

# Planning Opportunities for Financially Distressed Entities & Related Issues

Presented By

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## Planning Opportunities for Financially Distressed Corporations

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## Overview

- Debt Restructuring in Corporate Context
- Section 382
- SRLY Rules

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## Cancellation of Debt (“COD”) Income Overview

- COD Analysis in the Corporate Context
  - How does COD typically arise?
  - How do corporate taxpayers minimize impact of COD income?

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## COD Income – Basics – What is COD income?

- Generally, the receipt of loan proceeds do not give rise to gross income because of the obligation to repay the loan.
- However, if the obligation to repay is forgiven, then gross income is triggered. *U.S. v. Kirby Lumber Co.*, 284 U.S. 1 (1931).

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## COD Income – Triggers

- Corporation repurchases debt for less than face amount. § 61(a)(12); *U.S. v. Kirby Lumber Co.*, 284 U.S. 1 (1931).
- Corporation issues stock with FMV less than face amount of debt. § 108(e)(10)
- Corporation modifies terms of debt and new debt has an issue price less than face amount of old debt. Reg. § 1.1001-3(b).
- Related party purchases debt of the corporation at a discount. 108(e)(4).

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**COD Income – Triggers – Corporate Repurchase Example**

- **Facts:** P has a note outstanding with a principal amount of \$100. P repurchases the note from the holder for \$70.
- **Consequences:** P must recognize \$30 of COD income.

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**COD Income – Triggers – Stock Issuance Example**

- **Facts:** P has \$100 of outstanding debt. In satisfaction of the debt, P issues to its creditors common stock with a fair market value of \$70.
- **Consequences:** P must recognize \$30 of COD income.
- Note that creditor typically will recognize a loss unless the exchange of debt for stock qualifies as a tax-free recapitalization under Section 368(a)(1)(E). The exchange will so qualify only if the debt is treated as a "security" under Section 354. *Neville Coke & Chem. Co. v. Comm'r*, 148 F.2d 599 (3d Cir. 1945); *Lorch v. Comm'r*, 605 F.2d 657 (2d Cir. 1979).

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**COD Income – Triggers – Debt Modification Rules**

- **Generally, the following constitute a "significant modification":**
  - a change in yield of more than 0.25%.
  - lengthening the term of the instrument by more than the lesser of 5 years or 50% of the original term.
  - a substantial change in the collateral of a nonrecourse debt.
  - a change in nature of debt from recourse to nonrecourse or vice versa.
  - a change in priority of the debt that results in a change in payment expectations.
- **Treas. Reg. § 1.1001-3(e).**

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### COD Income – Triggers – Debt Modification Rules (Cont.)

- If a significant modification occurs, the debtor is treated as repaying the old debt in an amount equal to the issue price of the new debt. Reg. § 1.1001-3(b).
- For a private debt instrument, the issue price is generally its face amount unless the interest rate is less than the AFR. § 1.1274-2(b)(1).
- For a publicly traded debt instrument, the issue price is generally the FMV of the new debt instrument. § 1.1273-2(b)(1).

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### COD Income – Debt Modification – Example 1

- **Facts:** Suppose P and Bank agree to lower the interest rate on debt of \$100. Assume the debt is not publicly traded.
- **Consequences:** So long as the interest rate is above the AFR, the issue price of the new debt instrument should equal its face amount. Thus, P should not have COD income and B should not have gain or loss.
- **Note:** This example assumes the debt is not issued with OID such that the outstanding face amount equals the adjusted issue price.

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### COD Income – Debt Modification – Example 2

- **Facts:** Suppose P and Trustee of public bonds agree to lower the interest rate. Assume the debt is publicly traded and the FMV of the debt is \$70.
- **Consequences:** The issue price of the new debt is its FMV. Thus, P is treated as satisfying the old debt for \$70. P has \$30 of COD income.
- The bond holders should recognize a \$30 loss on the exchange of old debt with a basis of \$100 for new debt with a FMV of \$70, unless the debt instruments are "securities" such that the exchange constitutes a reorganization under § 368(a)(1)(E).

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### COD Income – Debt Modification – Example 3

- **Facts:** Suppose P and Bank agree to lower the principal amount of the debt from \$100 to \$70. Assume the debt is not publicly traded.
- **Consequences:** If the interest rate is equal to or greater than the AFR, then the issue price of the reduced debt instrument is \$70. Thus, P has \$30 of COD income because it satisfied a \$100 debt instrument with a \$70 debt instrument.

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### COD Income – Debt Modification – Example 4

- **Facts:** Suppose P owes Bank \$100. Investor (unrelated to P) purchases debt from Bank for \$70 and then negotiates with P to lower the interest rate and reduce the principal amount to \$80.
- **Consequences:** P has \$20 of COD income. Investor recognizes gain of \$10 (\$80 - \$70) assuming that the debt instruments are not "securities" such that the exchange would constitute a reorganization under Section 368(a)(1)(E). Such gain is short-term capital gain. Investor should be able to report the gain on the installment method under Section 453 since the debt is not publicly traded. However, Section 453A may impose an interest charge on investor.

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### COD – Minimizing the Impact

- **Insolvency Exception**
  - P may exclude COD income to the extent P is insolvent (P's liabilities exceed FMV of its assets). § 108(a)(1)(B), (a)(3).
  - P must reduce tax attributes (e.g., NOLs, tax basis). § 108(b).
- **Bankruptcy Exception**
  - P may exclude COD income in bankruptcy proceeding without regard to solvency. § 108(a)(1)(A).
  - P must reduce tax attributes (e.g., NOLs, tax basis). § 108(b).

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### COD – Minimizing the Impact (cont.)

- NOL utilization
  - Absent insolvency, P may utilize NOLs to shelter COD income. § 108(b)(4)(A).
  - But note P may owe 2% AMT. § 56(d)(1)(A)(i).

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### COD – Minimizing the Impact (cont.)

- New Section 108(i)
  - P may elect to defer COD income recognized in 2009 or 2010 until 2014. § 108(i)(1).
  - Deferred COD income is accelerated if P liquidates, sells substantially all of its assets (including in a bankruptcy case), ceases its business or similar circumstances. § 108(i)(5)(D)(i).
  - Note: COD exclusions do not apply to Section 1001 gain from foreclosure on nonrecourse debt. *Comm’r v. Tufts*, 461 U.S. 300 (1983).

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### COD Minimizing the Impact – Example

- Facts: P has assets worth \$70 and debt of \$100 to B. P has NOLs of \$40. B agrees to reduce the debt to \$60.
- Consequences: P has \$40 of COD income and may exclude \$30 (to the extent of insolvency). The remaining COD income may be sheltered by NOLs.
- Note: If an ownership change occurs in connection with the debt forgiveness, P may wish to elect to allocate income for the year of the change based on the interim closing of the books method as explained below.

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**Section 382**

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**Outline of Section 382 Issues**

- General Rules
- Calculation of Limitation
- Definition of Ownership Change
- Identifying 5% Shareholders
- Built-in Gains and Losses
- Stock v. Nonstock
- Bankruptcy Rules
- Application to Consolidated Groups
- Practical Issues
- Bailout Notices

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**Section 382  
General Rules**

- Section 382 of the Code limits the ability of a corporation to use its net operating losses following an “ownership change.”
- Section 383 of the Code extends the limitation to a corporation’s other tax attributes, such as tax credits and net capital loss carryovers.

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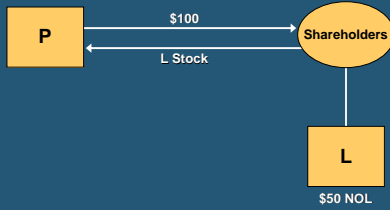
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## Section 382 Base Case



Facts: P buys 100% of L Stock from L's shareholders for \$100.

Conclusion: The P - L group's use of L's \$50 NOL is limited by Section 382.

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## Section 382 Definition of "Ownership Change"

- An "ownership change" occurs if the percentage of stock of the loss corporation owned by one or more "5 percent shareholders" has increased by more than 50 percentage points over the lowest percentage of stock of the corporation owned by such shareholders at any time during the testing period (generally 3 years or since the last ownership change, if shorter). IRC § 382(g).

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## Section 382 Calculation of Limitation

- If there has been an ownership change, the amount of taxable income of the loss corporation in any post-change year that can be offset by pre-change losses may not exceed the "Section 382 limitation." IRC § 382(a).
- The Section 382 limitation for any post-change year is, in general, an amount equal to:
  - The value of the loss corporation determined as of the time immediately before the ownership change, multiplied by
  - The long-term tax exempt rate published by the IRS. IRC § 382(b)(1).

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## Section 382 Allocation of Income for Change Year

- The Section 382 limitation does not apply to income incurred in the change year if it is allocated to the days of the year up to and including the change date (the pre-change period). This rule requires an allocation of change year income where a corporation's taxable year does not end on the same date as the ownership change date. IRC § 382(b)(3).
- There are two ways to allocate income: a daily ratable allocation method and the closing-of-the-books method. The taxpayer must elect to apply the closing-of-the-books method. Treas. Reg. § 1.382-6; Notice 87-79.
- Importantly, the IRS has ruled that discharge of indebtedness income generated by an ownership change may all be allocated to the pre-change period by applying the closing-of-the-books method. See, e.g., PLR 9427033 (April 13, 1994).

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## Section 382 Continuity of Business Enterprise

- Continuity of business requirement – If the corporation does not continue the business enterprise that it conducted prior to the ownership change at all times during the 2 year period beginning on the change date, the Section 382 limitation is zero. IRC § 382(c).

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## Section 382 Definition of “Ownership Change”

- Events that could result in an ownership change include:
  - Stock purchase/sale
  - Issuance
  - Redemption
  - Conversion
  - Section 351 exchange
  - Corporate split-off
  - Corporate reorganization

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## Section 382 Definition of "Ownership Change"

- In applying the test, the methodology is:
  - Identify each 5 percent shareholder whose stock ownership has increased compared with such shareholder's lowest stock ownership percentage during the testing period.
  - Total the increases of each such 5 percent shareholder and determine whether the sum amounts to more than 50 percent.

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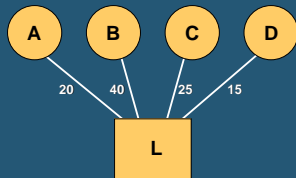
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## Section 382 Ownership Change – Example



Facts: In year 1, C buys 40 shares from B. In year 2, D buys 20 shares from C.

Conclusion: C's ownership has increased from 25% to 45% (20%) and D's ownership has increased from 15% to 35% (20%). The total increase by 5% shareholders is less than 50% (40%) and, therefore, an ownership change has not occurred.

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## Section 382 Definition of "Ownership Change"

- Special rules:
  - All stock percentage calculations are based on value, not vote. IRC § 382(k)(6)(C).
  - Options and warrants may be treated as exercised in certain situations. Treas. Reg. § 1.382-4(d)(1).
  - "Plain vanilla" preferred stock is ignored (generally, non-voting, non-convertible stock with a fixed coupon). IRC § 382(k)(6)(A).

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**Section 382**  
**Stock Ownership Percentage Based on Value**

- A stockholder's stock ownership is measured by the percentage of the fair market value of the stock owned by the shareholder compared to the fair market value of the outstanding stock of the company.
- Each share with the same terms is treated as having the same value (i.e., no control premium or blockage discount). Treas. Reg. § 1.382-2(a)(3)(i).
- Any change in the proportionate ownership that is attributable solely to fluctuations in the relative fair market values of different classes of stock shall not be taken into account. Thus, increases or decreases in the value of the company generally should not cause an ownership change, but the rule is not entirely clear. IRC § 382(l)(3)(C).

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**Section 382**  
**Fluctuation in Value – Example 1**

- L is a loss corporation with common and preferred stock outstanding. At the time L incurs its losses, the preferred stock is worth \$100 (its face amount) and the common stock is worth \$900. Thus, the common shareholders own 90% of the corporation by value. Two years later, the value of L drops dramatically to \$150. The preferred stock continues to be worth \$100, but the common stock declines in value to \$50. Thus, based on value, the preferred stockholder has increased its ownership in L from 10% to 66%.
- Has an ownership change occurred? Probably not, because the change is due solely to fluctuations in value.

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**Section 382**  
**PLRs on Fluctuation in Value Issue**

- The IRS has stated in several PLRs that:
  - “On any testing date, in determining the ownership percentage of any 5% shareholder, the value of such shareholder's stock, relative to the value of all other stock of the corporation, shall be considered to remain constant since the date that shareholder acquired the stock; and the value of such shareholder's stock relative to the value of all other stock of the corporation issued subsequent to such acquisition date shall also be considered to remain constant since that subsequent date.”
- PLR 200411012 (12/5/03); PLR 200511008 (12/6/04); PLR 200520011 (2/18/05); PLR 200622011 (2/2/06).

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**Section 382**  
**Fluctuation in Value – Example 2**

- On Date 1, A owns all of the common stock of L, a loss corporation. The FMV of A's stock is \$80.
- On Date 2, the fair market value of the common stock has remained constant at \$80. On that day, B pays \$20 for all of the preferred stock of L. The liquidation preference of B's stock is \$20.
- **Analysis:** No ownership change occurred on Date 2 because, in terms of fair market value, B acquired only 20% of the L's stock.

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**Section 382**  
**Fluctuation in Value – Example 2 (cont'd)**

- On Date 3, the common stock has collapsed in value to \$5, while B's preferred shares, as a result of their liquidation preference, have retained their value of \$20.
- **Analysis:** On Date 3, B holds 80% of L by value and A owns 20%. If Date 3 were a testing date, B would have a 60% increase in proportionate ownership and A would have a 60% decrease.
- Under the principle set forth in the PLRs, the value of B's preferred stock is considered to remain constant since Date 2, when he acquired his preferred stock. Thus, B is still considered to own 20% of L's stock (\$20 / \$100).
- Similarly, A is considered to still own 80% of L's stock because the value of his common stock relative to the value of B's preferred stock is considered to remain constant since Date 2 (the date that the preferred stock was issued to B).

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**Section 382**  
**Fluctuation in Value – Example 2 (cont'd)**

- On Date 4, C acquires all of B's preferred stock for \$20.
- **Analysis:** C's percentage ownership on Date 4 would be 80%, reflecting his actual acquired ownership percentage, rather than 20% (which is B's relative percentage ownership based on the date B acquired the preferred stock).
- Under the principle set forth in the PLRs, C's 80% ownership will be considered to remain constant from Date 4 (the date that C acquired the preferred stock) even if the relative value of the common stock increases after Date 4.

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## Section 382 Certain Options and Warrants Deemed Exercised

- An option is treated as exercised for ownership change purposes only if the option is issued or transferred “with a principal purpose of avoiding or ameliorating an ownership change” and it satisfies one of the following three tests:
  - **Ownership Test.** Was the option issued to avoid or ameliorate the impact of an ownership change by providing the holder of the option, prior to its exercise, with a substantial portion of the attributes of ownership of the underlying stock?
  - **Control Test.** Did the holder and any related persons directly or indirectly own more than the 50% of the company counting the options as exercised?
  - **Income Test.** Does the issuance of an option facilitate the creation of income (including accelerating income or deferring deductions) or value (including unrealized built-in gains) prior to the exercise or transfer of the option?
- Treas. Reg. § 1.382-4(d)(1).

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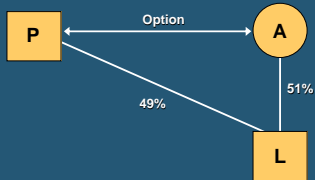
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## Section 382 Option – Example



Facts: P buys 49% of L with an option to buy the remaining 51%. P's 49% stock (by value) has 60% of vote.

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## Section 382 Certain Options and Warrants Deemed Exercised (cont'd.)

- Employee stock options generally are not deemed exercised.
- Warrants or options that have a nominal exercise price (e.g., one penny) are generally deemed exercised.
- Preferred stock generally is not deemed converted into common.

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**Section 382**  
**Identifying 5% Shareholders**

- General rule: a “5 percent shareholder” is an individual or “public group” that, directly or indirectly through intermediate entities, owns 5 percent or more of the stock (by value) of the corporation being tested for an ownership change. IRC § 382(k)(7).
- A “public group” is a group of individuals, entities or other persons each of whom owns less than 5 percent of the corporation. There can be (and there often are) more than one public group. IRC § 382(g)(4)(A).

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**Section 382**  
**Identifying 5% Shareholders**

- Application of attribution rules
  - The stock of the loss corporation is attributed upstream proportionately to the ultimate individual owners of intermediate entities (without regard to the threshold requirements under Section 318). IRC § 382(l)(3)(A)(ii).
  - Currently, there is no downstream attribution of the loss corporation stock to an entity from its owner.
    - However, future regulations could provide otherwise. IRC § 382(l)(3)(A)(iii).

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**Section 382**  
**Aggregation and Segregation Rules**

- The aggregation rules generally apply to treat all less-than-5% shareholders as a single 5% shareholder (a “public group”).
- The segregation rules generally apply, in the case of certain transactions (such as reorganizations, stock issuances and redemptions), to separate certain less-than-5% shareholders that would otherwise be treated as a single public group into two or more public groups

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**Section 382**  
**Treatment of Investment Advisors and Mutual Funds**

- In several PLRs, the IRS has distinguished between “economic ownership” and “reporting ownership” for purposes of identifying 5% shareholders
  - Under these rulings, investment advisors that do not have the right to dividends or proceeds from the sale of stock are not treated as the economic owners of such stock. Rather, the clients of the investment advisor are the economic owners of the stock.
    - A loss corporation generally can rely on statements made by an investment advisor in its public filings (Schedules 13D and 13G) that no client owns 5% of the corporation’s stock. Thus, the corporation may treat the clients as part of the public group.
    - However, a corporation may have a duty to investigate further where the public filings are silent. See PLR 200747016.
  - On the other hand, mutual funds typically are treated as the economic owners of the loss corporation’s stock.

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**Section 382**  
**Recognized Built-in Gains and Losses**

- Special rules apply to “built-in” gains and losses recognized within 5 taxable years of the ownership change. In general:
  - The Section 382 limitation is increased for any recognized built-in gains (“RBIGs”) in the year those gains are recognized.
  - Deductions for recognized built-in losses (“RBILs”) are subject to the Section 382 limitation along with pre-change losses. IRC § 382(h).
- Important: foregoing rules only apply if the loss corporation has a **net** unrealized built-in gain (“NUBIG”) or a **net** unrealized built-in loss (“NUBIL”) which exceeds de minimis amount (lesser of \$10 million or 15% of FMV of assets).

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**Section 382**  
**NUBIL Example**

- P acquires 100% of stock of L from unrelated shareholders.
- L has two assets: Asset A (FMV \$100/Basis \$0) and Asset B (FMV \$0/Basis \$100). L also has a \$100 NOL.
- One year after P acquires L, L sells Asset B for a \$100 loss.
- L did not have a NUBIL and, therefore, Section 382 does not limit L’s use of the \$100 loss.

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### Section 382 Built-In Income and Deduction

- As noted above, RBIGs increase the Section 382 limitation and RBILs are subject to the Section 382 limitation.
- Section 382(h)(6)(A) provides that any item of income “properly taken into account during the recognition period” is treated as RBIG if the item is “attributable to periods before the change date.” A similar rule is provided for built-in deductions.
- The theory is that items economically accruing before the change date should be subject to Section 382 in the same manner as if they had actually been recognized before the change date. Example – COD income triggered after the change date.

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### Section 382 Built-In Income and Deduction

- Notice 2003-65 provides taxpayers two safe harbor approaches for applying Section 382(h)(6) to built-in items:
  - Section 1374 Approach
  - Section 338 Approach

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### Section 1374 Approach

- **Overview** – Under the 1374 approach, NUBIG or NUBIL is the amount of gain or loss that would be recognized in a hypothetical sale of the assets of the loss corporation immediately before the ownership change.
- **Gains and Losses from Sale or Exchange of Assets** – The amount of gain or loss recognized during the recognition period on the sale or exchange of an asset is RBIG or RBIL. The sum of the RBIG or RBIL attributable to an asset cannot exceed the unrealized built-in gain or loss in that asset on the change date.

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## Section 1374 Approach (cont'd.)

- **Items of Income and Deduction** – In cases other than sales and exchanges, the 1374 approach generally relies on the accrual method of accounting to identify income or deduction items as RBIG or RBIL, respectively. Items of income or deduction during the recognition period are treated as RBIG or RBIL, respectively, only if an accrual method taxpayer would have included the item in income or been allowed a deduction for the item before the change date.
- **Example:** Immediately before an ownership change, LossCo, which uses the cash method of accounting, has a \$50 account receivable with a fair market value of \$40 and a basis of zero. In Year 2 of the recognition period, LossCo sells the account receivable for \$40 before collecting any part of it. LossCo has \$40 of RBIG in Year 2.

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## Section 1374 Approach (cont'd.)

- **Income Generated by Built-In Gain Assets** – In general, the 1374 approach does not treat income from a built-in gain asset during the recognition period as RBIG because such income did not accrue before the change date.
- **Example:** LossCo has a NUBIG of \$300,000 that is attributable to several non-amortizable assets with an aggregate fair market value of \$650,000 and an aggregate adjusted basis of \$500,000, and a patent with a fair market value of \$170,000 and an adjusted basis of \$20,000. This patent is an "amortizable Section 197 intangible" as defined in Section 197(c). In Year 1 of the recognition period, LossCo has gross income of \$75,000, \$20,000 of which is attributable to royalties collected in connection with the license of the patent. No part of the \$20,000 attributable to the royalties is RBIG in Year 1 because the income would not have been properly taken into account before the change date by an accrual method taxpayer. Accordingly, LossCo's Section 382 limitation for Year 1 is not increased by any part of that amount.

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## Section 338 Approach

- **Overview** – The 338 approach identifies items of RBIG and RBIL generally by comparing the loss corporation's actual items of income, gain, deduction, and loss with those that would have resulted if a Section 338 election had been made with respect to a hypothetical purchase of all the outstanding stock of the loss corporation on the change date (the "hypothetical purchase"). As a result, unlike under the 1374 approach, under the 338 approach, built-in gain assets may be treated as generating RBIG even if they are not disposed of at a gain during the recognition period, and deductions for liabilities, in particular contingent liabilities, that exist on the change date may be treated as RBIL.
- **Calculation of NUBIG and NUBIL** – Under the 338 approach, NUBIG or NUBILs are calculated in the same manner as under the 1374 approach.
- **Calculation of RBIG and RBIL** – The 338 approach identifies RBIG or RBIL by comparing the loss corporation's actual items of income, gain, deduction, and loss with the items of income, gain, deduction and loss that would result if a Section 338 election had been made for the hypothetical purchase.

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## Section 338 Approach – Wasting or Consumption of Built-In Gain Assets

- **Wasting Assets** – As described above, for loss corporations with a NUBIG, a 338 approach treats certain built-in gain assets of the loss corporation as generating RBIG even if such assets are not disposed of during the recognition period. The 338 approach assumes that, for any taxable year, an asset that had built-in gain on the change date generates income equal to the cost recovery deduction that would have been allowed for such asset under the applicable Code section if an election under Section 338 had been made with respect to the hypothetical purchase. Therefore, with respect to an asset that had a built-in gain on the change date, the 338 approach treats as RBIG an amount equal to the excess of the cost recovery deduction that would have been allowable with respect to such asset had an election under Section 338 been made for the hypothetical purchase over the loss corporation's actual allowable cost recovery deduction.

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## Section 338 Approach – Wasting or Consumption of Built-In Gain Assets

- **Example:**  
LossCo has a NUBIG of \$300,000 that is attributable to various non-amortizable assets with an aggregate fair market value of \$710,000 and an aggregate adjusted basis of \$500,000, and a patent with a fair market value of \$120,000 and an adjusted basis of \$30,000. The patent is an "amortizable Section 197 intangible" as defined in Section 197(c) for which ten years of tax depreciation remain. In Year 1 of the recognition period, LossCo has gross income of \$75,000. In Year 1, \$5,000 is RBIG attributable to the patent (the excess of the \$8,000 amortization deduction that would have been allowed had a Section 338 election been made with respect to a hypothetical purchase of all of the stock of LossCo (\$120,000 fair market value divided by 15, the amortization period) over \$3,000 (the actual allowable amortization deduction)). This \$5,000 of RBIG increases LossCo's Section 382 limitation for Year 1.

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## 338 Approach v. 1374 Approach Contingent Liabilities

- **Differing treatment of contingent liabilities**
  - **1374 approach:** A liability is taken into account only if it has accrued for tax purposes (i.e., contingent liabilities generally are not taken into account)
  - **338 approach:** A contingent liability is taken into account to the extent of the estimated liability
- **The 1374 approach often is the better approach for taxpayers with a NUBIL because contingent liabilities do not give rise to RBIL**

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### 338 Approach v. 1374 Approach Pick and Choose

- Notice 2003-65 allows taxpayers to use a different approach for each ownership change as long as one approach is applied to all items attributable to the ownership change

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### Section 382 Anti-stuffing Rule – Section 382(l)(1)

- Any capital contribution received by a loss corporation “as part of a plan a principal purpose of which is to avoid or increase any limitation” under Section 382 is not taken into account
  - Except as provided in the regulations, capital contributions during the 2 years prior to the ownership change are treated as part of such a plan
  - No regulations have been issued, but Congress intended that the following capital contributions be excepted from the 2 year presumption:
    - Capital contributions upon formation (but no BIL assets)
    - Capital contributions before the first year of the NOL or NUBIL
    - Capital contributions to continue business operations (e.g., payroll)

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### Section 382 Anti-stuffing Rule – Notice 2008-78

- Notwithstanding Section 382(l)(1), a capital contribution will not be presumed to be part of a plan solely as a result of having been made during the 2 year period
- Notice 2008-78 provided 4 safe harbors under which a capital contribution would not be considered part of a plan
- Taxpayers can rely on Notice 2008-78 for capital contributions occurring in tax years ending after September 25, 2008, until there is additional guidance

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**Section 382  
Anti-stuffing Rule – Notice 2008-78**

- **Safe Harbor 1**
  - The contribution was not made by a controlling shareholder (or a related party)
  - No more than 20% of L's stock was issued
  - There was no agreement, understanding, arrangement, or substantial negotiations at the time of the contribution regarding a transaction that would result in an ownership change
  - The ownership change occurs more than 6 months after the contribution

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**Section 382  
Anti-stuffing Rule – Notice 2008-78**

- **Safe Harbor 2**
  - The contribution is made by a related party but no more than 10% of L's stock is issued or the contribution is made by an unrelated party
  - In either case, there was no agreement, understanding, arrangement or substantial negotiations at the time of the contribution regarding a transaction that would result in an ownership change
  - The ownership change occurs more than 1 year after the contribution

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**Section 382  
Anti-stuffing Rule – Notice 2008-78**

- **Safe Harbor 3**
  - The contribution is made in exchange for the stock issued in connection with the performance of services, or stock acquired by a retirement plan, under the terms and conditions of Reg. § 1.355-7(d)(8) or (d)(9), respectively
- **Safe Harbor 4**
  - The contribution is received on the formation of L (not accompanied by BIL assets) or it is received before the first year of the NOL or NUBIL

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## Section 382 Stock v. Nonstock

- Treating “Nonstock” (e.g., debt) as “stock”
  - Nonstock will be treated as stock if:
    - At the time of its issuance or transfer, “such interest offers a potential significant participation in the growth of the corporation,”
    - Treating the interest as stock would result in an ownership change, and
    - The loss corporation’s NOL exceeds a specified de minimis amount (i.e., twice the FMV of the loss corporation stock multiplied by the long-term tax-exempt rate)
    - Treas. Reg. § 1.382-2T(f)(18)(iii)

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## Section 382 Application of “Nonstock” to “Stock” Rule

- Suppose debt has interest contingent on L’s earnings
- Suppose debt is trading at a discount
- Suppose debt is convertible
- Rather than debt, suppose the instrument is Section 1504(a)(4) preferred stock

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## Section 382 Bankruptcy Rules

- Two special rules exist for ownership changes occurring in a bankruptcy case:
  - **Section 382(l)(5)** – Provides a one-time “free pass” from the Section 382 rules for ownership changes in a limited class of bankruptcy cases.
  - **Section 382(l)(6)** – Provides for a higher Section 382 limitation than would otherwise apply in cases not falling under Section 382(l)(5).

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## Section 382 Bankruptcy Rules

- Under Section 382(l)(5), no Section 382 limitation will apply if:
  - The corporation is, immediately before the ownership change, under the jurisdiction of a court in a title 11 or similar case;
  - The transaction resulting in the ownership change is ordered by the court or pursuant to a plan approved by the court; and
  - The shareholders and “old and cold” creditors of the corporation as of the time immediately before the ownership change own at least 50 percent of the corporation’s stock following the ownership change.

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## Section 382 Bankruptcy Rules

- Old and cold creditors include:
  - Creditors who held their debt for at least 18 months prior to the filing of the title 11 case (bonds owned by “vultures” may not qualify); and
  - Creditors who have continuously held debt of the corporation that arose in the ordinary course of the corporation’s business.
    - *E.g.*, trade debt, liabilities arising from employment relationships, tort claims, etc.
    - A claim that arises upon the rejection of a burdensome contract or lease also qualifies as ordinary course indebtedness.

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## Section 382 Bankruptcy Rules

- Drawbacks of the Section 382(l)(5) exception:
  - The Section 382 limitation will be zero if there is another ownership change within 2 years.
  - Pre-change NOLs are reduced by the amount of any interest paid or accrued by the corporation during the three years prior to the date of the ownership change on debt that was converted into equity.
  - Ancillary issue: A corporation’s NOL carryforward is reduced by any COD income excluded under Section 108.
  - Because of the drawbacks, a corporation may elect not to have Section 382(l)(5) apply.

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### Section 382 Bankruptcy Rules

- Section 382(l)(6) provides that if Section 382(l)(5) does not apply, the value of the corporation for purposes of determining the Section 382 limitation shall reflect the increase in value resulting from any surrender or cancellation of creditors' claims in the transaction.
- Under this provision, the Section 382 limitation will be based on the lesser of:
  - The value of the stock of the corporation immediately after the ownership change; or
  - The value of the corporation's assets immediately before the ownership change.

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### Section 382 Bankruptcy Rules

- Section 382(l)(6) Example:
  - L has assets with a fair market value of \$250 million and debt of \$300 million. Y does an in-bankruptcy restructuring in which its creditors exchange the \$300 million of debt for \$200 million in new debt plus all of the common stock in Y. The existing equity holders receive nothing.
  - Without Section 382(l)(6), and assuming Section 382(1)(5) does not apply, the Section 382 limitation would be zero because the company's stock had no value immediately before the ownership change.
  - With Section 382(l)(6), the Section 382 limitation is \$50 million (i.e., the value of Y's stock immediately following the ownership change) multiplied by the tax-exempt rate.

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### Section 382 Application to Consolidated Groups

- Overview: Single Entity Theory
- Determine the following on a group basis (v. entity by entity):
  - Ownership Change
  - Amount of Section 382 Limitation
  - NUBIG/NUBIL
  - COBE

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## Section 382 Consolidated Ownership Change

- **Parent Change Method.** The general rule is that if the common parent of the loss group experiences an ownership change, all of the loss group's pre-change consolidated Section 382 attributes become subject to the consolidated Section 382 limitation. Although an individual subsidiary may not experience an ownership change on a separate company basis, its share of the consolidated NOL will be subject to the Section 382 limitation.
- **Supplemental Method.** The supplemental method is an anti-abuse rule. The supplemental method aggregates increases in percentage ownership by a 5% shareholder of the common parent in both the subsidiary and the common parent during a three-year period if such increases are pursuant to a "plan or arrangement."

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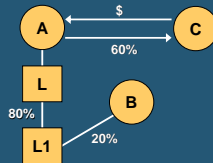
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## Section 382 Consolidated Ownership Change - Example



**Facts:** Individual A owns all the stock of L, which files a consolidated return with its 80% owned subsidiary, L1. Individual B owns the other 20% of L1. During 2007, the L group incurred a 100 consolidated NOL, attributable entirely to L1. On August 1, 2008, A sold 60% of its L stock to C, an unrelated individual.

**Conclusion:** The stock sale causes an ownership change with respect to the L-L1 group. Note that L1 did not experience an ownership change on a separate company basis (i.e., L1 has experienced only a 48% ownership shift).

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## Section 382 Consolidated NUBIG/NUBIL Determination – Example



**Facts:** L has Asset A (FMV \$100 / Basis \$0). L1 has Asset B (FMV \$0 / Basis \$100) and a \$100 NOL.

**Conclusion:** On a separate company basis, L has a NUBIG and L-1 has a NUBIL. But L-L1 group has no NUBIG or NUBIG.

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## Section 382 Preventing an Ownership Change - Examples

- Pilgrim's Pride Corporation
  - In connection with a bankruptcy reorganization, Pilgrim's Pride requested that the Bankruptcy Court approve the following plan to monitor and restrict trading of its stock in order to prevent an ownership change:
    - Shareholders owning 4.75% or more of the corporation's stock must provide notice of its stock ownership
    - 30 days prior to any proposed transfer of stock that would result in the disposition or acquisition of 4.75% or more of the corporation's stock, the proposed transferor and transferee must provide notice of its intent to dispose of or acquire such stock
    - The corporation has 25 days after receiving notice to object to any proposed transfer of its stock
    - Unauthorized transfers are void *ab initio*

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## Section 382 Preventing an Ownership Change - Examples

- PLR 8949040
  - Facts: L recently underwent a bankruptcy reorganization and proposed to amend its articles of incorporation to provide that a purported transfer of its stock would not be effective to the extent that the transfer would increase the transferee's ownership above 4.5%. If such a transfer occurred, L would be entitled to force the acquiror to transfer the excess shares to an agent, who would sell such excess shares to the public and return the proceeds to the acquiror.
  - The IRS ruled that, as long as the plan was enforceable under local law, it would suffice to treat the acquisition as never having occurred.

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## Section 382 Preventing an Ownership Change - Examples

- Loral Space & Communications, Ltd. and WorldCom, Inc.
  - Both of these corporations disclosed in public filings that their certificate of incorporation, bylaws and stock certificates shall contain provisions that
    - (i) prevented any member of the public group from acquiring 4.75% or more of its stock, and
    - (ii) prevented any existing 4.75% shareholder from acquiring additional shares.
- Similar restrictions should be effective outside of a bankruptcy context

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## Section 382 Bailout Notices

- **Notice 2008-76:** The IRS announced that upcoming regulations will provide that the Treasury's acquisition of a corporation's obligations or other securities pursuant to the Housing and Economic Recovery Act of 2008 will not be treated as a "testing date."
- **Notice 2008-83:** This Notice, which provided that a bank's bad debt deductions would not be treated as a BIL, was repealed by the American Recovery and Reinvestment Act of 2009.
- **Notice 2008-84:** The IRS announced that upcoming regulations will provide that the term "testing date" does not include any date as of the close of which the U.S. directly or indirectly owns a more-than-50-percent interest in a loss corporation.
- **Notice 2008-100:** The IRS provided favorable guidance on the application of Section 382 to loss corporations whose instruments are acquired by the Treasury Department under the Capital Purchase Program (CPP) pursuant to the Emergency Economic Stabilization Act of 2008.
- **Notice 2009-14:** The IRS provided additional favorable guidance with respect to the application of the rules set forth in Notice 2008-100 to certain other Emergency Economic Stabilization Act programs, (i) the CPP for publicly-traded issuers, (ii) the CPP for private issuers, (iii) the CPP for S corporations, (iv) the Target Investment Program, and (v) the Automotive Industry Financing Program.

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## SRLY Rules

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## SRLY Rules Overview

- **General Rule.** When a loss corporation joins a consolidated group, the SRLY regulations allow the group to utilize the loss corporation's pre-existing NOLs only against the loss corporation's share of consolidated net income. Treas. Reg. § 1.1502-21(c).
- **Built-in Losses.** Like Section 382, the SRLY rules apply to built-in losses as well as NOLs.
- **Creeping Acquisitions.** The SRLY rules apply to a new member of an affiliated group without regard to the degree of ownership change that occurs when the new member joins the group.

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## SRLY Rules Creeping Acquisition – Example

- **Facts:** P has owned 75% of L for several years. During that period, L has incurred significant NOLs. Now P acquires another 5% of L's subsidiary stock and includes L in its consolidated group.
- **Conclusion:** L's NOLs are subject to the SRLY limitation.

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## SRLY Rules Non-Applicability in Section 382 Overlap

- **General Rule.** When a corporation becomes a member of a consolidated group (a “SRLY event”) within six months of the change date of an ownership change that gives rise to a Section 382 limitation with respect to NOL carryover (a “Section 382 event”), the SRLY rules will not apply to such corporation’s NOL carryover.
- **Coextensive Subgroups.** The overlap rule only applies if the SRLY loss subgroup is coextensive with (i.e., identical to) the Section 382 loss subgroup.

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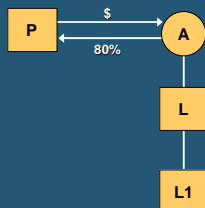
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## SRLY Rules Section 382/SRLY Overlap – Example



**Facts:** P buys 80% of L stock from A, an unrelated individual. L has both a SRLY event and a Section 382 event. L-L1 group constitutes both a Section 382 subgroup and a SRLY subgroup.

**Conclusion:** The NOLs of L and L1 are not subject to the SRLY rules.

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### SRLY Rules

Loss Subgroup Election Under Treas. Reg. § 1.1502-91(d)(4)

```

    graph TD
      P -- "$" --> T
      T -- "L + L1 stock" --> P
      T --> L
      T --> L1
      L --> L2
  
```

L, L1 and L2 are all members of the same SRLY subgroup but they do not comprise a Section 382 subgroup. Absent the -91(d)(4) election, the SRLY restrictions would apply to the losses of L, L1 and L2.

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### SRLY Rules

#### Planning Opportunities

- **Merger.** Merge SRLY member with a profitable member.
- **Conversion to LLC.** Convert SRLY member into a single-member LLC which is disregarded so that parent's income will count when computing SRLY limitation.
- **Stuffing.** Parent contributes income generating assets to SRLY member.

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### SRLY Rules

#### Stuffing - Conduit Transactions

```

    graph TD
      P -- "Asset A" --> S
      S -- "$" --> 3P
      3P -- "Asset A" --> S
  
```

Facts: Shareholder P contributes Asset A with built-in gain to S. S promptly sells Asset A to third party and shelters gain on Asset A with S's SRLY NOLs.

Business Purpose: *Stewart v. Comm'r*, T.C. Memo 1982-209, *aff'd*, 714 F.2d 977 (9th Cir. 1983); *Kluener v. Comm'r*, T.C. Memo 1992-579, *aff'd*, 154 F.3d 630 (6th Cir. 1998); *Hallowell v. Comm'r*, 56 T.C. 600 (1971); *W. & K. Holding Corp. v. Comm'r*, 38 B.T.A. 830 (1938).

Substance Over Form: *Comm'r v. Court Holdings*, 324 U.S. 331 (1943).

Section 482: *National Securities Corp. v. Comm'r*, 137 F.2d 600 (3d Cir. 1943); *Ruddick v. United States*, 643 F.2d 747 (Ct. Cl. 1981).

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### SRLY Rules Loss Waiver Election

Asset A  
FMV: \$200  
Basis: \$10

\$100 NOL

\$50 Basis

\$60 Basis

\$200

T Stock

Analysis: Without a loss waiver election, T2's \$100 expiring NOL reduces T1's stock basis in T2, creating a \$40 ELA in T1's T2 stock. This basis adjustment tiers up to T, creating a \$50 ELA in T's T1 stock. See Treas. Reg. § 1.1502-32(b)(4).

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## Planning Opportunities for Financially Distressed Partnerships

**Presented By:**  
**Thomas G. Hineman, J.D., LL.M.**

**MEADOWS, COLLIER, REED, COUSINS,  
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## Partnership Debt Workout Alternatives

1. Transfer encumbered property in satisfaction of all or part of the debt.
2. Reduction of the indebtedness in exchange for cash, without a transfer of property.
3. Modification of the terms of the existing indebtedness.
4. Forgiveness of the indebtedness in exchange for the issuance of a partnership interest to the creditor.
5. A combination of the foregoing alternatives.

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## Foreclosure

**Example.** Assume that Bubba and Bobby Partners owns real estate with a fair market value of \$500,000 and a basis of \$100,000, which secures a debt in the amount of \$700,000. The consequences of a transfer of that property in satisfaction of the indebtedness will either result in gain from a sale of the property or a combination of gain and COD income, depending on the nature of the debt as recourse or nonrecourse.

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## Foreclosure – Nonrecourse Debt

- **Nonrecourse Debt** – Sale gain to the extent the adjusted issue price of the debt exceeds the basis of the property transferred.
- **Partnership sale gain** = \$600,000 ( $\$700,000 - \$100,000$ ).

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## Foreclosure – Recourse Debt

- **Recourse Debt** – Sale gain to the extent the FMV of the property transferred exceeds the basis thereof and COD to the extent, if any, that the debt in excess of FMV of the property is discharged.
- **Partnership sale gain** = \$400,000 ( $\$500,000 - \$100,000$ ).
- **Partnership COD income** = \$200,000 if the \$200,000 debt in excess of FMV is discharged.

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## Reduction of Debt Alternative

- If the lender agrees to reduce the amount of the debt to the FMV of the property, without foreclosure, the debtor realizes COD income. Reg. § 1.61-12(a).
- COD income is ordinary.
- COD income may qualify for exclusion or deferral.
- **Partnership COD Income = \$200,000.**

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## Debtor Preference

- Debtor may prefer gain treatment to the extent that favorable capital gains rates are available.
- Alternatively, debtor may prefer COD treatment if debt discharge qualifies for an exemption under Sec. 108(a).
- **Gershkowitz** – Where partnership's nonrecourse debt is satisfied with cash, rather than foreclosure, the amount by which face value of debt exceeded cash paid constituted COD income.

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## Debtor Preference

- In light of *Gershkowitz*, insolvent partners may consider causing partnership to pay cash to creditor in nonrecourse debt workout, where possible.
- But see *2925 Briarpark, Ltd.* Apparently insolvent taxpayer with undercollateralized nonrecourse debt caused creditor to release the lien to permit a sale by debtor with agreement that proceeds be applied to pay down debt.
- **Held:** sale and cancellation of debt too closely intertwined so gain to extent debt exceeded basis.

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## Allocation of Partnership Debt Discharge Income

- Gain from a foreclosure sale is allocated in accordance with the terms of the partnership agreement so long as the substantial economic effect requirements of the §704 Regs. are satisfied.
- §704(c) must be considered in the allocation of gain from discharge income with respect to Sec. 704 property.

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## Allocation of Partnership Debt Discharge Income

- Substantial economic effect.
- Partnership minimum gain.
- §704(c) built-in gain.
- §731 deemed distributions.

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## Partner's Share of Recourse Liability

- A partner's share of recourse liability is the portion of the liability for which the partner, or a related person bears the economic risk of loss. Reg. §1.752-2.
- Economic Risk of Loss – A partner generally is considered to bear the economic risk of loss to the extent that if the partnership were constructively liquidated (after disposing of all assets in a taxable transaction for no consideration) the partner, or a related person is obligated to make a payment or contribution for which no right of reimbursement. Reg. §1.752-2(b)(1).

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## Economic Risk of Loss (cont.)

- All statutory and contractual obligations with respect to the partnership liability (e.g. guarantees, reimbursement agreements, indemnification agreement, capital contribution agreements and deficit restoration obligations are considered).
- Partner is considered to bear the economic risk of loss with respect to nonrecourse loan to the partnership by such partner, or a related party, to the extent no other partner bears the economic risk of loss for such liability.

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## Partner's Share of Nonrecourse Liabilities

- **First Tier:** Nonrecourse debt is first allocated in accordance with the partners' shares of partnership minimum gain
- **Second Tier:** Next nonrecourse debt allocated to partners in accordance with amount to be allocated to each partner under §704(c).
- **Third Tier:** Balance allocated in accordance with shares of profits or, alternatively, in manner in which it is reasonably expected the deductions attributable to such liabilities will be allocated.

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## Substantial Economic Effect

- Allocations will be respected under §704(b) if the allocations have substantial economic effect.
- Allocations must be consistent with the underlying economic relationship of the partners.
- Partners must agree to maintain capital accounts under rules of Reg. §1.704-1(b)(2)(iv) and liquidate according to positive capital account balances.

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## Substantial Economic Effect (cont.)

- Partners with negative capital account must agree to an unconditional deficit restoration obligation or satisfy alternate test for economic effect under Reg. §1.704-1(b)(2)(ii)(d).
- Rev. Rul. 92-97.

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## §731 Deemed Distribution

- A reduction in the partners' shares of partnership liabilities, resulting in COD income, is treated as a deemed distribution of cash. §§752(b) & §731(a).
- A partner's basis is first increased by share of COD income. §705(a)(1)(A).
- Deemed distribution then reduces basis. §733.
- Partners should avoid additional gain from deemed distribution so long as COD income is allocated in same manner as cancelled debt was allocated.

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## Sec. 108 COD Income Exclusions

- Bankruptcy in Title 11 Case. §108(a)(1)(A).
- Insolvency (to extent of insolvency). §108(a)(1)(B).
- Qualified Farm Indebtedness. §108(a)(1)(C).
- Qualified real property business indebtedness. §108(a)(1)(D).
- Qualified Principal Residence Indebtedness. §108(a)(1)(E).

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## Bankruptcy & Insolvency Exclusions

- Both exclusions are applied at the partner level for a partnership but at the entity level for an S corp.
- Unlike bankruptcy exclusion, insolvency exclusion applies only to extent of insolvency.
- **Insolvency Determination** – excess of liabilities over FMV of taxpayer's assets
  - Included assets
  - Nonrecourse liabilities
  - Contingent liabilities
  - Inclusion of partnership interests.

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## Reduction of Tax Attributes

- Cost of COD exclusion is reduction of tax attributes.
- **General Ordering Rules:**
  - NOLs
  - General business credits
  - Minimum tax credits
  - Capital loss carryovers
  - Basis of taxpayer's property
  - Passive activity loss & credit carryovers
  - Foreign tax credit carryovers

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## Alternate Basis Reduction

- Bankrupt or insolvent partner may elect to reduce the basis of depreciable property first.
- Election limited to depreciable property held by taxpayer as of start of taxable year following taxable year of discharge.
- Not required to fully reduce basis first.
- General rules apply to balance of discharge amount not covered by basis reduction election.
- Partnership interest as depreciable property.

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## Qualified Real Property Business Indebtedness

- Taxpayers, other than C corps, may elect to exclude CODI from discharge of "qualified real property business indebtedness ("QRPBI"). §108(a)(i)(D).
- QRPBI is indebtedness incurred in connection with real property used in a trade or business before 1/1/93 or incurred after that date to acquire, construct, reconstruct, or substantially improve such property.
- Partner level election
- Equity Limitation
- Basis Limitation
- Basis reduced to extent CODI is excluded. §108(c)(1)(A).

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## Partnership Debt-For-Equity Exchanges

- History of Debt-for-Equity Rules
- **Section 108(e)(8)**: on a partnership debt-for equity exchange the debt is deemed satisfied with money equal to FMV of partnership interest issued to creditor.
- **Proposed Regulations**
  - Safe harbor: partnership interest received by creditor valued at liquidation value.

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## Partnership Debt-For-Equity Exchanges

- **Safe harbor requirements:**
  - Maintain capital accounts in accord with Reg. §1.704-1(b)(2)(iv).
  - Everyone treat FMV of debt as equal to liquidation value for determining tax consequences.
  - Debt-for-equity transaction must be arm's length.
  - Neither partnership redeems, nor person related to partnership purchases, the debt-for-equity interest thereafter as part of a plan at the time of the exchange.

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## Partnership Debt-For-Equity Exchanges

- **Proposed Regulations: (Cont.)**

- Section 721 generally applies to Creditor but if FMV of the debt-for equity interest is less than the issue price of debt the partnership has COD income.
- No loss deduction for creditor.
- COD income allocated to those who were partners immediately before exchange.

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## Partnership Debt-For-Equity Exchanges

- **Gain from debt-for-equity liability reduction:**

- Reduction in liability results in deemed distribution to partners. §752(b).
- Distribution in excess of basis in partnership will cause gain. §731.
- COD income increases basis in partnership interest even if excluded under §108.
- Distribution deemed made on last day of tax year.
- If COD income is allocated consistent with liabilities deemed distribution should not trigger gain.

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## Existing Partners Debt-For-Equity Exchange

- §108(e)(6) (which treats shareholder contribution of debt to the corporate debtor as if the debt were settled for an amount equal to the shareholder's basis in debt) is not extended to partnerships.
- Where existing partner/creditors reduce the amount of partnership debt to them the transaction can result in COD income if the FMV of the partnership interests is less than the debt. [Compare contribution of debt by S corporation shareholder/creditor.]
- Contribution of cash which is then used to pay down debt may be better approach.

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## Stimulus Bill COD Deferral Election

- Taxpayer may elect to defer recognition of COD income for up to five years.
- Election requires a “reacquisition” of an “applicable debt instrument.”
- Applicable debt instrument is debt issued by (a) C corp., or (b) any other person *in connection with the conduct of a trade or business*.
- No OID Deduction to debtor for OID accruing before recognition of deferred COD income.

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## Stimulus Bill COD Deferral Election

- Exemptions under §108(a)(1)(A) – (D) not applicable if elect §108(i) deferral.
- For partnership, S corp. or other passthrough the election is made at the entity level.
- Acceleration of deferred COD.
- Deferred COD income allocated to partners in same manner as if COD recognized upon discharge.

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## Stimulus Bill COD Deferral Election

- Deferred §752 amount not a current distribution.
- Rev. Proc. 2009-37 addresses how to make the election and reporting requirements for partnership and partners.

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## Related Party Acquisition of Debt

- If debt is acquired by a related party (or acquired in anticipation of becoming related to debtor), debtor is treated as acquiring its own debt, thus triggering COD income.
- The amount of COD income is the difference between the adjusted issue price of the debt and the related party's adjusted basis.

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## Related Party Rules

- Related party determined by §§267(b) & 707(b)(1).
- 707(b) relationships include (a) partnership & person owning more than 50% of capital or profits (direct or indirect), and (b) two partnerships in which the same persons own more than 50% of capital or profits (again, directly or indirectly).
- Constructive ownership rules of §267(c)(1)(2)(4) & (5) apply in determining ownership.

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## Related Party Rules (cont.)

- For purposes of applying §267(c)(2) "family" includes an individual's spouse, children, grandchildren, parents and spouse of children and grandchildren (§108(e)(4)(B)).
- A sibling or grandparent the of debtor is not considered related for these purposes.

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## Bad Debt Deduction for Creditor Partner

- Deduction allowable for any valid debt which becomes worthless within the taxable year.
- If held by noncorporate partner loss allowed only to extent totally worthless and then treated as short term capital loss.
- Risk that bad debt loss of individual partner/creditor will be a nonbusiness bad debt.

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## Abandonment of Partnership Interest

- If the abandoning partner has a share of liabilities under §752 and abandonment results in a deemed distribution under §752(b) and §731, then there is a sale or exchange taxable as a capital loss.
- If abandoning partner has no share of liabilities then there is no "sale or exchange" and ordinary loss under §165.

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## Establishing Abandonment

- Notify all other partners in writing.
- Get written acknowledgement of abandonment, if possible.
- Have partnership agreement amended to reflect no longer a partner.
- Renounce any continuing liability and consider public notice via local newspaper.

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## Mandatory §754 Basis Adjustments

- §754 basis adjustment is mandatory if transfer of partnership interest with a "substantial built-in loss" ("SBIL").
- A SBIL occurs if the partnership's aggregate basis in partnership property exceeds the FMV of such property by at least \$250,000.

**Note:** While determination of the existence of a SBIL is made at the p'ship level, the resulting §754 basis adj. is based on the difference between the transferee partner's share of the inside basis of p'ship assets and his basis in the partnership interest.

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## Mandatory §754 Basis Adjustments

In case of death of a partner in a limited partnership for which discounts apply, and Partnership has an "SBIL", discounts don't affect determination of "SBIL" but once determined, discounts will exacerbate the impact of the mandatory basis reduction.

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## Mandatory §754 Basis Adjustments

**Example:** Billy Bob dies with a 30% interest in Double B, LP. Aggregate basis in p'ship assets = \$5.5M and FMV is \$5M. P'ship has SBIL. Billy Bob's 30% interest valued at \$975K after a 35% discount, and thus estate's basis of p'ship interest is \$975K. Estate's \$1.65M share of p'ship asset basis (\$5.5M X 30%) must be reduced by \$675K (\$1.65M - \$975K).

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## Mandatory §754 Basis Adjustments

- A partnership must also adjust basis of its property on a distribution under §734(b) if there is a “substantial basis reduction” (“SBR”).
- A SBR occurs if the sum of the following exceeds \$250K:
  - (a) any loss recognized by the distributee partner with respect to the distribution, or
  - (b) any excess of the distributee’s adj. basis for distributed property over p’ship’s basis for the property immediately before the distribution.

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