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BACKGROUND ON MASTER LIMITED PARTNERSHIPS

Prior to 1988, entities organized as corporations were subject to the entity level corporate income tax, while partnerships, including partnerships whose equity was publicly traded, were permitted to be taxed as partnerships. A partnership avoids the entity level tax and passes through all of its income to its constituent partners, who pay tax on their share of the net income of the partnership. In 1987, as part of the Revenue Act of 1987, Congress decided that publicly traded partnerships should be treated as corporations for federal income tax purposes.[1] Congress's intended purpose was to create tax parity between entities (corporations and publicly traded partnerships) that have very similar corporate law characteristics.

As part of the Revenue Act of 1987, Congress made certain narrow exceptions to the general rule that publicly traded partnerships should be subject to the corporate income tax.[2] One of those exceptions, known as the qualifying income exception, allowed partnerships to retain their flow-through character if more than 90% of their income was derived from passive sources[3]—for example, interest, dividends, real property rents and gains from the sale of real property.[4] Congress also allowed active income from activities in the energy sector to be treated as qualifying income.[5] Section 7704(d)(1)(E) provides that "income and gains derived from the exploration, development, mining or production, processing, refining, transportation (including pipelines transporting gas, oil, or products thereof), or the marketing of any mineral or natural resource (including fertilizer, geothermal energy, or timber)" constitute qualifying income.[6]

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1. Revenue Act of 1987, Pub. L. No. 100-203, § 10211(a), 101 Stat. 1330 (codified as amended at 26 U.S.C. § 7704); I.R.C. § 7704 (1986) (as amended).
2. *See* Revenue Act § 10211; § 7704.
3. § 7704(c).
4. § 7704(d)(1)(A–D).
5. *See* § 7704(d)(1)(E).
6. *Id.* Section 7704(d)(1)(E) was amended in 2008 to include income from the production of industrial source carbon dioxide and income from the transportation and storage of biofuels and ethanol.

The tax advantage provided by the Internal Revenue Code permitted businesses in the development and production of oil and gas (upstream businesses), businesses in the transportation and storage of hydrocarbons (midstream businesses), and businesses in the refining and cracking of oil and gas (downstream business) to use a publicly traded vehicle for the business without being subject to a corporate tax. Businesses that do not pay the U.S. corporate tax have a lower cost of capital than those subject to the corporate tax. This difference in tax treatment has led to businesses using the publicly traded partnership or master limited partnership (MLP)[7] structure to own and finance capital-intensive businesses, which heavily predominate the energy market. Since 1987, the energy industry has availed itself of the MLP structure. As of March 2017, there were 111 MLPs in the energy sector and the aggregate market capitalization of these MLPs was $471 billion.[8] Tax issues that arise in the partnership area can have a major impact on the energy sector by virtue of the prevalent use of MLPs as the preferred ownership structure for energy businesses.

INTRODUCTION

A publicly traded partnership is generally taxable as a corporation for federal income tax purposes unless 90% or more of its income is derived from qualifying sources.[9] If the qualifying income test is satisfied, the partnership does not pay a tax on its income, but instead the partners report the income on their individual tax returns.[10]

The investor in a publicly traded partnership has the advantage of the liquidity afforded by the capital markets, and the additional advantage that the income of the business is not subject to the corporate level tax.[11] In

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7. The terms "publicly traded partnerships" and "master limited partnerships" are used interchangeably in the MLP industry and in this article. The term "publicly traded partnership" is the term used in § 7704 to describe both a publicly traded partnership and a master limited partnership or MLP.

8. UBS GLOBAL ENERGY GROUP, *Weekly MLP Update*, March 31, 2017 (on file with the author).

9. § 7704(c)(2), (d); *see supra* text accompanying note 6.

10. *See* I.R.C. § 702.

11. If a corporation distributes all of its after-tax earnings to shareholders who are taxable at the maximum tax bracket, the maximum total tax burden on $100 of earnings is $50.47 under current law, assuming that the investor has held the shares for at least one year. If a partnership distributes all of its earnings to its partners, the total tax burden on $100 of earnings is $43.40. The maximum regular income tax rate for an individual on ordinary income and on corporate dividends is 39.6% and 20%, respectively, assuming that the shareholder has generally held the stock for more than 60 days. The additional 3.8% tax under the Affordable Care Act for the income of individuals who have more than $250,000 of taxable income on a joint return is added to the 39.6% and 20% rates. *See infra* App. A.

addition to the tax rate benefit, the investor also benefits from "tax shield." Non-cash deductions attributable to capital costs of the partnership flow out to the partners to offset the net income otherwise allocable to the investor attributable to partnership operations.[12] This has the effect of driving down the overall current tax on the distributions of a publicly traded partnership. The tax shield is made up of non-cash deductions such as depreciation, depletion, and the amortization of goodwill.[13] Therefore, while the 43.4% rate applies to the income of the partnership, in a capital-intensive partnership, usually only about 20% of the cash distributed is subject to the 43.4% rate. Moreover, the balance of the distribution is treated as a reduction in basis in the investor's partnership interest, which is subject to tax only when the investor sells his or her partnership interest.[14]

Part I of this article describes the situation in which an over-levered MLP finds itself when it must cease making cash distributions in order to pay its indebtedness. Part II outlines the complicated tax issues associated with an MLP renegotiating its indebtedness either in or outside of bankruptcy and discusses some tax planning considerations that an MLP should evaluate, including whether to change its tax status from a partnership to a corporation.

I. TAX DISCOMFORT WHEN AN MLP EXPERIENCES CREDIT PROBLEMS

This article focuses on the problems that arise for an MLP when it has over-leveraged its balance sheet and, in order to sustain itself as a going concern, must negotiate debt forgiveness either in or out of bankruptcy.

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12. If the investor is subject to the passive loss rules (and most non-management investors would be subject to these rules), the non-cash deductions of a partnership may offset the passive income of the same partnership, but may not offset passive income from other investments, including other MLPs. Section 469(k).

13. Those non-cash deductions are authorized by: I.R.C. §§ 167–168 (depreciation); § 611 (depletion); and § 197 (goodwill).

14. Assume that the $100 of earnings in note 11 was made up of $200 of revenue, $20 of cash deductions, and $80 of non-cash deductions (*e.g.*, depreciation). The corporation could distribute $145 of cash (free cash of $180 minus $35 corporate tax). If the corporation has sufficient earnings and profits from prior periods, the sum of the corporate and shareholder tax is $69.51. The net after-tax distribution is therefore $110.49 compared to $180 of available cash. Using the same numbers in the partnership context, the partnership is able to avoid the $35 corporate tax and make a distribution of $180, which is subject to a current tax of $43.40 for a net after-tax distribution of $136.60. Using these assumed facts, the partnership structure increases the after-tax return by roughly $25 on $100 of net income. *See infra* App. B. This example ignores the fact that the investor in the partnership would be required to reduce his tax basis in his partnership interest by $80–cash distribution of $180 less $100 of taxable income. This basis reduction will be included in the taxable income of the investor when the investor sells his partnership interest.

The publicly traded partnership mechanics work well when the partnership is generating cash flow available for distribution. Because of the tax shield, the investor receives a cash distribution that is only partially attributable to the partnership's taxable income. With a 20% tax shield, the investor receives $1.00 in cash but receives a Form K-1, which reports only $0.20 of taxable income with respect to the $1.00 cash distribution. In contrast with an investment in a high-grade corporate bond that might pay the same yield in the form of an interest payment, the corporate bond generates a $1.00 cash interest with respect to which the investor receives a Form 1099, which reports $1.00 of interest income.

An MLP in distress does not preserve the "tax shield" advantage. In fact, an MLP in distress may be said to generate a "reverse tax shield." When the partnership is required to use all of its available cash to service principal payments on its indebtedness, the partnership may not have any cash available for distribution. Because principal payments are not deductible against taxable income, the partnership's taxable income may exceed cash available for distribution. Unfortunately, unlike a regular C-corporation, a partnership is still required to report its taxable income to its investors, even if the partnership does not pay a cash distribution.[15]

This problem is exacerbated when the partnership has indebtedness that it cannot repay and must restructure the indebtedness through either a repurchase of the debt at a discount, a modification of existing indebtedness, an exchange of existing indebtedness for new indebtedness, or an exchange of old debt for new equity. In any number of these events, the partnership may recognize taxable income from the cancellation of its indebtedness, which income will be reported out to the partnership investors. There will not, however, be any cash to distribute to the partner-investors because the cash flow of the partnership must be used to pay down its indebtedness.

II. TAX ISSUES

This section describes the cancellation of indebtedness concept, the effect of cancellation of indebtedness income on an MLP, and various strategies to avoid or neutralize the cancellation of indebtedness income.

15. A standard risk factor in the prospectus of a publicly traded partnership warns the investors that they may have taxable income even if they do not receive a cash distribution from the partnership.

A. The Cancellation of Indebtedness Income (CODI)

This section summarizes the tax consequences of an MLP engaging in various transactions to renegotiate the terms of its outstanding indebtedness.

1. The Basics

Federal income tax law does not require a taxpayer to include borrowed proceeds in its taxable income upon the receipt of cash from a lender because the borrower has no "accession to wealth" due to the borrower's offsetting obligation to repay the indebtedness.[16] When the borrower repays the indebtedness, the payment of principal is not deductible by the borrower for tax purposes because the borrower is repaying cash proceeds that were never included in the borrower's income.

If the borrower is able to repay less than the full borrowed amount, the difference between the borrowed amount and the repaid amount is treated as income from the cancellation of indebtedness (CODI).[17] For example, if the borrower borrowed $100 but repaid the lender $60, then the borrower is said to have recognized $40 of CODI. CODI is recognized because the offsetting obligation to repay the lender has been extinguished either in full or in part. To the extent that there has been a reduction in the offsetting obligation when compared to the amount originally borrowed, the borrower has an accession to wealth that is includible in its taxable income at the time of the reduction in the offsetting obligation.[18] The income is recognized when the offsetting obligation to repay is modified to a lower amount regardless of when the debt is retired in full. If in year one the borrower borrows $100, and in year three the borrower and the lender agree to a reduced repayment to be made in year five, the CODI arises in year three when the agreement is made–not in year five when the reduced amount is repaid.

2. Repurchases

One method a borrower may recognize CODI is for the borrower to repurchase for cash its indebtedness for an amount that is less than its principal amount.[19]

16. *See* Comm'r v. Tufts, 461 U.S. 300 (1983); *see also* Comm'r v. Indianapolis Power & Light Co., 493 U.S. 203 (1990).
17. I.R.C. § 61(a)(12); United States v. Kirby Lumber Co., 284 U.S. 1 (1931).
18. *See* Friedman v. Comm'r, 216 F.3d 537, 548 (6th Cir. 2000).
19. Treas. Reg. § 1.61-12(c)(2)(ii).

3. Debt for Debt Exchanges.

If a debt instrument is publicly traded or if the debt instrument is exchanged for publicly traded debt, the amount of the CODI is the difference between the adjusted issue price (usually, the unpaid face amount) of the old debt and the issue price of the new debt.[20] The definition of *publicly traded* is very broad under the Treasury Regulations. An instrument is deemed to be publicly traded if a substantial amount of the debt instrument is traded on an established market.[21] The debt instrument is deemed to be traded on an established market if, at any time during the relevant valuation period, there is at least one indicative quote for the instrument from at least one broker, dealer, or pricing service.[22] The fair market value of the debt instrument is presumed to be the indicative quote unless there is more than one indicative quote.[23] In this case, the issuer is permitted to pick one indicative quote using a reasonable method to determine fair market value.[24] The relevant valuation period is the thirty-one day period ending fifteen days after the issue date.[25]

Further, if there is less than $100 million of the instrument outstanding at the time of determination, the instrument is not considered publicly traded.[26] If an instrument is not publicly traded, its issue price equals the face amount of the debt if the debt bears adequate stated interest—even if the instrument is issued for several items of property that are not publicly traded.[27]

If the debt instrument is publicly traded or is deemed to be publicly traded, the issuer may be the victim of a trap for the unwary. If, for example, the old debt instrument has a face amount of $100 and is exchanged for a new debt instrument with a face amount of $100, the issuer would think that it has no cancellation of indebtedness income. However, recall that the CODI amount is the difference between the face amount of the old debt and the issue price of the new debt.[28] Accordingly, if the new debt instrument is deemed to trade on an established market because it has one indicative quote of $60 under the publicly traded rules,

20. *Id.*; *see, e.g.*, I.R.C. § 108(e)(10)(B) (explaining how to determine the issue price of a debt instrument by reference to I.R.C. §§ 1273–1274).
21. Treas. Reg. § 1.1273-2(b)(1).
22. Treas. Reg. § 1.1273-2(f)(1)(iii); -2(f)(4).
23. Treas. Reg. § 1.1273-2(f)(5).
24. *Id.*
25. Treas. Reg. § 1.1273-2(f)(1). If the parties agree to restrict trading temporarily in order to avoid the publicly traded rule, the anti-abuse rule deems the instrument to be publicly traded. Treas. Reg. § 1.1273-2(f)(7).
26. Treas. Reg. § 1.1273-2(f)(6).
27. I.R.C. § 1274(c)(1); I.R.S. Priv. Ltr. Rul. 88-29-067 (Apr. 27, 1988); I.R.S. Tech. Adv. Mem. 2004-48-047 (August 30, 2004).
28. *See supra* note 20 and accompanying text.

the issuer has $40 of CODI as a result of the exchange. The debt instrument is also said to be issued with $40 of original issue discount,[29] which discount is a non-cash deduction to the issuer on a yield to maturity basis over the life of the new debt instrument using the constant yield method.[30]

This is a difficult rule to navigate because the issuer may not, and probably will not, know the issue price of the new debt instrument until it is issued. The CODI must be included as income in the year of the exchange, while the offsetting deductions for original issue discount will only be available to the issuer over the life of the indebtedness. This rule may be one of the most non-intuitive tax rules in the Code. There also exists a disconnect in the partnership context because the partners, at the time of the discharge of the debt, are allocated the CODI, but, because there may be public trading of the partnership equity interests, a separate group of partners may be allocated the original issue discount deductions over the life of the debt instrument.

4. Debt Modifications

If a partnership modifies its debt by changing the interest rate, by extending the term of the instrument, or by deferring the required payments under the instrument, the amendment to the debt instrument likely causes a deemed exchange of the existing note for a "new" note under the regulations.[31] An exchange can cause the issuer to recognize CODI equal to the excess of the adjusted issue price (usually, the principal amount) of the old debt over the issue price of the new debt.[32] The issue price of the "new" debt is equal to the fair market value of the "new" note or the old note if the "new" note or the old note are publicly traded.[33]

5. Debt for Equity Exchanges

If the partnership exchanges new equity for old debt, the CODI is equal to the adjusted issue price of the old debt less the fair market value of the new equity at the time of the exchange.[34] None of the CODI may be allocated to the holders of the old debt who receive new equity interests in the borrower.[35] The Treasury Regulations permit the parties to the exchange—the debtor partnership, the partners of the debtor partnership

29. *See* Treas. Reg. § 1.1273-1.
30. Treas. Reg. § 1.1272-1(b)(1).
31. *See* Treas. Reg. § 1.1001-3.
32. I.R.C. § 108(e)(10).
33. *See* Treas. Reg. § 1.1273-2(b); -2(c); *see* discussion *supra* Section II.A.3.
34. § 108(e)(8).
35. *See id.* at § 108(e)(8)(B).

and the creditor—to value the partnership interest received by the creditor using the liquidation value of the partnership interest.[36]

B. What Happens when an MLP Recognizes CODI

Once an MLP recognizes CODI, that income must be allocated to the MLP's partners. This section discusses the several considerations for how an MLP allocates that income and steps it can take to neutralize the impact of that allocation.

1. Who is Allocated the Income

When an MLP recognizes CODI, the income is generally allocated to the holders of the common units.[37] If the MLP has preferred units outstanding, those units generally are not allocated any of the CODI because they are usually treated as guaranteed payments for the use of capital.[38] As such, an allocation of CODI to the holders of the preferred units would cause the capital accounts of the preferred units to be greater than their liquidation preference. Therefore, such an allocation of CODI to the preferred units would not have substantial economic effect under § 704 because the holders of the preferred units would have a capital account greater than their economic rights upon liquidation of the partnership.[39] Likewise, a holder of a warrant to acquire a common unit is generally not allocated any CODI unless the warrant has an exercise price that is so low that the warrant is treated for tax purposes as an equity interest in the MLP.[40]

A reduction in the indebtedness of an MLP can cause the partners to have a reduction of the basis in their interests in the MLP under § 752. If the indebtedness is nonrecourse to the general partner of the MLP, the common unitholders would reduce the tax basis in their interest in the MLP by the unitholder's share of the reduced indebtedness.[41] The deemed distribution to a common unitholder would generally not result in any negative tax consequences because the common unitholder may not use any of the basis from nonrecourse debt to support deductions generated by the MLP and may not use any basis from the nonrecourse debt to support

36. Treas. Reg. § 1.108-8(b)(2). Liquidation value is equal to the amount that would be paid to the holder of the interest if all of the partnership's assets were sold for their fair market value and the partnership liquidated.

37. The common units of an MLP entitle the holders of such units to the increase in value of the MLP, current distributions of excess MLP cash flow, and all MLP losses to the extent of each holder's investment.

38. Treas. Reg. § 1.707-1(c).

39. *See* Treas. Reg. § 1.704-1(b)(2).

40. *See* Treas. Reg. § 1.761-3(a)(1); -3(d)(2)(B).

41. I.R.C. § 752(b).

return of capital treatment for cash distributions received from the MLP that, in each case, exceed the unitholder's equity basis. This is because most MLPs in the energy sector are subject to the at-risk rules. These rules do not permit the unitholder to claim deductions or claim return of capital treatment with respect to cash distributions received that are in excess of the sum of the unitholder's equity capital contributions and net taxable income allocated to the unitholder.[42]

2. Timing of the Income Allocation

Under the tax accounting systems of most MLPs, CODI is allocated to the common unitholders of record on the first day of the month in which the CODI event occurs. However, the partnership agreements of most MLPs permit the partnership to override this rule and to instead allocate the CODI to holders of common units of record on the date of the CODI event.[43]

In the case of the lender who exchanges its debt for an equity interest in the MLP and thus recognizes CODI, none of the CODI may be allocated to the units received by the lender in the exchange.[44]

3. Where's the Cash?

As noted above, no cash distributions will necessarily be associated with a CODI event.[45] It is probable that an MLP sustaining a CODI event will be in such a precarious financial position that it will be prohibited by its lenders from making any distribution to its unitholders.

4. Consequences to the Partnership and the Creditors

A creditor's contribution of the indebtedness of a partnership to that partnership in exchange for an equity interest in that partnership is a transaction in which no gain or loss is recognized for tax purposes.[46] As described above, the current equity owners of the partnership will

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42. *See* I.R.C. § 465(a)(1), (b), (e). If a distribution exceeds the sum of an investor's equity investment plus the aggregate net taxable income allocated to the investor or minus the aggregate net taxable losses allocated to the investor, the excess is treated as an "at-risk" recapture amount which causes the investor to recognize taxable income in the amount of the excess. The same excess amount is treated as a deduction that is deferred under the "at risk" rules to future years when the investor has a sufficient "at risk" amount to absorb the loss. Treas. Reg. § 7.465-2(b).

43. These allocation rules are set forth in Section 6.2 of most partnership agreements and limited liability agreements that govern the affairs of an MLP.

44. *See* I.R.C. § 108(e)(8).

45. *See supra* note 15 and accompanying text.

46. Treas. Reg. § 1.721-1(d).

recognize CODI to the extent of the excess of the adjusted issue price of the debt surrendered, over the fair market value of the equity interest issued to the creditor.[47]

For the equity owner whose interest in the partnership will be worthless following the debt restructuring, this leads to an inequitable result. The holders of the equity interests are allocated CODI from the debt restructuring and then have a capital loss for the remaining tax basis in their partnership interest (including additional tax basis from the recognition of the CODI).[48] The capital loss to the exiting partners with respect to the worthless partnership interests requires the partnership to decrease the tax basis of its assets by the aggregate amount of the loss.[49]

In the case in which the equity owner is retaining no interest or a very small interest in the partnership following the debt restructuring, the transaction should be structured as a sale of the assets by the old partnership to a new partnership controlled by the creditors who are surrendering their debt for equity.[50] This will allow the equity holders to be allocated CODI on the deemed sale of the old partnership's assets to the new partnership and to also be allocated a loss on the sale of the assets to the creditors. The old partnership will be deemed to have sold its assets in a liquidating sale in exchange for the assumption of indebtedness. The old partnership will recognize a § 1231 gain or loss for its depreciable assets held for more than one year and for its real property assets used in a trade or business and held more than one year.[51] Under § 1231, if there is an overall net gain, each gain and each loss is generally characterized as long-term capital gain and capital loss, and if there is an overall net loss,

47. *See* discussion *supra* Section II.A.5.

48. Rev. Rul. 93-80, 1993-2 C.B. 239 invokes sale or exchange treatment for a worthless partnership interest deemed surrendered in exchange for the release of partnership indebtedness. A capital loss may only offset all capital gains and up to $3,000 of ordinary income annually. I.R.C. § 1211(b).

49. Treas. Reg. § 1.734-1(b)(2). Any gain recognized by a partner on the termination of his or her interest in the partnership will allow the partnership to increase the basis in the partnership's assets. Treas. Reg. § 1.734-1(b)(1).

50. The new partnership will not be treated as a continuation of the old partnership unless the partners of the old partnership own more than 50% of the capital and profits of the new partnership. Treas. Reg. 1.708-1(c)(1).

51. Oil and gas assets are deemed to be I.R.C. § 1231 real property assets under IRS ruling policy. Rev. Rul. 68-226, 1968-1 C.B. 362.

each gain and each loss is characterized as an ordinary gain and an ordinary loss.[52]

If the assumed debt is recourse debt, the old partnership will also recognize CODI to the extent that the adjusted issue price of the assumed debt exceeds the fair market value of the assets and that CODI amount will be allocated to the partners of the old partnership.[53] Recourse debt is any debt that is not secured by the assets of the partnership where the lender can look to any assets of the partnership for repayment.[54] In the case where a partnership is not able to repay its recourse debt, the sale of assets will be treated partly as CODI to the extent the adjusted issue price of the debt exceeds the fair market value of the assets.[55] The sale will also be treated in part as gain or loss equal to the difference between the fair market value of the assets and the tax basis of those assets.[56]

In contrast to recourse debt, nonrecourse debt is debt that is secured by a particular asset (or subset of the assets) of the borrower and for which the lender may not seek repayment from any assets except the assets that secure the debt. Nonrecourse debt assumed by the buyer causes the partnership to recognize gain or loss as if the partnership sold the secured assets for an amount equal to the full principal amount of the indebtedness.[57]

The new partnership has a fair market value tax basis in the assets following the deemed purchase of the assets. The new partnership's tax basis in its assets is the same tax basis that the old partnership would have had if the creditors had contributed their debt to the old partnership and the interests of the incumbent partners had been terminated.[58] The partners who are exiting their investment in the old partnership have CODI (ordinary income) and an offsetting ordinary § 1231 loss.

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52. § 1231(a). The § 1231 gain or loss allocated to any particular partner will vary because each partner who purchased his or her interest in the public market will have a § 743 adjustment to account for the trading value in the interest on the date of the purchase. This adjustment will give each partner a special basis adjustment in the assets of the partnership, in addition to his or her share of the partnership's common tax basis, which will be taken into account in computing the share of the overall gain or loss allocated to the partner in the liquidating sale.

53. Treas. Reg. § 1.1001-2(a)(2); Comm'r v. Tufts, 461 U.S. 300, 317 (1983) (O'Connor, J., concurring).

54. *See* Raphan v. United States, 759 F.2d 879 (Fed. Cir. 1985); Great Plains Gasification Associates v. Comm'r, 92 T.C.M. (CCH) 534 (2006); CCA 201525010 (Mar. 6, 2015).

55. Treas. Reg. § 1.1001-2(a)(2); Treas. Reg. § 1.1001-2(c), Ex. 8; Treas. Reg. § 1.61-12(c)(2)(ii); Rev. Rul. 90-16, 1990-1 C.B. 12.

56. Treas. Reg. § 1.1001-2(a)(2); Treas. Reg. § 1.1001-2(c), Ex. 8; Rev. Rul. 90-16, 1990-1 C.B. 12.

57. *See Tufts*, 461 U.S. 300, 317.

58. *See supra* note 49.

5. Bad Debt Recapture

A creditor who receives a partnership interest in exchange for partnership indebtedness will have a tax basis in the partnership interest equal to the tax basis in the surrendered indebtedness.[59] To the extent that the creditor claimed a bad debt deduction with respect to the indebtedness, that same amount of reduced tax basis reflecting the bad debt deduction must be treated as ordinary income recapture when the partner (former creditor) sells that partnership interest.[60]

C. Qualified Real Property Business Indebtedness

Because an oil and gas property is generally treated as a real estate asset for tax purposes, an MLP may assume that a CODI exception applicable for secured real estate indebtedness may apply. Unfortunately, the text of that exception does not lend itself to easy application to an oil and gas asset.

1. Real Estate Exception

If a partnership modifies indebtedness it incurred to purchase or improve real property used in a trade or business that is secured by such indebtedness, each partner may elect to reduce the basis of the real property in lieu of including the CODI in his or her income.[61] The amount of the basis reduction is limited to the amount by which the principal amount of the indebtedness (prior to the modification) exceeds the fair market value of the real property.[62] The amount excluded is further limited, as the excluded amount may not exceed the adjusted tax basis of the depreciable real property.[63] Any CODI amount that exceeds the excess value or tax basis limitations must be included in the taxable income of the partnership and its partners.[64]

59. I.R.C. § 722.
60. I.R.C. § 108(e)(7)(E).
61. § 108(b), (c)(3), (c)(4).
62. § 108(c)(2)(A).
63. § 108(c)(2)(B).
64. *See* H.R. REP. NO. 103-111, at 623 (1993).

2. Is an Oil & Gas Interest Real Estate?

In general, an interest in oil and gas is treated as real property for federal income tax purposes.[65] There is, however, no indication in I.R.C. § 108(c) or its legislative history that Congress intended for indebtedness secured by oil and gas properties to benefit from this qualified real property CODI exception.

The statute contains the following provision:

> (B) OVERALL LIMITATION.—The amount excluded under subparagraph (D) of subsection (a)(1) shall not exceed the aggregate adjusted bases of depreciable real property (determined after any reductions under subsections (b) and (g)) held by the taxpayer immediately before the discharge (other than depreciable real property acquired in contemplation of such discharge).[66]

A central question is whether an oil and gas property is *depreciable real property*. In the ordinary use of the word, the term *depreciable* implies the deduction attributable to a tangible personal property asset or a real estate improvement.[67] The amortization deduction associated with an oil and gas asset is commonly referred to as *depletion*.[68]

The regulations continue this theme by stating that the basis limitation includes any basis reduction for "[d]epreciation claimed for the taxable year the taxpayer excluded [the CODI.]"[69] The Treasury Regulations define *depreciable property* as "property of a character subject to the allowance for depreciation or amortization[.]"[70] The common use of the word *amortization* is for the allowances associated with intangible property.

The depletion regulations distinguish between the terms depreciation and depletion. Depreciation is described as the allowance for physical property—casing, equipment, derricks and physical structures. Depletion includes the capital cost of the oil and gas property itself excluding the physical property.[71] This fairly clear dichotomy between what assets are depreciable and what assets are depletable presents an uphill battle in attempting to use basis reduction (instead of CODI inclusion) for

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65. I.R.C. § 897(c)(1)(A)(i) (oil and gas properties are United States real property interests for purposes of FIRPTA); Rev. Rul. 68-226, 1968-1 C.B. 362 (oil and gas interest are real property for purposes of §§ 1221, 1231 and 453 of the Code).
66. § 108(c)(2)(B).
67. I.R.C. §§ 167–168.
68. *See* I.R.C. § 611.
69. Treas. Reg. § 1.108-6(b)(1).
70. Treas. Reg. § 1.1017-1(e).
71. Treas. Reg. § 1.612-4(b)(1)–(2); Treas. Reg. § 1.612-4(c).

cancellation of debt secured by oil and gas real estate properties. Because of the Code's failure to include oil and gas properties in the application of § 108(c), the taxpayer would struggle to maintain that CODI related to the indebtedness secured by oil and gas properties should be able to be excluded as ordinary income under § 108(c) real estate exception.

D. The Bankruptcy and Insolvency Exception

Not all CODI must be included in the income of the taxpayer. If the indebtedness is discharged when the taxpayer is insolvent or is in a title 11 bankruptcy case, the CODI is not included in the income of the taxpayer.[72] The term *insolvent* is defined as the excess of the liabilities of the taxpayer over the fair market value of its assets.[73] The insolvency test is applied immediately prior to the discharge of the indebtedness. If the discharge of the indebtedness causes the taxpayer to become solvent, only the amount of indebtedness whose discharge is needed to cause the liabilities of the taxpayer to equal the fair market value of its assets is subject to the insolvency exception.[74]

1. Applied at the Partner Level for a Partnership

Unfortunately, for investors in an MLP, the insolvency and bankruptcy exceptions are applied at the partner level and not at the partnership level.[75] Therefore, the fact that the MLP is in financial distress does not affect whether the MLP recognizes CODI. Because insolvency and bankruptcy status is determined at the partner level, the partnership's CODI will be allocated to the partners without regard to the financial status of the partnership.

2. Applied at the Corporate Level for a Corporation

If the MLP were a corporation or became a corporation prior to the CODI event, the financial distress of the corporation would cause CODI to be avoided under the bankruptcy or insolvency exception.[76] The corporation would not allocate CODI to the partners in any event because, unlike a partnership, a shareholder of a corporation does not include any amount in his or her income until the corporation pays a dividend.

72. I.R.C. § 108(a)(1)(A)–(B).
73. § 108(d)(3).
74. § 108(a)(3).
75. § 108(d)(6).
76. *See* § 108(a)(1)(A)–(B).

However, even the corporation itself would not owe federal income tax on CODI under the insolvency and bankruptcy exceptions.

3. Attribute Reduction

There is no free lunch in the § 108 cafeteria. To the extent that CODI is not recognized, the corporate taxpayer must reduce its tax attributes. These attributes include net operating losses, net operating loss carryovers, certain tax credits, capital loss carryovers, tax basis in its assets and foreign tax credit carryovers.[77] The impact of this rule is that, if the taxpayer is able to recover from its credit distress, the taxpayer's future income will not be sheltered by the attributes that CODI burned through. As an example, if the unrecognized CODI amount reduces the corporation's net operating loss carryovers, then when the corporation returns to financial health, the future income may not be offset by those same net operating losses.

a. Net Operating Losses

The first attributes reduced are the net operating loss (NOL) for the taxable year of the CODI event and the NOL carryovers from prior years to the year of the CODI event.[78] These reductions are on the basis of one dollar of NOL and NOL carryover for every dollar of CODI.[79] The net operating losses first reduce current year income, ignoring the CODI.[80] If the NOL for the year of the discharge may be carried back to a prior taxable year, the carryback occurs before the NOL is reduced by the CODI.[81] Then, to the extent of the CODI, the remaining NOL for the current year is eliminated first and then the carryovers in the order of the taxable years from which the losses arose.[82]

b. General Business Credits

A taxpayer's general business credits including credits earned in the discharge year and credits from other years that are carried to the discharge year are eliminated next.[83] These credits are reduced on the basis of one dollar of credit for every three dollars of CODI.[84] This ratio takes into

77. § 108(b)(2).
78. § 108(b)(2)(A).
79. § 108(b)(3)(A).
80. § 108(b)(4)(B).
81. Treas. Reg. § 1.108-7(e), Ex. 2.
82. § 108(b)(4)(B).
83. § 108(b)(2)(B); *see also* I.R.C. § 38 (relating to the general business tax credit).
84. *See* § 108(b)(3)(B).

account the fact that, at the 35% to 39.6% corporate and individual tax rates, income is taxed at approximately one-third on the dollar.[85]

c. Capital Loss Carryovers

Much like the NOL, the capital loss carryovers are next reduced on a dollar for dollar basis.[86]

d. Tax Basis Reduction

The tax basis attribute is subject to timing rules, ordering rules and limitations.

i. Timing and Ordering

The next attribute reduction is to the tax basis of the borrower's assets. The basis reduction occurs on the first day of the taxable year following the year of the CODI event.[87] Accordingly, current year depreciation and depletion is unaffected by the required basis reduction. Further, assets sold in the year of the CODI event will not be subject to reduced basis in computing gain or loss on sale. The basis reduction is applied to properties in the following order: (1) real property used in a business or held for investment that secured the discharged indebtedness; (2) personal property used in a business or held for investment that secured the discharged indebtedness but not including inventory, accounts receivable, or notes receivable; (3) other real and personal property used in the business or held for investment but not including inventory, accounts receivable, or notes receivable; (4) inventory, accounts receivable, notes receivable, and real property held as inventory; and (5) property not used in a trade or business or held for investment.[88]

ii. Limitation for Basis Reduction

The basis reduction has a limit. The amount of the basis reduction may not cause the taxpayer's assets to have a tax basis that is less than the amount of the taxpayer's remaining indebtedness.[89] If the taxpayer has reduced its NOLs and other attributes for the CODI, this limitation is something of an exception to the "no free lunch" policy of §108. The

85. S. REP. NO. 96-1035 at 12 n.12 (1980).
86. § 108(b)(2)(D), (b)(3)(A).
87. I.R.C. § 1017(a).
88. Treas. Reg. § 1.1017-1(a).
89. § 1017(b)(2).

policy behind this limitation is that, if the taxpayer sells all of its property for an amount equal to the principal amount of its remaining indebtedness, there should be no gain or loss from the sale.[90]

iii. Impact of Basis Reduction

The advantage of basis reduction is that the taxpayer may be able to time its asset sales to defer the extra gain or reduced loss arising from an asset sale. The amortization, depreciation, and depletion deductions are also reduced over the recovery period since they are based on the amount of the taxpayer's tax basis.

If the taxpayer would prefer to preserve its NOL and NOL carryovers, the taxpayer is permitted to first reduce the tax basis of depreciable property.[91] Obviously, this election preserves the NOLs that may be used to offset earnings at an earlier time. The basis reduction for depreciable property is triggered on a taxable sale and is also reflected in reduced depreciation deductions. If the taxpayer makes the election, a taxpayer's interest in a partnership interest is treated as a depreciable property to the extent of the underlying partnership's basis in depreciable property. The partnership must reduce its basis in the depreciable property with respect to the taxpayer's interest.[92]

e. Foreign Tax Credits

Foreign tax credits are the next and final attribute to be reduced. As with the general business credits, the reduction is one dollar of foreign tax credit for every three dollars of CODI.[93]

E. Election by MLP to Become a Corporation for Tax Purposes

The CODI rules as applied to a corporation are demonstrably more favorable than those applied to a partnership. In a partnership, the CODI is simply allocated to the investor without any corresponding cash being

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90. S. REP. NO. 96-1035 at 13 (1980).

91. § 108(b)(5). If the taxpayer elects to reduce the tax basis attribute first, the limitation of basis reduction to the principal amount of the remaining indebtedness does not apply. § 1017(b)(2).

92. § 1017(b)(3)(C). The regulations set forth rules for obtaining the consent of the underlying partnership. Treas. Reg. § 1.1017-1(g)(2)(ii)–(iii). The regulations use the principles of a I.R.C. § 743 adjustment to account for the basis reduction in the assets. Treas. Reg. § 1.1017-1(g)(2(iv)–(v).

93. § 108(b)(2)(G). This discussion omits the required reduction of passive activity losses and credits under § 108(b)(2)(F) because a widely-held corporation would not be subject to the passive activity rules. I.R.C. § 469(a)(2).

distributed. Further, in keeping with partnership flow-through principles, the partnership business has increased in value or reduced its insolvency by the amount of the discharged indebtedness, but the partners must report this accession to wealth as taxable income.

In contrast, a corporation that is in bankruptcy or is insolvent may "kick the can down the road" by deferring its CODI into net operating loss or tax basis reduction.[94] The full cost of giving up those attributes may not be felt until years after the CODI event. This raises the question of why a partnership would not elect to become a corporation prior to a CODI event.

1. Check the Box Election

Since the effective date of the check the box regulations in 1997, the form of tax organization of an eligible entity[95] may be elected either at the time of formation or any time during the life of the eligible entity by making an election and filing that election on IRS Form 8832 with the Internal Revenue Service.[96] If the election is made prospectively, the management of the eligible entity may make the election without the approval of any partner.[97]

The most important question is why companies do not elect to incorporate, considering all of the advantages associated with being a corporation at the time of the CODI event.

94. § 108(a)–(b).
95. Generally, all entities are eligible entities except those organized as state law or foreign law corporations. Treas. Reg. § 301.7701-3(a).
96. Treas. Reg. § 301.7701-3(c).
97. Treas. Reg. § 301.7701-3(c)(2). There are corporate governance issues that would require an MLP to obtain unitholder approval to authorize the check the box election. Typically, the governance documents for MLPs would require affirmative amendments in order to provide management with the authority to make the tax election. Further, many (but not all) bank credit agreements require the borrower-MLP to obtain the approval of the lenders before it changes its tax character from a partnership to a corporation. The banks have an important stake in the tax character of its borrower since the borrower-MLP's CODI is allocated out to, and reported by, its partners, while a corporate borrower either must report the CODI (if it is not insolvent or bankrupt) or must reduce tax attributes (if it is insolvent or bankrupt). An entity treated as a corporation for tax purposes has an additional creditor—the IRS—that the banks may just as soon not have making an additional claim for taxes on the corporation's cash flow.

2. Tax Consequences of the Election

When a partnership elects to become a corporation for federal income tax purposes,[98] the partnership is deemed to contribute all of its assets to a newly formed corporation, the corporation is deemed to assume the indebtedness of the partnership and the new corporation is deemed to issue its stock to the partnership.[99] The partnership is then deemed to liquidate by distributing the stock to the partners.[100]

Incorporation is largely tax-free to the partnership and its partners. The partnership does not generally recognize gain or loss on the contribution of its assets to the corporation in exchange for stock of the new corporation as long as the partnership has control of the new corporation.[101] This will be the case even though the deemed liquidation of the partnership and distribution of the stock to the partners of the partnership would appear to break the "control test". The "control test" requires the continued ownership of 80% of the stock of the corporation by the contributor (the partnership) following the transfer of the partnership's assets in exchange for stock of the new corporation in order for the transfer to be tax-free.[102]

The partnership would recognize gain to the extent that the liabilities assumed by the new corporation exceed the tax basis of the contributed assets.[103] This may be the case if the partnership has fully or substantially depreciated or depleted assets. If a gain is recognized under I.R.C. § 357(c), then the partnership recognizes the gain on its final tax return and reports the gain out to its partners. If the incorporation is tax-free, the new corporation generally will take an initial tax basis in the contributed properties equal to the partnership's tax basis plus any gain recognized in

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98. The partnership can continue its state law organizational structure as a limited partnership or as a limited liability company. As long as the entity is not organized as a state law corporation, federal income tax law is not concerned with the type of organization. An entity can be a partnership for state law and governance purposes and can be a corporation for federal income tax purposes. On the other hand, a state law corporation is not an eligible entity and therefore may not elect to be taxed as a partnership. *See* Treas. Reg. § 301.7701-3(a).

99. Treas. Reg. § 301.7701-3(g)(1)(i).

100. *Id.*

101. I.R.C. § 351(a). The term "control" is defined to be at least 80% of the total combined voting power of all classes of stock entitled to vote and at least 80% of the total number of shares of all other classes of stock. I.R.C. § 368(c).

102. Rev. Rul. 84-111, 1984-2 C.B. 88 (implicitly holding that there is no issue with the control requirement if the stock is distributed by the partnership to the partners in proportion to their ownership in the partnership). There is no basis in the Code for this reading of the control requirement.

103. I.R.C. § 357(c).

the transfer under § 357(c).[104] But, if the assets have a built-in loss, then the basis of the assets steps down to their fair market value.[105]

There is some risk that I.R.C. § 351 does not apply unless the indebtedness is less than the fair market value of the assets. However, case law supports the application of § 351 even in situations where the corporation is initially insolvent.[106] The IRS has proposed regulations that, once effective, would prohibit § 351's application if the partnership did not contribute, or was deemed not to contribute, assets with a net value to the corporation.[107] This is known as the net value rule. If the net value rule applies, the asset transfer is fully taxable to the partnership, and the gain or loss is allocated to the partners of the partnership.

A major exception to the general rule of non-recognition of gain or loss is triggered when the partnership is in a bankruptcy proceeding and transfers the stock that it receives to its creditors instead of transferring the stock to its partners. In that case, the asset transfer is fully taxable to the partnership to the extent that the assets transferred are attributable to stock that is transferred by the partnership to its creditors in satisfaction of their claims, and the gain or loss is allocated to the partners of the partnership.[108] To the extent that the stock is transferred to partnership creditors, the corporation takes a fair market value tax basis in an equivalent amount of the partnership's assets.

3. Gain or Loss from the Transfer of Partnership Assets

Because the tax-free provisions of § 351 do not apply if the stock is transferred to partnership creditors, the partnership is deemed to have sold its assets in a liquidating sale in exchange for the assumption of indebtedness.[109]

Even if § 351(e)(2) did not apply to an incorporation of the partnership because the partners were retaining the equity of the new corporation, the

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104. I.R.C. § 362(a).

105. § 362(e). Alternatively, the corporation and the shareholders could elect to step-down the basis of the stock of the corporation to fair market value. § 362(e)(2)(C).

106. Norman Scott, Inc. v Comm'r, 48 T.C. 598 (1967) (Type A reorganization principles apply even though the target shareholders' stock had no net value). Rev. Rul. 70-240, 1970-1 C.B. 81. The IRS position is that tax-free reorganizations only exist if there is a net value surrendered by the target shareholders. Rev. Rul. 59-296, 1959-2 C.B. 87.

107. Prop. Treas. Reg. § 1.351-1(a)(1)(iii). If ultimately adopted as final regulations, these regulations will be effective for transactions occurring after the date such final regulations are published in the Federal Register. Prop. Treas. Reg. § 1.351-1(a)(1)(iv).

108. I.R.C. § 351(e)(2).

109. *See* discussion *supra* Section II.B.4.

partnership may have a challenge in treating the indebtedness that exceeds the value of the contributed property to be considered as having been assumed by the new corporation.[110] The IRS may seek to assert that indebtedness cannot be deemed to be assumed if the indebtedness exceeds the value of the assets transferred to the corporation in connection with the assumption. The indebtedness in excess of the value of the related assets may be deemed to be discharged immediately prior to the transfer since there could be no economic justification for the corporation to assume indebtedness that it had no prospect of repaying.

4. Deemed Debt Exchange and OID—Election to Allocate the Tax Items to the Corporation

As discussed above, the deemed or actual exchange of existing indebtedness for new indebtedness may give rise to CODI even if the principal amount of the old and new indebtedness are the same.[111] The new indebtedness is then issued with original issue discount (OID)—the excess of the principal amount of the new indebtedness over its issue price.[112] The issuer is then entitled to OID deductions over the life of the new indebtedness that are equal in amount to the CODI. The holder of the new indebtedness is likewise required to include the OID amount in income over the life of the new indebtedness.[113]

In the case in which the corporation is assuming the old indebtedness which old indebtedness is also being modified and where the issue price of the new indebtedness is lower than the face amount of the old indebtedness, the partners of the partnership will have additional CODI arising from the application of the issue price rules. The injustice is further amplified by the fact that the offsetting OID deductions will be the property of the corporation that assumed the indebtedness from the partnership. The net result is that the partnership's partners are allocated the CODI, but the corporation obtains the benefit of the offsetting OID deductions.

For those who are offended by this asymmetry, there is a way to move the CODI into the corporation. The regulations permit the CODI arising from the assumption of the indebtedness to be allocated to the corporate-buyer of the assets of the partnership. The general rule is that the assumed debt is deemed to be modified before the sale of the assets.[114] If the buyer and seller jointly elect, however, the regulations permit the debt

110. Finoli v. Comm'r, 86 T.C. 697, 738 (1986).
111. *See* discussion *supra* Section II.A.3.
112. Treas. Reg. § 1.1273-1(a).
113. I.R.C. § 163(e).
114. Treas. Reg. § 1.1274-5(b)(1).

modification to be considered as taking place after the sale or exchange. The buyer is first deemed to have assumed the unmodified indebtedness and then is deemed to have modified that indebtedness.[115] Any CODI is then the responsibility of the corporation. The corporation also obtains the OID deductions to offset the artificial amount of CODI which only arises because the issue price of the modified indebtedness is less than the adjusted issue price of the debt.

If the corporation is itself in a bankruptcy proceeding, CODI will not be includible in the corporation's income but instead will reduce the tax basis of the corporation in its assets. While NOL must be reduced first, it is unlikely that the corporation will have any NOL carryovers because the corporation will not have any operations prior to taking over the business from the partnership. The basis reduction and resulting reduced depreciation and depletion deductions will be offset by the OID deductions with respect to the modified indebtedness.

5. Section 267–Related Party Limitation

The selling party may not deduct a loss on a sale to a related party.[116] The test for determining whether a partnership and a corporation are related focuses on whether the same persons own 50% or more of the value of the outstanding stock of the corporation and also own more than 50% of the capital interest or profits interests in the partnership.[117] Under the assets down approach of check the box regulations, there will be a moment in time in which the partnership will own all of the stock of the corporation, which stock is then distributed to debt holders and equity holders.[118] The question is whether that momentary ownership is enough to bring the deemed asset sale within the scope of the restrictions of I.R.C. § 267.[119] Even if that momentary ownership is disregarded, a particular partner's share of the loss may be disallowed to the extent that it has an ownership interest in the new corporation.[120]

115. Treas. Reg. § 1.1274-5(b)(2)(i).
116. I.R.C. § 267(a).
117. § 267(b)(10).
118. *See* discussion *supra* Section II.E.2.
119. For example, an S Corporation's momentary ownership by a corporate parent in the process of spinning off that subsidiary to an individual owner does not disqualify the S Corporation's election. I.R.S. Priv. Ltr. Rul. 201429006 (July 14, 2014).
120. Treas. Reg. § 1.267(b)-1(b)(1).

6. Section 1239–Capital Gain Recharacterization

A rule similar to § 267 on loss disallowance applies to recharacterize what would otherwise be a capital gain or § 1231 gain on the deemed sale of depreciable assets as ordinary income. The gain recharacterization occurs if the partnership sells, or is deemed to sell, its assets to a person who owns, or is deemed to own, more than 50% of the capital and profits of the partnership.[121]

7. Section 269–Use of Corporation to Avail Itself of a Tax Benefit

The IRS could challenge the partnership's check the box election to become a corporation for federal tax purposes. Under I.R.C. § 269, the IRS may challenge a transaction if the partnership acquires control of a corporation with the principal purpose of avoiding federal income tax by securing the benefit of a deduction, credit or other allowance that such person would not otherwise enjoy.[122] The regulations define *allowance* as including an exemption or exclusion—this is what the CODI exclusions of § 108 afford the new corporation.[123] Therefore, it would appear that an incorporation of a partnership is vulnerable to a § 269 challenge.

Note that for § 269 to apply, the principal purpose of the acquisition must be the avoidance of tax through the securing of an allowance. Often, MLP debtholders who receive the equity of the new entity in exchange for their debt will not want to own equity of a flow-through entity. Because an MLP is a flow-through entity, its operating income may be subject to the unrelated business income tax[124] for a tax-exempt holder and non-U.S. persons will be subject to tax in the United States on its flow-through effectively connected income.[125] The interest income received from the MLP by the debtholders would not have been subject to the unrelated business income tax and would not have been considered effectively connected income. However, all of that changes when the debtholders exchange their indebtedness for an equity interest in a flow-through MLP.

Therefore, there may be situations where the use of the § 108 exemption is not the principal purpose for checking the box to become a corporation for tax purposes, but the incorporation is instead principally motivated by other factors.

121. *See* I.R.C. § 1239.
122. I.R.C. § 269(a).
123. Treas. Reg. § 1.269-1(a).
124. *See* I.R.C. § 512.
125. *See* I.R.C. § 875(1).

8. Property of the Estate

There is a concept in bankruptcy law that provides that tax elections are property of the estate and thus may be rejected by the bankruptcy trustee.[126] Therefore, a further challenge is that the bankruptcy trustee may seek to revoke the check the box election and force the partnership to remain a partnership for tax purposes. The trustee may want the partnership to remain a partnership so that the IRS is not a creditor of the new corporation for its federal income taxes. In a partnership, the taxes are the responsibility of the unitholders, rather than the entity that owes money to the lenders. The trustee thus has one fewer creditor (the IRS) if the check the box election is revoked.

a. Majestic Star Casino Case

One case that tested this theory involved a debtor that was a qualified subchapter S corporation subsidiary.[127] In *Majestic Star*, Don Barden[128] owned all the stock of Barden Development Inc. (BDI), which in turn owned all of the stock of Majestic Star Casino II, Inc. (Majestic).[129] BDI elected to be treated as an S Corporation, and Mr. Barden consented.[130] Further, BDI elected to treat Majestic as a qualified subchapter S subsidiary, which means that it was ignored as a corporation for federal income tax purposes and all of its items of income, gain, loss and deduction were reported on the tax return filed by BDI.[131] As with a partnership, an S Corporation does not generally pay tax on its income, but instead allocates that income to its shareholders.[132]

Majestic filed for bankruptcy protection.[133] While Majestic was in its bankruptcy proceeding, Mr. Barden revoked BDI's S Corporation election, which had the effect of also revoking Majestic's qualified subchapter S subsidiary election.[134] Mr. Barden did this because, if Majestic recognized any CODI in the bankruptcy proceeding, that income would be included in the income of BDI which CODI income would in

126. 11 U.S.C. § 362, 549, 550. *In re* Trans-Lines West, Inc., 203 B.R. 653 (Bankr. E.D. Tenn. 1996).
127. *See In re* Majestic Star Casino, LLC, 716 F.3d 736 (3d Cir. 2013).
128. Mr. Barden died after the bankruptcy case commenced, and John M. Chase was substituted as the personal representative of Mr. Barden's estate. For simplicity, Mr. Barden is referred to herein as the continuing shareholder of BDI.
129. *In re Majestic Star Casino*, 716 F.3d at 742.
130. *Id.*
131. *Id.* at 742–43; *see also* I.R.C. § 1361(b)(3)(A).
132. *See* I.R.C. § 1366.
133. *In re Majestic Star Casino*, 716 F.3d at 743.
134. *Id.* at 743–44.

return be required to be reported by Mr. Barden on his personal tax return. Once the S Corporation election was revoked, BDI and Majestic became separate corporate taxpayers.[135] As a separate corporate taxpayer, Majestic became responsible for its own CODI.[136]

The trustee of Majestic intervened to ask the court to determine that the S Corporation election was Majestic's estate property that may not be transferred under the Bankruptcy Code.[137] The trustee asked the court to order the IRS to reinstate the S Corporation election of BDI and the qualified subchapter S subsidiary election of Majestic.[138]

The court made fairly short work of deciding that the qualified subchapter S subsidiary election is not property of Majestic.[139] The court noted that a qualified subchapter S subsidiary election depended on many factors and most, if not all, of those factors were not in the control of Majestic. For example, in order to maintain its S Corporation status, BDI cannot have more than 100 shareholders and none of those shareholders may be a partnership or a nonresident alien.[140] Further, the flow-through status for Majestic is dependent on BDI continuing to own all of the stock of Majestic and on BDI making the qualified subchapter S subsidiary election.[141] The court concluded that Majestic could not have a property interest in an election that it could not control.[142] The court therefore allowed the revoked election to stand.

The trustee wanted the CODI to flow out to Mr. Barden and be reported on his tax return. Thus, more after-tax assets would be available for the Majestic creditors. If Mr. Barden prevailed, CODI would be reported by Majestic on its separate tax return. However, because Majestic was in bankruptcy, it could take advantage of the bankruptcy exception.[143] This would mean that Majestic would not be required to include the CODI in income but would instead reduce the NOLs or tax basis of Majestic's assets.[144]

Notably, the IRS did not intervene on the side of the trustee. Instead, the IRS asserted that the election was not property of Majestic's bankruptcy estate.[145] This position did not favor immediate collection of tax on the CODI: if the election had been reinstated, Mr. Barden would

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135. *Id.* at 744.
136. *Id.*
137. *Id.* at 745; *see also* 11 U.S.C. §§ 362, 549.
138. *In re Majestic Star Casino*, 716 F.3d at 745.
139. *Id.* at 757–58.
140. *See* I.R.C. § 1361(b)(1), (b)(3).
141. *See* § 1361(b)(3).
142. *In re Majestic Star Casino*, 716 F.3d at 758–59.
143. *See* discussion *supra* Section II.D.2.
144. *See* discussion *supra* Section II.D.3. Because a qualified subchapter S subsidiary does not have a tax history, it is unlikely that it will have any NOLs.
145. *In re Majestic Star Casino*, 716 F.3d at 745.

have included the income on his personal return. As the case turned out, the IRS will not be paid tax on the CODI until Majestic sells its assets and pays additional tax on the gain arising from the reduced tax basis under the attribute reduction required by the bankruptcy exception.[146]

Moreover, the IRS argued that the election should stand because it was not fair for the economic benefits of the discharged indebtedness to be enjoyed by the corporation, but the income to be allocated to the shareholders of the S Corporation parent. The court noted that the IRS observed in its brief that:

> In the typical case where an S Corporation or Q-sub receives income, the shareholder has the ability to extract the income from the corporation in order to pay taxes due on that income.[147]

The court agreed with the inequity of the assets remaining in the corporation to pay creditors but the tax being borne by the shareholders.[148] This is a strong statement on the equities of the case because, in the usual situation where the partnership pays an expense with borrowed money, the tax deduction flows through to the partners even if the partners have no responsibility to pay the debt that funded that deduction.[149] In contrast, if the partners had personal liability for debts of the partnership—which is not the case with the typical MLP—the use of partnership assets to repay the debts of the partnership would benefit the partners by reducing or eliminating their secondary personal liability.[150]

In the case where a partnership is in a bankruptcy proceeding, it would be much easier for a court to hold that the check the box election was property of the estate since the election is owned by the partnership itself and does not depend on any third party cooperation.[151] The partnership would then be left to argue that the election to be treated as a corporation was equitable because the cash of the partnership will be used by the partnership to repay creditors and it will not be fair to push the tax liability—including the tax liability for the CODI—on to the partners. A bankrupt partnership that had made the election to be treated as a corporation would then be dependent on the court holding that the election affected a fundamental fairness of not pushing tax on persons who will not enjoy the benefits of the reduced debt.

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146. *See* discussion *supra* Section II.D.3.
147. *In re Majestic Star Casino*, 716 F.3d at 757.
148. *Id.* at 757–58.
149. But the total net taxable losses may not exceed the equity tax basis of the investor under the at-risk rules. *See* discussion *supra* Section II.B.1.
150. *See In re* Harbor Village Dev., 1994 WL 774514 (Bankr. D. Mass. 1994).
151. Treas. Reg. § 301.7701-3(c)(2). If the election is to apply retroactively, partner consent is required. Treas. Reg. § 301.7701-3(c)(2)(ii).

9. Tension between Lenders and Unitholders

There is a notable tension between the lenders and the unitholders in a pre-bankruptcy negotiation. Often, the credit agreement will not permit the partnership borrower to revoke its pass-through election without the consent of the lender. Unlike the IRS in *Majestic Casino*, the lender likes the idea that the tax on the CODI is being paid by persons, the partners, who are not the borrower or a subsidiary of the borrower. Instead, the partners are picking up the tax tab, and the taxable income of the borrower and the tax attributes of the borrower are unaffected by the CODI.

When the borrower explains that the partnership can avail itself of the § 108 exemption if it incorporates and no one will have to pay the tax on the CODI, the lenders respond with two points. First, the lenders do not want the corporation to be engaged in a controversy with the IRS over whether the check the box election was valid. Second, even if the election is valid, the borrower must reduce tax basis in its assets, which will have the effect of increasing taxes of the borrower currently through reduced depreciation and depletion deductions and in the future when the assets are sold.

CONCLUSION

The recent decline in the price of oil and gas has put pressure on businesses (including MLPs) that leveraged their balance sheets for acquisitions of properties during more favorable commodity price times. These MLPs have developed plans to de-lever their balance sheets either in or out of bankruptcy. There are many tax and corporate governance issues associated with MLPs generally, but the tax issues and decisions that need to be considered by MLPs and the holders of their equity and debt interests are greatly multiplied when an MLP is forced to engage in the restructuring of its indebtedness. Because the CODI rules for corporations and the CODI rules for partnerships are so remarkably different, an MLP will often consider the incorporation of the business prior to the CODI event. The incorporation itself will create a tension with the MLP's creditors and the IRS who may well favor the retention of the partnership structure.

Appendix A

The after-tax earnings of a shareholder of a C Corporation if the shareholder is subject to the maximum tax rate on qualified dividends of 20% plus the 3.8% tax imposed on dividends by the Affordable Care Act.

Corporate Earnings	$100.00
Less: Corporate Tax (35%)	(35.00)
Net After-Corporate Tax Earnings	$65.00
Less: Shareholder Dividend Tax (23.8%)*	(15.47)
Corporation After-Tax Distribution	$49.53

Partnership Earnings	$100.00
Less: Corporate Tax	0.00
Partnership Earnings Available for Distribution	$100.00
Partner Tax on Earnings (39.6% + 3.8%)**	(43.40)
Partnership After-Tax Distribution	$56.60

*20% rate for qualified dividends plus 3.8% tax on investment earnings under the Affordable Care Act.
**Maximum 39.6% tax on ordinary income plus 3.8% tax on investment earnings under the Affordable Care Act.

Appendix B

Comparison of Corporate After-Tax Earnings to MLP After-Tax Earnings Illustrating the Impact of Non-Cash Deductions

	Corporate	Partnership
Revenue	$200.00	$200.00
Cash Deductions	(20.00)	(20.00)
Non-Cash Deductions	(80.00)	(80.00)
Net Entity Earnings	$100.00	$100.00
Corporate Tax (35%)	(35.00)	0.00
Net Earnings After-Tax	$65.00	$100.00
Add Back: Non-Cash Deductions	80.00	80.00
Cash Available for Distribution	$145.00	$180.00
Less: Shareholder Tax on Dividends (23.8% of $145)*	34.51	
Less: Partner Tax on Partnership Income (43.4% of $100)**		(43.40)
After-Tax Distribution	$110.49	$136.60

*20% rate for qualified dividends plus 3.8% tax on investment earnings under the Affordable Care Act.

**Maximum 39.6% tax on ordinary income plus 3.8% tax on investment earnings under the Affordable Care Act.