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IRS Issues Final Regulations on Treatment of Partnership Debt for Equity Exchanges

On November 15, the Internal Revenue Service issued final Treasury Regulations (Regulations) under Section 108(e)(8) of the Internal Revenue Code regarding the determination of the cancellation of debt (COD) income to a partnership that transfers a partnership interest to a creditor in satisfaction of a partnership debt. Pursuant to the American Jobs Creation Act of 2004, Public Law 108-357 (118 Stat. 1648), Section 108(e)(8) was amended to expand its scope to include cancellation of partnership indebtedness. Prior to the amendment, Section 108(e)(8) only applied to cancellation of corporate indebtedness. As amended, if a debtor partnership issues a capital or profits interest in the partnership in exchange for its debt (recourse or nonrecourse), the partnership is treated as having satisfied the debt with an amount of money equal to the fair market value (FMV) of the partnership interest issued to the creditor. The amount by which the discharged debt exceeds the FMV of the partnership interest is COD income and is included in the distributive shares of the partners in the partnership immediately before the discharge. The final Regulations provide that, for purposes of calculating the COD income to a partnership, the FMV of a partnership interest transferred to a creditor is its liquidation value. For these purposes, the liquidation value of the partnership interest is equal to the amount of cash that the creditor would receive with respect to the interest if, immediately after the transfer, the partnership sold all of its assets (including goodwill, going concern value, and any other intangibles) for cash equal to the fair market value of those assets, and then liquidated. However, under the final Regulations, this liquidation value can be used to determine the FMV of a partnership interest only if the following three conditions are met:

- The creditor, the partnership, and the partners treat the FMV of the debt as being equal to the liquidation value of the partnership interest issued to the creditor for the purposes of determining the income tax consequences of the exchange.
- The exchange is an arm's-length transaction.
- Subsequent to the exchange, neither the partnership nor any person related to the partnership redeems the creditor's partnership interest as part of a plan to avoid COD income.

If the conditions are not satisfied, the determination of the FMV of the transferred partnership interest will be based on all the facts and circumstances. The final Regulations also address treatment of debt-for-equity exchanges under Section 721, confirming that the creditor does not recognize a loss or a bad debt deduction upon the contribution of debt to the partnership in exchange for a partnership interest. The creditor's basis in the partnership interest received will be increased by the adjusted basis of the indebtedness exchanged. Similarly, while the partnership will have COD income to the extent the amount of the debt exchanged exceeds the FMV of the partnership interest issued, the partnership will have no gain or loss on the transfer of the partnership interest. However, gain or loss may be recognized by the creditor to the extent a partnership interest is issued in exchange for unpaid rent, royalties, or interest (including accrued original issue discount) that accrued on or after the beginning of the creditor's holding period for the indebtedness. The rationale for this exception is to protect against the conversion of ordinary income into capital gain. The final Regulations became effective on November 17.