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ARTICLE

Proposed Regulations on Partnership Debt for Equity Exchanges — IRS Addresses Certain Outstanding Questions But Defers on Others

by Richard G. Blumenreich[*]
KPMG LLP[**]

On October 31, 2008, the Department of the Treasury issued proposed regulations relating to the application of §108(e)(8) of the Internal Revenue Code (''Code'') to partnerships and their partners.[1] Generally, §108(e)(8) applies to a partnership when a debtor partnership transfers an interest in the partnership to a creditor in satisfaction of its indebtedness (a so-called ''debt-for-equity'' exchange). As described below, the proposed regulations address certain key questions that are critical to the application of the section, but leave several questions unanswered. Comments are requested by the Department of the Treasury and the Internal Revenue Service (IRS) on both the issues addressed and those not addressed by the regulations. These regulations are proposed to apply to debt-for-equity exchanges occurring on or after the date the regulations are published as final regulations in the Federal Register.

BACKGROUND

Gross income includes income from discharge of indebtedness (''COD income'').[2] Generally, a taxpayer has COD income if the taxpayer's debt is cancelled for less than the amount of the debt. Thus, a taxpayer has COD income if the taxpayer's debt is satisfied with an amount of money, or fair market value of property, that is less than the amount of the taxpayer's debt.[3] Section 108 provides exceptions and special rules for determining COD income. Before its amendment by the American Jobs Creation Act of 2004 [4] (the ''2004 Act''), there were no statutory rules for determining COD income if a partnership satisfied its indebtedness with a partnership interest. However, there was a rule for determining COD income when a corporation satisfied its indebtedness with stock. Section 108(e)(8) provided that, for purposes of determining COD income, if a debtor corporation transfers stock to a creditor in satisfaction of its indebtedness, such corporation shall be treated as having satisfied the indebtedness with an amount of money equal to the fair market value of the stock.

Section 108(e)(8) was amended by the 2004 Act to include discharges of partnership indebtedness occurring on or after 2004.[5] With respect to partnerships, it provides that for purposes of determining COD income, if a debtor partnership transfers a capital or profits interest in such partnership to a creditor in satisfaction of its recourse or nonrecourse indebtedness, such partnership shall be treated as having satisfied the indebtedness with an amount of money equal to the fair market value of the interest. Any COD income recognized by the partnership under §108(e)(8) is required to be included in the distributive shares of the partners who were partners in the partnership immediately before the discharge.

There are potentially many issues in applying §108(e)(8) and the general partnership tax rules to a partnership debt-for-equity exchange. While the proposed regulations address several of these issues, other issues are identified but not addressed. These issues, how the proposed regulations address the issues, and potential planning opportunities associated with §108(e)(8) and the proposed regulations are discussed below.

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[1] Prop. Regs. §1.108-8, REG-164370-05, 73 Fed. Reg. 64903 (10/31/08). Except where otherwise provided, references in this article to ''section'' or ''§'' are to the Internal Revenue Code and the regulations thereunder.

[2] §61(a)(12).

[3] *See, e.g.*, Regs. §1.1001-2(c), Ex. (8).

[4] P.L. 108-357 §896(a), 118 Stat. 1418 (10/22/04).

[5] For discussions of the partnership debt-for-equity exception before the 2004 Act, see H. Ahrens, ''Partnership Equity for Debt Transactions as an Exception to the Realization and Recognition of Cancellation of Indebtedness Income: Fact or Fiction?'' 93 *Tax Notes Today* 171-68 (8/17/93), and N.Y.S.B.A. (Tax Section), ''Report on Certain Issues Relating to Troubled Partnership,'' *reprinted in* 93 *Tax Notes Today* 140-19 (7/12/93).

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ISSUES PRESENTED BY A DEBT-FOR-EQUITY EXCHANGE SUBJECT TO SECTION 108(e)(8)

For purposes of discussing the issues presented by §108(e)(8), assume the following facts:

> PRS, a partnership for federal income tax purposes, has three equal partners, A, B, and C. Upon formation of PRS in 2005, each partner contributed $200x in exchange for its one-third interest in the profits and capital of the partnership. PRS used $500x to purchase Property X. In addition, PRS borrowed $400x from Creditor (''Creditor Note'') and used those proceeds plus $100x of the contributed cash to purchase Property Y for $500x. The Creditor Note is secured solely by Property Y. Three years later, in 2008, when Property X and Property Y have fallen in value to $200x each, PRS enters into an agreement with Creditor to transfer to Creditor an interest in PRS in satisfaction of the Creditor Note.

PRS's agreement to transfer a partnership interest to Creditor in satisfaction of the Creditor Note is a ''debt-for-equity'' exchange to which §108(e)(8) applies. Again, §108(e)(8) provides that, for purposes of determining COD income of a debtor partnership, the partnership is treated as having satisfied the indebtedness with an amount of money equal to the fair market value of the interest transferred to the creditor. COD income arises to the extent that the amount of the debt satisfied by the receipt of property from the debtor exceeds the fair market value of such property. There are many issues that can arise in determining the federal income tax consequences of a debt-for-equity exchange. The following issues are identified in the proposed regulations:

(1) How is the fair market value of the partnership interest determined for purposes of applying §108(e)(8)?

(2) Does §721(a) apply to the exchange?

(3) If §721(a) applies, what is the creditor's basis and holding period in the partnership interest received in the exchange?

(4) If §721(a) applies generally, are there any exceptions to this treatment?

(5) Should there be special rules that supersede the rules under §453B relating to dispositions of installment obligations?

(6) Should the COD income arising from the debt-for-equity exchange be treated as a first-tier item under Regs. §1.704-2(f)(6) for purposes of the minimum gain chargeback rules?

(7) How are the rules in the noncompensatory partnership options regulations relating to convertible debt to interact with the rules in these §108(e)(8) proposed regulations?

THE PROPOSED SECTION 108(e)(8) REGULATIONS

The proposed regulations under §108(e)(8) specifically address issues (1) through (4).[6] They also identify, but do not address, issues (5) through (7), and indicate that there likely are even more issues relating to debt-for-equity exchanges. The IRS has requested comments on all of these issues.[7] The issues addressed by the regulations are discussed below.[8]

Issue (1) — Fair Market Value of the Partnership Interest

The proposed regulations provide that the fair market value of a partnership interest transferred by a debtor partnership to a creditor in satisfaction of the debtor partnership's indebtedness (debt-for-equity interest) is the liquidation value of the debt-for-equity interest under specified conditions. Liquidation value equals the amount of cash that the creditor would receive with respect to the debt-for-equity interest, if, immediately after the transfer, the partnership sold all of its assets (including goodwill, going concern value, and any other intangibles associated with the partnership's operation) for cash equal to the fair market value of those assets and then liquidated. The conditions for using liquidation value are:

(i) The debtor partnership determines and maintains the capital accounts of its partners in accordance with the capital accounting rules of Regs. §1.704-1(b)(2)(iv);

(ii) The creditor, debtor partnership, and its partners treat the fair market value of the indebtedness as being equal to the liquidation value of the debt-for-equity interest for purposes of determining the tax consequences of the debt-for-equity exchange;

(iii) The debt-for-equity exchange is an arm's length transaction; and

(iv) After the debt-for-equity exchange, neither the partnership redeems nor any person related to the partnership purchases the debt-for-equity interest

[6] 73 Fed. Reg. at 64903-04.

[7] *Id.* at 64904.

[8] The proposed regulations also ask whether there should there be a special allocation of the COD income by the partnership when the partnership indebtedness is owed to a pre-existing partner. This article does not address this question.

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> as part of a plan at the time of the debt-for-equity exchange which has as a principal purpose the avoidance of COD income by the partnership.[9]

The proposed regulations state that if the requirements above are not satisfied, all the facts and circumstances will be considered in determining the fair market value of a debt-for-equity interest for purposes of §108(e)(8).[10]

Requirement to Maintain Capital Accounts

The first requirement to treat the fair market value of the partnership interest received in the debt-for-equity exchange as its liquidation value is for the partnership to determine and maintain capital accounts of its partners in accordance with Regs. §1.704-1(b)(2)(iv).[11] The §704(b) regulations have as one requirement for meeting a safe harbor for economic effect the maintaining of capital accounts of the partners in accordance with Regs. §1.704-1(b)(2)(iv). Under that requirement, the capital account of a partner who contributes property to a partnership is increased by the fair market value of the contributed property.

Partnerships that comply with the §704(b) safe harbor for economic effect will meet this requirement. To meet this safe harbor, however, the partnership must also provide for liquidation based on capital accounts. Many partnerships today do not liquidate based on these capital accounts. These partnerships generally liquidate based on the provisions in the agreement that govern cash distributions. However, the proposed regulations do not require satisfaction of the economic effect safe harbor, just that the §704(b) capital account maintenance rules are followed. Thus, if these partnerships still determine and maintain the capital accounts of their partners in accordance with the regulations, they apparently could meet this requirement.[12]

One observation on this requirement is that the partnership indebtedness will not continue to be recorded as an asset of the partnership's §704(b) books after the contribution. A second observation is that on a contribution of property in exchange for an interest in the partnership, the capital account maintenance rules provide generally for the revaluation of the partnership assets to fair market value and the gain or loss on those partnership assets to be allocated to the partners immediately before the contribution.[13]

Fair Market Value of Indebtedness Equal to Liquidation Value

The second requirement that must be met in order to treat the fair market value of the debt-for-equity interest received as its liquidation value is that the creditor, debtor partnership, and its partners must treat the fair market value of the indebtedness as being equal to the liquidation value of the debt-for-equity interest for purposes of determining the tax consequences of the debt-for-equity exchange.[14] Thus, the partnership must increase the creditor's capital account by this liquidation value upon contribution. Second, the relevant parties must treat the fair market value of the indebtedness as equal to the liquidation value of the interest received in the exchange.

The proposed regulations provide that the liquidation value is the amount of cash that the creditor would receive with respect to the debt-for-equity interest if, immediately after the transfer, the debtor partnership sold all of its assets (including goodwill, going concern value, and any other intangibles associated with the partnership's operations) for cash equal to the fair market value of those assets and then liquidated.[15] The preamble to the proposed regulations states that, if a partnership maintains capital accounts in accordance with the capital accounting rules of Regs. §1.704-1(b)(2)(iv), the amount by which the creditor's capital account is increased as a result of the exchange will equal the fair market value of the indebtedness exchanged.[16]

Applying the capital account maintenance rules to a debt-for-equity exchange, it would appear that the partnership would revalue the assets on its books to reflect the fair market value of the assets (taking into account §7701(g)),[17] and allocate the appreciation and/or depreciation in value of the assets to its partners immediately before the debt-for-equity exchange. Then, the extinguished debt would be eliminated from the balance sheet of the partnership and the creditor would receive an interest in the capital and profits of the partnership. For purposes of determining the federal income tax consequences of the debt-for-equity exchange, the creditor would be treated as receiving an amount of money equal to the amount of cash the creditor would receive with respect to the debt-for-equity interest in a deemed liquidation of the partnership immediately after the exchange.

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[9] Prop. Regs. §1.108-8(b)(1).

[10] Prop. Regs. §1.108-8(b)(2).

[11] Prop. Regs. §1.108-8(b)(1).

[12] At a Feb. 11, 2009 DC Bar Taxation Section luncheon (''DC Bar Luncheon''), the government panelists indicated that the §704(b) safe harbor requirement to liquidate in accordance with capital accounts was not intended to be a requirement to use liquidation value. *See* 2009 *TNT* 27-2.

[13] Regs. §1.704-1(b)(2)(iv)*(f)*.

[14] Prop. Regs. §1.108-8(b)(1)(ii).

[15] Prop. Regs. §1.108-8(b)(1).

[16] 73 Fed. Reg. at 64903; *see* Regs. §1.704-1(b)(2)(iv)*(b)* and *(d)*.

[17] *See* Regs. §1.704-1(b)(2)(iv)*(f)(i)*.

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Applying these rules to the facts of the Example above, immediately before the exchange, PRS would revalue its Property X and Property Y to fair market value, taking §7701(g) into account. As such, Property X would be reduced to $200x. With respect to Property Y, immediately before the debt-for-equity exchange, Property Y is still subject to the $400x nonrecourse debt. Thus, under a literal interpretation of the §704(b) regulations, the value of Property Y would be reduced to $400x ($200x value, but not less than the nonrecourse debt of $400x). This would result in a combined $400x book loss on Property X and Property Y that would be allocated $133x each to A, B, and C, reducing their capital accounts to approximately $67x each. Then, in the debt-for-equity exchange, the $400x debt would be extinguished in exchange for an interest in PRS. Assume, for purposes of continuing the Example, that the partnership agreement was amended to give Creditor a 50% interest in the profits of PRS and to credit Creditor's capital account for $200x.

If PRS were to then sell all of its assets and liquidate, PRS would have a further loss of $200x on Property Y ($200x value less $400x book basis). As this loss existed before the admission of Creditor to PRS, applying §704(c) principles, the loss should be allocated solely to A, B, and C. Query whether a better approach to accounting for this built-in loss would be to not take into account the $400x of nonrecourse debt (that was extinguished in the exchange) in determining the value of Property Y in the revaluation. As such, the value of Property Y would be reduced to $200x on the revaluation and the $300x loss on Property Y would be allocated $100x each to A, B, and C, reducing each of their capital accounts to zero. Assuming the $200x capital account represented the fair market value of the indebtedness, PRS would also recognize $200x of COD income, which would be allocated to A, B, and C, $67x each, increasing their capital accounts to $67x each. As such, upon a liquidation, PRS would have assets worth $400x. A, B, and C would receive $67x ($200x in total) and Creditor would receive $200x. Thus, the liquidation value of Creditor's interest would be $200x and Creditor, PRS, A, B, and C would treat that amount as the fair market value of the interest in PRS received in satisfaction of the $400x debt for purposes of determining the federal income tax consequences of the debt-for-equity exchange.

As can be seen from the Example, the liquidation value approach does not take into account the value of the profits interest received in the debt-for-equity exchange. That is, under a liquidation value approach (as in the case of receipt of a partnership profits interest for services provided to or for the benefit of the partnership),[18] the value of the partnership interest is determined solely by reference to the capital interest received. To illustrate this point, assume in the above Example that, instead of receiving a 50% interest in the profits and a $200x capital account, Creditor received a capital account of $100x in exchange for the debt. In addition, the partnership agreement provided that the first $150x of profits would be allocated to Creditor and, thereafter, Creditor would share in 50% of the profits. The liquidation value of the debt-for-equity interest would be $100x, implicating a COD income realization of $300x. Conversely, if Creditor received a capital account of $300x and a share in 10% of the profits after the first $150x of profits were allocated to A, B, and C, the liquidation value of the debt-for-equity interest would be $300x and the COD income recognized would be $100x.[19]

If the parties do not believe liquidation value should be used as the value for this purpose, it appears that the parties could agree to apply a different value. That value would need to represent the fair market value of the interest in capital and profits received, determined by taking into account all the facts and circumstances, including potential minority, liquidity, and other discounts or premiums.

Arm's Length Transaction Requirement

The third requirement to treat the fair market value of the partnership interest received in the debt-for-equity exchange as its liquidation value is that the debt-for-equity exchange must be an arm's length transaction.[20] A debt-for-equity exchange results from a negotiation between the creditor and the partnership (on behalf of its partners) to have the creditor's debt satisfied with an interest in the partnership. The value of the assets of the partnership is central to these negotiations and to the determination of the liquidation value of the partnership. An arm's length transaction helps to determine that those values are fairly determined. It appears that an arm's length agreement can arise in the context of a related party transaction, provided that the negotiated terms are arm's length.[21]

No Principal Purpose to Avoid COD Income

The fourth requirement to treat the fair market value of the partnership interest received in the debt-

[18] *See* Rev. Proc. 93-27, 1993-2 C.B. 343.

[19] For a discussion of some of the issues surrounding this point, see Rubin et al., "New Partnership Debt-for-Equity Regulations Deny Lender's Losses," 2008 *TNT* 242-47 ("Rubin Report"); *see also* Schler, "Partnership Equity for Debt Exchanges," 2009 *TNT* 2-68 (commenting on the Rubin Report).

[20] Prop. Regs. §1.108-8(b)(1)(iii).

[21] At the DC Bar Luncheon, the government panelists indicated that participation by a related party would not preclude a partnership from using the safe harbor, provided that the agreement is arm's length. See note 12 above.

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for-equity exchange as its liquidation value is that, subsequent to the debt-for-equity exchange, neither the partnership redeems nor any person related to the partnership purchases the debt-for-equity interest as part of a plan at the time of the debt-for-equity exchange which has a principal purpose the avoidance of COD income by the partnership.[22] This rule could, for example, prevent the creditor from being given a high capital account to avoid COD income, but with a plan to subsequently redeem the interest, or have the interest purchased by a related party for a lower amount. The proposed regulations do not provide a definition of a related party for this purpose.

Issues (2) and (3) — Application of Section 721(a) to the Debt-for-Equity Exchange and Creditor's Basis and Holding Period in a Debt-for-Equity Exchange to Which Section 721(a) Applies

The proposed regulations provide that, except as otherwise provided in §721 and the regulations thereunder and notwithstanding the proposed regulations described above, §721 applies to a contribution of a partnership's recourse or nonrecourse indebtedness by a creditor to the debtor partnership.[23] In the preamble to the proposed regulations, the IRS and the Treasury Department state that the nonrecognition rule of §721 generally should apply to the creditor's contribution of the partnership indebtedness (other than unpaid interest or accrued original issue discount) to the partnership in exchange for the partnership interest.[24] The IRS and the Treasury Department believe that such a rule is consistent with the policy underlying §721 to defer the recognition of gain or loss where persons join together to conduct joint business (including investment).[25]

Section 721(a) applies to both the partnership and the contributing partner and prevents the recognition of gain or loss on a transfer of property to the partnership in exchange for a partnership interest. For the partnership, the proposed regulations provide the intended result. No gain or loss should be recognized by the partnership on the issuance of the partnership interest in exchange for the contribution of the partnership's note. For the creditor, however, the treatment under the proposed regulations can be problematic. This article addresses the potential exceptions to §721(a) treatment in the discussion of Issue (4) below.

For the contributing creditor, the preamble to the proposed regulations indicates that, as a result of applying §721 to a debt-for-equity exchange, the basis of the creditor's interest in the partnership is determined under §722.[26] Section 722 provides that the basis of an interest in a partnership acquired by a contribution of property, including money, to the partnership is the amount of such money and the adjusted basis of such property to the contributing partner at the time of the contribution, increased by the amount of gain (if any) recognized under §721(b) to the contributing partner at such time.

The preamble also indicates that the IRS and the Treasury Department believe that a creditor should not recognize a loss in a debt-for-equity exchange subject to §721 in which the liquidation value of the debt-for-equity exchange is less than the outstanding principal balance of the indebtedness.[27] Rather, the IRS and the Treasury Department believe that the creditor's basis in the debt-for-equity interest received in the debt-for-equity exchange is the same as the creditor's basis in the debt under §722, and that the debt-for-equity interest includes the creditor's holding period in the indebtedness under §1223(1).[28] There are several potentially significant federal income tax implications to the creditor under the government's guidance.

For a property contributor, gain or loss generally is measured by the difference between the fair market value of the property contributed and its adjusted basis. Thus, when the creditor contributes the note receivable to the partnership in exchange for a partnership interest, the note is property (at least in the hands of the creditor), and §721 should apply. Applying this rule to the facts of the Example above where Creditor contributed the $400x Creditor Note to PRS for a partnership interest with a liquidation value of $200x, the Creditor Note has a $200x unrealized loss. Assume also that the partnership interest received by Creditor has a fair market value of $200x. As such, under the proposed regulations and applying the government's guidance on basis, Creditor would recognize no gain or loss on the contribution of the Creditor Note and would take a basis of $400x in the partnership interest. Thus, the Creditor continues to have an unrealized loss of $200x that is reflected in the partnership interest received (fair market value of $200x and adjusted basis of $400x).

One possible issue arising from this result is that the Creditor Note is not a continuing asset of PRS. Ordinarily, when a person contributes property to a

[22] Prop. Regs. §1.108-8(b)(1)(iv).

[23] Prop. Regs. §1.721-1(d)(1).

[24] 73 Fed. Reg. at 64904.

[25] *Id.*

[26] *Id.*

[27] *Id.*

[28] *Id.*

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partnership, the partnership generally takes a carryover basis in the property such that any built-in gain or loss continues to be reflected in the assets of the partnership. Under §704(c), that built-in gain or loss in the contributed property is required to be allocated to the contributing partner. In the case of the contribution of the Creditor Note, the Creditor Note is extinguished upon the contribution and is not a continuing asset of PRS. As such, the built-in loss inherent in the Creditor Note will not be recognized by PRS and will not be allocated back to the Creditor. Furthermore, by treating the Creditor as having a basis of $400x in the partnership interest, the partners' aggregate basis in the partnership interests will be $200x greater than the partnership's basis in its assets, creating an ''inside-outside'' basis disparity. More specifically, after the contribution, the Creditor would have an ''outside'' basis of $400x while his share of the ''inside'' basis appears to be $200x. Creating an inside-outside basis disparity is not something that historically has been looked upon favorably by the IRS or the courts.[29]

One reason that inside-outside basis disparities in the world of partnerships can be problematic is that the disparity may be cured in ways that arguably create unintended consequences. As an illustration of the challenges associated with these rules, assume in the Example above that Creditor is a corporation that transferred the partnership interest received in the debt-for-equity exchange (along with other assets) to its subsidiary in exchange for stock in a §351 transaction. Assume further that the subsidiary took a carryover basis in the partnership interest. If PRS makes a §754 election for the year of the transfer, the subsidiary would be entitled to a positive §743(b) adjustment of $200x (the subsidiary's outside basis is $400x and its share of inside basis is $200x). The subsidiary would have a positive adjustment even though it has an unrealized loss in its partnership interest. This result appears appropriate because the predecessor partner, Creditor, was required to include the entire debt basis in its PRS basis even though it lost the built-in loss in the Creditor Note when it was extinguished upon the contribution. One would think that the rules would operate so that this lost basis would move to the basis of the other partnership assets, creating additional unrealized loss in the remaining assets to equalize inside and outside basis. Thus, it might appear appropriate to allocate the §743(b) adjustment $100x each to Property X and Property Y.

However, under the facts of the Example, the §755 regulations that provide the rules for allocating §743(b) adjustments to partnership properties do not allow the §743(b) adjustment to be allocated to either Property X or Property Y in this fact pattern. These regulations apply to basis adjustments under §743(b) that result from exchanges in which the transferee's basis in the partnership interest is determined in whole or in part by reference to the transferor's basis in that interest.[30] Specifically, these regulations provide that if there is a positive §743(b) adjustment to be allocated to partnership assets, such increase must be allocated to capital gain property or ordinary income property, respectively, only if the total amount of gain or loss [31] that would be allocated to the transferee (to the extent attributable to the acquired interest) from the hypothetical sale of all such property would result in a net gain or net income, as the case may be, to the transferee.[32] Where, under the preceding sentence, an increase in basis may be allocated to both capital gain assets and ordinary income assets, the increase shall be allocated to each class in proportion to the net gain or net income, respectively, which would be allocated to the transferee from the sale of all assets in each class.[33] In our example, because the subsidiary would not be allocated any net gain or net income from a sale of the partnership's assets, the subsidiary's §743(b) adjustment would go unallocated. Both Property X and Property Y would generate a loss, and the loss would be allocable to A, B, and C (to the extent of their shares of the reverse §704(c) loss that arose when Creditor entered the partnership).

Nevertheless, it would appear that Creditor is not without options to cause the potential §743(b) adjustment to be allocated to partnership property. Assume that after the debt-for-equity exchange in the Example above, Creditor contributes property to PRS. The property has a fair market value of $300x and an adjusted basis of $100x. Assume further that Creditor then transfers the partnership interest to a subsidiary in a substituted basis transaction. In this case, the subsidiary's §743(b) adjustment would be positive $200x (outside basis of $700x less inside basis of $500x). In this fact pattern, under the applicable §755 regulation, the total amount of gain or loss that would be allocated to the subsidiary from the hypothetical sale of all the partnership's property would result in a $200x net gain to the subsidiary.[34] As such, it appears that the positive $200x §743(b) adjustment, arguably, would be allocated to the contributed property.

Thus, while the proposed regulations take the position that, because §721(a) applies to the contribution, no gain or loss is recognized on the contribution and

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[29] *See, e.g., Salina Partnership L.P. v. Comr.*, T.C. Memo 2000-352, 80 T.C.M. at 698; Notice 99-57, 1999-2 C.B. 692.

[30] Regs. §1.755-1(b)(5).

[31] This includes any remedial allocations under Regs. §1.704-3(d).

[32] Regs. §1.755-1(b)(5)(ii).

[33] *Id.*

[34] *Id.*

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the contributor takes a basis in the partnership interest equal to the basis in the note, even if the principal due on the note exceeds the fair market value of the note, this position may not be mandated by the application of §721(a) to the transaction. That is, because the Creditor Note is not a continuing asset of PRS, the mechanics of Subchapter K are distorted and alternatives potentially considered.

One such alternative could be to view the contribution consistent with §108(e)(8). That is, for §108(e)(8) purposes, PRS is treated as satisfying the Creditor Note for an amount of cash equal to the fair market value of the partnership interest transferred to the Creditor. As such, PRS recognizes COD income of $200x. Consistent with this treatment, one could treat the Creditor as having a bad debt deduction to the extent that the adjusted basis in the Creditor Note exceeds the fair market value of the Creditor Note. That portion of the Creditor Note would not be satisfied and should be treated as wholly worthless. Creditor would be considered to contribute the Creditor Note with the remaining basis in a carryover basis transaction under §721(a) and §722. This approach generally would eliminate the inside-outside basis disparity in the facts of the Example. It is noted that an inside-outside basis disparity could still exist if Creditor was not the issuer of the debt, but purchased the debt at a premium or at a discount. However, this alternative approach might at least limit the extent of the inside-outside basis disparity in those circumstances.

This alternative approach seems to be consistent with the general principles of the disguised sale rules.[35] Under those rules, the substance of the transaction governs purported contributions of property to a partnership. In the case of a debt-for-equity exchange, the substance of the transaction is the contribution of property to the partnership to the extent of the fair market value of the contributed property, the forgiveness of debt by the partnership and corresponding worthless debt of the creditor to the extent that the amount of the debt exceeds the fair market value of the contributed property.

This approach also puts creditors that are unable to take partial worthless deductions in the same position after a debt-for-equity exchange as creditors that are able to take a partial worthless deduction.[36] For example, if Creditor is a corporation, Creditor could have taken a $200x partial worthlessness deduction under §166 before contributing the Creditor Note to the partnership. If it properly did so, upon contribution of the Creditor Note, Creditor would have a $200x basis in its partnership interest.[37]

Issue (4) — Exceptions to the General Application of Section 721(a) to a Debt-for-Equity Exchange

The proposed regulations except from the application of §721 a transfer of a partnership interest to a creditor in satisfaction of a partnership's recourse or nonrecourse indebtedness for unpaid rent, royalties, or interest on indebtedness (including accrued original issue discount).[38] This portion of the article addresses the interest (and accrued original issue discount) component of a debt-for-equity exchange. In that regard, the proposed regulations specifically refer taxpayers to the Treasury Regulations under §§446 and 1275 for rules applicable to a determination of whether a partnership interest transferred to a creditor is treated as interest or accrued original issue discount.[39] Under those rules, except in certain limited circumstances (e.g., certain pro rata prepayments), each payment under a loan is generally treated first as a payment of interest to the extent of the accrued and unpaid interest (determined under those regulations) as of the date the payment becomes due.[40]

Before a debt-for-equity exchange, typically there is an outstanding debt instrument on which interest has accrued but is unpaid. Assume in the Example that, in addition to PRS owing $400x on the Creditor Note, there is $60x of accrued but unpaid interest. Assume further that Creditor has included the accrued interest in income and that PRS has taken a deduction for the accrued interest. According to the proposed regulations, and applying the general rules in the §446 regulations, PRS would be treated as satisfying the accrued interest before principal due on the Creditor Note in the debt-for-equity exchange. As such, from Creditor's perspective, the accrued but unpaid interest of $60x would be treated as having been satisfied with a partnership interest having a value of $60x. Thus, Creditor presumably would have an adjusted basis of $60x in that portion of the partnership interest. Creditor would then be treated as receiving a partnership interest with a fair market value of $140x in exchange for the principal portion of the Creditor Note. Under

[35] *See* §707(a)(2)(B) and the regulations thereunder.

[36] Note, however, that for noncorporate creditors unable to take a partial worthless debt deduction because the debt is not a business debt, a bad debt deduction would be characterized as a short term capital loss under §166(d)(1).

[37] See the Rubin Report, note 19 above, which identifies the book-tax difference and argues for a bifurcation approach to a debt-for-equity exchange. For a discussion of this issue, especially when the partnership debt is held by a partner, see Sowell, ''Debt Workouts: The Partnership and the Partners,'' 808 PLI /9AX311 (May-June 2008).

[38] Prop. Regs. §1.721-1(d)(2).

[39] *See* Regs. §§1.446-2(e) and 1.1275-2(a), respectively.

[40] *Id.*

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the proposed regulations, Creditor would have an adjusted basis of $400x in that portion of the partnership interest. As such, Creditor would have a total adjusted basis of $460x (further exacerbating the inside-outside basis disparity situation described above).

For the partnership, the question is whether §721(a) should apply to the accrued but unpaid interest portion of the debt contributed to equity. In this context, the issue seems no different from the issue of whether a partnership should recognize gain or loss on the transfer of a partnership interest to a service provider. The debate on that issue is summarized in the preamble to the proposed partnership equity-for-services regulations:

> There is a dispute among commentators as to whether a partnership should recognize gain or loss on the transfer of a compensatory partnership interest. Some commentators believe that, on the transfer of such an interest, the partnership should be treated as satisfying its compensation obligation with a fractional interest in each asset of the partnership. Under this deemed sale of assets theory, the partnership would recognize gain or loss equal to the excess of the fair market value of each partial asset deemed transferred to the service provider over the partnership's adjusted basis in that partial asset. Other commentators believe that a partnership should not recognize gain or loss on the transfer of a compensatory partnership interest. They argue, among other things, that the transfer of an interest is not properly treated as a realization event for the partnership because no property owned by the partnership has changed hands. In addition, taxing a partnership on the transfer of such an interest would result in inappropriate gain acceleration, would be difficult to administer, and would cause economically similar transactions to be taxed differently.
>
> Generally, when appreciated property is used to pay an obligation, gain on the property is recognized. The Treasury Department and the IRS are still analyzing whether an exception to this general rule is appropriate on the transfer of an interest in the capital or profits of a partnership to satisfy certain partnership obligations (such as an obligation to pay interest or rent). However, the Treasury Department and the IRS believe that partnerships should not be required to recognize gain on the transfer of a compensatory partnership interest. Such a rule is more consistent with the policies underlying §721 — to defer recognition of gain and loss when persons join together to conduct a business — than would be a rule requiring the partnership to recognize gain on the transfer of these types of interests. Therefore, the proposed regulations provide that partnerships are not taxed on the transfer or substantial vesting of a compensatory partnership interest. Under §1.704-1(b)(4)(i) (reverse §704(c) principles), the historic partners generally will be required to recognize any income or loss attributable to the partnership's assets as those assets are sold, depreciated, or amortized.[41]

The same arguments commentators made for nonrecognition treatment to the partnership on transferring a compensatory partnership interest can be made with regard to the transfer a partnership interest in a debt-for-equity exchange that includes accrued but unpaid interest. In the case of a debt-for-equity exchange, the creditor is actually contributing property in exchange for a partnership interest. This is clearly a revaluation event.[42] As such, similar to the situation with a compensatory partnership interest transfer, the historic partners generally will be required to recognize any income or loss attributable to the partnership's assets as those assets are sold, depreciated, or amortized.[43] Thus, as the commentators indicated with respect to compensatory partnership interest transfers, it is also possible that taxing a partnership on the transfer of a debt-for-equity interest, with respect to the accrued but unpaid interest portion of the exchange, would result in inappropriate gain (or loss) acceleration, would be difficult to administer, and would cause economically similar transactions to be taxed differently. The creditor and the historic partners are joining together to conduct a business, whether the creditor is an existing partner or an outsider. In either case, the policies underlying §721(a) — to defer recognition of gain and loss in these types of circumstances, arguably, should cause the partnership not to recognize gain or loss on the entire transfer (i.e., principal and accrued but unpaid interest) in a debt-for-equity exchange.

Issue (5) — Section 453B Rules Relating to Dispositions of Installment Obligations Not Superseded by the Proposed Regulations

The preamble to the proposed regulations provides that the proposed §108(e)(8) regulations do not super-

[41] REG-105346-03, 70 Fed. Reg. 29675, 29679 (5/24/05).

[42] *See* Regs. §1.704-1(b)(2)(iv)*(f)*.

[43] *See* Regs. §1.704-1(b)(4)(i) (reverse §704(c) principles).

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sede the rules under §453B relating to dispositions of installment obligations.[44] If an installment obligation is satisfied at other than its face value or is distributed, transmitted, sold or otherwise disposed of, gain or loss shall result to the extent of the difference between the basis of the obligation and (1) the amount realized, in the case of satisfaction at other than face value or a sale or exchange, or (2) the fair market value of the obligation at the time of distribution, transmission, or disposition, in the case of the distribution, transmission, or disposition otherwise than by sale or exchange.[45] Any such gain or loss is considered as resulting from the sale or exchange of the property in respect of which the installment obligation was received. Similarly, if any installment obligation is cancelled or otherwise becomes unenforceable (1) the obligation shall be treated as if it were disposed of in a transaction other than a sale or exchange, and (2) if the obligor and obligee are related persons,[46] the fair market value of the obligation shall be treated as not less than its face amount.[47]

While §453B does not provide any exceptions for nonrecognition transactions, the regulations under §453(d) (the predecessor to §453B) provides that "where the Code provides for exceptions to the recognition of gain or loss in the case of certain dispositions, no gain or loss shall result under §453(d) in the case of a disposition of an installment obligation," [48] and enumerates contributions of property to a partnership by a partner under §721 as one of those exceptions.[49] However, if the contribution of the installment note to the partnership results in the cancellation of the installment note due to the merger of debtor and creditor, the contribution would appear to cause the installment note to be treated as disposed of for purposes of §453B(a), notwithstanding that §721(a) applies to the contribution.[50] Thus, it would appear that a contribution of a partnership installment note by the holder of the note to the partnership debtor in exchange for an interest in the partnership is treated under §453B(a) as a disposition of the note.

Under §453(a), upon an exchange, gain or loss would be recognized by the holder on the contribution to the extent of the difference between the basis of the obligation and the amount realized. In this case, the amount realized would be the fair market value of the partnership interest received in the debt-for-equity exchange. Presumably, the fair market value of the partnership interest, as used for §108(e)(8) purposes, would also be used for §453B purposes.

For example, assume in the Example that Creditor has sold to Partnership certain property for $1,000x. Partnership paid $200x cash and gave Creditor an $800x installment note (I-Note). Assume that Creditor had a basis of $300x in the I-Note (that is, $500x of gain is accounted for under the installment method provided under §453). Assume that, in a subsequent year, when the I-Note has a principal amount due of $500x and a basis of $200x in the hands of Creditor, Creditor contributes the I-Note to Partnership for a partnership interest with a fair market value of $100x. Under §453B, Creditor would appear to recognize a loss of $100x on the disposition of the I-Note. The loss should be considered as resulting in the sale or exchange of the property in respect of which the installment obligation was received. In addition, under the proposed §721 regulations, Creditor should have a basis in the partnership interest of $100x. Under §108(e)(8), unless §108(e)(5) applies, Partnership generally would have COD income of $400x. Additionally, if §108(e)(5) applies, Partnership would reduce by $400x the basis of the property in respect of which the I-Note was received.

Issue (6) — Treatment of COD Income Arising from the Debt-for-Equity Exchange Should Be Treated as a First-tier Item Under Regs. §1.704-2(f)(6) for Purposes of the Minimum Gain Chargeback Rules

Regs. §1.704-2(f)(6) provides that any minimum gain chargeback required for a partnership taxable year consists first of certain gains recognized from the disposition of partnership property subject to one or more partnership nonrecourse liabilities and then if necessary consists of a pro rata share portion of the partnership's other items of income or gain for that year. If the amount of the minimum gain chargeback requirement exceeds the partnership's income and gains for the taxable year, the excess carries over. Thus, currently the §704(b) regulations provide that gain recognized on the disposition of property subject to nonrecourse debt is a first-tier item but do not distinguish between COD income and other items of income (other than gain recognized from the disposition of partnership property) in applying the minimum gain chargeback rule. Thus, if the partnership engages in a debt-for-equity exchange and a minimum gain chargeback is required for one or more partners, the partnership is required to allocate a pro rata portion of the partnership's items of income to satisfy the chargeback requirement. The question presented by

[44] 73 Fed. Reg. at 64904.

[45] §453B(a).

[46] Within the meaning of §453(f)(1).

[47] §453B(f).

[48] Regs. §1.453-9(c)(2).

[49] *Id.*

[50] *See Wilkinson v. Comr.*, 49 T.C. 4 (1967).

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the preamble to the proposed regulations is whether the chargeback requirement should be satisfied with COD income first, before allocating other items of partnership income.

This question can be illustrated by assuming the same facts as in the original Example, but that at the end of the tax year immediately preceding the year in which the debt-for-equity exchange (the ''Preceding Year'') takes place, Property Y had been depreciated to $200x for both §704(b) book and for tax purposes, and that depreciation had been properly allocated 50% to A, 25% to B, and 25% to C. All other items are properly allocated ⅓ to each member. Assume further that the debt-for-equity exchange takes place on the last day of the partnership's next tax year (the ''Current Year''). For the Current Year, assume that the partnership had other items of income and gain equal to $100x. Thus, as of the end of the Preceding Year, PRS would have allocated $200x of partnership nonrecourse deductions to its partners and the partnership would have $200x of partnership minimum gain ($400x Creditor Note less $200x §704(b) book basis). Assume that Partners A, B, and C were properly allocated $100x, $50x, and $50x, respectively, of those deductions and minimum gain.

Upon the debt-for-equity exchange, the $400x Creditor Note is cancelled in exchange for an interest in PRS. Assume that the exchange meets the requirements of the proposed regulations to use liquidation value as the fair market value of the interest issued in the exchange and that Creditor is properly credited with a $200x capital account. Also, assume that PRS treats the debt-for-equity exchange as a revaluation event under the §704(b) regulations.[51] As discussed below, the potential results under the minimum gain chargeback rules depend on whether the Creditor Note is taken into account in determining the fair market value of PRS's assets for purpose of revaluing PRS's assets.[52]

If the Creditor Note is taken into account in determining the fair market value of Property Y, the §704(b) book basis of Property Y would be ''booked up'' to $400x. As such, under the §704(b) regulations, the $200x of minimum gain eliminated in the book-up arguably would not trigger a minimum gain chargeback when the debt is extinguished in the debt-for-equity exchange.[53] Instead, the book-up would create reverse §704(c) gain to A, B, and C with respect to Property Y. This revaluation gain is allocated to A, B, and C in the same proportion as the nonrecourse deduction (i.e., $100x, $50x, and $50x, respectively).

Upon the debt-for-equity exchange, PRS would recognize $200x of COD income. However, because A, B, and C's share of minimum gain was eliminated in the revaluation, the COD income would not be allocated pursuant to the minimum gain chargeback rules, but rather would be allocated under the generally sharing arrangement of the partners.

Conversely, if the Creditor Note is not taken into account in determining the fair market value of Property Y, the §704(b) book basis of Property Y would remain at $200x.[54] Upon the debt-for-equity exchange, the Creditor Note would be extinguished. Assuming for sake of simplicity that the basis of Property Y at the end of the year of the debt-for-equity exchange is still $200x, the partnership would have a minimum gain chargeback requirement of $200x that would be allocable to A, B, and C in proportion to the manner in which the nonrecourse deductions were taken. As such, under the minimum gain chargeback requirement, A, B, and C would be allocated items of income and gain of $100x, $50x, and $50x, respectively. Under the current §704(b) regulations, A, B, and C would be allocated a pro rata portion of each item of income and gain. Because the COD income is $200x and the other items of income and gain are $100x, A would be allocated approximately $67x of COD income and approximately $33x of other items of income and gain. B and C each would be allocated $33x of COD income and $17x of other items of income and gain. The remaining items ($66x of COD income and $34x of other income) would be allocated ⅓ to each member.

If the IRS amended the §704(b) regulations to treat COD income recognized in a debt-for-equity exchange as a first-tier item, A would be allocated $100x of COD income under the minimum gain chargeback rule. B and C would each be allocated $50x of COD income. A, B, and C would then each be allocated ⅓ of each of the remaining items. Thus, each would be allocated approximately $33x of other items of income and gain.

As is illustrated by the above Example, in a debt-for-equity exchange, the minimum gain chargeback requirement is directly related to the reduction of the debt and the recognition of COD income. This relationship is very similar to that of gain recognized from the disposition of partnership property subject to

[51] See notes 13 and 17 above.

[52] See the discussion above under the heading ''Fair Market Value of Indebtedness Equal to Liquidation Value'' as to whether it is appropriate to take the Creditor Note into account in revaluing PRS's assets immediately before the Creditor Note is extinguished in the debt-for-equity exchange.

[53] *See* Regs. §1.704-2(d)(4). Note though that, because the revaluation is caused by the contribution of the Creditor Note, it is not clear that the decrease in minimum gain arises *solely* from the revaluation.

[54] Under the facts of the Example, the $200x §704(b) book basis equals the fair market value of Property Y.

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nonrecourse debt, an item that is a first-tier allocation under the minimum gain chargeback rules.

Issue (7) — Interaction of the Rules In the Noncompensatory Partnership Options Regulations Relating to Convertible Debt With the Rules In the Section 108(e)(8) Proposed Regulations

The §108(e)(8) proposed regulations do not address whether a debt that is convertible into a partnership interest (a ''convertible note'') may trigger COD income if the fair market value of the interest received upon conversion is less than the adjusted issue price of the convertible note.

In the proposed noncompensatory partnership options regulations,[55] the Treasury Department and the IRS addressed whether the treatment under the original issue discount (OID) rules of convertible corporate debt should also apply to convertible partnership debt. These proposed regulations would amend the final OID regulations to extend the corporate OID rules to partnership by defining stock as an equity interest in any entity that is classified, for federal tax purposes, as either a partnership or a corporation.[56] This change was explained in the preamble to these proposed regulations as follows:

> In response to Notice 2000-29, commentators requested that these special [OID] rules be extended to apply to debt instruments convertible into partnership interests. Treasury and the IRS agree with the commentators. Treating convertible debt issued by partnerships and corporations differently for purposes of these special rules could create unjustified distinctions between the taxation of instruments that are economically equivalent. Accordingly, the proposed regulations amend the OID provisions to treat partnership interests as stock for purposes of the special rules for convertible debt instruments.[57]

The issue of whether a note convertible into stock in a corporation may result in COD income upon conversion was addressed in the legislative history to §108(e)(8) (formerly §108(e)(10)). It provides:

> The House bill provides that a debtor corporation realizes income from discharge of indebtedness when it satisfies its debt with stock having a fair market value less than the principal of the debt. This rule applies where the principal amount of a corporate debt is discharged, including by reason of the exercise of a conversion right by the holder of the debt . . . . (Section 1032 does not prevent the recognition of this income from the discharge of indebtedness.)[58]

Thus, it appears that where convertible debt is repaid or satisfied for stock of the issuer of the debt, the issuer should be deemed to repay the debt for an amount equal to the FMV of the stock. If the value of the stock issued is less than the adjusted issue price of the debt, COD income corresponding to the shortfall would appear to arise.[59]

These authorities would appear to point toward causing a partnership to recognize COD income when the debt is converted into a partnership interest with a fair market value that is less than the adjusted issue price of the convertible debt. While one would think it would be unusual for a creditor to convert its debt into an equity interest if the value of the equity interest was less than the adjusted issue price of the debt, these conversions do happen. As such, this issue could be addressed in the final regulations under §108(e)(8).

CONCLUSION

The 2004 amendment to §108(e)(8) to include partnership debt-for-equity exchanges put to rest the argument that the principles of the corporate stock-for-debt exception under the case law still applied to a partnership such that the partnership would not recognize COD income on a debt-for-equity exchange. However, the amendment raises numerous other questions related to its application in the partnership context. The Treasury Department and the IRS raised many of the key questions in applying §108(e)(8) to partnership debt-for-equity exchanges and considered several of them in the proposed regulations. As this article notes, however, because of the flow-through taxation of partnerships, analogies to the corporate rules may not provide the best resolutions of these issues.

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[55] 68 Fed. Reg. 2930-31 (1/22/03).

[56] *See* Prop. Regs. §§1.1272-1(e), 1.1273-2(j), and 1.1275-4(a)(4).

[57] 68 Fed. Reg. 2930-31 (1/22/03).

[58] H.R. Rep. No. 98-861 Conf. Rep., 98th Cong., 2d Sess. 829 (1984), 1984-3 C.B. (Vol. 2) 83. *See also* TAM 200606036 (concluding that the conversion of the convertible preferred securities into Taxpayer's common stock at a time when the fair market value of Taxpayer's common stock was less than the adjusted issue price of the convertible preferred securities resulted in discharge of indebtedness income for purposes of §§61(a)(12) and 108 and Regs. §1.61-12(c)(2)(ii)).

[59] *See e.g.,* Keyes, *Federal Taxation of Financial Instruments & Transactions,* ¶3.04[3][A] (2008).

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RECENT DEVELOPMENTS
Legal Analysis of Current Legislative, Regulatory, and Judicial Developments

IRS Issues Controversial Advice on Aggregate Acquisition Indebtedness By Co-Owners

In general, personal interest is not deductible.[1] However, "qualified residence interest" is excepted from the general prohibition on deducting personal interest.[2] Qualified residence interest is defined, in part, as any interest which is paid or accrued during the taxable year on acquisition indebtedness with respect to any qualified residence *of the taxpayer*.[3] Acquisition indebtedness, in turn, is defined as indebtedness that is incurred in acquiring, constructing, or substantially improving any qualified residence of the taxpayer and is secured by that residence.[4] However, the aggregate amount treated as acquisition indebtedness for any period is not allowed to exceed $1,000,000 ($500,000 in the case of a married individual filing a separate return).[5]

The language of the Code provision setting forth the $1 million dollar limitation leaves open the question whether the limitation is a per-taxpayer or a per-residence limitation. The IRS Chief Counsel recently published advice stating that it is a per-residence limitation.

In CCA 200911007, Taxpayer owned a principal residence that he had purchased by obtaining an interest-only loan in excess of $1 million secured by the residence. No part of the loan constituted home equity indebtedness, and Taxpayer was the sole mortgagee on the recorded deed of trust.

The property was the principal residence of both Taxpayer and Co-Owner. For the first two years during which Taxpayer and Co-Owner jointly owned the property, Taxpayer paid all of the interest due on the mortgage. In the third year, Taxpayer and Co-Owner paid their respective portions of the interest.

There was no question that in years 1 and 2, Taxpayer was entitled to deduct all of the "qualified residence interest" up to a maximum of $1 million of acquisition indebtedness, because the joint owner who pays the interest is entitled to the deduction.

In year 3, Taxpayer contended that both Taxpayer and Co-Owner should be allowed to deduct interest of up to $1 million each on the acquisition indebtedness with respect to the residence. The IRS Chief Counsel concluded that the plain language of the statute did not support Taxpayer's position.

The Chief Counsel concluded that acquisition indebtedness is defined, in relevant part, as indebtedness incurred in acquiring a qualified residence of the taxpayer, not as indebtedness incurred in acquiring taxpayer's portion of a qualified residence.[6] In this case, the amount of indebtedness incurred in acquiring the qualified residence exceeded $1,000,000. However, the aggregate amount treated as acquisition indebtedness for purposes of the qualified residence interest deduction is limited to $1,000,000 of acquisition indebtedness.[7] The Chief Counsel reasoned that this was evident from the parenthetical language,[8] which limits the aggregate amount treated as acquisition indebtedness to $500,000 for a married taxpayer filing a separate return.

It can be argued that the Chief Counsel's conclusion converts two taxpayers into one for purposes of the statute, notwithstanding that the two taxpayers are not married. Generally, although a husband and a wife file a joint return, they are still treated as separate and distinct taxpayers. In certain cases, such as §1041, concerning transfers from one spouse to another spouse during marriage or incident to their divorce, and §267, concerning losses between related parties, the Code overrides this rule, but those are express statutory provisions. The fact that a married person filing a separate return is limited to a $500,000 limitation is more like a penalty for filing a separate return.

Other provisions in the Code support the Chief Counsel's interpretation of §163(h)(3)(B). For example, in §469, which deals with passive losses, the $100,000 active management phase-out threshold is a per-return threshold, so that if two individuals marry, they are collectively subject to the $100,000 phase-out. Similarly, §280A, dealing with vacation homes, appears to create a per-dwelling unit rule.

Nevertheless, CCA 200911007 has been criticized as discriminating against gays and lesbians who own residences together. While the Chief Counsel's conclusion therein is supportable, the language of the statute could easily be interpreted either way.

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[1] §163(h)(1).

[2] §163(h)(2)(D).

[3] §163(h)(3)(A)(i) (*emphasis added*).

[4] §163(h)(3)(B)(i).

[5] §163(h)(3)(B)(ii).

[6] *See* §163(h)(3)(B)(i).

[7] §163(h)(3)(B)(ii).

[8] In §163(h)(3)(B)(ii).

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Recent Legislative Developments

Levin Reintroduces ''Carried Interest'' Legislation

As Congress entered a two-week recess, House Ways and Means member Congressman Sander Levin (D-MI) reintroduced his legislation to tax certain partnership income resulting from a ''carried interest'' as ordinary income.

Levin's latest bill (H.R. 1935) is similar to what he proposed and to what the House passed in the last Congress. Levin's press materials on the bill state that the issue remains one of fairness: Partners' income based on services should not be taxed at the 15% capital gains rate when others' income based on services is subject to tax at rates up to 35%.

The Congressman's explanation of the bill states that H.R. 1935 is intended to have a broad reach, applying

> . . . to investment fund partnerships where the investors in the fund choose to compensate the people managing their assets through a carried interest. In practice, this means hedge funds, private equity funds, venture capital funds, and real estate partnerships.

The basis on which the compensation is paid, rather than whether the income originates from an activity like financial management or real estate, would determine how income is taxed under the bill.

Under H.R. 1935, income from ''investment services partnership interests'' would be taxable as ordinary income. An ''investment services partnership interest'' is a partnership interest held by a person who is reasonably expected, at the time the interest is acquired, to provide a substantial quantity of certain listed services with regard to specified partnership assets. The specified assets to be considered for the purposes of the bill are securities, rental or investment real estate, partnership interests, commodities, options contracts, and derivatives. The list of services to be considered in identifying an investment services partnership interest is broad: advising on investment in, purchasing, or selling a specified asset; managing, acquiring, or disposing of a specified asset; arranging financing; or any activity in support of any of these services.

The bill would still allow partners providing these services to receive capital gains treatment on their income to the extent that they have made an equity investment in the partnership interest on which the income is earned. Congressman Levin's explanation of the bill states:

> [T]he bill explicitly protects the investments that fund managers make themselves. To the extent they have put their own money in the fund, managers still get capital gains treatment, but to the extent they are being compensated for managing the fund, they will have to pay ordinary income tax rates like other service providers.

However, some investment arrangements would not qualify for capital gains treatment. A partner investing funds borrowed from or guaranteed by the partnership, another partner or person related to the partnership, or a partner would still be treated as having ordinary income or losses. An interest qualifying for capital gains treatment would also be limited to the fair market value of property or money contributed by the service provider in exchange for the interest. Further, allocations to such a partnership interest would have to be made on the same basis as significant allocations (relative to the service provider's interest) to the interests of non-service providing partners unrelated to the taxpayer.

The bill does not offer effective dates signaling when the legislation might trigger new taxes. Levin's press materials indicate that effective dates will be decided during the legislative process. A similar 2008 ''carried interest'' provision included in alternative minimum tax legislation generally would have taken effect on the date of the Ways and Means Committee's action on the bill in which it was included.

Snowe Introduces Net Operating Loss Legislation

Further relief on net operating losses (NOLs) is under discussion in Congress as Senator Olympia Snowe (R-ME) has introduced legislation (S. 823) to provide a general five-year carryback of NOLs. Although the recently-enacted stimulus legislation (The American Recovery and Reinvestment Act of 2009) included an NOL carryback, the provision is limited to allowing ''small businesses'' with no more than $15 million in gross receipts to carry back their 2008 losses. The final stimulus provision replaced broader House and Senate proposals that would have allowed most larger firms to carry back losses for five years.

Estate and Gift Tax Action Also Built into Budgets

The basic approach to dealing with estate and gift taxes is the same in the House and Senate budgets that were passed during the last week of March. Both budget resolutions accommodate retaining for 2009 a 45% top rate and $3.5 million per decedent exemption. Senate Finance Committee Chairman Max Baucus (D-MT) has already introduced legislation (S. 722) to extend many of the 2001 and 2003 tax cuts, which includes a permanent $3.5 million exemption amount and 45% top rate.

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Senate Members expressed some interest in expanding the proposed estate and gift tax relief in their budget, although the outlook for additional relief is muddled. Senators Blanche Lincoln (D-AR) and Jon Kyl (R-AZ) got an amendment to the budget passed by 51 votes, which would provide for a deficit-neutral program offering a $5 million exemption amount and a top rate of 35%.

That amendment was itself modified by a further amendment allowing a point of order to be raised unless the additional relief is accompanied by an equal amount of tax relief for those making under $100,000. The author of that amendment, Senator Dick Durbin (D-IL), described it thus:

> My amendment is simple. It creates a point of order. It says we should help struggling Americans first. Before we give an additional $100 billion in tax breaks to the superwealthy, we must first give at least as much in tax relief to Americans earning less than $100,000. It will be tax relief beyond that already included in this budget resolution.

As both amendments require the additional relief to be offset, the purported $100 billion cost of the Lincoln/Kyl amendment could complicate providing more than the budgets allow even if the House does accept the amendments in conference.

Republicans Propose Home Ownership Incentives

House Republicans continued to focus on means of improving housing markets in March as Minority Whip Eric Cantor (R-VA), Congressman Mike Pence (R-IN) and other members of the Republican Economic Working Group promoted a bill to be introduced as the Responsible Homeowners Act. The bill will offer several incentives to buyers of residential housing, including:

- a $5,000 tax credit for homeowners who refinance;
- a $15,000 tax credit to buyers of a principal residence who make a down payment of at least 5%; and
- an exclusion of gains on appreciated housing for investors in rental properties.

The bill would also authorize law enforcement resources to combat mortgage fraud.

Relief from property taxes has also been proposed by Representative Baron Hill (D-IN) and a bipartisan group of other members. Hill's H.R. 1716 would allow all taxpayers to take an above-the-line deduction for real property taxes paid on a principal residence.

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You Are Invited to Attend the May Tax Management Advisory Board Meeting

AGENDA:

Compensation Planning

MEMORANDA:

1. ***"Kennedy v. Plan Administrator for DuPont Savings and Investment Plan:*** **Beneficiary Determinations Under ERISA and the Plan Document Rule,"** *by Albert Feuer, Esq., Forest Hills, New York*
2. **Employee Benefits Issues in Bankruptcy**, *by Chad R. DeGroot, Esq., Bryan Cave LLP, St. Louis, Missouri*
3. **Fiduciary Duties in the Face of Troubled Economic Times**, *by John H. Wilson, Esq., and Anita Domalik Hogue, Esq., Buchanan Ingersoll & Rooney, PC, Pittsburgh, Pennsylvania*

TO BE HELD
THURSDAY, MAY 21, 2009
WALDORF-ASTORIA HOTEL
BEEKMAN SUITE
NEW YORK, NY
MEETING: 5:30 PM
RECEPTION: 7:00 PM

RSVP ***Reception follows***

Requests to attend will be honored and accommodations made within the limited capacity available and in the order in which they are received. Requests should specify the MAY COMPENSATION PLANNING MEETING and be addressed to BNA Tax & Accounting, 1801 S. Bell Street, Arlington, VA. 22202. For information about CPE or CLE credit hour awards, or to register, call Sandy Mackall at: (703) 341-5906.

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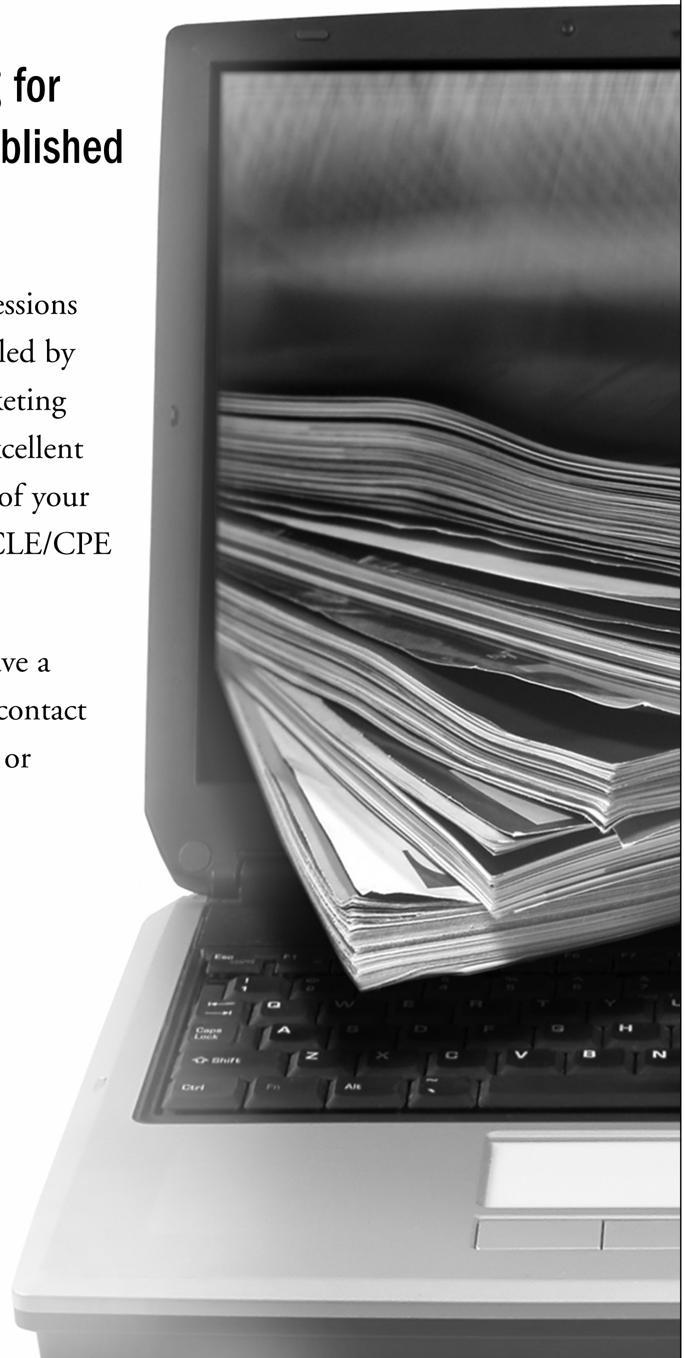

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