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May 4, 2009

Hon. Douglas Shulman  
Commissioner  
Internal Revenue Service  
1111 Constitution Avenue, N.W.  
Washington, DC 20224

Re: Comments on Proposed Regulations under Section 108(e)(8)

Dear Commissioner Shulman:

Enclosed are comments on proposed regulations under section 108(e)(8). These comments represent the views of the American Bar Association Section of Taxation. They have not been approved by the Board of Governors or the House of Delegates of the American Bar Association, and should not be construed as representing the policy of the American Bar Association.

Sincerely,

A handwritten signature in black ink, appearing to read "SML", written over a white background.

Stuart M. Lewis  
Chair - Elect, Section of Taxation

Enclosure

cc: Clarissa C. Potter, Acting Chief Counsel, Internal Revenue Service  
Eric A. San Juan, Acting Tax Legislative Council, Department of the Treasury  
Steven G. Frost, Senior Counsel, Office of Tax Policy, Department of the Treasury  
Curtis G. Wilson, Associate Chief Counsel, Passthroughs & Special Industries, Internal Revenue Service

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**AMERICAN BAR ASSOCIATION SECTION OF TAXATION  
COMMENTS ON PROPOSED REGULATIONS  
UNDER SECTION 108(e)(8)**

The following comments (“Comments”) are submitted on behalf of the American Bar Association Section of Taxation and have not been approved by the House of Delegates or Board of Governors of the American Bar Association. Accordingly, they should not be construed as representing the position of the American Bar Association.

Principal responsibility for preparing these Comments was exercised by Karen Lohnes of the Partnerships and LLCs Committee of the Section of Taxation. Substantive contributions were made by Bahar A. Schippel, Howard E. Abrams, Richard A. Latta, Hamang B. Patel, Craig Gerson, John Schmalz, James B. Sowell, Carlene Miller, Monte Jackel, and Eric B. Sloan. The Comments were reviewed by R. Brent Clifton, Chair of the Committee, Charles H. Egerton, of the Section’s Committee on Government Submissions, and William H. Caudill, the Section’s Council Director for the Committee.

Although the members of the Section of Taxation who participated in preparing these Comments have clients who might be affected by the federal income tax principles addressed by these Comments, no such member (or firm or organization to which such member belongs) has been engaged by a client to make a government submission with respect to, or otherwise to influence the development or outcome of, the specific subject matter of these Comments.

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May 4, 2009

## EXECUTIVE SUMMARY

Section 108(e)(8), as amended by the American Jobs Creation Act of 2004,<sup>1</sup> provides that if a debtor partnership transfers a capital or profits interest in the partnership to a creditor in satisfaction of its recourse or nonrecourse indebtedness, then, for purposes of determining the cancellation of indebtedness (“COD”) income of the partnership, the partnership shall be treated as satisfying the indebtedness with an amount of money equal to the fair market value of the partnership interest.<sup>2</sup> Any COD income recognized under section 108(e)(8) must be included in the distributive shares of the partners in the debtor partnership immediately before the discharge.

On October 30, 2008, the Department of the Treasury (“Treasury”) and the Internal Revenue Service (“Service”) published a notice of proposed rulemaking in the Federal Register containing Proposed Regulations under section 108(e)(8) (the “Proposed Regulations”).<sup>3</sup> The Proposed Regulations provide that the fair market value of a capital or profits interest in a partnership issued to a creditor is the liquidation value of the interest if (i) capital accounts are properly maintained under the section 704(b) Regulations, (ii) all parties treat the fair market value of the indebtedness as equal to the liquidation value, (iii) the transaction is an arm’s-length transaction, and (iv) there is no planned repurchase by the partnership or by a related party to the partnership. If these requirements are not satisfied, the fair market value of the interest is determined by taking into account all facts and circumstances.

The Proposed Regulations generally apply the nonrecognition rule of section 721 to the contribution of the indebtedness (other than unpaid interest or accrued original issued discount) to the partnership. The preamble to the Proposed Regulations (the “Preamble”) explains that the Treasury believes such a rule is “consistent with the policies underlying section 721 to defer the recognition of gain or loss where persons join together to conduct joint business (including investment).”

In the Preamble, the Treasury and the Service request comments regarding specific issues. We appreciate the opportunity to provide comments both in response to those specific requests and in regard to other portions of the Proposed Regulations.

We recommend that the final Regulations:

1. Expressly permit a partial bad debt deduction on the debt-for-equity exchange by deeming the creditor to have “written off” immediately prior to the section 721 exchange the portion of the debt that exceeds the fair market value of the partnership interest or, alternatively, include an example in which a creditor writes off a portion of the debt before the

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<sup>1</sup> Pub. L. No. 108-357, § 896, 118 Stat. 1648.

<sup>2</sup> References to a “section” herein are to sections of the Internal Revenue Code of 1986, as amended (the “Code”), unless otherwise indicated.

<sup>3</sup> 73 Fed. Reg. 64,903 (2008).

exchange to confirm that the application of section 721 does not preclude a partial debt write-off, if applicable, prior to the exchange.

2. Not include an anti-abuse rule to address use of the liquidation value approach to generate artificial losses or inappropriately accelerate economic losses. We believe that the mechanics of subchapter K, including Section 704(b) and the underlying Regulations, as well as existing judicial doctrines are available to address any potential abuses.
3. Not include any mandatory allocation rules under section 704(b) with respect to COD income, except as provided below.
4. Amend Regulation sections 1.704-2(f)(6) and (j)(2)(i) to provide that when a minimum gain chargeback results in whole or in part from the discharge of partnership or partner nonrecourse debt, the minimum gain chargeback shall consist of an allocation of COD income relating to such debt before the allocation of any other item of income or gain.

## DISCUSSION

### I. Application of Section 721 to Debt-for-Equity Exchanges

#### A. Summary

The Proposed Regulations generally provide that section 721 applies to a contribution of a partnership's recourse or nonrecourse indebtedness by a creditor to the debtor partnership in exchange for a capital or profits interest in the partnership.<sup>4</sup> Although we generally support this approach, the overlap of section 108(e)(8) with other provisions, including sections 1271 and 707(b), impedes the creation of a system that balances all of the interests of the government and taxpayers.

For example, although the section 721 approach resolves many of the potential difficulties that could arise under alternative systems, it also has significant drawbacks. Specifically, applying section 721 to partnership debt-for-equity exchanges defers any loss or bad debt deduction to which a lender might otherwise be entitled. Section 721 may also cause a potential character shift for the lender on its loss. Applying section 721 also creates an inside-outside basis disparity and has other consequences for the partner and the partnership. The final Regulations should offer guidance that addresses these consequences of the section 721 approach in a fair and logical manner.

#### B. Treatment of Debt as Property

As noted above, the Proposed Regulations generally provide that section 721 applies to a contribution of a partnership's recourse or nonrecourse indebtedness by a creditor to the debtor partnership in exchange for a capital or profits interest in the partnership. This general rule is based on the debt instrument's qualification as property for purposes of section 721. Despite the fact that the debt is extinguished when reacquired by the partnership, we believe it is reasonable to treat the contributed debt instrument as "property" for purposes of section 721 based on the Tax Court's decision in *Duncan v. Commissioner*.<sup>5</sup>

*Duncan* involved the surrender of judgment claims to a debtor corporation in consideration for the issuance to the creditors of stock of the debtor corporation. After the issuance, the creditors were in control of the debtor corporation. The Tax Court held that the surrender of the judgment claims in exchange for stock constituted a tax-free exchange within the meaning of section 112(b)(5) of the Internal Revenue Code of 1939, the predecessor to section 351. As under section 351, section 112(b)(5) of the 1939 Code required a transfer of property to a corporation, and in *Duncan* the Tax Court held that the claims of judgment creditors constituted property for the purposes of that section.

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<sup>4</sup> Although section 108(e)(8) refers to partnership "indebtedness," this term is not specifically defined in the Code or Regulations. We recommend that the final Regulations specify the scope of the section 108(e)(8) Regulations by referencing either the term "debt instrument," as defined in section 1275 (and section 108(i)(3)), or the term "obligation," as defined in Regulation section 1.752-1(a)(4)(ii).

<sup>5</sup> 9 T.C. 468 (1947), *acq.* 1948-2 C.B. 2; *see also A.L. Kniffen v. Commissioner*, 39 T.C. 553 (1952). Congress enacted section 351(d)(2) as part of the Bankruptcy Tax Act of 1980, Pub. L. No. 96-589, 1980-2 C.B. 607, overruling the result in *Duncan* for corporations.

Although there is neither a case similar to *Duncan* in the partnership area nor a statutory provision providing that debt constitutes property for section 721 purposes, it is generally understood that the term “property” for purposes of section 721 has the same meaning as the term for purposes of section 351.<sup>6</sup> Thus, we agree that a debt instrument should constitute property for purposes of section 721.

### **C. Policy Reasons for Permitting a Bad Debt Deduction in Connection with a Partnership Debt-for-Equity Exchange**

Although we support the application of section 721 to debt-for-equity exchanges, we believe that denying a creditor a bad debt deduction in connection with such an exchange is inequitable and leads to undesirable disparities between inside and outside basis.

#### **1. Timing and Character Inequities**

In general, when a partner contributes property to a partnership, that partner takes a basis in the partnership interest received equal to the basis of the property contributed. Under section 704(c) principles, the partner will recognize its built-in gain or built-in loss in the contributed property either upon the partner’s sale of the partnership interest or the partnership’s sale of the contributed asset. When a creditor exchanges partnership debt for a partnership interest under the Proposed Regulations, however, the debt disappears by virtue of its contribution to the debtor partnership. As a result, there is no asset to which section 704(c) may apply, and the partner must wait until the sale or exchange of the partnership interest to recognize any loss inherent in the contributed debt.

In addition to this timing disadvantage, any loss recognized upon the sale or exchange of the partnership interest will constitute a capital loss under section 741 (except as provided in section 751(a)), creating another disadvantage for many creditors who would otherwise be entitled to ordinary loss treatment under section 1001 and section 1221(a)(4) or an ordinary bad debt deduction under section 166.

Moreover, in most situations, the partners in the debtor-partnership will recognize COD income currently because the section 108 exclusions to the recognition of COD apply at the partner level. When the creditor is an existing partner, the creditor is likely to be allocated all or portion of the COD income resulting from the debt-for-equity exchange. At the same time, under the approach of the Proposed Regulations, the creditor would be precluded from claiming a current loss upon the debt-for-equity exchange. This may result in both inequitable timing and character differences to the creditor partner, as is illustrated by the following example.

**Example 1.** A and B form an equal partnership. A is in the business of lending money and lends the partnership \$100. A and B do not contribute any assets to the partnership. The partnership acquires for \$100 raw land that it intends to hold for investment.

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<sup>6</sup> *Stafford v. United States*, 727 F.2d 1043, 1049 (11<sup>th</sup> Cir. 1984).

At a time when the adjusted basis in the land is still \$100, A contributes the debt to the partnership in exchange for a partnership interest with a fair market value of \$40, causing the partnership to recognize \$60 of COD income. Assume that A is allocated \$30 of the COD income, but is not able to exclude the COD income under section 108(a).<sup>7</sup>

Under the Proposed Regulations, A is not able to claim either a bad debt deduction under section 166 or an exchange loss under section 1001 and section 1221(a)(4). Further, if A eventually sells its partnership interest at a loss, that loss would be a capital loss under section 741. As a result, in addition to losing the potential benefit of an ordinary loss or a bad debt deduction upon the contribution of the debt to the partnership, A recognizes COD income in connection with its contribution to the partnership, with only the possibility of recognizing a capital loss in the future. The disadvantages illustrated by this example may well discourage creditors that are existing partners from entering into debt workouts.

## **2. Inside/Outside Basis Disparities**

The provisions of subchapter K generally preserve equality between a partner's basis in the partnership interest and the partner's share of basis in the assets of the partnership. The Service has issued guidance to implement this principle.<sup>8</sup> If a creditor contributes debt to a partnership in exchange for a partnership interest with a fair market value less than the adjusted issue price and basis of the debt, however, the partners' aggregate bases in their partnership interests ("outside basis") generally will exceed the partnership's basis in its assets ("inside basis").

The Preamble states that because section 721 applies to a debt-for-equity exchange, the basis of the creditor's interest in the partnership is determined under section 722. The Preamble also states:

The Service and the Treasury Department believe that a creditor should not recognize a loss in a debt-for-equity exchange subject to section 721 in which the liquidation value of the debt-for-equity interest is less than the outstanding principal balance of the indebtedness. Rather, the creditor's basis in the debt-for-equity interest received in the debt-for-equity exchange that is subject to section 721 will be increased by the adjusted basis of the indebtedness.

In a typical section 721 transaction, the basis of the contributed asset is reflected both in the assets of the partnership and in the contributing partner's interest in the partnership. When the asset is sold, the amount of any gain or loss attributable to the asset at the time of the contribution is allocated to the contributing partner under

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<sup>7</sup> For the sake of simplicity, the application of section 108(i) is ignored in this example.

<sup>8</sup> See, e.g., Notice 99-57, 1999-2 C.B. 692, discussed *infra*.

section 704(c) principles. This equilibrium between asset basis and basis of partnership interests helps ensure that the partners recognize the same amount of gain whether the partnership sells its assets or the partners sell their partnership interests. In contrast, when a creditor exchanges partnership debt for equity under the Proposed Regulations, the debt disappears. This “disappearing asset” creates an inside-outside basis disparity. Consider the following examples.

**Example 2.** A and B form an equal partnership, with each contributing \$50. C lends the partnership \$200. AB partnership acquires property for \$300. When the property is worth \$150 and its basis has been depreciated by \$80 to \$220, C contributes the debt to the partnership in exchange for a partnership interest with a fair market value of \$150, causing the partnership to recognize \$50 of COD income. Neither A nor B can exclude the COD income under section 108(a).<sup>9</sup> After the contribution, each of A and B’s outside basis equals \$35 (\$110 of basis before the exchange, increased by \$25 of COD, less \$100 deemed distribution under section 752(b)). C’s basis in the partnership interest equals \$200. Thus, the partners’ aggregate outside basis is \$270. The partnership’s inside basis is only \$220.

Thus, the situation described in the example creates a \$50 inside-outside basis disparity.

**Example 3.** Now assume the same facts as above, except that C contributes the debt to the partnership at a time when the property is worth \$150 and its basis has been depreciated by \$180 to \$120.

As in Example 2, A and B will each recognize COD income of \$25, and each will receive a deemed distribution of \$100 under section 752(b). These deemed distributions will exceed each partner’s \$85 outside basis (\$60 immediately before C’s contribution, plus \$25 of COD income) by \$15. Thus, A and B will each recognize \$15 of gain under section 731(a) and have a \$0 outside basis. C’s outside basis will equal \$200. Thus, the partners’ aggregate outside basis will equal \$200. The partnership’s basis in its property is only \$120. Under these facts, there is an \$80 inside-outside basis disparity, which equals the sum of the COD income and the section 731(a) gain recognized by A and B.

A later sale of the property on liquidation of the partnership would likely cause recognition of ordinary income due to depreciation recapture on the sale of partnership assets, and a capital loss to the partners on liquidation.

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<sup>9</sup> For the sake of simplicity, the application of section 108(i) is ignored in this illustration.

If the partnership redeems the creditor partner's interest before the partnership's sale of assets, the result is also inequitable. As a result of the debt extinguishment upon its contribution to the partnership, the partnership may effectively recognize duplicate COD income upon a later sale of its assets, as demonstrated by the following example.

**Example 4.** A creditor, C, lends a partnership \$1 million. C later contributes the \$1 million debt to the partnership in exchange for an interest in the partnership with a fair market value of \$700,000. The partnership recognizes COD income of \$300,000 in connection with the contribution.

Sometime later, the partnership redeems C's interest for \$700,000, causing C to recognize a \$300,000 loss. Under the mandatory basis adjustment rules of section 734(b)(2), the partnership must reduce the basis of its undistributed assets by \$300,000. If the assets are depreciable, this negative adjustment would deprive the continuing partners of \$300,000 of tax depreciation. Moreover, if these assets were sold before the partnership liquidates, the remaining partners would recognize an additional \$300,000 of gain because of the negative section 734(b)(2) adjustment.

This reduction of depreciation, gain acceleration, or both is a consequence of disallowing the creditor's loss upon the exchange of debt-for-equity. Although the remaining partners would eventually be entitled to an aggregate (and offsetting) loss equal to \$300,000 upon the sale of their partnership interests or upon a liquidation of the partnership, in this situation we find it difficult to justify depriving them of depreciation deductions, accelerating gain to the partners of the debtor partnership, or both.

As illustrated above, if a creditor contributes debt to a partnership in exchange for a partnership interest with a fair market value less than the adjusted issue price of the debt (which is the basis of the debt), the partners' outside bases in their partnership interests will exceed the inside basis in the partnership's assets. This is contrary to the general approach of the provisions of subchapter K, which is to preserve equality between a partner's basis in the partnership interest and the partner's share of basis in the assets of the partnership.

For example, in Notice 99-57, the Service announced its intention to promulgate Regulations under section 705 to address situations in which a partnership sells stock of a corporate partner, creating gain or loss that is excluded under section 1032, but that would nevertheless affect the partners' bases in their partnership interests. The Service was concerned that when a corporation acquires an interest in a partnership that holds the corporation's stock, and a section 754 election is not in effect with respect to the partnership for the taxable year of the acquisition, gain or loss may be improperly created as a result of the inside-outside basis disparity. The Service stated that "[t]he partnership rules generally attempt to preserve equality between a partner's basis in the partnership

interest and the partner's share of inside basis in the assets of the partnership." The Service also stated that it would issue Regulations to provide that, in such situations, a corporate partner may increase its basis in its partnership interest under section 705 only by the amount of the partner's share of the section 1032 gain that the partner would have realized had a section 754 election been made. Later, the Treasury and the Service promulgated Proposed and final Regulations under section 705 consistent with Notice 99-57.<sup>10</sup> The Regulations state "[t]he rules under section 705 generally are intended to preserve equality between the adjusted basis of a partner's interest in a partnership (outside basis) and such partner's share of the adjusted basis in partnership assets (inside basis)."<sup>11</sup>

For the same reasons that supported the promulgation by the Treasury and the Service of the section 705 Regulations and other guidance,<sup>12</sup> we believe that the final Regulations should be revised so that the Regulations do not create a disparity between inside and outside basis. Therefore, we recommend that the Treasury and the Service modify the Regulations to permit a creditor to claim a loss in connection with a debt-for-equity exchange to the extent that the creditor's basis in the debt exceeds the fair market value of the debt-for-equity interest. Alternatively, we recommend that consideration be given to creating a complementary set of rules that would preserve the equilibrium between the inside and outside basis.

#### **4. Section 721 will Apply to All Partnership Debt-for-Equity Exchanges**

Although applying section 721 might initially appear to parallel the application of section 351 for corporate debt-for-equity exchanges, that comparison is imperfect. Section 351 applies only if the creditor is part of the 80% control group exchanging property for stock. Thus, even without section 351(d)(2), many debt-for-equity exchanges do not qualify for section 351 treatment, opening the door for loss recognition on the exchange. By contrast, because section 721 does not require 80% control for its provisions to apply, all partnership debt-for-equity exchanges would be covered by section 721. Disallowing the creditor's bad debt write-off in connection with its contribution to the partnership will impede the ability of a partnership to accomplish a debt workout. This impediment will exist even if debt constitutes a small percentage of a partnership's asset value, because the creditor's loss on its contribution will be deferred.

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<sup>10</sup> Reg. § 1.705-2; *see also* Prop. Reg. § 1.705-2, 66 Fed. Reg. 315 (2001).

<sup>11</sup> Reg. § 1.705-2(a).

<sup>12</sup> *See, e.g.*, Rev. Rul. 96-10, 1996-1 C.B. 138; Rev. Rul. 96-11, 1996-1 C.B. 140.

#### **D. Proposal -- The Final Regulations Should Permit Creditors to Recognize Loss**

To mitigate the concerns discussed above, we recommend that the final Regulations specify that the creditor may recognize a loss in its position despite the overall application of section 721. The Treasury and the Service may use either of two alternative methods to achieve this result.<sup>13</sup>

First, the Treasury and the Service might permit the loss recognition by deeming the creditor to write off immediately before the section 721 exchange the portion of the debt that exceeds the value of the partnership interest received, resulting in a loss to the extent of the excess of the creditor's basis in the debt over the fair market value of the partnership interest. Although not specifically contemplated by either section 721 or section 108(e)(8), section 166 provides analogous support for this bifurcation approach.

Specifically, Regulation section 1.166-6 permits a bad debt deduction when a creditor receives as a result of foreclosure proceedings property with a value less than the amount of the debt.<sup>14</sup> Pursuant to Regulation section 1.166-6, when a creditor acquires property secured by the debt in a foreclosure sale, the transaction is bifurcated.<sup>15</sup> The first part of the transaction involves the repayment of the debt to the creditor. Pursuant to Regulation section 1.166-6(a), the creditor may deduct under section 166 the portion of the debt remaining unsatisfied after the foreclosure for the taxable year in which such amount becomes wholly worthless or is charged off as partially worthless, but only to the extent that the creditor's basis in the debt exceeds the bid price. The second part of the transaction involves the purchase of the property by the creditor. Pursuant to Regulation

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<sup>13</sup> For completeness, we note that the Treasury and the Service might use a third method, which is to specify that a write off will be respected if it would be respected under general tax principles as a separate transaction. If this approach is adopted, it would be helpful to provide a safe harbor. Although we understand that the Service and the Treasury generally have expressed reluctance to create bright-line timing rules around which taxpayers may plan, in this context a safe harbor would help taxpayers achieve greater certainty and would facilitate debt workouts in many circumstances.

<sup>14</sup> See generally *Community Bank v. Commissioner*, 62 T.C. 503 (1974); Rev. Rul. 80-56, 1980-1 C.B. 154.

<sup>15</sup> In *Community Bank v. Commissioner*, 62 T.C. 503 (1974), the Tax Court described the effect of Regulation section 1.166-6 as follows:

The Regulations have the effect of breaking the foreclosure sale transaction into two parts: (1) The mortgagee is entitled to a bad debt deduction equal to the unsatisfied, uncollectible difference between the unpaid balance and the bid price and (2) the mortgagee realizes gain or loss measured by the difference between the amount of the mortgage obligation applied to the bid price and the fair market value of the property. See *Malden Trust Co. v. Commissioner*, 110 F.2d 751 (1<sup>st</sup> Cir. 1940).

In *Community Bank*, the government argued that the fair market value of the property was greater than the bid price of the properties and that taxpayer must therefore recognize gain equal to the excess of the fair market value over the bid price. The Court determined that the government did not overcome the presumption set forth in Regulation section 1.166-6(b)(2). Thus, the taxpayer was not required to recognize a gain.

section 1.166-6(b), the creditor recognizes gain or loss equal to the difference, if any, between the fair market value of the property and the bid price.<sup>16</sup>

In Rev. Rul. 80-56,<sup>17</sup> the Service applied Regulation section 1.166-6. The creditor, a REIT in the business of making loans, made a construction loan of \$1000x to borrower, a corporation. The loan was secured by a mortgage on land and the building to be constructed thereon. The creditor acquired the property at a foreclosure sale after the borrower defaulted on the loan. The creditor did not obtain a deficiency judgment as part of the foreclosure proceedings, and, at the time of the creditor's acquisition of the property, the mortgage note was wholly uncollectible. At the time of the foreclosure sale, the fair market value of the property was clearly established to be \$500x and the creditor's bid price was \$400x. The creditor's basis in the note was \$900x. Rev. Rul. 80-56 focuses on the character of the creditor's gain recognized in the second step of the foreclosure. In determining the amount of the gain, Rev. Rul. 80-56 applies the two-step approach of Regulation section 1.166-6. The Service concludes that the creditor is entitled to a bad debt deduction of \$500x (the difference between the bid price, \$400x, and the basis of the note, \$900x). In addition, the creditor realizes a gain of \$100x (the difference between the fair market value of the property, \$500x, and the bid price, \$400x). The Service also concludes that the creditor's loss is an ordinary loss under sections 166(a) and 166(c). The Service states that, even though the mortgage would be treated as a capital asset if the creditor were not in the business of making loans, because the creditor acquired the property in a foreclosure sale, the creditor would be entitled to an ordinary bad debt loss in step one and the gain recognized as a part of step two would be ordinary under the tax benefit rule.

Applying the Regulation section 1.166-6 analogy in the case of a partnership debt-for-equity exchange to which section 721 applies, no gain or loss would be recognized to the creditor under the second step. Under this approach, although section 721 would apply to the transaction, section 721 would apply only to the extent of the amount of the debt actually exchanged for the partnership interest. The portion of the debt extinguished as part of step one would be written off as a bad debt pursuant to section 166. Because there is no bidding as part of a partnership debt-for-equity exchange, the fair market value would be deemed to be the fair market value of the partnership interest as otherwise determined under the final Regulations. This approach would be consistent with the holding in *Duncan* in that it would treat the debt as property for section 721 purposes, but only up to the fair market value of the property received in exchange for the debt. Because the fair market value of the debt in *Duncan* did not exceed the fair market value of the stock received in exchange for the debt, the holding in *Duncan* would not preclude a rule that would permit a write-off of such excess portion as part of the debt-for-equity exchange.

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<sup>16</sup> For the purposes of Regulation section 1.166-6, the fair market value of the property is presumed to be the amount for which it is bid in by the taxpayer. This presumption may be overcome through clear and convincing evidence. Reg. § 1.166-6(b)(2).

<sup>17</sup> 1980-1 C.B. 154.

We acknowledge section 721 does not appear to allow for bifurcation of contributed property, although the disguised sale rules of section 707(a)(2)(B) specifically bifurcate contribution transactions. We further acknowledge that although Regulation section 1.166-6 provides an analogous rule, there is arguably some tension between this rule and the Supreme Court's decision in *McClain v. Commissioner*.<sup>18</sup> Nevertheless, we urge the Treasury and the Service to consider whether such an approach is viable because it would achieve a uniformly equitable result.

Alternatively, if the Treasury and the Service do not expressly provide for the availability of loss recognition in the context of partnership debt-for-equity exchanges, we request that the final Regulations include an example in which a creditor writes off a portion of the debt immediately before the exchange. The purpose of this example would be to confirm that the application of section 721 does not preclude a partial debt write-off, if applicable, prior to the debt-for-equity exchange. Under the facts of such an example, the creditor would determine that its debt is partially worthless and would be entitled to a deduction under section 166. Some time later, in a transaction that is properly regarded as separate for federal income tax purposes, the creditor would reach agreement with the partnership to convert its creditor position into an equity interest in the partnership pursuant to section 108(e)(8). The inclusion of an example with similar facts would clarify the applicable rules for all taxpayers.<sup>19</sup>

## **II. It is not Necessary to Include an Anti-Abuse Rule to Support the Liquidation Value Safe Harbor**

The Proposed Regulations generally would permit partnerships to determine the fair market value of the interest issued to a creditor by reference to the amount credited to the creditor-partner's capital account balance (the "liquidation value approach").<sup>20</sup> We believe that such an approach is a reasonable and appropriate method to facilitate the integration of section 108(e)(8) with respect to subchapter K.<sup>21</sup> We recognize, however, that if a creditor is allowed to take a bad debt deduction or loss in connection with the debt-for-equity exchange, there is concern that permitting a partnership to elect to value

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<sup>18</sup> 311 U.S. 527 (1941). This arguable tension arises because the Court held that a partial payment on a debt instrument was a capital transaction and it is not clear whether the holding of the Court is applicable to cases in which a creditor reacquires the property securing the debt in a foreclosure transaction or to cases in which securities, as defined by section 165(g), are involved. See Garlock, *Federal Income Taxation of Debt Instruments*, ¶ 1603.03 at 16,036 (CCH 5<sup>th</sup> Ed.).

<sup>19</sup> See TAM 9253003 (Sept. 22, 1992); Keyes, *Federal Taxation of Financial Instruments and Transaction*, ¶ 3.04[1][b][iii] & n. 285 (WG&L) ("If the decline in value is (or can only be) determined by an exchange between the creditor and debtor, then the loss realized should be a capital loss (assuming the debt is a capital asset). However, if the decline in value is determined independently by the creditor before the exchange, then the decline in value may be claimed as a bad debt deduction.").

<sup>20</sup> One of the requirements of using the liquidation value approach 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 that has as a principal purpose the avoidance of COD income by the partnership. For this purpose, the Proposed Regulations do not define the term "related." We suggest that the final Regulations clarify the meaning of related in this context.

<sup>21</sup> Alternatively, this safe harbor rule might be included in a companion revenue procedure, similar to approach adopted in the Proposed Regulations addressing partnership interests transferred in exchange for services and the proposed revenue procedure included in Notice 2005-43, 2005-24 I.R.B. 1221.

the equity granted in exchange for debt based on its liquidation value may permit taxpayers to take artificial losses or excessive bad debt deductions. Although the artificial losses or excessive bad debt deductions recognized by the creditor would be matched by equally artificial COD income to the partnership, there may be opportunities for inappropriate tax arbitrage if one or more of the partners may exclude the COD income. If, however, a creditor contributes a debt in exchange for an artificially low capital account balance and the partnership liquidates in accordance with capital account balances, the creditor would be taking a true economic risk with respect to the low valuation. Thus, there would be a disincentive for a creditor dealing at arm's length with the partnership to attempt to manipulate the capital account balance received in exchange for the debt in such a manner.<sup>22</sup> Moreover, we believe that the mechanics of subchapter K, including Section 704(b) and the underlying Regulations, as well as existing judicial doctrines are available to address such potential abuses. For these reasons, we do not believe that it is necessary to include an anti-abuse rule to address such concerns.

### III. Allocation of COD Income

In general, the allocation of entity-level items of income, gain, loss, deduction and credit is determined by reference to the partnership agreement so long as those allocations have “substantial economic effect” within the meaning of section 704(b). In general, an allocation will have substantial economic effect if it (i) is consistent with the underlying economic arrangement of the partners (the economic effect requirement)<sup>23</sup> and (ii) affects the dollar amounts to be received by the partners from the partnership independent of tax consequences (the substantiality requirement).<sup>24</sup> In the absence of valid allocations in the partnership agreement, the partnership tax items must be allocated in accordance with the partners’ interests in the partnership (determined by taking account all facts and circumstances).<sup>25</sup>

Some tax items, such as tax credits, generally do not affect capital account balances. The allocation of these items cannot have substantial economic effect.<sup>26</sup> Other items, such as nonrecourse deductions, affect capital account balances, but have no associated economic benefit or burden to the partners. The allocation of these items also cannot have economic effect.<sup>27</sup> In contrast, COD income affects capital accounts balances and has an associated economic benefit to the partners.<sup>28</sup> Accordingly, the

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<sup>22</sup> We note that, under the Proposed Regulations, the liquidation value approach only applies if the transaction is arm's length.

<sup>23</sup> See Reg. § 1.704-1(b)(2)(ii)(a).

<sup>24</sup> See Reg. § 1.704-1(b)(2)(iii)(a).

<sup>25</sup> See I.R.C. § 704(b)(1)-(2).

<sup>26</sup> See Reg. § 1.704-1(b)(4)(ii).

<sup>27</sup> See Reg. § 1.704-2(b)(1).

<sup>28</sup> The cancellation of a partnership debt increases the net book value of the partnership's assets. See Reg. § 1.704-1(b)(2)(iv)(b). Thus, the cancellation should increase the amount available for eventual distribution to the partners.

allocation of COD income must satisfy the statutory requirement of “substantial economic effect” as described in applicable Regulations.<sup>29</sup>

If partnership nonrecourse debt is discharged, then the minimum gain chargeback provision may come into play.<sup>30</sup> This provision requires that partnership-level income be allocated to a partner whose share of partnership minimum gain declines. Partnership minimum gain equals the excess of partnership nonrecourse indebtedness over the section 704(b) book value of property securing such debt.<sup>31</sup> A similar rule applies to reductions in shares of “partner nonrecourse debt minimum gain.” Partner nonrecourse debt minimum gain is defined by reference to otherwise nonrecourse debt for which one or more partners bear the economic risk of loss.<sup>32</sup>

We considered whether additional rules should be adopted to address the allocation of COD income when partnership level debt is discharged in exchange for an interest in the partnership and the fair market value of the interest received is less than the amount of the debt discharged, but concluded additional rules generally should not be required. Because the allocation of COD income affects the dollar amount that will be distributed to the partners, constraining the allocation of such income has the effect of constraining the manner in which the partners will divide the economic results of their venture. Our conclusion is consistent with the conclusions of the Service in prior guidance addressing the allocation of COD income.

In a number of Revenue Rulings, the Service has examined when an allocation to a partner of a share of a partnership’s COD income has substantial economic effect to the extent the allocation differs from the partner’s share of the canceled debt under section 752(b). For example, in Rev. Rul. 92-97,<sup>33</sup> the Service concluded that an allocation may differ from the partner’s share of the canceled debt under section 752(b) provided certain requirements are met. Pursuant to Rev. Rul. 92-27, an allocation that differs from the partner’s share of the canceled debt under section 752(b) will have substantial economic effect if: (i) the deficit restoration obligations with respect to any negative capital account balances resulting from the cancellation of indebtedness income allocations can be applied to satisfy other positive capital account balances of the partners; (ii) the other substantial economic effect test requirements are met; and (iii) substantiality is established independently.

Similarly, in Rev. Rul. 99-43,<sup>34</sup> the Service examined whether a partnership’s allocations met the substantiality requirements of the section 704(b) Regulations. In Rev. Rul. 99-43, after the partnership recognized COD income, the partnership agreement was amended to allocate the entire COD income to an insolvent partner, resulting in a tax benefit to one partner without a tax detriment to the other partner. Further, pursuant to

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<sup>29</sup> See, e.g., Rev. Rul. 99-43, 1999-2 C.B. 506 (applying requirement of substantial economic effect to partnership income from the cancellation of indebtedness).

<sup>30</sup> See Reg. § 1.704-2(f)(1).

<sup>31</sup> See Reg. § 1.704-2(d).

<sup>32</sup> See Reg. § 1.704-2(i).

<sup>33</sup> 1992-2 C.B. 124.

<sup>34</sup> 1999-4 C.B. 506.

the amendment, the book loss resulting from a revaluation was allocated to the partner who was allocated the COD income. The Service ruled that the allocations lacked substantiality and would not be respected because they resulted in no change to the economic position of the partners. We agree with the approach in these Revenue Rulings and do not believe additional guidance relating to the allocation of COD income among partners is required. We believe that, except as specifically noted below, the partners should be free to allocate COD income in any manner agreed upon by the partners as long as the allocation otherwise complies with the section 704(b) Regulations, subject to the discussion below regarding the minimum gain chargeback rules of Regulation section 1.704-2.

#### **IV. COD Income Should be a First Tier Item**

Consistent with the discussion above, we believe that Regulation section 1.704-2(f)(6) and (j)(2)(i) should be amended to provide that when a minimum gain chargeback results in whole or in part from the discharge of partnership or partner nonrecourse debt, the minimum gain chargeback should consist of an allocation of COD income relating to such debt before the allocation of any other item of income or gain.<sup>35</sup> Currently, the Regulations dealing with the partnership minimum gain chargeback and partner minimum gain chargeback provide that the minimum gain chargeback will consist first of an allocation of gains from disposition of property subject to the debt and then, if necessary, a pro rata portion of other items of income and gain. Specifically, Regulation section.1.704-2(f)(6) states:

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 of more partnership nonrecourse liabilities and then if necessary consists of a pro rata portion of the partnership's other items of income and gain for that year.

Under this Regulation and the companion Regulation dealing with minimum gain chargeback of partner nonrecourse debt, no preference is given to COD income, even though the minimum gain chargeback and COD income both result from the cancellation of debt. The COD income is more closely related to the minimum gain chargeback than the partnership's other items of income and gain and, therefore, like gains from the disposition of property subject to nonrecourse debt, should be given preference over other items of income and gain under the chargeback. If there is both COD income and disposition gain on the debt-for-equity exchange, we propose that the COD income and

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<sup>35</sup> There is significant uncertainty at what level, partner or partnership, the recourse or nonrecourse nature of the debt is tested for determining whether discharge of the debt in exchange for the property gives rise to COD income under section 61(a)(12) or gain under section 1001, and whether the rules of section 752 or section 1001 apply in determining whether the debt is recourse or nonrecourse for this purpose. We suggest the Treasury and the Service consider addressing this issue. We also suggest the Treasury and the Service consider specific guidance for situations in which Rev. Rul. 90-16, 1990-1 C.B. 12, could apply because the debt is treated as recourse for section 1001 purposes even though it is treated as nonrecourse for purposes of sections 704 and 752.

disposition gain be allocated pro rata within the first tier. Mandatory application of this proposed allocation would provide mechanical rules easily understood and certain results.