



WEALTH PRESERVATION AND TAX PLANNING ALERT

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July 2009

Current Issues Regarding New Election to Defer COD Income:

Should Election be Made by a Partnership/LLC that has
both Solvent and Insolvent Partners/Members?

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In last month's issue of our Wealth Preservation and Tax Planning Alert, we discussed new Tax Code ("Code") Section 108(i) enacted as part of the American Recovery and Reinvestment Act of 2009. Where applicable, this new provision allows a taxpayer to elect to defer, for a multi-year period, the recognition of COD income which it otherwise would recognize in 2009 or 2010.

In this issue, we discuss the dilemma facing a partnership or LLC which has both solvent and insolvent partners/members because this election to defer COD income may be beneficial to the solvent partners/members but not the insolvent partners/members.

This discussion relates to both State law partnerships and to LLCs classified as partnerships for tax purposes. Accordingly, any reference herein to the term "partnership" shall include both State law partnerships and LLCs taxed as partnerships. Likewise, any reference herein to the term "partner" shall include a partner in a State law partnership, as well as a member in an LLC taxed as a partnership.

General Overview of New Law

The primary benefit of this new provision is the time value of the lengthy deferral period. New Code Section 108(i) provides that an eligible taxpayer may elect to defer COD income with respect to the "reacquisition" of an "applicable debt instrument" during 2009 or 2010, in which case the COD income is included in income ratably over a 5-year period beginning in 2014.

The term "applicable debt instrument" means any debt instrument (i.e., bond, debenture, note, certificate or any other instrument constituting indebtedness) issued either by a C corporation, or any other entity or person in connection with the conduct of a trade or business. There are no further requirements for qualification of a debt instrument for this purpose.

The statutory definition of a debtor's "reacquisition" of a debt instrument is broad. It explicitly includes (i) an acquisition for cash, (ii) the exchange of the debt instrument for another debt instrument, (iii) the contribution of the debt instrument to capital or (iv) the complete forgiveness of the

indebtedness by the holder of the debt instrument.

The election to defer COD income under Code Section 108(i) is elective (not mandatory) and is irrevocable once made. This election is made on the tax return for the year in which the reacquisition of the debt instrument occurs, and it is made on a debt instrument-by-debt instrument basis, meaning that an election may be made with respect to one or more debt instruments but not with respect to other debt instruments.

In addition, with respect to a partnership, S corporation or other "pass through" entity, the election to defer COD income shall be made at the entity level (i.e., by the partnership, S corporation, etc.), and not at the partner or shareholder level. This feature of the new provision may raise material issues among the owners of the entity, as discussed below.

Code Section 108(i) provides for the acceleration of deferred COD income in certain circumstances. For example, in the event of the death of the taxpayer, the liquidation or sale of substantially all the assets of the taxpayer

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(including in a title 11 or similar case), the cessation of business by the taxpayer or similar circumstances, any COD income which is deferred as a result of this Code Section 108(i) election shall be accelerated and taken into account in the taxable year in which such “acceleration” event occurs (or in the case of a title 11 or similar case, the day before the petition is filed). With respect to partnerships, S corporations and other “pass-through” entities, these “acceleration” events also include the sale, exchange or redemption of an interest in the “pass-through” entity by the holder of such interest.

If a debtor elects to defer COD income under Code Section 108(i), the exceptions to the recognition of COD income for insolvency, bankruptcy, qualified farm indebtedness, and qualified real property indebtedness will not apply to any COD income for the tax year of the election or any subsequent tax year. Accordingly, the potential cost of the Code Section 108(i) election may be the loss of these exclusions from the recognition of COD income, in the ultimate reporting years, which otherwise may be available.

Dilemma Facing a Partnership with Both Solvent and Insolvent Partners – Should Election to Defer COD Income be Made?

As previously noted, the election to defer COD income under Code Section 108(i) with respect to a partnership is made at the partnership level and not at the partner level. This rule contrasts with the exceptions to the recognition of COD income (i.e., insolvency, bankruptcy, qualified farm indebtedness and qualified real property business debt exceptions), which apply at

the partner level. Significantly, any such election by the partnership to defer COD income will terminate the partners’ right to use these exceptions to the recognition of COD income which may otherwise be available to them. This disparity in a partnership context between the election to defer COD income at the entity level and the application of the COD income exceptions at the partner level may create a tension and a potential conflict of interest between those partners for whom the election to defer COD income would be beneficial and those partners for who the election to defer COD income would result in adverse income tax consequences (i.e., future recognition of COD income which would otherwise be excluded).

For example, with respect to a partnership which has only solvent partners who are not expected to avail themselves of the bankruptcy or any COD exceptions (and assuming there are no acceleration events contemplated), the decision by the partnership whether to make or not make the election to defer COD income may be simple – the election to defer COD income probably would be beneficial to all partners.

By contrast, with respect to a partnership which has only insolvent partners who expect to avail themselves of the insolvency exception (and/or any of the other COD exceptions), the decision by the partnership whether to make or not make the election to defer COD income may be equally harmonious – the election to defer COD income may not be beneficial to any of the partners.

Even in the context where all owners are insolvent, however,

a more detailed analysis is necessary. For instance, an insolvent partner may have net operating loss carryovers which it projects to apply against business income to be earned during the deferral period. In that case, the Code Section 108(i) election will provide for a time value benefit for some owners which otherwise would not exist. The owners in this scenario may differ on whether the entity should make the election, depending on their particular income tax attributes.

The potentially divergent interests of owners are perhaps most readily apparent where a partnership has both solvent and insolvent partners (or partners some of whom expect to avail themselves of the bankruptcy or qualified real property indebtedness exceptions, and some who do not expect to be eligible for any exceptions from COD income). In this scenario, the decision by the partnership whether to make or not make the election to defer COD income is not simple at all as some of the owners will want this election to be made whereas others will not.

Such “conflicting” and “competing” interests raise fiduciary duty concerns which the general partner/manager will need to address. The general partner of the partnership (or the manager of an LLC) will need to determine whether the election to defer COD income will result in adverse income tax consequences to the other partners. Otherwise, that general partner/manager may be inviting litigation claims by the other partners whose interests may be adversely affected by this tax election. This potential liability exposure places the general partner/manager in a very precarious position with

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respect to the other partners. Also, it is important that the governing agreement for the partnership (i.e., the partnership or operating agreement) clearly specify who will be allowed to make this tax election on behalf of the partnership, and whether the other partners will have the right to approve (or veto) any such tax election.

Summary

The election to defer income under Code Section 108(i) by a partnership raises fiduciary duty issues regarding whether or not to make this election, especially if the partnership includes both solvent and insolvent partners.

The ability to make (or not make) this tax election on behalf of the partnership should be clearly spelled out in the partnership or operating agreement. Even with applicable provisions in the owners' agreement, the general partner's or manager's personal income tax stake in the outcome of the election may raise issues as to good faith and fair dealing. Full disclosure, super-majority voting, and/or other potential courses of action may be necessary for the general partner or manager to fulfill its fiduciary duties with respect to the entity's decision on the election. Advance planning with legal counsel in this setting would be advisable. ■

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