

Code Sec. 108(e)(8)(B) Adds Another Twist to Debt vs. Equity Considerations

By Joseph F. Schlueter¹

Joseph F. Schlueter addresses several aspects of Code Sec. 108(e)(8)(B), including an analysis of the law prior to its enactment, the strategic issues it presents, and structuring considerations.

Introduction

The major tax law enacted in 2004² included certain partnership provisions that received a great deal of attention both before and after enactment. Interestingly, one key provision that has received almost no attention either before or after the law's enactment is nevertheless extremely important to consider at several critical stages in entity and transaction planning. In fact, failure to address the potential implications of Code Sec. 108(e)(8)(B) properly could yield a very costly tax issue at a time when the entity owners can least afford it—upon exiting a failed venture. This article will address several aspects of Code Sec. 108(e)(8)(B), including an analysis of the law prior to its enactment, the strategic issues it presents, and structuring considerations.

For illustrative purposes, the following example will be referred to throughout this article.

Example. In 2001, Able, Baker and Charlie formed ABC LLC to acquire and operate a small but growing hot rod building business. Each partner contributed \$750,000 cash to form the LLC. Bank debt of \$8 million and the initial equity was used to fund the business acquisition and its initial working capital needs. By 2003, a variety of factors were creating a financial crisis for ABC. Its bank debt remained at \$8 million,

secured by company assets, while other general and unsecured creditors were owed \$4 million. To provide liquidity and appease its creditors, Baker loaned \$2 million to the LLC in 2003. In exchange for debt covenant waivers and as part of a plan negotiated with the trade creditors pursuant to a workout plan to address its production and marketing failures, Baker agreed to subordinate the \$2 million note to all existing creditors. By 2005, ABC was in liquidation mode and the secured creditor forced a sale of all assets of the business, which generated \$7 million cash to apply against the \$8 million bank debt.

Application of Prior Law

Following the sale of the business assets, the affairs of ABC are wound up, including cancellation of any outstanding indebtedness that remains unpaid (excluding member debt, which will be addressed separately). The LLC will have cancellation of debt (COD) income to recognize, which in this example will equal \$5 million.³ When tax returns are prepared, the COD income will be a separately stated item of ordinary income passed through to the LLC members, presuming there are no additional elements layered into the transaction.⁴ The determination of whether any of the \$5 million of COD income can be excluded from taxation under Code Sec. 108 will be made at the member level,⁵ which is an important corporation/partnership distinction to be considered. For

¹Joseph F. Schlueter is a Director in the Minneapolis office of Grant Thornton LLP.

example, even though the LLC is clearly insolvent, the Code Sec. 108(a)(1)(B) “insolvency exception” will only be applicable if the individual partner to whom the COD income has been allocated is likewise insolvent. Consistent with the aggregate theory and the pursuit of economic effect, there is an understandable symmetry in the resulting COD income recognition. In essence, the COD income represents a reversal of previously claimed losses for which the members are ultimately not economically responsible,⁶ so that this particular instance of COD income recognition does not present a distinctly unfair situation.

In the example, there remains the \$2 million of subordinated member debt to consider. The \$2 million debt will have been included as a part of Baker’s basis for his interest in the LLC, which has subsequently been reduced to zero through his allocated share of LLC losses. (Presumably, the \$2 million infusion satisfied trade creditor debt, and all the associated losses were allocated to Baker pursuant to the rules of Code Sec. 704(b).) Prior to the enactment of Code Sec. 108(e)(8)(B), few practitioners would have done anything further with the member debt. Whether or not it is formally documented, the debt might generally be viewed as having attained the characteristics of equity.⁷ As such, a formal COD recognition is not necessary. Several factors would support this deemed conversion to equity, including the significant subordination of the debt and failure to make any periodic interest payments. Although the note would have superior liquidation rights to the formal equity, the member debt in this example effectively functions as a form of preferred equity.

Under this “deemed” conversion to equity theory nothing further will occur regarding the member debt. When the dust settles, Baker will have claimed ordinary deductions for the actual unrecovered (and lost) dollars invested in the business, whether it took the visible form of either debt or equity. Similar to the passthrough of COD income to the partners, there is a certain symmetry and an economic clarity to this treatment of the member debt. It is also very consistent with a general aggregate theory of taxation in which dollars invested by the owners of the entity should have some element of fungibility in order that

entrance through either debt or equity should not be of significant importance.⁸

Prior to enactment of Code Sec. 108(e)(8)(B), there was a lack of formal guidance or authority regarding the proper treatment of the contribution of partner loans to the capital of the partnership.⁹ Despite this lack of authoritative guidance, several commentators discuss the widely-held view that a contribution of a note to capital (where the note was given for money, not services) should be treated as a contribution covered under Sec. 721, and should not generate COD income.¹⁰ Furthermore, although the IRS indicated an intent to issue regulations to clarify that COD income recognition would not be eliminated in certain nonrecognition transactions (including transactions involving Code Sec. 721¹¹), no action was ever taken.¹²

Application of the New Law

Code Sec. 108(e)(8)(B) now provides that a partnership transferring an interest to a creditor in satisfaction

of a debt is treated (like a corporation)¹³ as satisfying the debt with an amount of money equal to the FMV of the transferred interest. The provision applies to both recourse and nonrecourse debt and specifically provides that any COD income recognized by the partnership

must be allocated to the partners who held an interest immediately prior to the satisfaction of the debt. The recognition of COD income for the member debt restores the member’s tax basis in the debt, which will in turn need to be written off as a worthless debt.

Let’s take a look at how the rules will impact Baker. Following the asset sale by ABC LLC and payment of the proceeds to the bank, ABC has nothing left to satisfy its remaining debt. If Baker’s debt is “deemed” to have been converted to equity, Code Sec. 108(e)(8)(B) requires that the LLC recognize COD income to the extent the debt exceeds the value of the LLC interest received in return for the debt. Because the LLC has no value, under the deemed conversion theory, Code Sec. 108(e)(8)(B) will require COD income recognition for the full \$2 million note. Consequently, whether by a straight cancellation of the note or through the application of Code Sec. 108(e)(8)(B),

[F]or situations involving partner debt, and LLC members in particular, the landscape remains uncertain, with no reported case law that specifically addresses member debt in an LLC context.

\$2 million of COD income will be recognized by the LLC, all of which will be allocated to Baker. The allocation of COD income to Baker—ordinary in character—leaves Baker holding a worthless note with a \$2 million tax basis. Obviously, Baker will be able to claim a bad debt deduction, but will it be characterized as a business or a nonbusiness bad debt? Will it generate an ordinary loss or a capital loss? Herein lies a critical issue created by the enactment of Code Sec. 108(e)(8)(B).

Business vs. Nonbusiness Debt

This brings us to one of the key points of focus behind the origination of this article—an analysis of the applicability of the case of *G.A. Butler*¹⁴ and similar authority to an LLC.¹⁵ There is generally no shortage of authorities to consult to address issues related to business versus nonbusiness bad debt classification.¹⁶ However, for situations involving partner debt, and LLC members in particular, the landscape remains uncertain, with no reported case law that specifically addresses member debt in an LLC context.

A brief overview of the general rules applicable to individual taxpayers regarding bad debts is in order at this point. Code Sec. 166 and the rules promulgated thereunder create two classes of bad debt losses: business bad debts, which give rise to ordinary losses, and nonbusiness bad debts, which create short-term capital losses. If the loss is recognized as a business bad debt, the amount is deductible by the taxpayer in full as an ordinary loss. However, if recognized as a nonbusiness bad debt, the amount is treated as a capital loss and (for individual taxpayers) will therefore be subject to the limitations applicable to capital loss deductions. In addition to the capital loss limitations, there are also tax rate differentials to consider.

In the *Butler* case, the taxpayer had made loans to a limited partnership in which he was a limited partner. The taxpayer claimed a business bad debt in 1952 when loans to the partnership became worthless. Upon examination, the IRS disallowed the business bad debt deduction, and replaced it with a nonbusiness bad debt deduction. The Tax Court held in favor of the taxpayer, applying the principles

of the aggregate theory of taxation to attribute the partnership's business to its partners, including Butler as a limited partner, holding that the taxpayer/partner was engaged in the business of the partnership. The loans in question were found to be made for purposes proximately related to and in furtherance of the business of the partnership, and were therefore considered business bad debts.

The *Butler* case certainly appears to provide a nice, tidy solution to help take the potential bite out of Code Sec. 108(e)(8)(B). Unfortunately, there are a few caveats to this tidy conclusion that need to be dealt with in greater detail. The *Butler* case involved tax years 1951 and 1952, which preceded the enactment of the 1954 Code, and, more significantly, preceded the enactment of Code Sec. 707.¹⁷ Code Sec. 707(a) and Reg. §1.707-1(a) specifically state that a partner's loan to a partnership shall be treated as a transaction between the partnership and one who is not a partner, which would appear to present

To be considered business debt, the debt must be distinct from that of a shareholder attempting to increase his or her return on investments.

a rule that is inconsistent with the rationale underlying the analysis utilized in the *Butler* opinion. In the 1965 case of *A.L. Stanchfield*,¹⁸ the Tax Court appeared to reaffirm its holding in *Butler*, though it was in the context of a general part-

nership in which the taxpayer was required to satisfy a partnership debt pursuant to a personal guarantee. As we all know, there are important distinctions between general partners and limited partners, and LLC members fall somewhere in between.

The next significant case in this analysis is the 1963 case of *A.J. Whipple*.¹⁹ Although *Whipple* presents the issue in a corporate context, it addresses principles that are applicable in the partnership context. In this case, the Supreme Court ruled that whether a debt is incurred in a trade or business is to be determined by substantially the same test as whether a loss is incurred in a trade or business. Specifically, the character of the debt shall be determined by the relation that the loss resulting from the debt's becoming worthless bears to the trade or business of the taxpayer. More importantly, the court stated that investing is not a trade or business. To be considered business debt, the debt must be distinct from that of a shareholder attempting to increase his or her return on investments.

There are a variety of other authorities that address the issues raised in the *Butler* and *Whipple* cases in situations that do not directly involve partner loans, but might be utilized to assist in analyzing the proper application of the tax law.²⁰ However, an analysis of all the business versus nonbusiness situations could consume volumes, which is beyond the scope of this simple little article. Of these ancillary authorities, TAM 9728002²¹ contains some interesting analysis by the IRS. In this ruling, the IRS states its agreement with the *Whipple* opinion that the trade or business of a corporation is distinct from the trades or businesses of its stockholders, and also notes that that it does not believe a similar distinction can be made in the case of a partnership and its partners. However, the TAM goes on to qualify the scope of *Butler* and *Whipple* by stating that a limited partner is considered primarily a passive investor who contributes capital to acquire a right to share in the business profits. As such, the TAM states a limited partner's investment in a partnership is no different than holding corporate stock because both a limited partner and a shareholder are merely investing rather than actively participating in the trade or business. Like a shareholder, a limited partner does not take part in the management of the partnership's business and his or her relationship to the partnership is detached and impersonal; it strictly limits his or her liability, thereby avoiding the risks customarily attendant to trade or business activities. Finally, the TAM concludes that, as understood by Congress, a limited partner is not considered to be engaged in the trade or business of his or her partnership.

This brief analysis of available authorities indicates that the outcome of the business versus nonbusiness bad debt issue in the context of a creditor-member of an LLC is uncertain. The authorities indicate that there is most likely some type of continuum onto which the facts of any particular situation can probably be viewed to determine whether the situation is closer to one end or the other. An LLC member heavily involved in the business activity of the LLC is more likely to have a loan to the LLC treated as a business debt. At the other extreme, an LLC member that fits the classic role of a "silent" limited partner receiv-

ing a return solely with respect to invested capital is more likely to have a loan to the LLC characterized as a nonbusiness debt.

Ultimately, the real analysis boils down to one of risk assessment. How solid is the support provided by the available authorities for LLC member debt? Is it worth the potential risk, particularly in situations where a passive LLC investor is being asked to loan additional funds to a venture that is having financial difficulty?

Planning Considerations

Where does this leave a practitioner faced with advising clients on the subject of debt versus equity? It really boils down to a few key considerations and questions that need to be addressed. What are the specific facts regarding the LLC member's involvement in the business? How strongly do you

feel about the support provided by the existing tax rules and authorities to that situation? In this regard, it is always worthwhile to keep in mind that while the tax law formerly had some very bright lines that could be drawn in the distinction between a general partner and a

limited partner, such is not the case with LLC members. How much risk is the client willing to accept regarding the potential costs of nonbusiness bad debt treatment in the event the business fails? How much risk is the client willing to assume based on the different legal position of a debt holder versus a holder of preferred equity?

Given that most situations will fall somewhere in the middle of the continuum that might be developed from the existing authority, it is safe to say that most LLC member loans will present some risk of eventual treatment as a nonbusiness debt. To minimize or eliminate the risks associated with debt, careful consideration should be given to the use of preferred equity, thereby avoiding Code Sec. 108(e)(8)(B) entirely. Provide the preferred equity with a return equivalent to the interest on a debt, plus an additional profit share to support its equity classification. If the member loan is being made to help prop up a struggling (but hopeful) business, the extra profit element

Careful planning should allow a practitioner to craft a situation that achieves an equivalent economic return in a preferred equity structure without the risk of the potential nonbusiness bad debt whipsaw.

for the preferred equity can be utilized to provide the risk premium that might otherwise be appropriate on a loan in that situation.

Careful planning should allow a practitioner to craft a situation that achieves an equivalent economic return in a preferred equity structure without the risk of the potential nonbusiness bad debt whipsaw. What of the distinction between the position of a creditor versus that of a preferred equity owner? Generally speaking, the equity owner will have a lower liquidation position than general creditors. While this is true, and must be taken into consideration,

the practical reality is that in the event of a business failure the likelihood that a creditor-member has a higher prospect for recovery than a preferred equity member is—well—slim and none. Nevertheless, it is an aspect of the equation to be considered carefully and discussed with the client.

Whether the situation you are working with involves the formation of a new venture, one that is struggling financially, or is somewhere in between, it is advisable to consider the potential implications of Code Sec. 108(e)(8)(B) when counseling on the best form for an investment of additional capital.

ENDNOTES

¹ The author would like to thank Kari M. Kraus, associate in the Minneapolis office of Grant Thornton LLP, for her excellent assistance with the research, writing and editing of this article.

² American Jobs Creation Act of 2004 (P.L. 108-357).

³ \$4 million general creditor debt plus \$1 million remaining on bank debt.

⁴ Debt workouts involving financially troubled businesses will sometimes involve a deed in lieu of foreclosure transaction, constructed for the purpose of allowing the business to sell its assets in exchange for the debt, thereby generating (typically) Code Sec. 1231 gain, which generally results in long-term capital gain treatment. This article is constructed, based on the author's experience with small and middle market business situations, utilizing the assumption that there will be insufficient assets to satisfy the secured creditor, as is typically the case. Consequently, the situation does not present an opportunity to engage in a deed in lieu swap with the trade and general creditors.

⁵ See Code Sec. 108(d)(6).

⁶ The creditor is the party that suffers the economic loss of value.

⁷ For tax purposes, taxpayers are generally bound by the form chosen for the transaction. See, e.g., *J.D. Crouch*, CA-10, 82-2 USTC ¶9651, 692 F2d 97. But some room

may exist to take tax positions contrary to the formal structure where the issue involves the substantive nature of the interest held in a closely held business. See, e.g., *E.M. Selfe*, CA-11, 86-1 USTC ¶9115, 778 F2d 769.

⁸ Recognize that this is, obviously, very different from the treatment in a corporate setting where, for example, interest payments are deductible and dividends are not.

⁹ See, e.g., LTR 8117210, (Jan. 30, 1981) in which the IRS declined to rule on whether cancellation of indebtedness for a contribution to capital qualified for nonrecognition treatment under Code Sec. 721.

¹⁰ See, e.g., ARTHUR WILLIS, JOHN PENNELL AND PHILIP POSTLEWAITE, *PARTNERSHIP TAXATION*, at ¶4.02[3][e] (6th ed.); WILLIAM MCKEE, WILLIAM NELSON AND ROBERT WHITMIRE, *FEDERAL TAXATION OF PARTNERSHIPS & PARTNERS* at ¶4.02[3] (3d ed.); Carman and Scott, *Accounting Issues*, 4 J. *PARTNERSHIP TAX'N* 264 (1987).

¹¹ CO-90-90, 1991-1 C.B. 774, 777, Notice of Proposed Rulemaking: Income from Discharge of Indebtedness—Acquisition of Indebtedness by Person Related to the Debtor

¹² See, e.g., Notice 91-15, 1991-1 CB 319.

¹³ The corporate version of this rule is now contained in Code Sec. 108(e)(8)(A), but has been part of the Code since the original enactment of this rule in 1993. The rules were originally enacted and applied as a

corporate only provision until Code Sec. 108(e)(8) was amended in 2004 to extend the rule to partnerships.

¹⁴ *G.A. Butler*, 36 TC 1097, Dec. 25,038 (1961).

¹⁵ Specifically, the article originated from a discussion between the author and an attorney colleague regarding the impact of Code Sec. 108(e)(8)(B) on the choice of debt versus equity for additional member funds put into an LLC. He commented that he was not concerned with the potential whipsaw of (COD) ordinary income and (nonbusiness bad debt) capital loss based upon support from the *Butler* case.

¹⁶ An extensive analysis of this issue is beyond the scope of this article, which will remain closely focused only on the aspects pertinent to the specific subject matters at hand.

¹⁷ Also involving partnership situations prior to the 1954 Code are the cases of *A.G. Wade, II*, 22 TCM 190, Dec. 25,973(M), TC Memo. 1963-50 (involving an active managing partner) and *S.E.M. Brenhouse*, 37 TC 326, Dec. 25,141

¹⁸ *A.L. Stanchfield*, 24 TCM 1681, Dec. 27,635(M), TC Memo. 1965-305.

¹⁹ *A.J. Whipple*, SCt, 63-1 USTC ¶9466, 373 US 193, 83 SCt 1168.

²⁰ See, e.g., *W.F. Lemons*, 74 TCM 522, Dec. 52,237(M), TC Memo. 1997-404.

²¹ TAM 9728002 (Mar. 11, 1997).

This article is reprinted with the publisher's permission from the JOURNAL OF PASSTHROUGH ENTITIES, a bi-monthly journal published by CCH, a Wolters Kluwer business. Copying or distribution without the publisher's permission is prohibited. To subscribe to the JOURNAL OF PASSTHROUGH ENTITIES or other CCH Journals please call 800-449-8114 or visit www.CCHGroup.com.

All views expressed in the articles and columns are those of the author and not necessarily those of CCH or any other person. All Rights Reserved.