REPORT #766

TAX SECTION

New York State Bar Association

Report on Certain Issues

Relating to Troubled Partnerships

June 28, 1993

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June 28, 1993

Margaret Richardson
Commissioner
Internal Revenue Service
1111 Constitution Ave. NW
Room 3000
Washington, D.C. 20224

Dear Commissioner Richardson:

Enclosed is a report of the Tax Section, jointly prepared by the Committees on Partnership and Bankruptcy, which deals with many of the technical issues raised by the restructuring of troubled partnerships. This is a subject of great practical importance, which has not been dealt with in any comprehensive way by the relevant statutory, administrative, and judicial authorities.

The report suggests an approach to the allocation of cancellation of indebtedness income which is believed to be consistent with the underlying theory supporting the Section 704(b) and Section 752 regulations. The report also analyzes whether a “partnership equity for debt” exception can be said to exist under current law. The conclusion of the report is that the status of such an exception is uncertain and that clarification, preferably legislative, is required. Finally, the report deals with certain of the ancillary issues arising from the operation of a “partnership equity for debt exception” should one be deemed to exist.

We hope the report will serve as a helpful guide through this complex and unclear area.

Yours truly,

Peter C. Canellos

cc: Leslie B. Samuels
Harry L. Gutman

enclosure

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NEW YORK STATE BAR ASSOCIATION

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REPORT ON CERTAIN ISSUES RELATING TO TROUBLED PARTNERSHIPS[1]

I. Introduction. The federal income tax consequences of restructurings of troubled partnerships is a topic of major current concern to both the tax and bankruptcy bars. Until recently the Internal Revenue Service (the “Service”) had provided virtually no guidance with respect to the many issues that arise in this context. This report focuses on two subject areas relating to troubled partnerships.

The first area is the treatment of cancellation of indebtedness (“COD”) income recognized by partnerships, including in particular issues relating to permissible allocations with respect to both recourse and nonrecourse debt, the effect of minimum gain chargebacks, and allocations between former partners and newly admitted partners. Within the past year the Service issued Revenue Ruling 92-97, which addressed two issues relating to cancellation of partnership indebtedness, but the guidance provided is less than complete in view of the special fact pattern used in the ruling. As summarized below, the report

1 This report was prepared by the Committees on Partnerships (Joel Scharfstein Co-Chair) and Bankruptcy (Stuart J. Goldring and Dennis E. Ross Co-Chairs) and topic subcommittees chaired by Harvey Berenson, Jill E. Darrow, Michael Hirschfeld, Mark Leeds, and Andrew P. Solomon. Significant contributions were made by Bill Abrams, Reuven S. Avi-Yonah, Andrew Berg, Michael J. Close, Quincy Cotton, Paul J. Crispino, Mitchell L. Engler, Robert C. Holmes, Deborah Paul, Carol A. Quinn, Madelyn Shulman, Lewis Steinberg, Paul Steinberg, Linda Z. Swartz, Robert Wallingford, Hershel Wein, and John C. Vlahoplus. Other helpful comments were received from Roger J. Baneman, William L. Burke, Peter C. Canellos, John A. Corry, David P. Hariton, Robert A. Jacobs, Stephen B. Land, Carolyn Joy Lee, Stephen L. Millman, Elliot Pisem, and Michael L. Schler.

recommends that certain modifications be made to the Section 704(b) regulations to address COD income and other liability related issues and that certain other issues be clarified by revenue ruling.

The second area covered addresses the question of the existence of an equivalent of the “stock for debt exception” in the partnership context. The report concludes that the existing case law which deals only with the corporate stock-for-debt exception offers no clear answer to the question of whether a comparable exception exists in the partnership area. Moreover, the stock-for-debt exception has been subject of repeated Congressional action and limitation. In view of the foregoing and the important bankruptcy policies which may be implicated, the Report recognizes that a legislative solution might be more appropriate than administrative action. The second topic also addresses collateral consequences which would arise from the application of a partnership equity for debt exception, including capital account and minimum gain chargeback issues.

II. Summary of Recommendations. Set forth below is a summary of the Committee's recommendations and conclusions:

A. COD Allocation Issues. The Committee recommends: (i) that the Section 704(b) regulations be amended to provide for an expansion of the existing “qualified income offset” requirement to cases where a partner's deficit restoration obligation is unexpectedly reduced, as a result of COD income or otherwise, below the negative balance of such partner's capital account, (ii) that Revenue Ruling 92-97 be clarified to indicate that allocations of COD income in accordance with the Section 752 sharing ratio of the liability discharged will not necessarily have economic effect if less than all of the partnership's liabilities are discharged or to otherwise indicate how the portion of the partnership's liabilities discharged is calculated, (iii) that Reg. § 1.704-2(f)(6) be amended to provide for the treatment of COD income as a priority item allocation for purposes of effecting a “minimum gain chargeback” in a manner similar to the treatment of gains on disposition of property; (iv) that a revenue ruling be issued confirming that under Section 706 of the Code, COD income arising on the date of admission of a new partner, will be included in the pre-admission period under an interim closing of the books method, and accordingly, none of such income need be allocated to the newly admitted partner, and (iv) that the Section 704(b) regulations be amended (or a revenue ruling issued) to provide that where a partnership elects to revalue its assets for book purposes upon admission of a new partner, the partnership would also be able to elect to revalue its liabilities for book purposes (but not for tax purposes).

B. Equity For Debt Exception. The Report concludes that the principal support for a “partnership equity for debt” exception is by analogy to the case law underlying the corporate “stock-for-debt” exception. However, current acceptance of the underlying rationale of such cases is questionable, making the extension of such cases to the partnership context uncertain, particularly in light of the increasing criticism of the “stock-for-debt” exception. In addition, the Report raises a number of differences between the application of such an exception in the corporate and partnership contexts -- both from a technical and tax policy perspective -- some of which support a “partnership equity for debt” exception, and others of which do not. In view of the confused state of the law and the importance of the issue which can have both positive and adverse effects, no matter which way decided -- a prompt solution is desirable. The Report further recognizes that a legislative solution might be more appropriate than administrative action.

C. Collateral Issues in Equity for Debt Exchanges.

Assuming a “partnership equity for debt” exception exists, the Committee believes that in a partnership equity for debt exchange the creditor/partner's capital account Should initially be established by reference to the fair market value of the debt contributed and assuming an equity for debt exception to income recognition exists, any excluded COD should be treated as the equivalent of tax exempt income for capital account maintenance purposes (but not for basis purposes). For tax purposes, Section 704(c) principles should be applied in the post exchange period by treating the creditor/partner as though it had contributed money equal to the fair market value of the debt contributed. The Committee recommends that a revenue ruling be issued explaining such treatment. In addition, the Committee recommends that the Service confirm the following application of the Section 704(b) regulations to equity for debt exchanges, provided that partnership assets are revalued in connection with an equity for debt exchange: (i) any reduction in minimum gain resulting from the exchange, other than a reduction corresponding to recognized COD income, would be excepted from the “minimum gain chargeback” requirement and that any obligation to allocate income under a minimum gain chargeback, to the extent attributable to the period through the revaluation date, would have no application with respect to periods after the revaluation date and (ii) where the issue price of nonrecourse debt contributed to a partnership is greater than the value of the property securing it, the revaluation of the property would be to its fair market value (not the greater issue price of the debt as would be the case if the debt were not extinguished in the transaction).

III. Allocations of COD Income

A. Discharges of Partnership Recourse Debt

As a general proposition it would be expected that allocations of COD income with respect to recourse indebtedness will be respected if, and only if, such allocations have "substantial economic effect," within the meaning of Section 704(b) of the Code and the regulations thereunder.[2]

No special rules are provided in the Section 704(b) regulations for COD allocations. The Service's one pronouncement on this issue is recently issued Rev. Rul. 92-97, 1992-46 I.R.B. 6. That ruling involved partnership AB which had (i) one asset fully depreciated to zero from its original cost basis of 1000, (ii) one recourse liability of 900 to an unrelated lender (who was not the seller of the property) all of which was forgiven for no consideration and (iii) allocations which provide that partners A and B share profits equally (without chargeback of prior losses) and share losses in a 10/90 ratio. Immediately

[2] The regulations provide two alternative tests for economic effect. An allocation will satisfy the primary test for "economic effect" under Reg. § 1.704-l(b)(2)(ii)(b) where: (a) capital accounts are maintained in accordance with Reg. § 1.704-l(b)(2)(iv); (b) liquidating partnership distributions are made in accordance with the partners' positive capital account balances; and (c) each partner has an unconditional obligation to restore any deficit in his capital account following a liquidation of his partnership interest (an "Unconditional Deficit Restoration Obligation" or an "UDRO"). Where the first two requirements are satisfied but each partner does not have an UDRO, allocations which do not cause or increase a partner's deficit capital account balance (in excess of any deficit restoration obligation) will generally have "economic effect" under the "alternate test" if the partnership agreement contains a "Qualified Income Offset" (a "QIO") (Reg. § 1.704-l(b)(2)(ii)(d)). Note that allocations which have "economic effect" will only be respected if the "economic effect" is "substantial" within the meaning of Reg. § 1.704-l(b)(2)(iii).

prior to the time the COD is recognized, partners A and B have respective deficit capital account balances of (90)/(810). Under the partnership agreement the COD income of 900 is allocated 450/450 to A and B. The ruling addressed two situations where COD income is allocated in a manner which “differs from the partner's share of the cancelled debt under Section 752(b).” In Situation 1 of the ruling the Service held that where the partners were obligated to restore deficit capital accounts only to the extent necessary to pay creditors, the allocations lacked economic effect. In contrast, Situation 2 of the ruling held that the allocation of COD income had “substantial economic effect” where each partner had an Unconditional Deficit Restoration Obligation. The special facts of the ruling, including in particular that there was only one debt all of which was forgiven and that there was only one property which was fully depreciated for both book and tax purposes, enabled the ruling to avoid addressing many of the hard questions relating to COD allocations.[3] In the discussion which follows the Committee has attempted to address more generally issues and principles of COD allocations with respect to recourse debt.

1. Allocations where each partner has an UDRO. Allocations of COD income with respect to recourse indebtedness will always have economic effect under the Section 704(b) regulations in cases where each partner has an UDRO. If each partner has an UDRO, an allocation of COD income will have economic effect whether or not it is in accordance with the

[3] Another “special” fact is that the lender forgave the entire indebtedness for no consideration. This suggests that the asset was worthless.

manner in which the liability is shared among the partners under Section 752 principles.[4]

Example 1:[5] A and B form a general partnership AB. Neither A nor B makes any capital contributions to AB. AB borrows 1000 on a recourse basis from an unrelated lender and purchases depreciable property with the proceeds of the loan. The AB partnership agreement provides that net profits are to be shared 50/50 and net losses are to be allocated 10% to A and 90% to B, and contains an UDRO with respect to each partner.

Assume during each of the first 4 years the property generates 100 of depreciation deductions and all other partnership deductions and losses equal partnership income so that the partnership has a net loss of 100 each year which is allocated 10 to A and 90 to B. If the lender cancels 400 of the debt at the beginning of year five, the partnership will realize 400 of COD income. The allocation of the COD income 50/50 as provided in the partnership agreement (assuming the fifth year has a net profit including the COD income) will have economic effect. In addition any other allocation of the COD would have economic effect, including an allocation in

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4 COD allocations have the potential for presenting particular concerns with regard to the substantiality of their economic effect. Since COD income often corresponds to a sharp decline in the value of partnership property below its book value and COD events are not generally a basis for capital account revaluations there is the potential for transitory allocation issues with respect to the COD (i.e., COD allocated to partner A with subsequent loss on the property allocated to A to reverse the COD allocation). Without commenting on the appropriateness of the regulation in this context, see Reg. § 1.704-l(b)(2)(iii)(c)(2) which provides that for purposes of the "substantiality" rules, the adjusted tax basis of partnership property will be presumed to be its fair market value.

5 Unless otherwise stated, it may be assumed that all partnerships in this Report: (1) maintain their capital accounts in accordance with Reg. § 1.704-l(b)(2)(iv) and (2) are required to liquidate in accordance with the partners' positive capital account balances and Reg. § 1.704-l(b)(2)(ii)(b)(2) and (3) either all partners have UDROs or the partnership has a QIO. In addition it is assumed that the partners agree that upon liquidation, ultimate responsibility for unsatisfied partnership recourse indebtedness will be borne by the partners in accordance with their negative capital account balances.

accordance with the manner in which the partners shared the liability under Section 752.[6]

2. Allocations where each partner does not have an UDRO. Where fewer than all partners of a partnership have UDROs, the partnership's allocations of COD may lack economic effect. The Committee agrees that allocations similar to those in Situation 1 of Revenue Ruling 92-97 generally lack substantive economic effect and should not be respected.[7] Indeed the problem is more general than the COD case and can arise whenever a partner's share of a partnership recourse liability is reduced for any reason (including actual repayment of the liability) and after such reduction the negative balance of the partner’s capital account exceeds his remaining limited deficit restoration obligation.

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[6] In this example at the end of the 4th year A's and B's capital accounts would be (40) and (360), respectively. After the COD allocation, A and B's capital accounts would be 160 and (160), respectively. If the property were sold at this point for its book value of 600, there would be no further gain or loss and the 600 of proceeds would be paid to the lender in full satisfaction of the debt. The allocation of COD income would have economic effect since under the deficit restoration provision B would have to pay 160 to the partnership and A would receive 160 from the partnership upon liquidation. See Situation 2 of Revenue Ruling 92-97. A similar analysis would show that any other allocation of COD income would also have economic effect, including a 10/90 allocation in accordance with the partners' Section 752 sharing ratios.

[7] The Ruling does not discuss the value of the partnership's property other than indicate that it had declined significantly from its original cost of 1000. If the property was worth 720 or more at the time of the discharge and a revaluation of the property for book purposes were permitted at the time of the discharge (which it generally is not) the allocation in Situation 1 could satisfy the requirements for economic effect under the regulations (i.e.. each partner would be allocated 360 of book up gain and 450 of COD income resulting in ending capital accounts of 720/0 for A and B respectively). The Committee considered whether to recommend that COD events be added to the list of events which trigger permissive revaluations of partnership property for book purposes under Reg. § 1.704-l(b)(2)(f). While this may be appropriate, the Committee is not making a specific recommendation, since it believes that revaluation triggering events should be addressed in a more general context.

However, while the Committee supports the result in Situation 1 of Revenue Ruling 92-97, as well as its application to the more general case described above, it is concerned that the result is inconsistent with the literal language of the regulations, since any allocation of COD income to the partners literally satisfies the alternate test for economic effect under Reg. § 1.704-l(b)(2)(ii)(d). Under that test, if the capital account maintenance, liquidation and QIO requirements are satisfied, an "allocation will be considered to have economic effect ... to the extent such allocation does not cause or increase a deficit balance in such partner's capital account [in excess of such partner's limited restoration obligation]." An allocation of income can "not cause or increase a deficit balance in [any] partner's capital account" (emphasis added).[8] In view of the foregoing, as discussed more fully below, the Committee recommends that the Section 704(b) regulations be amended to expressly address the case where a partner's deficit restoration obligation is reduced.

Where an allocation of COD income lacks economic effect, the COD income must be allocated in accordance with the "partners' interest in the partnership." The Regulations provide

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[8] The Revenue Ruling cites Example 15(iii) of Reg. § 1.704-l(b)(5) as support for the conclusion in Situation 1. Although this example does involve a factual situation where an allocation of income (which by itself can never cause or increase a deficit balance) was rejected, the example can be distinguished from Situation 1 of the Revenue Ruling on grounds that Example 15 involved a situation where the income allocation at issue was charging back a prior loss allocation which had no economic effect. This suggests that Example 15 stands for no more than the proposition that the primary and alternate tests for "economic effect" under the Section 704(b) regulations cannot be relied on once the capital accounts have been tainted by an allocation which has no economic effect. In contrast, the original allocation of depreciation in Situation 1 of Revenue Ruling 92-97 apparently was not challenged. Cf. Reg. § 1.704-l(b)(4)(vi) (prior allocations may be reallocated if a partner's restoration obligation is reduced or eliminated by an amendment to the partnership agreement that, in effect, was expected at the time of the original agreement).

that if the capital account and liquidation requirements of the economic effect tests of the Regulations are satisfied, the partners' portion of an allocation that lacks economic effect will be determined by comparing (i) the manner in which distributions would be made if all partnership property were sold at book value and the partnership were liquidated at the end of the year to which the allocation relates to (ii) the manner in which distributions would be made if the partnership had been similarly liquidated at the end of the immediately preceding year.[9] In the COD context, application of this procedure generally results in a specific manner in which the COD income is to be allocated. That is where a cancellation of debt, or any other event (e.g., the payment of principal from partnership income), reduces a partner's deficit restoration obligation below the amount of the deficit balance in his capital account (or increases an existing discrepancy), partnership income must first be allocated on a priority basis to eliminate any excess in the partner's deficit capital account over his remaining deficit restoration obligation.[10] The holding in Situation 1 of Revenue Ruling 92-97 is consistent with this rule.

For this purpose it is important to know to what extent a partnership recourse obligation gives rise to a deficit restoration obligation and the regulations are not clear on this point.[11] With respect to this issue, the Committee believes that

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[9] Reg. § 1.704-l(b)(3)(iii).

[10] This provision is an analogue to the existing QIO requirement of Reg. § 1.704-l(b)(2)(ii)(d) (limited deficit restoration obligation unexpectedly reduced below deficit balance vs. [QIO case] deficit balance unexpectedly increased in excess of limited deficit restoration obligation).

[11] Reg § 1.704-l(b)(2)(ii)(c)(2) provides that a partner's deficit restoration obligation includes "The amount of any unconditional obligation of such partner (whether imposed by the partnership

consistency with the approach of the Section 704(b) regulations requires that recourse indebtedness be treated as giving rise to a deficit restoration obligation only to the extent that a partner would be liable for payment of the debt (using section 752 principles for determining allocation of the burden among the partners) if the partnership’s property were sold for its book value and the proceeds were applied to satisfy the partnership's indebtedness.[12] Note that this approach does not assume that the partnership's property is worthless as do the Section 752 13 regulations in allocating debt for basis purposes.[13]

In view of the foregoing, the Committee recommends that the Section 704(b) regulations be amended to expressly provide for a priority allocation of income in any case where a partner's limited deficit restoration obligation is unexpectedly reduced to an amount which is less than the amount of the negative balance of such partner's capital account. This rule could be implemented by amending Reg. § 1.704-l(b)(2)(ii)(d) to expand the circumstances under which a QIO triggers a gross income allocation. Appropriate guidance should also be provided as to the determination of deficit restoration obligations attributable to particular recourse indebtedness. Example 2 illustrates the application of these principles:

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agreement or state or local law) to make subsequent contributions to the partnership.”

12 Note in particular that the regulations employ the limited deficit restoration concept only for purposes of the alternate test for economic effect and in that context the deficit restoration obligation is compared with the deficit balance of a partner's capital account. It would make little sense to compare a book basis capital account deficit with a deficit restoration obligation determined on a different basis. See Reg § 1.704-l(b)(2)(ii)(d).

13 The result in situation 1 of Rev. Rul 92-97 should not change if shortly before the discharge the partnership borrowed 600x on a recourse basis which it kept in a bank account through the end of the year of discharge, even though B's Section 752 share of the post discharge debt, 540x, would then exceed his negative capital account balance (360x) after allocation of the COD.

Example 2: Case 1 - A and B form a general partnership AB. Neither A nor B makes any capital contributions to AB. AB borrows 1000 on a recourse basis from an unrelated lender and purchases depreciable property with the proceeds. The AB partnership agreement provides that net profits are to be allocated 50/50 between A and B. Net losses are to be allocated first 300 to B and thereafter 10/90 between A and B. The partnership agreement does not contain an UDRO.

During its first year of operation the partnership has 300 of depreciation deductions and other expenses equal other income, so that the partnership has a 300 net loss all of which is allocated to B. Assume that in year 2 gross income equals total deductions, including 100 of depreciation, and the 100 of depreciation cash flow is used to pay down the debt to 900. At the end of year 2 A and B have capital accounts of 0 and (300) respectively. If at the beginning of year 3 the value of the property has declined to 600 (its book value) and the lender forgives 300 of the liability, there will be 300 of COD income.

Under the partnership agreement, the COD income would be allocated according to the general profits split or 150/150 (assuming the third year has a net profit including the COD income). Such an allocation would result in A and B having capital accounts of 150 and (150) respectively. The allocation should not be viewed as having economic effect since B does not have an obligation to restore the deficit balance in his capital account to fund the positive balance in A's capital account, and if the partnership were liquidated with its remaining assets sold at their book values, A would not receive the positive balance in his capital account.

Case 2 - The facts are the same as Case 1, above, except that the partnership contains a provision that income must be allocated on a “priority” basis per the Committee's recommendation where a partner's limited deficit restoration obligation is unexpectedly reduced below the negative balance of such partner's capital account. Under this provision, the 300 of COD income would be allocated solely to B, leaving both A and B with 0 capital accounts. This allocation conforms with what would happen on an economic basis if the partnership were then liquidated with no further recognition of gain or loss (i.e., all property sold at book value).

a. Allocations in accordance with Section 752 principles. Where a partnership does not have UDROs for all partners, an allocation of COD income attributable to a discharge of all of the partnership's recourse liabilities in the manner in which such liabilities are shared in the aggregate under Section 752 will always have economic effect.[14] However, where only a portion of a partnership's recourse liabilities are discharged, allocations of COD income in the manner in which the discharged liability is shared under Section 752 principles will not necessarily have economic effect.[15]

Example 3: Same facts as Example 2 (Case 1) except that the partnership agreement provides that net profits and losses are to be computed without regard to COD

[14] This follows because (i) any allocation of COD will have economic effect as long as it does not result in any partner having a negative capital account in excess of his deficit restoration obligation, (ii) if the partnership's allocations have met the requirements of the alternate test for economic test through this time no partner will have a deficit balance in his capital account in excess of the sum of his Section 752 share of the partnership's recourse liabilities plus his share of partnership minimum gain plus any explicit deficit restoration obligation he has under the partnership agreement (except in cases where a QIO would be triggered) and (iii) since each partner's share of the COD will equal his section 752 share of the partnership's recourse liabilities an allocation of COD in accordance with the manner the partners' share the discharged liabilities under Section 752 will ensure that after the COD allocation no partner will have a deficit capital account in excess of his remaining limited deficit restoration obligation.

Under the Section 752 regulations a partner's share of a recourse liability equals the portion of the liability for which the partner bears the ultimate economic risk of loss. This portion is computed by determining how the economic burden of the liability would be shared if all of the partnership's assets became worthless, they were disposed of for no consideration (other than relief from nonrecourse liabilities), and the partnership then liquidated.

[15] While the Section 752 regulations provide clear rules as to how all of the partnership's recourse liabilities are shared, there are no rules for determining a partner's share of (i) a portion of a single liability or (ii) a single liability where the partnership has multiple recourse liabilities.

income, which is to be specially allocated in accordance with the manner in which the partners share the liability under Section 752.

Immediately before the discharge, A and B's respective shares of the entire liability are 60 and 840 under Section 752. An allocation of the 300 of COD income in a 60/840 ratio would result in a 20/280 allocation of the COD. After the allocation, A and B would have capital accounts of 20 and (20) respectively. This allocation will lack economic effect because B's restoration obligation has been reduced to zero.

To the extent that Revenue Ruling 92-97 (Situation 1) suggests that allocations lacking economic effect will always be reallocated according to the Section 752 sharing ratio,[16] the ruling should be clarified to provide that the reallocation will not always be in accordance with such ratio unless all the partnership's liabilities are discharged. Alternatively, the Service should explain how to determine the partners' shares under Section 752 of a discharged recourse liability when less than all of the partnership's recourse liabilities are discharged.[17]

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[16] The ruling states that the COD income must be reallocated 90x to A and 810x to B "which is the same ratio as the decrease in A's and B's shares of partnership liability."

[17] This determination should correspond with the manner in which COD income with respect to the discharged liability would be allocated under the partners' interest in the partnership test. An alternative approach that might be considered would be for the determination to be made by analyzing how responsibility for the discharged liability would be borne, in accordance with Section 752 principles, if the partnership's assets were sold, not for their book values (as in the partners' interest in the partnership test), but for an amount equal to the amount of non discharged liabilities and the proceeds were then used to repay such non discharged liabilities - leaving the discharged liabilities to be paid by the partners. Note, however, that this approach effectively provides for a revaluation of the partnership's assets to the amount of the non-discharged liabilities. In the case of Example 3 either approach would result in the entire 300 of COD income being appropriately allocated to B, and would likewise produce the appropriate result if only 200 of COD were triggered.

B. Discharges of Partnership Nonrecourse Debt.

A discharge of partnership nonrecourse debt raises special issues because of the possibility that it will trigger a minimum gain chargeback ("MGCB"). In addition, a partner's share of nonrecourse debt is considered part of a deficit restoration obligation only to the extent of the partner's share of partnership minimum gain.[18]

1. Allocations where partnership minimum gain is not reduced. Subject to the discussion below relating to equity for debt exchanges, if a nonrecourse lender to a partnership, who is otherwise unrelated to the partnership, forgives a portion of the nonrecourse loan, the partnership will recognize COD income. To the extent that the allocation of COD is not governed by the partnership's MGCB provision (e.g., because forgiveness does not result in a reduction of the partnership's minimum gain), any allocation of the COD income under the partnership agreement should generally have economic effect[19].

2. Income allocated to satisfy MGCB resulting from discharge of debt. To the extent that the forgiveness results in a reduction of the partnership's minimum gain, the COD income (and potentially other income as well) will be allocated to the partners pursuant to the partnership's MGCB provision. Under current law (Reg. § 1.704-2(f)(6)), the MGCB requirement is satisfied first by gains on the disposition of partnership property subject to nonrecourse debt and then by a pro rata

[18] Reg. § 1.704-2(g)(1).

[19] This follows since the allocation will satisfy the alternative test for economic effect and since the debt is nonrecourse its discharge will not reduce the partners' limited deficit restoration obligations. See Reg. § 1.704-2(g)(1).

portion of all other items of income and gain (including COD) for the year.

If COD income is recognized with respect to nonrecourse debt, this rule can result in the COD income being allocated in significantly different proportions than the nonrecourse deductions with respect to such debt were allocated.[20] The manner in which the COD income is allocated can be important since COD income is eligible for exclusion from the gross income of insolvent or bankrupt partners under Section 108, while other income items are generally not excluded. The Committee believes that COD income with respect to nonrecourse debt should generally be allocated in the same manner as though the COD income had been realized on [21] disposition of the property. Accordingly, the Committee recommends amending Reg. 1.704-2(f)(6) to provide for the treatment of COD income as a "priority" item allocation for purposes of the MGCB in a manner similar to the treatment of gains on disposition.[22]

> Example 4: A and B are the partners in the AB partnership with each making a 50 capital contribution. The AB partnership agreement provides that net income is to be allocated 50% to A and 50% to B and that net loss

[20] This would occur where the partnership has other significant items of income or gain in the year of discharge and the nonrecourse deductions were allocated in different proportions than the current residual allocation of income and gain.

[21] On the disposition of property subject to nonrecourse debt where the value of the property is less than the face amount of the debt, the excess of the debt over the value of the property is included in the amount realized on disposition. See Tufts v. Commissioner, 461 U.S. 300, 83-1 USTC 9328 (1983) and Section 7701(g).

[22] The Committee recognizes that existing Reg. § 1.704-2(f)(6) provides only rough justice with respect to item allocations in certain other situations as well, particularly where a partnership holds multiple properties. However, the Committee believes that a priority allocation of COD income merits special attention. Note the issue with respect to COD arises even in simple single property partnerships if profit and loss sharing ratios differ.

is to be allocated 75% to A and 25% to B. Nonrecourse deductions for a year are allocated as part of the net income or net loss for such year. AB purchases depreciable property for 1000, borrowing 900 on a nonrecourse basis from an unrelated lender. The partnership agreement contains a MGCB.

Assume that in year 1 AB has 400 of depreciation deductions with respect to the property (300 of which are nonrecourse deductions) and that other income equals other expenses. The 300 of nonrecourse deductions are allocated 225 to A and 75 to B per their loss sharing ratios. Assume that at the end of year 2 the property has declined in value and the lender forgives 200 of the debt resulting in 200 of COD and that other income equals 800 and other expenses for such year equal 790 (assume for simplicity no depreciation in year 2). A and B's shares of minimum gain are accordingly reduced by 150 and 50, respectively.

Under the current rules (Reg § 1.704-2(f)(6)) the minimum gain chargeback of 200 would be effected by allocating 30 of COD income and 120 of other income to A and 10 of COD income and 40 of other income to B. The balance of the partnership's income and deductions would be allocated equally between A and B.[23] Overall A would be allocated 110 of COD income and a net amount of 45 of other items. If A were in bankruptcy A could exclude the COD income under Section 108 but the 45 of other income would be subject to tax.

Under the rule suggested by the Committee, the MGCB would be effected by a priority chargeback of the COD. Thus A would would be allocated 150 of COD pursuant to the MGCB and a net amount of 5 other income. A could exclude the 150 of COD income under Section 108 and would have only 5 of net taxable income.

C. Special Considerations Regarding Allocations of COD Income Between "Old" Partners and Newly-Admitted Partners.

[23] The allocation would be 50/50 since without regard to items used to effect the chargeback the partnership had a net profit of 10. A and B would each be allocated 80 of the remaining 160 of COD income, 320 of the remaining other income, and 395 of deductions. Overall A would be allocated 110 of COD income and 440 of other income and B would be allocated 90 of COD income and 360 of other income.

1. COD realized on date of admission. The restructuring of a troubled partnership often results in COD income being recognized on the same date that a new partner is admitted to the partnership. Such COD income should be allocated solely to the old partners; none should be allocated to the new partners. It is likely that under Section 706(d) the partners can achieve this result by providing for an interim closing of the partnerships books as of the date of admission of the new partner. Some practitioners, however, are concerned that it is not clear under the Section 706 regulations whether the date of the closing can always be treated as part of the pre-admission period or whether such date must be treated as the first date of the post-admission period.[24] In view of this concern, the Committee recommends that a revenue ruling be issued confirming that the date of admission can be included in the pre-admission period under an interim closing of the books method.

2. Discount and COD economically accrued at the time of admission of a new partner. A partnership which has the potential for the realization of “economically accrued” COD income as part of a plan or otherwise, may admit new partners prior to the date that the COD income is actually realized.[25] In

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[24] See Reg. § 1.706-l(c)(2)(ii) (Example) (on a sale by a partner on June 30th of his partnership interest, the partner includes in income his share of the partnership's income “up to” June 30th). On the other hand, the text of the Regulation states that a partner shall include “his distributive share ... for his partnership taxable year ending with the date of such sale ....”

[25] The COD may be realized in a different taxable year than the year the new partner is admitted. In addition, note that rather than realizing the economic gain through a negotiated discharge of the liability at a discount, the economic gain may be realized over time by servicing the existing debt with its below-market rate of interest (e.g., below AFR). This situation is analogous to a below-market lease (which would be an asset subject to revaluation under the current regulations), or to a below-market receivable or payable. See the textual discussion following Example 5 regarding the theoretically correct treatment of the gain in these circumstances.

general, such COD income should not be allocated (for book or tax purposes) to the newly admitted partners, at least to the extent that such COD income was [26] "economically accrued" at the time of the admission. In this context, "economically accrued" COD income may be viewed as the equivalent of any "built-in" gains in partnership assets.

The case of COD income (which case is of particular interest to troubled partnerships) highlights a more general issue under the Section 704(b) and Section 704(c) regulations; the treatment of partnership liabilities, both recourse and nonrecourse[27], which have a fair market value which differs from their "tax value."[28] The issue is the appropriate treatment of a partnership liability which is clearly not worth its tax value (e.g., because of increases in market interest rates, impending cancellation of a portion of the liability or its contingent nature) when a new partner is admitted to the partnership and the partnership's assets are revalued. Particularly with respect to contingent liabilities, a common practice in such a case (which the Committee believes is the theoretically correct approach) is for the partnership's capital accounts to be established by reference to the economic value of the liability rather than its

[26] Cf. Section 382 where analogous treatment applies: PLR 9226026 (COD income recognized after an ownership change treated as a "built in gain" item under Section 382(h)(6) [income items properly attributable to pre-change period]); PLRs 9216019 and 8812065 (COD income recognized after an ownership change treated as "economically accrued" prior to ownership change); Notice 87-97, 1987-2 C.B. 387 (COD income "integrally related" to a transaction resulting in an ownership change allocable to the pre change period).

[27] For a discussion of special considerations with respect to nonrecourse debt, see Section III.C.2.a of this Report.

[28] For these purposes "tax value" will mean the instrument's adjusted issue price (or zero in the case of a contingent liability).

tax value[29]. This approach is parallel to the treatment of assets for capital account purposes. If the partnership subsequently settles the liability for less or more than its booked value, the partnership will realize book gain or loss. If this approach is not used, distortions in the economic arrangements of the partnership can occur.[30] From a tax point of view, differences between the liability's book value and tax value can be addressed using Section 704(c) principles, as discussed below.

Valuing a liability for book purposes does not affect the overall amount of the liability for tax purposes and is like valuing assets for book purposes. Liability valuation only affects allocations among the partners, and then only to conform with their economic arrangements.[31]

The Committee recognizes that valuation of liabilities can be burdensome. It believes, however, that where a partnership elects to revalue its property under Reg. 1.704-1(b)(2)(iv)(f) the partnership should be able to also revalue its liabilities, but it should not be able to revalue its liabilities unless it

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[29] Under Reg. § 1.704-l(b)(2)(iv)(h), it may be possible to arrive at the same initial capital account balances without specifically valuing liabilities if the partners increase (or reduce) the fair* market value of partnership property to compensate for liability valuations. The Committee is concerned, however, that where the agreed value of the partnership property is clearly overstated, including particularly cases where the value of the property is readily ascertainable (e.g., as in the case of marketable securities), the agreed upon value would not be respected as “reasonably” determined in arm's length negotiations.

[30] For example, if after admission of the new partner, the debt's value increased back to its tax value (e.g., because of a decrease in market rates), there would not be any COD income to allocate for tax purposes but the book loss would be properly allocated among the “old” and “new” partners according to their post-admission sharing ratios.

[31] For example, it would not affect the partnership's basis in its assets, gain from the sale of such property or the partner's basis in their partnership interests.

also revalues its assets[32]. In general, the Committee believes that liability valuation should be elective only. However, in some circumstances where assets are to be revalued and the value of a liability is clearly ascertainable it may be appropriate to require that liabilities also be revalued. Such circumstances might include the case where anticipated COD income is recognized within a short time after admission of a partner and possibly cases where (i) a liability is publicly traded, (ii) the creditors' position in a substantial portion of the liability has recently changed hands in an arm's length transaction for a price substantially different from the adjusted issue price of the debt or (iii) the interest rate on the liability is below the AFR at the time of the transaction.

Following revaluation of a liability, capital accounts would be subject to the subsequent adjustments rule of Reg. § 1.704-l(b)(2)(iv)(g) and the tax allocations rule of Reg. § 1.704-(b)(4)(i).[33]

The following example illustrates the application of the revaluation rules applied to a liability:

> Example 5: Partners A and B form the AB partnership with 100 of capital contributions by each (used to purchase the property described below). The partnership borrows

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[32] The valuing of a partnership liability is already provided for, to a limited extent, in the existing regulations. See Reg. § 1.704-l(b)(2)(iv)(g)(2), setting forth the principles to be applied to the book allocations with respect to accounts payable and other accrued but unpaid items that have a book/tax discrepancy. Liabilities are also valued in other partnership contexts. See, e.g., Revenue Ruling 93-7, 1993-4 I.R.B. 5, holding that a partner/debtor's Section 731 gain on the transfer of a debt obligation of the partner/debtor to the partner/debtor in full satisfaction of its partnership interest was determined by reference to the fair market value of the liability (and not its adjusted issue price).

[33] This rule requires the application of Section 704(c) principles.

800 at 6% interest to purchase nondepreciable property worth 1000 in year 1. Cash income equals cash expenses during year 1. Market interest rates increase such that at the start of year 2, the debt has a fair market value of 600, and the partnership's “true” book equity value is 400 since the property has retained its 1000 value. At the start of year 2, new partner C contributes 100 cash for a 20% interest in the partnership's profits and capital. During year 2, cash income equals cash expenses and the partnership borrows 600 at market rates which is used to pay off the original debt in full. Absent a revaluation of the liability at the time of admission, the COD income on the satisfaction of the debt at a 200 discount would be allocated 20% to C and the capital accounts at the end of year 2 would be 180/180/140 (A/B/C). This result is a distortion of the economic arrangement since the capital accounts should be 200/200/100 in accordance with the intended economic arrangement.[34]

On the other hand, if the partnership liability is revalued to 600 at the time of admission, A's and B's capital accounts would each be increased to 200 on the admission of C and on repayment of the liability for 600 there would be no book COD income. At the end of year 2, the capital accounts would be (200/200/100) (A/B/C) reflecting the intended economic arrangement. For tax purposes, 200 of COD income would be recognized and would be allocated solely to A and B under Section 704(c) principles to account for the difference between the book value and the tax value of the liability.[35]

If the liability in Example 5 was not discharged but rather was satisfied in accordance with its terms, the

[34] At this point, the partnership has property worth 1000, cash of 100 and a liability of 600, leaving the partnership with 500 of equity.

[35] As an alternative to the revaluation of the liability, the partners could have agreed that the first 200 of COD income would be allocated 50/50 to A/B. However, A and B are not going to like this arrangement since they will want assurances that in all events the proper economics would be achieved. The alternative structure will not produce the desired result in all events. For example, if due to a subsequent decline in market interest rates the debt increases in value to 700 such that there is only 100 of COD to allocate, the ending capital accounts would be (150/150/100) (A/B/C) rather than 160/160/80 (A/B/C) (the appropriate result, since the 100 increase in the debt should be allocated 40/40/20). Since this alternative does not comport with the intended economics, it should not be forced on the partners.

technically correct approach would be as follows: for book purposes, the liability would have an adjusted issue price of $600 and a stated redemption price at maturity of $800, i.e., it would have $200 of book OID. (No OID would be created for tax purposes by the revaluation.) Book interest deductions, including book deductions for OID, would be reflected in adjustments to the partners' capital accounts. Consistent with Section 704(c) principles, C would be allocated for tax purposes an interest deduction in each year[36] equal to C's share of the book interest deduction, and the balance of the partnership's interest deduction for tax purposes would be allocated to A and B. The allocations of interest deductions with respect to the liability for the remainder of its five-year term would be as follows:

	A and B		C	
	Book	Tax	Book	Tax
Year 1	63.02	32.24	15.76	15.76
2	66.26	31.43	16.57	16.57
3	69.92	30.52	17.48	17.48
4	74.06	29.49	18.51	18.51
5	78.74	25.32	19.68	19.68
Total	352.00	152.00	88.00	88.00

The foregoing allocations, by creating book interest deductions that exceed tax interest deductions by $200 (the amount by which the liability was revalued) and by allocating to the new partner interest deductions, as determined for tax purposes, up to the amount of book interest charge allocated to him, will eliminate the $200 book/tax disparity created for the

[36] If the Section 704(c) ceiling rule applied, the allocation of interest deductions to C could not exceed the partnership's actual interest deduction for the year. The partnership agreement might, however, provide for curative allocations using other deductions.

old partners by the revaluation in a manner analogous to the allocation of depreciation deductions on revalued assets. [37]

a. Special considerations with respect to nonrecourse debt. In cases where the issue price of nonrecourse indebtedness exceeds the fair market value of the property securing the debt, revaluation should generally lead) to a booking of the gross value of the property to its unencumbered fair market value and a booking of the debt to the same number. In some cases this may involve a booking up of the asset and a booking down of the liability. In other cases it may involve both a booking down of the asset and a booking [38] down of the liability. The booking down of a nonrecourse liability may reduce or eliminate partnership minimum gain in the same manner that partnership minimum gain is eliminated or reduced when assets are booked up. As in the asset case, this reduction in minimum gain should then be accounted for through the Section 704(c) analog

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[37] To avoid undue complexity where liabilities are revalued, a partnership could (at least in most circumstances) not be required to ratably account for book OID created by the revaluation and could be permitted to instead account for it only upon sale or satisfaction of the liability. Corresponding treatment would apply to the partnership's tax deductions under Section 704(c). The Committee believes that, in particular, this simplified treatment should generally be available in cases, if any, where mandatory revaluation of liabilities is required. Under this approach, C would receive only his regular 20% of interest deductions in each year but upon retirement of the debt C would be specially allocated ordinary deductions (for book and tax, but not necessarily interest deductions) in the amount of 40. Note that the 40 matches both (1) the extra interest deductions which C would receive through the OID calculations described above in the case where the below-market debt remains outstanding (i.e., 88 rather than 48 (20% x 240)) and (2) the shift of COD income away from C where the debt was paid off at less than face in Example 5 (i.e., C was allocated 0 rather than 40 of COD income (20% x 200)). Compare the curative allocations provision of Prop. Reg. § 1.704-3(c).

[38] Reg. § 1.704-1(b)(2)(iv)(f)(1) provides that property being revalued cannot be booked down below the amount of any nonrecourse liability to which the property is subject. If revaluations of liabilities are permitted, this regulation should be interpreted as providing that assets cannot be booked down below the revalued book value of the liability to which the property is subject.

provision for liabilities by providing for special allocations of tax items to reflect the difference between the adjusted issue price (tax basis) of the liability and its book value (rather than through application [39] of the MGCB provisions). The following example illustrates these principles:

> Example 6: A and B form a 50/50 partnership AB with a capital contribution of 50 each (held as cash by the partnership). AB borrows 1000 nonrecourse to purchase 1000 depreciable property (the 100 of cash does not secure the debt). The partnership takes 500 of depreciation deductions (cash income equals cash expenses) which reduces the capital accounts of A and B down to (200) each and creates 500 of minimum gain. At a time when the property's value has declined to 800, a new partner C contributes 100 for a 50% interest in partnership capital and profits. The partnership elects to revalue under Reg. § 1.704-l(b)(2)(iv)(f). The asset should be revalued only to its fair market value of 800 and the debt should be revalued down to its value of 800. There is a 500 reduction in minimum gain. The MGCB should not be triggered under Reg. § 1.704-2(d)(4) since the full 500 of gain will be accounted for through Section 704(c) principles (300 on the asset side and 200 on the liability side).

IV. Cancellation of Debt and Partnership Equity for Debt Exchanges

As discussed below, it is uncertain whether a partnership equivalent to the “stock-for-debt” exception to the recognition of COD income exists under current law. Although, by analogy to the stock-for-debt case law, there is support for the existence of a “partnership equity for debt” exception, it is

[39] See the discussion of the MGCB in Section V.C. - “Special Consideration with Respect to Nonrecourse Equity for Debt Exchanges.” In periods after a book liability revaluation, the MGCB should be limited to the amount, if any, by which the book value of the liability exceeds the book value of the asset since Section 704(c) principles would govern to account for (i) the difference between the tax basis of the asset and its fair market value and (ii) the difference between the adjusted fair market value of the liability and its tax value.

unclear whether a court would extend the rationale of these cases to the partnership context. Moreover, there are a number of differences between the application of such an exception in the corporate and partnership contexts -- both from a technical and tax policy perspective -- some of which support a partnership exception, and others of which do not.

A. Brief History of Stock-for-Debt Exception. general, a debtor is required to recognize income from the cancellation of debt.[40] It has long been accepted, however, both by the courts and the Service, that a corporate debtor that issues its own stock in satisfaction of its debt generally does not recognize COD income, even though the value of the stock is only a fraction of the debt.[41] This is commonly referred to as the “stock-for-debt” exception. Moreover, as part of the Bankruptcy Tax Act of 1980, the stock-for-debt exception received statutory recognition, although Congress engrafted certain “de minimis” exceptions, i.e., the “nominal or token” and “proportionality” tests in Section 108(e)(8).[42]

Since then, the stock-for-debt exception has been statutorily limited to insolvent and bankrupt corporations[43] and

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40 Section 61(a)(2); United States v. Kirbv Lumber Co., 284 U.S. 1 (1931).

41 See, e.g., Commissioner v. Motor Mart Trust, 156 F.2d 122 (1st Cir. 1946), aff’q 4 T.C. 931 (1945), acq. 1947-1 C.B. 3 Alcazar Hotel, Inc. v. Commissioner, 1 T.C. 872 (1943), agfiL, 1943 C.B. 1; Capento Securities Corp. v. Commissioner, 140 F.2d 38 (1st Cir. 1944), aff'q 47 B.T.A. 691 (1942), nonacg. 1943 C.B. 28; Rev. Rul. 59-222, 1959-1 C. B. 80; T.A.M. 8738003 (May 22, 1987); T.A.M. 8837001 (May 10, 1988); T.A.M. 8933001 (August 22, 1988).

42 Similarly, in the Bankruptcy Reform Act of 1978, Congress codified the stock-for-debt exception for state and local tax purposes. See 11 U.S.C. § 346(j)(7).

43 See Section 108(e)(10)(i), which was enacted in its original form as part of the Tax Reform Act of 1984. In addition, as part of the Tax Reform Act of 1986, Congress repealed the “qualified workout” exception for solvent corporations. See old Section 108(e)(10)(C).

only applies where "nondisqualified" stock (i.e., nonredeemable) stock is used.[44] Moreover, Congress is currently considering legislation -- identical in form to that vetoed by President Bush last year on election eve -- that would repeal the stock-for-debt exception in its entirety, at least as it relates to corporations. [45]

B. Lack of Guidance in Partnership Area. To date, no case has addressed the existence of an equivalent exception in the partnership area. Similarly, the Service has consistently refused to rule on the issue, [46] although the Service's proposed 1993 Business Plan calls for the issuance of a revenue ruling addressing the issue.[47]

In addition, there is no indication in the legislative history to either the Bankruptcy Tax Act of 1980 (the "1980 Act") or the Bankruptcy Reform Act of 1978 as to whether Congress believed a "partnership equity for debt" exception existed under common law. Nevertheless, there are indications that Congress may have believed the existence of a "partnership equity for debt" exception to be appropriate as a matter of bankruptcy tax policy. In fact, section 346(j)(7) of the Bankruptcy Code (which pre-

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[44] See Section 108(e)(10)(ii), enacted as part of the Revenue Reconciliation Act of 1990.

[45] See Joint Committee on Taxation, Description of Senate Finance Committee Chairman's Mark on Revenue Reconciliation Proposals, dated June 17, 1993 (JCX-6-93) at p. 47.

[46] See PLR 8117210 (January 30, 1981); PLR. 8444069 (July 31, 1984), withdrawn for other reasons, PLR 8643062 (July 31, 1986). See also Notice 91-15, 1991-1 C.B. 319 (stating that notwithstanding an indication to the contrary in the preamble to the proposed Section 108(e)(4) regulations, the transfer of debt to a partnership in exchange for a partnership interest would not be covered by forthcoming regulations designed to prevent the elimination of income on the extinguishment of indebtedness in certain nonrecognition transactions).

[47] Reprinted at Daily Tax Report #11 (January 19, 1993), at L-62, L-63.

dates the 1980 Act) incorporates such an exception for state and local income tax purposes where the creditor receives back a general partnership interest (in either a general or limited partnership).

In addition, the House version of the 1980 Act -- which proposed to codify the stock-for-debt exception, although limiting it to debt constituting a “security” for tax purposes -- included a provision directing the Service to promulgate similar rules with respect to debt of a partnership.[48] The House report did not elaborate on this provision,[49] however, and, as mentioned above, the final version generally preserved the judicially created stock-for-debt exception and thus deleted the stock-for-debt provisions of the House version relating to the corporation's treatment. It should also be noted that the final version enacted Section 108(e)(7) addressing the creditor's treatment in a stock-for-debt exchange and, in Section 108(e)(7)(F), retained for this purpose the provision providing for the promulgation of similar rules for partnerships.

The absence of an explicit recognition of a partnership counterpart to the stock-for-debt exception may evidence Congress' belief that none existed, providing a possible explanation as to why Congress imposed limits on the exemption in the corporate context but not in the partnership context. An alternative explanation, however, is that the concerns in the partnership context were less significant since in the corporate context the exception permanently eliminates one level of tax

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48 H. Rep. 96-833, 96th Cong., 2d Sess. 58-59 (proposed section 108(f)(2)).

49 See H.R. Rep. No. 833, 96th Cong., 2d Sess. 15 (1980).

while in the partnership context the effect of the exception is generally only deferral.[50]

C. Application of Stock-for-Debt Exception to Partnerships. Despite the absence of case law addressing the existence of a partnership equivalent to the stock-for-debt exception, the "stock-for-debt" cases provide analogous support for a partnership exception.

The case law advances two rationales for the stock-for-debt exception: a "shifting of liability" theory and a "subscription price" theory.[51] Under the shifting of liability theory, the exchange is viewed as the substitution of one liability (a debt liability) for another (a capital stock liability), not a cancellation. Under the subscription price theory, the Board of Tax Appeals in the Capento case reasoned that, just as no gain is realized by a corporation upon the receipt of the subscription price of its shares, the same should be true when, instead of being newly paid, the amount has already been paid in as the principal of the debt. T Although the Capento case involved preferred stock with a liquidation price equal to the principal amount of the bond exchanged there for, subsequent cases and rulings have applied the stock-for-debt exception to common stock regardless of "whether the par value of the stock or its then market value was greater or less than the face value of the bonds."[52]

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50 See Section IV.C.l. below.

51 See, e.g., Capento Securities Corp., supra note 33.

52 Commissioner v. Motor Mart Trust, supra note 33, at 127; see other cases and rulings cited at note 33.

These two rationales lead to the conclusion that the stock-for-debt transaction is a continuation of the lender's investment rather than a hypothetical settlement of that debt for property having a value equal to the stock issued. The same tension and arguably, by analogy, the same resolution between "continuing investment" and "realization based on value" apply in the partnership context.

We observe that the partnership analogue is based on the view of the partnership as an "entity" rather than an "aggregation of partners." This is consistent with provisions like Sections 703 and 721 but, as discussed below, is inconsistent with the approach of Section 108(d)(6) which overturns the decision in the Stackhouse case[53] and provides that the Section 108 insolvency and bankruptcy exceptions to COD income are determined on a partner-by-partner basis pursuant to Section 108(d)(6).

Aside from case law, it is possible that Section 721 alone may avoid COD income in a debt-for-equity exchange[54]. In this regard, Section 721 provides that "[n]o gain or loss shall be recognized to a partnership or to any of its partners in the case of a contribution of property to the partnership in exchange for an interest in the partnership." In absence of a ruling from the Service, however, reliance on Section 721 is problematic. In particular, it is unclear whether "gain" for this purpose includes COD income. Support for a narrower reading can be found, by analogy, in the legislative history to Section 361, which governs the nonrecognition of gain or loss by a corporation in a

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53 Stackhouse v. United States, 441 F.2d 465 (5th Cir. 1971).

54 See, e.g., W. McKee, W. Nelson & R. Whitmire, Federal Taxation of Partnerships and Partners 4.02[3] (Warren, Gorham & Lamont 2d Ed. 1990).

tax-free reorganization upon the distribution to its creditors of stock or securities in another party to the reorganization. The legislative history thereto expressly states that: “this provision is not intended, however, to affect the recognition of discharge of indebtedness income by the acquired corporation on a transfer to a creditor.” [55] In addition, the definition of “property” for Section 721 purposes may not include obligations incurred for past services or accrued interest, given that the direct issuance of a partnership interest for services falls outside of Section 721.[56]

Accordingly, the principal support for a “partnership equity for debt” exception lies, by analogy, with the stock-for-debt cases. Yet, current acceptance of the underlying rationale of these cases is questionable, and one wonders whether a court, if deciding the stock-for-debt cases anew (on the basis of prior statutory law), would reach a similar result, particularly in light of the increasing criticism of the “stock-for-debt” exception. Reflective of the atmosphere of discontent espoused by critics of the stock-for-debt exception is the “Reasons for

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[55] Conference Report to the Tax Reform Act of 1986, H.R. Rep. No. 841, 99th Cong., 2d Sess. II-844 (1986). Recently, the Service issued Rev. Rul. 93-7, 1993-4 I.R.B. 5, which held in the “mirror-image” case -- where partner debt with an adjusted issue price in excess of its value was distributed to the debtor/partner -- that Section 731 provided nonrecognition treatment to the distributing partnership but <u>not</u> to the distributee partner. The ruling stated that partner level recognition of income (including COD income) was required because the extinguishment of the debt left “no opportunity for income recognition at a future time.” This is not true, however, in the case of an exchange of partnership debt for equity. Here, as discussed below, the tax accounts are kept in balance through the operation of Section 752.

[56] Reg. § 1.721-l(b). As discussed below, one of the principal criticisms raised against stock-for-debt exception is the corporation's retention of the prior interest deductions. Application of Section 721 to require income recognition on the part of the contributing creditor/partner in respect of accrued interest arguably avoids that result.

Change" included in the 1992 proposed repeal of the stock-for-debt exception (which was vetoed by President Bush):

> The committee believes that the stock-for-debt exception results in a significant permanent mismeasurement of income by debtor corporations, by failing to treat as income (and failing to reduce attributes by) the amount by which a debtor corporation's borrowings are not repaid.[57]

Given this perspective, it is unclear whether a court would be willing to extend such cases to the partnership area.

1. Deferral of Income. Not Forgiveness. Assuming that a "partnership equity for debt" exception exists, it should be noted that it only dispenses with the COD consequences of the exchange. As illustrated below, the partners must still take into account the Section 752 "deemed" cash distribution and potentially the minimum gain chargeback provisions of the Section 704 regulations[58]. As a result of the Section 752 deemed cash distribution, an existing partner will reduce the tax basis in its partnership interest (but not below zero) and may even recognize gain under Section 731 to the extent the distribution exceeds the tax basis. This assumes, as we believe is the case, that the existing partner's tax basis in its partnership interest would not be increased for its share of the COD income avoided by

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[57] H..R. Rep. No. 735, 102d Cong., 2d Sess (1992) reprinted in Special Supplement to Tax Notes Today (Aug. 4, 1992) at 1944. Note that the New York State Bar Association, Tax Section has urged that the issue of stock-for-debt exchanges not become the subject of legislative action, without further study of the tax and bankruptcy policies involved, including public hearings. Letter dated July 16, 1992, reprinted at 92 TNT 155-75 (July 30, 1992).

[58] The application of the minimum gain chargeback provisions to equity-for-debt exchanges are discussed below in part V.B.

reason of the equity-for-debt exception.[59] Thus, in contrast to the stock-for-debt exception which results in a permanent forgiveness of income -- an original criticism of the stock-for-debt exception raised by the Treasury Department, but subsequently dropped in recognition of competing tax and bankruptcy policies[60] -- an equity-for-debt exception in the partnership context is, at best, a deferral mechanism.

> Example 7: A and B form a general partnership AB, with each contributing $100. In addition, AB borrows $800 on a nonrecourse basis from an unrelated lender. The loan provides for no principal payments until maturity. AB purchases depreciable property for $1,000. After four years, the property's value declines to $550, with its tax basis depreciated to $700 (and the unamortized debt still at $800). The partnership's cash flow becomes insufficient to meet debt service payments, and the lender agrees to reduce its debt to $500 in return for an 80% partnership interest. Immediately before the exchange, A and B each had a tax basis in his partnership interest of $350.
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> Absent an equity-for-debt exception, the restructuring would generate $260 of COD income for the partnership ($300 debt reduction less a $40 partnership interest), which would be allocated equally between A and B. In addition, A and B would incur a deemed cash distribution of $800 ($400 each), reflecting the debt reduction and the reallocation of the remainder of the loan to the lender as the ultimate partner at risk. This would leave A and B with an $80 basis in each of their partnership interests ($350 + $130 - $400). Under this approach, A and B would each have a $75 built-in loss in their

59 This is consistent with the notion for corporate tax purposes that the COD income avoided by reason of the stock-for-debt exception is not treated as earnings and profits. See S. Rep. No. 445, 100th Cong., 2d Sess. 96 (1988); Western Maryland Railway Company v. United States, 131 F. Supp. 873, 893-894 (DC Md. 1955). Cf. Estate of Newman v. Commissioner. 91-1 U.S.T.C. 50,281 (2d Cir. 1991)(no increase in "outside" basis for COD income excluded under prior law by reason of applying the "insolvency" exception at the partnership level).

60 See Hearings on H.R. 5043 Before the Subcomm, on Select Revenue Measures of the Committee on Ways and Means, 96th Cong., 1st Sess. 9-10 (1979) (Statement of Daniel I. Halperin, Deputy Assistant Sec. of the Treasury for Tax Legislation).

> partnership interest since the value of each interest will equal $5 (10% x 550 - 500).
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> In contrast, assuming an equity-for-debt exception exists -- and reserving until later the issue of minimum gain chargeback -- the sole effect would be the deemed cash distribution of $400 to each of A and B. Such distribution would reduce the basis in their partnership interests to zero, and produce $50 of Section 731 gain to each (rather than $130 of COD income). In short, A and B have effectively utilized the $75 built-in loss and the remaining $5 of basis in their partnership interest against the COD income.

Although Section 731 gain is possible and, in many cases, likely, it is also possible that Section 731 gain may be avoided and any deferral prolonged depending on whether there are offsetting adjustments to the partner's basis in his partnership interest (such as contribution of assets, additional borrowings, etc.)

In addition, one possible exception to the current recognition of gain under Section 731 is Rev. Rul. 71-301, 1971-2 C.B. 356, wherein the Service concluded that the common law "insolvency" exception protected the partners from Section 731 gain in analogous circumstances under prior law. We understand, however, that the Service is currently inclined to revoke Rev. Rul. 71-301 as obsolete, given that the 1980 Act overturned the result in Stackhouse to which the ruling was addressed. As discussed below, the application of the "partnership equity for debt" exception produces an analogous result to that in Stackhouse.

2. Stackhouse Case Analogy. A side-effect of a partnership "equity for debt" exception is to create a situation akin to that in the Stackhouse case. Decided prior to the 1980 Act, the Stackhouse case involved an insolvent partnership which

settled a $127,000 debt, thereby rendering the partnership solvent. Rejecting the IRS's position, the Fifth Circuit found that the Section 752 rules of Subchapter K overrode the COD rules of Section 61(a)(12). As a result, the partners had a deemed cash distribution, with potential Section 731 gain, and no separate creation of COD income. As illustrated in Example 7, this is the same result engendered by an equity-for-debt exception.

In the 1980 Act, Congress adopted Section 108(d)(6) -- which applies the insolvency and bankruptcy exceptions to COD income and the attribute reduction rules of Section 108(b) at the partner level, rather than at the partnership level -- noting that "[t]he effect of these provisions of the bill is to overturn the decision in Stackhouse". S. Rep. No. 1035, 96th Cong., 2d Sess. 21 n.26 (1980). Given that Section 108(d)(6) successfully achieves its objectives in Stackhouse-type situations where a straight debt cancellation is involved, a fair reading of the quoted reference to Stackhouse could stop there -- leaving untainted the separate issue of a "partnership equity for debt" exception.[61] However, a broader reading would suggest that Congress would never consider Section 752 to be the proper determinant of income recognition in debt cancellation cases.

3. Partners' Preferences May Differ. We observe that a "partnership equity for debt" exception may not be the treatment of preference for all partners. For example, individual partners that are themselves involvent or in bankruptcy, and thus benefit from the attribute reduction rules of Section 108(b), may prefer COD income over a deemed cash distribution that reduces the tax basis in their partnership interests and possibly produces

[61] The partnership level application of the statutory purchase price exception could be reconciled with such a reading given its focus on the "purchaser" (in this case, the partnership). See Section 108(e)(5); S. Rep. No. 1035, 96th Cong., 2d Sess. 22 (1980).

Section 731 gain. As a result, so long as the law on a "partnership equity for debt" exception remains unclear, the IRS may find partners taking differing positions as to the existence of such an exception. For this reason, a clear resolution is desirable. In view of the confused state of the law, such a resolution may be best achieved through legislation.

4. Retention of Interest Deductions. One of the criticisms that has recently been raised against the stock-for-debt exception, which has led to the cut-back provisions of Section 382(1)(5)(B), is the retention of the tax benefit of the interest deductions associated with debt. This issue should be dealt with in any statutory codification of a "partnership equity for debt" exception.

D. Applicability of Statutory Limitations Relating to Stock-for-Debt Exchanges. As mentioned above, there are several statutory limitations to the stock-for-debt exception. These are the "nominal and token" and "proportionality" tests in Section 108(e)(8), the insolvency/bankruptcy requirement of Section 108(e)(10)(i) and the "disqualified" stock rule of Section 108(e)(10)(ii). In each case, the statute speaks solely in terms of "stock" and a "corporation." Accordingly, the statutory exceptions do not currently apply to partnerships.

Even in the absence of an express statutory de minimis rule, the equity interest received by a creditor in the partnership context nevertheless would in any event have to be of a sufficient amount to avoid "sham" treatment. In this regard, we note that the Service, in PLR 8837001 (May 10, 1988), stated that the "nominal or token" test of Section 108(e)(8)(i) "was intended to continue the general notions of the substitution of liability theory underlying the stock for debt rule and to limit the application of the rule in the case of a stock for debt exchange which was essentially a sham transaction." Thus, even in the partnership context, a "nominal or token" test must effectively be satisfied.

Congress, in recently restricting the stock-for-debt exception to insolvent or bankrupt corporations, rejected the exception as a rule grounded solely in generic tax accounting principles, and instead embraced the view that, in the context of a solvent corporation, use of stock to satisfy indebtedness ought to be treated the same as a use of cash of equivalent value.[62] Accordingly, a limitation on the partnership equity-for-debt exception restricting its use to insolvent or bankrupt partnerships might well be appropriate in any statutory codification of a "partnership equity for debt" exception given the policies underlying such limitations in the corporate area.

Restricting use of a partnership equity for debt exception to insolvency or bankruptcy, of course, raises the technical question of how one would determine the insolvency of a partnership and whether the assets of the general partner should be taken into account. We believe they should not. As discussed above, the focus of a partnership equity-for-debt exception is the partnership entity. Moreover, the purpose of an equity-for-debt exception should be to encourage restructurings of the

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[62] That view no doubt reflected corporate activity around the time of the Tax Reform Act of 1984. A common transaction involved the purchase by a financial institution of corporate debt which traded at a discount because of then high market interest rates. The institution would exchange the debt with the issuer for issuer stock and then sell the stock to the public. Although the transaction was a stock-for-debt exchange from the issuer's perspective, it pointedly raised the question of why the tax result should be any different than if the issuer had engaged the financial institution to sell its stock to the public, and used the cash proceeds from the underwriting to retire its own debt. See Staff of Joint Committee on Taxation, General Explanation of Tax Reform Act of 1984, 167 (1984).

business enterprise, rather than liquidation.[63] To take into account individual partner assets would be inconsistent with this focus and, in many cases, administratively cumbersome. In effect, the general partner should be viewed in the nature of a guarantor.

V. Collateral Consequences of Partnership Equity for Debt Exchanges

A. General Concepts. A partnership equity for debt exchange may involve recourse or nonrecourse debt. In either case the exchange is an appropriate triggering event for a revaluation of the partnership's assets, and corresponding adjustments to the partnership's capital accounts.[64] Revaluation of the partnership's assets would generally be to their fair market values. If a partnership equity for debt exception to recognition of COD income exists or is created, the exchange will not result in COD income. However, accounting for excluded COD raises significant issues with respect to capital account maintenance and subsequent book and tax allocations. The Committee is particularly concerned that the Section 704(b) and Section 704(c) regulations not operate in a manner inconsistent with a partnership equity for debt exception.

As discussed below, the Committee believes that many of the issues and concerns in this context can be addressed by clarifying how the revaluation provisions of the existing Section 704(b) regulations apply to an equity for debt exchange. Such clarification could be effected through revenue rulings or

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63 Cf. S. Rep. No. 1035, 96th Cong., 2d Sess. 11 (1980).

64 The discussion below assumes a revaluation of partnership assets upon the occurrence of an equity for debt exchange. This Report does not address the case where the partnership does not elect to revalue.

otherwise. Equity for debt exchanges involving potential COD also raise issues that the Committee believes should be addressed in the Section 704(c) regulations (and corresponding provisions of the Section 704(b) regulations).[65]

B. Considerations Relating to Both Equity for Recourse and Equity for Nonrecourse Debt for Equity Exchanges. The Committee believes that in an equity for debt exchange the creditor/partner's capital account should initially be established by reference to the fair market value of the debt contributed.[66] Basing the creditor/partner's capital account on the adjusted issue price of the contributed debt or its face value would generally result in an inconsistency between the net book value of the partnership and the partners' aggregate capital accounts, and distortions in the post exchange economics of the partnership.[67] For the same reasons, if the exchange results in a COD amount which is excluded from income under a partnership equity for debt exception, the excluded COD amount should be treated as the equivalent of tax exempt income for capital account maintenance purposes (but not for basis purposes).[68]

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[65] See Reg. § 1.704-l(b)(2)(iv)(f)(4). See also Prop. Reg. § 1.704-3(a)(4).

[66] Cf. Revenue Ruling 93-7, 1993-4 I.R.B. 5 (where in an analogous context the Service held that where indebtedness of a partner is distributed to the partner, the amount of the distribution is the fair market value of the debt at the time of distribution).

[67] In an arm's length exchange the value of the debt should equal the value of the equity received, with the intended consequence that the post valuation net book value of the partnership (book value of gross assets less book value of liabilities) will generally equal the aggregate balance of the partners' capital accounts. As in the case of contributions of property to a partnership the fair market value as determined by the partners should generally be presumed to be correct. Reg. § 1.704-l(b)(2)(iv)(h).

[68] Thus, the “COD” amount would increase the capital accounts of the “old” partners under Reg. § 1.704-l(b)(2)(iv)(b)(3), but it would not increase the bases of the partners' partnership interests. Since no actual income would be received, the gross book value of the

Example 8: Partnership AB has one asset with a book value (and tax basis) of 600 and a fair market value of 800 and one liability with a 1000 adjusted issue price and an 800 value. The lender, C, exchanges the debt for a partnership interest. C's capital account is initially set at 800 and profits are to be split 50/50 between C and the "old" partners. If the property is subsequently sold for 900 and AB is liquidated, C will have an 850 capital account and the 900 of proceeds would be distributed 850 to C and 25 each to A and B, reflecting the intended economics. This would not be the result if C had been given a 1000 capital account.[69]

In general, partnership tax items, including COD, are allocated in the same manner as corresponding book items are allocated.[70] However, in an equity for debt exchange, asset and/or liability revaluations will result in book/tax differences in the post exchange period, which must be accounted for using Section 704(c) principles. Consistent with the book treatment of the exchange outlined above, Section 704(c) should generally be applied in the post exchange period by treating the creditor/partner as though it had contributed money equal to the fair market value of the debt contributed.[71]

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partnership's assets would not be changed. In the case of an equity for nonrecourse debt exchange, capital account increases resulting from the COD (whether the COD is excluded from income or not) should be subject to the rules of Section I.A.2 regarding permissible allocations of COD where partners do not all have UDROs.

69 A's and B's pre-exchange capital accounts were each (200). Upon the exchange A and B each were allocated a revaluation book gain of 100 and 100 of excluded COD, leaving them with 0 capital accounts. Upon the sale of the property for 900, and the allocation of the 100 of book income, each would have a 25 capital account consistent with the intended economics.

70 See Reg. § 1.704-l(b)(2)(iv)(b)(3),(7) (capital accounts must be increased (decreased) by allocations of tax income and gain (loss and deduction)).

71 To the extent permitted by the Section 704(c) regulations the partnership's allocation could be subject to the ceiling rule or could provide for curative allocations. See Prop. Reg. § 1.704-3(c).

Example 9: The facts are the same as in Example 8. Immediately after the exchange the property will have a book value of 800 and a tax basis of 600. On the subsequent sale of the property for 900, 100 of book gain and 300 of tax gain will be recognized. Under Section 704(c) the 200 excess of tax gain over book gain will be allocated solely to A and B. However, the 100 of tax gain corresponding to the 100 of book gain would be allocated 50 to C and 25 to each of A and B.

C. Special Considerations with respect to Equity for nonrecourse debt exchanges. A partnership equity for nonrecourse debt exchange[72] will generally result in a reduction in partnership minimum gain and this reduction will in turn generally trigger the application of a partnership's MGCB provision. The Committee believes there is considerable confusion as to how the MGCB would apply in this context. In addition, there is concern that it could operate in a manner inconsistent with a partnership equity for debt exception to recognition of COD income.

As a general proposition, under Reg. § 1.704-l(b)(2)(iv)(f) when a partnership revalues its assets upon admission of a new partner any partnership minimum gain that exists prior to the revaluation will be eliminated as result of the book up.[73] In addition, any obligation to allocate income for book and tax purposes under a MGCB, to the extent attributable to

[72] For purposes of this Section a “partnership equity for nonrecourse debt exchange” means an exchange by a nonrecourse lender with a partnership (previously unrelated to the partnership except for his interest as a creditor) of all or part of his creditor position for an interest in the partnership.

[73] The revaluation will result in the book value of a partnership asset subject to a nonrecourse liability being equal to the greater of the fair market value of the asset or the amount of the liability immediately before the revaluation. See Reg. § 1.704-l(b)(2)(iv)(f) and Reg. § 1.704-2(d)(4).

the period through the revaluation date, should have no application with respect to periods after the revaluation date. Any other rules would result in a distortion of the economics of the partnership for periods after the revaluation.[74] The MGCB provision may still be relevant, however, for purposes of the partnership's allocations of income among the “old” partners for the portion of the year through the date of revaluation.

The Committee believes that these rules should also apply when a revaluation occurs incident to a partnership equity for nonrecourse debt exchange and that the rules should apply regardless of whether the value of the partnership interest received is less than or equal to the issue price of the debt extinguished. The same justifications apply as in the general case. In this regard, the Committee recommends the following technical clarifications of the application of existing Section 704(b) regulations:

(i) Where the issue price of the debt contributed to the partnership is greater than the fair market value of the property securing it, the revaluation should be to the property's fair market value (not to the greater issue price of the debt), since the debt is extinguished in the transaction. The adjustment of capital accounts pursuant to Reg. § 1.704-1(b)(2)(iv)(f) should be made in a corresponding manner i.e.,, by assuming the property is sold for its fair market value.[75]

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74 A rule under which any part of the old MGCB obligation was preserved would imply a priority allocation of post revaluation book income (which could well correspond to economic income) to the “old” partners resulting in potential economic detriment to the newly admitted partner.

75 See also the discussion in Section III.C.2.a. - “Special considerations with respect to nonrecourse debt.”

(ii) The Internal Revenue Service should confirm that the reduction in minimum gain resulting from an equity for debt exchange, other than a reduction corresponding to recognized COD income, will be exempted from the MGCB (and thus extinguish an equivalent amount of the MGCB obligation).[76]

The following example illustrates the application of these principles:

> Example 10: A and B are 50/50 partners in the AB partnership. Both A and B made a 100 capital contribution to AB (held as cash by the partnership and not securing the nonrecourse liability described below). AB borrows 1000 nonrecourse from C, an unrelated lender, to purchase 1000 of depreciable property. At the end of year 10 the property has an adjusted basis (and a book value) of 0 and a fair market value of 200, and the debt is still 1000. A and B each have deficit capital accounts equal to (400) (cash income equaled cash expense in each year and 1000 of depreciation was taken on the property). At the beginning of year 11, C exchanges the entire liability for partnership equity worth 200. Under the revised partnership agreement, C has a 50% interest in partnership capital and profits. The partnership elects to revalue on the entry of C. Assume that the partnership has 400 taxable operating income for year 11 and that the exchange qualifies for the equity for debt exception. The partnership agreement contains a MGCB.
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> Under the Committee's recommendations, the treatment would be as follows: (1) the property is revalued to 200,[77] thereby reducing the deficit in A & B's capital

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[76] The basis for the ruling could be Reg. § 1.704-(2)(e)(5) (additional exceptions to the MGCB requirement).

[77] Note that there would still be 200 of built-in gain for tax purposes, which would be allocated to A and B under Section 704(c) principles. However, if the partnership had a Section 754 election in effect, the partnership's basis would be increased (and the built-in gain would be decreased) by the lesser of the Section 731 gain to A and B or the amount of the built-in gain. Presumably, the partnership's basis would not be increased to the extent the built-in gain exceeded the amount of Section 731 gain.

accounts to (300) each, (2) the 800 “COD” amount is excluded from tax income but nonetheless increases A & B's capital accounts (but not basis)[78] to 100 each, and (3) the full 1000 of potential MGCB is extinguished. The 400 of post-admission income is allocated 50% to A and B and 50% to C, which is in accordance with their economic arrangement.[79]

If the MGCB were not extinguished, A & B would receive a priority allocation of the 400 of post-admission income and the resulting capital accounts would be 300/300/200 which is a clear distortion of their economic arrangement.

As indicated above, an obligation under the MGCB arising in periods through the revaluation date should have no effect on periods beginning after the revaluation date. However, the MGCB can apply to allocate partnership income for the period through the revaluation date among the “old” partners. For this purpose, under Reg. § 1.704-2(d)(4), reductions in minimum gain “arising solely from revaluations” are not taken into account. In a nonrecourse equity for debt exchange the reduction in minimum gain can be ascribed to two overlapping mechanisms, extinguishment of debt and revaluation, and as such arguably fails the “solely attributable” requirement. However, to the extent that the reduction is attributable to both mechanisms (i.e., does not exceed the difference between the adjusted basis of the asset securing the debt and its fair market value), the

[78] As discussed above, the failure to increase the partners' outside bases in the amount of the excluded COD income reduces the tax benefits of the COD exclusion to a possible deferral advantage. On the simplified facts of this example, there would not be a deferral benefit since both A and B would have 400 of Section 731 gain. However, in more complex cases, Section 731 gain would not be recognized or would be less than the 800 of COD. This would occur, for example, in cases where the partnership had other liabilities which were not discharged or where A and B had made additional contributions to the partnership to acquire other property.

[79] Thus, A's, B's and C's capital accounts would be 200, 200 and 400, respectively. The partnership would hold the property with a book value of 200 and cash assets of 600 (400 cash income plus the initial capital contributions).

Committee believes that even with respect to allocations of income for the period through the revaluation date among the "old" partners, the appropriate treatment is generally to exempt the reduction from the MGCB in order to avoid economic distortions.[80] The Committee believes it would make little sense to require that, for example, any operating book income for the period through the revaluation date be required to be allocated to cover a MGCB of excluded COD income if the economics of the partnership are otherwise.[81]

In addition, consistent with the Committee's approach to capital account maintenance, to the extent COD amounts are excluded under a partnership equity for debt exception, a corresponding portion of any MGCB obligation should be eliminated.[82] The justification is basically the same as that articulated above; i.e., to do otherwise would result in a distortion of the partnership's economics. Moreover, for tax purposes, allocations corresponding to the MGCB would undermine

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80 The same issue arises where cash is contributed in exchange for a partnership interest, there is a revaluation, and the cash is then used to pay down the nonrecourse debt. Should the result where the two events occur at the same time differ from the result if the debt repayment occurs some time after the contribution, at which point the minimum gain will already have been reduced? Similar possibilities exist in the exchange context, where for example the exchange is a later component of a multi-part restructuring. It is difficult to see why the results should be different or to articulate significant policy reasons for preserving the MGCB with respect to allocations among the "old" partners when debt is paid down with funds provided by a new partner. Cf. Reg. 1.704-1(b)(2)(iv)(f)(5) (permissive revaluation generally allowed only where the adjustments are made for a substantial non-tax business purpose).

81 To the extent a reduction of minimum gain is attributable to an actual pay down of nonrecourse debt prior to the revaluation, or to recognize COD income, the allocation of income pursuant to the chargeback is appropriate.

82 Under the Committee's approach, upon revaluation, the book value of property would be limited to its fair market value and accordingly an excess of issue price over such fair market value cannot be eliminated by revaluation.

the equity for debt exception. Thus under the approach recommended by the Committee any reduction in minimum gain arising solely from an equity for debt exchange would be exempted from the MGCB, except to the extent that COD income is actually recognized on the exchange.[83]

The following example illustrates the application of these principles:

> Example 11: The facts are the same as Example 10 except that: (1) prior to the admission of C, losses were allocated 10% to A and 90% to B (thus the minimum gain is shared 100/900 (A/B)); (2) in year 11 but prior to the exchange, cash income exceeded cash expenses by 100 giving the partnership 100 of pre-admission net income (there is no additional depreciation), (3) 50 of the net cash income is used to pay down 50 of principal as part of the exchange while the other 50 is retained as cash by the partnership, and (4) the value of the property is 250 when C exchanges the remaining 950 debt for an equity interest equal to 250.
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> Under the Committee's recommendation, the treatment would be as follows. First, the MGCB would be preserved with respect to the 50 reduction in minimum gain caused by the principal payment; thus 50 of the pre-admission income would be allocated 5/45 (A/B). Second, the MGCB would not apply with respect to (1) the 250 reduction in minimum gain caused by the revaluation (and the discharge) under Reg. §1.704-2(d)(4) or (2) the remaining 700 reduction which qualified as excludable COD income. Thus, the remaining 50 of pre-admission income would be allocated to A and B according to their normal profits split (25/25) rather than under the MGCB (5/45).[84]

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[83] Note that for tax purposes, the reduction in the partners' shares of minimum gain to the extent attributable to the revaluation would be accounted for in accordance with Section 704(c) principles.

[84] A's, B's and C's capital accounts at the end of year 11 will be 125, 125 and 250, respectively, and the partnership will have 250 of cash and property with a book value of 250. It is appropriate to allocate 25 of the 50 of pre-admission income retained by AB to A since it represents actual economic income to A as reflected in his capital account.