DOWNTURN TAX PLANNING

CONTRIBUTIONS OF DEBT

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Many businesses (e.g., corporations, partnerships, and limited liability companies) have a capital structure that includes debt from owners (e.g., shareholders, partners and members). The current economic environment may cause those businesses to consider converting that debt to equity rather than change other terms of the debt. After all, the owners made the same initial investment to the business whether or not classified as debt. A conversion may have the effect of simply readjusting the initial classification without altering the rights among the owners.

A debt to equity conversion, though, may cause a business, its owners or all of them to recognize cancellation of indebtedness or "debt discharge" (COD) income for US or California income tax purposes. In turn, that would require them to seek some form of exclusion, deferral or offset or face paying tax liabilities when cash may be short.

Specifically, under Section 108(e)(6) of the Internal Revenue Code, a creditor generally can contribute debts owed by a corporation to the capital of the corporation and not cause the corporation to recognize COD income if the corporation does not issue additional stock and the shareholder has a tax basis in the debt no less than the amount of the debt. Generally, an owner will have tax basis in the debt for a loan of cash, as distinct from amounts owed to the owner for rent, salaries, interest and other items for which the owner has not yet recognized income. Moreover, a special rule does not trigger COD income for debt contributed to an S corporation even if S corporation losses have reduced the tax basis of debt below the amount of the debt. California conforms to those provisions.

In contrast, if the corporation issues its stock in exchange for the debt, then the corporation generally recognizes COD income to the extent the debt exceeds the fair market value of the stock issued.

The IRS could issue regulations under Section 108(e)(6), which could clarify when the IRS will deem an issuance of stock when the issuance of actual shares would be a "meaningless gesture" because the ownership percentage would remain the same. To date, the IRS has not issued those regulations, but has issued private rulings that apply Section 108(e)(6) if the corporation does not actually issue shares.

On May 22, 2020, the IRS released a legal memorandum, 2020-005, which states that it will deem stock to be issued in "meaningless gesture" transactions if it affects the holding period of the shares. In an informal conversation with the contact attorney for the legal memorandum, the attorney confirmed that the legal memorandum is not intended to signal a change in policy regarding Section 108(e)(6).

No statutory or judicial exception, such as Section 108(e)(6), appear to apply to a partnership (or LLC taxed as such) debt to equity conversion after changes to Section 108 enacted in 2004.

