LLC AND PARTNERSHIP ISSUES IN BANKRUPTCY
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By Timothy A. Nettesheim
Reinhart Boerner Van Deuren s.c.

1. Fact pattern: an LLC loses real property to a bank in foreclosure.

   - After the foreclosure, the LLC has no assets.
   - The mortgage debt is $2 million.
   - The property FMV is $1 million.
   - The LLC's basis in the real estate is $500,000.
   - The debtor holds a 51% LLC interest with a basis of $500,000.

   A. Assume the debtor goes through bankruptcy, but the LLC does not.

   (1) The debtor's LLC interest becomes property of the bankruptcy estate. The transfer of the LLC interest into the bankruptcy estate is not treated as a taxable disposition and the bankruptcy estate is treated as a member. IRC § 1398(f)(1). The reverse occurs when the bankruptcy concludes and the LLC interest, if still held by the estate, is transferred back to the member. IRC § 1398(f)(2).

   (2) If a foreclosure occurs during the debtor's bankruptcy, the tax consequences at the LLC level flow through to the bankruptcy estate if it has not abandoned the LLC interest. *Gulley v. Com'r,* T.C. Memo 2000-190. IRC § 706(a). If the foreclosure occurs after the debtor's bankruptcy is concluded and the LLC is returned to the debtor, the tax consequences of the foreclosure at the LLC level flow through to the debtor.

   (3) If the bankruptcy estate seeks to abandon the LLC interest to the debtor to avoid the foreclosure tax consequences, there is authority that the abandonment can trigger a deemed cash distribution from the LLC to the bankruptcy estate as an LLC member. Here the 752 distribution would be the mortgage debt amount—$2 million. This IRC § 752 deemed distribution of $2 million triggers gain to the estate of $1.5 million ($2 million less $500,000 basis). *See In Re Olson,* 930 F.2d 6 (8 CA 1991) and *A.J. Lane*, 133 Bankr. 264 (Bankr. D. Mass 1991) (abandonment taxable); and PLR 9611208 abandonment not taxable).

(4) If the mortgage debt is recourse to the LLC, then there is foreclosure gain of $500,000 (FMV minus basis). IRC § 1001; Rev. Rul. 90-16, 1980-1 C.B. 12. If the LLC has no other assets and it is clear the remaining mortgage debt is uncollectible, then debt discharge income occurs at the LLC level in the amount of $1 million. *See Cozzi v. Com'r,* 88 TC 435 (1987) and *Salva v. Com'r,* T.C. Memo 1993-90.

(5) If the mortgage debt is non-recourse, then there is foreclosure gain of $1.5 million, which will be allocable to the LLC members. Regs. § 1.1001-2(c), Exs. 2, 7; *Tufts Com'r,* 461 U.S. 300 (1983).

(6) If the foreclosure occurs while the debtor is in bankruptcy, the foreclosure gain and debt discharge income flow through to the bankruptcy estate. The debt discharge income will be tax free under IRC § 108(a)(1)(A).

(7) If the foreclosure occurs after the debtor's bankruptcy is concluded, then the foreclosure gain and debt discharge income flows through to the debtor, assuming the LLC interest was returned to the debtor at the conclusion of the bankruptcy. In such case, the debt discharge income will be taxable to the debtor unless the debtor is insolvent. To avoid this result, the debtor member should consider placing the LLC in bankruptcy in order to force occurrence of the LLC debt discharge and foreclosure gain while the debtor is in bankruptcy. The same result could occur by causing the LLC to surrender the real estate to the bank while the debtor is in bankruptcy.

B. Assume the LLC is in bankruptcy but the member is not.

(1) No separate taxable entity is created for the LLC. IRC § 1399.

(2) Normally, if the LLC mortgage debt was nonrecourse, then foreclosure gain of $1.5 million would result and 51% of this would be allocable to the member. However, in PLR 8918016 the IRS asserted that Bankruptcy Code § 506(a) limited the bank's secured claim to the FMV of the real estate so that debt in excess of FMV became unsecured and generated debt discharge income. This only helps the debtor member if the section 108(a)(1)(B) insolvency exception applies or another exception under section 108 is applicable.

(3) If the mortgage debt is recourse, then the foreclosure gain is $500,000 and debt discharge income is $1 million. 51% of each are allocated to the member. The section 108(a) exclusions for debt discharge income are applied at the member level, not the

LLC level. IRC § 108(d)(6). This means the purchase price reduction exception of section 108(e)(5) is applied at the LLC level. In this case, if the bank had been the seller of the real estate to the LLC, the debt discharge income would be nontaxable.