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Commentary

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Restructuring Oil and Gas Partnership Debt? Tax Planning Is Key

Tax partnerships, including MLPs, seeking to restructure debt face peril and possibility during challenging times.

With the lowest oil prices in more than a decade and the equity markets effectively closed to them, oil and gas companies are facing difficult decisions regarding their capital structures. For many companies, this will involve working with creditors to restructure existing debt — a complicated undertaking for any business, but even more complex for companies classified as tax partnerships, such as master limited partnerships (MLPs). Unlike corporations, which are generally able to exclude cancellation of debt income (CODI) from their taxable income, partnership CODI passes through to the partners, often resulting in partner cash tax liabilities.

Phantom Income and the Problem of Character Mismatch to Partners

MLP investors are familiar with the concept of a “tax shield,” which is often associated with an investment in MLP common units. As partners in an MLP, common unitholders receive allocations of income, gain, loss and deduction with respect to their units. Non-cash deductions, such as depreciation and depletion, often lower the net income allocated to these unitholders to an amount less — in many cases substantially less — than the cash distributed to them. These “excess” cash distributions instead reduce a unitholder’s basis in his or her units, effectively resulting in tax deferral. But, just as non-cash deductions can defer a current tax liability, non-cash income can accelerate it, creating “phantom income.” Simply put, phantom income results in a cash tax liability without a sufficient distribution of cash with which to pay the tax bill. When a partnership has non-cash income, such as CODI, the partners are allocated phantom income. Although the partners receive additional basis in their partnership interests as a result of the income allocation, they often cannot offset the CODI, even if they were to sell their partnership interests at a loss, due to the character mismatch — the CODI is generally ordinary income whereas the loss is generally a capital loss, and capital losses can only offset capital gains.

Income Triggers to Partners in Partnership Debt Restructurings

The discharge of debt, such as in a partnership debt-for-equity exchange or a reduction in the principal of partnership debt, can result in the partners recognizing CODI. But CODI can arise even if no debt is forgiven. For example, a “significant modification” of partnership debt (*e.g.*, a sufficiently large extension of the maturity or change in the interest rate) may trigger CODI if the debt is trading at a discount. In addition, a party related to the debtor acquiring the debt at a discount can trigger CODI. Thus, if an MLP buys back its public debt at a discount, CODI may be triggered.

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Debt restructurings can give rise to other income and gain as well. For example, if a creditor forgives nonrecourse debt in exchange for the property securing the debt, the borrower realizes gain from the property's sale rather than CODI. If a creditor instead forgives recourse debt in exchange for property, both gain from the property's sale and CODI can result.

Individual Results May Vary

Gain from the disposition of property, such as when a partnership and a creditor exchange property for debt, can affect different partners in different ways. For example, a partner that previously contributed property to a partnership, such as an MLP sponsor, is required to recognize pre-contribution gain or loss in that property at the time of the exchange. In the normal case of MLPs and many other partnerships, this recognition typically occurs over the property's depreciable life through "remedial allocations." In contrast, a taxable disposition of the property will accelerate the contributing partner's recognition of this pre-contribution gain or loss. A property-contributing partner may, therefore, prefer a restructuring plan that does not involve a taxable disposition of the contributed property, whereas other partners may prefer to exchange the property for the related debt to avoid CODI.

Different partners' interests may diverge in other ways as well. For example, certain partners may have suspended passive losses they can use to offset partnership allocations of CODI. Other partners, such as those who recently acquired their partnership interests or assert they have been actively involved in the business and are not subject to the passive loss rules, may not have significant suspended passive losses, and accordingly they may be less amenable to a debt restructuring that generates CODI.

Planning Opportunities — Use of Corporations

To some extent, incorporating a partnership prior to restructuring its debt can sidestep partnership-specific complexities. Doing so creates a corporation to "trap" CODI, which is typically excluded from the corporation's taxable income during bankruptcy or insolvency. However, partnership incorporation comes with its own set of complexities. There are several ways to effect a partnership incorporation: election, statutory conversion, merger or through contributing either partnership assets and liabilities or partnership interests to a corporation. These alternatives can produce different tax results for each partner. For example, incorporation may or may not trigger gain or loss on the partnership's assets and, even if nontaxable to the other partners, may trigger pre-contribution gain or loss to a partner that previously contributed property. In addition, even if a partnership incorporation is otherwise nontaxable, partners may recognize gain to the extent the partnership's liabilities exceed its tax basis in its assets.

As even this brief discussion illustrates, there are both tax structuring opportunities and pitfalls associated with restructuring partnership debt, and careful tax planning is essential. Partnerships that are considering restructuring their debt should consult their tax advisors in order to fully understand and best navigate the myriad options available to them. As with most tax planning, the earlier the partnership begins its tax analysis, the more options will likely be available to address the tax complexities inherent in a partnership debt restructuring.

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