



April 24, 2010

Mezzanine Debt Accorded Status of Qualified Indebtedness

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In today's real estate market, lenders in many cases have agreed to forgive a portion of real estate debt. While this discharge of indebtedness would normally result in taxable income for the real estate owner in the year of the discharge, the Internal Revenue Code generally allows an individual to exclude this income if the debt is "qualified real property business indebtedness," i.e., certain debt which is secured by real property used in a trade or business. In a recent private letter ruling, the IRS considered whether mezzanine financing, where debt is secured by interests in an entity that owns real property but not by the real property itself, can be qualified real property business indebtedness.

Background

If a lender cancels all or a portion of a borrower's indebtedness, the borrower generally has taxable income equal to the amount of the discharge. However, section 108 allows certain taxpayers (e.g., if the taxpayer is insolvent or in bankruptcy) to exclude discharge of indebtedness income (cancellation of indebtedness or "COD" income), generally in exchange for a reduction in basis or other tax attributes of the taxpayer.

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The economic downturn of the early 1990's resulted in a significant amount of real estate being "underwater." Under the Code that was then in effect, the discharge of a portion of the debt on underwater property would generally result in COD income unless the taxpayer was insolvent or in bankruptcy proceedings. Further, in the case of partnership indebtedness, even if the partnership was insolvent or in bankruptcy, each partner could benefit from the insolvency or bankruptcy exclusions of COD income only if the partner itself was insolvent or in bankruptcy. Congress responded by enacting section 108(c) to provide for the exclusion of COD income resulting from the discharge of qualified real property business indebtedness ("QRPBI").

Qualified Real Property Business Indebtedness

Under section 108(c), COD income of a taxpayer other than a C corporation is excluded from gross income as QRPBI if (1) the debt was incurred or assumed by the taxpayer in connection with real property used in a trade or business and "is secured by such real property," (2) the debt was incurred or assumed to acquire, construct, reconstruct, or substantially improve such property (or was incurred or assumed before January 1, 1993), and (3) the taxpayer elects for the debt to be QRPBI. The amount excluded from gross income as QRPBI is generally limited to the excess of the outstanding principal

amount of the debt over the fair market value of the property at the time of discharge. In the case of partnership indebtedness, the election for the debt to be QRPBI is made at the partner level.

In exchange for the exclusion of COD income resulting from the discharge of QRPBI, a taxpayer electing for debt to be QRPBI must reduce the basis of his or her depreciable real property by the amount of the exclusion (and the amount of COD income which is excluded from gross income as QRPBI may not exceed the aggregate basis of depreciable real property held by the taxpayer immediately before the discharge). Thus, section 108 allows for the exclusion of COD income resulting from the discharge of QRPBI at the cost of lost depreciation deductions and, if the property is sold before being fully depreciated, increased gain upon sale of the property.

For the 2009 and 2010 taxable years, section 108(i) provides taxpayers with an opportunity to defer certain COD income and recognize it ratably over the five-year period beginning in 2014. Still, it is often more advantageous for a taxpayer to elect for debt to be QRPBI. To illustrate, suppose that, in 2010, a lender agrees to cancel a portion of a taxpayer's debt which is secured by real property with a remaining depreciable life of 35 years. Excluding this COD income as QRPBI and reducing the property's basis would cause the

taxpayer to lose depreciation deductions in the amount of the deferred COD income ratably over the 35-year period (assuming that the property is not sold), which generally would have the effect of spreading out the taxpayer's COD income over those 35 years. In contrast, if the taxpayer were to elect for the COD income to be deferred under section 108(i), the taxpayer would recognize all of the COD income by 2018, a less advantageous result. Further, COD income which is deferred under section 108(i) must be recognized in full upon the death of the taxpayer, while a taxpayer's death does not affect the recognition of COD income that is excluded as QRPBI. In addition, section 108(i) is in effect only with respect to COD income arising through December 31, 2010.

Mezzanine Debt

Real estate is often financed through mezzanine debt, which is secured by interests in an entity that owns real property but not directly by the real property itself. Until recently, there has been an absence of guidance regarding whether mezzanine debt meets the requirement that QRPBI be "secured by such real property." On the one hand, if an entity owns real property and no other significant assets, it would appear to be a meaningless distinction whether the lender upon default receives the real property directly or receives the interests in the entity that owns the property. On the other hand, one could argue that, based on a technical reading of the statute, mezzanine debt is not "secured by such real property" and therefore cannot be QRPBI.

Private Letter Ruling 200953005

In a recent private letter ruling (PLR),¹ the IRS ruled that mezzanine debt, collateralized by a 100 percent ownership interest in a limited liability company that owned real property, met

the requirement that QRPBI be "secured by such real property." The ruling involved a taxpayer that, through a series of wholly-owned limited liability company subsidiaries, indirectly owned real estate used in a trade or business. As part of a refinancing, the taxpayer had received a mezzanine loan that was secured by 100 percent of the ownership interests in the limited liability company that owned the property ("Owner LLC"), but not by the property itself. As a result of a decline in the value of the property, the taxpayer anticipated that a portion of the mezzanine debt would be discharged and requested a ruling that the debt would be considered to be secured by the property for purposes of being QRPBI under section 108(c).

In support of its conclusion that the mezzanine debt was "secured by such real property," the well-reasoned ruling noted that the creditor would obtain a 100 percent ownership interest in Owner LLC upon default, which would result in it acquiring full ownership of the property. Therefore, the only difference between the creditor's security interest in this property and a mortgage is the method of foreclosure, a distinction that the IRS did not find to be relevant for purposes of determining whether the debt can be QRPBI. The ruling further explained that the statute could have explicitly required that QRPBI be secured by a mortgage, but instead used the broader phrase "secured by such real property," which suggests that Congress intended for QRPBI to include security interests other than mortgages on real property. In addition, the ruling also observed that, in other areas of the Code (e.g., provisions regarding real estate investment trusts), the IRS has ruled that debt which is secured indirectly by real property that the lender could acquire upon default is considered to be secured by real property. It is

particularly noteworthy that the favorable authority in the real estate investment trust context exists despite the more restrictive statutory standard of "mortgages on real property" that applies in that area.

Impact of the Decision

Since this ruling is a PLR, it may be formally relied upon only by the taxpayer to whom it was issued. However, PLRs generally indicate positions that the IRS is likely to take in the future. In using this PLR to anticipate future IRS rulings, though, it potentially could be relevant that the PLR notes that Owner LLC was a disregarded entity for Federal income tax purposes and suggests that it would be "incongruent" to give significance to it for purposes of determining whether the debt was secured by the property while disregarding it for all other purposes. However, none of the ruling's other arguments in support of the property being considered to be secured by the debt are dependent on Owner LLC being a disregarded entity, and the ruling gives no indication that its conclusion would be different had the property not been owned through a disregarded entity. Thus, it appears that the ruling's conclusion was not dependent on the fact that the property was owned by a disregarded entity.

It is on the Business Plan for the Treasury to address the definition of "secured by such real property" under section 108(c). Hopefully, a Treasury regulation or a revenue ruling will be adopted to embody the conclusion of PLR 200953005 and clarify that it is not limited to real property owned by a disregarded entity. In the meantime, the PLR provides real estate owners with an indication that the IRS will consider mezzanine debt to meet the requirement that QRPBI must be "secured by such real property."

¹ Priv. Ltr. Rul. 200953005 (Jan. 4, 2010).