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Potential Tax Problems with Restructuring Debt from a Shareholder or Partner

By Walter R. Stone

A partnership client wants to restructure existing debt due to a partner [*Note:* In this article, a limited liability company will be treated as a partnership. Similar rules also apply to S corporations]. For valid economic or tax reasons the original transaction was structured as a loan rather than as an equity investment. The client considers two options: modifying its existing debt by a substantial reduction in the applicable interest rate or extension of the repayment term, or having the debt converted into equity.

Modification of Existing Debt

From the Debtor's Perspective: If the original debt instrument is modified "materially," then pursuant to applicable Treasury Regulations, there is a deemed exchange of debt and a resulting satisfaction of the old instrument by the issuance of the new instrument. Material modifications include significant changes in the interest yield or a significant deferral in the debt's payment schedule.

Generally, the debtor will recognize income to the extent the fair market value of property given in satisfaction of the debt is less than the debt's issue price. However, if the debt instrument is issued in satisfaction of debt, the debtor is treated as having satisfied the old debt with an amount of money equal to the issue price of the new debt instrument for purposes of determining the debtor's income under §108(e)(10).

Subject to a number of exceptions and limitations, §1274 applies in general to non-publicly traded debt instruments which are issued for property where some or all of the payments are due more than six months after the sale or exchange. Under Treas. Regs. §1.1274-1(a), for purposes of Section 1274, "property includes debt instruments."

Section 1274(a)(1) provides that the issue price of a debt instrument issued for property equals the stated principal amount where there is adequate stated interest (i.e., at a rate at least equal to the applicable federal rate compounded semi-annually), even if interest is not paid currently. Accordingly, substantial adverse tax consequences may be avoided by having "adequate stated interest."

Where there is not adequate stated interest, the issue price of the new debt instrument typically is its imputed principal amount, which under Section 1274(b) is generally the sum of the present values of all payments due under the debt instrument, computed using a discount rate equal to the applicable federal rate compounded semi-annually. This may result in substantial discharge income which would then be passed through to the partnership's partners, including the creditor- partner.

From the Creditor's Perspective: In the event of a taxable debt restructure, partner or S corporation shareholder creditors generally will recognize gain on the difference between the tax basis and the principal amount of the debt where tax losses have substantially reduced the basis of their debt.

For example, if a partner is owed $1 million but the tax basis is $500,000, the partner will realize taxable income of $500,000 upon such a debt modification.

Conversion of Debt to Equity

From the Debtor's Perspective: Pursuant to Section §108(e)(8), a debtor partnership is treated as having satisfied the debt with money equal to the fair market value of the partnership interest received in exchange for the debt.

A similar rule applies to debtor corporations, except under Section 108(e)(6) where the creditor contributes the debt to the capital of the corporation and thus does not receive any shares of stock in the exchange.

With respect to partnerships, discharge income is recognized by partners who were partners in the partnership immediately before such discharge. Furthermore, the exception under §108(a)(1)(B) exempting discharge of indebtedness income for "insolvent" taxpayers is applied at the partner level rather than at the partnership level.

Prop. Regs. §1.108-8 published in 2008 provide that the fair market value ("FMV") of an equity interest received in the conversion is the interest's "liquidation value" if the conditions set forth therein are met.

Essentially, "liquidation value" means the amount of cash that the partner would receive with respect to the interest if immediately after the conversion, the partnership sold all of its assets (including goodwill and other intangible assets) for cash equal to their FMV and then liquidated. Otherwise, FMV is determined based on all the facts and circumstances. The FMV of the entity interest may well be less than the amount of the debt.

From the Creditor's Perspective: Prop. Regs. §1.721-1(d) generally follows the non-recognition rules of §721 so that no gain or loss is recognized on the transfer of debt to a partnership in exchange for a partnership interest, except for unpaid rent, royalties or interest.

As to corporate shareholders, the transfer will in general not result in taxable income to the shareholder if the transfer qualifies under the non-recognition provisions of §351.

Conclusion

A material debt modification or the issuance of an equity interest in a debt restructure may result in substantial taxable income to the partnership which then would be passed through to its partners.

As a creditor, the partner may prefer to convert the debt to equity as the non-recognition rules of §721 may eliminate taxable gain. These complex potential tax problems require substantial consideration.

Walter R. Stone, a member of Adelberg, Rudow, Dorf & Hendler, LLC, concentrates his practice in the areas of the acquisition, sale, development and management of commercial real estate, as well as general business, corporate and taxation law.

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