This Month in M&A

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This Month's Features

- Final "COD income" regulations on partnership issuance of capital or profits interest to a creditor in satisfaction of debt
- Temporary and proposed regulations on basis allocations in "All Cash D" reorganizations
- Proposed regulations under section 382 for "Small Shareholders"
- Proposed regulations defining "interest in a limited partnership as a limited partner"
- *Southgate Master Fund LLC v. United States*: Fifth Circuit denies rehearing request

Did you know...?

On November 15, the IRS issued final regulations (T.D. 9557) (the "Final Regulations") providing guidance regarding recognition of cancellation of indebtedness income ("COD income") and related issues that arise when a debtor partnership issues a capital or profits interest to a creditor in satisfaction of its debt ("debt-for-equity exchange"). The Final Regulations adopt, without substantive change, the rules set forth in proposed regulations issued on October 31, 2008. (See the November/December 2008 edition of This Month in M&A). The Final Regulations apply to partnership debt-for-equity exchanges occurring on or after November 17, 2011.

Background

In general, when a partnership enters into a debt-for-equity exchange, the partnership recognizes COD income to the extent the amount owed on the debt exceeds the fair market value of the partnership interest issued to satisfy the debt. This COD income is specially allocated to the partners in the partnership immediately before the debt-for-equity exchange.

Since the enactment of section 108(e)(8) (indebtedness satisfied by corporate stock or partnership interest), taxpayers have been uncertain how to apply the principles of that section in the partnership context. With issuance of the Final Regulations, taxpayers now have guidance for determining the consequences of a debt-for-equity exchange between a creditor and partnership.

Final Regulations

The Final Regulations address three key debt-for-equity exchange issues: (1) determining the fair market value of the partnership interest issued in satisfaction of indebtedness, (2) applying the nonrecognition rules under section 721 in debt-for-equity exchanges, and (3) including COD income in a minimum gain chargeback allocation.

1. ***Determination of fair market value*** - The Final Regulations include a safe harbor under which the fair market value of a partnership interest issued in a debt-for-equity exchange equals its liquidation value. For this purpose, liquidation value is defined as the amount that would be distributed with respect to the partnership interest issued in the debt-for-equity exchange if the partnership sold all its assets at fair market value and liquidated immediately after the exchange.

   To qualify for this safe harbor, certain requirements must be met. First, the debtor partnership and creditor both must use liquidation value in determining the tax consequences of the exchange. Second, if multiple partnership interests are issued as part of the same overall debt workout transaction, liquidation value must be used for all such interests. Third, the terms of the debt-for-equity exchange must be arm's-length. Finally, the exchange must not be part of a plan that

has as a principal purpose the avoidance of COD income by the debtor partnership.

2. ***Application of section 721*** - The Final Regulations provide that the nonrecognition rules of section 721 apply to the contribution of a partnership's indebtedness by the creditor in a debt-for-equity exchange. At the same time, the reference to section 721 does not prevent recognition of COD income by the debtor partnership in the exchange. In addition, the Final Regulations further specify that section 721 will not prevent income recognition by the creditor if the partnership interest is issued to satisfy the partnership's indebtedness for unpaid rent, royalties, or interest.

3. ***Allocation of Minimum Gain Chargeback*** - The Final Regulations provide that a special allocation of income under the Minimum Gain Chargeback rules first consists of gains from the disposition of encumbered property *and* COD income. If the amount of the gains from the disposition of encumbered property and COD income is less than the Minimum Gain Chargeback amount, a pro rata portion of all other items of partnership income will be included in the special allocation to cover the shortfall. Under the previous regulations, COD income was not given any priority in a Minimum Gain Chargeback allocation.

Observations

The rules in the Final Regulations regarding the application of section 721 to a debt-for-equity exchange generally will result in asymmetrical tax treatment to the debtor partnership and the creditor.

For example, if the debtor partnership satisfied a $100 debt with a partnership interest worth $80, the partnership would recognize COD income of $20 (excess of the $100 owed over the $80 partnership interest issued). This COD income would be recognized currently by the debtor partnership and treated as ordinary income.

However, under section 721, the creditor would not be permitted to recognize any loss on the debt-for-equity exchange. The exchange instead would result in the creditor holding a partnership interest with a substituted tax basis of $100 and a value of $80. The partnership's basis in the assets would continue to be the same, creating a disparity between the creditor's outside basis and its share of inside basis in the partnership.

The creditor's economic loss would not be recognized until the disposition of the partnership interest. Thus, while the debtor partnership has a current ordinary income inclusion of $20, the creditor has a deferred capital loss of $20. The preamble to the Final Regulations notes that a creditor could claim a bad debt deduction on partnership debt prior to the debt-to-equity exchange; however the transaction giving rise to the bad debt deduction would have to be separate and independent from the exchange.

The Final Regulations provide a taxpayer-favorable rule when the debt-for-equity exchange is for debt attributable to unpaid rent, royalties, or interest. In such an exchange, the partnership will not be viewed as having satisfied the debt with a fractional share of its assets. This is a significant exception to the general tax rules requiring that gain inherent in property exchanged in a transaction must be recognized by the transferor.

The preamble to the Final Regulations states that future regulations will provide that if the indebtedness for future payments due on an installment sale is contributed in a debt-for equity exchange, then any deferred gain on the sale will be accelerated and recognized on the exchange date. The preamble also clarifies that there have been no changes to the rules regarding the allocation of COD income among partners in a partnership (see Rev. Ruls. 92-97 and 99-43). *For additional information, please contact Brian Meighan, Monte Jackel, Jennifer Bennett, or Scott Campbell.*

Treasury Regulations

Final "COD Income" Regulations – See "Did You Know" above.

Allocation of Basis in "All Cash D" Reorganizations (T.D. 9558)

On November 21, the IRS released temporary and proposed regulations under section 358 clarifying that in an "All Cash D" reorganization, only the person that actually owns shares in the issuing (acquiring) corporation may designate the share of stock of the issuing corporation to which the remaining basis, if any, in the surrendered stock or securities of the target corporation will attach. The temporary regulations apply to exchanges and distributions of stock occurring on or after November 21, 2011.

In general, the "All Cash D" regulations provide that a transaction is treated as satisfying the distribution requirement of section 368(a)(1)(D) notwithstanding that there is no actual issuance of stock and/or securities of the acquiring corporation if the same person or persons own, directly or indirectly, all the stock of the target and acquiring corporations in identical proportions.

The "All Cash D" regulations deem that a nominal share is issued if the property received by the target corporation consists solely of "boot" equal to the value of the target's assets. The nominal share then is deemed distributed by the target to its shareholders and, where appropriate, further transferred through the chains of ownership to the extent necessary to reflect the actual ownership of the target and acquiring corporations. Any remaining basis in the nominal share is eliminated on the deemed distribution under section 311(a).

Some practitioners had commented that the mechanics for preserving basis in the stock of the issuing corporation were unclear under final regulations issued under sections 358 and 368 on December 17, 2009. They suggested that in the context of a reorganization with a lower-tier target corporation where the acquiring corporation was in a different chain of ownership, the

regulations could be interpreted to allow persons who did not actually own stock of the issuing corporation to allocate the basis of the nominal share to stock of the issuing corporation directly owned by another shareholder before the nominal share was deemed to be distributed. The IRS considered this result inappropriate, prompting the issuance of the new regulations.

Observations: Taxpayers that want to avoid losing basis in loss shares of a lower-tier target corporation as a result of the mechanics of the "All Cash D" regulations should cause the issuing corporation to actually issue shares in the reorganization. By issuing shares, taxpayers effectively can make the "All Cash D" regulations elective and preserve basis that would otherwise be eliminated. *For additional information, please contact Timothy Lohnes, Bruce Decker or Colin Zelmer.*

Proposed section 382 Small Shareholder Regulations (REG-149625)

On November 23, the IRS issued proposed regulations under section 382 that would provide guidance regarding the application of the segregation rules to "small shareholders" and certain public groups. The proposed regulations define "small shareholders" as shareholders who are not five-percent shareholders ("Small Shareholders").

The proposed regulations generally adopt the "Purposive Approach" described in Notice 2010-49. That approach reflects the view that it is unnecessary to take into account all identifiable acquisitions of stock by Small Shareholders because Small Shareholders generally are not in a position to acquire loss corporation stock in order to contribute income-producing assets or divert income-producing opportunities.

The proposed regulations would modify the general segregation rules of section 382 in the following ways:

- The segregation rules generally would be rendered inoperative to transfers of loss corporation stock to Small Shareholders by five-percent entities or individuals who are five-percent shareholders. In these cases, the stock transferred would be treated as being acquired proportionately by the public groups existing at the time of the transfer. This rule also would apply to transfers of ownership interests in five-percent entities to public owners and to five-percent owners who are not five-percent shareholders.

- The "small redemption" exception would exempt from segregation (at the loss corporation's option), either 10 percent of the total value *or* 10 percent of the number of shares of the redeemed class outstanding at the beginning of the taxable year. If this exception applies, each public group existing immediately before the redemption would be treated as redeeming its proportionate share of exempted stock.

- The segregation rules would not apply to a transaction involving a five-percent entity if (1) the five-percent entity owns 10 percent or less (by

value) of all the outstanding stock of the loss corporation, *and* (2) the five-percent entity's direct or indirect investment in the loss corporation does not exceed 25 percent of the entity's gross assets (excluding the redeemed entity's cash and cash like items).

Observations: Overall, the proposed rules should be viewed as taxpayer-favorable guidance as they include several changes that would serve to reduce the administrative burden and complexity of the current segregation rules. Among the most important of the proposed changes is the rule that would turn off the segregation rules' application to certain transfers of loss corporation stock by five-percent shareholders to the public or to Small Shareholders. Of further note, the proposed rules reflect recommendations made by PwC (see the September 17, 2010 issue of *Tax Notes Today* for comments issued by PwC with respect to Notice 2010-49) with respect to the creation of an exception utilizing mechanics similar to the small issuance exception to exempt small redemptions from the segregation rules.

Taxpayers should note, however, that the new rules are proposed to take effect only on a prospective basis, and would apply only to testing dates occurring on or after the regulations are issued in final form. Since the determination of whether a loss corporation has undergone a section 382 ownership change generally requires an analysis of ownership shifts occurring during the three-year period preceding the testing event in question, this effective date could create inconsistencies with respect to application of the segregation rules and the creation of public groups within the testing period. *For additional information, please contact Rich McManus or Mary Abramtsev.*

Proposed Material Participation Regulations (REG-109369-10)

On November 25, the IRS issued proposed regulations (the "Proposed Regulations") providing a new definition of a limited partner for purposes of applying the material participation tests in Treas. Reg. 1.469-5T(a). The regulations are proposed to be effective for taxable years beginning on or after the date final regulations are published in the Federal Register.

Section 469 generally limits the deduction of losses attributable to passive activities ("passive activity losses") to the extent of passive activity income. Passive activities are any activities that involve the conduct of a trade or business, and in which the taxpayer does not materially participate as generally determined under seven tests provided in Treas. Reg. 1.469-5T(a). Generally, persons may avail themselves of any one of the seven tests to qualify as materially participating and avoid the application of the passive activity loss rules. However, a limited partner may rely on only three of these seven tests.

The determination of a limited partnership interest is based on the designation of the interest as such in the limited partnership agreement or on the limitation of liability for a partnership's obligations to a certain fixed amount based on state law. References to state law designations of limited partners and partnerships in the regulatory definition of limited partner have

created uncertainty regarding the application of the material participation tests to limited liability company ("LLC") members. Several courts have held that LLC members are not covered by the regulatory definition of a limited partnership interest and have allowed such members to use all seven material participation tests.

The Proposed Regulations would bring parity to the treatment of limited partners and LLC members under the material participation and passive activity loss rules by adopting a new definition of limited partner. The new definition focuses on a partner's (or LLC member's) management rights with respect to the partnership's (or LLC's) trade or business, as opposed to state law designations. Prop. Reg. 1.469-5T(e)(3)(i) would define a limited partner as a person who holds an interest in a partnership and does not have rights to manage the entity at all times during the entity's taxable year under the law of the jurisdiction in which the entity is organized and under the governing agreement. The preamble to the Proposed Regulations states that rights to manage include the power to bind the entity.

Observations: The preamble to the Proposed Regulations emphasizes that the new definition of limited partner is solely for purposes of the passive activity loss rules and that no inference would be intended for any other provisions of the Code requiring a distinction between general and limited partner. However, by requiring a limited partner or LLC member to have the rights to manage the partnership or LLC at all times during the year to utilize all seven material participation tests, a limited partner or LLC member may cross the line from a limited partner to a general partner for other tax purposes (e.g., the self-employment tax rules). *For addition information, please contact Briean Meighan, Monte Jackel, Diana Miosi, Jennifer Bennett, or Scott Campbell.*

Court Watch

Southgate Master Fund LLC v. United States

On November 28, the U.S. Court of Appeals for the Fifth Circuit (the "Fifth Circuit") declined to rehear a case that the petitioners believe sets forth an erroneous standard for respecting the existence of a partnership under federal income tax law.

Southgate Master Fund LLC, 2011 WL 4504781 (5th Cir. 2011), involved a distressed asset/debt tax shelter used to generate $1 billion in losses for a U.S. investor. The losses were generated pursuant to a plan in which: a Chinese tax-indifferent party first contributed assets with built-in losses (nonperforming loans) to a partnership; the Chinese tax-indifferent party then sold the majority of its partnership interest to the U.S. investor; and the partnership then allocated the built-in losses, when recognized, to the U.S. investor.

The Fifth Circuit held that the acquisition of the foreign distressed assets had economic substance because the transaction had a profit motive, while also finding that the partnership was a sham under the totality-of-the-

circumstances test in *Commissioner v. Culbertson*, 337 U.S. 733 (1949). Citing *Culbertson*, the Fifth Circuit stated:

> "The fact that a partnership's underlying business activities had economic substance does not, standing alone, immunize the partnership from judicial scrutiny. The parties' selection of the partnership form must have been driven by a genuine business purpose. This is not to say that tax considerations cannot play *any* role in the decision to operate as a partnership. It is only to say that tax considerations cannot be the *only* reason for a partnership's formation. If there was not a legitimate, profit-motivated reason to operate as a partnership, then the partnership will be disregarded for tax purposes even if it engaged in transactions that had economic substance."

Observations: The Fifth Circuit's opinion undermines the holding in *Moline Properties Inc. v. Commissioner*, 319 U.S. 436 (1943), that as long as a business entity has either a business purpose or conducts business activity, courts should recognize the entity for federal tax purposes. While many tax practitioners continue to believe that under *Moline Properties* a business purpose is not required to operate in partnership form provided the partnership conducts business activity, with *Southgate Master Fund LLC* there is now precedent in two Circuits to suggest otherwise (see *ASA Investerings Partnership v. Commissioner,* 201 F.3d 505, (D.C. Cir. 2000)). *For additional information, see the October 2011 edition of This Month in M&A; or contact Brian Meighan, Monte Jackel, Jennifer Bennett, or Scott Campbell.*

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