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IRS Ruling Limits Exclusion to COD Income

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While cancellation of indebtedness generally results in ordinary income for the debtor (“COD income”), the Internal Revenue Code provides for several exceptions under which COD income can be excluded. Of particular importance for owners of real estate is section 108(c), under which a taxpayer can elect to exclude COD income that results from the discharge of “qualified real property business indebtedness” (“QRPBI”) under certain circumstances. The IRS recently interpreted one of the requirements for debt to constitute QRPBI in a manner that will cause debt secured by condominium units held for sale to fail to qualify.

Background

Under Code section 108(c), a taxpayer can elect for debt to be QRPBI if (i) 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 (the “qualifying real property”) and (ii) the debt was incurred or assumed to acquire, construct, reconstruct, or substantially improve such property.

Even if a taxpayer elects for cancelled debt to be QRPBI, there are still certain restrictions that can limit the taxpayer’s ability to elect under section 108(c) to exclude COD income. First,

the amount of the COD income excluded from gross income from the discharge of QRPBI is generally limited to the excess of (i) the outstanding principal amount of the debt immediately before the discharge over (ii) the fair market value of the qualifying real property at that time. Second, the amount of COD income that a taxpayer can exclude from a discharge of QRPBI cannot exceed the aggregate adjusted basis of all depreciable real property held by the taxpayer immediately before the discharge.

In exchange for the exclusion of COD income resulting from the discharge of QRPBI, the taxpayer must reduce the basis of depreciable real property of the taxpayer by the amount of the exclusion. Thus, section 108(c) in effect provides for a deferral of COD income. The Treasury Regulations include an ordering rule under which a taxpayer must first reduce the basis of the qualifying real property before reducing the basis of other depreciable real property.

In the case of debt of a partnership, the election for debt to be QRPBI is made at the partner level, and the Treasury Regulations include rules that provide for a taxpayer’s share of the basis of depreciable property of a partnership to be reduced.

Revenue Ruling 2016-15

In 2016, the IRS issued Revenue Ruling 2016-15 (2016-26 I.R.B. 1060), which considered whether debt constitutes QRPBI in two scenarios. The first scenario involved a simple fact pattern

involving debt secured by an apartment building held for rental, where the taxpayer was able to elect for the debt to be QRPBI and exclude COD income.

In the second scenario, the taxpayer owed an \$8,000,000 debt secured by a residential community consisting of lots held primarily for sale. The value of the property had fallen to \$5,000,000, and the lender agreed to accept \$5,250,000 of cash in satisfaction of the \$8,000,000 loan. The taxpayer would recognize \$2,750,000 of COD income (i.e., the \$8,000,000 amount owed minus the \$5,250,000 that was accepted by the lender) unless the taxpayer were able to elect under section 108(c) for the COD income to be excluded.

The revenue ruling noted that the debt in this scenario is secured by property that is considered to be “held by the taxpayer primarily for sale to customers in the ordinary course of his trade or business” (commonly referred to as “dealer property”), which is not depreciable. The revenue ruling concluded that such debt does not meet the requirement that QRPBI must be secured by “real property used in a trade or business.” As a result, the IRS ruled that the taxpayer was unable to elect to treat the debt as QRPBI.

The revenue ruling made two arguments in support of this conclusion. First, it noted that the Treasury Regulations require that a taxpayer electing for debt to be QRPBI must “reduce the ad-

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justed basis of the qualifying real property to the extent of the discharged [QRPBI] before reducing the adjusted bases of other depreciable real property.” The revenue ruling explained that if debt secured by dealer property could constitute QRPBI, then the taxpayer would not be able to reduce the basis of the qualifying real property in such a case (since the basis reduction must be made with respect to depreciable real property). Instead, the full basis reduction would have to be made with respect to other real property of the taxpayer that is depreciable.

In addition, the revenue ruling cited the legislative history behind section 108(c), which stated that the deferral of COD income under section 108(c) “generally... should not extend beyond the period that the taxpayer owns the [qualifying real property].” The revenue ruling explained that if debt secured by

dealer property can constitute QRPBI, it “would create deferrals of COD income that extend well beyond the period the taxpayer holds the [dealer property] because the taxpayer would need to reduce the basis of depreciable real property unrelated to the indebtedness, and typically a taxpayer holds depreciable business property substantially longer than it holds [dealer property].”

Analysis

Neither of the arguments made by Revenue Ruling 2016-15 in support of its conclusion seems particularly compelling. While the Treasury Regulations provide that a taxpayer electing for debt to be QRPBI must first reduce the basis in the qualifying real property, that requirement could easily be interpreted to apply only if the qualifying real property is depreciable. The revenue ruling’s argument based on the legislative history

appears to be even more questionable, given that the legislative history merely expresses the intent that the deferral of COD income “generally” should not extend beyond the period that the taxpayer owns the qualifying real property. It does not seem clear that this congressional intent would be violated by having taxpayers make the full basis reduction to other real property if the qualifying real property is non-depreciable (as would be the case if the qualifying real property has a basis of \$0).

Were a taxpayer to contest the conclusion of Revenue Ruling 2016-15 in court, the IRS would benefit from the fact that courts generally grant some level of deference to revenue rulings (albeit a lower level of deference than is granted to Treasury Regulations). It would be interesting to see the outcome!

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