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Partnerships in Distress Debt/Equity Tax Overview

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Participation Question

When I look at my client base, I would describe the partnerships generally as:

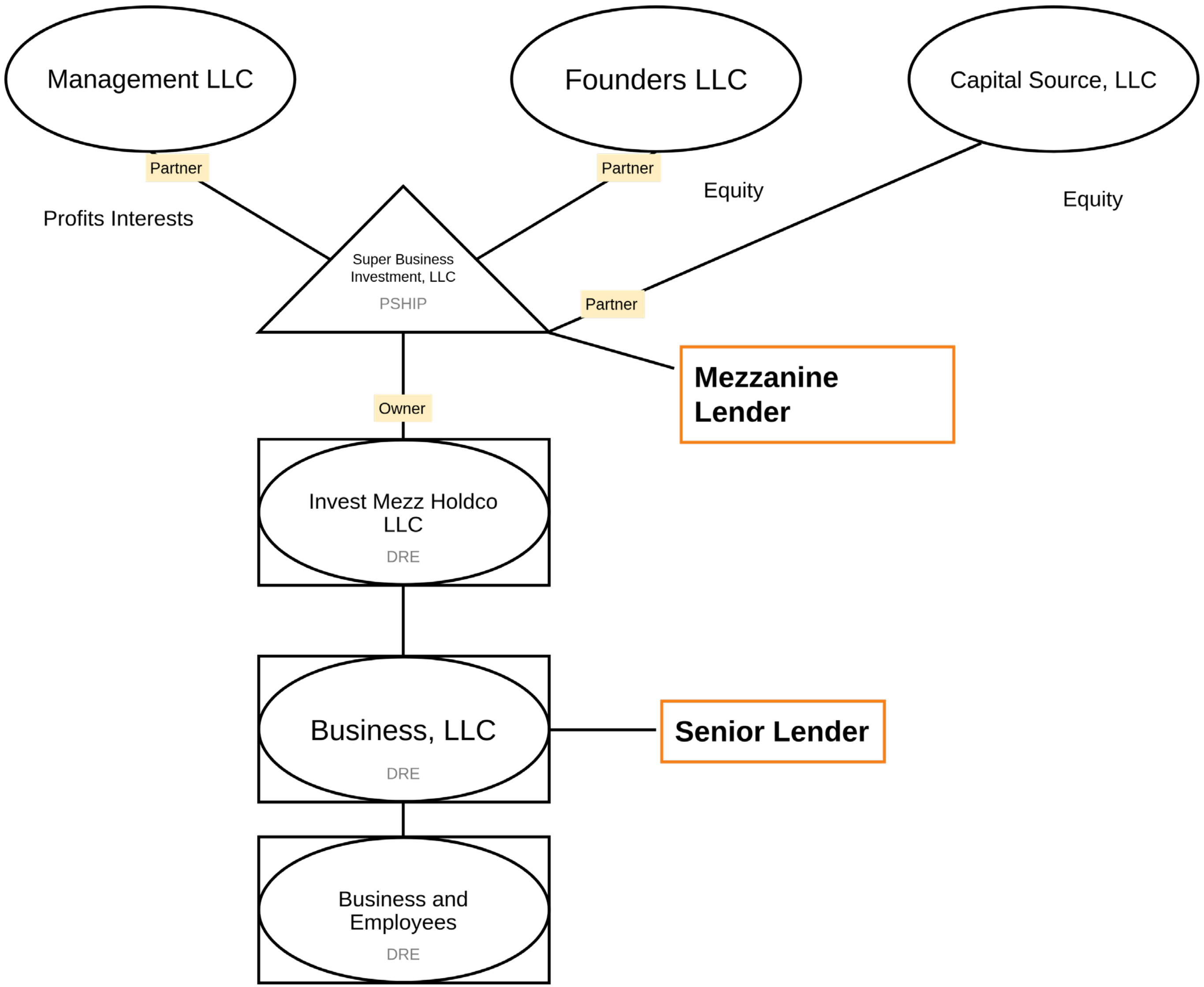
A. Complex – there are multiple tiers of allocations and distributions

B. Medium – there are some issues, but not overly complex

C. Straightforward – allocations and distributions are by ownership or P/L percentages

D. Partnerships are like LLCs, right?

Simplified Structure of a Operating Partnership Structure



The Capital Stack: Debt Vs Equity

- Types of Equity:
  - Common
  - Preferred
    - Perpetual Preferred
- Debt Hierarchy
  - Senior
  - Junior
  - Mezzanine
- Types of Debt
  - Convertible Debt
  - Term Debt
  - Fixed Rate/Floating
  - Amortizing/Interest only

The Capital Stack

- Definitions
  - Preferred vs Common Equity
    - Usually documented as a direct investment in the entity
    - Preferred return paid prior to common
    - Return of capital prior to common
    - Limited, if any upside
    - Mandatory Redemption
  - Senior Debt – Collateral is a first lien position on the business/property
  - Junior Debt – Collateral is typically behind the Senior Lender; collateral may also be the business/property
  - Mezzanine Debt - Typically behind both the Senior and Junior Debt, collateral is usually a pledge of the ownership interest in the entity that owns the business

Raising Additional Capital - Tax Considerations

Classification of Investment – Business and tax considerations

- Do the parties care? Is there taxable income/ loss generated in the business?
  - If business is operated as a C-corp – probably no income until a capital event (sale or refinancing)
  - If real estate development deal – no income generated until property is built

Types of Income/deduction

- Debt- Interest income to investor, interest expense to partnership
  - OID?
- Equity – character of income generated by partnership and type of deduction by the partnership

Raising Additional Capital - Tax Considerations

Equity

- Capital shifts
- Allocation of Income and Deductions
- Revaluations and reverse 704(c)
- Loss of Debt Basis – IRC section 752
- Non-Compensatory Options - IRC Regulation 1.721-2

Debt

- Timing of Deductibility
- Computation of amount
    - OID

IRC 704(c)

- IRC 704(c) governs allocations related to property contributed to the partnership in which the fair value differs from the adjusted tax basis of the property contributed.

- Intent is to prevent shift of built-in gain or loss related to contributed property away from contributing partner.

- Regulations provide for three methods for allocations related to IRC 704(c) property:
  - Traditional
  - Traditional with curative
  - Remedial

- Partnership can select allocation method on asset-by-asset basis. Once 704(c) method is determined by partnership, irrevocable by partnership for that particular asset.

- Partner's share of net unrecognized section 704(c) built-in gains or losses a Schedule K-1 reporting item (Items M & N) as well as the impact of 704(c) on current year allocations (line 20AA).

Code Section 704(c)

- Sample partnership agreement language:

4.6 Code Section 704(c). In accordance with Code Section 704(c) and the Regulations thereunder, income, gain, loss and deduction with respect to any property contributed to the capital of the Company shall, solely for tax purposes, be allocated among the Members so as to take account of a variation between the adjusted basis of such property to the Company for federal income tax purposes and its initial Gross Asset Value. In the event the Gross Asset Value of any Company asset is adjusted, subsequent allocations of income, gain, loss and deduction with respect to such asset shall take account of any variation between the adjusted basis of such asset for federal income tax purposes and its Gross Asset Value in the same manner as under Code Section 704(c) and the Regulations thereunder. Any elections or other decisions relating to such allocations shall be made by the Board of Managers in any manner that reasonably reflects the purpose and intention of this Agreement. Allocations pursuant to this Section 4.6 are solely for purposes of federal, state and local income taxes and shall not affect, or in any way be taken into account in computing, any Member's Capital

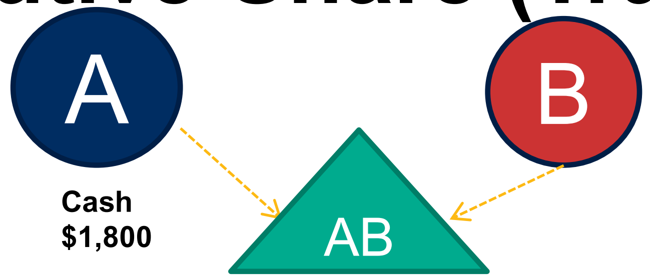
(b) Section 704(c) Items. In accordance with Section 704(c) of the Code and the traditional method with curative allocations of Regulations Section 1.704-3(c) thereunder, income, gain, loss, and deduction with respect to any property contributed to the capital of the Company shall, solely for tax purposes, be allocated among the Members so as to take account of any variation between the adjusted basis of such property to the Company for federal income tax purposes and its initial Gross Asset Value. If the Gross Asset Value of a Company

IRC 704(c) – Example #1

- Partner A and B agree to contribute $1,500 in exchange for 50% partnership interest, respectively. Partner A contributes cash of $1,500 and Partner B will contribute land valued at $1,500 but with an adjusted tax basis of $500. During the year, the partnership sells the land for its fair value of $1,500.

1) What is the amount of built-in gain related to the Section 704(c) property?
2) How will the partnership allocate the taxable gain related to the sale of land?

Section 704(b) Example – Determination of Distributive Share (Traditional Method)



Cash
$1,800

Building
FMV $1,800
Basis $1,500

Gain $300

For demonstration, straight line depreciation over 30 years

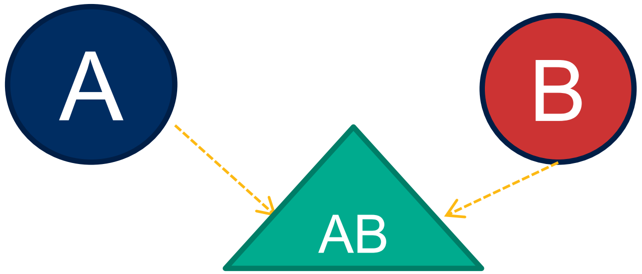
A is the "noncontributing partner" **B is the "contributing partner"**

	Partner A – 704(b)	Partner A – Tax	Partner B – 704(b)	Partner B – Tax	Partnership AB – 704(b)	Partnership AB - Tax
Capital Account - Beginning Balance	$1,800	$1,800	$1,800	$1,500	$3,600	$3,300
Book Depreciation according to 704(b) ($1,800/30 years)	(30)		(30)		(60)	
Tax Depreciation to noncontributing partner		(30)				(30)
Tax Depreciation to Contribution Partner				(20)*		(20)
Capital Account – Ending Balance	$1,770	$1,770	$1,770	$1,480	$3,540	$3,250

***$300 gain/30 years = $10**

Section 704(b) Example – Ceiling Rule Limitation

Cash $1,800



Building
FMV $1,800
Basis $750

Gain $1,050

For demonstration, straight line depreciation over 30 years

A is the "noncontributing partner" **B is the "contributing partner"**

	Partner A – 704(b)	Partner A – Tax	Partner B – 704(b)	Partner B – Tax	Partnership AB – 704(b)	Partnership AB - Tax
Capital Account - Beginning Balance	$1,800	$1,800	$1,800	$750	$3,600	$2,550
Book Depreciation according to 704(b) ($1,800/30 years)	(30)		(30)		(60)	
Tax Depreciation to noncontributing partner		(25)				(25)
Tax Depreciation to Contribution Partner				(0)*		(0)
Capital Account – Ending Balance	$1,770	$1,775	$1,770	$750	$3,540	$2,525

***Only able to shift away $25 of deductions, whereas BIG per year would be $35 ($1,050/30)**

Capital Account Revaluation Events

- A revaluation may be performed only if done (1) principally for a substantial nontax business purpose and (2) in connection with one of the following events.
- 1) Contribution of cash or other property (excluding a *de minimis* amount) to the partnership by a new or existing partner in exchange for an interest in the partnership.
- 2) Liquidation of the partnership or the partnership's distribution of cash or other property (excluding a *de minimis* amount) to a retiring or continuing partner in redemption of an interest in the partnership.
- 3) The grant of a partnership interest (excluding a *de minimis* interest) in exchange for services to or for the partnership's benefit by an existing, new, or anticipated partner.
- 4) The partnership's issuance of a noncompensatory option (excluding a *de minimis* one).
- 5) Under GAAP, substantially all of the partnership's property (excluding money) consists of readily marketable securities, such as stock, commodities, options, futures, etc.

“Reverse” IRC 704(c)

- Under the capital account rules of Sec. 704(b), if agreed upon in the partnership agreement, partnerships may adjust Sec. 704(b) capital accounts to reflect the FMV of the partnership’s property if done in connection with a qualifying event. These revaluations can be made to any asset and are generally known as “reverse” Sec. 704(c) allocations or “capital account book-ups (book-downs).

- There is no requirement to use the same Sec. 704(c) allocation method for each reverse Sec. 704(c) allocation, even if it is for the same property.

- Capital account revaluations / reverse 704(c) included as part of new Schedule K-1 reporting requirement.

Capital Account Revaluation - Example

- Partners A and B formed AB Partnership, LLC in 2019, in which they have owned 50/50 since inception. In 2021, A and B are considering admitting Partner C as a 1/3 partner in exchange for Partner C contributing $5,000 to the partnership. At the time of Partner C's admittance, Partner A and B both had a tax capital account balance of $1,000.

1) What are Partner A, B, and C's respective IRC 704(b) capital accounts upon Partner C's admittance?

2) What is the amount of Partner A and B's built-in gain upon the admittance of Partner C?

IRC Section 707 - Disguised Sale Rules

- A disguised sale can result from certain property transfers between partners and partnerships that appear to be nontaxable contributions but are recharacterized as a sale. (Governed under Section 707)

- General Rule:
  - Property is contributed to a partnership; and
  - Concurrent (or subsequent) distribution of cash or property to that partner (or another partner); and
  - When viewed together, would be properly characterized as a sale or exchange of the property in whole (or in part).

Facts & circumstances dictate and there are 10 “tests” to review in Reg. 1.707-3(b)(2) to argue for or against a disguised sale.

IRC Section - Disguised Sale Rules (Continued)

- IRC Section 707(a)(2)(B):
  - A property contribution by a partner to a partnership followed by a distribution of cash from the partnership to the contributing partner (or another partner)
  - A cash contribution by a partner to a partnership with a property distribution from the partnership to the contributing partner (or another partner)
  - A property contribution by one partner and cash by another partner with a cash distribution from the partnership to the partner contributing property and a property distribution to the partner contributing cash
- If, within a two-year period, a partner transfers property to a partnership and the partnership transfers consideration to the partner, the transfers are presumed to be part of a disguised sale. ("Mixing Bowl Rules")
  - When the transfers of property and consideration are not simultaneous, the sale date is deemed to be the date the property is transferred.

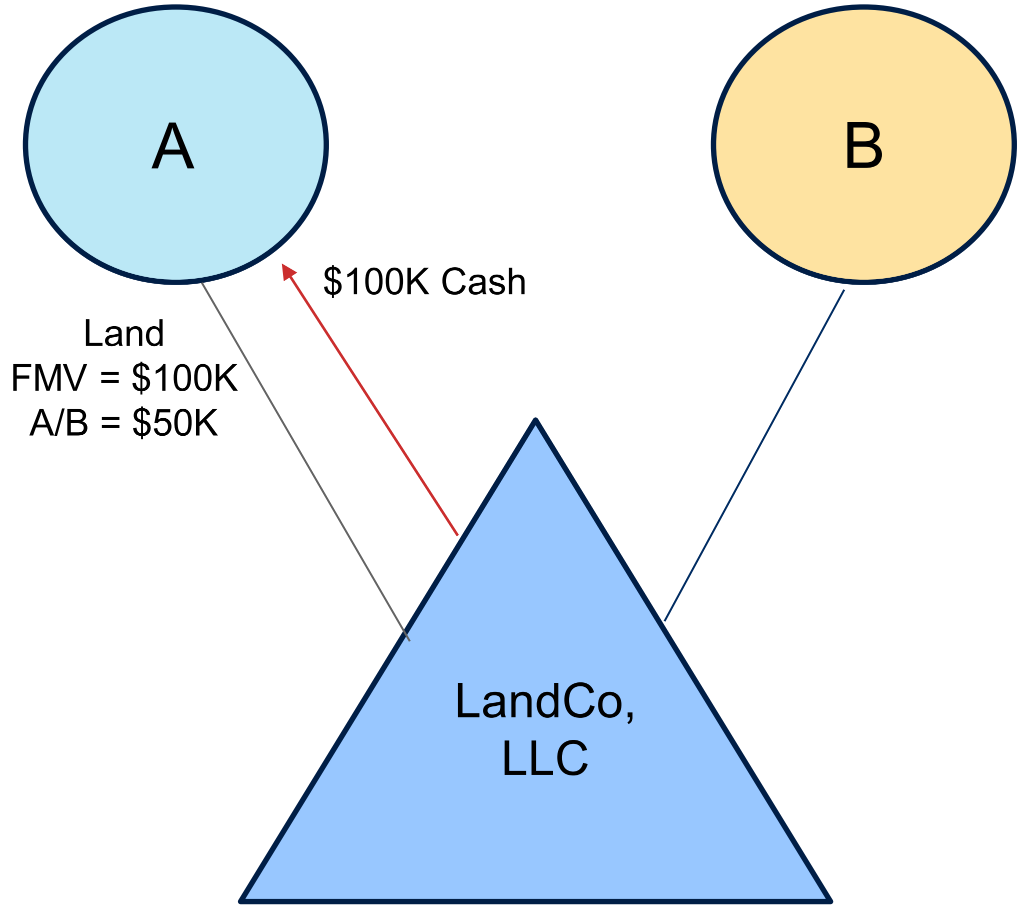
Disguised Sale Rules

- Special rules related to liabilities in connection with potential disguised sale transaction [IRC 1.707-5]:
- The Regulations provide that where a partner contributes property to a partnership and the partnership assumes or takes subject to a liability, the tax consequences depend on whether or not the liability is a "**qualified"** liability.
- Determination of "qualified" liability includes:
  - The liability (i) was incurred by the partner more than two years prior to transfer and (ii) has encumbered the transferred property throughout that two-year period. [Referred to as "old and cold"].
  - The liability was incurred by the partner within the two-year period prior to the transfer, but (i) was not incurred in anticipation of the transfer and (ii) has encumbered the transferred property since it was incurred.
  - The liability is allocable to capital expenditures with respect to the transferred property.
  - The liability (i) was incurred in the ordinary course of the trade or business in which the transferred property was used or held and (ii) all of the material assets related to that trade or business are transferred to the partnership.

- If the liability is not a qualified liability, then the partnership is generally treated as transferring cash to the partner to the extent of the decrease in the partner's "share" of the nonqualified liability.

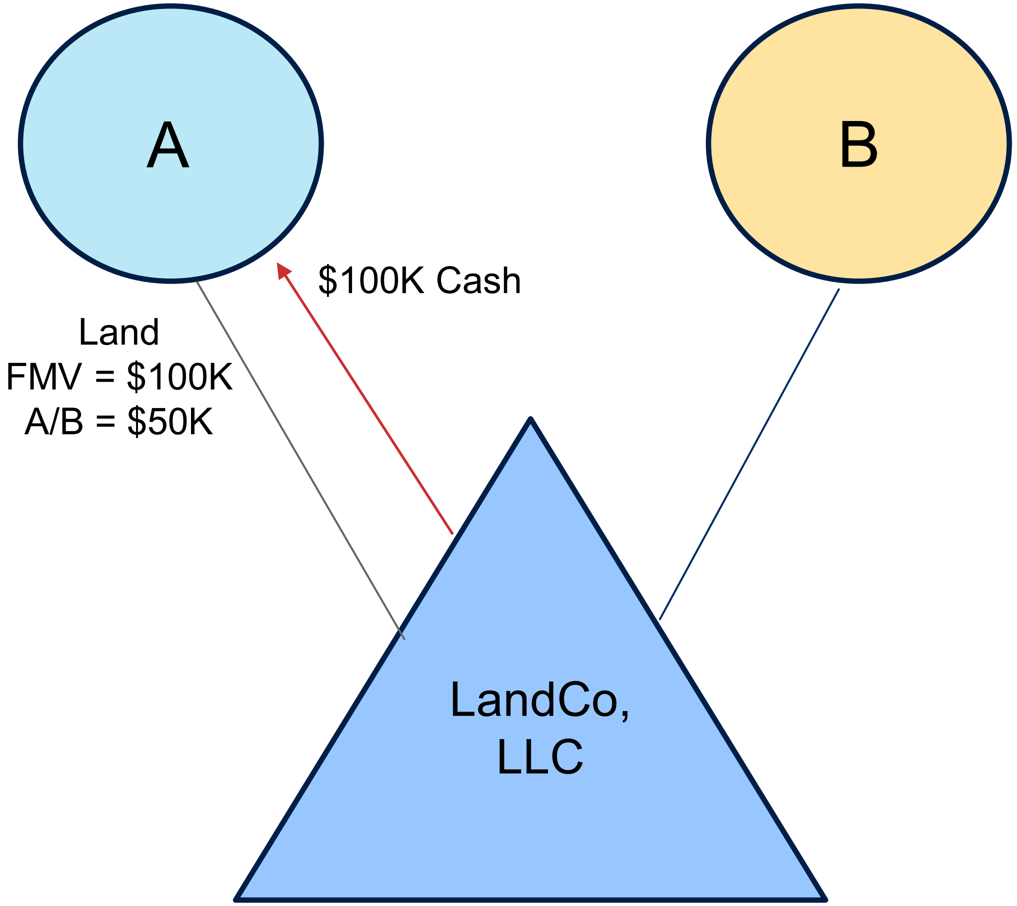
Disguised Sale Rules - Examples

- A contributes a piece of land to LandCo, LLC; FMV = $100,000 and adjusted basis = $50,000
- LandCo, LLC distributes $100,000 cash to A
- IRS would recharacterize this as a deemed sale of Land by A to LandCo



Disguised Sale Rules - Examples

- Partner A:
  - Recognize gain of $50,000
  - Basis in partnership interest = $100,000
- LandCo, LLC
  - Takes basis in the land of $100,000



Disguised Sale Rules - Exceptions

- Guaranteed payments
  - Any payment to a partner that is determined without regard to partnership income and is for the use of that partner's capital
- A preferred return that is reasonable in amount
  - Must have stated provision in operating agreement; Cannot make payment until after existence in agreement
- A distribution of operating cash flow
  - Not a GP or preferred return
  - Not a 707(a) payment
- A reimbursement of preformation expenses
  - Expenditures incurred during the two years preceding contribution.
  - Syndication / Org costs.

Debt vs Equity Tax Authority

- IRC Section 385 gives the IRS the right to prescribe regulations “as may be necessary or appropriate to determine whether an interest in a corporation is to be treated …..as stock or indebtedness(or as in part stock part indebtedness) for federal income tax purposes.
  - Regulations issued in 2016 which became final in a revised form in 2018.
    - Multi-factor debt-equity test continues to apply alongside the regulations
    - Literal reading is it only applies to interests in corporations versus debt

Debt vs Equity Tax Authority

IRC Section 385 Regulations (continued).

- Five factors
  - Existence of a promise to repay
  - Subordination of the instrument to debt
  - The issuer's debt to equity ratio
  - Convertibility of the instrument into stock
  - Relationship between holdings of stock and holdings of the interest in question (i.e examining any pro rata holdings of the instrument in questions and of the issuer's equity.).
- Code Section 1361 provides safe harbor for interests issued by Subchapter S Corporations to be treated as debt rather than potentially being characterized as a second class of stock.

Debt vs Equity Tax Authority

- Notice 94-47 – 8 Factor test – IRS uses as part of its examination process and issuing guidance to taxpayers
  - Whether there is an unconditional promise to pay a sum certain on demand or at a fixed maturity date in the reasonably foreseeable future
  - Whether the holder possess the right to enforce the payment of principal and interest
  - Are the rights of the holder subordinate to the payment rights of general creditors
  - Do the holders have the right to participate in the general management of the borrower entity
  - Is the issuer thinly capitalized
  - Is there identity between the owners of the instrument and the owners of the equity in the borrowing entity
  - What is the label placed on the instrument?
    - Never want to argue against the form you have chosen
  - How is the equity treated for non-tax purposes (i.e, debt or equity).

Debt v Equity Tax Authority

- Supreme Court in Culbertson v. Commissioner (1949) provided a starting point to determine whether a person rises to the level of a partner which requires that the parties in good faith and acting with business purpose intended to join together in the present conduct of a business enterprise.
  - Totality of Circumstances Test:
    - Intent
    - Sharing of profits
    - Agreement to share costs or losses
    - The ownership of a capital interest or the performance of service
    - Participation in management.

Debt vs Equity Tax Authority

- Hambuechesen – Tax Court case which concluded that Corporate debt equity tests apply to partnerships. This case focused on the partnerships lack of creditworthiness which is the focus od corporate analysis, i.e thin or adequate equity/
- Other Courts look to factors and perform a balancing test.
- Castle Harbour – Illustrates that reasonable minds can differ.
  - ., GE contributed fully depreciated aircraft to a partnership, Dutch Bank contributed 18% of the partnership capital , but were allocated 98% of the operating income.
  - Distributions were arranged to previously agreed schedule that the Ducth Bank would get reimbursed their investment plus annual rate of return near 9%, plus a small share in any unexpected profits,
  - Partnership held funds equal to 110% of the Dutch Banks Investment.
  - Partnership agreement specially allocated disposition gains to GE.

Debt vs Equity Tax Authority

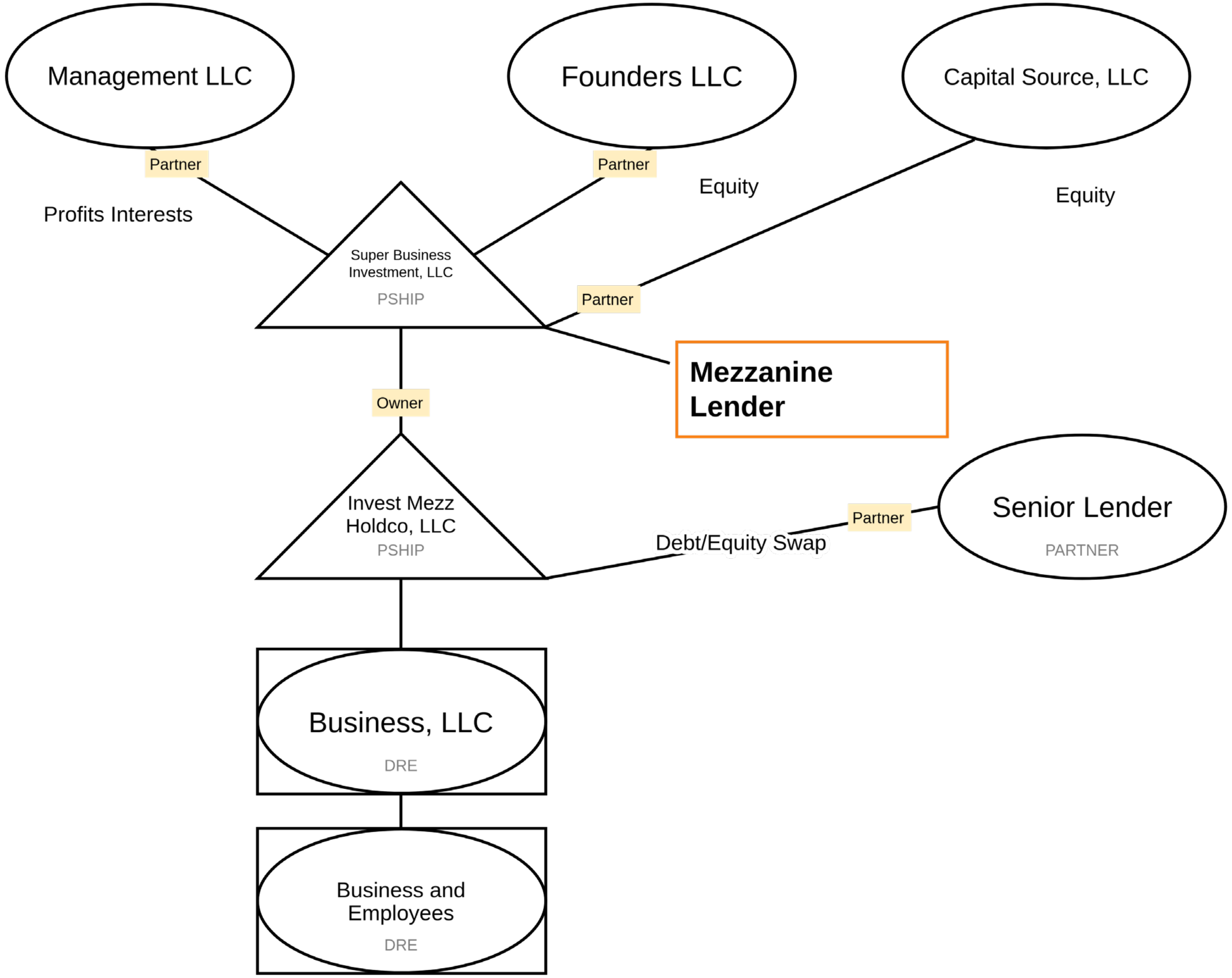
- Castle Harbour
  - Arrangement effectively allowed GE to redepreciate the aircraft by shifting excess income to the Dutch Banks over eight years.
  - First District Court held that Dutch Bank was a partner for tax purposes under IRC 761. Court used factors in Notice 94-47.
  - Second Circuit reversed – Dutch Bank were not partners – Arrangement only gave the taxpayer superficial profits and losses, investment operated like a repayment of a secured loan.
    - Court was influenced by the following
      - partnership had to keep an asset in the partnership equal to 110% of the Taxpayers investment.
      - Partnership was obligated to keep 300mm worth of casualty loss insurance to protect Dutch Bank's investment
      - GE Capital, provided a personal guaranty which effectively secured the partnership's obligation to the Bank
      - Ability to receive unexpected profits were severely limited.
      - Case was remanded consistent with traditional debt equity factors

Debt vs Equity Tax Authority

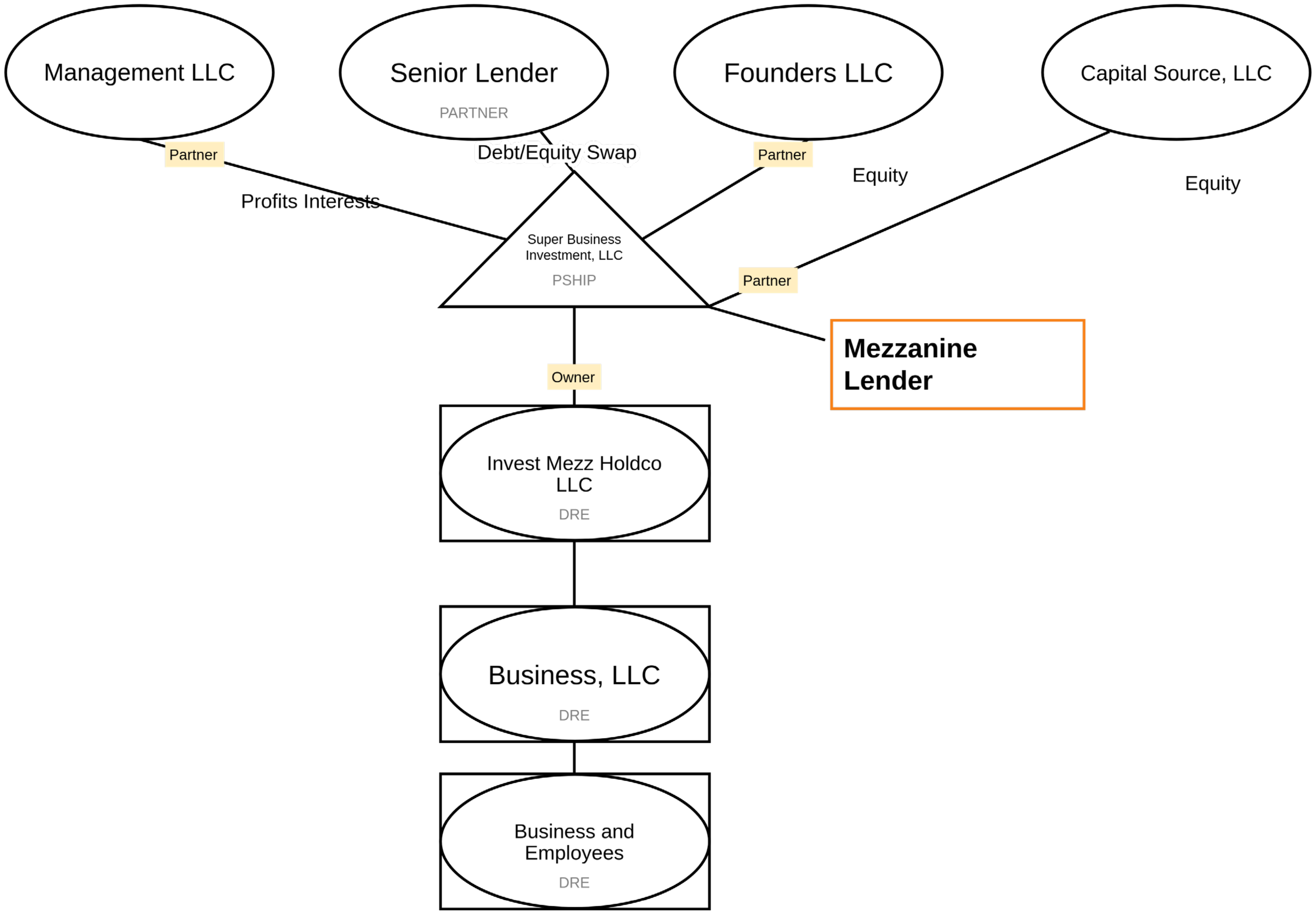
Castle Harbour (cont'd)

- On remand District Court held again for Dutch Bank saying they were partners –
  - Court used 704(e) and said statute is not limited to family partnerships
    - Capital was a material income producing factor
    - Dutch Bank were real owners of their respective capital interests
    - Dutch Bank had a true capital interest
    - Court said Culbertson was not relevant if taxpayers qualified under 704(e)
  - Second Circuit again reversed and said Dutch Banks did not have a capital interest under 704(e), for the same reasons as their earlier opinion as the investment was not bona fide equity.
  - Court said Dutch Banks interest for all practical purposes a fixed obligation requiring reimbursement of their investment plus a set rate of return in all but the most unlikely scenarios, was debt for tax purposes.

Debt For Partnership Equity Swap into a DRE



Debt For Partnership Equity Swap into a Pre-existing Partnership i



Debt for Equity Swaps into a Pre-Existing Partnership

Tax Considerations

- IRC Section108(e)(8)
- Regulation 1.721 – 1
- Loss of Debt Basis – IRC 752
- Allocation of Future Income and Deductions
    - Super Preferred Equity and Allocation of income
    - Guaranteed Payments

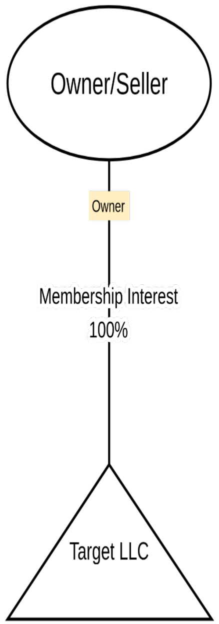
Debt for Equity Swaps into a Disregarded entity

Tax Considerations

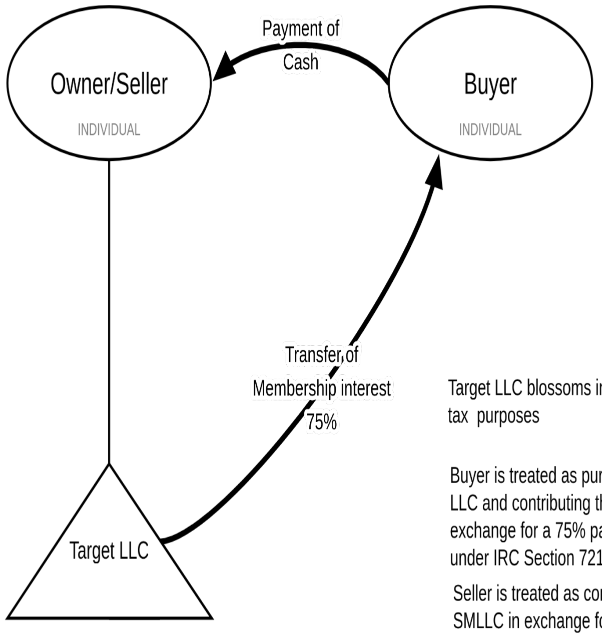
- Revenue Ruling 99-5 Situation 1 or 2
- IRC Section 108(e)(8) and Reg 1.108-8
- Regulation 1.721–1
- Loss of Debt Basis – IRC 752
- Allocation of Future Income and Deductions
  - Super Preferred Equity and Allocation of income
  - Guaranteed Payments

Revenue Ruling 99-5 Situation 1

Ownership Prior to Transaction



Buyer purchases 75% of Membership interest in Target LLC

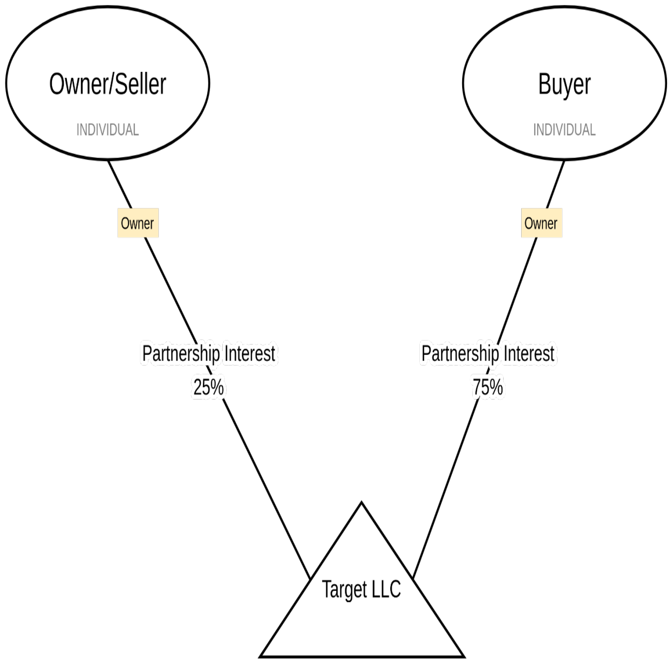


Target LLC blossoms into a partnership for Federal Income tax purposes

Buyer is treated as purchasing 50%of assets held by Target LLC and contributing them to Target partnership in exchange for a 75% partnership interest in Target LLC under IRC Section 721

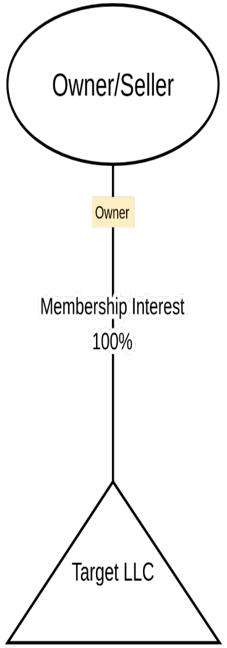
Seller is treated as contributing 25% of the assets of Target SMLLC in exchange for a 25% interest in Target LLC under IRC Section 721

Final Structure

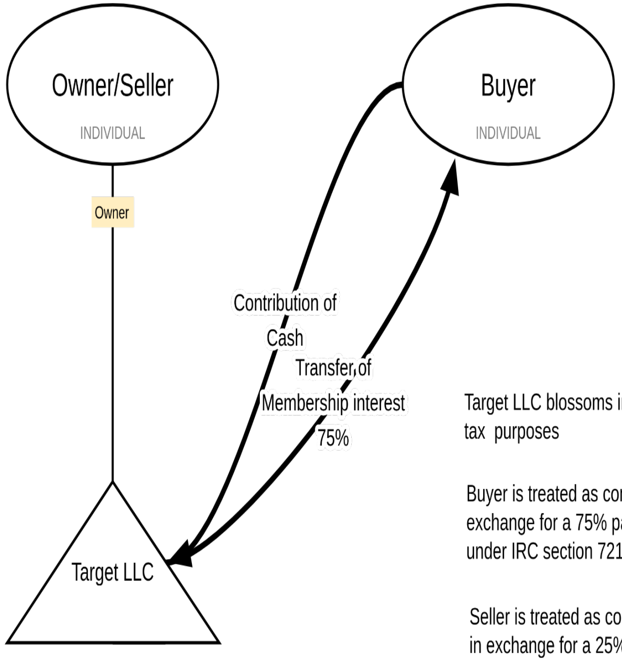


Revenue Ruling 99-5 Situation 2

Ownership Prior to Transaction



Buyer Contributes Cash in exchange for a 75% Membership interest in Target LLC

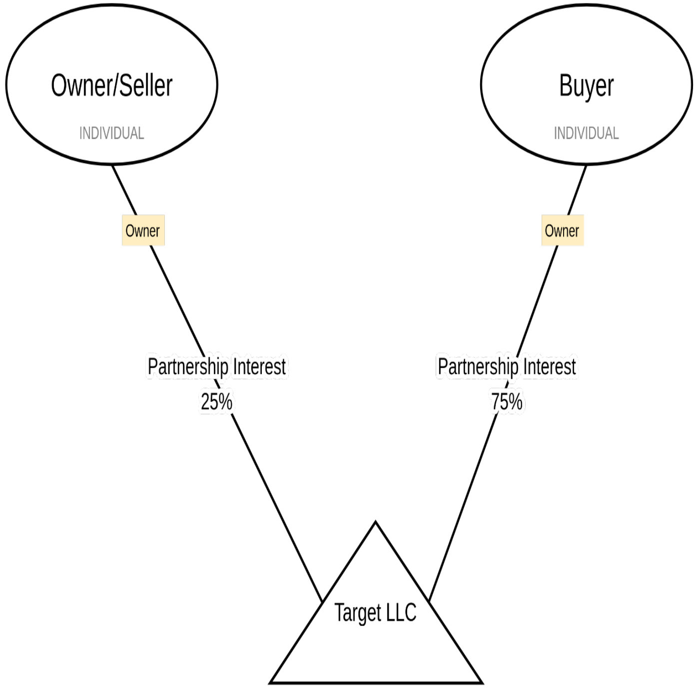


Target LLC blossoms into a partnership for Federal Income tax purposes

Buyer is treated as contributing cash to a partnership in exchange for a 75% partnership interest in Target LLC under IRC section 721

Seller is treated as contributing all the assets of Target LLC in exchange for a 25% interest in Target LLC under IRC Section 721

Final Structure



Differences between Revenue Ruling 99-5 Situation 1 and 2

- Taxable v. Nontaxable

  Situation 1 – Target seller has a taxable sale of 75% on the assets of Target SMLLC

  Situation 2 – Target recognizes no tax on the contribution of cash

- Step Up

  Situation 1 – Target 1065 receives tax basis equal to FMV for 75% of the Assets

  Situation 2 – Target 1065 retains carryover tax basis for 100%

- Target Seller Contribution to New Target Partnership

  Situation 1 – Target Seller contributes 25% of the assets with a carryover basis, but receives a 25% stepped up capital account for 704(b) purposes

  Situation 2 – Target Seller contributes 100% of the assets with a carryover basis, but receives a 100% stepped up capital account for 704(b) purposes

Buyer Holdco tax treatment is governed under 721 and has the exact same tax treatment – tax basis and 704(b) are the same.

The Capital Stack

- Illustrations of recent transaction
- XYZ REIT
  - REIT invests in an LLC with a Developer member. REIT's capital is preferred and receives an 8% return from operating distributions, all remaining operating cash goes to developer member.
  - Distributions on Capital Events, go first to pay preferred member's capital back. Remaining cash goes to Developer.
  - Redemption provision that says Developer can redeem all of the preferred equity. If redemption occurs within 12 months of closing, then the Developer must pay a redemption premium equal to a 12% return.
  - Mandatory redemption prior to the earlier of 1) 6 years preferred member made its final capital contribution or 2) 8 years.
  - REIT and Developer are co-managing members
  - What other Facts would you like to know to start the analysis of debt versus equity.?

The Capital Stack

- JV DEAL
  - Investor puts cash into an LLC with a Developer member. Investor’s capital is preferred and receives an 8% return from operating distributions, all remaining operating cash goes to developer member.
  - Distributions on Capital Events, go first to pay preferred member’s capital back. Remaining cash goes to Developer. i.e Investor has no upside.
  - Redemption provision that says Mandatory redemption at the end of 2 years
  - If Investor is not redeemed, then the Investor has the right to force a sale of the property.

Thoughts?

Presenter

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Thank You