October 31, 2006

VIA E-MAIL

Attn: Comments on the *Tax Technical Corrections Act of 2006*
U.S. Senate Committee on Finance
219 Dirksen Senate Office Building
Washington, DC 20515

Re: Proposed technical correction to section 108(e)(8) concerning partner contributions of debt to equity

We are writing to propose, as an addition to the pending technical corrections bill, a new technical correction to the provision of the American Jobs Creation Act of 2004 that extended the application of section 108(e)(8) of the Internal Revenue Code to partnerships. We have proposed this technical correction previously and have had discussions with the staff of the Joint Committee on Taxation with regard to the proposal. We would like to follow up on those discussions shortly.

As part of the American Jobs Creation Act of 2004, section 108(e)(8) was expanded to cover certain partnership contributions of debt in exchange for equity. As explained in more detail in the attached document we submitted to the Treasury Department last year, we are proposing that section 108(e)(8) be clarified to provide comparable scope to both partnerships and corporations. Currently, section 108(e)(8) does not apply to the contribution of debt to corporate equity when the company does not issue shares, such as when the shareholders make pro rata contributions of debt and the issuance of shares has no economic consequence. The proposed technical correction would make it clear that section 108(e)(8) similarly does not apply to pro rata debt contributions to partnerships, even though the partnership may make capital account adjustments pursuant to the section 704(b) safe harbor regulations. The proposal is described in more detail in the attached memorandum. We would also be open to discussing other alternatives to resolve this problem, such as the application of an exception for partnerships among members of a consolidated group.

We will follow up with the Joint Committee on Taxation staff to request a meeting to discuss this proposal. In the meantime, please call David Zimmerman (202-626-5876), Steven Schneider (202-626-6063) or me (202-626-5828) with any questions or comments.

Sincerely,

David B. Cubeta

October 31, 2006

Proposed Technical Correction to Section 108(e)(8) --
Recognition of Cancellation of Indebtedness Income
Realized on Satisfaction of Indebtedness
with a Partnership Interest

Background

In the American Jobs Creation Act of 2004 (the "2004 Jobs Act"), Congress extended the application of section 108(e)(8) to acquisitions of indebtedness by a partnership from a partner in exchange for a capital or profits interest in the partnership.[1] Prior to this amendment, section 108(e)(8) had by its terms only applied to corporations. As is discussed more fully below, because the safe harbor provisions of the section 704(b) regulations require that an adjustment be made to the partners' capital accounts when the partners contribute debt to the creditor partnership, the partnership may be deemed to have issued a capital interest for purposes of section 108(e)(8) even if the partnership does not formally issue a partnership interest in exchange for its indebtedness. As a result, the partnership will be unable to avoid the application of section 108(e)(8) in situations where the partners contribute their indebtedness to the partnership on a pro rata basis and no partnership interest was actually issued in exchange. In similar cases in the corporate context, a corporation has the ability to choose whether to be subject to section 108(e)(8) or section 108(e)(6) by the simple expedient of issuing, or refraining from issuing, stock. Because a corporation will generally recognize less cancellation of indebtedness income if section 108(e)(6) applies to the cancellation of the debt rather than section 108(e)(8), pro rata cancellations of shareholder debt, including acquisitions of debt from a sole shareholder, are usually structured as capital contributions.

Proposal

Amend section 108(e)(8) to clarify that this section will not apply to a pro rata contribution of indebtedness by partners to a partnership.

Specifically, we would recommend that the following sentence be added to section 108(e)(8):

> ***If a debtor partnership acquires its indebtedness from its partners proportionate to the manner in which the partners share future profits and there have been no changes to any partner's profit sharing as a result of such contribution, then this paragraph shall not apply.***

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[1] All section references are to the Internal Revenue Code of 1986, as amended.

Current Law

If a corporation acquires its indebtedness from its sole shareholder or from each of its shareholders on a pro rata basis, the corporation and its shareholders will be indifferent as to whether additional shares are issued in the transaction. In such circumstances if the form of the transaction is respected, section 108(e)(8) will apply if the corporation issues its stock in satisfaction of the indebtedness and section 108(e)(6) will apply if the shareholders contribute the indebtedness to the corporation as a contribution to capital. If section 108(e)(6) applies, the corporation is treated as if it satisfied the indebtedness for an amount of money equal to the shareholder's adjusted basis in the debt. If section 108(e)(8) applies, the corporation will be treated as if it satisfied the indebtedness for an amount of money equal to the fair market of the stock issued in the exchange. The corporation will generally either realize the same or a lesser amount of cancellation of indebtedness income under section 108(e)(6) because the shareholder's adjusted tax basis in the indebtedness typically will be equal to or greater than the fair market value of the debt.

Although the IRS does not appear to have a formal ruling policy with respect to pro rata cancellations of debt in the corporate arena in "overlap" cases where the issuance of stock by the corporation in exchange for the debt would be economically meaningless and either section 108(e)(6) or section 108(e)(8) could be construed to apply to the cancellation, the private letter rulings that have been issued to date appear to have followed the taxpayer's form in every case.[2] In effect, the IRS does not apply the authorities that might otherwise deem stock to be issued based on the "meaningless gesture" doctrine to section 108(e)(8) in situations where the taxpayer did not issue stock.[3] On the other hand, the IRS does not ignore the issuance of stock in situations where the taxpayer in form issued stock. This gives a corporation the flexibility to avoid having section 108(e)(8) apply to the cancellation.

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[2] *See, e.g.*, PLR 9018005 (Nov. 15, 1989) (applying section 108(e)(8) to contribution of debt to a wholly owned subsidiary in exchange for subsidiary stock); PLR 9024056 (Mar. 20, 1990) (contribution of debt to a wholly owned subsidiary respected as capital contribution subject to section 108(e)(6) in accordance with form); PLR 8606032 (Nov. 8, 1985) (same); PLR 9215043 (Jan. 14, 1992) (same); PLR 9623028 (March 7, 1996) (same); cf. TAM 9822005 (May 29, 1998) (noting that there was a potential issue as to whether section 108(e)(6) or section 108(e)(8) should be the controlling authority in situations where both could apply; ruling did not resolve the issue because either section would give equivalent results under the assumed facts of the ruling).

[3] In certain circumstances, such as for purposes of section 351, the IRS and the courts will deem an exchange requirement to have been met even though no shares were issued in circumstances where the issuance of the shares would have been a "meaningless gesture." *See, e.g.*, Rev. Rul. 64-155, 1964-1 C.B. 138 (contribution to 100% owned corporation); *Lessinger v. Commissioner*, 872 F2d 5 19 (2d Cir. 1989) (section 351 applies to transfer by 100% shareholder); and *Warsaw Photographic Associates v. Commissioner*, 84 T.C. 21 (1985) (pro rata transfer by multiple shareholders).

Reasons for Change

The proposed amendment affords partnerships the same ability to avoid the application of section 108(e)(8) as is allowed to corporations under the Internal Revenue Service's informal ruling policy, and it would limit this flexibility to fact patterns where it would be a matter of economic indifference to the partnership and the partners whether to issue additional partnership interests in exchange for the indebtedness. This would be the case if the debt contribution is in proportion to each partner's interest in profits and there is no change in the profit allocations of any partner as a result of the contribution. In such circumstances, while capital account credit must still be assigned to the contributing partner to satisfy the section 704(b) safe harbor,[4] the capital account credit will be in proportion to each partner's profit sharing ratio and merely represents the same amount that the partners otherwise would receive as profits if the capital account were not adjusted. Thus, when coupled with the absence of any change to the partners' future profit sharing ratios as a result of the contributions, the capital account adjustment would be a matter of economic indifference to the partners (as in the pro rata case for corporations), and there would be no tax policy reason to require income recognition as a result of the contribution. Absent clarification, it is unclear whether a partnership is afforded comparable flexibility because the requisite adjustment to the capital account may properly be regarded as the issuance of a capital interest and, if so treated, would cause section 108(e)(8) to apply even in the case of a pro rata contribution of indebtedness. This change is consistent with the clear intent of the 2004 Jobs Act's revision as a whole -- to treat corporations and partnerships in a like manner for purposes of section 108(e)(8). When Congress extended the application of section 108(e)(8) to partnerships it is reasonable to assume that Congress did not intend to disadvantage partnerships as compared to corporations. Nor, in the pro rata case, would there appear to be any tax policy justification for requiring a greater amount of cancellation of indebtedness income recognition, because there would be no meaningful change in the partners' economic sharing arrangement by reason of the contributions of debt. Consequently, in the pro rata case, the imposition of section 108(e)(8) on the partnership would create the potential for a tax "whipsaw" on the partners (ordinary income allocated to each partner with a corresponding capital loss incurred by each partner in its capacity as creditor) in a circumstance presenting no underlying economic change of any substance.

The following examples will help clarify this point.

Example 1. **Pro rata contribution in corporate context.** A and B are shareholders in Corporation. Each originally contributed $2,000 in exchange for 100 shares of stock and loaned $4,000 to Corporation. At a time when the fair market value of Corporation's assets is $12,000 and the liabilities are $8,000, A and B each contribute their debt to Corporation and do not receive any additional stock in return. Immediately before the contribution, the Corporation stock was worth $4,000 and immediately after the

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[4] Treas. Reg. § 1. 704-1(b)(2)(iv)(b).

contribution the stock was worth $12,000. The value of each shareholder's equity interest has increased from $2,000 to $6,000 as a result of the contribution. If Corporation had instead issued an additional 200 shares to each shareholder in exchange for the contribution of the indebtedness, the value of an individual share would be unchanged, but the value of each shareholder's total equity interest would have increased from $2,000 to $6,000. In this example, the act of issuing additional stock would have been a meaningless gesture because A and B each will share in the $8,000 net value increase in the same 50:50 ratio whether new stock is issued in a 50:50 ratio or whether their historical stock, also held in a 50:50 ratio, increases in value.

Example 2. **Pro rata contribution in LLC context -- not liquidating in accordance with capital accounts.** Same as Example 1 except that the entity is an LLC that liquidates and shares profit in accordance with relative outstanding units. Like Example 1, it would be a meaningless gesture to issue additional units because the "profit" to each member from the increased net value of LLC would be the same whether reflected in an increased value of the historical units or in additional units with a constant value.

Example 3. **Pro rata contribution in LLC context -- liquidating in accordance with capital accounts.** Same as Example 2 except that the LLC follows the section 704(b) safe harbors and liquidates in accordance with positive capital accounts. The LLC shares profits in accordance with the relative outstanding units, or 50% each to A and B. In this example, it would be a meaningless gesture for the LLC to issue additional units since they would be issued in the same ratio as the existing outstanding units and the issuance of the additional units would not affect the relative profit percentages. However, because the LLC follows the section 704(b) safe harbors, it must credit the member capital accounts in an amount equal to the net fair market value of their contributions. In this case, similar to Example 2, this credit increases the liquidation rights of the existing units by $4,000 each, which is in proportion to both the contributed debt and the members relative profit sharing percentages.

The results would be the same for an entity organized as a state law partnership rather than an LLC.

The progression shown by these examples demonstrates three identical economic fact patterns where the issuance of additional stock or LLC units would be a meaningless gesture. In all three cases, the contributions of debt and any corresponding section 704(b) capital account increases were "pro rata" to the manner in which the existing outstanding shares/units shared in the benefit of the increased net value of the entity resulting from the contribution. In other words, when the contribution of debt was pro rata to the owners' profit sharing percentages, the issuance or non-issuance of additional stock/units would be a meaningless gesture and would fit within the constraints of the proposed technical correction.

By providing a rule that defines pro rata based on the sharing of future profit, any existing partnership special allocations are already incorporated into the rule as part of the future profit sharing percentages. Similarly, the rules regarding partnership liabilities in section 752 would operate as they do under current law, and the manner in which the partners share liabilities for purposes of those rules would not impact the application of section 108(e)(8) because those sharing rules do not reflect the economic and tax policy analysis above.

The proposed technical correction is limited to excluding pro rata contributions of indebtedness by partners to partnerships from section 108(e)(8) treatment. We recognize that it may be logical to apply section 108(e)(6) in such circumstances. As section 108(e)(6) by its terms applies only to corporations, a further technical correction would be necessary to apply section 108(e)(6) in this context. We would be happy to provide you with additional input in this regard.