IRS Issues Final Regulations on Partnership Debt-for-Equity Exchanges

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Debtor partnerships often transfer an interest in such partnership to a creditor in satisfaction of the partnership's recourse or nonrecourse debt (known as a "debt-for-equity" exchange). Debt-for-equity exchanges occur for a number of reasons. Debtor partnerships sometimes initiate the exchange for purposes of restructuring the partnership to improve the partnership's "financial health" in the marketplace. In other instances, creditors initiate the exchange. For example, where the partnership is facing bankruptcy, creditors sometimes prefer to acquire equity interests in the partnership instead of the more cumbersome (and possibly more risky from a liability standpoint) acquisition of title to the partnership's assets. The U.S. federal income tax consequences of debt-for-equity exchanges, however, have not been entirely clear. Therefore, the U.S. Treasury Department has recently issued final regulations as guidance in this area.

Under Section 108(e) of the Internal Revenue Code of 1986, as amended (the "Code"), a debtor partnership that engages in a debt-for-equity exchange is treated as having satisfied its debt with an amount of money equal to the fair market value ("FMV") of the transferred partnership interest. If the debt exceeds the FMV of the interest, the partnership must recognize cancellation of debt ("COD") income equal to the excess amount. The COD income is allocated to the partners who were partners in the partnership immediately before the satisfaction of the partnership debt.[1]

The FMV of the Transferred Partnership Interest

As noted above, a debtor partnership will recognize COD income in a debt-for-equity exchange equal to the amount by which the debt exceeds the FMV of the transferred partnership interest. The FMV of the transferred partnership interest generally is based on an examination of all relevant facts and circumstances. One way to determine the FMV of a partnership interest is to look to the "liquidation value" of the interest. The "liquidation value" is the amount of cash a creditor would receive for his debt-for-equity partnership interest if, immediately after transferring the partnership interest to the creditor, the partnership sold all of its assets (including goodwill, going concern value, and other intangibles) for cash equal to the fair market value of

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[1] There are certain exceptions to this COD rule, including when a debtor is insolvent or in bankruptcy. In the case of a partnership, it is the status of the partners, not the partnership, that is relevant for purposes of determining eligibility for any such exception.

those assets, and then liquidated. In instances where the debtor partnership holds an interest in another partnership (the "lower-tier partnership"), the liquidation value of the lower-tier partnership is taken into account when determining the liquidation value of the debtor partnership.

Under the new final regulations, the FMV of the transferred partnership interest in a debt-for-equity exchange is the liquidation value if the following four conditions are met:

- The creditor, debtor partnership, and its partners must all treat the FMV of the debt-for-equity partnership interest as being equal to the liquidation value.

- Where the debtor partnership transfers more than one debt-for-equity interest to one or more creditors in the same overall transaction, then the partnership, its partners, and each creditor must treat the FMV of each transferred debt-for-equity interest as equal to the liquidation value.

- The debt-for-equity exchange must be an arm's-length transaction, which means that the terms of the exchange must be comparable to terms that would be agreed to by unrelated parties negotiating with adverse interests.

- Subsequent to the debt-for-equity exchange, the partnership cannot redeem the debt-for-equity interest, and persons related to the debtor partnership or any of its partners cannot purchase the debt-for-equity interest, in either case, as part of a plan at the time of the exchange that has as a principal purpose the avoidance of COD income by the partnership.

For purposes of determining the FMV of the transferred partnership interest, it may be in many parties' best interest to use the liquidation value instead of the more uncertain "facts and circumstance" test. Therefore, if parties want to ensure their qualification for using the liquidation value, the debtor partnership, its partners, and the creditor(s) should consider entering into an agreement at the time of the debt-for-equity exchange in which they all agree to abide by the four conditions listed above.

Section 721's Non-Recognition Provision

The final regulations also clarify the extent to which Section 721 of the Code applies to creditors and debtor partnerships engaging in a debt-for-equity exchange. Under Section 721 of the Code, a partnership and its partners generally do not recognize gain or loss when property is contributed to the partnership in exchange for a partnership interest. The final regulations apply Section 721's non-recognition provision to debt-for-equity exchanges, such that neither the creditor nor the debtor partnership recognize gain or loss at the time of the exchange (aside from the partnership's COD income). Therefore, a creditor that receives a partnership interest in satisfaction of the partnership's debt, where the FMV of the partnership interest is less than the debt, cannot immediately claim a bad debt loss. Instead, the creditor receives a tax basis in his partnership interest equal to his tax basis in the transferred debt. Under this rule, the creditor can only claim a loss (which likely will be treated as a capital loss) when he ultimately disposes of the partnership interest, instead of claiming a bad debt ordinary loss when the exchange occurs.

The final regulations provide an exception to the application of this Section 721 non-recognition provision to debt-for-equity exchanges. Under this exception, the non-recognition provision does not apply to a creditor who receives a partnership interest in satisfaction of the debtor partnership's liabilities for unpaid rent, royalties, or interest on debt (including accrued original issue discount) accrued on or after the beginning of the creditor's holding period for the debt. In such cases, the creditor may recognize income upon receiving the partnership interest in exchange for his claim for unpaid rent, royalties, or interest. The non-recognition provision, however, still applies to the debtor partnership in such cases.

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