Final Regulations on Partnership Debt-for-Equity Exchanges

November 22, 2011

The U.S. Department of the Treasury recently issued final regulations providing helpful clarifications on the partnership and partner level tax consequences of debt-for-equity exchanges.

On November 15, 2011, the U.S. Department of the Treasury (DOT) issued final regulations governing the federal income tax treatment of a transaction in which a partnership issues a partnership interest to a creditor in satisfaction of the partnership's indebtedness. These regulations largely follow the approach taken in the proposed regulations issued in 2008, but with some helpful clarifications added.

Background

In 2004, Congress amended Section 108(e)(8) of the Code to provide that, when a debtor partnership issues a capital or profits interest to a creditor in satisfaction of a recourse or nonrecourse debt of the partnership, the partnership is treated as having satisfied the debt for an amount of money equal to the fair market value of the partnership interest being issued to the creditor. To the extent that the principal amount of the debt exceeds the fair market value of the equity being issued, the partnership recognizes cancellation of debt (COD) income. Such COD income generally must be included in the distributive shares of the partners immediately prior to the discharge (subject to any applicable exclusions at the partner level). This required recognition of COD income generally comports with the treatment of a corporation that undertakes a debt-for-equity exchange.

Key Provisions of Proposed Regulations

In 2008, the DOT issued proposed regulations that addressed a number of issues that arise when a partnership issues equity in exchange for the discharge of a debt of the partnership. The proposed regulations provided that, for purposes of determining the amount of COD income recognized by the partnership, the partnership and the creditor may treat the equity being issued to the creditor as having a fair market value equal to its liquidation value, assuming four conditions are satisfied. The four conditions for this liquidation value "safe harbor" are (i) a requirement to maintain capital accounts consistent with the capital accounting rules under Section 704(b) of the Code; (ii) a consistency requirement that both the partnership and partner will treat the debt-for-equity interest as having a fair market value equal to its liquidation value; (iii) an arm's length requirement; and (iv) an anti-abuse rule prohibiting a planned retirement or sale of the debt-for-equity interest designed to avoid COD income.

At the partner level, the proposed regulations applied Section 721 of the Code to the debt-for-equity exchange. As a result, the creditor generally does not recognize gain or loss on exchange of the debt for a capital or profits interest in the debtor partnership. Also, a bad debt deduction may not be claimed in the debt-for-equity exchange. Instead, under Section 722 of the Code, the creditor's basis in the debt-for-equity interest will equal the creditor's tax basis in the debt. However, an exception to Section 721 treatment applies for transfers of partnership equity in satisfaction of debt for unpaid rent, royalties or accrued interest. This exception was designed to prevent the conversion of what would otherwise be ordinary income into capital gain.

Final Regulations

The final regulations do not deviate materially from the approach taken in the proposed regulations, but do provide some helpful clarifications and instructive explanations.

- At the request of commentators, the final regulations provide that the capital account maintenance requirement for the liquidation value safe harbor does not require the partnership to liquidate in accordance with positive capital account balances.
- The final regulations retain the exception to Section 721 treatment for the satisfaction of ordinary income items (unpaid rent, royalties and accrued interest). The regulations also clarify that when a partnership issues equity in satisfaction of these types of debt, the partnership will not be treated as having transferred a fractional interest in each asset to the creditor. There was a concern among practitioners that if Section 721 did not apply, the exchange could be treated as a deemed sale of assets under an aggregate theory of partnership taxation. Instead, the final regulations take a circular cash flow approach, treating the creditor as having received cash and then as having contributed the cash to the partnership for equity in a tax-free Section 721 transaction.

- In a debt-for-equity exchange, the final regulations also state that the portion of the equity treated as exchanged for any accrued interest or accrued original issue discount (OID) is determined under Treasury Regulations Sections 1.446-2 and 1.1275-2, respectively. Because these regulations generally apply payments first to interest, it is not likely that a creditor in a debt-for-equity will be in a position to claim a bad debt deduction for accrued but unpaid interest.
- Despite the request of commentators, the final regulations reject a bifurcation approach that would have allowed a creditor to take a bad debt deduction or loss on the portion of the debt that exceeded the fair market value of the equity and treat the balance of the debt as having been contributed to the partnership in a Section 721 exchange. However, the preamble to the final regulations indicates that a creditor may claim a bad deduction under Section 166 of the Code prior to (and independent of) the debt-for-equity exchange. Of course, under Section 166(d)(3), a taxpayer other than a corporation may not deduct a partially worthless nonbusiness debt.

Conclusion

While the final regulations generally track the proposed regulations, they contain a few helpful clarifications which should provide greater certainty to parties that are planning to undertake a partnership debt-for-equity exchange.