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## A Primer on Qualified Real Property Business Indebtedness

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When times are tough and it becomes necessary for real property owners to enter into negotiations with lenders, there are many issues to consider. Among these issues is the federal income tax impact of a reduction or elimination of the debt relating to the real property. Taxpayers, of course, generally will prefer to pay no federal income tax with respect to cancellation of indebtedness ("COD") income that results from a debt workout transaction, and there are a number of exclusionary rules that can facilitate this result. Among the useful exclusions is the rule relating to "qualified real property business indebtedness," which is explained in this article.

Although real property values generally have rebounded since the downturn that began in 2007, and debt workouts in the real estate context currently are the exception rather than the norm, the IRS recently issued a number of guidance items addressing the scope of the qualified real property business indebtedness exception. Accordingly, it is an opportune time to review the parameters of this exclusionary rule.

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## 1. In General

Taxpayers other than C corporations may elect to exclude COD income derived from the discharge of "qualified real property business indebtedness."[1] "Qualified real property business indebtedness" is defined as indebtedness that (1) was incurred or assumed by the taxpayer in connection with real property used in a trade or business and is secured by the real property; (2) was incurred or assumed before January 1, 1993,[2] or was incurred or assumed after that date to acquire, construct, reconstruct, or substantially improve the property; and (3) with respect to which the taxpayer makes an election.

Like the exclusions for bankrupt[3] or insolvent[4] taxpayers, the exclusion for qualified real property business indebtedness applies at the partner, rather than the partnership, level.[5]

## 2. In Connection with Real Property Used in a Trade or Business

The phrase "real property used in a trade or business" is not defined in section 108(c) or the related regulations. Recently, in Revenue Ruling 2016-15,[6] the IRS analyzed this standard in two different situations, one involving the construction of an apartment building for use in the taxpayer's leasing business and one involving a residential subdivider who developed and held real property for sale.

As part of its analysis, the IRS cited the legislative history underlying the qualified real property business indebtedness exception, which states that the deferral under this provision should not extend beyond the period that the taxpayer owns the property securing the debt that is discharged.[7] The IRS then focused on the basis reduction rules relating to qualified real property business indebtedness, highlighting that (1) section 1.1017-1(c)(1) requires that taxpayers must first reduce the basis in the

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1 Section 108(a)(1)(D). Unless otherwise indicated, section references are to the Internal Revenue Code of 1986, as amended (the "Code") or the applicable regulations promulgated pursuant to the Code (the "regulations").

2 Sections 108(c)(3) and (4). The IRS has ruled privately that pre-1993 debt of a partnership was incurred "in connection with" real property used in the partnership's trade or business when, at the time that the debt was incurred, real property used in the partnership's trade or business was pledged to secure the indebtedness. TAM 200014007 (Dec. 13, 1999). Qualification of debt having no greater connection than being secured by real property used in a trade or business at the time incurred and as of January 1, 1993, seemingly contradicts certain language contained in the preamble to the final regulations. That language states that "[t]he IRS and Treasury Department do not believe that [section 108(c)(3)(A)] should be interpreted to mean only that the debt must be secured by real property used in a trade or business as of January 1, 1993." T.D. 8787 (1998) (preamble). The IRS distinguished the preamble language on the basis that the debt also was secured by business real property at the time that the debt was incurred, even though the debt did not relate to the acquisition of the property. Reasonable minds may differ as to whether this is a justifiable distinction.

3 Section 108(a)(1)(A).

4 Section 108(a)(1)(B).

5 Section 108(d)(6).

6 2016-26 I.R.B. 1060.

7 H.R. Rep. 103-111, at 622-623 (1993).

property securing the discharged debt,[8] and (2) because property held for sale is not depreciable under section 167, the property could not be the subject of basis reduction.[9]

Following from these points, the IRS stated that it would be inconsistent with congressional intent to permit the exclusion of COD income under section 108(c) when the debt is secured by property held for sale that could not be the subject of the required basis reduction. The IRS further noted that to allow qualification of debt associated with the property likely would result in the deferral of COD income beyond the period that the taxpayer owns the property securing the debt,[10] which again would be inconsistent with congressional intent.

Based on this analysis, the IRS concluded that while the apartment property held for lease would qualify as property held in connection with a trade or business, the property held for sale would not.[11]

As a separate point, there is some question as to the proper time for determining whether the real property is used in a trade or business. Private Letter Ruling 200953003[12] states that this determination must be made at the time that the debt was incurred or assumed.

## 3. "Secured by" Real Property

One may think of the "secured by" real property requirement as necessitating a direct legal security interest in the subject property. In many situations, however, junior debt with respect to real property is "structurally" subordinated rather than "legally" subordinated, meaning that the junior loan is secured by

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8 *See infra* note 32 and accompanying text.

9 Unlike the basis reduction rules for section 108(b)(5) applicable to the bankruptcy, insolvency, and qualified farm indebtedness exclusions, a taxpayer may not elect to treat real property described in section 1221(a)(1) as depreciable real property for purposes of the qualified real property business indebtedness provisions. Section 1017(b)(3)(F)(ii); section 1.1017-1(f).

10 Dealer property often will be held for a short term. Depreciable property that would be subject to the basis reduction likely would be held for a longer time period, so that the income associated with the basis reduction would be deferred beyond the time that the property held for sale was disposed.

11 Prior to issuance of Revenue Ruling 2016-15, advisors were divided as to the appropriate interpretation of this standard. Those advocating treatment of dealer property as qualifying trade or business property for these purposes generally cited section 1.1017-1(a)(1), which, in describing the ordering rule for basis reduction under section 1017, uses the phrase "real property used in a trade or business, *other than real property described in section 1221(1).*" (Emphasis added.) By describing the broad term "real property used in a trade or business" and then specifically carving out "real property described in section 1221(1)" from that broader definition, the regulation arguably recognizes that it is at least possible for "dealer" property to be treated as "real property used in a trade or business." *See generally D.C. Bar Tax Section Comments on Cancellation of Qualified Real Property Business Indebtedness*, 94 Tax Notes Today 157-36 (Aug. 11, 1994); S. Aaron, *Clear as Mud: The Treatment of the Discharge of Qualified Real Property Business Indebtedness*, 25 J. of Real Est. Tax'n 138 (1998).

12 (Sept. 23, 2009). Written determinations such as private letter rulings and technical advice memoranda represent the IRS's analysis of the law as applied to a taxpayer's specific facts, and these type of written determinations are not intended to be relied on by third parties and may not be cited as precedent. Section 6110(k). They do, however, provide an indication of the IRS's position on the issues addressed.

an interest in a disregarded entity that owns the real property (or possibly a higher-tier disregarded entity, depending on the levels of subordinated debt).[13] Practitioners have argued over whether debt secured by an interest in a disregarded entity can meet the "secured by" requirement contained in section 108(c).

In 2014, the IRS issued a "safe harbor" revenue procedure indicating that, under certain circumstances, the debt can satisfy the "secured by" requirement in this context. More specifically, Revenue Procedure 2014-20 provides that if the following five requirements are satisfied, debt secured by a 100 percent ownership interest in a disregarded entity holding real property will be treated as indebtedness that is "secured by" real property for purposes of section 108(c)(3)(A).

> (1) The taxpayer or a wholly owned disregarded entity of the taxpayer ("Borrower") incurs indebtedness.
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> (2) Borrower directly or indirectly owns 100 percent of the ownership interest in a separate disregarded entity owning real property ("Property Owner"). Borrower is not the same entity as Property Owner.
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> (3) Borrower pledges to the lender a first priority security interest in Borrower's ownership interest in Property Owner. Any further encumbrance on the pledged ownership interest must be subordinate to the lender's security interest in Property Owner.
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> (4) At least 90 percent of the fair market value of the total assets (immediately before the discharge) directly owned by Property Owner must be real property used in a trade or business and any other assets held by Property Owner must be incidental to Property Owner's acquisition, ownership, and operation of the real property.
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> (5) Upon default and foreclosure on the indebtedness, the lender will replace Borrower as the sole member of Property Owner.[14]

In the context of large real property acquisitions, it is not at all unusual to see multiple tranches of structurally subordinated junior debt, with each more junior tranche secured by a disregarded entity interest that is directly above the next more senior tranche. Unfortunately, the revenue procedure is very limited in that it appears only to allow for one level of debt to be "secured by" a disregarded entity interest. Although the second requirement contains "direct or indirect" language, seemingly implying that multiple layers of security interests may be permitted, the limitation in the third requirement requires that the lender must take a first priority security interest in the disregarded entity that owns the property

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[13] By taking a security interest in a disregarded limited liability company ("LLC") that holds real property, the lender, upon foreclosure, would take ownership of the disregarded entity that owns the property and that has separately borrowed from a senior lender. The foreclosing lender would take its interest in the property held by the disregarded LLC subject to the senior lenders direct security interest in the property. The economic result is essentially the same as if the junior lender had taken a direct security interest in the property that was contractually subordinated to the senior lender's interest.

[14] Rev. Proc. 2014-20, 2014-9 I.R.B. 614; *see also* PLR 200953005 (Sept. 23, 2009).

(i.e., the Property Owner). In addition, the fifth requirement providing that, upon default, "the lender will replace Borrower as the sole member of Property Owner" seemingly makes clear that only one level of security interest will be permitted. No more senior lender whose debt is secured by an intervening disregarded entity interest would permit a more junior lender to become the sole member of the property-owning disregarded entity.

Revenue Procedure 2014-20 does provide that if a taxpayer fails to meet the requirements of the safe harbor, it will not be precluded from arguing, based on facts and circumstances, its debt satisfies the "secured by" requirement in section 108(c)(3)(A). Accordingly, it may still be possible to meet the "secured by" requirement when multiple tranches of structurally subordinated security interests exist.[15]

## 4. Making the Election

The election to apply the qualified real property business indebtedness is made by filing Form 982, *Reduction of Tax Attributes Due to Discharge of Indebtedness (and Section 1082 Basis Adjustment)*.[16] The IRS has granted section 9100 relief to make a late election under section 108(c)(3)(C) excluding COD income with respect to qualified real property business indebtedness.[17]

## 5. Identifying the Qualifying Portion of a Debt

It is possible—and will often be the case—that only a portion of a debt instrument will be treated as qualified real property business indebtedness.[18] This raises a question as to how taxpayers should identify the portion of a debt that is forgiven as qualified real property business indebtedness or not.

An example is helpful in illustrating this point. Assume that a partnership initially incurred $50 million of debt in order to acquire an office building. Assume that this debt is treated entirely as qualified real

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[15] Beyond the revenue procedure, there are certain analogous authorities that advisors previously have considered in analyzing this issue. For real estate investment trusts ("REITs"), Revenue Procedure 2003-65, 2003-2 C.B. 336, provides that, when certain requirements are met, a loan that provides for a security interest in a partnership or disregarded entity that owns real property will be treated as "secured by" real property or an interest in real property. Although helpful, certain distinctions exist under the REIT rules (e.g., rules also apply to an "interest in real property" as defined under section 856(d)(5)(C) and section 1.856-3(g) generally provides look-through treatment for partnership interests) that make it difficult to rely on this authority in the context of section 108(c). Structural subordination was not used in any significant way at the time that section 108(c) was enacted, so it is not surprising that the legislation and legislative history do not address the issue. These arrangements have been dealt with favorably under section 1.465-27 in the context of defining qualified nonrecourse financing for purposes of the "at-risk" rules. Section 1.1038-1(a)(2) also would appear to be helpful in providing that "[a]n indebtedness of the seller is secured by the real property for purposes of this section whenever the seller has the right to take title or possession of the property or both if there is a default with respect to such indebtedness." A lender of structurally subordinated debt generally will be able to obtain possession of the property as a remedy upon default, although not title. The rules relating to "qualified residence indebtedness" under section 1.163-8T(o) apply a stricter "security" requirement and must be considered by analogy.

[16] Section 1.108-5(b).

[17] *See* PLR 201316009 (Jan. 18, 2013); PLR 201325004 (Mar. 18, 2013).

[18] PLR 200953005 (Sept. 23, 2009) confirms that the entire debt need not constitute qualified real property business indebtedness in order to rely on section 108(c) with respect to a portion of the indebtedness.

property business indebtedness. At a later date, when the property has appreciated significantly, the partnership refinances the property, incurring an additional $50 million of debt for a total of $100 million of debt secured by the property. The partnership distributes all $50 million of the additional debt proceeds to its partners, so no portion of the additional borrowing can be treated as qualified real property business indebtedness. Afterwards, the property falls in value to $50 million, and the lender agrees to forgive $50 million of the $100 million owed. Is any portion of the $50 million COD income excludable under section 108(c)?

In one private letter ruling,[19] the IRS indicated that taxpayers must use a "reasonable allocation method" in determining the portion of a debt instrument that is qualified real property business indebtedness and the portion that is not. This language may imply some flexibility in determining whether the discharged portion of a debt qualifies for exclusion under section 108(c). It is not clear, however, whether the statement in the ruling is directed at determining the portion of the *discharged debt* that is qualified real property business indebtedness or, instead, is simply aimed at measuring the qualifying and non-qualifying portions of the overall debt instrument.

In any event, the impact of the equity limitation under section 108(c)(2)(A) in this instance would seem to make the allocation issue irrelevant. As described immediately below, a taxpayer may exclude COD income only to the extent that the outstanding principal of the qualified real property business indebtedness immediately before the discharge exceeds the net fair market value of the qualifying property immediately before the discharge. In the example set forth above, the amount of qualified real property business indebtedness is $50 million and the value of the underlying property also is $50 million. Accordingly, under these facts (and many other situations that raise the issue of identifying the qualifying portion of a debt), it appears that no portion of the COD income would be excludable under section 108(c) regardless of what portion of the forgiven debt was treated as qualified real property business indebtedness.

## 6. Limitations on the Amount of COD Income Exclusion

### *a. Equity Limitation*

Taxpayers are subject to dual limitations as to the amount of COD income they can exclude with respect to qualified real property business indebtedness. The first limitation relates to the security for the specific indebtedness being discharged and is intended to prohibit taxpayers from excluding COD income related to qualified real property business indebtedness to the extent that the discharge will create equity in the secured property.[20] Under this limitation, the amount excluded cannot exceed the excess, if any, of the outstanding principal of the qualified real property business indebtedness immediately before the discharge over the net fair market value of the qualifying real property immediately before the discharge.[21]

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[19] *Id.*

[20] H.R. Rep. No. 103-111, at 622-23 (1993).

[21] Section 108(c)(2)(a); section 1.108-6(a).

For purposes of the first limitation, net fair market value is defined as the fair market value of the qualifying real property, reduced by the outstanding principal amount of any qualified real property business indebtedness (other than the discharged indebtedness) that is secured by the property immediately before and after the discharge.[22] The outstanding principal amount of qualified real property business indebtedness referred to in the limitation is not necessarily the stated principal amount of the liability. For purposes of this provision, "outstanding principal amount" means the principal amount of indebtedness together with additional amounts that, immediately before the discharge, are equivalent to principal, in that interest on these amounts would accrue and compound in the future.[23] Accordingly, if interest will further accrue with respect to interest that is not paid, the accrued interest will be treated as outstanding principal. In addition, any portion of the indebtedness the payment of which would give rise to a deduction under section 108(e)(2) will not be considered part of the outstanding principal amount.[24] This provision will exclude accrued but unpaid interest with respect to a cash basis taxpayer and may exclude interest owed by an accrual basis taxpayer who has stopped deducting interest due to the substantial likelihood that the accrued interest will never be paid.[25] Finally, the outstanding principal amount must be adjusted to account for unamortized premium and discount consistent with section 108(e)(3).[26]

Recently, in Chief Counsel Advice 201623009,[27] the IRS addressed the application of the equity limitation in a context in which the taxpayer held multiple properties secured by multiple liabilities. Specifically, the taxpayer owned two properties–Property A and Property B. Both debts were secured by both properties, although one debt ("Debt A") was used solely to acquire and construct Property A and the other debt ("Debt B") was used solely to acquire and construct Property B.

Under the facts of the Chief Counsel advice, Debt A was reduced. The questions at issue essentially involved whether the equity limitation should apply by reference to all qualified real property business indebtedness (i.e., Debts A and B) and all property securing the indebtedness (i.e., Properties A and B) or instead by reference only to the qualified real property business indebtedness being discharged and the fair market value of the specific property or properties with respect to which the discharged debt is qualified real property business indebtedness. In its analysis, the IRS took the latter and more narrow view, concluding that the equity limitation should apply by comparing the amount of Debt A, determined immediately before the discharge, to the fair market value of Property A. The fact that Debt A also was

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[22] Section 1.108-6(a). The net fair market value computation does not take into account section 7701(g). *Id.* "Qualifying real property" is defined as real property with respect to which indebtedness is qualified real property business indebtedness within the meaning of section 108(c)(3). Section 1.1017-1(c)(1).

[23] Section 1.108-6(a).

[24] *Id.*

[25] *Cf.* Kellogg v. United States, 82 F.3d 413 (5th Cir. 1996) (deduction denied for accrued interest when debtor was hopelessly insolvent); Tampa & Gulf Coast RR Co. v. Commissioner, 469 F.2d 263 (5th Cir. 1972) (subsidiary could not accrue deduction on debt owed to parent when parent had ceased to accrue income due to remote likelihood of collection); *but see* Zimmerman Steel Co. v. Commissioner, 130 F.2d 1011 (8th Cir. 1942) (allowing deduction for interest although eventual payment was unlikely).

[26] Section 1.108-6(a).

[27] (Mar. 2, 2016).

secured by Property B and Debt B also was secured by Property A was not considered relevant, given that Debt A did not play any role in funding Property B and Debt B did not play any role in funding Property A.

### *b. Basis Limitation*

The second limitation, referred to as the overall limitation, is intended to ensure that a taxpayer incurs some tax detriment (through basis reduction) to offset the benefit of excluding COD income. This limitation provides that the amount of COD income excluded with respect to qualified real property business indebtedness may not exceed the aggregate adjusted basis of all depreciable real property held by the taxpayer immediately before the discharge reduced by the sum of (1) depreciation claimed with respect to the property for the year of the discharge, and (2) reductions to the basis of the property pursuant to section 108(b), the general attribute reduction provision of section 108.[28] Depreciable real property acquired in contemplation of the discharge may not be considered for purposes of this calculation.[29]

## 8. Basis Reduction

A taxpayer is required to reduce the basis of depreciable real property to the extent that COD income is excluded with respect to qualified real property business indebtedness.[30] Gain subsequently recognized with respect to the disposition of the property will be recaptured as ordinary income.[31] A taxpayer must first reduce the basis of qualifying real property (generally depreciable real property that secures the qualifying real property business indebtedness)[32] before reducing the basis of other depreciable real property.[33]

In some cases, a partner may treat an interest in a partnership as depreciable real property to the extent of the partner's proportionate interest in the depreciable real property held by the partnership.[34] A partner's share of partnership basis in depreciable real property is equal to the sum of the partner's section 743(b) basis adjustments to items of partnership real property and the common basis depreciation deductions (not including remedial allocations) that are reasonably expected to be allocated to the partner over the property's remaining useful life (determined under the partnership agreement effective for the tax year when the discharge occurs).[35]

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[28] Section 108(c)(2)(B); section 1.108-6(b). Reductions to basis for qualified farm indebtedness under section 108(g) also must be excluded.

[29] Section 108(c)(2)(B); section 1.108-6(b).

[30] Section 108(c)(1)(A). The general ordering rule for basis reduction under section 1.1017-1(a) is appropriately modified for qualified real property business indebtedness so that only the basis of depreciable real property will be reduced. Section 1.1017-1(c)(1).

[31] Section 1017(d).

[32] *See* section 1.1017-1(c)(1).

[33] *Id.*

[34] Section 1017(b)(3)(C).

[35] Section 1.1017-1(g)(2)(iv).

To treat a partnership interest as depreciable real property, the partner must request that the partnership make a corresponding reduction in the partnership's basis in depreciable real property with respect to the partner.[36] The partner generally has the option to request that the partnership make such an adjustment, and similarly, the partnership generally is free to accept or reject the request.[37] In certain situations, however, the partner will be required to request consent, and in some situations, the partnership will be required to consent to adjust the basis of partnership property.

The regulations regarding mandatory request and consent generally are written with an eye to preventing taxpayers from contributing depreciable property to a partnership and then not making an election with respect to the partnership interest in order to block a basis adjustment with respect to the contributed property.[38] Pursuant to these regulations, a taxpayer must request a partnership's consent to reduce basis if, at the time of the discharge, the taxpayer owns (directly or indirectly) a greater than 50 percent interest in the capital and profits of the partnership or if the reductions to the basis of depreciable real property are being made with respect to the taxpayer's distributive share of COD income of the partnership.[39] A partnership must consent to reduce a requesting partner's share of inside basis with respect to a discharged indebtedness if consent is requested with respect to the debt by partners owning (directly or indirectly) an aggregate of more than 80 percent of the capital and profits interests of the partnership or five or fewer partners owning (directly or indirectly) an aggregate of more than 50 percent of the capital and profits interests in the partnership.[40]

A reduction in the basis of partnership property resulting from the exclusion of COD income related to qualified real property business indebtedness is partner-specific and does not reduce the common basis of a partnership's assets.[41] These basis adjustments are treated in the same manner and have the same effect as basis adjustments under section 743(b).[42]

Finally—contrary to the general timing rule requiring that basis reductions attributable to the exclusion of COD income must occur at the beginning of the tax year after the related debt is discharged[43]—with respect to the discharge of qualified real property business indebtedness, if depreciable real property is disposed of prior to the end of the tax year, the basis of the property will be reduced immediately before disposition.[44]

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[36] Section 108(b)(3)(C).

[37] Section 1.1017-1(g)(2)(ii)(A).

[38] T.D. 8787 (preamble).

[39] Section 1.1017-1(g)(2)(ii)(B).

[40] Section 1.1017-1(g)(2)(ii)(C).

[41] Section 1.1017-1(g)(2)(v)(A).

[42] Section 1.1017-1(g)(2)(v)(C).

[43] Section 1017(a).

[44] Section 1017(b)(3)(F)(iii).

## 9. Conclusion

While debt workouts with respect to real property are somewhat rare in the current economy, one never knows when the next downturn for real estate will occur. When addressing the tax issues in a debt workout with respect to real estate, it is important to remember that COD income relating to qualified real property indebtedness may be excluded so long as the taxpayer is not a C corporation. Recent guidance has elaborated on some of the requirements in qualifying for this exception, and it will be important to be aware of these items the next time a downturn comes around.

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