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New tax deferral election may lead to investor disputes during loan workouts

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As anyone who has ever been involved in a debt workout or restructuring has learned, one of the most significant hurdles in structuring a suitable arrangement between a lender and a borrower involves the negative impact of US income taxes on the borrower. In the United States, as is the case in many other countries, when a borrower reduces or cancels its outstanding indebtedness for less than the full amount due, the borrower is deemed to realise taxable income on the amount of the reduction. This cancellation of indebtedness ('COI') income is subject to many nuances and exceptions, the primary exceptions being that an insolvent debtor can avoid COI income to the extent he, she or it is insolvent. Similarly, a bankrupt borrower can also avoid recognising COI income.

Complications and problems multiply when the borrower who realises COI income is treated, for federal income tax purposes, as a partnership. In the event that a partnership recognises COI income, that income passes through to the partners, who must report the COI income on their own tax returns and pay the tax attributable to the COI. A partner may be able to avoid paying tax on the pass-through COI income if that partner is bankrupt or to the extent of the partner's insolvency. However, absent a partner's insolvency or bankruptcy, they often face the situation of having to pay income tax with respect to an underperforming asset without receiving a corresponding cash disbursement. This scenario has become commonplace since the emergence of limited liability companies (in the last decade) as the investment entity of choice. While investors have become accustomed to structuring their investments through LLCs and other entities that are treated as partnerships, they rarely consider the impact of the entity's debt workout on their own tax situation.

Of course, tax partnership debt workouts have increased, which have magnified the impact of COI income passed through to partners. The US Congress was sympathetic to these concerns. As part of the American Recovery and Reinvestment Act of 2009, a taxpayer that realises certain COI income in 2009 or 2010 can elect to include that income rateably over a five-year period that generally begins in 2014. Only debt instruments issued in connection with the conduct of a trade or business, as opposed to those held for investment, are eligible for the election. Congress specifically provided that the election may shelter partnership COI income if the debt was issued in connection with the partnership's trade or business. Of significant note, Congress required the election be made by the partnership rather than the partners, although the election can be made on a debt-by-debt basis. Thus, whether the partnership wishes to defer its pass-through of COI income to the partners by making the election is an 'all or nothing' decision, with the choice either affecting all of the partners or none of the partners. This 'entity approach' for the election can impact each partner differently.

Requiring a partnership-level election can cause a conflict between one or more partners, including various investors and promoters who may also be partners. Many solvent partners would prefer that the COI income recognition be deferred and would benefit by the partnership's making the newly-available deferral election. In contrast, some partners, including those who may control the partnership decisions, may be insolvent, causing them to prefer foregoing the deferral election in favour of current recognition of COI income. Other partners with useable net operating losses may also prefer that the partnership not make the election and currently recognise COI income. While some practitioners have asked the IRS to provide a procedure to allow certain partners to 'elect out' of the election, it is questionable whether the IRS has the authority to promulgate such a rule. In the event of such a conflict, the terms of the partnership agreement, or operating agreement in the case of an LLC, would govern. Managing partners (usually Managers in the LLC context) would be wise to consider whether making or foregoing the election could have a disproportionate impact on its investors and whether a decision could give rise to a future claim of breach of the agreement or other fiduciary duties.

If the election is made, the COI income is allocated among the partners in the same way as the income would have been allocated had the partnership not made the election. In other words, income is allocated according to percentages at the time of the debt reduction, not the time that the income is actually reported. In addition, all COI income that a partner deferred as a result of the partnership making the election becomes accelerated upon the partnership's termination or sale of all of its assets or upon such partner's sale, exchange or redemption of his partnership interest. This is significant because many workout plans, both in and out of the bankruptcy context, involve terminating the debtor entity concurrently with the debt reduction. When the dissolving debtor entity is treated as a tax partnership, no deferral election is possible. As the insolvency and bankruptcy exceptions are applied at the partner level, some partners may favour dissolving the partnership, while others may want to retain the partnership's existence to take advantage of the new COI income deferral election – another source for partner vs. partner disputes.

The American Recovery and Reinvestment Act of 2009 only became effective on 17 February 2009, so many questions regarding how the COI deferral election applies to partnership situations remain unanswered. Investors who are entrenched in financing workouts involving a tax partnership debtor should consider the impact on the election to defer COI income or failure to make such election to their tax situations. Based on such investor's tax situation, the investor may be in a position to force the entity to make election, build a coalition with other similarly-situated investors or otherwise seek to influence the party empowered to make such an election. ■

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