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With Great Power Comes Great Responsibility:

Deferring Cancellation of Debt Income for Tax Partnerships

by Brian A. Smith, Partner and William E. Russell, Partner

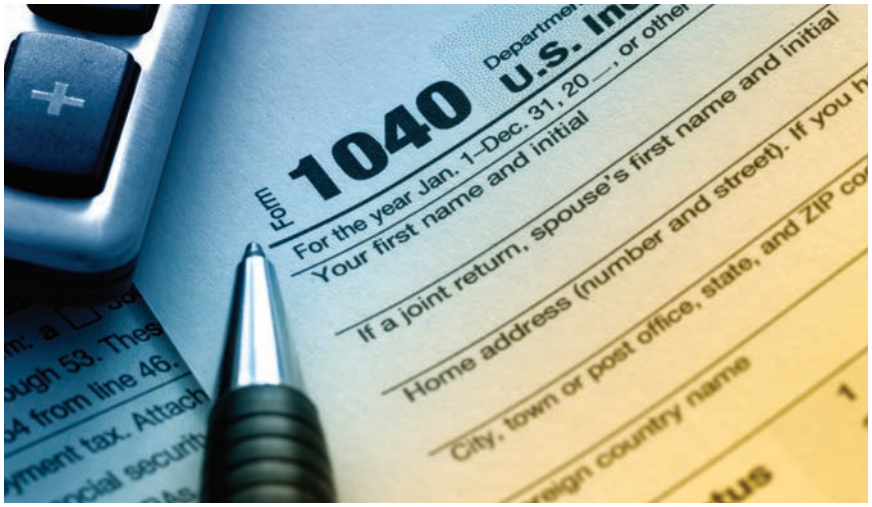
A FREEBORN & PETERS WHITE PAPER

ABOUT THIS WHITE PAPER:

Income gained through the Cancellation of Indebtedness (COI) can create great challenges for partners in ventures that are going through workouts and restructurings, particularly if the partners have conflicting objectives in terms of their tax position. This white paper considers the various options available to partners when making elections to recognize COI income immediately or to defer it. It also describes the perils that might befall general partners who fail to consider the potential impact of these elections on their partners' financial situation.

One of the most significant hurdles in structuring a suitable debt workout or restructuring arrangement between a lender and a borrower involves the negative impact of U.S. income taxes on the borrower. In the United States, as is the case in many other countries, when a borrower reduces or cancels its outstanding indebtedness for less than the full amount due, the borrower is deemed to realize taxable income on the amount of the reduction. This cancellation of indebtedness (COI) income is subject to many nuances and exceptions, the primary exception being that an insolvent debtor can avoid COI income to the extent it is insolvent. Similarly, a bankrupt borrower can also avoid recognizing COI income. Also, a borrower may avoid COI income recognition if the debt constitutes qualified real property business indebtedness (QRPBI).

Complications and problems multiply when the borrower who realizes COI income is treated, for federal income tax purposes, as a partnership. In the event that a partnership recognizes COI income, that income passes through to the partners, who must report the COI income on their own tax returns and pay the tax attributable to the COI. A partner may be able to avoid paying tax on the pass-through COI income if that partner is bankrupt or to the extent of the partner's insolvency. However, absent a partner's insolvency or bankruptcy, partners often face the situation of having to



pay income tax with respect to an underperforming asset without receiving a corresponding cash disbursement. In the past decade, this scenario has become commonplace since the emergence of limited liability companies as the investment entity of choice. While investors have become accustomed to structuring their investments through LLCs and other entities that are treated as partnerships, they rarely consider the impact of the entity's debt workout on their own tax situation.

Of course, tax partnership debt workouts have increased, which have magnified the impact of COI income passed through to partners. Congress was sympathetic to these concerns. As part of the American Recovery and Reinvestment Act of 2009, a taxpayer that realizes certain COI income in 2009 or 2010 can elect to include that income ratably over a five-year period that generally begins in 2014. Only debt instruments issued in connection with the conduct of a trade or business, as opposed to those held for investment, are eligible for the election. Congress specifically provided that the election may shelter partnership COI income if the debt was issued in connection with the partnership's trade or business. Of significant note, Congress required the election be made by the partnership rather than the partners, although the election can be made on a debt-by-debt basis. Seemingly, whether the partnership wishes to defer its pass-through of COI income to the partners by making the election is an all-or-nothing decision with the choice either affecting all of the partners or none of the partners. This "entity approach" for the election would have impacted different partners differently.

Requiring a partnership-level election had the potential of causing a conflict among partners, including various investors and promoters who may also be partners. Many solvent partners would prefer that the COI income recognition be deferred, as they would benefit by the partnership's making a deferral election. In contrast, some partners, including partners who may control the partnership decisions, may be insolvent, causing them to prefer foregoing the deferral election in favor of current recognition of COI income. Other partners with useable net operating losses may also prefer that the partnership not make the election and currently recognize COI income. Still others would rather pay the tax currently rather than pay it at future tax rates.

The IRS recognized the incongruity that Congress created with respect to the COI of partnerships. In August of 2009, the IRS issued a Revenue Procedure which allows a partnership to make "partial" elections. What this means is that a partnership may divide up the debt into portions which include deferred COI income and portions that are not deferred (i.e., potentially subject to tax, or excluded due to a partner's insolvency or bankruptcy, or offset by net operating losses). The partnership may direct that deferred COI income be allocated to certain partners and current COI income be allocated to other partners.

While the Revenue Procedure seemingly solves the "all or nothing" problem, it creates additional complexities. Congress mandated that the election must be made by the partnership, and the IRS permitted such partnership-level election to treat different partners differently from one another. Taken together, the new rules effectively burden managing partners (usually managers in the LLC context or general partners in the limited partnership context) with the task of considering whether the partnership should make or forego the election with respect to each partner. A failure by a manager or general partner to consider the impact of this new election could provide an affected partner with a claim that the manager or general partner violated his/her fiduciary duties owed to the other partners or that he/she breached the partnership agreement.

All COI income that a partner deferred as a result of the partnership making the election becomes accelerated upon the partnership's termination, sale of all of its assets, or upon such partner's sale, exchange or redemption of his/her partnership interest. This is significant because many workout plans, both inside and outside of the bankruptcy context, involve terminating the debtor entity concurrently with the debt reduction. When the dissolving debtor entity is treated as a tax partnership, no deferral election would be possible. As the insolvency and bankruptcy exceptions are applied at the partner level, some partners may favor dissolving the partnership while others may want to retain the partnership's existence to take advantage of the COI income-deferral election—a ripe source for partner vs. partner disputes.

The American Recovery and Reinvestment Act of 2009 became effective on February 17, 2009, and many questions regarding how the COI deferral election applies to partnership situations still remain unanswered. Managers and general partners who are entrenched in financing workouts involving a tax partnership debtor should ask each partner whether such partner would prefer that the partnership make the COI income deferral election with respect to that partner. Investors who are entrenched in financing workouts involving a tax partnership debtor should consider the impact of the election to defer COI income or failure to make such election to their tax situations and bring such considerations to the attention of the manager or general partner.

ABOUT THE AUTHORS:

Brian A. Smith

Partner

Chicago Office
Phone: (312) 360-6472

bsmith@freeborn.com

Brian Smith is a Partner in the Firm's Corporate Practice Group, where he helps companies anticipate, negotiate and implement strategies involved in all types of capital events.

William E. Russell

Partner

Chicago Office
Phone: (312) 360-6373

brussell@freeborn.com

Bill Russell is a Partner in the Corporate Practice Group and advises closely-held businesses and professionals on business and tax matters. His practice consists of corporate transactions and business consulting, advanced estate planning and probate, and asset protection.

CHICAGO
311 South Wacker Drive
Suite 3000
Chicago, IL 60606
(312) 360-6000
(312) 360-6520 fax

SPRINGFIELD
217 East Monroe Street
Suite 202
Springfield, IL 62701
(217) 535-1060
(217) 535-1069 fax

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