year after the related debt is discharged, with respect to the discharge of qualified real property business indebtedness, if depreciable real property is disposed of prior to the end of such taxable
year, the basis of such property will be reduced as of the time immediately before disposition.\(^{181}\)

C. **Temporary Deferral of COD Income in Debt “Reacquisitions”**

As part of the American Recovery and Reinvestment Act of 2009, Congress enacted a temporary provision providing for deferral of COD income in limited circumstances. Under section 108(i), a taxpayer who reacquired “an applicable debt instrument” in 2009 or 2010 was entitled to elect to include any COD income resulting from such reacquisition in gross income ratably over a five-tax-year period.\(^{182}\) In the case of a reacquisition occurring in 2009, this five-year period would begin with the fifth taxable year following the taxable year of the reacquisition.\(^{183}\) In the case of a reacquisition occurring in 2010, this five-year period would begin with the fourth taxable year following the taxable year of the reacquisition.\(^{184}\) Thus, the income generally would not have to begin to be taken into account until the five-year period that begins in 2014.\(^{185}\)

While section 108(i) does not permit the deferral of COD income recognized after 2010, the provision remains relevant in current years for purposes of determining the ultimate inclusion of COD income, section 752 deemed distributions, and OID deductions that have been deferred. In addition, there were numerous technical issues under section 108(i) that may be disputed on audit by the IRS. Accordingly, the discussion below continues to address issues that relate to qualification and reporting under section 108(i).

Treasury and the Service attempted to address many of the open issues under section 108(i) through two separate forms of guidance. Rev. Proc. 2009-37\(^{186}\) set forth the initial guidance. This guidance primarily addressed issues related to reporting

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\(^{183}\) I.R.C. §108(i)(1)(A).

\(^{184}\) I.R.C. §108(i)(1)(B).

\(^{185}\) For non-calendar year partnerships, the first taxable year of inclusion could be 2015. For example, if a partnership with a November taxable year end that realizes COD income in December 2009 and elects to defer that income under section 108(i), that COD income would first be included in the taxable year beginning December 1, 2014, and ending November 30, 2015.

\(^{186}\) 2009-36 I.R.B. 309.
deferred COD income, although certain technical issues were considered in the revenue procedure. More recently, temporary and proposed, and then final, regulations were issued addressing a number of previously unanswered technical questions.  

There were a myriad of technical requirements that had to be satisfied to take advantage of section 108(i). Initially, in order for the provision to apply, the reacquired debt had to be an “applicable debt instrument.” A “debt instrument” includes any bond, debenture, note, certificate, or any other instrument or contractual arrangement constituting indebtedness (within the meaning of section 1275(a)(1)). In order for a “debt instrument” to be an “applicable debt instrument,” the instrument had to be issued by (1) a C corporation or (2) any other person in connection with the conduct of a trade or business by such person.

The “trade or business” requirement was a problem for real estate ventures that would like to have used the provision but held their property solely for investment and conducted no trade or business. This requirement also could be a problem for partnerships investing in portfolio companies that were corporations, as the businesses of the portfolio companies was not attributed to the partnership. In those contexts, however, it was more common for debt to be incurred at the portfolio company level rather than the partnership level, so this problem probably did not arise often.

Guidance issued by Treasury and the Service does not address what sorts of activities will qualify as the conduct of a trade or business for purposes of section 108(i). For partnerships that were engaged in a trade or business, however, the regulations do provide certain safe harbors for purposes of determining when debt would be treated as “issued in connection with” that trade or business. Specifically, a debt instrument issued by a partnership is treated as an “applicable debt instrument” if:

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191 Vacant land held for appreciation would be an example. There also may be some concern where property is held pursuant to a triple-net lease and the partnership otherwise provides no services with respect to the property. Cf. Rev. Rul. 73-522, 1973-2 C.B. 226 (discussing net lease property); Priv. Ltr. Rul. 9840026 (June 30, 1998) (discussing rental property generally); Pinchot v. Commissioner, 113 F.2d 718 (2nd Cir. 1940) (discussing rental property generally); DeAmadio v. Commissioner, 34 T.C. 894 (1960), aff’d, 299 F.2d 623 (3rd Cir. 1962) (discussing rental property generally).
(i) The gross fair market value of the trade or business assets of the partnership . . . that issued the debt instrument represented at least 80 percent of the gross fair market value of the partnership’s . . . total assets on the date of issuance;

(ii) The trade or business expenditures of the partnership . . . that issued the debt instrument represented at least 80 percent of the partnership’s total expenditures for the taxable year of issuance;\(^\text{192}\)

(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 §1.163-8T 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.\(^\text{193}\)

In the partnership context, issues also could arise where the debt was incurred by a partner who contributed the funds to a partnership that was engaged in a trade or business.\(^\text{194}\) The safe harbors provided in the final regulations generally provide no comfort that the trade or business of the lower-tier partnership would be attributed to the contributing partner for purposes of section 108(i). Note, however, that, where an upper-tier partnership contributed borrowed proceeds to a lower-tier partnership, the safe harbor contained in (iii) may apply, as it may be possible to characterize interest attributable to the debt as trade or business expenditures by reference to the activities of the lower-tier partnership based upon the rules set forth in Notice 89-35.\(^\text{195}\) Debt of an upper-tier partnership the proceeds of which were contributed to a lower-tier partnership also may be treated as an “applicable debt instrument” based upon the safe harbors outlined in (i) and (ii) above regardless of the use of the proceeds where the

\(^{192}\) Note that the safe harbors in (i) and (ii) require no tracing of debt proceeds or payments to a trade or business of the partnership. Instead, these safe harbors would appear to allow treatment of debt used to finance distributions to partners as an “applicable debt instrument” based solely on the proportionate magnitude of the partnership’s gross trade or business assets on the date of issuance or total expenditures attributable to the partnership’s trade or business in the taxable year of issuance.

\(^{193}\) Treas. Reg. §1.108(i)-2(d)(1).

\(^{194}\) For a discussion of these issues, see NYSBA 108(i) Report, supra note 188; ABA 108(i) Report, supra note 188; New Legislation, supra note 182; Selected Issues, supra note 182.

\(^{195}\) 1989-1 C.B. 675. For a discussion of the issues relating to Notice 89-35 and the safe harbor under section 108(i), see Much Needed Guidance, supra note 187.
upper-tier partnership had sufficient trade or business assets or expenditures as of the relevant time or time period.

By its terms, section 108(i) only applies to certain specified transactions that involve debt forgiveness. Specifically, the COD income must have arisen in connection with a “reacquisition” of an “applicable debt instrument.” A “reacquisition” is defined as any “acquisition” of an “applicable debt instrument” by (1) the debtor that issued (or is otherwise the obligor under) such debt instrument or (2) a person related to the debtor within the meaning of section 108(e)(4). The statute provides that an “acquisition . . . shall include” (1) an acquisition of a debt instrument for cash, (2) the exchange of a debt instrument for another debt instrument (including an exchange resulting from a modification of a debt instrument), (3) the exchange of corporate stock or a partnership interest for a debt instrument, (4) the contribution of a debt instrument to the capital of the issuer, and (5) the complete forgiveness of a debt instrument by a holder of such instrument.

Interestingly, the statute does not explicitly reference an acquisition of debt for property. This omission initially raised some concern that a foreclosure transaction with respect to recourse debt may not qualify for deferral, given that the debt was being acquired for property in that situation. The Service settled this issue favorably in Rev. Proc. 2009-37. Specifically, the revenue procedure provides that an “acquisition” under section 108(i) includes an acquisition of a debt instrument for cash “or other property.” The regulations also use the phrase “or other property” in this same context.

A taxpayer was required to elect to take advantage of section 108(i). The election was made on an instrument-by-instrument basis and the election, once made, was irrevocable. A taxpayer could make the election by including with its tax return

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196 I.R.C. §108(i)(1). See NYSBA 108(i) Report, supra note 188, discussing the difficult issues that can arise in identifying the relevant “debt instrument” in today’s market.


198 I.R.C. §108(i)(4)(B). Although the partial forgiveness of debt is not included in the list, such a transaction will, in most situations, result in a deemed exchange of the debt instrument as a result of the change in yield with respect to such instrument. See Treas. Reg. §1.1001-3(g), Ex. 3.

199 In a foreclosure transaction with respect to nonrecourse debt, the entire debt is treated as the amount realized in calculating gain or loss related to the property. No COD income arises in such a transaction. Treas. Reg. §1.1001-2(c), Ex. 7; Commissioner v. Tufts, 461 U.S. 300 (1983).


201 Id. at §2.03. The Conference Report, in defining an “acquisition,” states that the term “includes, without limitation,” the transactions described in the prior paragraph. H.R. Conf. Rep. No. 111-16, at 56 (2009) (emphasis added); see also I.R.C. §7701(c) (“includes” and “including” shall not be deemed to exclude other things otherwise within the meaning of the term defined).

202 Treas. Reg. §1.108(i)-0(a)(1).


for the taxable year in which the reacquisition occurred a statement that (1) clearly identified the debt instrument and (2) included the amount of income deferred under section 108(i) along with any such other information as Treasury may prescribe.\textsuperscript{205}

While the statute appeared to require that the section 108(i) election must be made by reference to an entire debt instrument, Rev. Proc. 2009-37 and the regulations allowed partial elections under section 108(i).\textsuperscript{206} Accordingly, a taxpayer could elect to defer some or all of the COD income realized with respect to a debt instrument. This option was particularly beneficial where a taxpayer was only partially insolvent or otherwise might have been able to exclude only a portion of its COD income under section 108(a). By virtue of the partial election, such a taxpayer could defer the portion of its COD income that could not otherwise be excluded. The partial election, in combination with certain other rules, also provided much-needed flexibility that made section 108(i) more useful in the partnership context.

For pass-through entities, including partnerships and S corporations, the election had to be made by the entity.\textsuperscript{207} A strict application of this rule would have created significant fiduciary issues for fund sponsors.\textsuperscript{208} These problems would have arisen because, once a taxpayer elected deferral under section 108(i), the taxpayer was precluded from taking advantage of the other COD income exclusions with respect to the income that was the subject of the election.\textsuperscript{209} When a partnership had numerous partners, some of whom were bankrupt or insolvent, some of whom were individuals who might have taken advantage of the exclusion for qualified real property business indebtedness (for real estate partnerships), and some of whom were eligible for no exclusion, the sponsor was presented with a “no win” situation.

Thankfully, the Service, in Rev. Proc. 2009-37 and in the regulations, provided much-needed flexibility in the application of section 108(i) to partnerships. As discussed above, under Rev. Proc. 2009-37 and in the regulations, a taxpayer could elect to defer only a portion of the COD income realized with respect to an applicable debt instrument.\textsuperscript{210} In the partnership context, an election to partially exclude COD income established a “deferred amount” and “included amount” with respect to the applicable debt instrument.\textsuperscript{211} While the partnership had to allocate COD income with

\textsuperscript{205} I.R.C. §108(i)(5)(B)(i).


\textsuperscript{207} I.R.C. §108(i)(5)(B)(iii).


\textsuperscript{209} I.R.C. §108(i)(5)(C).


respect to a debt instrument among the partners in the partnership who were present immediately prior to the acquisition in the manner required under section 704(b),\textsuperscript{212} as to any partner, the partnership was permitted to determine the portion of the allocated COD income that was “deferred” and the portion that was “included.”\textsuperscript{213} Similar flexibility was provided where an upper-tier partnership in a tiered partnership structure was allocated both a “deferred amount” and an “included amount” from a lower-tier partnership. That is, the upper-tier partnership could determine how to allocate the “deferred” and “included” amounts among its partners who were otherwise allocated the COD income under section 704(b).\textsuperscript{214} To the extent that a partner was allocated an “included” amount, the partner was eligible to exclude such amount under the section 108(a) provisions related to bankruptcy, insolvency, or qualified real property business indebtedness.\textsuperscript{215}

It was important to recognize that the procedures provided for partnerships required significant coordination between the partnership and its partners in determining what portion of the partnership’s COD income should be deferred and how that deferred amount should be allocated among the partners. Given this necessary coordination, accomplishing deferral for a partner was not as simple as if the partner was allowed to make the deferral election itself.\textsuperscript{216} In addition, there are significant reporting requirements that go along with making the section 108(i) election,\textsuperscript{217} and these requirements may have served as a disincentive for partnerships to make the section 108(i) election in some circumstances.

Prior to the issuance of the temporary regulations, an issue existed as to how COD income deferred under section 108(i) should be taken into account for purposes of

\textsuperscript{212}Rev. Proc. 2009-37, 2009-36 I. R.B. 309, at §2.08; Treas. Reg. §1.108(i)-2(b)(1). In a tiered partnership structure, the COD income similarly must be allocated by the upper-tier partnership to the partners who were present immediately prior to the reacquisition of the debt instrument by the lower-tier partnership. Rev. Proc. 2009-37, 2009-36 I. R.B. 309, at §4.12(3); Treas. Reg. §1.108(i)-2(b)(4)(i).

\textsuperscript{213}Rev. Proc. 2009-37, 2009-36 I. R.B. 309, at §4.04(3); Treas. Reg. §1.108(i)-2(b)(1). The revenue procedure states that this provision is applicable for purposes of section 108(i) only and is not intended as an interpretation of, or a change to existing law under, section 704.


\textsuperscript{216}Congress’s decision to require that the deferral election must be made at the partnership level was made, in large part, due to concerns with respect to information reporting relating to the deferred COD income. That is, if the deferral election was made at the partner level, the partnership would report the COD income to its partners on Schedule K-1 in the year that such income is realized by the partnership. There would be no further information reporting obligation of the partnership in the year that the deferred income is to be included by an electing partner, so the Service would have limited information to track partners who should be reporting the deferred COD income. The solution reached in both Rev. Proc. 2009-37 and the temporary regulations preserves the information reporting goals of Congress, as the partnership will have a continuing obligation to report deferred COD income to the partners who take advantage of section 108(i). Rev. Proc. 2009-37, 2009-36 I. R.B. 309, at §5.03(2).

\textsuperscript{217}Rev. Proc. 2009-37, 2009-36 I. R.B. 309, at §§4 (requirements for election) and 5 (annual information reporting once election is made).
determining capital accounts under section 704(b).\textsuperscript{218} The regulations settle this issue by providing that, for purposes of determining capital accounts under Treas. Reg. §1.704-1(b)(2)(iv), the capital account of a partner will be adjusted for a partner’s share of the partnership’s deferred items as if no election under section 108(i) were made.\textsuperscript{219}

By forcing partnerships to make the election and by deferring the income at the partnership level, Congress created certain problems that required additional rules. First, remember that when debt of a partnership is forgiven, the COD income allocated to a partner will increase that partner’s basis in the partnership interest, generally offsetting any deemed distribution that the partner might receive under section 752(b).\textsuperscript{220} By deferring the COD income, the partner would not be allowed to currently increase its basis in its partnership interest,\textsuperscript{221} so that the deferral of COD income could cause the partner to recognize gain under section 752(b). Section 108(i)(6) attempted to address this problem by providing that any decrease in a partner’s share of liabilities as a result of a discharge of partnership debt will not be taken into account for purposes of section 752 at the time of the discharge to the extent it would cause the partner to recognize gain under section 731.

Rev. Proc. 2009-37 initially set forth certain technical rules that were intended to apply for purposes of the section 752 deferral rule,\textsuperscript{222} but the regulations now set forth more detailed rules in this regard. The regulations first state that a partner’s share of a partnership liability that is not treated as a current distribution by reason of section 108(i)(6) is referred to as the partner’s “deferred section 752 amount.”\textsuperscript{223} A partner’s “deferred section 752 amount” with respect to an applicable debt instrument equals the decrease in the partner’s share of a partnership liability under section 752(b) resulting from the

\textsuperscript{218} Prior to issuance of the regulations, this issue was discussed in both the NYSBA 108(i) Report, supra note 188 and the ABA 108(i) Report, supra note 188. The issue is particularly important for real estate partnerships that intend to take advantage of the exception to the general acquisition indebtedness rules under section 514(c) by complying with the “fractions rule,” as those rules generally operate by reference to the allocation of section 704(b) book income that increase or decrease a partner’s section 704(b) capital account. Treas. Reg. §1.514(c)-2(c)(1)(i). If the section 704(b) book income had been deemed to occur when the COD income was deferred and recognized, rather than when such income was realized, the special allocation of “deferred amounts” and “included amounts” could have created problems under the fractions rule. Treas. Reg. §1.514(c)-2(e)(1)(v), which permits allocations mandated by statute or regulations other than subchapter K, seemingly would not apply in this situation since the special allocations are not “mandated” but instead are voluntarily undertaken.

\textsuperscript{219} Treas. Reg. §1.108(i)-2(b)(2)(i).


\textsuperscript{221} Query whether, absent the rule provided by statute with respect to deferring the deemed distribution under section 752, the deferred COD income might have been considered to currently increase basis in the partnership interest under the theory of preserving inside-outside basis parity as was done in Rev. Rul. 96-10, 1996-1 C.B. 138, and Rev. Rul. 96-11, 1996-1 C.B. 140. The regulations make clear that items deferred under section 108(i) will not affect a partner’s adjusted basis in its partnership interest until deferral ceases and such amounts are taken into account. Treas. Reg. §1.108(i)-2(b)(2)(i).


\textsuperscript{223} Treas. Reg. §1.108(i)-2(b)(3)(i).
reacquisition with respect to the debt instrument that is not treated as a current distribution under section 752(b) by reason of section 108(i)(6).224

The regulations go on to provide that, in computing a partner’s “deferred section 752 amount,” the partnership first must determine the amount of gain that its direct partner would recognize in the taxable year of reacquisition under section 731 as a result of the reacquisition of one or more applicable debt instrument absent the deferral provided in section 108(i)(6).225 If a direct partner would recognize gain as a result of such a reacquisition or reacquisitions absent the application of section 108(i)(6), the partner’s deferred section 752 amount is equal to the lesser of (1) the partner’s aggregate deferred amounts from the partnership for all applicable debt instruments reacquired during the taxable year, or (2) the gain that the partner would recognize in the taxable year of the reacquisitions under section 731 as a result of the reacquisitions absent the application of section 108(i)(6) deferral.226 In determining the gain that a partner would recognize under (2) of the prior sentence, the regulations make clear that the amount of any deemed distribution under section 752(b) resulting from the decrease in a partner’s share of reacquired debt will be treated as an advance or draw of money under Treas. Reg. §1.731-1(a)(1)(ii).227 The result is that gain would be measured, not as of the specific date that the reacquisition occurred, but instead after taking into account any income (including COD income) that was allocated to the partner during the year. The regulations go on to state that the advance or draw rule under Treas. Reg. §1.731-1(a)(1)(ii) would be applied as if no COD income resulting from the reacquisition is deferred under section 108(i).228 The regulations also contain rules

225 Id.
226 Id.
227 Id. This rule is consistent with other guidance providing that a deemed distribution of debt under section 752 is treated as an advance or draw against partnership income. Rev. Rul. 94-4, 1994-1 C.B. 196; Rev. Rul. 92-97, 1992-2 C.B. 124.
228 Treas. Reg. §1.108(i)-2(b)(3)(ii). The effect of this provision is not necessarily intuitive. An example is helpful in understanding how this provision would appear to apply. Consider partner A whose adjusted basis in a partnership is $25x and whose share of liabilities under section 752 is $50x. The entire partnership liability is forgiven on June 30, and the partnership will defer under section 108(i) the entire $50x of COD income that is allocated to partner A. Under the advance or draw rule under Treas. Reg. §1.731-1(a)(1)(ii), the entire $50x section 752 deemed distribution will be deferred until the end of the year for purposes of measuring gain that might be recognized. Assuming that the partnership has no other income and partner A makes no other contributions to the partnership, the deferred section 752 amount would appear to be $25x, as this is the amount of the section 752(b) distribution that would exceed the partner’s basis in its partnership interest as of the end of the year. Although the income deferred under section 108(i) is taken into account in applying Treas. Reg. §1.731-1(a)(1)(ii), the effect is that the deemed distribution also may be offset by contributions made later in the taxable year to the
addressing the partnership’s calculation of a partner’s deferred section 752(b) amount with respect to multiple debt instruments where the partnership made multiple section 108(i) elections in a taxable year.229

Note that the rule in the regulations operates only to defer deemed distributions so as to prevent gain with respect to direct partners in the partnership making the election under section 108(i).230 Consider a tiered partnership situation where a lower-tier partnership electing to defer $100x of COD income under section 108(i) has two partners each of whom has a $25x basis in its partnership interest. Prior to the forgiveness of the debt, each partner has a $50x share of the liability. If the $100x of COD income is deferred under section 108(i), section 108(i)(6) should delay $25x of the deemed distribution with respect to each partner. Now assume that one of the partners is a partnership with two equal partners, A and B. A had a $25x basis in the upper-tier partnership prior to the discharge and B had a $0 basis in such interest. Each partner in the upper-tier partnership had a $25x share of the liability allocated from the lower-tier partnership under section 752 prior to the discharge and each partner has been allocated a $25x share of the deferred COD income (i.e., a $25x “deferred amount”). The regulations make clear that, in a tiered partnership structure, the “deferred section 752 amount” is allocated only to those partners of the upper-tier partnership that have a “deferred amount” with respect to the applicable debt instrument.231 Accordingly, in the example, the $25x “deferred section 752 amount” allocated to the upper-tier partnership will be divided equally between A and B. Based upon this allocation, B will recognize $12.50x gain and A will have $12.50x of positive adjusted basis in its partnership interest at the end of the taxable year when the COD income is deferred.

It is important to recognize that section 108(i)(6) did not necessarily defer the entire deemed distribution under section 752(b) that resulted from the forgiveness of the debt. Instead, it only deferred the portion that otherwise would have created gain under section 731 at the time of the forgiveness. Accordingly, if this provision was invoked, the partner’s basis in the partnership interest became zero following the transaction. This potentially prevented a partner from taking future losses232 that otherwise would have been available if COD income had been included currently. Similarly, any future cash distributions (actual or deemed) would be taxable to the extent that they are not matched by an allocable share of partnership income and no contribution has been made in the extent that the contributions do not exceed the COD income deferred under section 108(i)). The temporary regulations also contain an example illustrating the operation of the rule where the electing partnership has net taxable income in addition to the deferred COD income during the year. Treas. Reg. §1.108(i)-2(b)(3)(v), Example 2.

231 Id.
232 I.R.C. §704(d).
to the partnership. This result would not necessarily have followed had COD income been included currently.

The regulations mirror the statute in providing that deemed distributions that are deferred will be taken into account at the same time, and to the extent remaining in the same amount, as income deferred under the provision is taken into account by the partner.\textsuperscript{233} Prior to the issuance of the final regulations, if only a portion of the deemed distribution under section 752(b) was deferred, there was some question as to how those amounts would be taken into account as COD income is subsequently included. The unanswered question specifically was whether the deemed distribution under section 752 would be treated as occurring in proportion to the relative COD income included in the applicable year as compared to the total deferred COD income, or instead whether a first-in-first-out rule would apply, causing each dollar of COD income recognized to end the deferral with respect to a dollar of the deferred section 752(b) distribution. The final regulations resolved this issue by illustrating in an example that a “first-in-first-out” methodology will apply so that the deferred section 752(b) distribution will be triggered on a dollar-for-dollar basis as COD income is recognized.\textsuperscript{234}

One final point is worth observing with respect to section 108(i)(6) and the impact of deferring deemed distributions under section 752(b). In order to determine the “deferred section 752 amount” for a partner who was allocated a “deferred amount,” it was necessary for the partnership to know the adjusted basis of such partner’s interest in the partnership. The regulations provide that, at the request of an electing partnership, each direct partner that has a “deferred amount” with respect to the partnership must provide the partnership with a written statement containing information requested by the partnership that is necessary to determine the partner’s “deferred section 752 amount” (e.g., the partner’s adjusted basis in its partnership interest).\textsuperscript{235} This written statement had to be signed under penalties of perjury and provided to the requesting partnership within 30 days of the request.\textsuperscript{236}

Although the statute provides relief from gain that could result from deemed distributions under section 752(b), no statutory relief was provided with respect to at-

\textsuperscript{233} Treas. Reg. §1.108(i)-2(b)(3)(i).

\textsuperscript{234} Treas. Reg. §1.108-2(b)(3)(v), Ex. 1(iv) and (v). A Treasury representative had implied that this should be result prior to issuance of the final regulations. See Distribution Related to COD Income Deferral Election Uses FIFO Recapture, Crnkovich Says, 2010 Tax Notes Today 182-1 (Sept. 21, 2010) (quoting Bob Crnkovich, Senior Counsel in Treasury’s Office of Tax Policy) (hereafter referred to as “Crnkovich Says”).

\textsuperscript{235} Treas. Reg. §1.108(i)-2(b)(3)(iv).

\textsuperscript{236} Id. Rev. Proc. 2009-37 provided that a partnership must make reasonable efforts to secure the necessary information to compute a partner’s basis and its “deferred section 752 amount” prior to making a section 108(i) election. Rev. Proc. 2009-37, 2009-36 I.R.B. 309, at §4.07(3). Where a partner failed to comply with the reporting requirements, Rev. Proc. 2009-37 stated that the partnership’s section 108(i) election could be invalidated unless “the partnership makes reasonable efforts before making the section 108(i) election to obtain the written statement from the partner and otherwise complies with the requirements of section 4 [of Rev. Proc. 2009-37].” The regulations contain no such language regarding the possible invalidation of the section 108(i) election.
risk recapture under section 465(e). Such recapture might arise where partnership debt that has provided at-risk basis for a partner (e.g., qualified nonrecourse financing under section 465(b)(6)) is eliminated with no basis increase attributable to the resulting COD income. Thankfully, the regulations do provide for such relief. In this regard, the regulations provide:

To the extent that a decrease in a partner’s amount at risk (as defined in section 465) in an activity as a result of a reacquisition of an applicable debt instrument would cause a partner with a deferred amount to have income under section 465(e) in the taxable year of the reacquisition, such decrease (not to exceed the partner’s deferred amount with respect to the applicable debt instrument) (deferred section 465 amount) shall not be taken into account for purposes of determining the partner’s amount at risk in an activity under section 465 as of the close of the taxable year of the reacquisition.237

As is the case with respect to deferred section 752(b) amounts, a partner’s deferred section 465 amount is treated as a decrease in the partner’s amount at risk in an activity at the same time, and to the extent remaining in the same amount, as the partner recognizes its deferred amount of COD income.238

Section 108(i) contains certain rules that accelerate the deferred COD income upon the occurrence of specified events. In the partnership context, one set of rules accelerates the deferred COD income by reference to events occurring at the entity level. A second set of rules accelerate COD income by reference to events occurring at the partner level. While the statute contains a list of acceleration events, the regulations set forth the more detailed list that taxpayers must consider in the context of section 108(i). The regulations also contain certain exceptions with respect to transactions that otherwise would constitute acceleration events.

With respect to transactions occurring at the electing partnership level, the regulations provide that the following will result in the acceleration of deferred COD income in the taxable year that the transaction occurs:

1. Liquidation of the partnership;

2. The partnership sells, exchanges, transfers (including contributions and distributions), or gifts substantially all of its assets;239


239 Note that, in the context of a foreclosure transaction, this acceleration rule could still make the provision of little use in some circumstances. For instance, many real estate developers segregate each
3. The partnership ceases doing business; or

4. The partnership files a petition under Title 11 of a similar case.240

For purposes of the second acceleration event, the term “substantially all” is defined to mean assets representing at least 90 percent of the fair market value of the net assets, and at least 70 percent of the fair market value of the gross assets, held by the partnership immediately prior to the sale, exchange, transfer, or gift.241 Note that this rule requires analysis at the time of each sale, exchange, transfer, or gift. Accordingly, while a partnership might sell, in the aggregate, assets that comprise 90 percent of the net, and 70 percent of the gross, fair market value of its assets over a period of time, it appears that each sale that occurs as part of a separate transaction would be analyzed in isolation. Thus, so long as no sale constitutes a sale of “substantially all” of the assets, taking into account the assets of the partnership immediately prior to the sale, no acceleration event will occur. As a separate point, for “underwater” partnerships, the reference to the fair market value of “net assets” can serve no role, as the net value of such a partnership’s assets would be zero. Presumably, an acceleration event would occur upon the sale of 70 percent of the gross fair market value of the partnership’s assets in this context, although this result is not entirely clear.

The fourth acceleration event has created some concerns among taxpayers. The point to realize in the context of this acceleration event is that it is relevant only where the Title 11 petition is filed after deferred COD income has been recognized, so this acceleration event will not be invoked with respect to COD income recognized in connection with the Title 11 filing.242 This acceleration event apparently was added in the regulations due to statute of limitations concerns.243 Specifically, the statute provides that deferred COD income is taken into account on the day immediately prior to the filing of a Title 11 petition.244 If the acceleration rule was invoked only where

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240 Treas. Reg. §1.108(i)-2(b)(6)(i)(A). According to the preamble to the temporary regulations relating to corporations, “[a] common trait of [the entity-level] acceleration events is that they involve situations where collection of the tax liability associated with a taxpayer’s deferred COD income may be hindered, either because the taxpayer has ceased to exist or because the taxpayer has disposed of the business to which the COD income relates.” T.D. 9497 (preamble).


242 T.D. 9623 (preamble), 2013-30 I.R.B. 73 (“The filing acceleration rule applies to partnerships . . . that make an election under section 108(i) before filing a petition in a title 11 or similar case”); see also Crnkovich Says, supra note 234.

243 T.D. 9623 (preamble), 2013-30 I.R.B. 73 (“Without this rule, the period of limitations on assessment under section 6501 may prevent the IRS from assessing tax on deferred COD income”).

244 I.R.C. §108(i)(5)(D)(i).
substantially all of the partnership’s assets were sold in connection with the Title 11 filing, it might be the case that the filing of the Title 11 petition would have occurred four years or even more prior to the disposition of the assets in connection with the Title 11 petition such that the taxable year required for acceleration would have closed and collection would be barred by the statute of limitations.

The regulations set forth a number of exceptions to the partnership-level acceleration events. First, while a transfer, including contributions, of substantially all of a partnership’s assets generally will constitute an acceleration event, a direct or indirect partner’s share of an electing partnership’s deferred items will not be accelerated if the electing partnership contributes all or a portion of its assets in a transaction governed by section 721(a) to another partnership in exchange for an interest in the transferee partnership.245 This exception will not apply if the partnership terminates under section 708(b)(1)(A) or transfers its assets and liabilities in connection with a merger described in section 708(b)(2)(A) or a division described in section 708(b)(2)(B).246 Note, however, that a separate exception may apply in the context of a partnership merger.247

Where the exception for section 721 contributions does apply, if the transferee partnership subsequently sells, exchanges, transfers, or gifts “substantially all” of its assets (or a lower-tier partnership of the transferee partnership that receives contributed assets makes such a disposition), the entire interest in the transferee partnership (or such lower-tier partnership) will be treated as sold, exchanged, transferred, or gifted.248 This, in turn, could cause the electing partnership to be considered to have engaged in a sale, exchange, transfer, or gift of substantially all of its assets, thus causing an acceleration event at that time.

Section 1031 exchanges are generally ignored in determining whether a partnership has sold, exchanged, or transferred substantially all of its assets, except to the extent that the partnership receives “boot” in the exchange.249

A separate set of acceleration rules apply by reference to partner-level transactions. These rules generally are intended to prevent taxpayers from disassociating themselves with the deferred COD income that is attributable to their interests. The regulations provide that a direct or indirect partner’s share of an electing partnerships deferred items with respect to a separate interest will be accelerated and must be taken into account by the partner in the taxable year in which:

(1) The partner dies or liquidates;

246 Id.
249 Treas. Reg. §1.108(i)-2(b)(6)(iii)(B)
(2) The partner sells, exchanges (including redemptions treated as exchanges under section 302), transfers (including contributions and distributions), or gifts (including transfers treated as gifts under section 1041) all or a portion of its separate interest;

(3) The partner’s separate interest is redeemed . . .; or

(4) The partner abandons its separate interest.250

The regulations reference the separate regulations applicable to C corporations and indicate that, with respect to C corporation partners, acceleration events that would apply under the C corporation regulations also will apply to accelerate income with respect to a C corporation partner.251

The term “separate interest” is important in analyzing the partner-level acceleration events. “Separate interest” is defined, for purposes of these rules, as “a direct interest in an electing partnership or in a partnership . . . that is a direct or indirect partner of an electing partnership.”252

Special rules apply with respect to partial transfers and redemptions. The regulations provide that, for transactions referred to in the second acceleration event listed above that occur with respect to only a portion of a partner’s separate interest, the partner’s share of the electing partnership’s deferred items with respect to the partner’s overall separate interest that is proportionate to the partner’s separate interest sold, exchanged, transferred, or gifted will be accelerated and must be taken into account by such partner.253 Separately, for purposes of the third acceleration event listed above relating to redemptions, a partner’s separate interest will be treated as being redeemed only if the partner receives a distribution of cash and/or property in complete liquidation of such interest.254

As with the entity-level acceleration rules, the regulations provide a number of exceptions to the partner-level acceleration events described above. First, no acceleration will occur where a direct or indirect partner contributes its entire electing partnership separate interest in a transaction governed all or in part by section 721(a) to another partnership in exchange for an interest in the transferee partnership.255 The

252 Treas. Reg. §1.108(i)-0(a)(29); see also Treas. Reg. §1.108(i)-2(b)(6)(v), Example 1.
253 Treas. Reg. §1.108(i)-2(b)(6)(ii)(B)(1); see also Treas. Reg. §1.108(i)-2(b)(6)(v), Example 3.
255 Treas. Reg. §1.108(i)-2(b)(6)(iii)(A)(2). To the extent that the transaction does not qualify under section 721(a), the partner-level acceleration events will apply. Id.
transferee partnership will become subject to section 108(i), including all reporting requirements, with respect to the contributing partner’s share of the electing partnership’s deferred items associated with the contributed separate interest. The exception for section 721 contributions will not apply if the partnership in which the separate interest is held terminates under section 708(b)(1)(A) or transfers its assets and liabilities in a merger described in section 708(b)(2)(A) or a division described in section 708(b)(2)(B). A separate exception is provided, however, with respect to certain partnership mergers.

Although a termination under section 708(b)(1)(B) will cause a partner to be treated as receiving an interest in a new partnership in liquidation of its interest in the terminated partnership, the termination under section 708(b)(1)(B) of an electing partnership or a partnership that is a direct or indirect partner in an electing partnership will not cause an acceleration event. This exception, however, does not excuse the transaction or transactions that cause the termination. The partner or partners engaged in the transaction or transactions that cause the termination may separately be the subject of an acceleration event.

A limited exception applies with respect to distributions by a partnership of an interest in a partnership. The exception is aimed at providing relief where a partner who ultimately would be subject to tax on the deferred COD income would remain in the chain of ownership of the electing partnership such that the deferred COD income can continue to be allocated to such partner following the distribution of a partnership interest. The exception, however, does not apply in all situations where continued reporting would be possible. Specifically, the regulations provide that, if a partnership (the “upper-tier partnership”) that is a direct or indirect partner of an electing partnership distributes its entire separate interest (the “distributed separate interest”) to one or more of its partners (the “distributee partners”) that have a share of the electing partnership’s deferred items from the upper-tier partnership with respect to the distributed separate interest, the distributee partners’ shares of the electing partnership’s deferred items with respect to such distributed separate interest will not be accelerated. With respect to the partnership the interest in which is distributed, that partnership must allocate and report the share of the electing partnership’s deferred items associated with the distributed separate interest only to such distributee partners that had a share of the electing partnership’s deferred items from the upper-tier partnership.

256 Id.
257 Id.
260 Id.
261 Id.
262 Treas. Reg. §1.108(i)-2(b)(6)(iii)(E); see also Treas. Reg. §1.108(i)-2(b)(6)(v), Example 2; Much Needed Guidance, supra note 187 (providing detailed discussion of exceptions relating to distributions of a partnership interest).
partnership with respect to the distributed separate interest prior to the distribution.\textsuperscript{263} Under a new rule added as part of the final regulations, acceleration will not be excused if the electing partnership terminates under section 708(b)(1)(A) in connection with the distribution.\textsuperscript{264}

Finally, the regulations provide two exceptions applicable to transactions by C corporation partners. First, the regulations reference to the rule in the regulations applicable to C corporations relating to section 381 transactions and provide that, if the rule applicable to C corporations is satisfied, the fact that a partnership interest is transferred in a section 381 transaction will not cause an acceleration event.\textsuperscript{265} With respect to this exception, the final regulations added a rule providing that acceleration still will occur if the electing partnership terminates under section 708(b)(1)(A) in connection with the section 381 transaction.\textsuperscript{266} Second, the regulations state that a C corporation partner’s share of an electing partnership’s deferred items will not be accelerated if the C corporation partner transfers its entire separate interest in an intercompany transaction, as described in Treas. Reg. §1.1502-13(b)(1)(i).\textsuperscript{267} This exception will not apply if the electing partnership terminates under section 708(b)(1)(A) as a result of the intercompany transaction.\textsuperscript{268}

Section 108(i) also contains rules addressing the treatment of original issue discount deductions when COD income is deferred. Certain debt-for-debt exchanges gave rise to original issue discount with respect to the re-issued debt instruments. Without a special rule, taxpayers could have taken advantage of current interest deductions under the original issue discount rules while deferring COD income recognized in connection with the transaction. To address this issue, section 108(i)(2) essentially defers the deduction for original issue discount until the related COD income is taken into account. Rev. Proc. 2009-37 made clear that the deferral of deductions for original issue discount would apply at the entity level for partnerships.\textsuperscript{269} The regulations further elaborate, providing that:

An issuing entity’s deferred OID deduction for a taxable year is the lesser of:

(A) The OID that accrues in a current taxable year during the deferral period with respect to the debt instrument

\textsuperscript{263} Treas. Reg. §1.108(i)-2(b)(6)(iii)(E).
\textsuperscript{264} Id.
\textsuperscript{265} Treas. Reg. §1.108(i)-2(b)(6)(iii)(F).
\textsuperscript{266} Id.
\textsuperscript{267} Treas. Reg. §1.108(i)-2(b)(6)(iii)(G).
\textsuperscript{268} Id.
\textsuperscript{269} Rev. Proc. 2009-37, 2009-36 I. R.B. 309, at §2.01. The entity-level application of these rules can give rise to issues when deferred COD income and original issue discount deductions are made to the partners in different proportions. See NYSBA 108(i) Report, supra note 188; ABA 108(i) Report, supra note 188.
(less any of such OID that is allowed as a deduction in the current taxable year as a result of an acceleration event), or

(B) The excess, if any, of the electing entity’s deferred COD income (less the aggregate amount of such deferred COD income that has been included in income in the current taxable year and any previous taxable year during the deferral period) over the aggregate amount of OID that accrued in previous taxable years during the deferral period with respect to the debt instrument (less the aggregate amount of such OID that has been allowed as a deduction in the current taxable year and any previous taxable year during the deferral period). \(^{270}\)

The regulations also provide a rule that will accelerate deferred OID deductions as a result of an event that also accelerates deferred COD income. \(^{271}\) The regulations further provide an example illustrating how the deferral of OID deductions can impact partners who do not benefit from the deferral of COD income, specifically addressing the deferral result with respect to a partner who enters a partnership after an election has been made to defer COD income under section 108(i). \(^{272}\) Rules also apply whereby OID deductions can be deferred with respect to debt of a related party that is used to reacquire an applicable debt instrument of an issuer that elects deferral under section 108(i). \(^{273}\)

While the rule deferring OID deductions is generally equitable when the debt is acquired by an unrelated person, it could mute the effect of the COD income deferral in a related-party acquisition under section 108(e)(4). That is, when a related party acquired the debt, there would be significant (and possibly complete) overlap between the parties who are including the original issue discount income and those who are including the deductions. By deferring the deductions in this situation, the original issue discount income recognized by the related party would not be shielded by an offsetting deduction. So while the COD income is deferred under section 108(i), a related holder of the debt re-issued under section 108(e)(4) would recognize original

\(^{270}\) Treas. Reg. §1.108(i)-2(d)(2)(i).

\(^{271}\) Treas. Reg. §1.108(i)-2(d)(2)(ii) and (iii), Ex. 2.

\(^{272}\) Treas. Reg. §1.108(i)-2(d)(2)(ii) and (iii), Ex. 1.

\(^{273}\) Treas. Reg. §1.108(i)-3(a); Treas. Reg. §1.108(i)-2(b)(6) (relating to acceleration events affecting OID deductions deferred by a related partnership). This situation could arise, for example, where an upper-tier partnership borrowed money and contributed the proceeds to a greater than 50-percent owned lower-tier partnership so that the lower-tier partnership could partially repay an applicable debt instrument under terms that would create a deemed exchange of the debt instrument and generate COD income that would be deferred.
issue discount income that otherwise would have been offset by a deduction.\textsuperscript{274} This result obviously reduced the benefit of deferral provided under section 108(i).

The regulations reference the rules under section 1446 regarding withholding by a partnership on a foreign partner’s share of income that is effectively connected with a U.S. trade or business.\textsuperscript{275} The preamble to the temporary regulations indicates that this reference is intended “to signal to partnerships, including tiered partnerships, that they may have an obligation to pay a section 1446 tax when income deferred under section 108(i) is recognized (either ratably over the inclusion period or as a result of an acceleration event).”\textsuperscript{276}

### D. Purchase Money Debt Reduction

Section 108(e)(5) provides that, 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.\textsuperscript{277} Accordingly, where a partnership acquires property partially or wholly in exchange for its note, a subsequent reduction of the note generally will not give rise to COD income, but instead will result in a reduction of the partnership’s basis in the property.

Unlike the exclusions discussed above, section 108(e)(5) applies at the partnership level.\textsuperscript{278} Section 108(e)(5), by its terms, is not available where the debtor is bankrupt or insolvent,\textsuperscript{279} but this restriction makes little sense with respect to a bankrupt or insolvent partnership, given that the bankruptcy and insolvency exceptions to COD income are applied at the partner level. The Service has recognized this disconnect and provided that it will not challenge a bankrupt or insolvent partnership’s treatment of a reduction in debt owed by the partnership as a purchase price adjustment, provided that the transaction would otherwise qualify under section 108(e)(5) but for the bankruptcy

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\textsuperscript{274} This statement assumes exact identity of the parties including the original issue discount income and deduction. Obviously, this would not always be the case where debt is treated as forgiven under section 108(e)(4), but there often would be significant overlap.

\textsuperscript{275} Treas. Reg. §1.108(i)-2(b)(7).

\textsuperscript{276} T.D. 9498 (preamble).

\textsuperscript{277} Note that this rule is mandatory, not permissive. If purchase money debt issued or acquired by someone other than the seller of the property is reduced, such a reduction generally will not be treated as a purchase price adjustment. See Preslar v. Commissioner, 167 F.3d 1323 (10th Cir. 1999); Rev. Rul. 92-99, 1992-2 C.B. 518. The Service has stated, however, that it will treat a debt reduction in third-party lender cases as a purchase price adjustment to the extent that the debt reduction by the third-party lender is based on an infirmity that clearly relates back to the original sale (e.g., the seller’s inducement of a higher purchase price by misrepresentation of a material fact or by fraud). Rev. Rul. 92-99, 1992-2 C.B. 518.

\textsuperscript{278} Priv. Ltr. Rul. 8429001 (Mar. 12, 1984) specifically holds that section 108(e)(5) applies at the partnership level.

\textsuperscript{279} I.R.C. §108(e)(5)(B).
or insolvency of the partnership. All partners must consistently report the transaction for this rule to apply.

E. Exclusion of Lost Deductions

Pursuant to section 108(e)(2), COD income will be excluded to the extent that payment of the liability would have given rise to a deduction. This is largely a rule of convenience. When debt is discharged, the situation is analogous to the creditor transferring money to the debtor with the debtor then re-transferring the money to the creditor. With respect to obligations described in section 108(e)(2), the debtor would have income on receipt of the payment, but also would have an offsetting deduction (interest, salary, rent, etc.) on repayment of the money to the creditor. Section 108(e)(2) essentially allows the taxpayer to net the two payments.

While there is no authority on point, it seems that this exception may properly apply at either the partnership or partner level, depending on the character of the deductible expenditure. Under section 702, certain deductions are netted against income at the partnership level, while other items are passed through and deducted as separately stated items on the partner’s return. Logically, section 108(e)(2) should apply with respect to a liability at the level where the deduction would be taken, consistent with section 702.

V. Other Approaches

Often, the parties involved in a partnership workout will not be able to avail themselves of any of the exclusions discussed above. In such situations, the participants in the workout may wish to explore other structural alternatives in an effort to avoid recognition of income in connection with the workout.

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282 Cf. Priv. Ltr. Rul. 9251023 (Sept. 18, 1992) (providing that, where the taxpayer was not originally entitled to basis in stock attributable to a nonrecourse note given in exchange for the acquisition of the stock, the forgiveness of the debt after the stock had become worthless would give rise to COD income that was excludable under section 108(e)(2) because the taxpayer would be entitled to a worthless stock deduction upon payment of the note). Compare 1995 FSA Lexis 223 (Feb. 21, 1995) (concluding that the entire amount of the note given for the purchase of stock should be included in the basis of the stock for purposes of determining the amount of the deduction upon a finding of worthlessness; deduction should not be delayed until payment on the note).
283 Section 108(e)(3) also provides that the amount of COD income will be adjusted for unamortized premium and discount with respect to the debt discharged.
A. Acquisition of Debt by a Third Party

1. In General

One approach for avoiding the recognition of income in a workout is to find a “friendly” third party to acquire the debt from the current lender. Given the remote probability that the lender will realize the full amount of the indebtedness, the lender may be willing to transfer the debt instrument to another person for less than the face amount of the liability. The person acquiring the debt may be willing to provide the troubled debtor more time to turn things around since the acquiror generally will be looking to post-acquisition appreciation in the business to realize a profit on the purchased debt.

2. Related Party Acquisition of Indebtedness

If structured correctly, a debtor will not recognize COD income when a liability of the debtor is acquired by a third party for less than the face amount of the debt. However, there are a number of pitfalls that must be avoided in order to obtain this result.

First, the debt cannot be acquired by a related party. Section 108(e)(4) essentially considers a debtor to acquire its own debt if a person related to the debtor acquires the debt from a third party. The regulations under section 108(e)(4) apply to both direct and indirect acquisitions of debt by a person related to the borrower.\(^{284}\) A direct acquisition occurs where a person related to the debtor acquires debt from a person who is not related to the debtor.\(^{285}\) An indirect acquisition occurs if a holder of debt is not related at the time of acquisition but subsequently becomes related to the debtor, and the holder of the debt is deemed to have acquired the debt “in anticipation of becoming related to the debtor.”\(^{286}\) Whether a holder acquired debt in anticipation of becoming related to the debtor is generally determined based upon an analysis of all relevant facts and circumstances.\(^{287}\) However, if a holder acquires debt less than six months before becoming related to the debtor, the acquisition will automatically be treated as being made “in anticipation of becoming related to the debtor.”\(^{288}\)

\(^{284}\) Treas. Reg. §1.108-2(a).

\(^{285}\) Treas. Reg. §1.108-2(b).

\(^{286}\) Treas. Reg. §1.108-2(c)(1).

\(^{287}\) Treas. Reg. §1.108-2(c)(2).

\(^{288}\) Treas. Reg. §1.108-2(c)(3). In certain other situations, a holder will be presumed to have acquired debt in anticipation of becoming related to the debtor unless the holder attaches a statement to its return for the taxable year in which the debtor becomes related to the holder. See Treas. Reg. §1.108-2(c)(4).
In general, persons are treated as related if they are related within the meaning of sections 267(b) and 707(b)(1). However, certain modifications are made with respect to the family relationship rules contained in those provisions. In addition, two entities treated as a single employer under section 414(b) or (c) will be treated as having a relationship described in section 267(b).

If a party related to a debtor directly purchases a liability of the debtor, the debtor will recognize COD income equal to the excess of the adjusted issue price of the debt instrument over the related party’s adjusted basis in the liability determined on the date of purchase. With respect to indirect purchases, COD income is measured as the excess of the adjusted issue price of the debt instrument over the related party’s adjusted basis in the liability determined as of the date that the holder becomes related to the debtor (if the holder acquired the debt within six months before becoming related) or the fair market value of the indebtedness on the date that the holder becomes related (if the holder acquired the debt more than six months before becoming related).

The related holder is deemed to receive a new debt instrument with an issue price determined by reference to the amount used to determine the debtor’s COD income (either adjusted basis or fair market value). Accordingly, if the principal amount of the debt is not reduced, the related holder could have significant original issue discount associated with the debt instrument. If significant original issue discount is created with respect to the debt instrument, the parties should be mindful of the impact that the AHYDO rules under section 163(e)(5) can have in disallowing the

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292 Treas. Reg. §1.108-2(f)(1). The regulations create an exception to section 108(e)(4) with respect to “a direct or indirect acquisition of indebtedness with a stated maturity date on or before the date that is one year after the acquisition date, if the indebtedness is, in fact, retired on or before its stated maturity date.” Treas. Reg. §1.108-2(e)(1). This rule could present an opportunity in a situation where a lender might allow a borrower to retire nonrecourse debt at a discount within the one-year period prior to maturity of the debt. Rather than paying off the debt at a discount, which would create COD income, the borrower might consider purchasing the note at the discounted amount in an entity with identical ownership to the borrower. The purchaser of the note might thereafter foreclose on the property (which should be treated as a retirement of the debt), with the full nonrecourse debt balance being treated as amount realized, and with no COD income being recognized. Of course, section 1239 must be considered in a gain transaction involving depreciable property, and the loss disallowance rules under section 267 or 707 must be considered in a loss transaction.
293 Treas. Reg. §1.108-2(f)(1) & (2). The regulations contain an anti-abuse rule providing that the COD income will be measured by reference to fair market value rather than adjusted basis where a principal purpose for the acquisition is the avoidance of federal income tax. Treas. Reg. §1.108-2(f)(4).
deduction for original issue discount accrual to the extent allocable to corporate partners.\footnote{I.R.C. §163(e)(5); cf. Treas. Reg. §1.701-2(f), Ex. 1 (applying aggregate approach to partnerships for purposes of section 163(e)(5)).  Although section 1232 of the American Recovery and Reinvestment Act of 2009 provided for the temporary suspension of the AHYDO rules in some circumstances, the provision did not apply to any obligation issued to a related party (within the meaning of section 108(e)(4)). I.R.C. §163(e)(5)(F).  Notice 2010-11, 2010-1 C.B. 326, extended the suspension of the AHYDO rules to December 31, 2010.}

3. **Significant Modifications and Deemed Reissuance of Debt**

Even if a debt instrument is not acquired by a person related to the debtor, the parties must be careful to ensure that no “significant modification” is made to the debt instrument in connection with the transfer. If the legal rights or obligations of the debtor or holder of the debt instrument are significantly modified in connection with the transfer, there will be a deemed exchange of the original debt instrument for a modified debt instrument that differs either in kind or in extent.\footnote{Treas. Reg. §1.1001-3(b).  See generally R. Lipton, Real Estate Workouts in 2008 – The Rules Have Changed, 108 J. of Tax’n 207 (2008); T. Maynes and T. Davis, Distressed Debt in Disorderly and Dysfunctional Markets, 87 Taxes 55 (2009); C. Morgan, Bridge Loans – Confronting Tax Issues Triggered by the Recent Economic Downturn, 7 J. of Tax’n of Financial Products 35 (2009).} Changes in security or credit enhancements often will result in a significant modification to a debt instrument.\footnote{Treas. Reg. §1.1001-3(e)(4)(iv).}

If a debtor issues (or is deemed to issue) a new debt instrument in satisfaction of a liability, the debtor will be treated as satisfying the old debt with money in an amount equal to the issue price of the new debt instrument.\footnote{Treas. Reg. §1.1001-3(e)(10).} So long as the new debt instrument is respected as debt for federal income tax purposes, has adequate stated interest, and is not publicly traded, this generally will not be a problem for the debtor, since, in most cases,\footnote{Historically, it was important to consider former Treas. Reg. §1.1274-3(b)(3) relating to debt instruments issued in “potentially abusive situations” where the adjusted issue price of non-traded debt still could be determined by reference to the fair market value of debt. See R. Mandel, Lender Beware: Tax Planning for Troubled Loans in Troubled Times, 80 Taxes 77 (2002). Notwithstanding the title of the rule, situations described as “potentially abusive situations” in former Treas. Reg. §1.1274-3(a) did not appear, in all situation, to be abusive (e.g., recent sales transactions and nonrecourse financing). Recently finalized regulations change the rule with respect to recent sale transactions by providing that a debt instrument issued in a debt-for-debt exchange (including exchanges under Treas. Reg. §1.1001-3) will not be treated as the subject of a recent sales transaction even if the debt instrument exchanged for the newly-issued debt was recently acquired prior to the exchange. Treas. Reg. §1.1274-3(b)(4)(i).} the issue price of the new debt instrument should equal the adjusted issue price of the old debt instrument.\footnote{I.R.C. §1273(b)(4).}

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If a debtor issues (or is deemed to issue) a new debt instrument in satisfaction of a liability, the debtor will be treated as satisfying the old debt with money in an amount equal to the issue price of the new debt instrument. So long as the new debt instrument is respected as debt for federal income tax purposes, has adequate stated interest, and is not publicly traded, this generally will not be a problem for the debtor, since, in most cases, the issue price of the new debt instrument should equal the adjusted issue price of the old debt instrument. If the old or new debt were publicly traded...
traded, the issue price of the new debt would be the fair market value of the debt, which could result in the recognition of COD income.

The recasting of the modified debt as equity for tax purposes may result in COD income (or the recognition of gain on a deemed distribution under section 752(b)). The applicable regulations provide that a modification that results in a debt instrument not being treated as debt for federal income tax purposes will constitute a significant modification. However, under regulations finalized in 2010, in making a determination as to whether an instrument resulting from a modification to a debt instrument will be recharacterized as equity, any deterioration in the financial condition of the obligor between the issue date of the debt instrument and the date of modification (as it relates to the obligor’s ability to repay the debt) will not be taken into account unless there is a substitution of a new obligor or the addition or deletion of a co-obligor.

Other changes to the terms of a debt instrument may cause the re-issued instrument to be treated as equity for Federal income tax purposes. One situation where this issue can arise involves arrangements where a lender will agree to subordinate its debt to equity attributable to new capital contributed by investors. The lender may agree to such an arrangement where the new capital is needed to preserve or increase the value of the underlying security for the debt. Even though the obligation to the lender still will be represented, in form, by a debt instrument, it often will be difficult to conclude that the instrument is debt for Federal income tax purposes if the instrument ranks in priority behind an instrument that is structured as equity for commercial and Federal income tax purposes. Such a conversion of the debt for Federal income tax purposes may result in COD income.

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301 Recently finalized regulations alter the rules regarding the determination of when debt will be treated as publicly traded. See Treas. Reg. § 1.1273-2(f); T.D. 9599, 2012-2 C.B. 417.

302 I.R.C. § 1273(b)(3).

303 See infra notes 321-358 and accompanying text.

304 Treas. Reg. § 1.1001-3(e)(5)(i).

305 Treas. Reg. § 1.1001-3(f)(7). Prior to the 2010 amendment to the regulations, there was concern that, if a significant modification of the debt instrument had otherwise occurred, the new debt instrument might be recast as equity based upon the financial condition of the debtor, so that the potential recognition of COD income could follow. See R. Lipton, The Section 1001 Debt Modification Regulations: Problems and Opportunities, 85 J. Tax’n 216 (1996). A representative of the Service had informally indicated that the rule in the original regulations was intended to be more favorable, so that after a significant modification, the financial status of the issuer would be ignored in determining whether the interest is debt or equity. See J. Martin, ABA Briefs: IRS Official Addresses Cottage Savings Regs’ Debt/Equity Testing Rule, 72 Tax Notes 1104 (Aug. 26, 1996) (quoting Thomas Kelly, principal IRS drafter of the regulations). Nonetheless, it was somewhat difficult to get comfortable with this reading based upon the language of the original regulations. The IRS drafter admitted that such an interpretation “might not be obvious on a first read – or second read.” Id.
purposes generally will cause the debt to be treated as contributed to the partnership in exchange for an equity interest in the partnership.306

306 See infra notes 337-347 discussing section 108(e)(8) and the final regulations thereunder. Note also that a recharacterization of the debt as equity could cause adverse results for lenders who are foreign or tax-exempt, as these parties would go from receiving interest income that generally would not be subject to tax in the U.S. to receiving a distributive share of partnership income and, in many cases, being treated as engaged in the trade or business of the partnership. This risk may cause many such lenders to forego negotiations to modify debt. In many instances, the debt may be owed by a disregarded entity that is owned by a partnership. If the lender’s instrument is converted to an equity interest in the disregarded entity, the disregarded entity will become a partnership for Federal income tax purposes. There is some question as to the proper treatment of the conversion transaction. Under one view, the lender may be treated as contributing its debt to the equity of a newly-formed partnership such that section 108(e)(8) would apply to measure any COD income resulting from the transaction. Alternatively, the lender could be treated as acquiring an interest in the property from the debtor, with the debtor and lender then each contributing their interests in the property to a newly-formed partnership. Cf Rev. Rul. 99-5, 1999-1 C.B. 434 (situation one). Although far from clear, the latter treatment seems more appropriate. The comments of the New York State Bar Association (Tax Section) with respect to the proposed regulations under section 108(e)(8) advocate this approach, citing the preamble to the proposed partnership equity-for-services regulations and McDougal v. Commissioner, 62 T.C. 720 (1974). See NYSBA Members Comment on Proposed Regs on Discharge of Partnership Indebtedness Income, 2009 Tax Notes Today 122-75 (June 29, 2009); see also D. Friedline, Debt-For-Equity Exchange of a Disregarded Entity, 39 J. of Real Est. Tax’n. 52 (2012); compare P. Gall & F. Wang, The Mysterious Case of Disappearing Debt in Partnership Transactions, 90 Taxes 157 (2012). In addition, in order to find that section 108(e)(8) could apply to the transaction, one would have to respect the partnership as coming into existence immediately prior to the contribution of debt. Otherwise, it would not be possible to have a contribution of debt to a debtor partnership. See Treas. Reg. §1.108-8(a) (referencing transfer of a partnership interest by a “debtor partnership” in application of section 108(e)(8)). Because the debt is eliminated as part of the contribution, it is difficult to find a contribution of the debt to a partnership. It is worth noting that, in speaking on numerous panels with IRS representatives involved in the final section 108(e)(8) regulations, the uniform view expressed by these representatives was that section 108(e)(8) does not apply to the contribution of a debt instrument to a debtor-disregarded entity in a transaction that converts the entity into a partnership for federal income tax purposes. To this author’s knowledge, these statements never were reported. An adviser’s determination as to whether section 108(e)(8) applies to such a transaction often will have a significant tax impact, particularly where the debt is nonrecourse. If section 108(e)(8) applies, the transaction will give rise to COD income. Under the alternative treatment, if the debt is nonrecourse, the debtor could recognize gain or loss upon the deemed sale of the interest in the property, but no COD income. Under the latter view, however, if the taxpayer is permitted to retain a portion of the equity in the existing collateral, it may be necessary to bifurcate the debt, treating a portion of the debt as an amount realized in a sale transaction and the portion allocable to the property interest retained by the debtor’s as COD income. For example, if, following the contribution of the debt, the continuing entity interest held by the prior single owner of the disregarded entity represents 20 percent of the liquidation value of the entity, one might conclude that the creditor only foreclosed on 80 percent of the debt instrument and forgave the other 20 percent. Where a creditor has a right to claim all of the collateral in repayment of a debt, but allows the debtor to keep a portion of the property that otherwise could have been claimed, it arguably is appropriate to bifurcate the debt instrument and treat a portion of the debt as forgiven in a transaction that generates COD income and a portion as giving rise to an amount realized in a foreclosure transaction. Cf Priv. Ltr. Rul. 9251023 (Sept. 18, 1992) (bifurcating debt where lender foreclosed on only a portion of the collateral, accepting a partial payment in cash to allow the debtor to retain the other collateral). In the context of the transaction described above, the proportion of the liquidation value of the collateral foreclosed upon is one possible method for bifurcating the debt instrument for these purposes. There is, however, no guidance on this point, and other methods for bifurcation also may be reasonable. As one final point, if a loss will be recognized in the transaction and

225-72
4. **Acquisition of Debt by an Agent**

Finally, even if the acquiror of the debt is not related to the debtor and the debt is not deemed to be reissued, it still is important that the purchaser of the debt not be considered to act as the conduit or agent of the debtor in acquiring the debt.\(^{307}\) If this is deemed to be the case, the debtor will be treated as acquiring its own debt instrument, and if such acquisition is for less than the adjusted issue price of the debt instrument, COD income will result.\(^{308}\)

**B. Admission of a New Partner**

In attempting to work out debt problems of a partnership, it may be advisable to consider admitting an additional partner. This additional partner could be either a third party who will contribute cash to shore up the partnership’s financial situation and possibly pay down some of the partnership’s debt, or the lender who will contribute some or all of the indebtedness in exchange for an equity interest in the partnership. Under either scenario, there are significant tax issues that must be confronted.

1. **Admission of a Third Party as a Partner**
   a. **Direct Admission to the Debtor Partnership**

   If a third party is admitted as a new partner, the partnership generally will revalue its assets.\(^{309}\) Section 7701(g) applies in determining the booked up value of property,\(^{310}\) so the new book value of partnership property subject to nonrecourse debt will be equal to at least the amount of the nonrecourse debt attributable to such property.\(^{311}\) If the partnership has minimum gain\(^{312}\) immediately prior to the admission

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\(^{308}\) Treas. Reg. §1.61-12(a).


\(^{311}\) Query whether section 7701(g) properly applies by reference to the full amount of the debt where, as part of the negotiations for the new contribution to the partnership, the lender has agreed to reduce the amount of the debt following the contribution. Although the property is revalued immediately prior to the contribution at a time when the debt has not been reduced, the application of section 7701(g) could distort the economic deal of the parties by artificially inflating the book value of the property as compared to the...
of the new partner, this minimum gain will be eliminated as a result of the revaluation. However, the elimination of minimum gain as a result of a revaluation will not invoke the minimum gain chargeback requirement contained in the section 704(b) regulations.\textsuperscript{313}

The admission of a new partner also generally will result in a shift in a portion of the partnership’s nonrecourse liabilities from the old partners to the new partner. Due to the operation of the regulations under section 752, this shift generally will not result in the recognition of gain by the old partners, so long as the amount of the debt is not also reduced in connection with the admission.\textsuperscript{314} However, as the partnership claims depreciation or amortization with respect to the booked-up assets over time, additional debt will be shifted to the new partner which could eventually cause the old partners to recognize gain.\textsuperscript{315} In addition, if a portion of the debt is paid off with funds

value of the property that the parties base the economics of their deal upon. For instance, assume that property worth $1 million is encumbered by debt equal to $2 million at the time of the contribution, but the parties have negotiated with the lender to reduce the debt to $1 million immediately after the contribution. The contributor is entitled to a preferred return and intends that appreciation of the property above $1 million will apply to satisfy the preferred return. The COD income presumably will be allocated to the historic partners (1) because no preferred return has yet accrued on the investment of the new contributor, and (2) the new contributor was not present in the partnership at the time that the debt reduction had been negotiated by the partnership, so the value attributable to the reduction was essentially inherent in the partnership at the time of the contribution and arguably would not properly be allocable to a new partner. Although the $1 million book loss that exists with respect to the partnership asset would be allocable to the historic partners upon an immediate revaluation following repayment of the debt, if the property is not booked down and then subsequently appreciates in value back to $2 million, the new partner will have been denied its share of that appreciation, contrary to the deal negotiated by the parties. Cf. NYSBA, Report on Certain Issues Relating to Troubled Partnership, reprinted at 93 Tax Notes Today 140-19 (July 12, 1993) (hereafter referred to as the “NYSBA Report”) (arguing that the partnership liability should be revalued to an amount equal to its value, thus creating a section 704(c) allocation with respect to the liability; section 7701(g) then would be applied by reference to the booked-down value of the liability).

\textsuperscript{312} See supra text accompanying note 74.

\textsuperscript{313} Treas. Reg. §1.704-2(d)(4), (g)(2), and (m), Ex. 3(ii).

\textsuperscript{314} A partner’s share of partnership minimum gain will be eliminated as a result of revaluation connected with the admission of the new partner, so the partner will no longer be allocated a share of debt under Treas. Reg. §1.752-3(a)(1). However, the partnership minimum gain will become section 704(c) minimum gain which will provide the partner with an equivalent allocation of debt under Treas. Reg. §1.752-3(a)(2). In most situations, this allocation will be sufficient to prevent the partner from recognizing gain. The debt shifted to the new partner will be a portion of the debt that is allocated in the third tier pursuant to Treas. Reg. §1.752-3(a)(3).

\textsuperscript{315} As depreciation or amortization is claimed, the amount of section 704(c) minimum gain will be reduced and the amount of partnership minimum gain will be increased. This will cause a portion of the debt previously allocated to the old partners under Treas. Reg. §1.752-3(a)(2) to be reallocated to the new partner under Treas. Reg. §1.752-3(a)(1). Depending on which section 704(c) method (traditional, curative, or remedial) the partnership has adopted, the income recognized by the historical partner, as this shift occurs, will be either ordinary income or capital gain income, and the incoming partner will either use the additional basis to deduct additional current depreciation expense or to create a potential deferred capital loss.
contributed by the new partner, there likely will be a deemed distribution to the old partners which could generate significant gain under section 731.\textsuperscript{316}

b. Admission to a Subpartnership

In some situations, the new partner may refuse to contribute cash to the existing partnership and instead insist on being admitted to a subpartnership to which the old partnership will contribute its assets. This may result from the new partner’s desire to avoid undisclosed or unknown liabilities of the old partnership.

The tax results obtained through the use of a subpartnership generally may not be significantly different from those that follow where the new partner comes directly into the old partnership, although the mechanics giving rise to this result are significantly different. This determination would depend upon whether a contribution of underwater property to a partnership can qualify as a property contribution under section 721.\textsuperscript{317} If the contribution does qualify under section 721, the property

\textsuperscript{316} See supra notes 100-101 and accompanying text. Issues can arise as to the appropriate partners for allocation of COD income where the discharge of indebtedness is anticipated at the time a new partner is admitted, but where such discharge does not occur until after such partner is admitted. In comments prepared by the New York State Bar Association, the suggestion was made that, when a new partner is admitted to a partnership with debt that may be forgiven, the liabilities of the partnership should be revalued, effectively locking in the allocation of the anticipated COD income to the existing partners under reverse section 704(c) principles. \textit{NYSBA Report}, supra note 311; cf. Treas. Reg. \textsection1.752-7(c)(1)(ii) (providing for the revaluation under section 704(b) of Treas. Reg. \textsection1.752-7 liabilities). Absent application of such principles, partners may shift value to an incoming partner that is effectively attributable to activities which occurred before the new partner entered the partnership (i.e., the negotiation of debt relief by the partnership with the lender). Rules consistent with the New York State Bar proposal have never been adopted, and it is not clear that the Service could prevent allocations that fail to follow such principles. It is worth noting, however, that when section 108(e)(8) was amended in 2004 to address contributions of debt to a partnership in exchange for an equity interest in the partnership, the statute specifically provided that COD income recognized under the provision must be allocated to taxpayers who were partners in the partnership immediately before the contribution of the debt.

\textsuperscript{317} See generally W. McKee, W. Nelson & R. Whitmire, \textit{Federal Taxation of Partnerships and Partners}, ¶7.06[3] (4th ed. 2007) (hereafter referred to as “\textit{Federal Taxation of Partnerships}”); see also Priv. Ltr. Rul. 201103018 (Sept. 23, 2010) (transfer of underwater property to a partnership did not result in a disguised sale under section 707 where debt in excess of value was effectively forgiven immediately after the transfer; ruling indicated that, for purposes of Treas. Reg. \textsection1.707-5(a)(6), the debt should be bifurcated into the portion that did not exceed the fair market value of the property at the time of the contribution and the portion that did (“\textquoteright excess debt”); debt, including the excess debt, was contributed to the transferee partnership immediately after the assets were transferred and liabilities were assumed, so that the transferee partnership was solvent at the end of the transaction); GLAM 2011-003 (Aug. 18, 2011) (in a check-the-box election to convert an insolvent corporation to a partnership, the deemed contribution of underwater assets to the newly-formed partnership qualified under section 721; liabilities assumed by partnership were limited under section 752(c)); A Elliott, \textit{Practitioners Troubled By \textquoteright Schizophrenic\textquoteright Memo Involving Worthless Partnerships}, 2011 Tax Notes Today 207-2 (Oct. 26, 2011) (describing technical inconsistencies in GLAM 2011-003 that highlight different views of different divisions of the IRS National Office that participated in drafting the GLAM); M. Jackel and N. Holovach, \textit{Contributions to No Net Equity Partnerships}, 2012 Tax Notes Today 19-8 (Jan. 30, 2012) (commenting on the section 721 conclusion in GLAM 2011-003).
contributed to the subpartnership will be section 704(c) property with respect to the old partnership. In addition, although the assets of the old partnership will be contributed to the subpartnership subject to all of the old partnership’s nonrecourse liabilities, section 752(c) will limit the amount of the nonrecourse liabilities that the subpartnership is considered to assume to the fair market value of the property subject to the debt.

If the contribution qualifies under section 721, the nonrecourse debt of the subpartnership will be allocated to the old partnership to the extent of the section 704(c) minimum gain inherent in the property contributed to the subpartnership. In addition, the portion of the debt that is not treated as assumed by the subpartnership as a result of section 752(c) presumably will remain as debt of the old partnership. Because the new partner will not be admitted to the old partnership, there will be no revaluation with respect to the old partnership, so there will be no reduction in the partnership minimum gain with respect to the partners in the old partnership. All of this should result in a shift in liabilities for the old partners that is no greater than the shift where the new partner comes directly into the old partnership.

2. Admission of Lender as a Partner

A whole host of separate issues must be confronted where the lender is admitted to the partnership in connection with a workout.

a. Application of Section 721

Section 721 provides that no gain or loss shall be recognized to a partnership or to any of its partners where property is contributed to a partnership in an exchange for an interest in the partnership. If section 721 does not apply to the transfer of debt in exchange for an interest in a partnership, such an exchange arguably should be taxable.

318 Section 7701(g) does not apply in determining the fair market value of the contributed property for purposes measuring the section 704(c) gain inherent in the property. Treas. Reg. §1.704-1(b)(2)(iv)(d)(1).

319 Treas. Reg. §1.752-3(a)(2).

320 As discussed above, section 7701(g) applies in determining the booked-up value of property so that, where the new partner comes into the existing partnership, reverse section 704(c) gain will take into account section 7701(g). Conversely, section 7701(g) is not considered in determining the section 704(c) gain with respect to property contributed to the subpartnership. Where the new partner is admitted to the old partnership, nonrecourse debt in excess of value is taken into account under the second tier (Treas. Reg. §1.752-3(a)(2)) as part of the section 704(c) minimum gain (which should equal the sum of the partnership minimum gain and section 704(c) minimum gain before the admission of the new partner). Where the new partner is admitted to the subpartnership in a contribution that qualifies under section 721, section 752(c) appears to leave the debt in excess of the true fair market value of the contributed property behind at the old partnership. For a discussion of the complexity engendered by section 752(c), see L. Stafford, Section 752(c): The Other Issue in Tufts v. Commissioner, 42 Tax. Law. 93 (1998).

321 Treas. Reg. §1.721-1(b). Cf. Mas One Limited Partnership v. U.S., 390 F.3d 427 (6th Cir. 2004) (partnership recognized ordinary income where former partner paid debt of a partnership; no partnership interest was received in exchange for payment of the debt).
Recently issued final regulations\(^{322}\) provide that section 721 generally will apply to a contribution of a partnership's indebtedness by a creditor to the debtor partnership in exchange for a capital or profits interest in the partnership.\(^{323}\) As an exception, the regulations state that section 721 will not apply upon the transfer of a partnership interest to a creditor in satisfaction of a partnership's liability for unpaid rent, royalties, or interest on indebtedness (including accrued original issue discount) that accrued on or after the creditor's holding period for the indebtedness.\(^{324}\) Both the primary rule and the exception would apply regardless of whether the contributed debt is recourse or nonrecourse.\(^{325}\)

While section 721 does not apply to the creditor side of the transaction for unpaid rent, royalties, or interest (including accrued original issue discount), the final regulations provide that the debtor partnership will not recognize gain or loss upon the transfer of a partnership interest to a creditor in a debt-for-equity exchange relating to these obligations.\(^{326}\) The nonrecognition treatment provided in the final regulations for the partnership represents a change from the proposed regulations. The preamble to the final regulations indicates that, under the approach taken in the proposed regulations, the partnership might have been treated as satisfying the indebtedness for unpaid rents, royalties, and interest with a fractional interest in each partnership asset, with the partnership recognizing gain or loss equal to the difference between the fair market value and adjusted basis of each partial asset deemed transferred.\(^{327}\) In adopting the more generous rule in the final regulations, Treasury and the Service stated a belief “that in a debt-for-equity exchange where the partnership has not disposed of any of its assets, the partnership should not be required to recognize gain or loss on the transfer of a partnership interest in satisfaction of its indebtedness for unpaid rent, royalties, or interest.”\(^{328}\)

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\(^{322}\) See infra notes 337-347 and accompanying text discussing other aspects of the final regulations.

\(^{323}\) Treas. Reg. §1.721-1(d)(1).

\(^{324}\) Treas. Reg. §1.721-1(d)(2). This rule generally will be significant with respect to cash method taxpayers who, because they will not have accrued income with respect to the unpaid rent, royalties, or interest, will have no basis with respect to the corresponding debt amount. The provision turning off application of section 721 is intended to prevent creditors from avoiding ordinary income treatment with respect to value realized that is attributable to accrued rents, royalties, or interest, as these items generally gives rise to ordinary income for the creditor and an ordinary deduction for the debtor. See T.D. 9557, 2011-51 I.R.B. 855 (preamble). By providing that section 721 does not apply only with respect to interest that accrued on or after the beginning of the creditor’s holding period for the indebtedness, Treasury and the Service appear to have recognized that the holder of a debt instrument cannot convert ordinary income to capital gain (as a result of obtaining a carryover basis in a partnership interest for contributed debt) where the creditor receives a partnership interest in exchange for interest that accrued while the creditor did not hold the instrument.

\(^{325}\) As a result of the application of section 721 to the creditor’s contribution of the debt, the creditor’s holding period with respect to the debt under section 1223 would carry over to the partnership interest received in exchange for the debt.

\(^{326}\) Treas. Reg. §1.721-1(d)(2).


\(^{328}\) Id. Although not stated in the regulations, the Service apparently views the transaction in a deemed circular flow of cash construct. In a panel discussing the final regulations, Beverly Katz, Special
With respect to the creditor side of the contribution transaction, it is significant that the regulations reference Treas. Reg. §§1.446-2(e) and 1.1275-2(a) for rules applicable to determining whether a partnership interest transferred to a creditor is treated as payment of interest or accrued original issue discount. Those rules apply the partnership interest received first to interest rather than principal. This rule also was included in the proposed regulations. With respect to the rule in the proposed regulation, commentators argued that the result is not appropriate where the loan is being terminated. Although apparently recognizing some justification for complaints about the ordering rule, Treasury and the Service seem to have determined that the regulations addressing contributions of partnership debt to equity were not the appropriate forum to re-think the rule, which has broader application.

It would seem that the “interest-first” ordering rule could limit or eliminate the availability of section 721 in many contribution transactions. For instance, read

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Counsel, IRS Office of Associate Chief Counsel (Passthroughs and Special Industries), was quoted as follows: “It’s as if the debtor partnership paid the interest and the creditor took the cash that they received from the payment of the interest, along with the remaining outstanding debt, and contributed it back to the partnership.” M. Dalton, Nonrecognition Treatment in Final Debt-For-Equity Regs Praised, 2011 Tax Notes Today 222-5 (Nov. 17, 2011) (hereafter referred to as “Nonrecognition Treatment Praised”); see also A. Elliott, Treasury Finalizes Debt-For-Equity Regs With Implied Circular Flow of Cash, 2011 Tax Notes Today 221-1 (Nov. 16, 2011) (hereafter referred to as “Implied Circular Flow of Cash”) (quoting Bob Crnkovich, former Senior Counsel (Partnerships) in Treasury’s Office of Tax Legislative Counsel, as stating that “[t]his could be viewed as creating an implicit circular flow of cash from the debtor’s standpoint.”). Compare Treas. Reg. §1.1032-3 (providing for circular flow of cash to create basis in stock where stock is contributed to another corporation or partnership and then issued by such entity in exchange for property or in satisfaction of an obligation). The nonrecognition treatment provided for the partnership is quite favorable for taxpayers and may present significant opportunities. Note that a cash method partnership with low basis property could issue a partnership interest to a partner in payment of its rent and take a current deduction, deferring gain with respect to the property that effectively funded the current deduction until that property is sold. In effect, each partner who is allocated a share of the deduction obtains a timing benefit. Although not stated in the regulations, presumably it is intended that the partnership will revalue its assets under Treas. Reg. §1.704-1(b)(2)(iv)(f) in connection with the contribution by the creditor, so that the gain inherent in the partnership assets that fund the deduction will be “locked in” with respect to the historic partners as a “reverse section 704(c)” allocation.  

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330 See NYSBA, Report on Proposed Regulations Under Sections 108(e)(8) and 721, reprinted at 2009 Tax Notes Today 122-75 (June 29, 2009) (hereafter referred to as the “NYSBA Section 108(e)(8) Report”); see also D. Garlock, How to Account for Distressed Debt, 2010 Tax Notes Today 105-3 (June 2, 2010) (“applied to a final settlement of a debt for an amount less than principal plus accrued interest . . . the rule produces a plainly wrong result”); L. Sheppard, Aggressive Advice and Useful Warnings at Hedge Fund Meeting, 2011 Tax Notes Today 9-1 (Jan. 13, 2011) (quoting Garlock for the proposition that there is substantial authority for the position that the payment ordering rule in Treas. Reg. §1.446-2(e) should not apply in the context of collection of the final payment on distressed debt).

331 See Implied Circular Flow of Cash, supra note 328 (quoting Bob Crnkovich, former Senior Counsel (Partnerships) in Treasury’s Office of Tax Legislative Counsel, as stating “[w]e felt that this project was not the appropriate forum to take on the reg. section 1.446-2 ordering rule. We understand the objections. That’s an income tax and accounting issue.”). See generally A. Elliott, IRS Takes Hard Line on Interest-First Ordering Rules in Debt-For-Equity Regs, 2011 Tax Notes Today 240-4 (Dec. 14, 2011) (hereafter referred to as “IRS Takes Hard Line”).
literally, if the value of the partnership interest issued is less than the interest or original issue discount that has accrued with respect to the debt instrument, section 721 would seem not to apply at all to the transaction. For example, consider a situation where a partnership owes $100, $20 of which is accrued interest. If the partnership issues a partnership interest valued at $15 in exchange for the contribution of the debt to equity, the creditor would be deemed to receive an interest payment of $15; section 721 would not apply to that payment, so if the creditor had not already included the accrued interest in income, it would have $15 of interest income at that time. With respect to the remainder of the debt instrument, with respect to which no portion of the partnership interest is allocated, it seems that section 721 would not literally apply. Under this reading of the regulation, it would seem that a current loss generally would be available with respect to any basis attributable to the excess portion of the debt (which would be bifurcated and treated as separate from the interest portion of the debt to which section 721 does not apply). Nonetheless, the Service apparently will take the position that section 721 does apply to the remainder of the debt, so that the basis attributable to the excess portion of the debt will carry over to the partnership interest received.

Where the debt is wholly worthless, and no partnership interest is transferred in connection with the contribution of the debt, there is a further question as to whether the contribution of debt can qualify under section 721. Existing authority indicates that, in order for section 721 to apply to a transaction, the contributing partner must receive a partnership interest in exchange for the contribution. Where a partnership is insolvent, both before and after the contribution of the debt, it would seem that the

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332 Santa Monica Pictures, LLC v. Commissioner, 89 T.C.M. (CCH) 1157 (2005) (“a contribution of a worthless debt is not a ‘contribution of property’ for purposes of section 721 or the partnership basis rules”; debt in this case was a third-party receivable); see also Coordinated Issue Paper – Distressed Asset Trust (DAT) Tax Shelters, LMSB4-0210-008 (Mar. 23, 2010) (contribution of worthless asset to a partnership is not a contribution under section 721 “because nothing of value has been contributed”); Coordinated Issue Paper – Distressed Asset/Debt Tax Shelters, LMSB-04-0407-031 (Apr. 18, 2007) (same); compare GLAM 2011-003 (Aug. 18, 2011) (in a check-the-box election to convert an insolvent corporation to a partnership, the deemed contribution of underwater assets to the newly-formed partnership qualified under section 721; liabilities assumed by partnership were limited under section 752(c)).

333 There could be some concern that the loss would be disallowed where the creditor and partnership are related under section 267(b) or section 707(b). See infra text following note 394.

334 See IRS Takes Hard Line, supra note 331 (in addressing this example, quoting Mary Beth Carchia, a Technical Reviewer in Branch 3 of the IRS Office of Chief Counsel (Passthroughs and Special Industries) as follows: “[The regs specify that section 721] doesn’t apply to the extent that the interest is in exchange for the debt. [(Presumably the reference to “debt” is intended as a reference to the interest component of the debt,)] So if you’re only getting $15 for the partnership interest, only $15 is the part that section 721 does not apply to because that’s what’s being used to satisfy that piece.” Joseph Worst, an attorney in Branch 3, further stated: “Even though it doesn’t appear that section 721 would apply to the rest of the debt, we would still say that the rest of the debt – including the $5 [of additional interest] – is being contributed in a section 721 transaction.”); Nonrecognition Treatment Praised, supra note 328 (stating that Beverly Katz, Special Counsel, IRS Office of Associate Chief Counsel (Passthroughs and Special Industries) indicated that the Service intended for section 721 to apply to the excess portion of the debt).

335 See supra note 332.
contributing partner could not increase its interest in the partnership, so qualification under section 721 would seem highly questionable.\footnote{Query whether an interest in future profits would be sufficient to allow a contribution to qualify under section 721.}

\section*{b. Partnership Debt-for-Equity Exchange}

As a result of the American Jobs Creation Act of 2004 (the “2004 Act”), if the value of the partnership interest issued in exchange for the debt is less than the adjusted issue price of the debt, the partnership will recognize COD income. Prior to October 22, 2004, some practitioners believed that a common-law debt-for-equity exchange could provide for the exclusion of COD income.\footnote{For excellent discussions of the partnership debt-for-equity exception prior to the 2004 Act, see H. Ahrens, Partnership Equity for Debt Transactions as an Exception to the Realization and Recognition of Cancellation of Indebtedness Income: Fact or Fiction?, 93 Tax Notes Today 171-68 (Aug. 17, 1993) and NYSBA Report, supra note 311.} But now, under section 108(e)(8), as amended by the 2004 Act, where a partnership transfers a capital or profits interest to a creditor in satisfaction of a recourse or nonrecourse liability owed by such partnership, the partnership will be treated, for purposes of section 108, as having satisfied the liability with an amount of money that equals the fair market value of the transferred partnership interest. To the extent that COD income is recognized under this provision, that income must be allocated to the taxpayers who were partners immediately before the discharge.

Note that section 108(e)(8) determines the amount of the debt that is treated as satisfied by reference to the “fair market value” of the capital or profits interest transferred. This reference creates significant uncertainty regarding whether the deemed satisfaction is measured by reference to the “liquidation” value (\textit{i.e.}, capital account) or “willing-buyer-willing-seller” value of the partnership interest. Because the statute references the fair market value of a profits interest (which would not share in the capital of the partnership upon issuance),\footnote{See Rev. Proc. 93-27, 1993-2 C.B. 343; Rev. Proc. 2001-43, 2001-2 C.B. 191.} the statute could be read to imply that a “willing-buyer-willing-seller” value is intended. In valuing a partnership interest received in exchange for a contribution of indebtedness, the “willing-buyer-willing-seller” analysis could require consideration of minority discounts, discounts for lack of liquidity, control premiums, etc.

Final regulations issued in 2011 address the measurement of the “fair market value” of the partnership interest issued in exchange for the debt. Under these regulations, the fair market value of the partnership interest transferred to a creditor will be deemed to equal the “liquidation value” of the partnership interest when certain conditions are satisfied.\footnote{Treas. Reg. §1.108-8(b)(2)(i).} For purposes of the regulations, “liquidation value” is defined as the amount of cash that the creditor would receive with respect to the
partnership interest if, immediately after the transfer, the partnership sold all of its assets (including goodwill, going concern value, and any other intangibles associated with the partnership's operations) for cash equal to the fair market value of those assets and then liquidated.340

As stated above, “liquidation value” will be deemed to be the fair market value of the partnership interest issued to the creditor only where certain requirements are satisfied. These requirements are: (1) the creditor, debtor partnership, and its partners treat the fair market value of the indebtedness as being equal to the liquidation value of the interest for purposes of determining the tax consequences of the debt-for-equity exchange; (2) if, as part of the same overall transaction, the debtor partnership transfers more than one partnership interest to one or more creditors, then each creditor, debtor partnership, and its partners treat the fair market value of each partnership interest transferred by the debtor partnership to such creditors as equal to its liquidation value; (3) the debt-for-equity exchange is a transaction that has terms that are comparable to terms that would be agreed to by unrelated parties negotiating with adverse interests; and (4) subsequent to the debt-for-equity exchange, the partnership does not redeem the partnership interest, and no person related (under section 267(b) or section 707(b)) to the partnership or its partners purchases, the partnership interest as part of a plan at the time of the debt-for-equity exchange which has as a principal purpose the avoidance of COD income by the partnership.341

The regulations also provide that, where section 108(e)(8) is applied by reference to the liquidation value of a partnership interest, the liquidation value of an interest in an upper-tier partnership that directly or indirectly owns an interest in one or more lower-tier partnerships will be determined by taking into account the liquidation value of the lower-tier partnership interests.342

The regulations seem to make clear that the use of “liquidation value” is elective for taxpayers. As mentioned above, the regulations indicate, as one of the conditions, that “liquidation value” will be required where the creditor, debtor partnership, and its partners treat the fair market value of the indebtedness as being equal to the “liquidation value” of the interest.343 Based upon this language, it would appear that, by agreeing not to “treat” the “liquidation value” of the partnership interest as its fair market value, the parties could avoid application of the rule, essentially making the rule elective.

If the conditions for application of “liquidation value” do not apply, the regulations state that “all facts and circumstances” will be considered in determining the

342 Treas. Reg. §1.108-8(b)(2)(ii). While this rule generally is logical, in situations where the upper-tier partnership owns only a small interest in a lower-tier partnership, query whether it will be possible to obtain the information necessary to determine the liquidation value of the lower-tier partnership interest.
The final regulations added a provision not contained in the proposed regulations that has created some confusion for practitioners. This provision states that “[i]f the fair market value of the debt-for-equity interest does not equal the fair market value of the indebtedness exchanged, then general tax principles shall apply to account for the difference.” The preamble to the final regulations elaborates a bit, stating that “section 707(a)(2)(A), as it relates to the treatment of payments to partners for transfers of property, will be considered, if appropriate.”

A situation where this provision might arise is as follows: A non-U.S. creditor is owed debt with a face amount and adjusted issue price of $100x, and a fair market value of $70x. The partners in the debtor partnership are insolvent, so they would like to maximize excludible COD income. Accordingly, they negotiate with the non-U.S. (i.e., tax indifferent) creditor to contribute its debt in exchange for a $30x capital interest. The creditor also will receive an allocation of the first $40x of taxable gross income from the partnership, coupled with a distribution to match the allocation. By undertaking this transaction, the existing partners are attempting to increase their excludible COD income by $40x (because the liquidation value of the debt-for-equity interest would be $40 lower than if the creditor had received an interest equal to $70x) and reduce their future taxable income by $40x. Under section 707(a)(2)(A), the contribution of debt would be viewed as a contribution of property, and the allocation and distribution would be treated as a non-partner capacity payment on the debt. Accordingly, by invoking section 707(a)(2)(A), the creditor would be treated as receiving $70x with respect to its contributed debt (i.e., the $30x debt-for-equity interest and $40x non-partner capacity payment), and the COD income recognized would be only $30x.

This provision might create some concern in an alternate situation where, in order to incentivize the existing partners to help in the “turnaround” efforts with respect to the partnership, a creditor allows the partners in the debtor partnership to maintain some capital interest in what is, before the debt contribution transaction, an insolvent partnership. The concern would be that the Service might apply the regulation to recast the retention of the capital interest by the existing partners as a receipt of such interest by the creditor followed by a re-issuance of the interest to the historic partners in exchange for the provision of future services. Such a transaction does not involve

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346 T.D. 9557, 2011-51 I.R.B. 855 (preamble); see also Implied Circular Flow of Cash, supra note 328 (quoting Bob Crnkovich, former Senior Counsel (Partnerships) in Treasury’s Office of Tax Legislative Counsel, as stating “[w]e wanted to be clear that if you play games with valuations, there is another code provision – section 707(a)(2)(A) – that could come into play”).
347 Note that such a recast seemingly would result in a reduction of the COD income recognized by the partnership, as the creditor would be treated as receiving a greater quantum of partnership interest in
any transfer of property by the historic partners, and those partners are not receiving an allocation and distribution, as contemplated in section 707(a)(2)(A). Accordingly, section 707(a)(2)(A) should not apply to this transaction. Nonetheless, even though the preamble references payments to partners under section 707(a)(2)(A), the regulation applies a broader “general tax principles” standard. But it seems that the regulation generally should not be invoked in this fairly common and non-abusive scenario. Debtors and creditors always negotiate over the amount of debt to be forgiven, and, completely apart from Federal income tax considerations, it is not at all unusual for the creditor to forgive an amount of debt that creates some equity value for the existing owners. Such an arrangement historically has not been challenged as having an effect other than with respect to the amount of the COD income, and it seems that the regulation should not change this historic approach for debt-relief transactions that are the product of commercial arm’s-length negotiations.

As discussed above, it is unclear whether section 721 can apply where a partner contributes debt to a partnership and the partner receives no partnership interest in exchange for the contribution. Similarly, it would appear that section 108(e)(8) technically does not apply in this situation. That provision applies only where a partner receives a capital or profits interest in the partnership in exchange for a contribution of debt.

c. Liability Shifts and Gain Recognition

As previously discussed, a partner will increase its basis in its partnership interest to the extent of any COD income recognized in connection with the contribution of debt to a partnership. This will be the case even if such income is excluded by the partner under section 108. Accordingly, the partners will not recognize gain under section 731 with respect to the portion of the debt that is treated as being forgiven, thereby giving rise to COD income. To the extent, however, that a section 752(b) distribution resulting from an exchange exceeds the COD income allocated to the partner, such partner may recognize gain under section 731.

As illustrated in Rev. Rul. 92-97, there are some circumstances where COD income may be allocated differently than the discharged indebtedness was allocated under section 752. In these circumstances, a partner’s basis increase in its partnership interest may not fully offset the deemed distribution under section 752(b). A

exchange for the contribution of the debt. The historic partners then would be treated as receiving compensatory partnership interests, which presumably would give rise to ordinary income to the extent that the interests deemed transferred are capital interests. See Rev. Proc. 93-27, 1993-2 C.B. 343. The effect likely is not a significant change in the ordinary income recognized by the historic partners, but the reduction in COD income means that less of the income resulting from the transaction would be potentially excludable under section 108. The creditor presumably would have a deductible or capitalizable expenditure equal to the value of the transferred interest.

348 See supra note 102 and accompanying text.
349 See supra notes 85-88 and accompanying text.
contribution of a portion of a debt instrument also could cause gain recognition to partners as a result of a shift in debt among the partners, as opposed to a deemed distribution resulting from the elimination of debt. If some or all of a nonrecourse loan remains outstanding following the entry of the debtor into the partnership, the debt will become partner nonrecourse debt, except in certain circumstances where the debtor does not obtain more than a 10-percent interest in the partnership. For purposes of section 752, partner nonrecourse debt is treated as recourse debt with respect to the partner who made the loan. Accordingly, nonrecourse debt previously shared by the existing partners will be shifted to the lender/partner.

The circumstances surrounding the shift in the liability away from the old partners may result in the chargeback of minimum gain with respect to such partners, since the partnership minimum gain will be transformed into partner nonrecourse debt minimum gain with respect to the new partner. It is not clear whether a revaluation resulting from the admission of the lender as a partner will free an existing partner from the requirement to chargeback minimum gain where the existing partner’s share of debt is eliminated in the same transaction that gives rise to the revaluation. The regulations provide that reductions in minimum gain will not be taken into account where such reductions arise “solely from a revaluation.” Arguably, where the reduction in a partner’s share of minimum gain results from both a revaluation of the property and a conversion of the debt into partner nonrecourse debt, the “solely” requirement is not satisfied. With that said, it may be possible to avoid this risk by creating a “book-up” event prior to the entry of the new partner.

In addition to the potential chargeback of minimum gain, the deemed distribution under section 752(b) may result in the recognition of additional gain with respect to such partners under section 731. For this purpose, it is important to remember that, to the extent that a partner is allocated income or gain as a result of a minimum gain chargeback, that partner’s basis in its partnership interest should be increased so that the shifting of the nonrecourse debt that previously was allocated in

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350 Treas. Reg. §1.752-2(c)(1); Treas. Reg. §1.704-2(i).
351 Treas. Reg. §1.752-2(d).
352 Treas. Reg. §1.704-2(i).
353 See supra note 77 and accompanying text.
354 See NYSBA Report, supra note 311.
356 See generally M. Frankel & C. Coffin, Partnership Workouts: Problems and Solutions Under Final Section 704(b) and 752 Regulations, 9 J. of P-ship Tax’n 287 (1993).
357 If the minimum gain chargeback is avoided, the partner formerly subject to the chargeback still may recognize increased gain as a result of the deemed distribution under section 752(b). However, the character of the gain from a distribution is likely to be capital (but see I.R.C. §751(b)), while the minimum gain chargeback may result in the recognition of ordinary income, depending on the character of the partnership’s income for the year. Treas. Reg. §1.704-2(j)(2).
accordance with partnership minimum gain\textsuperscript{358} will not cause the partner to recognize gain under section 731. However, the partner could recognize gain under section 731 to the extent that remaining portion of the debt is shifted away from such partner.

C. Elimination of Partner Debt

In addition to the partnership debt-for-equity exception, historically some practitioners believed a partner could successfully argue that the contribution of debt by an existing partner should be treated as a nontaxable contribution to capital. In the corporate context, Treas. Reg. §1.61-12(a) provides that, “[i]n general, if a shareholder in a corporation which is indebted to him gratuitously forgives the debt, the transaction amounts to a contribution to the capital of the corporation to the extent of the principal of the debt.” Section 118 generally provides that a contribution to capital will not be taxable to the corporation. In the context of debt forgiveness, section 108(e)(6) specifically provides that, “if a debtor corporation acquires its indebtedness from a shareholder as a contribution to capital – (A) section 118 shall not apply, but (B) such corporation shall be treated as having satisfied the indebtedness with an amount of money equal to the shareholder’s adjusted basis in the indebtedness.”

Although sections 118 and 108(e)(6) do not, by their terms, apply to partnerships, arguments could be made prior to the 2004 Act that the principles of section 118 should apply in the context of partnerships.\textsuperscript{359} However, by expanding

\textsuperscript{358} Treas. Reg. §1.752-3(a)(1).

\textsuperscript{359} In an article published before the 2004 Act, one commentator stated that “[a]s in the case of section 118(a), there appears to be no economic or policy reason to treat partnerships differently than corporations under section 108(e)(6).” K. Blanchard, The Taxability of Capital Subsidies and Other Targeted Incentives, 1999 Tax Notes Today 215-65 (Nov. 8, 1999). While this may have been true from an economic or policy perspective, section 108(e)(6), by its terms, did not apply to partnerships. In a technical advice memorandum and private letter ruling, both published around 1980, the Service ruled that the exclusion provided in section 118 was available to partnerships. Tech. Adv. Mem. 7950002 (Aug. 2, 1979), revoked Tech. Adv. Mem. 9032001 (Jan. 12, 1990); Priv. Ltr. Rul. 8038037 (June 24, 1980). The Service subsequently repudiated these rulings in General Counsel Memorandum 38944. (Dec. 27, 1982); see also 1998 FSA Lexis 583 (Sept. 3, 1998) (reiterating the Service’s position that case law decided prior to the enactment of section 118 has no application to partnerships). While the memorandum justified its position on the basis of there being no continuing nonstatutory basis for excluding contributions to capital, the real concern underlying the decision appeared to be the lack of a counterpart to section 362(c) in the partnership context to deal with basis adjustments for non-partner contributions to capital by a partner. In the partnership context, there also is some question as to how section 118 principles are reconciled with the literal language of section 721. Section 721(a) only provides for nonrecognition treatment with respect to contributions “in exchange for an interest in the partnership.” Applying this language literally, a partnership would have income to the extent that it does not issue a partnership interest in exchange for property (including cash). Cf. Twenty Mile Joint Venture, PND, Ltd. v. Commissioner, 200 F.3d 1268, 1277 n.7 (10th Cir. 1999) (taxpayer argued that a contribution to capital is not covered by section 721, but that such a contribution still does not constitute income to the partnership; given that the taxpayer’s general case was rejected on other grounds, the court chose not to address this issue); Mas One Limited Partnership v. U.S., 390 F.3d 427 (6th Cir. 2004) (payment by a partner of partnership debt one day after the partner abandoned its partnership interest did not qualify as a contribution under section 721 because the partner did not make the contribution in exchange for a partnership interest).
section 108(e)(8) in the 2004 Act to encompass partnership interests, while failing to similarly expand section 108(e)(6). Congress would seem to have effectively foreclosed application of the contribution to capital argument with respect to partner debt. In addition, the Service recently has indicated, in no uncertain terms, that it does not believe a section 118 analog can apply to partnerships generally.

VI. Passive Activity Rules

The Service has held that COD income will constitute income from a passive activity to the extent that, at the time the indebtedness is discharged, the debt is allocated to passive activity expenditures under section 1.163-8T of the temporary regulations.


361 See IRS Issues LMSB Directive on Abuse of Capital Contribution Provision, 2007 Tax Notes Today 202-16 (Oct. 18, 2007) (establishing as a Tier 1 audit issue arguments by taxpayers operating in partnership form that section 118 or the common law predecessor authority allows them to exclude payments from gross income); Partnerships Can’t Use Contribution-to-Capital Doctrine to Exclude Some Payments from Income, 2008 Tax Notes Today 225-14 (Nov. 20, 2008) (IRS coordinated issue paper for all industries indicating that section 118(a) and similar common law doctrines do not apply outside the corporate context); IRS Official Foresees No Change in Taxation of Nonpartner Capital Contributions, 2008 Tax Notes Today 181-7 (Sept. 16, 2008) (quoting IRS official speaking at American Bar Association meeting). There would appear to be some justification for treating partnerships differently than corporations with respect to contributions to capital. Unlike corporations, which conceptually are respected as separate juridical entities in all events, partnerships, at some level, represent a way to keep track of various partners’ shares of partnership assets. A partner is supposed to receive capital account credit under section 704(b) in exchange for the value of its contributions to a partnership. Treas. Reg. §1.704-1(b)(2)(iv)(d)(1). Where this does not occur, so that other partners are enriched by virtue of the contribution, there may be a taxable capital shift to the other partners. Cf Treas. Reg. §1.721-1(b)(1). Another way to reconcile contributions to capital with the capital account concept for partnerships is to say that such contributions are taxable to the partnership. Taking this approach, each partner would receive capital account credit to the extent of its allocable share of the attributable income. Different issues would appear to be present where contributions are made by a non-partner in the context where non-shareholder contributions would qualify for nonrecognition treatment under section 118. While “capital shifts” among partners do not arise in this context, concern has been expressed in providing relief due to the lack of an analog to section 362(c) for reducing the basis of partnership property attributable to such contributions.

362 Rev. Rul. 92-92, 1992-2 C.B. 103; see also Priv. Ltr. Rul. 9522008 (Feb. 22, 1995) (COD income arising from debt incurred to acquire property held for investment will be treated as investment income within the meaning of section 163(d)(4)(B)); Priv. Ltr. Rul. 200952018 (Sept. 17, 2009) (income from cancellation of indebtedness or amount realized related to relief of indebtedness treated as investment income for purposes of section 163(d) where debt was incurred to acquire investment property).
VII. At-Risk Rules

It appears that COD income will create at-risk basis for partners in a partnership. The proposed regulations under section 465 provide that a taxpayer’s amount at risk in an activity is increased by the excess of the items of income (including tax-exempt receipts) over the deductions allocated to the taxpayer from the activity for the taxable year. In addition, the Service recently stated in a field service advice that limited partners may, subject to section 704(d), deduct losses arising from an activity to the extent of COD income recognized by the partners with respect to the same activity.

An issue can arise where a partner has relied on partnership debt to take at-risk losses, and the partner elects to defer COD income under section 108(i) with respect to that partnership debt. While section 108(i)(6) defers the deemed distribution under section 752 to the extent that the relevant partner would recognize gain under section 731 upon reduction or elimination of the debt, there is no similar rule to prevent a partner from recapturing under section 465(e) previously deducted at-risk losses attributable to the forgiven liability. Hopefully, favorable guidance will be forthcoming on this issue.

VIII. Partner-Specific Issues

The issues discussed up to this point have related to events that occur at the partnership level. That is, the partnership has taken certain steps related to working out its indebtedness. While the partners may be presented with numerous alternative decisions in accounting for items allocated to them, these decisions generally are reactionary to decisions of the partnership. Except with respect to contributing partner debt to the capital of a partnership, they do not involve an analysis by the partner of the partner’s own investment in the partnership.

Where a partnership enters into a workout (or forced liquidation) scenario, partners may be confronted with decisions that are not merely reactionary. If the partner is also a creditor, there may be decisions as to whether to write off the debt owed by the partnership. The treatment of certain aspects of such a transaction from the partnership’s perspective was discussed earlier in this outline. However, as part of this decision, or separately, the partner may need to decide whether it is desirable and appropriate to take a bad debt deduction with respect to the liability. In addition, where the partnership is in serious financial straits, the partner may wish to abandon its partnership interest or otherwise declare the partnership interest to be worthless.

364 F.S.A. 200043004 (July 11, 2000); see also COD Income and Basis Adjustments, supra note 86.
365 See ABA 108(i) Report, supra note 188 (discussing issue under section 465(e)).
366 See supra notes 321-361 and accompanying text.
A. Debt Owed by the Partnership to a Partner

Where a partner has loaned money to a partnership, and the partnership becomes financially distressed, the partner/lender may realize an economic loss with respect to the amount advanced to the partnership due to the partnership’s inability to repay the loan. The rules governing the treatment of the partner with respect to its debt investment are relatively confusing, and the results for the partner are not at all clear in a number of situations. The issues would seem to diverge based upon whether the debt is wholly worthless or partially worthless, and the discussion below will consider these two situations separately.

1. Debt is Wholly Worthless

Where a partner is owed debt by a partnership and the debt is wholly worthless, section 166 would appear to determine the treatment of the partner is writing off the debt. Section 166 provides different rules for business debt and nonbusiness debt, so it is important to distinguish between these two types of liabilities in analyzing worthless debt.

A taxpayer will be entitled to an ordinary deduction where a business debt is wholly worthless.\textsuperscript{367} Conversely, for nonbusiness indebtedness owed to a taxpayer other than a corporation, a loss resulting from complete worthlessness will be allowed as a short-term capital loss.\textsuperscript{368}

Business debt is any debt that is not otherwise classified as nonbusiness debt. Nonbusiness debt is defined as any debt other than (1) debt created or acquired in connection with the trade or business of the taxpayer, or (2) a debt the loss from the worthlessness of which is incurred in the taxpayer’s trade or business.\textsuperscript{369} The use to which borrowed funds are put is not relevant to these determinations.\textsuperscript{370}

The determination as to when debt becomes worthless is based on all of the facts and circumstances.\textsuperscript{371} The value of the collateral securing the debt and the financial condition of the debtor are two of the more important factors to be considered in

\textsuperscript{367} I.R.C. §166(a); Treas. Reg. §1.166-3.
\textsuperscript{368} I.R.C. §166(d)(1); Treas. Reg. §1.166-5(a)(2).
\textsuperscript{369} I.R.C. §166(d)(2); Treas. Reg. §1.166-5(b)(1) & (2).
\textsuperscript{370} Treas. Reg. §1.166-5(b). The determination as to whether the loss on a debt’s becoming worthless has been incurred in the trade or business of a taxpayer is made in substantially the same manner as in determining whether a loss has been incurred in a trade or business for purposes of section 165(c)(1). \textsuperscript{Id} For purposes of making this determination, the character of the debt is determined by the relation which the loss from the debt’s becoming worthless bears to the trade or business of the taxpayer. \textsuperscript{Id} The debt will not be nonbusiness debt if the relation is a proximate one in the conduct of the trade or business in which the taxpayer is engaged at the time that the debt becomes worthless. \textsuperscript{Id}
\textsuperscript{371} Treas. Reg. §1.166-2(a).
determining worthlessness. According to the regulations, where the surrounding circumstances indicate that a debt is worthless and uncollectible and that legal action to enforce payment in all probability will not result in the satisfaction of an execution on a judgment, a taxpayer should be entitled to a deduction under section 166 attributable to the worthlessness of the debt.

A taxpayer has the burden of showing that a debt has become worthless. In order to satisfy this burden, the taxpayer must prove that the debt had some value at the beginning of the taxable year and that it became worthless during the year.

Generally, the simple act of canceling a debt will not establish a creditor’s right to a bad debt deduction. While a taxpayer need not necessarily institute a suit for collection in order to show worthlessness, a taxpayer may not simply fail to enforce a debt and then claim a bad debt deduction under section 166.

In the corporate context, the circumstances surrounding a write-off of debt by an equity owner in an entity appear to invite particular scrutiny in determining whether a bad debt deduction should be permitted. Where a shareholder gratuitously forgives debt owed by the corporation, the transaction will be treated as a contribution to capital. A shareholder who contributes debt to the capital of a corporation will not be permitted to take a worthlessness deduction with respect to the debt.

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372 Id.
373 Treas. Reg. §1.166-2(b). Bankruptcy generally is an indication that at least part of an unsecured and unpreferred debt is worthless. Treas. Reg. §1.166-2(c)(1). In some instances, a debt may become worthless before settlement of the bankruptcy estate. Treas. Reg. §1.166-2(c)(2). In other situations, the debt will become worthless only when settlement of the bankruptcy estate has been reached. Id.
377 Treas. Reg. §1.166-2(b).
378 Cole v. Commissioner, 871 F.2d 64, 67 (7th Cir. 1989). Where other parties in addition to the partnership may be liable for the debt (either because the partnership is a general or limited partnership or because one or more parties have guaranteed the debt), it would appear that the creditor must look beyond the partnership for satisfaction of the debt before it may take a bad debt deduction. See Hotel Continental, Inc. v. Commissioner, 70 T.C.M. (CCH) 295 (1995); Priv. Ltr. Rul. 8131012 (Apr. 28, 1981).
379 Treas. Reg. §1.61-12(a).
Lidgerwood Manufacturing Co. v. Commissioner 14 illustrates one situation where the Service successfully asserted that a shareholder was not entitled to a bad debt deduction under a contribution to capital analysis. In that case, the parent/creditor cancelled debt owed to it by a subsidiary in order to enable the subsidiary to obtain additional financing from outside lenders. In holding that the parent was not entitled to a bad debt deduction, the court stated:

[Even on the assumption that the debtors were insolvent after as well as before the cancellations, wiping out the debts was a valuable contribution to the financial structure of the subsidiaries. It enabled them to obtain loans, to continue in business to prosper. This was the avowed purpose of the cancellations. Where a parent corporation voluntarily cancels a debt owed by its subsidiary in order to improve the latter’s financial position so that it may continue in business, we entertain no doubt that the cancellation should be held a capital contribution and preclude the parent from claiming it as a bad debt deduction.]

While the Service has continued to aggressively assert the contribution to capital analysis in denying the worthless debt deduction, some courts have limited the holding in Lidgerwood. According to these courts, where the debt is truly worthless, so that forgiveness of the debt does not enhance the value of the taxpayer’s stock, the taxpayer will not be denied a bad debt deduction based on a characterization of the transaction as a contribution to capital.

Unlike the corporate analysis, the treatment of partner contributions to capital is generally uncertain, at least from the perspective of the party who is contributing the debt. The determination of COD income resulting from such transactions seemingly

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381 229 F.2d 241 (2nd Cir. 1956).
382 Id.
383 Cf. Priv. Ltr. Rul. 200101001 (Aug. 7, 2000) (distinguishing Lidgerwood based upon the fact that the shareholder’s debt was eliminated pursuant to the subsidiary corporation’s bankruptcy proceeding).
384 See Giblin v. Commissioner, 227 F.2d 692 (5th Cir. 1955); Celanese Corp. v. Commissioner, 85-2 U.S.T.C. ¶9517 (Cl. Ct. 1985); Mayo v. Commissioner, 16 T.C.M. (CCH) 49 (1957); but see Plante v. Commissioner, 168 F.3d 1279 (11th Cir. 1999) (distinguishing Giblin, but also expressing a preference for the analysis in Lidgerwood). Compare Jostens, Inc. v. Commissioner, 956 F.2d 175, 176-77 (8th Cir. 1992) (a creditor may not voluntarily cancel debt that has value and claim a bad debt deduction because the debt is valueless following cancellation).
385 In a technical advice memorandum and private letter ruling, both published around 1980, the Service ruled that the exclusion provided in section 118 was available to partnerships. Tech. Adv. Mem. 7950002 (Aug. 2, 1979), revoked Tech. Adv. Mem. 9032001 (Jan. 12, 1990); Priv. Ltr. Rul. 8038037 (June 24, 1980). The Service subsequently repudiated these rulings in General Counsel Memorandum 38944 (Dec. 27, 1982); see also 1998 FSA Lexis 583 (Sept. 3, 1998) (reiterating the Service’s position that case law decided prior to the enactment of section 118 has no application to partnerships); IRS Issues LMSB Directive on Abuse of Capital Contribution Provision, 2007 Tax Notes Today 202-16 (Oct. 18, 2007) (establishing as a Tier 1 audit issue arguments by taxpayers operating in partnership form that section 118 or the common law predecessor authority allows them to exclude payments from gross income); Partnerships Can’t Use Contribution-to-Capital Doctrine to Exclude Some Payments from Income, 2008 Tax Notes Today 225-14 (Nov. 20, 2008) (IRS coordinated issue paper for all industries indicating that
was clarified by the 2004 Act when Congress amended section 108(e)(8) (relating to debt-for-equity exchanges) to include partnership interests while neglecting to similarly amend section 108(e)(6) (relating to contributions of debt to capital). But these changes would seem to have further muddled the treatment of such transactions from the partner/creditor’s perspective.

If a partner is treated as contributing debt to the capital of a partnership, the corporate authority would indicate that the adjusted basis attributable to the debt should carryover to the partner’s adjusted basis in its partnership interest. If the debt has no value, however, so that no partnership interest is received as a result of the contribution, it seems that section 721 would not apply to the contribution, notwithstanding recently issued final regulations addressing debt contributions and section 721. When no additional partnership interest is acquired in exchange for the contribution of the debt, there would seem to be little justification for applying section 722 to carry over the basis of the debt to the partner/creditor’s interest in the partnership. A recent coordinated issue paper issued by the Service reaches a conclusion that is consistent with this view. A contribution to a corporation can qualify under section 118 (and hence section 108(e)(6)) regardless of whether stock is issued to the contributor. It is
worthwhile noting, however, that even in the corporate context, there is a significant question as to whether a contribution of worthless property can qualify as a contribution under section 118 or 351.

If a partner/creditor cannot carry over its basis in wholly worthless debt to its interest in the debtor/partnership, it seems inconsistent to deny the partner a bad debt deduction with respect to its investment in the debt instrument. All of this would seem to lead one to the conclusion that, where debt owed by a partnership to a partner becomes wholly worthless, the partner should be entitled to a bad debt deduction under section 166. One could, it seems, persuasively argue that the Service should not apply the Lidgerwood line of analysis to treat a partner who forgives wholly worthless debt owed by a partnership as a contribution to the capital of the partnership by that partner.

2. Debt is Partially Worthless

The issues grow much more complex where a partner is owed debt by a partnership that is partially worthless. A taxpayer will be entitled to an ordinary deduction under section 166 where a business debt is partially worthless. No such loss, however, is allowed with respect to a partially worthless nonbusiness debt.

Where a partner forecloses on partnership property or collects the proceeds with respect to a sale of partnership property securing the partner’s debt, Treas. Reg. §1.166-6(a) would seem to be relevant. That regulation provides that, if mortgaged or pledged property is sold (to the creditor or another purchaser) for less than the amount of the debt and the portion of the debt remaining unsatisfied after the sale is wholly or partially uncollectible, the creditor may deduct the uncollectible amount as a bad debt under section 166(a) for the taxable year in which it becomes wholly worthless or is charged off as partially worthless. Accordingly, under this rule, it would appear that, where a partnership sells its property and realizes an amount that is insufficient to pay debt owed to a partner, the partner/creditor would be allowed to take a bad debt deduction under section 166. That deduction would be ordinary or capital depending on whether the partner/creditor is a corporation or the debt is business or non-business in nature.

some value; either an increase in its partnership capital account or an increase in its share of partnership profits.

390 See Seaboard Commercial Corp. v. Commissioner, 28 T.C. 1034 (1957), acq. 1958-2 C.B. 7 (transfer of worthless stock to a corporation was not a “contribution to capital” within the meaning of the corporate carryover basis rules).

391 See Meyer v. U.S., 121 F. Supp. 898 (Ct. Cl. 1954), cert. denied, 348 U.S. 929 (1955) (worthless stock could not be contributed to a corporation “in an exchange” for stock); Prop. Reg. §1.351-1(a)(iii) (“no net value” proposed regulation under section 351; preamble recognizes analogy to section 721 and requests comments); compare Rosen v. Commissioner, 62 T.C. 11 (1974), aff’d w/out op., 515 F.2d 507 (3rd Cir. 1975) (contribution of underwater property to corporation qualified under section 351; contributing shareholder remained personally liable for the debt); Tsivoglou v. U.S., 31 F.2d 706 (1st Cir. 1929) (transfer of worthless property to a corporation does not justify recognition of gain or loss).

392 I.R.C. §166(a); Treas. Reg. §1.166-3.
In addition to Treas. Reg. §1.166-6(a), however, section 1271 also must be considered. 393 Section 1271(a)(1) provides generally that an amount received by the holder of a debt instrument on retirement of such a debt instrument will be considered as an amount received in exchange for the debt instrument. Section 1271(a)(1) would appear to conflict directly with the regulation under section 166, and no authority clearly reconciles the two provisions. Commentators express concern that the relevant authority appears to point towards section 1271 as controlling. 394 If section 1271 does control, then where a partner holds a debt instrument as a capital asset (as will usually be the case), and that partner receives property or cash in retirement of the debt with a value less than the adjusted issue price of the debt, that partner presumably will recognize a capital loss in connection with the transaction.

Note that, if section 1271(a)(1) applies, the recognition of the capital loss will be dependent on the application of the related-party rules under sections 267 and 707. Where these rules apply, the loss may be disallowed. Disallowance in this context is particularly harsh, given that the debt instrument disappears in the transaction so that section 267(d) cannot apply to shield the partnership (i.e., the related party who purportedly receives the debt instrument in the exchange) from gain in connection with a future disposition of the property.

The possible implications under section 1271 make it imperative that a partner who holds business debt consider taking a write-off for partial worthlessness in advance of settling the debt for an amount less than that adjusted issue price of the debt. 395 As previously discussed, such a write-off is not possible where the debt is non-business debt.

393 See generally Debt Instruments, supra note 8, at ¶1603.03; M. Kliegman and A.Turkenich, Debt Losses: Timing and Character Revisited, 111 J. of Tax’n 8 (2009); compare J. Cummings, Bad Debt or Loss?, 2009 Tax Notes Today 64-11 (Apr. 7, 2009) (concluding that, properly interpreted, the Supreme Court in McLain v. Commissioner, 311 U.S. 527 (1941), should not be viewed to have foreclosed a bad debt deduction in these circumstances); Rev. Rul. 2003-125, 2003-2 C.B. 1243 (possibly permitting bad debt deduction under section 166 where assets transferred in partial satisfaction of debt on deemed liquidation of entity). For a discussion of the possible application of section 166 or 1271 in Rev. Rul. 2003-125, see J. Sowell, Check-the-Box Conversions: Analyzing the Economic Substance of Deemed Transactions, 45 Tax Mgmt. Mem. (BNA) 425 (2004) (discussing Rev. Rul. 2003-125). Cf. GLAM 2011-003 (Aug. 18, 2011) (check-the-box conversion of insolvent corporation does not, standing alone, justify a bad debt deduction with respect to shareholder debt because the full amount of the debt (except as limited by section 752(c)) is treated as surviving the liquidation and as being contributed to the newly-formed partnership; oddly, the Service recognized that the debt treated as assumed by the newly-formed partnership would be limited under section 752(c), but failed to acknowledge any inconsistency with respect to its “full assumption” justification for denying the section 166 deduction); Dagres v. Commissioner, 136 T.C. no. 12 (2011) (permitting a bad debt deduction in situation where creditor apparently received partial payment in retirement of debt); M. Bauer and C. Kulish Harvey, Tax Court Addresses Bad Debt Deduction in an Investment Fund Context: Dagres Raises Bad Debt Loss and Business Attribution Issues, 27 Tax Mgmt. Memo. 251 (2011) (discussing Tax Court’s failure to address the potential application of 1271).

394 Debt Instruments, supra note 8, at ¶1603.03[E].

395 Note that, as part of the 2013-2014 Guidance Plan, Treasury and the IRS have proposed to issue regulations under section 108(o)(7). 2013-2014 Guidance Plan, supra note 160. The regulations would apply to a taxpayer who previously has taken a worthlessness deduction with respect to debt and who
Under recently finalized regulations, where the creditor contributes debt to a partnership in exchange for a partnership interest, section 721 will apply to the transaction. As a result, the entire basis in the debt instrument will carry over under section 722 to the creditor’s basis in its partnership interest.

The result provided in the final regulations is consistent with the proposed regulations. In response to the proposed regulations, some commentators had suggested that a contribution of debt by a partner to a partnership should be bifurcated, with an amount of debt equal to the value of the partnership interest received being treated as contributed in a section 721 exchange, and the remaining portion of the debt, from the creditor’s perspective, being treated as charged off, thereby giving rise to a bad debt deduction under section 166. In response, Treasury and the Service stated a belief that the bifurcation approach “would be inconsistent with the treatment of analogous corporate debt-for-equity transactions involving corporate indebtedness evidenced by a security in which section 351 would apply.” Treasury and the Service further stated that “comments in favor of the bifurcation approach assume a creditor has not validly taken a bad debt deduction under section 166 prior to the debt-for-equity exchange in a transaction independent of and separate from the debt-for-equity exchange.”

As discussed above, the regulations provide that section 721 will not apply upon the transfer of a partnership interest to a creditor in satisfaction of a partnership’s liability for unpaid rent, royalties, or interest on indebtedness (including accrued

396 Treas. Reg. §1.721-1(d)(1).


398 To the extent that a portion of the debt is treated, from the creditor’s perspective, as being charged off in connection with a transaction where the creditor is receiving property in the form of a partnership interest, the Service could assert that section 1271 applies to characterize the treatment of the debt being charged off. If the debt is truly bifurcated, however, it would seem that the creditor would not be treated as receiving any property in exchange for the portion of the debt that is treated as being charged off. The partnership interest would be received only in exchange for the portion of the debt that is contributed in the section 721 transaction.


400 Id. See also Implied Circular Flow of Cash, supra note 328 (quoting Bob Crnkovich, former Senior Counsel (Partnerships) in Treasury’s Office of Tax Legislative Counsel, as stating “[w]e wanted to signal that if you have a valid pre-contribution write-off that’s not stepped together, that’s one way to achieve” a result that is similar to the bifurcation approach). If a creditor has taken a loss under section 166 with respect to contributed debt, section 108(e)(7)(E) provides regulatory authority to impose section 1245 recapture treatment with respect to the partnership interest received in exchange for the contribution. See Federal Taxation of Partnerships, supra note 317 at ¶4.02[3].

401 See supra notes 324 - 328 and accompanying text.
original issue discount) that accrued on or after the creditor’s holding period for the indebtedness.\textsuperscript{402} As also discussed previously,\textsuperscript{403} it would seem that the “interest-first” ordering rules referenced in Treas. Reg. §§1.446-2(e) and 1.1275-2(a) arguably could limit or eliminate the availability of section 721, particularly where the value of the issued partnership interest does not exceed the accrued interest with respect to the contributed debt. Under this reading of the regulation, a current loss arguably could be available with respect to any basis attributable to the excess portion of the debt, although it appears that the Service will take the position that section 721 does apply to the remainder of the debt.\textsuperscript{404}

3. Some Examples

a. Writing Off Wholly-Worthless Debt in the Year of Forgiveness

Where a partner is permitted to take a deduction under section 166 in connection with the cancellation of wholly worthless partnership debt, the appropriate results would seem to be fairly clear. First, the partner/creditor takes a deduction under section 166 for the debt that is charged off.\textsuperscript{405} Second, the partnership has COD income or sale gain depending on the nature of the debt (recourse or nonrecourse) and whether property is transferred to the partner in connection with the discharge. Third, there is a deemed distribution under section 752(b).

In this scenario, it is quite likely that the amount of all of the various adjustments will net to zero for the creditor/partner. Consider the following example: Partner (“A”), a member of an LLC, determines that a $100 loan that it made to the LLC is worthless. Accordingly, A forgives the debt. Prior to the forgiveness, A’s basis in its LLC interest is $100 (attributable entirely to A’s share of the liability). No other partner had guaranteed the debt or otherwise undertaken any liability for the debt, so the debt was allocated entirely to A under the section 752 regulations.\textsuperscript{406} Assuming that the debt was business debt,\textsuperscript{407} A will be permitted to take an ordinary loss equal to $100 for the worthlessness of the debt. A also will be allocated $100 of COD income, provided

\textsuperscript{402} Treas. Reg. §1.721-1(d)(2).
\textsuperscript{403} See supra notes 329 - 334 and accompanying text.
\textsuperscript{404} See supra note 334.
\textsuperscript{405} Although section 166(d)(1)(B) generally treats the deduction for a nonbusiness bad debt as a loss from the “sale or exchange” of a capital asset held for less than one year, arguably the loss should not be denied under section 267 or 707 even where the creditor is related to the partnership because the deemed sale or exchange created under section 166(d)(1)(B) is not necessarily between the debtor and creditor.
\textsuperscript{406} Treas. Reg. §1.752-2(c)(1).
\textsuperscript{407} Often, debt advanced by a partner that is not a C corporation will not be business debt. In that context, the deduction under section 166 would be a short-term capital loss. I.R.C. §166(d)(1)(B).
that the COD income is allocated in the same manner as the debt.\textsuperscript{408} The allocation of COD income will increase A’s basis in its partnership interest to $200.\textsuperscript{409} However, by virtue of the elimination of the debt, A will receive a deemed distribution under section 752(b) which will reduce A’s basis in its partnership interest back to $100.

After all is said and done, A has a net income inclusion of zero, and A’s basis in its partnership interest is unchanged. It is important to note, however, that the partner’s basis in its partnership interest that previously was attributable to its share of liabilities would have converted to “pre-taxed capital” basis\textsuperscript{410} as a result of the COD income inclusion. In addition, while the bad debt deduction and COD income, in theory, offset each other, there may be a net benefit to the taxpayer if it can avail itself of one of the COD income exclusions under section 108.\textsuperscript{411}

b. Contributing Wholly-Worthless Debt to Partnership Capital

If, contrary to the discussion above,\textsuperscript{412} the Service were to successfully assert that a partner should be treated as contributing the wholly-worthless debt to capital in a carryover basis transaction, the partnership would recognize COD income in an amount equal to the debt contributed, and the partner’s basis in the debt would carry over to its basis in its partnership interest.

Consider the results for A in this situation. A arguably is not entitled to a bad debt deduction because A is treated as having contributed the debt to the capital of the partnership. While A is denied a deduction, A should be able to increase its basis in its partnership interest by $100 (i.e., its basis in the contributed debt). The partnership has COD income of $100 which is allocated entirely to A. A’s basis in its partnership interest increases by the amount of the COD income to $300, but is decreased back to $200 as a result of the deemed distribution under section 752(b) that follows from the elimination of the debt.

c. Deduction for Worthless Debt in a Year Prior to Forgiveness

Matters arguably get more complicated if a partner is permitted to take a bad debt deduction before the debt is actually forgiven. Remember that the bad debt deduction must be taken in the year that the debt becomes wholly worthless. This may

\textsuperscript{408} See S. Rep. No. 96-1035, at 21 (1980) (assumes that COD income will be allocated in a manner that is consistent with how the debt is allocated); \textit{but see} Rev. Rul. 92-97, 1992-2 C.B. 124 (permitting allocation of COD income in a manner that is different from the allocation of partnership liabilities).

\textsuperscript{409} S. Rep. No. 96-1035, at 21 & 22 n. 28 (1980) (partner increases basis in partnership interest under section 705 for allocable share of COD income even where COD income is excluded); Priv. Ltr. Rul. 9739002 (May 19,1997) (same).

\textsuperscript{410} See Treas. Reg. §1.743-1(d)(1).

\textsuperscript{411} If the taxpayer does take advantage of section 108 to exclude COD income, it will have to reduce tax attributes, which may include its basis in the partnership interest.

\textsuperscript{412} See \textit{supra} text accompanying notes 379-385.
not necessarily coincide with the year that the debt is discharged. While it may be a rare circumstance for partnership debt to become worthless within the meaning of section 166 without having the debt cancelled (or deemed cancelled), where this does occur, the interaction of the bad debt deduction and the debt allocation rules under subchapter K is murky.

Before addressing the technical results, it is useful to briefly analyze whether there may, in fact, be contexts in which a partner may take a bad debt deduction before the partnership is treated as having recognized COD income. A field service advice issued by the Service in 1997 contains an interesting analysis that is somewhat analogous to the write-down of partner debt. The field service advice addressed the impact of a subsidiary corporation taking a bad debt deduction for debt owed by the subsidiary’s parent corporation. In the field service advice, the Service attempted to reconcile the taking of a bad debt deduction by the subsidiary with Treas. Reg. §1.301-1(m), which provides that “the cancellation of indebtedness of a shareholder by a corporation shall be treated as a distribution of property.” The Service noted that the event triggering the bad debt deduction (i.e., worthlessness of the debt) and the event giving rise to the realization of dividend income (i.e., the actual or deemed cancellation of the debt) are not the same. According to the Service’s analysis, where the debt becomes wholly worthless prior to cancellation, a bad debt deduction should be allowed, and no dividend income would be realized under Treas. Reg. §1.301-1(m) upon a subsequent cancellation of the debt because the value of the debt distributed is zero.

In the field service advice, the Service continues to recognize, and give effect to, the indebtedness as real indebtedness until the debt is actually or deemed forgiven. Accordingly, the Service did not find that a dividend would result under Treas. Reg. §1.301-1(m) upon the occurrence of the worthlessness of the debt. (In fact, the Service did not even speculate that such a result might be appropriate.)

Note that the field service advice assumes that debt may be characterized as worthless without discussing case law that relates to the deemed discharge of indebtedness. Courts generally have held that whether a debt has been discharged is

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413 Compare 1997 FSA Lexis 233 (July 11, 1997) (worthlessness occurs when debt has no value; discharge occurs when the debt is actually or deemed cancelled by the creditor) with Cozzi v. Commissioner, 88 T.C. 435 (1987) (“[t]he moment that it becomes clear that a debt will never have to be paid, such debt must be viewed as having been discharged”).

414 1997 FSA Lexis 233 (July 11, 1997).

415 Note that, unlike Treas. Reg. §1.61-12(a), which quantifies the contribution to capital based upon the principal amount of the debt, Treas. Reg. §1.301-1(m) does not provide a specific reference for quantifying the amount of the dividend. Compare 1999 IRS CCA Lexis 345 (Oct. 8, 1999) (denying bad debt deduction for corporation attributable to debt owed by a shareholder; apparently deeming debt to be forgiven so that the forgiveness is treated as a dividend).

416 Compare Midwest Stainless, Inc. v. Commissioner, 80 T.C.M. (CCH) 472 (2000) (cancellation of shareholder debt was a dividend). Cf. Treas. Reg. §1.1502-14(d)(3) (bad debt deduction is taken into account before cancellation for purposes of determining dividend result to parent). While the parent corporation does not recognize dividend income, presumably it does have COD income.
dependent on the substance of the transaction. The surrender or failure to surrender a
note is not determinative of the release of liability.417 According to the Tax Court,
“[t]he moment that it becomes clear that a debt never will be paid, such debt must be
viewed as having been discharged.”418 In order to find a discharge of the debt, there
must be some “identifiable event” indicating that a cancellation of the liability has
occurred.419

The “identifiable event” requirement for finding a discharge of indebtedness is
not unlike the “identifiable event” that must occur in order to fix the worthlessness of
indebtedness for purposes of section 166.420 However, it seems that there should not be
an exact overlap between the events that justify a worthlessness deduction and
cancellation of debt. A creditor giving up on the ability to collect a debt arguably is
different from a debtor actually avoiding an obligation to pay a liability.421

In addition, there is some flexibility in determining the timing of when the
discharge of indebtedness and worthlessness deduction should occur. Note that courts
generally have held that, in determining whether debt is worthless, the taxpayer must
exercise sound business judgment based upon the information that is as complete as is
reasonably available.422 In making this determination, the creditor should be neither an
“incorrigible optimist” nor a “stygian pessimist.”423 Similarly, for purposes of
determining when “it becomes clear that a debt will never have to be paid” so that the
debt will be treated as discharged, taxpayers are required to make a “practical
assessment of all the facts and circumstances surrounding the likelihood of repayment
of the debt.”424 Obviously, these standards are not significantly different. Nonetheless,
under these analyses, it is possible that a partner would determine, based on the
information available to it, that debt is worthless before the partnership might
reasonably determine that it will not make good on the debt.425

(6th Cir. 1997); Kleber v. Commissioner, 102 T.C.M. (CCH) 326 (2011).
419 Friedman v. Commissioner, 216 F.3d 537, 548 (6th Cir. 1999).
420 See American Offshore, Inc. v. Commissioner, 97 T.C. 579, 593-95 (1991) (discussing identifiable
events sufficient to justify a finding of worthlessness).
421 Cf. Treas. Reg. §1.6050P-1(b)(2)(i) (identification events that trigger the discharge of indebtedness
reporting requirement).
425 Note that, if a partner is intimately involved in the operations of a partnership, so that the partner is
privy to essentially all of the information available to the partnership and potentially makes decisions on
behalf of the partnership, it probably will be hard to draw a distinction between the knowledge and
judgment of the partner and the partnership.
Finally, where a partner determines to take a deduction for partial worthlessness of partnership indebtedness (assuming that the debt is business indebtedness), in general, the partnership should not be treated as incurring discharge of indebtedness income with respect to a portion of the debt. The case law relating to the deemed discharge of indebtedness involves situations where the creditor has effectively foreclosed on the underlying security but has delayed taking title to the property to delay recognition of gain by the debtor,426 or where the underlying security has become worthless.427 It would appear to be only in these extenuating circumstances that a court may find that a debtor who retains its property and remains liable for the debt can be treated as having been forgiven its liability for the debt.

If a partner does take a worthlessness deduction with respect to debt owed by the partnership, the partner will be required to write down its basis in the debt.428 However, it is unclear if that basis write-down translates into a deemed distribution with respect to the liability under section 752(b). In form, the liability has not been discharged, and assuming that the liability is not deemed to have been cancelled, no other event has occurred that would give rise to a deemed distribution under section 752(b) or the regulations thereunder. Nonetheless, at first blush, it seems odd that a partner would write off some or all of its basis in a debt instrument, yet still be allowed to claim full basis for the debt in its partnership interest by virtue of the rules under section 752.

While this result seems odd, consistent with the field service advice (which continues to respect the debt as outstanding), the proper result should be that the partner continues to have basis in its partnership interest for the debt until the debt is treated as being forgiven. First, it is important to distinguish between results to the taxpayer in its capacity as a creditor and in its capacity as a partner. If a third-party creditor took a deduction for worthless debt but did not actually cancel (and was not deemed to cancel) the debt, it seems relatively clear that the partners would continue to receive credit in the basis of their partnership interest for the debt. The finding of worthlessness does not change the partnership’s relationship with the creditor as it relates to the debt. The result seemingly should be no different where the creditor is a partner in the partnership.

Additionally, there is a significant policy in subchapter K that a partner’s outside basis in its partnership interest should match that partner’s share of inside basis in the partnership’s assets.429 If the partner is treated as receiving a deemed distribution under section 752(b) before the debt is actually (or deemed) discharged, this will create a disparity between the relevant inside and outside basis amounts.430 The desired conformity is preserved by continuing to respect the debt until it is actually forgiven.

426 L & C Springs Assoc. v. Commissioner, 188 F.3d 866 (7th Cir. 1999).
428 See FSA 200242004 (July 19, 2002); 1997 FSA Lexis 233 (July 11, 1997).
430 No assets actually leave the partnership in connection with the deemed distribution. Generally, inside/outside basis parity is preserved where debt is discharged because COD income is allocated among
When the debt is ultimately forgiven, the partner will receive a deemed distribution under section 752(b). Generally, no gain is recognized with respect to the distribution on the partnership interest, because either (1) the COD income allocated to the partner offsets the amount of the deemed distribution or (2) the partner will have sufficient basis (i.e., no negative tax capital account) to absorb the deemed distribution. The deemed cash payments under section 752(b) should not cause the partner to recognize gain with respect to the zero basis note held by the partner because these payments are deemed to be received by the partner in its capacity as a partner, not as a creditor.

Going back to the example considered above where partner A has written off $100 of debt owed by the partnership and then actually forgives the debt in a subsequent year, the results to A should be the same as where A takes a bad debt deduction in connection with the discharge of the indebtedness, except that the bad debt deduction would be taken in a taxable year prior to when the COD income is realized and the deemed distribution under section 752(b) occurs. This result seems appropriate and is consistent with the substance of what actually occurs.

B. Abandonment Loss

A partner who has seen the value of its partnership interest decrease to virtually nothing may wish to abandon its partnership interest and recognize a current loss. The partners and increases those partners’ bases in their partnership interest by the amount of the debt discharged, thereby offsetting the deemed distribution under section 752(b).

431 See supra note 106 and accompanying text.

432 See supra text accompanying note 406-409.

433 The partner may also wish to abandon its partnership interest prior to the forgiveness of partnership debt in order to avoid an allocation of COD income. While there appears to be no authority directly addressing this issue, courts have found an effective abandonment in situations where it appeared obvious that cancellation of indebtedness was in the partnership’s future. See, e.g., Echols v. Commissioner, 935 F.2d 703 (5th Cir. 1991) (partnership defaulted on purchase money debt obligation in 1976; thereafter, in May 1976, taxpayer took steps that were treated as sufficient to abandon his partnership interest; lender foreclosed on property on February 1, 1977), rehearing denied, 950 F.2d 209 (5th Cir. 1991). In addition, even in Rev. Rul. 93-80, 1993-2 C.B. 239, the IRS found an effective abandonment during the year when the partnership became insolvent. Cf. also 1998 FSA Lexis 583 (Sept. 3, 1998) (expressing doubt as to whether the Service could successfully assert step transaction to reorder abandonment of partnership interest and contribution of cash by abandoning partner to repay partnership debt; FSA appears to relate to facts underlying Mas One Limited Partnership v. U.S., 390 F.3d 427 (6th Cir. 2004)). There may be concern that Court Holding or assignment of income principles could prevent a taxpayer from shifting COD income to another partner if the partnership has already entered into negotiations with respect to the indebtedness. Cottle v. Commissioner, 89 T.C. 467 (1987), would seem helpful in overcoming this argument. That case emphasizes that the timing of income inclusion is determined at the partnership level, and it is the partner who owns the partnership interest at the time the income properly accrues who will be taxable on that income.
The results that follow from an abandonment can vary greatly, depending on the liabilities of the partnership and how they are allocated to the various partners.\footnote{See generally J. Williford, Tax Consequences of Abandoning a Partnership Interest, 11 J. P-ship Tax’n 39 (1994); R. Lipton, How to Avoid Capital Loss Treatment on the Abandonment of a Partnership Interest, 80 J. Tax’n 158 (1994); K. Bambas & G. Grider, Can an Ordinary Abandonment Loss be Taken on Publicly Traded Securities?, 84 J. Tax’n 80 (1996).}

Rev. Rul. 93-80\footnote{1993-2 C.B. 235.} represents the Service’s most recent formal pronouncement regarding the tax treatment of a partner upon the abandonment of its partnership interest. The revenue ruling addresses two situations. In the first situation, a partner in a general partnership that has only nonrecourse liabilities abandons its interest in the partnership. The partner has an adjusted basis of $180x in its partnership interest and a $40x share of liabilities. In the second situation, a limited partner in a limited partnership abandons its interest. The partner has a $200x basis in its partnership interest and does not share in any of the partnership liabilities.

In analyzing the two situations, the Service begins by recognizing that the abandonment of a partnership interest may give rise to a loss deductible under section 165(a).\footnote{Section 165(a) provides that “[t]here shall be allowed as a deduction any loss sustained during the taxable year and not compensated for by insurance or otherwise.” The basis for determining the loss is the adjusted basis provided under section 1011 for determining the loss from the sale or other disposition of property. I.R.C. §165(b).} According to the Service, whether a loss from abandonment is capital or ordinary depends on whether the loss results from the sale or exchange of a capital asset.

The revenue ruling provides that, where there is a deemed distribution under section 752(b) in connection with the abandonment of a partnership interest, section 731 causes the transaction to be treated as a sale or exchange of the partnership interest, and any loss resulting from the transaction is capital (except as provided in section 751(b)).\footnote{Note that, if the partnership holds inventory property with an adjusted basis in excess of fair market value, section 751(b) would not cause the loss recognized on liquidation of the partnership interest to be ordinary because the property would not be “substantially appreciated.” In these circumstances, it might be preferable to sell the partnership interest so that section 751(a) (which is not dependent on inventory being “substantially appreciated”) would apply and permit ordinary loss treatment by reference to the partnership’s underlying property. If the sale represents a bona fide transfer to a party who is acquiring the partnership interest with a legitimate hope that, either through effective negotiations with lenders or appreciation in the underlying property, the partnership may eventually become valuable, the sale seemingly should be respected regardless of the sales price. Cf Granite Trust Co. v. U.S., 238 F.2d 670 (1st Cir. 1956) (respecting sale of stock to avoid section 332 nonrecognition upon liquidation even though the sale was undertaken in an effort to avoid taxes); Commissioner v. Day & Zimmerman, Inc., 151 F.2d 517 (3rd Cir. 1945) (same); FSA 200148004 (July 11, 2001) (same). If, however, the sale is for nominal consideration, and the purchaser is acting merely as an accommodation party who has no real hope of obtaining any economic benefit from the investment, the purchase may be attacked based upon a lack of economic substance with respect to the transaction. Cf. Frank Lyon Co. v. U.S., 435 U.S. 561 (1978) (“where . . . there is genuine multiple-party transaction with economic substance which is compelled or encouraged by business or regulatory realities, is imbued with tax-independent considerations, and is not shaped solely by tax-avoidance features that have meaningless labels attached, the Government should . . .”)}
The revenue ruling goes on to state that an abandonment of a partnership interest that gives rise to a deemed distribution under section 752(b) is not treated, for tax purposes, as involving a loss from the abandonment of a partnership interest, even when the deemed distribution is de minimis.

In contrast to an abandonment that gives rise to a shift in liabilities, where there is no actual or deemed distribution in connection with the abandonment of a partnership interest, the ruling states that the loss will be ordinary. This conclusion follows from

honor the allocation and rights of the parties). In addition, if the partnership interest is truly worthless at the time of transfer, there are some old cases dealing with the timing of a worthless stock deduction that have some troubling language regarding the ability to transfer worthless property. Cf. De Loss v. Commissioner, 28 F.2d 803 (1928) ("we understand [the rule providing that only a sale can establish a gain or loss] to be not merely a rule of convenience, but to inhere in the essence of income arising from capital gains or losses. Nevertheless, we think it inapplicable when the security can no longer fluctuate in value, because its value has become finally extinct. In such cases a sale is necessarily fictitious; it establishes nothing, and cannot be intended to do so, for there is no variable to determine"), cert. denied, 279 U.S. 840 (1929); Bair v. U.S., 20 F. Supp. 191 (D.C. E.D. Penn. 1937); Rand v. Commissioner, 40 B.T.A. 233 (1939), aff’d, 116 F.2d 929 (8th Cir. 1941), cert. denied, 313 U.S. 594 (1941), rehearing denied, 314 U.S. 709 (1941); Kayser v. Commissioner, 27 B.T.A. 816 (1933); Pearsall v. Commissioner, 10 B.T.A. 467 (1928), acq. 1928 C.B. 24; see also supra notes 372-377 (citing authority providing that worthless property cannot be contributed under sections 118, 351, and 721). While the language in these cases is quite broad, query whether the cases should be read as only being relevant to the timing of the worthlessness deduction and not to the ability of a taxpayer to dispose of tax ownership of the property. Cf. Moyer v. Commissioner, 35 B.T.A. 1155 (1937), acq. 1937-2 C.B. 19 ("While the sale of the stock at auction on the day of 1933 was a bona fide sale in the sense that it was an actual and not an accommodation sale, it was a futile and expensive gesture, unnecessary to establish the loss, since the stock was worthless prior thereto."); Peter Doelger Brewing Co., Inc. v Commissioner, 22 B.T.A. 1176 (1931), acq. 1931-2 C.B. 23 ("Although we are convinced that the sale of the stock at auction on November 28, 1923, was bona fide, we do not think it fixed the amount of petitioner’s loss. Inasmuch as the stock was worthless in June, 1923, the act of petitioner in selling the stock at auction in November of that year was unnecessary in order to establish the loss."). Est. of Franklin v. Commissioner, 64 T.C. 752 (1975), aff’d, 544 F.2d 1045 (9th Cir. 1976), and its progeny may also be relevant to this analysis. These cases dealt with the acquisition of property subject to nonrecourse debt in excess of the value of the property transferred. In this regard, the opinion in Regents Park Partners v. Commissioner, 63 T.C.M.(CCH) 3131 (1992), is interesting in distinguishing the analysis of tax ownership where excess seller financing is involved and where property is acquired subject to excess third-party debt. There, the Tax Court stated:

We note that, although ownership for Federal tax purposes is arguably distinct from its commonsense meaning, if we were to find that the partnership had not acquired the benefits and burdens of ownership, we would in effect be stating that no person owns the property. If we were dealing with a transaction involving seller financing and found that the benefits and burdens of ownership had not passed, the seller would be the appropriate party to whom ownership would be attributable, but in the circumstances of this case involving as it does the acquisition of property subject to a mortgage, neither the Developer, which has retained no further connection with the property, nor HUD appears to be a suitable candidate to whom to attribute ownership of the property.

Id. at n. 10.
the fact that there is no sale or exchange of the partnership interest, which generally is a necessary component to recognizing a capital gain or loss. 438

According to the revenue ruling, in determining whether section 752(b) applies to create a deemed distribution upon abandonment, liability shifts that take place in anticipation of an abandonment are treated as occurring at the time of the abandonment under general tax principles. The revenue ruling then cites Treas. Reg. §1.731-1(a)(2), which provides that the liquidation of a partner’s interest may take place by means of a series of distributions.

Following the general analysis, the ruling concludes that the partner in situation 1, by virtue of receiving a deemed distribution of $40x under section 752(b) from the shift in nonrecourse liabilities, recognizes a capital loss of $140x upon abandonment of its partnership interest. 439 The partner in situation 2, as a limited partner, does not have a share of partnership liabilities. Accordingly, that partner recognizes an ordinary loss upon the abandonment of its interest. 440

With respect to issues relating to abandonment, Rev. Rul. 93-80 generally is consistent with established authority. 441 However, there are numerous relevant issues that are not discussed in the revenue ruling. For instance, what if the liabilities of the partnership were recourse to the partner, and the partner was not released from those liabilities in connection with the abandonment? It is arguable that, in this situation, the partner would not receive a deemed distribution in connection with the abandonment of its interest, so that the partner would be entitled to an ordinary loss. 442

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439 Note that, if the partner had previously used debt basis to take deductions so that the partner had a negative tax capital account (i.e., the partner’s share of debt exceeds its basis in its partnership interest), the partner may actually recognize gain on the abandonment of its partnership interest.

440 Where the only liabilities of a cash basis partnership are accounts payable, it would seem that a partner abandoning its interest in the partnership would be entitled to ordinary loss treatment because the zero-basis accounts payable would not be treated as liabilities for purposes of section 752. Cf. Rev. Rul. 88-77, 1988-2 C.B. 128.


442 Cf. In re Kreidle, 91-2 U.S.T.C. ¶50,371 (Bankr. D. Col. 1991), aff’d, 143 B.R. 941 (D.C. Col. 1992) (partner was entitled to an ordinary loss for the worthlessness of its interest in a general partnership; the court stated that the result would have been no different if the partnership terminated because the partner would have been deemed to assume its share of partnership liabilities under state law, so that there would
Some question exists, however, as to whether a partner who is personally liable for partnership debt may recognize any loss at the time that the partner abandons its partnership interest. Courts generally have held that a taxpayer may not deduct its loss on property given as security for a recourse obligation in the year that they allegedly abandon the property.\textsuperscript{443} Instead, the taxpayer must wait until the property is foreclosed upon. According to the Third Circuit Court of Appeals, ”[t]he property continues until foreclosure sale to have some value which, when determined by the sale, bears directly upon the extent of the owner’s liability for a deficiency judgment.”\textsuperscript{444}

In the partnership context, where a partner continues to share in the liabilities of a partnership following the formal abandonment of its partnership interest, whether by a guarantee or otherwise, a lender may still foreclose on the assets of the partnership, thereby reducing the debt owed by the partner. Accordingly, while the partner may have disclaimed all rights to its partnership interest, the interest in the underlying property embodied by that partnership interest may still be applied so as to economically benefit the partner.\textsuperscript{445}

This theory may explain what otherwise was a very confusing decision in \textit{Proesel v. Commissioner}.\textsuperscript{446} In that case, a general partner in a partnership with recourse liabilities attempted to claim a deduction attributable to the worthlessness of its partnership interest. Instead of analyzing the value of the partnership interest to determine whether it was worthless, the court looked to see if the underlying assets of the partnership were worthless. Although the liabilities encumbering the partnership’s assets greatly exceeded the value of those assets, the court found that the assets themselves retained some value. On that basis, the court found that the taxpayer was not entitled to a deduction with respect to the worthlessness of its partnership interest.

\begin{itemize}
\item have been no deemed distribution under section 752). \textit{Cf. also Weiss v Commissioner}, 956 F.2d 242 (11th Cir. 1992) (partner whose status as a partner was forfeited pursuant to the partnership agreement was not released from partnership liabilities that he had personally guaranteed); \textit{McDaniel v. Commissioner}, 77 T.C.M. (CCH) 1880 (1999) (same); \textit{compare Priv. Ltr. Rul. 9622014 (Feb. 27, 1996) (Weiss not applicable where the partner deeded its interest to another partner and, although the lender would not release the transferor partner from its guarantee obligation, the transferee partner agreed to indemnify the transferor partner); \textit{Moore v. Commissioner}, 68 T.C.M. (CCH) 660 (1994) (partner transferred interest to another partner; debt followed the partnership interest even though transferor might retain liability under state law because transferor could obtain indemnification from transferee); \textit{cf. Barker v. Commissioner}, 47 T.C.M. (CCH) 131 (1983) (partner in multiple partnerships was liable to bank under a guarantee agreement; court speculated that the partner would have had gain resulting from the deemed distributions under section 752(b) in connection with the termination of his interests “if the partnerships assumed [his] liability”). Of course, there would be tax consequences to follow from the ultimate discharge of the debt or payment of the debt by a party other than the abandoning partner.
\item \textsuperscript{443} \textit{See Commissioner v. Green}, 126 F.2d 70 (3d Cir. 1942); \textit{George v. U.S.}, 97-2 U.S.T.C. ¶50,644 (10th Cir. 1997) (unpublished opinion); \textit{see also Helvering v. Hammel}, 311 U.S. 504 (1941).
\item \textsuperscript{444} \textit{Commissioner v. Green}, 126 F.2d at 72.
\item \textsuperscript{445} \textit{But cf. In re Kreidle}, 91-2 U.S.T.C. ¶50,371 (Bankr. D. Col. 1991), aff'd, 143 B.R. 941 (D.C. Col. 1992) (finding that a general partner was entitled to a deduction for the worthlessness of his partnership interest where he had a share of the partnership’s recourse liabilities).
\item \textsuperscript{446} \textit{77 T.C.} 992 (1981).
\end{itemize}
While the Tax Court in Proesel gave no explanation for why it analyzed the gross value of the partnership’s assets to determine whether the partner’s interest was worthless, it may be that, because the partner could potentially be held responsible for a portion of the liabilities of the partnership, and the assets of the partnership might still serve to reduce that personal liability, the partnership interest actually was not without value to the partner. Implicit in this decision may have been the concept that, only if the partnership’s assets were found to be completely worthless, so that those assets could not serve to reduce the partner’s personal liability, would the partner’s interest truly be worthless.447

Another potential issue arises where a financially distressed partnership disposes of virtually all of its property and, in connection with the disposition, discharges all of its liabilities. Where the partnership does not formally liquidate at the time of the property disposition, a partner may attempt to subsequently abandon its interest, claiming an ordinary loss because no liability relief occurs “in connection with” the abandonment. Three cases have considered such facts, and in each case, the court determined that the partner was not entitled to an ordinary loss.448 According to those courts, the sale of the relevant property and discharge of the liabilities could not be separated from the ultimate liquidation of the partnership. In each case, the property that was sold represented essentially all of the partnership’s property, so when the property was disposed of in connection with the discharge or assumption of the liabilities, the partnership effectively terminated.449 This termination essentially rendered the abandonment a nullity, and the partners were treated as receiving the deemed distribution from discharge of the liabilities as a distribution in liquidation of their interests.

Apart from issues relating to liabilities, there also is a question as to what actions a partner must take in order to effectively abandon its partnership interest. In

447 Even if this analysis does apply, it may be possible, in limited situations where recourse debt is involved, to take a loss upon the abandonment of a partnership interest. One case, affirmed on appeal, has held that, even though a taxpayer abandoned property that arguably was subject to a recourse liability, where the taxpayer and the Service had stipulated the amount of the loss, a loss would be allowed in connection with the abandonment. Middleton v. Commissioner, 77 T.C. 310 (1981), aff’d per curiam, 693 F.2d 124 (11th Cir. 1982); cf. Frazier v. Commissioner, 111 T.C. 243 (1998) (loss on foreclosure determined by reference to an appraisal rather than the amount bid in by the lender). In this situation, it was not necessary to wait for a foreclosure action to claim the loss. Of course, speculation as to the value at a time when the foreclosure action is still likely to be far off in the future would not be satisfactory. However, a valuation of the property shortly before a foreclosure action might be sufficient to fix the loss in a taxable year prior to foreclosure where the foreclosure sale will likely take place early in the subsequent year.


449 In Pietz, the partnership actually received a second mortgage upon disposition of the property, but that mortgage was distributed to partners other than the partner claiming the ordinary loss.
order for an abandonment to occur, there must be (1) an intention to abandon, and (2) an affirmative act of abandonment.\textsuperscript{450}

Where a partner is attempting to abandon its interest, the properly advised partner will take such explicit actions so as to leave no doubt of its intention to abandon. At a minimum, the partner should deliver written notice to the partnership (and, if possible, all of the partners) describing the intention to abandon the interest and foregoing all future rights with respect to the partnership.\textsuperscript{451} The partner should also disavow all of its obligations in its capacity as a partner.\textsuperscript{452} When creditors are involved, it probably is a good idea to also inform those creditors of the abandonment.\textsuperscript{453} Finally, in order to obtain additional comfort, it may be wise to give public notice in the local newspaper, so that all potentially affected parties would be deemed to be notified.

The discussion set forth above provides a general discussion of the law relating to abandonment up to the time that the Service published Rev. Rul. 93-80. Consideration must be given, however, to whether the amendment in 1997 of section 1234A may have altered the analysis with respect to that situation. Prior to 1997, section 1234A provided that:

Gain or loss attributable to the cancellation, lapse, expiration, or other termination of –

a right or obligation with respect to personal property (as defined in section 1092(d)(1)) which is (or on acquisition would be) a capital asset in the hands of the taxpayer; or

a section 1256 contract (as defined in section 1256) not described in paragraph (1) which is a capital asset in the hands of the taxpayer.

shall be treated as gain or loss from the sale of a capital asset. The preceding sentence shall not apply to the retirement of any debt


\textsuperscript{452} See Echols v. Commissioner, 935 F.2d at 707 (taxpayer stated that it would contribute no further funds to the partnership), rehearing denied, 950 F.2d 209 (5th Cir. 1991).

\textsuperscript{453} Cf. Citron v. Commissioner, 97 T.C. 200, 212 (1991) (partners were personally liable; accordingly, “there were no interested parties, such as mortgagees, to whom to manifest the abandonment”).
instrument (whether or not through a trust or other participation arrangement).454

Prior to the 1997 Act, several courts had interpreted the “sale or exchange” requirement in section 1222 to mean that, if a capital asset were disposed of in a transaction other than in a sale or exchange, such as by lapse, termination, cancellation, or abandonment, such disposition would produce an ordinary gain or loss.455 Congress became concerned that, as a result of this precedent, losses from terminations, cancellations, lapses, or abandonments that are the economic equivalent of a sale or exchange were being characterized as fully deductible losses instead of capital losses.456 Congress also was concerned that this precedent effectively provided some, but not all, taxpayers with the ability to elect ordinary or capital gain or loss treatment.457 In order to correct this perceived inequity, Congress amended section 1234A in 1997 to delete “personal” from the phrase “personal property” in section 1234A(1).458 The reference to section 1092(d)(1) as the definition for personal property also was removed.

Although a partnership interest generally is thought to be personal property, most partnership interests would not have fallen within the scope of section 1234A prior to amendment because, for purposes of section 1234A, the term personal property was defined to include only personal property of a type that is publicly traded. However, because a partnership interest is property, it is possible that such interests now fall within the expanded scope of section 1234A.459 In analyzing the statute to determine if this is so, two issues appear to be of primary importance: (1) whether an abandonment falls within the meaning of “cancellation, lapse, expiration, or other termination,” and (2) whether a partnership interest can be described as a “right or obligation with respect to property.”

With respect to the first issue, the statute does not explicitly refer to abandonment, but instead references the offending acts as a “cancellation, lapse, expiration, or other termination.” A report published by the Joint Committee on Taxation references a discussion of the fiscal 1998 budget proposal of the Clinton Administration (which was the genesis of the 1997 amendment) provided that “[t]he administration proposal is unclear whether cancellation, lapse, expiration, or other termination of any right or obligation with respect to property covers abandonment of


457 Id.

458 Id. at 188.

459 By eliminating the reference to section 1092(d)(1), Congress eliminated the requirement that the property must be publicly traded.
rights in property." This uncertainty stemmed from the fact that, while the statute did not specifically refer to abandonment, the legislative history for section 1234A contained numerous references relating to abandonment. One can argue that the failure to clarify this ambiguity in 1997, at a time when Congress clearly was aware of the issue, implies that Congress intended to exclude abandonments from the scope of section 1234A. Nonetheless, in light of the ambiguous statutory language and the numerous references to abandonment in the legislative history, it is hard to get terribly comfortable that a court would interpret section 1234A to exclude abandonments.

The analysis with respect to the second issue arguably should be more encouraging. That is, it would appear to be that a “right or obligation” with respect to property should refer only to contractual rights and obligations with respect to property and not to the actual property itself. The plain language of the statute seemingly supports this view. As additional support, one can point to legislative history relating to a 1984 amendment to section 1234A which described that section as “the provision of present law prescribing capital gain or loss treatment with respect to certain contract terminations.” Furthermore, virtually all of the examples contained in the original 1981 legislative history discuss contract rights with respect to capital assets. Finally, the legislative history relating to the 1997 amendment seemingly provides additional support for this view. Specifically, the report of the Joint Committee states:

[T]he extension of the ‘sale or exchange rule’ of prior law section 1234A to all property that is a capital asset in the hands of the taxpayer affects capital assets that are (1) interests in real property and (2) non-actively traded personal property. An example of the first type of property interest that will be affected by the Act is the tax treatment of amounts received to release a lessee from a requirement that the premises be restored on termination of the lease. An example of the second type of property interest that is affected by the Act is the forfeiture of a down payment under a contract to purchase stock. The Act does not affect whether a right is property or whether property is a capital asset.

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Note that both examples relate to contract rights. In addition, by stating that “the Act does not affect whether a right is property”, Congress seems to implicitly recognize that there is a difference between “a right with respect to property” and the underlying property itself.

While the scope of section 1234A has been expanded over the years, the phrase “right or obligation” (and presumably the intended consequences that flow from that phrase) has never been altered. Accordingly, it would seem that a strong argument could be made for interpreting “right or obligation” so as not to include a direct interest in property such as a partnership interest.

Following from this technical argument, it seems that one also could take comfort from the fact that the Service has not revoked or modified Rev. Rul. 93-80 in light of the 1997 amendment to section 1234A. Clearly, an unfavorable reading of section 1234A would obsolete the conclusion in situation 2 of Rev. Rul. 93-80. It seems unlikely that the Service would have neglected to correct the revenue ruling for this long if it thought that section 1234A, as amended, changed the result. Thus, it is arguable that taxpayers could continue to rely upon the conclusions in Rev. Rul. 93-80.464

A recent Tax Court decision, however, has created significant concern as to the application of section 1234A in connection with the abandonment of a partnership interest. In Pilgrim’s Pride Corp. v. Commissioner,465 the Tax Court concluded that section 1234A did apply to a taxpayer who abandoned stock of a corporation. The court specifically rejected the argument that section 1234A does not apply to direct interests in property, holding that the phrase “‘a right or obligation . . . with respect to property’ encompasses the property rights inherent in intangible property as well as ancillary and derivative contractual rights.”466

Although the court in Pilgrim’s Pride was specifically addressing the abandonment of stock, the court also called into question the holding in Rev. Rul. 93-80 that a partner with no share of partnership liabilities can claim an ordinary loss upon abandonment of its partnership interest. Specifically, the Tax Court decision states as follows:

Rev. Rul. 93-80, supra, addresses the character of a loss on the abandonment of a partnership interest when the

464 Cf. Rauenhorst v. Commissioner, 119 T.C. 157 (2002) (“the Commissioner will be held to his published rulings in areas where the law is unclear, and may not depart from them in individual cases. Furthermore, . . . the Commissioner may not retroactively abrogate a ruling in an unclear area with respect to any taxpayer who has relied upon it”). Compare Barnes Group, Inc. v. Commissioner, 105 T.C.M. (CCH) 1654 (2013); T. Jacobs, Barnes Group: Tax Court Turns a Blind Eye to Rauenhorst, 2013 Tax Notes Today 147-72 (July 31, 2013).

465 141 T.C. no. 17 (2013).

466 Id.; see generally S. Pappadopoulos, Can an Asset Be a Derivative of Itself?, 11 J. of Fin. Prod. 31 (2014) (discussing Pilgrim’s Pride and the history of section 1234A).
taxpayer's share of partnership liabilities is reduced as a result of the termination of his ownership in the partnership. In situation 1 there was a deemed distribution to the partner resulting from the reduction in his share of partnership liabilities. The ruling held that the loss on the abandonment was a capital loss. In situation 2, the partner was not entitled to include any portion of partnership liabilities in the basis of his partnership interest and did not receive any actual or deemed distributions when he abandoned his partnership interest. The ruling held that the loss in situation 2 was an ordinary loss. The ruling holds that a loss incurred on the abandonment or worthlessness of a partnership interest is an ordinary loss only if sale or exchange treatment does not apply. The ruling makes clear that, if a provision of the Code requires the transaction to be treated as a sale or exchange, such as when there is a deemed distribution attributable to the reduction in the partner's share of partnership liabilities pursuant to section 752(b), the partner's loss is capital. Rev. Rul. 93-80, supra, was issued four years before section 1234A was amended in 1997 to apply to all property that is (or would be if acquired) a capital asset in the hands of the taxpayer. As we previously stated, the Commissioner is not required to assert a particular position as soon as the statute authorizes such an interpretation, whether that position is taken in a regulation or in a revenue ruling. Dickman v. Commissioner, 465 U.S. at 343; Dresser Indus. Inc., 238 F.3d at 609; Yarbro v. Commissioner, 737 F.2d at 483.\textsuperscript{467}

Practitioners are not in uniform agreement that the Tax Court's decision in Pilgrim's Pride is a proper interpretation of section 1234A.\textsuperscript{468} Nonetheless, it obviously is important to consider this decision in evaluating the risk that section 1234A might apply to prevent ordinary treatment when an abandoning partner has no share of liabilities.

Finally, when a partner intends to abandon a partnership interest, it is important to analyze the relevant partnership agreement to see if there is any limitation on the ability of a partner to dispose of a partnership interest or withdraw from the partnership. None of the cases or rulings addressing abandonment describe a situation where such a limitation existed. While certain cases describe relatively insignificant legal steps as

\textsuperscript{467} Id.

\textsuperscript{468} See W. Davis, Tax Court Complicates Analysis of Securities Terminations' Capital Loss Treatment, 2014 Tax Notes Today 26-2 (Feb. 7, 2014) (in reference to argument that section 1234A applies only to a contractual or other derivative right to property, Michael Yaghmour of PWC stated, “I was of that view and I think I am still of that view for the most part even after this opinion”).

225-110
being sufficient to accomplish abandonment,\textsuperscript{469} authority addressing the tax ownership of a partnership interest focuses on the legal rights of the relative parties in determining who is treated as the owner of a partnership interest.\textsuperscript{470} Although the relevant authority provides no clear guidance, it would seem preferable to actually dispose of all legal rights and obligations relating to the partnership interest in order to support the abandonment of a partnership interest.

C. Worthlessness

A partner may abandon a partnership interest and recognize a loss even though the partnership interest is not necessarily worthless.\textsuperscript{471} This leaves open the question as to whether a partner may claim a deduction for a worthless partnership interest under section 165 without actually abandoning the interest. If this is possible, the question follows as to what is the tax treatment that results from a worthless partnership interest.\textsuperscript{472}

Originally, it appears to have been the position of the Service that a taxpayer could not claim a loss under section 165 based solely on the worthlessness of a partnership interest. According to the Service, a loss could “be taken on the occurrence of worthlessness only in relation to securities under section 165(g).”\textsuperscript{473} Because a partnership interest was not a security, as that term is defined for purposes of characterizing the treatment of worthless securities under section 165(g),\textsuperscript{474} the Service believed that no deduction was allowed on the mere occurrence of worthlessness of a partnership interest. According to the Service, to claim a loss, there needed to be some

\textsuperscript{469} See, e.g., Echols v. Commissioner, 935 F.2d 703 (5th Cir. 1991) (taxpayer offered to tender title to his interest to any partner who would “step forward and assume” the nonrecourse payment on the partnership’s obligation; taxpayer stated that it would contribute no further funds to the partnership; actions found to be sufficient to constitute an abandonment), rehearing denied, 950 F.2d 209 (5th Cir. 1991).

\textsuperscript{470} See Rev. Rul. 77-137, 1977-1 C.B. 178 (limited partner who was not entitled to substitute another limited partner without the general partner’s consent was treated as transferring its partnership interest to another partner; limited partner could, without the general partner’s consent, assign the right to share in profits and losses and to receive all distributions, including liquidating distribution); G.C.M. 36960 (Dec. 20, 1976) (contains additional analysis underlying Rev. Rul. 77-137).

\textsuperscript{471} Cf. Citron v. Commissioner, 97 T.C. 200 (1991) (partner abandoned interest in a movie partnership, in part, because of the partnership’s decision to convert the project to an X-rated movie).


\textsuperscript{473} 1993 FSA Lexis 353 (Aug. 31, 1993).

\textsuperscript{474} I.R.C. §165(g)(2)(A); 1995 FSA Lexis 369 (June 9,1995) (even where a partnership holds exclusively securities, as that term is defined under section 165(g)(2)(A), section 165(g) will not apply with respect to the partnership interest). See also Draper v. United States, 2004 U.S. Claims LEXIS 265 (Fed. Cl. Oct. 5, 2004) (ruling that a purported limited partnership interest in what was actually a pyramid (or Ponzi) scheme was not a security within the meaning of section 165(g)(2) because the purported limited partnership was neither a corporation nor a government entity; therefore, the taxpayers could not avail themselves of the seven-year statute of limitations period for a worthless security deduction under section 6511(d)); ECC 200851054 (Oct. 27, 2008) (“Because there is no equivalent of section 165(g) for partnership interests. [sic] Worthlessness of a partnership interest is an ordinary loss, if the partner receives nothing in exchange.”).
sort of closed and completed transaction evidencing the worthlessness such as a sale, exchange, or abandonment of the interest.

The Service’s position was contrary to prior court decisions in Zeeman v. U.S.,475 Tejon Ranch Co. v. Commissioner,476 and In re Kreidle.477 Nonetheless, the conflict did not really come to a head until the Fifth Circuit Court of Appeals addressed the issue in Echols v. Commissioner.478 There, the Fifth Circuit explicitly recognized the distinction between “abandonment” and “worthlessness”. According to the court, “either concept can, under proper circumstances, justify a deduction pursuant to section 165(a).”479

The taxpayer in Echols owned an interest in a partnership where the value of the assets was far exceeded by the nonrecourse debt secured by the assets. In analyzing whether the partnership interest was worthless, the Fifth Circuit provided that the determination of worthlessness is both subjective and objective. The court stated that “the IRS cannot disallow an I.R.C. §165(a) deduction by a taxpayer who can demonstrate his subjective determination of worthlessness in a given year, coupled with a showing that in such year the asset in question is in fact essentially valueless.”480 The court then found that the taxpayer was, in fact, entitled to a deduction based upon the worthlessness of its partnership interest.

In response to the Fifth Circuit’s decision, the Service filed a request for rehearing solely on the issue of whether a taxpayer can take a deduction under section 165(a) based on a finding that a partnership interest is worthless.481 The Fifth Circuit provided a rather lengthy opinion justifying its denial of the Service’s motion for rehearing.482

The court began by quickly disposing of the Service’s argument that section 165(g) (dealing with worthless securities) subsumes all of the assets with respect

476 49 T.C.M. (CCH) 1357 (1985); cf. Webb v. Commissioner, 23 T.C. 1035 (1955) (taxpayer entitled to a loss with respect to an investment in its partnership interest in the year that the loss was sustained; it is not clear from the facts described whether the loss arose in connection with the liquidation of the partnership), acq. 1955-2 C.B. 10.
478 935 F.2d 703 (5th Cir. 1991).
479 Id. at 706.
480 Id. at 708. In a footnote, the court stated, “[w]e speak of the assets as being ‘virtually valueless,’ ‘essentially valueless’ or ‘of virtually no value’ to emphasize the de minimis rule that the taxpayer does not have to prove that a given asset is absolutely, positively without any value whatsoever. Barring an actual transaction, value can only be proved by appraisal and appraisals, being opinions, are inexact at best.” Id. at 708 n.2.
481 The Service did not dispute the court’s holding that the taxpayer had properly claimed an abandonment loss with respect to his partnership interest.
482 950 F.2d 209 (5th Cir. 1991)
to which taxpayers may take a deduction for mere worthlessness. According to the
Fifth Circuit, “[w]hile Code section 165(g) does provide a positive rule for treatment of
worthless securities, it does not follow that worthlessness is not a valid basis upon
which to deduct losses incurred in connection with any other type of property.”

The Fifth Circuit went on to address the Service’s accusation that the Fifth
Circuit’s initial opinion “threatened substantial and lasting damage to the law governing
losses under section 165(a).” The court stated:

Conceding that transfer of title is not a prerequisite, the Commissioner
continues to insist that worthlessness must be coupled with an
identifiable event ‘such as abandonment, sale, exchange, forfeiture or
foreclosure . . .’. How odd, inasmuch as each ‘identifiable event’ in that
list other than abandonment involves divestiture of title! We did not, as
intimated by the Commissioner, hold that in a worthlessness situation ‘an
act evidencing a closed and completed transaction was unnecessary.’
We do, however, continue to maintain that, for assets not expressly
covered by a Code section or Treasury Regulation, neither the
‘identifiable events’ nor the ‘completed transactions’ need be a nominate
property transaction such as a sale, exchange, donation – or
abandonment, need involve the asset in question directly or need include
the taxpayer as a party.

The Service has not acquiesced in the Fifth Circuit’s decision in Echols,
and there is reason to believe that the Service will continue to assert the position that it put
forth in that case. Even if that argument were to fail, it seems that the Service still
has other arguments that, at least in some circumstances, it could assert in denying a
deduction for worthlessness. For instance, where partnership liabilities are recourse
with respect to a partner, the Service might attempt to deny a worthlessness deduction
on the same basis that some courts have used to deny an abandonment loss. That is,

483 Id. at 211.
484 Id. Some identifiable events specified by the court that do not involve direct action by the taxpayer
included insolvency of the partnership, an increase in expense of operation, and the need for costly
renovation. Compare IRS IRS CCA 200637012 (Sept. 2, 2005), 2005 IRS CCA Lexis 106 (IRS
concluded that interest in professional service partnership was not worthless after firm was criminally
indicted, causing firm to cease operations); IRS NSAR 20064601F (Feb. 16, 2006), 2006 IRS Non-
Docketed SAR Lexis 176 (same); Rev. Rul. 2004-58, 2004-1 C.B. 1043 (analyzing worthlessness with
respect to film production rights).

position. It is the Service’s position that a loss may be taken on the occurrence of worthlessness only in
relation to securities under I.R.C. §165(g)”; 1997 FSA Lexis 190 (July 7, 1997) (characterizing the Fifth
Circuit’s holding as “an unusual position that has been rejected in other circuits,” citing Corra Resources
Ltd. v. Commissioner, 945 F.2d 224, 226-27 (7th Cir. 1991); Gulf Oil Corp. v. Commissioner, 914 F.2d
396, 402 (3d Cir. 1990)). Interestingly, the Service cited Echols in the preamble to the proposed
regulations relating to abandonment of stock as supporting the positions asserted in those proposed
regulations. See REG-101001-05 (preamble), 2007-36 I.R.B. 548. These proposed regulations were
486 See supra notes 443-447.
so long as the partnership’s assets have some value, the partnership interest should not be considered worthless because the assets may still reduce a personal obligation of the partner.487

In the context of a partnership with nonrecourse debt, the Service might attempt to invoke section 7701(g) in some circumstances. Section 7701(g) provides that “[f]or purposes of subtitle A, in determining the amount of gain or loss (or deemed gain or loss) with respect to any property, the fair market value of such property shall be treated as being not less than the amount of any nonrecourse indebtedness to which such property is subject.” The Service might argue that, where a partnership has nonrecourse liabilities, for purposes of analyzing the worthlessness of the interest, the partner must treat all of the partnership assets as if their value is at least equal to the amount of the nonrecourse liabilities that are secured by those assets. In some situations, such an analysis may foreclose a finding of worthlessness by the partner. The Service may attempt to carry the analysis even further and argue that, where a partner has a share of the partnership’s nonrecourse liabilities, the partner’s interest has a value that is at least equal to the share of nonrecourse liabilities, thus foreclosing a deduction for worthlessness.488

The latter argument seems to strain the literal language of the statute. Although the partner is allocated nonrecourse liabilities under section 752, the partnership interest is not actually “subject to” those liabilities.489 In addition, with respect to the first argument, the report of the Joint Committee provides that section 7701(g) “is to be limited in application to those Code provisions which expressly refer to the fair market value of property in determining the amount of gain or loss with respect to certain transfers of property . . .”.490 While worthlessness arguably is a reference to fair market

487 Cf. Proesel v. Commissioner, 77 T.C. 992 (1981) (even though the partnership was hopelessly insolvent, the Tax Court refused to find that the general partner’s interest was worthless absent a finding that the partnership’s assets were valueless without consideration of the debt). Where the partner’s personal liability flows only from its ownership of a partnership interest (as opposed to a guarantee or similar arrangement), arguably the obligation should not be considered separately from the asset. The liability is part and parcel with the partnership interest, so that the partnership interest and liability make up one economic investment. Cf. Priv. Ltr. Rul. 9619002 (Jan. 31, 1996) (discharge in bankruptcy of a partner for his share of recourse partnership liabilities was not a COD event because the partnership, rather than the partner, was the primary obligor on the debt). Under this theory (for which, admittedly, there is no direct authority), where the liability greatly exceeds the value of the partnership interest (determined as if unencumbered), the partner could claim a deduction for worthlessness.

488 Query whether an asset is worthless when the asset is worth exactly the amount of the nonrecourse debt securing the asset. Generally, to claim a deduction for worthlessness, absent an overt act, the debt must exceed the value of the property to such an extent that recovery is essentially hopeless. See Morton v. Commissioner, 38 B.T.A. 1270, 1278-79 (1938), nonacq. 1939-1 C.B. 57, aff’d, 112 F.2d 320 (7th Cir. 1940). However, if section 7701(g) does not actually create positive value, a court could look to the underlying circumstances and if recovery was, in fact, hopeless, the court might not find section 7701(g) to be a barrier to a finding of worthlessness.

489 Presumably, section 752(d) is not implicated, given that there is no transfer of a partnership interest where a deduction for worthlessness is claimed.

Recognizing the Service’s disagreement with Echols, it is odd that Rev. Rul. 93-80 seemingly recognizes the possibility that a partnership interest may be found to be worthless without an abandonment of the interest. Although both situations in Rev. Rul. 93-80 involved a partner abandoning its interest, the legal analysis for each situation includes a statement that the result would be the same if the partner’s interest in the partnership were found to be worthless.

While the statement regarding worthlessness in Rev. Rul. 93-80 may be viewed by some as a concession by the Service in line with the decision in Echols, it may be intended more to force taxpayers into parallel tax treatment regardless of whether they abandon their interest or declare their partnership interest to be worthless. The Service’s position in this regard clearly is subject to challenge. Where a taxpayer merely declares its partnership interest to be worthless, that person technically remains as a partner. Accordingly, it is not at all clear that a finding of worthlessness will give rise to a liability shift under section 752. Without this liability shift, there is no deemed distribution under section 752(b) and presumably no basis for finding a sale or exchange that causes capital loss treatment.

Rev. Rul. 93-80 contains no analysis justifying the parallel treatment of worthlessness and abandonment. In a field service advice issued after Rev. Rul. 93-80, the Service stated that “[i]f a loss based on worthlessness were allowed, it would arguably be capital, since Echols did not distinguish the character of the loss based on worthlessness from the capital loss allowed as an abandonment.” Obviously, this statement does not convey unqualified confidence on the part of the Service with respect to its asserted position. While it is true that the taxpayer did not claim an ordinary loss in Echols, that certainly does not mean that the taxpayer would not have been entitled to such a loss if it had remained as a partner. Note that the Fifth Circuit found that the taxpayer actually abandoned his interest in the partnership. Having found that the taxpayer was no longer a partner, it would have been difficult to then permit that taxpayer to claim an ordinary loss for a corresponding claim of worthlessness. The taxpayer asserted that he abandoned his interest and thus did not even try to claim an ordinary loss.

Contrary to the position of the Service, the courts in Zeeman, Tejon Ranch, and In re Kreidle all found that the relevant taxpayers were entitled to ordinary loss deductions upon the finding of worthlessness with respect to their partnership interests. While the operation of section 752 was not discussed in the first two of these cases, it

491 Note that the Service issued a field service advice in 1997, well after issuing Rev. Rul. 93-80, where it continued to assert that Echols was incorrectly decided. See 1997 FSA Lexis 190 (July 7, 1997). But see supra note 485 discussing statements in preamble to the proposed regulations relating to abandonment of stock.

appears, at least in *Tejon Ranch*, that the taxpayer should have had a share of the partnership’s liabilities at the time that its interest became worthless. Furthermore, the bankruptcy court in *In re Kreidle* actually did discuss the issue and specifically held that, at the time that the partnership interest became worthless, there was no discharge of liabilities that would have given rise to a deemed distribution under section 752.494

As discussed above, the court in *Echols* indicated that some “identifiable events” still are necessary to show that a partnership interest is worthless. The Service has attempted to impose a fairly rigorous standard, in the form of unilateral acts by the taxpayer, for accomplishing an abandonment. However, some courts have found an abandonment of property to have occurred under circumstances that are more akin to the “events” that the Fifth Circuit described in *Echols* as being sufficient for purposes of finding worthlessness.495 Taxpayers should be aware of these cases when evaluating the risks involved in claiming an ordinary loss with respect to the worthlessness of a partnership interest.

The referenced cases are distinguishable from *Echols* in that they involved taxpayers who were attempting to avoid recognition of gain upon the abandonment of low basis property secured by nonrecourse debt.496 In analyzing one such case, the Seventh Circuit Court of Appeals stated:

> [W]hen a taxpayer seeks to take a beneficial deduction because of an abandonment, an affirmative act on the part of the taxpayer is entitled to great weight because it provides some objective measure of the taxpayer’s intent. On the other hand, when the abandonment will result in the recognition of income, the taxpayer’s unilateral activity is entitled to less weight because it might well be motivated by a desire to postpone the recognition of income. The proper test is whether, under the facts and circumstances, it is clear for all practical purposes that the

493 The taxpayers in both *Tejon Ranch* and *Zeeman* were limited partners. In *Tejon Ranch*, it appears that the partnership had incurred certain nonrecourse liabilities. Presumably, the taxpayer would have been allocated a portion of those liabilities.

494 *In re Kreidle*, 91-2 U.S.T.C. ¶50,371 (Bankr. D. Col. 1991), aff’d, 143 B.R. 941 (D.C. Col. 1992). It is worth noting that the partnership in this case was a general partnership, so that any deemed distribution arguably would have been matched with a contribution under Treas. Reg. §1.752-1(f) by virtue of the partner assuming liability for the partnership’s debt under state law. Thus, there would have been no net deemed distribution to the partner.

495 *L&C Springs Assoc.* v. *Commissioner*, 188 F.3d 866, 870 (7th Cir. 1999); *Carlins v. Commissioner*, 55 T.C.M. (CCH) 228 (1988). See supra note 484 (citing identifiable events discussed in *Echols*).

496 Courts generally have held that, where a taxpayer abandons property secured by nonrecourse debt, the taxpayer will be treated as conveying the property in exchange for relief from the debt, thus triggering taxable gain. See, e.g., *Yarbro v. Commissioner*, 737 F.2d 479, 485 (5th Cir. 1984), cert. denied, 469 U.S. 1189 (1985); *Lockwood v. Commissioner*, 94 T.C. 252, 259 (1990); see generally F. Robinson, *Nonrecourse Indebtedness*, 11 Va. Tax Rev. 1, 26 (1991).
taxpayer will not retain the property; an overt act of abandonment by
the taxpayer is not necessary.497

In Carlins v. Commissioner,498 the Tax Court essentially equated worthlessness
and abandonment in analyzing a case where the taxpayer was trying to delay
recognition of gain with respect to stock that was secured by nonrecourse debt.
Although the court recognized that an identifiable event is necessary to find an
abandonment, the court found that “[t]he facts in the instant case that identify the
worthlessness of the Sagtat stock similarly identify the time of this asset’s
abandonment.”499 The court further stated that “[t]hese petitioners, through their
inaction in 1978, allowed their Sagtat stock to become worthless. Because of
worthlessness, this stock was abandoned in 1978; and the nonrecourse debt which the
stock secured was therefore discharged.”500

As indicated in the language quoted above from the Seventh Circuit’s opinion,
courts generally have accelerated a finding of abandonment where the taxpayer was
attempting to realize a benefit by deferring the recognition of income. Recognition of a
loss obviously is different, and a court may be less inclined to accelerate a finding of
abandonment under these circumstances. Nonetheless, if a taxpayer were to obtain a
benefit in the form of an ordinary loss for a worthless partnership interest, instead of a
capital loss on abandonment of the partnership interest, a court might find this line of
analysis to be relevant.

Absent a finding of abandonment, if a partnership is continuing its operations501
and a partner remains as a partner at the time that the partnership interest becomes
worthless, the better technical answer, at least where none of the partnership’s debt is
recourse to the partner,502 would appear to be that the partner is entitled to an ordinary
loss.503 The worthlessness of a partnership interest and the ultimate relinquishment of a

497 L&C Springs Assoc. v. Commissioner, 188 F.3d 866, 870 (7th Cir. 1999) (citations omitted); see also
and remanded on other grounds, 692 F.2d 152 (1st Cir. 1982), aff’d in part, rev’d in part on other grounds
sub. nom., CRC Corp. v. Commissioner, 693 F.2d 281 (3d Cir. 1982), cert. denied, 462 U.S. 1106 (1983);

498 55 T.C.M. (CCH) 228 (1988).

499 Id.

500 Id.

501 See supra notes 448-449 and accompanying text.

502 See supra notes 445-447 and accompanying text; but see In re Kreidle, 91-2 U.S.T.C. ¶50,371 (Bankr.
D. Col. 1991), aff’d, 143 B.R. 941 (D.C. Col. 1992) (ordinary loss allowed for worthlessness of a general
partnership interest).

503 The situation is somewhat analogous to the situation in 1997 FSA Lexis 233 (July 11, 1997)
discussed supra at notes 414-416 and accompanying text) relating to bad debt deductions. There, in
analyzing the income tax results that follow where a debt instrument of a parent corporation held by its
subsidiary is found to be worthless, the Service specifically recognized that the finding of worthlessness
and ultimate cancellation of the debt may be two separate events. By giving separate effect to the
partner’s interest in a partnership can, under the appropriate facts, be separate events that should be respected as such for federal tax purposes. Where the events are properly respected as separate, the mere finding that a partnership interest is worthless seemingly should not cause the partner to cease to be treated as a partner. Accordingly, such a finding would not give rise to a shift in liabilities under section 752. Without a shift in debt, there would seem to be no basis for finding a sale or exchange and thus no justification for sticking taxpayers with a capital loss.505

If, in fact, there is no shift in debt upon a finding of worthlessness, so that a taxpayer is entitled to an ordinary loss, there still is a question as to the appropriate measurement for the loss. A loss from worthlessness generally should equal a partner’s basis in its partnership interest, as determined for purposes of section 1011. In the context of an interest in a partnership, this basis would include a partner’s share of liabilities under section 752. While creating basis in the partner’s interest, those

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504 Where there is only one class of partnership interest, all interests would become worthless at the same time. Presumably, und... 505 Even if a partnership interest is treated as a “right or obligation with respect to property”, there is no “cancellation, lapse, expiration, or other termination” in connection with a finding of worthlessness, so section 1234A should not apply where a partnership interest is found to be worthless unless an abandonment also is deemed to occur in connection with the finding of worthlessness.

506 I.R.C. §165(b).

Note that, in measuring the loss taken by the taxpayer, a partner also must take into account section 465 to determine if the taxpayer is “at-risk” with respect to the liabilities that give rise to basis. The passive activity rules under section 469 could be relevant as well. Section 469 does not apply to limit a loss with respect to a passive activity if the taxpayer disposes of its entire interest in such passive activity in a fully taxable transaction. I.R.C. §469(g). It is unclear whether the worthlessness of a partnership interest constitutes a “disposition” for purposes of section 469. The legislative history to section 469 explains that a disposition “includes an abandonment, constituting a fully taxable event under present law, of the taxpayer’s entire interest in a passive activity . . . . Similarly, to the extent that the event of the worthlessness of a security is treated under section 165(g) of the Code as a sale or exchange of the security, and the event otherwise represents the disposition of an entire interest in a passive activity, it is treated as a disposition. No inference is intended with respect to whether a security includes an interest in any entity other than a corporation.” Staff of the Jt. Comm. on Tax’n, General Explanation of the Tax Reform Act of 1986, 227 (1987). In a 1996 field service advice, the Service observed that “[i]t is possible, . . . that for section 469 purposes, worthlessness is only a ‘disposition’ for losses covered by section 165(g).” 1996 F.S.A. Lexis 53, n.5 (Oct. 30, 1996). The Service, however, stated that it “assume[d]” that the “worthlessness” example in the legislative history to section 469 was “only illustrative” and that the worthlessness of an interest “may be a section 469 ‘disposition’ even though it is not within the scope of section 165(g).” Id. Although this statement seems hopeful in the context of treating worthlessness as a disposition for purposes of section 469, the statement was preceded by recognition that the issue was outside the jurisdiction of the drafters of the 1996 field service advice. Accordingly, little comfort can be taken from this statement. The legislative history implies that worthlessness will give rise to a disposition under section 469 only in the context of a worthless security. In that context, the Code actually deems a sale or exchange of the worthless security to occur. Following the implication of the legislative history, the better position would appear to be that a disposition would
liabilities also would give rise to an amount realized upon a transfer of the partnership interest, assuming that the liabilities followed the interest, thus reducing the potential loss that would be recognized with respect to the interest. Nonetheless, where a partner’s interest becomes worthless, there is no transfer of the interest, and the partner, under the fiction created by section 752, presumably continues to share in the relevant liabilities.

This analysis is consistent with the Tax Court’s discussion in Proesel v. Commissioner. There, although the court ultimately held that the partner was not entitled to a worthlessness deduction, the court still undertook an analysis of the partner’s basis in the partnership interest for purposes of calculating the potential worthlessness deduction. The Service argued “that the ‘technical liability’ of the partners does not come within the meaning of section 752, and that only if a partner was found to be liable and actually made payments on the loan should he be allowed to include his pro rata share of [the partnership’s] liabilities in his basis.” Rejecting the Service’s argument, the court concluded that the partner was entitled to include in his basis his share of liabilities under section 752. The court stated that “[t]he Commissioner cites no authority for such proposition, nor has this Court been able to find any authority for our holding that the mere avoidance of repayment, without more, precludes a partner from including a liability in his basis.” Admittedly, the partner in Proesel was a general partner, so that the creditor could actively pursue him for his share of the liabilities. The court, however, recognized the significant possibility that the partner would not pay any of the liabilities.

Apart from authority relating to partnerships, courts generally have permitted taxpayers to include unrelated third party debt in the basis of property acquired using the proceeds of such debt. Cases also permit taxpayers to include purchase money debt in basis, with the caveat that basis for nonrecourse debt cannot exceed the value of the property securing the debt. However, published authority by the Service is at odds with this view, at least when measuring the deduction for worthlessness.

not occur for purposes of section 469 where a partner’s interest in a partnership interest is written off as worthless.

508 I.R.C. §752(d).


510 Id. at 1004. In the alternative, the Service argued that the taxpayer could only include in his basis liabilities incurred subsequent to his admittance to the partnership. The Tax Court rejected this argument as well. Id. at 1005.

511 Id. at 1004.

512 Crain v. Commissioner, 75 F.2d 962, 964 (8th Cir. 1935) (a taxpayer may claim a loss for basis attributable to debt even though the person has not made payments on the debt where the taxpayer is personally liable for the debt).

513 Pleasant Summit Land Corp. v. Commissioner, 863 F.2d 263 (3d Cir. 1988); Est. of Isaacson v. Commissioner, 860 F.2d 55 (2d Cir. 1988); Regents Park Partners v. Commissioner, 63 T.C.M. (CCH) 3131 (1992); cf. Est. of Franklin v. Commissioner, 544 F.2d 1045 (9th Cir. 1976).
Specifically, Rev. Rul. 74-80\textsuperscript{514} holds that a cash basis taxpayer who acquired stock in exchange for a note could not determine its basis for worthlessness by reference to the amount of the note, but instead could only deduct a loss after the stock became worthless as payments were made on the note.\textsuperscript{515} The Service’s holding in Rev. Rul. 74-80 is generally consistent with the argument that it made in Proesel; that is, the taxpayer should not get credit for liabilities in basis but instead, should receive basis only as payments are made on the debt.

The Service has not revoked Rev. Rul. 74-80. However, in a field service advice issued in 1995, the Service repudiated the holding in the revenue ruling.\textsuperscript{516} Like Rev. Rul. 74-80, the field service advice analyzed the worthlessness deduction allowed for stock acquired by a cash basis taxpayer with a recourse purchase money note. The field service advice recognized that Rev. Rul. 74-80 was directly on point. Nonetheless, the field service advice states:

Rev. Rul. 74-80 holds that amounts paid on a note issued for stock which became worthless are deductible by a cash basis taxpayer in the years the note is paid rather than the year the stock became worthless. The facts of the ruling are that in 1970, the taxpayer buys stock for a $500 note; in September, 1970, he pays $250; in December, 1970, the stock is worthless; in September, 1971, he pays the final $250. The revenue ruling holds that the taxpayer may deduct $250 in 1970 and $250 in 1971 – allocating the deduction for a cash basis taxpayer to the year payments are made on the note. We believe that the section 165(g) deduction should be $500 in 1970, the year of worthlessness, because $500 is the taxpayer’s basis in the stock. If the taxpayer had made only one payment by 1970, we believe that he would still be entitled to a $500 deduction, but he would also have $250 cancellation of indebtedness income.

We believe that cash method taxpayers are allowed worthless stock deductions to the extent of basis, which includes genuine debts. If they

\textsuperscript{514} 1974-1 C.B. 117.

\textsuperscript{515} Priv. Ltr. Rul. 9251023 (Sept. 18, 1992). In Lockwood v. Commissioner, 94 T.C. 252 (1990), the Service argued that a taxpayer, by abandoning an asset secured by purchase money nonrecourse debt, essentially destroyed his payment obligation under the note, which thereby resulted in a reduction of the original purchase price of the asset, and hence, the asset’s basis. According to the Tax Court, the Service was relying on cases that dealt with agreed reductions in purchase money debt, and those cases had no application to the situation being considered. In rejecting the Service’s argument, the court apparently determined that the taxpayer appropriately included the debt in determining its adjusted basis in the property. The Service’s argument is curious given that the court included the nonrecourse debt in the amount realized for purposes of measuring gain or loss on abandonment of the property. It would not seem appropriate to include the debt for purposes of determining the amount realized, but disregard the debt in determining the basis of the property. It may be that the Tax Court was merely addressing an alternative argument put forth by the Service in the event that the court did not find that a sale or exchange occurred as a result of the abandonment of the property.

\textsuperscript{516} 1995 FSA Lexis 223 (Feb. 21, 1995).
later are discharged of responsibility for payment on the debt, they must recognize discharge of indebtedness income . . . at that time.  

If the 1995 field service advice represents the Service’s current thinking, it seems that the Service would consider a partner to have basis in its partnership interest for its share of genuine partnership liabilities, even if the partner (or, because of financial constraints, the partnership) might never make payment on such liabilities. Consistent with the field service advice, however, the failure to satisfy the liabilities would have future adverse tax ramifications. For instance, because the partner would have written down the basis in its partnership interest to zero, any subsequent shift in debt would give rise to a deemed distribution under section 752(b), triggering gain to the partner. If the debt is forgiven, the taxpayer will receive a deemed distribution, but the taxpayer may also receive an allocation of COD income that increases (under section 705) the partner’s basis in its interest and offsets the deemed distribution. Where the partnership gives property in exchange for the debt, the gain from the exchange presumably would not generate a large enough basis increase (under section 705) to offset a distribution attributable to all of the debt allocated to the partner. Accordingly, in this situation, the partner could recognize some gain as a result of the deemed distribution.

517 Id. (emphasis added). While the field service advice analyzes a cash basis taxpayer, it states that “both a cash and accrual method taxpayer will have the same basis in stock represented by a note, assuming a genuine, noncontingent debt.” In analyzing the cases relied upon to support Rev. Rul. 74-80, the field service advice states that the cases “either do not support the revenue ruling because a note was not given to purchase stock, or the court opinions were result oriented in order to give taxpayers a worthless stock deduction where the year of worthlessness was not before the court.”

518 Cf. IRS FSA 200106005 (Oct. 3, 2000) (seemingly contrary to the 1995 filed service advice; draws a distinction between third party debt and purchase money debt in determining the timing of currency losses).


520 Query whether the Service might assert application of the tax benefit rule to treat the gain as ordinary income. Cf. Hillsboro National Bank v. Commissioner, 460 U.S. 370 (1983) (ordinary deduction for bad debt loss recaptured as ordinary income under tax benefit principals when portion of charged off debt is recovered); Rev. Rul. 80-56, 1980-1 C.B. 154 (applying the tax benefit rule in an analogous situation); I.R.C. §108(e)(7) (ordinary income recapture on disposition of stock when debt that has been the subject of a bad debt deduction is contributed to a corporation for stock and the stock is subsequently sold for a gain). See generally A. Cunningham, Characterization of Income Recovered Under the Tax Benefit Doctrine, 7 Va. Tax Rev. 121 (1987).

521 If the property transferred in cancellation of the debt has some positive basis, the gain from the discharge of the debt would be less than the full amount of the debt. In taking a deduction for a worthless partnership interest, the partner would have written off its entire basis in its partnership interest, including the full amount of the partner’s share of partnership debt.