

Cancellation of Debt

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Background

In 2017, Joe Jones invested in a real estate joint venture partnership (the “**Partnership**”). Each year Joe received some healthy cash distributions from the Partnership. He also received an IRS Form K-1 annually from the Partnership stating his allocable share of the Partnership’s income, gains, losses, deductions, etc. Although the Partnership allocated to Joe his proportionate share of its income, the resulting tax liability was always less than the amount of cash distributions Joe received from the Partnership. But then in 2020, the Partnership had difficulty collecting rents, the cash distributions ceased and, of course, the annual Form K-1 still appeared. Recently, Joe received a notice from the Partnership that the Partnership is in default on its loan payments to its lenders and that investors in the Partnership may be subject to adverse tax consequences. Joe panicked and thought “What does this mean?”

A Partnership is a pass-through entity for federal income tax purposes

Partnership’s pass through to its owners all items of income, gains, losses, deductions, etc. regardless of its or its owners’ particular circumstances. For example, if someone buys a partnership interest immediately before an event occurs that causes income to be recognized, that investor may be allocated its proportionate share of that income even though it receives no cash with respect to this income.

What is discharge of indebtedness income or “CODI”? How does it work in a Partnership?

Under the U.S. Tax Code, when debt is cancelled or forgiven for less than full payment, the amount cancelled or forgiven is treated as income to the entity that owed the debt. For example, if a bank loans a partnership \$1 million and later agrees to accept \$600,000 in full payment of this indebtedness, then the partnership will recognize \$400,000 as CODI. But because the partnership is a pass-through entity, the CODI is allocated among its owners in accordance with the partnership’s operating agreement (or partnership agreement). This means that because of the CODI, an owner of a partnership interest may receive an unexpected allocation of income without a cash distribution related to it. **Note:** certain debt may be treated as non-recourse for tax purposes and then a settlement of that debt will not result in CODI, although it may still result in the realization of other taxable income.

Is there an exception to recognizing CODI in bankruptcy or due to insolvency?

There are a few important exceptions to the rule requiring the recognition of CODI, the most significant of which are the “bankruptcy exception” and the “insolvency exception.” The bankruptcy exception basically provides that if the taxpayer is bankrupt when the CODI occurs, then the income will not be recognized by the taxpayer (i.e., it will not be included in the taxpayer’s income). Similarly, the insolvency exception basically provides that if the taxpayer is insolvent when the CODI occurs, then the income will not be recognized by the taxpayer (i.e., it will not be included in

the taxpayer's income), but only to the extent of the taxpayer's insolvency. Insolvency generally means the amount that the taxpayer's liabilities exceed the fair market value of its assets.

How do the CODI rules apply to pass-through entities?

In the case of a pass-through entity like the Partnership, the two exceptions noted above are applied to the entity's owners (i.e., at the owners' level), and not at the entity level. If a pass-through entity recognizes CODI in connection with its bankruptcy, the bankruptcy exception doesn't apply to protect the owners when this income is passed through to them. In the example above, if a bank loans a partnership \$1 million on a recourse basis and later agrees to accept \$600,000 in full payment of this indebtedness, then the partnership will recognize \$400,000 as CODI, the \$400,000 CODI is then passed through to the partners of the partnership, and the exceptions to recognizing the CODI are applied at the partner level. Assuming the partners are neither bankrupt nor insolvent when the event causing the CODI occurred, these exceptions will not apply to them. In that case, the partners will have a tax liability without any cash distribution.

The importance of the Partnership's Operating (Partnership) Agreement.

Do not underestimate the importance of the Partnership's operating agreement. It defines how income, gains, losses, deductions, etc., are allocated among its owners. For example, the partnership's operating agreement may include special allocations of certain types of income to certain groups of partners and not to other partners.

What are imminent warning signs?

A CODI event or other settlement of debt for a discounted amount most frequently happens when an entity is in bankruptcy, though it can also happen at any time that indebtedness is restructured leading to a partial or complete discharge of such indebtedness. So if an entity has indebtedness, particularly a significant amount of indebtedness, that it cannot service or that is not reasonably proportionate with the value of the entity's assets, then a debt discharge scenario becomes a real possibility. Of course, another indication is that the entity files for bankruptcy protection or is involuntarily placed into a bankruptcy. If any of these facts exist/occur, an owner can try to avoid the potential for a tax problem by disposing of its interest in the Partnership before the occurrence of the CODI event or other tax realization event, but that likely will be impossible to achieve. There may be a couple of different planning possibilities available to the owner, but these are very fact dependent, so we would recommend the owner consult with its own tax advisor.

Is there any good news?

It depends how someone defines "good news." But the short answer is – not really. If an owner is allocated CODI or other phantom taxable income or gain by a partnership, this is treated as regular, ordinary income or gain, which will increase the owner's tax basis in its investment. When the owner ultimately disposes of its interest in the partnership, the increased tax basis will reduce the amount of gain or increase the loss recognized by the owner with respect to this investment. But if and to the extent there is a loss with respect to this investment, the loss will be a capital loss, only offsettable against capital gains (except for a de minimis amount). This is not a good tax result in light of the fact that the CODI is ordinary income that is taxed at ordinary income rates.