**THE STATE BAR OF CALIFORNIA**
**LOS ANGELES COUNTY BAR ASSOCIATION**
**TAXATION SECTIONS**
**BUSINESS ENTITIES COMMITTEES**[1]

# PROPOSALS REGARDING IRC SECTION 108(e)(8) AS APPLIED TO PARTNERSHIPS

This proposal was principally prepared by Layton L. Pace, a past Chair of the Business Entities Committees of the Taxation Sections of the State Bar of California and Los Angeles County Bar Association. The author wishes to thank Gary Q, Michel at Ervin, Cohen & Jessup LLP in Beverly Hills, California and David O. Kahn at Latham & Watkins LLP in Los Angeles, California for their valuable contributions to this paper. [2]

Contact Person: Layton L. Pace, Esq.
Attorney at Law
Phone: (310) 546-8138
Fax: (310) 546-8139
E-mail: layton@pacetaxlaw.com

[1] The comments contained in this paper are the individual views of the author(s) who prepared them, and do not represent the position of the State Bar of California or of the Los Angeles County Bar Association.

[2] Although the participants on this project might have clients affected by the rules applicable to the subject matter of this paper and have advised clients on applicable law, no such participant has been engaged by a client to participate on this project.

## EXECUTIVE SUMMARY

On January 22, 2003, the Internal Revenue Service ("Service") and the US Department of the Treasury ("Treasury") issued proposed regulations regarding the issuance of partnership interests in connection with the exercise of non-compensatory partnership options (the "Noncompensatory Option Regs."). The Noncompensatory Option Regs. treat debt convertible into a capital or profits interest in a partnership as a partnership option for purposes of those rules.

On October 22, 2004, the President signed into law the American Jobs Creation Act of 2004[3] (the "2004 Jobs Act") that revised Section 108(e)(8) of the Internal Revenue Code of 1986, as amended (the "Code").[4] The Code now specifically addresses cancellation of indebtedness ("COD") income consequences if a partnership satisfies its indebtedness with the transfer of a capital and profits interest in the partnership.

On May 22, 2005, the Service and Treasury issued proposed regulations regarding the issuance of capital and profits interests in partnerships in connection with the performance of services (the "Compensatory Regs."). The Compensatory Regs. provide a "safe-harbor" for the valuation of profits and capital interests in partnerships. The Service and Treasury have not finalized the Noncompensatory Option Regs. or the Compensatory Regs. Both projects are on the current Priority Guidance Plan of the Service.

This paper advocates a statutory addition to Section 108 that would expand the principles of Section 108(e)(6) to capital contributions of partnership indebtedness by existing partners. The change would create COD income from a capital contribution of partnership indebtedness by an existing partner only if the outstanding amount of the debt exceeds the contributing partner's tax basis in the debt. This paper also highlights issues in the Noncompensatory Option Regs. and Compensatory Regs that should be coordinated for purposes of Section 108(e)(8) and recommends a "safe-harbor" for valuation of partnership interests. The proposals will enable taxpayers to comply with the Code with reasonable costs and efforts and facilitate the restructuring of risk capital.

---

[3] H.R. 4520, P.L. 108-357, §896(a) (2004).
[4] Hereafter, Section references are to the Code unless otherwise specified.

## DISCUSSION

## I. PURPOSE AND PROBLEM ADDRESSED BY THIS PROPOSAL

Taxpayers generally must include cancellation of indebtedness (COD) income in gross income and have that income taxed at ordinary income tax rates.[5] Therefore, any time a debt is satisfied for cash or property, the debtor must determine whether the satisfaction of debt has created COD income.

On October 22, 2004, the 2004 JOBS Act revised Section 108(e)(8). That Section now extends to the satisfaction of partnership debt with the transfer of a profits or capital interest in a partnership. Section 108(e)(8) now provides the following:

> For purposes of determining income of a debtor from discharge of indebtedness, if -- (A) a debtor corporation transfers stock, or (B) a debtor partnership transfers a capital or profits interest in such partnership, to a creditor in satisfaction of its recourse or nonrecourse indebtedness, such corporation or partnership shall be treated as having satisfied the indebtedness with an amount of money equal to the fair market value of the stock or interest. In the case of any partnership, any discharge of indebtedness income recognized under this paragraph shall be included in the distributive shares of taxpayers which were the partners in the partnership immediately before such discharge.

Accordingly, partnerships and their partners will now recognize COD income if the partnership transfers a profits or capital interest to a partnership creditor and the fair market value of that interest is less than the amount of the debt. The legislative history expressly states that no inference is to be drawn regarding the law before the 2004 JOBS Act changes.[6]

Much residential, commercial and industrial real property held in the United States is held by limited liability companies (LLCs), limited partnerships (LPs), limited liability partnerships (LLPs), limited liability

[5] Section 61(a)(12); Treas. Reg. § 1.61-12.

[6] S. Rep. No. 108-192, 108th Cong., 1st Sess. 179 (2003).

limited partnerships (LLLPs) and general partnerships (GPs), that are partnerships for Federal tax purposes under the "check the box" classification rules of the Section 7701 Regulations. A potential downturn in the market for real property may cause partnerships to restructure their debts. Therefore, current market conditions make changes and guidance on Section 108(e)(8) an impending need.

The proposed statutory change to expand the principles of Section 108(e)(6) to contributions of partnership debt by existing partners discussed below will provide tax certainty to taxpayers and enable them to comply with the Code and regulations with reasonable costs and efforts. That change also should avoid potentially inequitable tax treatment for partners, and promote new business formation and survival by allowing flexibility in the structuring and restructuring of partnership risk capital.

Additionally, both the proposed Noncompensatory Option Regs. and the Compensatory Option Regs. contain detailed rules related to the tax treatment of the issuance of profits and capital interests in partnerships. Those rules update old regulations and address issues left unaddressed since the 1954 enactment of the partnership tax provisions of Subchapter K of the Code. As described below, those regulations projects need coordination with Section 108(e)(8).

## II. ANALYSIS OF SECTIONS 108(e)(6) and 108(e)(8) AND RECOMMENDED CHANGES

### A. Background of Section 108(e)(6) and 108(e)(8).

Before the Bankruptcy Tax Act of 1980 (the "1980 BTA")[7], corporations, and presumably partnerships, could satisfy their debts with their own stock and capital and profits, respectively, under case law, such as *Fulton Gold Corp.*[8] and *Capento Securities Corp.*,[9] without realizing COD income. The 1980 BTA provided many rules and exceptions that govern the exclusion of COD income from gross income and codified those exceptions in Section 108. Those exceptions provide detailed rules that may apply differently for corporations, S corporations and partnerships.

[7] Bankruptcy Tax Act of 1980, P.L. 96-589 (1980).
[8] *Fulton Gold Corp. v. Commissioner*, 31 B.T.A. 519 (1934).
[9] *Capento Securities Corp. v. Commissioner*, 140 F.2d 382 (1st Cir. 1944).

Two rules enacted by the 1980 BTA that, by their terms, applied to corporations only were Sections 108(e)(6) and 108(e)(8). Congress subsequently amended both Sections, including in 1993 to their pre-2004 form.[10]

After amendment in 1993 and before 2004, (i) Section 108(e)(6) provided that a capital contribution of indebtedness to the debtor corporation without an issuance of stock of the debtor produced COD income only to the extent the outstanding debt amount exceeded the contributing shareholder's adjusted tax basis in the debt, and (ii) Section 108(e)(8) provided that a corporation recognized COD income to the extent that the fair market value of stock issued for debt was less than the amount of the debt.

Because Sections 108(e)(6) and 108(e)(8) by their terms only applied to corporations, many practitioners and commentators debated for years whether Section 108 provided the only exceptions to COD income for partnerships. The debate centered on how and to what extent judicial authorities, such as *Fulton Gold* and *Capento Securities*, should apply to exclude or avoid COD income.

Since its amendment in 1993, Section 108(e)(6) has read as follows:

> Except as provided in regulations, for purposes of determining income of the debtor from discharge of indebtedness, if a debtor corporation acquires its indebtedness from a shareholder as a contribution to capital -- (A) section 118 shall not apply, but (B) such corporation shall be treated as having satisfied the indebtedness with an amount of money equal to the shareholder's adjusted basis in the indebtedness.

The 2004 JOBS Act did not revise Section 108(e)(6). The Service and Treasury have not issued the regulations referenced in Section 108(e)(6).

In private letter rulings and similar advice, the Service has generally applied Section 108(e)(6), rather than Section 108(e)(8), if a

---

[10] For a detailed discussion of the prior histories of Sections 108(e)(6) and 108(e)(8), see Bittker & Lokken, Federal Taxation of Income, Estates, and Gifts, ¶¶ 7.3.3 and 7.5 (2d ed. WG&L).

corporation does not issue shares. This seems to be the case even though the issuance of shares may have been a "meaningless gesture" because it would not change the proportionate ownership of the corporation.[11]

The legislative history of Section 108(e)(6) indicates that its purpose was to overturn the case of *Putoma Corp.*[12], in which a cash basis shareholder-employee forgave a debt owed to him by the corporation. The court held that the corporation did not have COD income even though it had previously deducted the accrued liability.

Whether Congress omitted intentionally a companion provision to Section 108(e)(6) applicable to partnerships in the 1980 BTA is an unsolved mystery.[13] As explained in the footnoted article, the original House version of the 1980 BTA had the language of Section 108(e)(6) in Section 108(f)(1)(B). Section 108(f)(2) contained language that applied the corporate provisions of Section 108(f)(1)(B) to partnerships. The Senate version, though, moved provisions of Section 108(f) into Section 108(e). Specifically, the Senate version made Section 108(f)(1)(B) become Section 108(e)(6) and Section 108(f)(2) become Section 108(e)(7)(F). However, the Senate version of Section 108(e)(7)(F) omitted a reference to Section 108(e)(6). The author of the footnoted article could not determine from the legislative history whether the Senate version intentionally omitted the House provision. He found that the Senate Finance Committee had not addressed partner contributions of debt to partnerships and that the Joint Committee on Taxation ("JCT") had not given thought to the question.

Neither the statutory language of Section 108(e)(8) nor the 2004 JOBS Act committee reports for Section 108(e)(8) expressly limit the application of Section 108(e)(8) to creditors who are not already partners of the debtor partnership. The language of Section 108(e)(8) merely limits the consequences of COD income to the partners in place before the satisfaction of the partnership indebtedness.

The first publication of the specific proposal to expand Section 108(e)(8) to partnerships appears to be in a JCT Report entitled "Review of

---

[11] McKee, Nelson & Whitmire, Federal Taxation of Partnerships and Partners ¶ 4.02[3] (WG&L); *See* TAM 9822005 (May 29, 1998)(Service acknowledges an overlap of the provisions).

[12] *Putoma Corp. v. Commissioner*, 66 T.C. 652 (1976), *aff'd*, 601 F.2d 734 (5th Cir. 1979); S. Rep. No. 1035, 96th Cong., 2d Sess. 8, 19 fn. 22 (1980).

[13] "Partner Contributions of Indebtedness: Congressional Intent of Technical Oversight?", 28 Tax Notes 1319 (Sep. 16, 1985). H.R. 5043, 96th Cong. 2d Sess. § 2(a) (as passed by the House, Mar. 24, 1980).

Selected Entity Classification and Partnership Tax Issues," dated April 8, 1997. That report also does not limit "creditors" to non-partners of the debtor partnership.

Apparently, the first official pronouncement of an intention to treat the issuance of profits and capital interests in a partnership as potentially creating COD income was in the preamble to proposed regulations (CO-9090, 3/21/1991) related to COD income for acquisitions of debt by related persons under Section 108(e)(4). Notice 91-15, 1991-1 CB 319, withdrew the reference and stated that until further guidance is issued, the treatment of the transactions was to remain unchanged. Presumably, the regulation project would have addressed Section 108(e)(6)-type transactions involving partnerships where the creditors were sufficiently related to the partnership by direct or constructive ownership.

### B. Need for Expansion of Section 108(e)(6) to Partnerships.

The revisions to Section 108(e)(8) highlight the need to expand the principles of Section 108(e)(6) to contributions of partnership indebtedness by existing partners of the partnership. Presumably, this would be done legislatively with an amendment to the Code because of the broad language in Section 108(e)(8). The reasons for change are set forth below:

#### 1. *Income Mismatch Whipsaw.*

The practical consequence of COD income under Section 108(e)(8) is an income and loss character mismatch to a creditor-partner. The COD income recognized by the partnership under Section 108(e)(8) would flow through to the partners, including the creditor-partner, as ordinary income. A creditor-partner would most likely have a capital loss on the debt as described below, which would not offset the ordinary income.

It is not clear to this author whether Section 721 would apply to the contribution of debt to a partnership after the enactment of Section 108(e)(8). The language of Section 108(e)(8) provides that *for purposes of determining COD income*, the partnership is treated as paying cash for the debt. It is not clear whether that treatment means the partner received cash for the debt for purposes of Sections 166, 721 and 1271 and whether the partner is then treated as contributing cash to the partnership to the extent of the value of the partnership interest. If Section 721 applies, the creditor-partner could not claim a loss for the short-fall in the value of the

partnership interest. The creditor-partner would have to add the basis of the debt to the tax basis in its partnership interest to be recovered later. If the debt is not property for purposes of Section 721, or Section 108(e)(8) treats the partnership interest as cash paid and contributed to the partnership for other provisions of the Code, then the creditor-partner likely has a capital loss under Sections 166 or 1271, which the related-party loss disallowance rules of Section 267 may limit. The non-business bad debt rules would not allow an ordinary deduction unless the creditor made the loan in connection with its trade or business.

In the events described in the preceding paragraph, the economic loss of the creditor-partner would not offset the COD income created by Section 108(e)(8). The whipsaw would generate an income tax liability for the creditor-partner in a transaction that does not produce cash or that may not even change the proportionate ownership of the partnership. This situation is consistent with the "fresh start" upon which Section 108 is premised; the government should not impose tax liabilities upon a financially distressed taxpayer because of the restructuring of its financial affairs.[14]

The income and loss character mismatch is considerably more likely to occur in the context of a partnership than with corporations that have COD income caused by Section 108(e)(8). The mismatch problem is less severe for corporations because Section 108 applies differently to corporations.

First, the insolvency and bankruptcy provisions of Section 108(a) apply at the corporate level for an S or C corporation.[15] A corporation that issues its virtually worthless stock to satisfy one of its debts stands a good chance of excluding the resulting COD income from its gross income because of insolvency. Moreover, suspended and net operating losses are generally captured at the corporate level, so the corporation may have loss offsets. With a partnership, the bankruptcy and insolvency provisions of Section 108(a) apply at the partner level. Therefore, the connection between undervalued partnership interests and insolvent partners is more tenuous, and the ability to exclude COD income more unlikely under Section 108.

---

[14] The Senate Report states "To preserve the debtor's 'fresh start' after bankruptcy, the bill provides that no income is recognized by reason of debt discharge in bankruptcy so that a debtor coming out of bankruptcy (or an insolvent debtor outside of bankruptcy) is not burdened with an immediate tax liability." S. Rep. No. 1035, 96th Cong., 2d Sess. 14 (1980).

[15] Compare Section 108(d)(6) applying those rules at the partner level.

Second, Section 351 requires 80% control for its provisions to apply. Even if Section 351 would apply, the 1980 BTA enacted Section 351(d)(2) to exclude corporate debts that are not securities from being "property" under those rules. Therefore, Section 351 generally would not prevent a creditor-shareholder from claiming a bad debt deduction in connection with a Section 108(e)(8) transaction.

Expanding the principles of Section 108(e)(6) to cover contributions of partnership debts to partnerships by existing creditor-partners should rectify the income and loss character mismatch problem by removing the income, except to the extent the outstanding debt exceeds the tax basis of the debt. An increased tax basis in the creditor-partner's partnership interest may end up becoming the same capital loss that creditor-partner would have recognized on a worthless non-business bad debt, but a mismatch of ordinary income and capital loss would not occur.

An income and loss character mismatch should not occur with non-partner creditors. Those persons will not receive a distributive share of the COD income from the partnership. Furthermore, those creditors have a greater chance of being in the business of lending money to claim partial business bad debts that reduce ordinary income.

### 2. *Debt vs. Equity and Transfer Determinations.*

Determining what constitutes debt or equity of a partnership can be difficult because the determination depends upon all of the facts and circumstances. However, debt-vs.-equity determinations are even more difficult when partners are the purported lenders because of their dual status. For instance, if a partner makes advances to a partnership after the partnership has suffered losses are the new advances debt or equity? Were initial advances always equity? Can advances become a capital interest because of the lack of proper enforcement of creditor rights, the insolvency of the partnership, the need to subordinate the amounts to raise other capital or the expiration of the statute of limitations? If so, is it clear how often or how much of the debt is converted?

Similarly, determining whether a partnership has transferred a profits or capital interest to an existing partner also will prove difficult. Would a mere oral agreement among the partnership and creditor-partner to contribute a partnership debt be sufficient for a transfer of a

capital interest? It seems that it could. How about a mere book entry by the partnership's accountant showing an increase in the creditor-partner's capital account? The partners presumably would have already signed the operating or partnership agreement and generally would not receive certificates evidencing an additional contribution. The LLC or limited partnership also likely would have no written resolutions authorizing a book entry. As raised in the previous paragraph, do conversions of debt to equity even require a volitional or knowing act or hinge on a single identifiable event?

These thorny questions could potentially plague the practical administration of Section 108(e)(8). Expanding the principles of Section 108(e)(6) to contributions of partnership debt by existing creditor-partners would lessen the tax consequences arising from an incorrect determination and thereby lessen the potential for tax controversy. A partner would be treated ultimately as adding the advances to the tax basis of his or her partnership interest without regard to whether, when or how advances started as, or are converted to, equity.

A transfer of a partnership interest for a partnership debt held third-party creditors of the partnership will likely have a clearer, more arm's-length set of documents and facts. Therefore, those transactions should pose fewer problems in applying Section 108(e)(8).

### 3. *Expanding Section 108(e)(6) Does not Create Potential for Abuse.*

The principles of Section 108(e)(6) protect against different taxpayers whipsawing the Service. Section 108(e)(6) reverses the *Putoma* situation where one side receives a deduction and the other avoids income. It does so because Section 108(e)(6) causes COD income to the extent the amount owed on the debt exceeds the creditor's tax basis in the debt.

Furthermore, the Service is not without remedies in the courts to correct potentially abusive situations. For instance, in *Twenty Mile Joint Venture*[16], the courts found that COD income resulted when a partner purportedly contributed a portion of a partnership debt to the capital of the partnership as part of the same transaction in which the partner sold the balance of its partnership interest. The courts looked to the substance of the

[16] *Twenty Mile Joint Venture v. Commissioner*, 200 F.3d 1268 (10th Cir. 1999).

transactions and disregarded the purported capital contribution. The Service might tax the transaction as a gift, payment of compensation, adjustment to the sale price of other property or other similar transaction. The Service and Treasury have reserved the right to recharacterize an issuance of a profits or capital interest in a partnership in accordance with its substance.

If needed, a statutory change that expands the principles of Section 108(e)(8) to existing creditors of partnerships could include other restrictions to address potential abuses. For instance, the partner may need to own at least a 10% capital or profits interest or be a partner for a minimum specified period of time.

Section 108(e)(7) requires ordinary income recharacterization on the disposition of stock the basis of which reflect a previously claimed bad debt deduction. It may be appropriate to amend Section 108(e)(7) to apply to partnership interests to prevent abuse.

Additionally, the partners of the debtor partnership still may suffer from other tax consequences caused by the contribution of partnership debt. A shift of capital among partners generally is taxable; certainly for services rendered to the partnership. Also, a reduction in a partner's share of partnership liabilities will be treated as a deemed cash distribution under Section 752. Distributions in excess of a partner's tax basis in his or her partnership interest will cause gain recognition under Section 731. Similarly, a reduction or elimination of a nonrecourse debt will cause a reduction in minimum gain that may cause an allocation of income to the partners under a minimum gain chargeback provision under the Section 704(b) Regulations. Therefore, a contribution of a partnership debt to a partnership that causes the debt to merge itself out of existence may cause income recognition even without Section 108(e)(8).

#### 4. ***Revenue Effects and Other Support for Proposal.***

The revenue lost from expanding the principles of Section 108(e)(6) to partnerships, as proposed, appears to be *de minimis*. The Senate Report to the 2004 JOBS Act estimated the revenue collection from the changes to Section 108(e)(8) to be approximately $4 to $5 million per year.[17] The proposal to expand the principles of Section 108(e)(6) to partnerships would affect only a portion of that revenue. Moreover, as

[17] Sen. Rpt. 108-192, 108th Cong., 1st Sess. 229 (2003).

stated above, some of the revenue lost from partners having less COD income will be offset because of other tax consequences of the transaction.

Other reasons support expanding the principles of Section 108(e)(6) to partnerships. First, the tax treatment is similar to that which would result if the creditor-partner contributed cash to the partnership which the partnership then paid to the creditor-partner to satisfy the debt. Second, it is not clear whether the 1980 BTA omitted such a provision intentionally. Third, having a corporate provision, but not a comparable partnership provision, is a trap for the unwary, particularly if the difference is not justified by differences in tax policy.

An argument could be made for allowing the treatment under Section 108(e)(8) to be elective. That situation exists today for a corporation depending on whether the corporation transfers stock in satisfaction of its debt. Presumably, an election to trigger COD income would result in a deferral of tax receipts to the government. However, facilitating the restructuring of partnership debt and eliminating distinctions between the tax treatment of corporations and partnerships in the same economic situations are worthy tax policies.

### C. Aggregate vs. Entity Theory.

The Noncompensatory Option Regs. and Compensatory Regs. apply an entity theory to the issuance of partnership interests. Accordingly, under those rules, the partnership generally will not be treated as disposing of an undivided interest in each and every asset upon issuance of the partnership interest.[18]

Likewise, those regulations do not treat the issuance of a partnership interest as the disposition of property by the partnership with a $0 tax basis. Therefore, the partnership does not receive income because of the issuance of a partnership interest.

Section 108(e)(8) treats the partnership as paying cash to satisfy the debt contributed to the partnership for purposes of determining COD income. If that treatment does not extend to other tax consequences of the transaction, then this paper recommends the same treatment for the issuance of the partnership interests set forth in the two preceding paragraphs. No

[18] Preamble to Prop. Reg. 1.83-1(i) (May 24, 2005).

part of Section 108(e)(8) suggests that the partnership should be treated as receiving income or gain in excess of the COD income recognized under that Section.

### D. Convertible Partnership Debt.

If the partnership has issued a convertible partnership debt and the holder exercises the conversion feature, should Section 108(e)(8) apply? The Non-Compensatory Option Regs. generally treat the conversion of a convertible partnership debt as a non-taxable contribution to the partnership under Section 721. Moreover, in *Centennial Savings Bank*,[19] the US Supreme Court held that a bank did not recognize COD income when a depositor paid penalties because of the early withdrawal of certificates of deposit. The Court found the prepayment penalties not to be COD income because the depositors paid the penalties under the terms of the original contracts. In TAM 200606037 (2/10/2006), the Service took a contrary position and concluded that *Centennial Savings Bank* did not prevent the conversion of a convertible debt of a corporation into stock of the corporation from being COD income as determined by Section 108(e)(8). The Service relied upon the legislative history of Section 108(e)(8) to reach its conclusion. Presumably, the Service will extend the position of TAM 200606037 to convertible debts of partnerships. If so, the Service will need to revise the Noncompensatory Option Regs.

### E. Section 108(e)(8) Valuation.

Section 108(e)(8) requires COD income to be recognized only to the extent the fair market value of the capital or profits interest in the partnership transferred to the creditor is less than the amount of the outstanding debt satisfied. So how is that value to be determined?

The Service has recognized the difficulty in valuing profits interests in partnerships after the *Campbell* and *Sol Diamond* cases.[20] The response was the "safe-harbor" provisions of Revenue Ruling 93-27.

The Compensatory Regs. acknowledge the difficulties in valuing partnership interests. In particular, the Compensatory Regs. provide for a liquidation value "safe harbor" that enables the partnership and its

---

[19] *United States v. Centennial Savings Bank*, 499 U.S. 573 (1991).

[20] *Campbell v. Commissioner*, 943 F.2d 815 (8th Cir. 1991); *Diamond v .Commissioner*, 492 F.3d 286 (7th Cir. 1974).

partners to elect to treat the fair market value of a qualifying partnership interest as its liquidation value.[21] The liquidation value is the amount of cash that the partner would receive if, immediately after the transfer, the partnership sold all of its assets for cash equal to the fair market value of such assets and liquidated. The mechanisms and merits of the election and the Compensatory Regs. are beyond the scope of this paper. However, this paper recommends that such a "safe-harbor" be available for purposes of valuing a capital or profits interest under Section 108(e)(8).

Furthermore, other regulations issued under Subchapter K, of the Code, including Section 704 and 752, also require the valuation of all the assets of a partnership based on a hypothetical liquidation of a partnership. Accordingly, information regarding the liquidation value of the partnership's assets may be readily available for purposes of Section 108(e)(8). Using liquidation value for the fair market value of partnership interests also aligns the capital accounts of the partners for purposes of Section 704.

Determining the fair market value of a partnership's assets, which, if challenged by the Service often devolves into a battle of appraisers, is far from a science and is too often fodder for tax litigation. A partnership should not be compelled to spend the time and expense of valuing its partnership interests for purposes of Section 108(e)(8) just when its time and money are likely to be in the shortest supply. The uncertainty of tax liabilities generated by a debt restructuring and the cost and time delay in determining that liability may cause the partnership to fail. A convenient "safe-harbor" that assists a partnership in quickly realigning its risk capital structure may well assist in saving a financially distressed partnership.

In fact, a good argument for expanding the principles of Section 108(e)(6) to contributions of partnership debt to partnerships by existing creditor-partners is that it effectively provides a "safe-harbor" for valuing the profits and capital interests of the partnership at the tax basis of the debt. Determining the tax basis of a partnership debt does not require valuing the tangible and intangible assets owned by a partnership at various stages of development and exploitation. A creditor-partner already must know and maintain records for the tax basis of the debt, so that amount generally can be quickly and inexpensively determined. Accordingly, using the tax basis of debt for purposes of Section 108(e)(8) supports the goals of efficient administration of the tax laws.

---

[21] Prop. Reg. 1.83-3(l); Notice 2005-43, 2005-24 I.R.B. (Jun. 13, 2005).

As with the Compensatory Regs., other valuation methods still should be available to the partnership. For instance, valuing the partnership interest by reference to the fair market value of the debt would be consistent with capital account maintenance requirements that require capital accounts to increase by the fair market value of contributed property, and finds support in the law for determining the amount realized from the disposition of "hard to value" assets. Other valuation methods for Section 108(e)(8) also would be appropriate for valuing profits interests, which under the liquidation value method would value a profits interest at $0.

## III. CONCLUSION

A statutory provision should be enacted to expand the principles of Section 108(e)(6) to creditor-partners of partnerships. Expanding the principles of Section 108(e)(6) to cover contributions of partnership debt by existing partners effectively provides a "safe-harbor" for valuing profits and capital interests in the partnership at the tax basis of the debt in the hands of the contributing partner for purposes of Section 108(e)(8). The statutory change also removes the inequitable consequences of collecting income tax derived from a mismatch of ordinary income and capital loss at a time when a "fresh start" for the partnership is warranted and economic losses are actually suffered by a creditor-partner.

The convertible partnership debt provisions of the Noncompensatory Option Regs. may need to be changed in light of the expansion of Section 108(e)(8) to partnerships.

A valuation of a profits and capital interest in a partnership for purposes of Section 108(e)(8) should have an elective "safe-harbor" based on liquidation value. The "safe-harbor" should be coordinated with the valuation "safe-harbor" rules ultimately adopted for the Compensatory Regs. Consistent with the Noncompensatory Option Regs. and the Compensatory Regs., a partnership issuing a profits or capital interest should not be treated as receiving income to the extent of the fair market value of that interest or as selling an undivided interest in its assets.