

# Private Equity and Hedge Fund

By *Thomas C. Lenz* and *Joseph J. Bergtold*

## When Private Equity Fund Debt Goes Bad

In these difficult economic times, private equity funds are reviewing their portfolio company debt holdings to determine if write-downs or write-offs are appropriate. The tax law concerning the timing and treatment of a bad debt write-off can be confusing and complex. In this column we provide a decision roadmap to help guide you through this process.

Questions fund managers often have related to bad debts are as follows: When is it appropriate to write-off the debt? Can a partial write-off be taken or must the debt be wholly worthless? What if the lender takes back an equity interest in the borrower in exchange for the debt? What if the fund abandons the debt? What if partial payment is received in satisfaction of the debt? First we'll discuss the general principles governing the typical loans made by private equity funds and then apply those principles to various scenarios.

### Is the Debt an Ordinary or Capital Asset?

Determination of whether the debt is an ordinary or capital asset is the first step in determining the ultimate treatment of a write-off or write down of debt; however, the test for determining whether or not an asset should be treated as an ordinary or capital asset was not always clear. The 1988 landmark decision by the Supreme Court in *Arkansas Best* provided the guidance taxpayers had been previously without.<sup>2</sup> Pre-*Arkansas Best*, a taxpayer could treat a loan as an ordinary asset if the loan were made during the ordinary course of the taxpayer's business by applying the *Corn Products* doctrine.<sup>3</sup> The *Corn Products*



CCH

a Wolters Kluwer Business



**Thomas C. Lenz** is a Managing Director, and **Joseph J. Bergtold** is a Manager in the Financial Services Group of RSM McGladrey, Inc.

CCH Draft

doctrine provides that profit and loss incurred in connection with a trade or business should receive ordinary treatment. In *Arkansas Best*, the Supreme Court overturned the *Corn Products* doctrine and determined that an asset was a capital asset unless it was excluded in one of the statutory exemptions found in Code Sec. 1221.<sup>4</sup> Such statutory exemptions include inventory and assets such as trade accounts and notes receivable acquired in the ordinary course of a trade or business for services rendered or from the sale of property held primarily for sale to customers.<sup>5</sup> In other words, debts held as inventory, certain notes receivables and trade debts are treated as ordinary assets, and generally all other debts are treated as capital assets unless excluded elsewhere in the Code. Examples of certain taxpayers specifically excluded elsewhere under the Code are a taxpayer who holds debts and is considered a securities dealer or an entity that is considered to be a qualified financial institution.<sup>6</sup>

### **Debt Determined to be an Ordinary Asset**

---

If the debt held is determined to be an ordinary asset, the tax treatment of debt impairment is relatively straightforward. The write-off or write-down of such debt, which occurs when the debt is determined to be either wholly or partially worthless, will receive ordinary loss treatment. In addition, partial worthlessness is only available if the debt is not considered a security.<sup>7</sup> The amount of such loss will be referenced by the amount of the adjusted basis of the debt determined under Code Sec. 1011. Except for loans made by SBIC funds, which would qualify as financial institutions, loans made by private equity funds generally would be considered capital assets.<sup>8</sup> Moreover, most private equity funds' lending activities would be considered for investment, thereby not rising to the level of a trade or business.

### **Securities Dealer**

The regulations define a dealer as a merchant of securities who may be an individual, partnership or corporation, who has an established place of business, and is regularly engaged in the purchase and resale of securities to customers. Taxpayers who buy and sell securities for investment and speculation purposes, regardless of whether buying and selling constitutes the carrying on of a trade or business, are not considered dealers in securities. A dealer is one

who generally is considered a broker-dealer and, therefore, must obtain a license from state securities regulators and register with the SEC. The securities held by the dealer are considered inventory similar to any other merchant, and the profit and loss from the sale of these securities, or losses on debt for purposes of this column, are considered ordinary income or loss.

### **Financial Institution**

The sale or exchange of a bond, note, certificate or other evidence of indebtedness is not considered the sale or exchange of a capital asset for entities listed as financial institutions under Code Sec. 582(c)(2). Financial institutions listed under this section are as follows: a bank, an entity licensed as a small business investment company under the Small Business Investment Act, any financial institution listed under Code Sec. 591, or a business development corporation. Additionally, the general rule under Code Sec. 582 states that subsections (a) and (b) of Code Sec. 166 shall apply to a financial institution that holds a debt which is considered to be a security. In other words, a bad debt deduction will receive ordinary treatment for an entity that qualifies as a financial institution for purposes of Code Sec. 582.

### **Debt Determined to be a Capital Asset**

---

As stated earlier, debt generally is treated as a capital asset unless excluded under some provision in the Code. Code Secs. 165 and 166 can both apply to a debt loss. Determining when each section applies can be confusing. If the debt is determined to be a capital asset, then the next step is determining whether or not the debt is defined as a security for tax purposes under Code Sec. 165(g)(2)(c). The determination of whether or not the debt is a security or not a security will be a crucial part in determining the ultimate tax treatment in writing off the debt. Based upon *Spring City Foundry Co.*<sup>9</sup> and Rev. Rul. 69-458,<sup>10</sup> if a debt is not a security, tax treatment of the loss on the debt will be dictated by Code Sec. 166; however, if it is determined that the debt is a security, Code Sec. 165 will apply.<sup>11</sup>

### **Section 165 Treatment (Applies to Debt Securities)**

---

The general rule under Code Sec. 165 permits a deduction for any loss sustained during the tax year

that has not been compensated for by insurance or by some other party.<sup>12</sup> The section more specifically addresses the treatment of losses incurred on a security that is deemed to be worthless. Under Code Sec. 165(g), in the case of a security that is a capital asset, is worthless, and meets the definitional requirements to be deemed a security, the loss resulting therefrom is treated as a loss from the sale or exchange of such asset on the last day of the tax year.<sup>13</sup> The loss on the worthless security is treated as a long-term capital loss, and the amount of the loss is equal to the adjusted tax basis of the security as computed under Code Sec. 1011.<sup>14</sup> Ordinary loss treatment is available if the security is both completely worthless and Code Sec. 165(g)(3) applies.<sup>15</sup>

In order for Code Sec. 165 treatment to apply, all three requirements discussed above must be met. Further, in analyzing the language of Code Sec. 165(g) and the requirements set forth, a couple of questions arise: What is a security? What factors need to be present to consider a security worthless? Does the security need to be wholly worthless or can a deduction be taken for partial worthlessness? Can one abandon the security and circumvent capital loss treatment under Code Sec. 165?

### Definition of a Security

A security is defined under Code Sec. 165(g)(2) as the following:

- a share of stock in a corporation;
- a right to subscribe for, or to receive, a share of stock in a corporation; or
- a bond, debenture, note, or certificate, or to other evidence of indebtedness, issued by a corporation or by a government or political subdivision thereof, with interest coupons or in registered form.

The determination of whether debt will meet the definition of a security hinges on whether the debt is issued with interest coupons or in registered form. A debt is considered to be in “registered form” if (1) it only can be transferred on the books and records of the issuer via the book-entry system of the issuer (or its agent), (2) the obligation is registered as to both principal and any stated interest with the issuer and

transfer of the obligation may be effected only by surrender of the old instrument, and either the re-issuance by the issuer of the old instrument to the new holder or the issuance of a new instrument to the new holder, or (3) it is registered as to both principal and any stated interest with the issuer (or its agent) and may be transferred by way of either of the methods described in (1) and (2).<sup>16</sup> As a rule of thumb, debt designed to trade in a secondary market is generally in registered form and debt issued in private lending transactions frequently are not in registered form; however, private equity funds generally will issue debt in registered form so as to qualify for the portfolio interest exception.<sup>17</sup> Careful analysis of the debt instrument and the specific provisions regarding transferability should be performed to determine if the instrument is in registered form.

**[D]ebts held as inventory, certain notes receivables and trade debts are treated as ordinary assets, and generally all other debts are treated as capital assets unless excluded elsewhere in the Code.**

### Worthlessness

Generally, in order for a taxpayer to recognize a loss on a capital asset, the loss should be evidenced by a closed and completed transaction in a sale or exchange; however, if the security becomes worthless, an

opportunity to sell or exchange the security may not occur as it is unlikely one would find a willing buyer for a security that is truly worthless. To address this scenario, tax law has long permitted a taxpayer to claim a loss for a worthless security absent a closed and completed transaction.

As discussed above, Code Sec. 165(g) requires that a security be worthless in order to take a loss. Neither Code Sec. 165 nor the regulations thereunder define what is meant by worthlessness; however, the regulations do provide a framework for determining worthlessness. A close examination of the facts and circumstances must be performed. The regulations provide that no deduction is permitted solely on account of a decline in value, and that the debt must be wholly worthless.<sup>18</sup> To prevent a taxpayer from prematurely taking a loss, an identifiable event evidencing the worthlessness of the debt is required. Examples of identifiable events that may provide proof as to the worthlessness of the debt are bankruptcy, termination of business operations, complete liquidation of the issuer and receivership. Note that the taxpayer has the burden of proof to establish that a debt is completely

worthless and the deduction should be claimed in the first tax year where facts and circumstances support the debt is completely worthless.

### Abandonment

Prior to the issuance of Reg. §1.165-5(i), it was believed that a taxpayer may be able to obtain an ordinary loss deduction under Code Sec. 165(a) by irrevocably abandoning the debt prior to the occurrence of an event establishing the debt's complete worthlessness. With the issuance of this regulation, if the debt is a security and a capital asset, the abandonment of the debt establishes its worthlessness and the loss is treated as a capital loss, unless Code Sec. 165(g)(3) applies. The regulation further states that to abandon a security, a taxpayer must permanently surrender and relinquish all rights in the security and receive no consideration in exchange for the security.<sup>19</sup>

### Section 166 Treatment (Applies to Debts That are Not Securities)

Code Sec. 166 provides for a bad debt deduction on wholly or partially worthless debt that is not a security under Code Sec. 165(g)(2)(C). Stated another way, taxpayers are precluded from claiming a bad debt deduction if the loan is categorized as a security for Code Sec. 165 purposes.<sup>20</sup> For those loans that are not considered securities, a bad debt deduction is permitted only if the debt is considered bona fide indebtedness.<sup>21</sup> Bona fide indebtedness is established under the regulations when a debtor-creditor relationship exists based upon a valid and enforceable obligation to pay a sum of money.

Determination of whether or not a taxpayer other than a C corporation may receive a bad deduction on a wholly or partially worthless debt will depend upon whether the debt is a business debt or a non-business debt.<sup>22</sup> The amount of the deduction is equal to the adjusted tax basis as determined by Code Sec. 1011 plus any adjustments to basis determined under Reg. §1.1016.<sup>23</sup>

A taxpayer that is a C corporation can claim an ordinary deduction on a wholly worthless or partially worthless debt. Taxpayers other than C corporations may claim an ordinary deduction if the debt is a busi-

ness debt. Nonbusiness debts held by a taxpayer other than a C corporation may receive a deduction treated as short-term capital loss only if the nonbusiness debt is wholly worthless.<sup>24</sup> No deduction is permitted on a nonbusiness debt held by a taxpayer other than a C corporation that is partially worthless.<sup>25</sup>

### Business and Nonbusiness Debt

The term business bad debt is defined in Code Sec. 166 as (1) a debt that was created or acquired in connection with a trade or business of the taxpayer or (2) a debt the loss from the worthlessness of which is incurred in the taxpayer's trade or business.<sup>26</sup> A nonbusiness bad debt is defined in Code Sec. 166 as any debt other than a business bad debt. Reg. §1.166-5 provides that the determination of whether a debt is a business bad debt or a nonbusiness bad debt will depend upon the relationship between the worthless debt and the taxpayer's trade or business when the loan was made or became worthless.

A taxpayer is not permitted a business bad debt deduction unless the taxpayer can establish that it is engaged in a trade or business, and the acquisition or worthlessness of the debt is proximate in relation to the conduct of such trade or business. So in other words, the debt must have a proximate relationship to the taxpayer's trade or business, and if this relationship exists, the debt is considered a business debt. The standard for determining a proximate relationship was set in *E. Genes*.<sup>27</sup> In this case, a closely held corporation owed a debt to a shareholder-employee that became worthless. The issue that was decided by the Court was whether the debt was considered to be a business or nonbusiness debt. The Court closely examined the language in the statute pertaining to a "proximate" relationship, which is required by the statute in order for a taxpayer to claim a business bad debt deduction. The Court questioned whether a dominant business motivation on the part of the shareholder-employee was required or was a significant motivation sufficient. It was the Court's decision that dominant motivation must exist in determining a proximate relationship. The other requirement in the determination of whether a debt is a business bad debt is the taxpayer must be engaged in a trade or business. To be engaged in a trade or business

No deduction is permitted on a nonbusiness debt held by a taxpayer other than a C corporation that is partially worthless.

requires continuity and regularity of the business activities and the taxpayer's primary purpose for engaging in the activity must be for profit. Determination of a trade or business is based largely on facts and circumstances.

### Worthlessness

Under Code Sec. 166, a taxpayer may receive a bad debt deduction on a debt that is either wholly or partially worthless. Similar to the analysis in determining worthlessness for purposes of Code Sec. 165 discussed previously in this column, the taxpayer has the burden of proof to establish a debt is wholly worthless. The identifiable events previously discussed are examples of evidence supporting worthlessness.

Similar to the deduction for a wholly worthless debt, the taxpayer has the burden of proof for establishing the extent of uncollectibility on the debt. Code Sec. 166 addresses the tax treatment of an item that is partially worthless. Code 166(a)(2) states a deduction shall be allowed in an amount not to exceed the amount of the "charge off" within the tax year. The term "charge off" is not defined in the Code or regulations, but case law provides guidance on what represents a charge-off. The charge-off requirement is satisfied when a portion of the debt is removed from the taxpayer's books and records. This generally is accomplished by reducing the debt's book basis. Thus, when an amount has been deducted for partial worthlessness, there generally is a reduction of both the book basis and the tax basis of the debt. Note the reluctance to charge off assets for financial statement purposes may provide an effective limitation on partial worthlessness deductions. However, the fact that a debt has been charged-off does not mean that the holder is not entitled to pursue collection.

### Debt is Settled for an Amount Less than Holder's Basis

How is debt that is not a security under Code Sec. 165(g)(2)(C) treated when the debt is settled for an amount less than the holder's basis in the debt? Two options exist: (1) the loss is capital, as the transaction is treated as a deemed sale or exchange under Code Sec. 1271(a)(1), or (2) the loss is ordinary, as a partially worthless bad deduction under Code Sec. 166(a)(2). The law is unclear and inconsistent with respect to how this scenario should be treated. The question that this scenario presents is does the deemed sale rule prevail or does the taxpayer get a

bad debt deduction on the worthless uncollected portion of the debt? Congress has failed to address the priority and interaction of these two sections.

### Code Sec. 1271

Code Sec. 1271 provides that amounts received by the holder on retirement of any debt instrument shall be considered as amounts received and a deemed sale or exchange shall have occurred.<sup>28</sup> This section applies to all debts except for (1) any obligation issued by a natural person before June 9, 1997; (2) any obligation issued before July 2, 1982, by an issuer which is not a corporation and is not a government or political subdivision thereof; and (3) and certain debt instruments issued before January 1, 1955.<sup>29</sup> If the aforementioned transaction was deemed to be a retirement for purposes of Code Sec. 1271(a), then the character of the debt loss is determined as if the loss was incurred in a sale or exchange, with the resulting loss treated as a capital loss.

### Position Supporting that Code Sec. 1271 Prevails

A case that specifically appears to address whether the deemed sale rules or the bad debt rules prevail is *D.S. McClain*.<sup>30</sup> The Supreme Court held when a debt security was settled for an amount less than its face, the holder had a capital loss, not an ordinary bad debt deduction. If one were to apply the logic from this case, one could argue that treatment under Code Sec. 1271(a) should trump Code Sec. 166. In GCM 36877 (Sep. 30, 1976), the IRS indicates that *McClain* is applicable in situations in which Code Secs. 1271(a)(1) and 166(a)(2) overlap.<sup>31</sup>

### Position Supporting that Code Sec. 166 Prevails

While evidence seems to support the theory that Code Sec. 1271(a)(1) trumps Code Sec. 166, other evidence would suggest the contrary. In Rev. Rul. 2003-125, the IRS held when a corporation is indebted to its parent and distributes (or is deemed to distribute) all of its assets to the parent, and the value of the distributed assets are worth less than both the adjusted issue price of, and the parent's basis in the debt, the parent may be entitled to a partially or wholly worthless bad debt deduction.<sup>32</sup> Note that the ruling does not discuss nor contemplate interaction with Code Sec. 1271. In addition, the ruling only states that the parent may be entitled to a bad debt deduction. In TAM 9253003, the IRS seemingly

provides a framework within which these sections may interact.<sup>33</sup> A bad debt deduction under Code Sec. 166 would result when the creditor unilaterally determined the worthlessness of the debt and Code 165 loss would apply when the loss was determined by the actions of both the creditor and debtor. The IRS states in the TAM that the creditor's write-off was a bad debt deduction even though the write-off was made immediately before the settlement. The amount paid at settlement was an amount compromised and negotiated for settlement.

As discussed, no clear guidance has been issued providing definitive authority on how these sections should interact. In evaluating the evidence, it would appear that an argument to apply the deemed sale rules would seem to be stronger; however, if Code Sec. 1271 is applied in its literal application, strange tax results may occur. For example, a taxpayer that holds a bad debt that is a capital asset and not a security for purposes of Code Sec. 165(g)(2)(c) would be entitled to a bad debt deduction receiving ordinary treatment for the portion it charges off before and independently of a sale or discount settlement with the debtor. If the charge off arises as a result of a sale or exchange, then capital loss treatment would prevail. Equally concerning is that a creditor would be entitled to an ordinary loss if the debt becomes wholly worthless; however, if the creditor receives even a single penny in exchange, the treatment is shifted to capital loss treatment.

## Exchange of Debt for Equity

The tax treatment of debt for equity exchanges in the private equity fund context will hinge on whether the loan is to a portfolio company that is a corporation or a partnership. In the corporate setting, either Code Sec. 108(e)(6) or Code Sec. 108(e)(8) will apply. In the partnership setting, only Code Sec. 108(e)(8) will apply.

If the fund is also a shareholder in the company and no additional stock is issued in connection with the contribution of debt to capital, it is likely that Code Sec. 108(e)(6) will govern, which provides that if a company acquires its debt from a shareholder as a contribution to capital, Code Sec. 118 does not apply. Code Sec. 118 provides that the corporation does

not recognize income upon a contribution of capital to the corporation. Instead, the debt is considered satisfied for the shareholder's basis in the debt. Accordingly, if the fund's basis in the portfolio company debt is equal to face value, no COD income is recognized by the portfolio company. If the fund's basis in the debt is less than face value (such as would be the case if the fund were entitled to a business bad debt partial write-off), the corporation would recognize COD income for the difference.

If the corporate borrower issues new stock in exchange for its debt, then Code Sec. 108(e)(8) will govern. Code Sec. 108(e)(8) also applies in the partnership context, whereby debt is exchanged for an interest in the partnership.<sup>34</sup> In both situations, the portfolio company's debt is deemed satisfied for an amount equal to the value of the stock or partnership interest issued in the exchange. This usually will generate COD income to the portfolio company since the value of the stock or partnership interest issued is usually less than the book value of the debt on the books of the portfolio company. With respect to the fund, a bad debt deduction generally would be available in the corporate context.<sup>35</sup>

The tax treatment of debt for equity exchanges in the private equity fund context will hinge on whether the loan is to a portfolio company that is a corporation or a partnership.

## Fact Patterns

Based upon current law, we will discuss the ultimate tax treatment of each of the transactions discussed in the various fact patterns listed below. The diagrams in Figures 1 and 2 depict typical scenarios.

Figure 1.

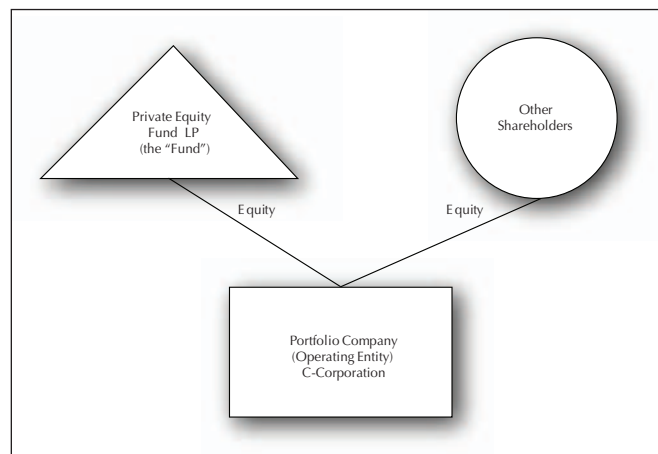
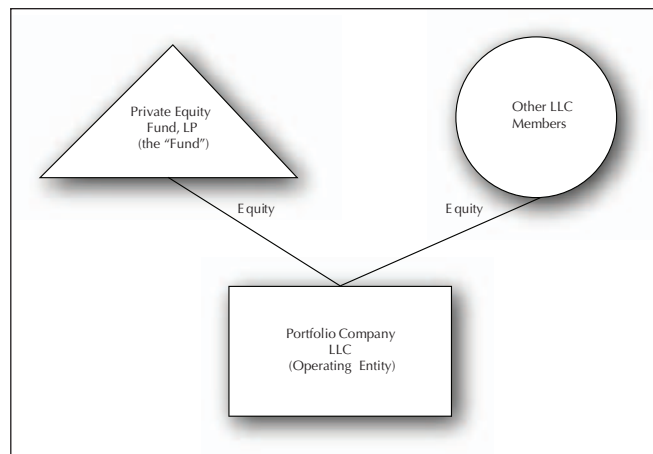


Figure 2.



### Situation One: Portfolio Company Customer Receivable

**Issue:** Portfolio Company has an accounts receivable on its books that it determines is uncollectible. Assuming the portfolio company is an operating business, and conducts a trade or business, how is this treated for tax purposes by the Portfolio Company?

**Conclusion:** Portfolio Company will receive an ordinary deduction on the bad debt. Accounts receivable are considered ordinary assets and are specifically excluded as a capital asset in Code Sec. 1221.

### Situation Two: Sale of Debt Security for a Loss

**Issue:** The Fund has an outstanding loan with a portfolio company, which is a corporation. Assume the loan is a capital asset and is a security. The loan is sold to a third party for less than the value of the Fund's tax basis in the loan. How should this transaction be treated for tax purposes?

**Conclusion:** The debt is a capital asset and meets the definitional requirements of Code Sec. 165(g)(2)(c); therefore, a capital loss will be allowed on the sale of the debt.

### Situation Three: Worthless Debt Security

**Issue:** The Fund has an outstanding loan with a portfolio company, which is a corporation. Assume the loan is a capital asset and is a security. The portfolio company has entered into bankruptcy and is unable to repay the loan to the Fund. How should this transaction be treated for tax purposes?

**Conclusion:** The debt is a capital asset and meets the definitional requirements of Code Sec. 165(g)(2)

(c). Additionally, the portfolio company has entered into bankruptcy and is unable to repay the debt. These events should provide evidence to support the worthlessness of the security. The Fund is allowed capital loss treatment on the worthless security, and the loss is deemed to have occurred on the last day of the tax year.

### Situation Four: Abandonment of Debt Security

**Issue:** The Fund has an outstanding loan with a portfolio company, which is a corporation. Assume the loan is a capital asset and is a security. The Fund believes it is unlikely to receive payment on the loan from the portfolio company and abandons the loan. How should this transaction be treated for tax purposes?

**Conclusion:** The debt is a capital asset and meets the definitional requirements of a security under Code Sec. 165(g)(2)(c). Pursuant to the regulations, the abandonment of the debt will establish the worthlessness of the debt and the loss recognized by the Fund is a capital loss.

### Situation Five: Worthless Business Bad Debt

**Issue:** The Fund has an outstanding mezzanine loan with the portfolio company, which is a partnership for federal income tax purposes. The loan is a capital asset; however, the provisions in the debt instrument regarding the transferability of the loan are restrictive and prevent the loan from being in registered form. Accordingly, the debt is not a security under the definitional requirements. Also, assume the Fund is in the trade or business of lending; however, the Fund does not qualify for the lender exception rules as it is not a bank or financial institution. The portfolio company is in financial distress and the company is liquidating, whereby only the senior lender will receive any payment upon liquidation. How should this transaction be treated for tax purposes?

**Conclusion:** The debt is a capital asset and does not meet the definitional requirements of Code Sec. 165(g)(2)(c), as the debt fails the requirements that it must be issued by a corporation and be in registered form. Since the debt is not security, Code Sec. 166 will be the guiding provision for determining the tax treatment of the debt. The fact pattern states that the portfolio company is liquidating and that Fund's trade or business is a lending activity. Assuming the debt has a proximate relationship to the trade or business of the Fund, the debt will be considered a business

bad debt. Further, the liquidation of the portfolio company is an identifiable event that can establish the worthlessness of the business bad debt. The loss recognized by the Fund on the worthless business bad debt would be ordinary.

### Situation Six: Debt Settlement for Less than Face Amount

**Issue:** The Fund has an outstanding loan with the portfolio company, which is a partnership for federal income tax purposes. The Fund is not considered to be in the trade or business of lending nor is the loan considered a business loan. In addition, the loan is a capital asset, but is not a security. The portfolio company is in financial distress and negotiates a settlement with the Fund and pays a sum to the Fund that is an amount less than the Fund's basis in the debt. How should this transaction be treated for tax purposes?

**Conclusion:** The debt is a capital asset and does not meet the definitional requirement of Code Sec. 165(g)(2). The facts state that the Fund received partial payment by the portfolio company in an amount less than the Fund's basis in the debt. The authoritative guidance is unclear in this fact pattern whether Code Sec. 1271 or Code Sec. 166 will apply; however, the debate may be merely academic. If Code Sec. 1271(a)(1) is deemed to apply, the transaction will be considered a deemed sale or exchange and the resulting loss will be treated as a capital loss. Similarly, if Code Sec. 166 applies, a capital loss may be taken as a bad debt deduction. Conversely, the difference may be relevant in situations whereby the Fund is considered in the trade or business of lending. In the business bad debt situation, the loss would be considered ordinary. As mentioned earlier in the column, the authority with respect to this transaction is unclear and inconsistent, so further guidance would be helpful.

### Situation Seven: Debt Security Held by an SBIC Fund

**Issue:** The Fund, a licensed SBIC fund, has an outstanding loan with the portfolio company, which is a corporation for federal income tax purposes. The

loan is a capital asset and a security. Assume that the loan is sold to a third party for an amount less than the Fund's basis in the loan. How should this transaction be treated for tax purposes?

**Conclusion:** The Fund is a licensed Small Business Investment Company under the Small Business Investment Act, which makes it a financial institution for purposes of Code Sec. 582. The debt would appear not to be a capital asset for purposes of Code Sec. 582, and the loss on the sale of the debt would appear to be ordinary.

### Situation Eight: Fund Takes Back Equity Interest

**Issue:** The Fund is issued a new equity interest in the portfolio company in exchange for the debt. The Fund takes the position that its loans are considered non-business for purposes of Code Sec. 166. How should this transaction be treated for tax purposes?

**Conclusion:** The portfolio company will recognize COD income to the extent the value of the equity interest issued is less than the amount of the debt on the company's books. If the portfolio company is a partnership for tax purposes, the Fund will not be able to recognize a corresponding loss [at least according to proposed regulations under Code Sec. 108(e)(8)]. Rather, the Fund will have a basis in the partnership interest equal to its basis in the exchanged debt. If the portfolio company is a corporation, then the Fund will be entitled to a bad debt deduction, unless the debt is considered a security for Code Sec. 354 purposes.

## Conclusion

The rules concerning the timing and character of bad debt losses are confusing and complex. In addition, more definitive guidance is needed to help taxpayers navigate through these rules, especially in the context of a bad debt that is not a security and partial payment is received. As discussed in this column, some of the tax results are surprising after applying the rules and even may seem counterintuitive.

## ENDNOTES

<sup>1</sup> The authors are grateful to Nick Gruidl, Chris Immelman, Kristen Slusarczyk, Laura Holakovsky, and Adam Castic, all at RSM McGladrey, for their invaluable contributions in the preparation of this column.

<sup>2</sup> *Arkansas Best Corp.*, SCt, 88-1 USTC ¶9210, 485 US 212, 108 SCt 971.

<sup>3</sup> *Corn Products Refining Co.*, SCt, 55-2 USTC ¶9746, 350 US 46, 76 SCt 20.

<sup>4</sup> See Code Sec. 1221 for a complete list of statutory exclusions.

<sup>5</sup> Code Secs. 1221(a)(1) and (a)(4).

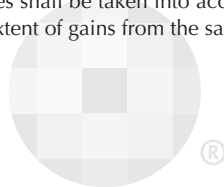
<sup>6</sup> Code Secs. 475(c)(1) and 582(a), and Reg. §1.475-5.

<sup>7</sup> See discussion on debt securities, *infra*. See also Reg. §1.165-5(b) and Code Sec. 166(e).

<sup>8</sup> See, however, *Fed. Nat'l Mortgage Ass'n*, 100 TC 541, Dec. 49,102 (1993), wherein mortgage notes were considered "notes receivables" within the meaning of Code Sec. 1221(a)(4).

## ENDNOTES

- <sup>9</sup> *Spring City Foundry Co.*, SCt, 4 USTC ¶1276, 292 US 182, 54 SCt 644 (1934).
- <sup>10</sup> Rev. Rul. 69-458, 1969-2 CB 33.
- <sup>11</sup> Code Sec. 166(e).
- <sup>12</sup> Code Sec. 165(a).
- <sup>13</sup> Code Sec. 165(g)(1).
- <sup>14</sup> Code Sec. 165(b).
- <sup>15</sup> Code Sec. 165(g)(3): This section states that any security (debt for purposes of this column) in a corporation affiliated with the taxpayer shall not be treated as a capital asset. The corporation must own directly the stock of the affiliated corporation and meet the ownership requirements set forth in Code Sec. 1504(a)(2). Additionally, more than ninety percent of the aggregate gross receipts for all taxable years must have been from sources other than royalties, rents, dividends, interest, annuities and gains from sales or exchanges of stocks and securities. In computing gross receipts for purposes of the preceding sentence, gross receipts are defined as total receipts without reduction for cost of goods sold. Also, gross receipts from sales or exchanges of stocks and securities shall be taken into account only to the extent of gains from the sales.
- <sup>16</sup> Regs. §1.871-14(c), (c)(1)(i)(A), (c)(1)(i)(B), and (c)(1)(i)(C).
- <sup>17</sup> Code Sec. 871(h)(1)—The general rule under Code Sec. 871(h)(1) states that in the case of any portfolio interest received by a non-resident individual from sources within the United States, no tax shall be imposed under paragraphs (1)(A) and (1)(C) of subsection (a). The term portfolio interest means any interest (including original issue discount) which would be subject to tax under Code Sec. 871(a) and which is described in subsections (h)(2)(A) and (h)(2)(B).
- <sup>18</sup> Reg. §1.165-5(f).
- <sup>19</sup> Reg. §1.165-5(i)(1), T.D. 9386, 73 FR 13124 (Mar. 12, 2008).
- <sup>20</sup> Code Sec. 166(e).
- <sup>21</sup> Reg. §1.166-1(c).
- <sup>22</sup> See Rev. Rul. 93-36, 1993-1 CB 187.
- <sup>23</sup> Code Sec. 166(b).
- <sup>24</sup> Code Sec. 166(d)(1)(B).
- <sup>25</sup> Code Sec. 166(d)(1)(A).
- <sup>26</sup> Reg. §1.166-5(b).
- <sup>27</sup> *E. Generes*, SCt, 72-1 USTC ¶9259, 405 US 93, 92 SCt 827.
- <sup>28</sup> Code Sec. 1271(a)(1).
- <sup>29</sup> Code Secs. 1271(b) and (c).
- <sup>30</sup> *D.S. McClain*, SCt, 41-1 USTC ¶9168, 311 US 527, 61 SCt 373.
- <sup>31</sup> Rev. Rul. 80-57, 1980-1 CB 157.
- <sup>32</sup> Rev. Rul. 2003-125, IRB 2003-52, 1243; 2003-2 CB 1243.
- <sup>33</sup> TAM 9253003 (Sept. 22, 1992).
- <sup>34</sup> Code Sec. 108(e)(6) will govern the contribution of debt to capital in the corporate context, while Code Sec. 108(e)(8) will govern the contribution of debt in exchange for capital in the partnership context. For a more detailed discussion of Code Sec. 108(e)(8) in the partnership context, see Blake D. Rubin, Andrea Macintosh Whiteway and Jon G. Finkelstein, Real Estate & Passthrough Planning, *Creditors Beware: Proposed Partnership Debt-For-Equity Regulations Deny Your Tax Loss*, J. PASSTHROUGH ENTITIES, Nov.–Dec. 2008, at 13.
- <sup>35</sup> This conclusion assumes the debt is not a security for Code Sec. 354 purposes and that the debt is considered nonbusiness. If the debt is a business bad debt and not a security, a partial bad debt ordinary deduction would presumably be taken before the debt is exchanged.



CCH

a Wolters Kluwer business