

## Treatment of Excess Nonrecourse Partnership Debt and COD Income Under Section 108

The U.S. Internal Revenue Service (IRS) has just issued helpful guidance that may allow partners in partnerships whose debt is being cancelled or reduced to avoid or minimize tax on cancellation of debt (COD) income. Guidance issued more than a decade ago left unsettled a crucial tax factor in determining whether a partner in such a situation could take advantage of the insolvency exception to recognition of COD income under section 108(d)(4) of the U.S. Internal Revenue Code of 1986, as amended (the Code). On May 25, 2012, the IRS issued Revenue Ruling 2012-14, which addresses that issue and allows a partner to take into account partnership non-recourse debt when calculating whether such partner is personally insolvent and thus, eligible for this exemption from recognizing COD income.

### Prior Guidance

Prior IRS guidance in Revenue Ruling 92-53 addressed the treatment of nonrecourse debt, generally, for purposes of determining whether a taxpayer is insolvent. According to Revenue Ruling 92-53, if nonrecourse debt exceeds the fair market value of property securing the debt, such excess is treated as a liability of the taxpayer to the extent that such excess nonrecourse debt is discharged. For purposes of section 108, a taxpayer could count such liability to determine whether or not the taxpayer qualifies for the insolvency exclusion for COD income.

In general, the exclusions under section 108 for COD income, including the insolvency exclusion, are applied at the partner level and not at the partnership level. Thus, partnership COD income is excludable from the gross income of a partner to the extent, among other possible exclusions, such partner is personally insolvent. However, it was unclear how Revenue Ruling 92-53 applied to partnerships. The fact patterns

discussed in Revenue Ruling 92-53 do not specifically address nonrecourse debt of a partnership.

### Revenue Ruling 2012-14

Prior to Revenue Ruling 2012-14, a fair number of commentators and practitioners believed that a partnership ought to be able to treat his or her pro rata share of a partnership's discharged excess nonrecourse debt as a personal liability for purposes of the section 108 insolvency exclusion, and some have taken a reasoned position that this is the proper result under Revenue Ruling 92-53 and section 108. Revenue Ruling 2012-14 provides that for purposes of measuring the insolvency of partners, the partnership's discharged excess nonrecourse debt is treated as a liability of the partners of such partnership. The excess nonrecourse debt should be allocated based upon the allocation of the partnership's COD income.

After nearly a decade, the IRS has aided taxpayers by confirming that partners should take into account partnership discharged excess nonrecourse debt for purposes of applying the insolvency exclusion. While complex in application, this guidance illustrates how

proper application of the revised rules can minimize or even eliminate tax liability. Please contact us if you would like any further guidance regarding the implications of this ruling.

---

## Practice group contacts

For more information, please contact one of the attorneys listed, or any Dechert attorney with whom you regularly work. Visit us at [www.dechert.com/tax](http://www.dechert.com/tax).

**Adrienne M. Baker**

Boston  
+1 617 728 7151  
adrienne.baker@dechert.com

**Daniel M. Dunn\***

New York  
+1 212 698 3857  
daniel.dunn@dechert.com

**Richard M. Hervey**

New York  
+1 212 698 3568  
richard.hervey@dechert.com

**Michael Hirschfeld**

New York  
+1 212 698 3635  
michael.hirschfeld@dechert.com

**Edward P. Lemanowicz**

Philadelphia  
+1 215 994 2492  
edward.lemanowicz@dechert.com

**Joshua Milgrim**

New York  
+1 212 641 5659  
joshua.milgrim@dechert.com

**James H. Nix**

New York  
+1 212 698 3595  
james.nix@dechert.com

**Michael J. Rufkahr**

Washington, D.C.  
+1 202 261 3437  
michael.rufkahr@dechert.com

**Richard P. Wild**

Philadelphia  
+1 215 994 2670  
richard.wild@dechert.com

\* Practice Chair

Sign up to receive our other [DechertOnPoints](#).

---

**Dechert**  
LLP

[www.dechert.com](http://www.dechert.com)

IRS Circular 230 disclosure: To ensure compliance with requirements imposed by the IRS, we inform you that any U.S. federal tax advice contained in this communication (including any attachments) is not intended or written to be used, and cannot be used, for the purpose of (i) avoiding penalties under the Internal Revenue Code or (ii) promoting, marketing or recommending to another party any transaction or matter addressed herein.

© 2012 Dechert LLP. All rights reserved. Materials have been abridged from laws, court decisions, and administrative rulings and should not be considered as legal opinions on specific facts or as a substitute for legal counsel. This publication, provided by Dechert LLP as a general informational service, may be considered attorney advertising in some jurisdictions. Prior results do not guarantee a similar outcome.

---

Almaty • Austin • Beijing • Boston • Brussels • Charlotte • Chicago • Dubai • Dublin • Frankfurt • Hartford  
Hong Kong • London • Los Angeles • Luxembourg • Moscow • Munich • New York • Orange County  
Paris • Philadelphia • Princeton • San Francisco • Silicon Valley • Tbilisi • Washington, D.C.