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### Real Estate Workouts: Cancellation of Indebtedness Income, Part III

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The past two columns (See [Part I](#) and [Part II](#)) we discussed cancellation of indebtedness income (COD income) in the context of restructuring or work out of a troubled property or a mortgage securing the property (troubled loan) where the property does not generate sufficient cash to service the troubled loan or maintain the troubled property. This column continues the discussion in the context of when a partnership and/or LLC is the entity that owns the troubled property.

The April column reviewed the bankruptcy and insolvency exceptions to the COD income rules in connection with a restructuring or workout of a troubled loan.

**Applying the Bankruptcy and Insolvency Exemptions to Partnerships and LLCs.** Code Section 108(d)(6) specifically provides that the bankruptcy and insolvency exceptions to COD income apply at the individual partner rather than the partnership level. The effect of applying Code Section 108(d)(6) at the partner level is illustrated by the following example.

Assume that the liabilities of a partnership exceed the value of its assets, and that the partners are equal partners in every respect. A lender of the partnership discharges partnership indebtedness. Applying Code Section 108(a) at the partnership level results in no income to the partnership, assuming that the partnership is either bankrupt or insolvent for purposes of Code Section 108(a). As such, no income would be allocated to the partners but there would be a Code Section 752 deemed distribution of money to the extent of the decrease of each partner's share of the partnership's liabilities. Thus, the adjusted bases of the partners' interests in the partnership will be decreased by the amount of the deemed distribution without a corresponding increase, since no income from the discharge was allocated. If the deemed distribution of money to the partners exceeds their adjusted bases in their partnership interests, Code Section 731 requires them to recognize "phantom" gain on the excess as a result of the distribution.

On the other hand, applying Code Section 108(a) at the partner level results in partnership COD income, which must be allocated to the partners. The allocated income increases the partners' bases, which, in this example, will fully offset the decrease in their bases on account of the reduction of the partnership's liabilities. The partners will be required to include the COD income in their gross income unless one of the exceptions to the recognition of such income applies.

In a 1996 Technical Advice<sup>1</sup> the IRS ruled that when a bankruptcy court discharges a partner from his share of the partnership's debt, the partner's tax consequences are not determined under the debt discharge provisions and the bankruptcy exception, but rather under Code Sections 731 and 752. The effect is a cash distribution deemed to be made to the partner as a result of the debt discharge.

In the Technical Advice, T, the taxpayer, was a partner in ABC. ABC's partnership agreement allocated to T one-third of ABC's secured recourse debt. T filed a chapter 7 bankruptcy petition listing his share of the ABC secured debt as a liability. At the time, T had a negative capital

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account of \$91,000 and a basis in his ABC interest of \$18,000. The bankruptcy court released T from all dischargeable debts, including his \$93,000 share of ABC's \$279,000 secured debt. T's bankruptcy estate closed before the end of 1992, at which time the partnership interest reverted to T. T claimed that the bankruptcy discharge of his share of ABC recourse debt gave rise to COD income that was excluded under the bankruptcy exception.

The IRS reasoned that T did not incur COD income, which arises only where a taxpayer is discharged from his or her own debt. The IRS pointed out that the bankruptcy discharge applied only to T and did not reduce or eliminate ABC's recourse debt. T did not establish that the debt would probably never be repaid, that ABC did not intend to repay the debt, or that the creditor did not intend to enforce his claim against ABC. Since ABC realized no COD income, the IRS said that no COD income flowed through from ABC to T from the bankruptcy court's discharge of T's share of partnership debt. Instead, the two remaining partners in ABC each assumed one-half rather than their former one-third of ABC's debt.

The IRS ruled that the bankruptcy court's discharge of T's share of partnership debt caused a reduction in shared partnership liabilities which, under Code Section 752(b), creates a deemed cash distribution equal to the amount of the reduction. The IRS cited Rev. Rul. 94-4<sup>2</sup>—the distribution is treated as an advance that is taken into account at the end of the partnership tax year. Since the partnership was on a calendar year, the deemed distribution of T's \$93,000 recourse debt took place on Dec. 31, 1992, at which time T's bankruptcy estate was closed and the partnership interest with a tax basis of \$18,000 reverted to T. Therefore, the IRS ruled that T recognized a gain of \$75,000 (\$93,000 deemed distribution less \$18,000 basis in the partnership interest).

**Purchase Money Debt Exception.** Prior to the Bankruptcy Tax Act, several courts permitted taxpayers to exclude from gross income amounts resulting from the discharge of indebtedness incurred in connection with the acquisition of property, provided that there was a corresponding reduction in the value of the underlying property below the amount of the indebtedness.<sup>3</sup> Instead of recognizing income, the taxpayer was required to reduce its adjusted tax basis in the property by the amount of the debt reduction.

There are, however, several limitations formulated by the courts which prevent the application of the exception in the following instances: (1) where the debt is not owed to the original seller of the property (i.e., it is not purchase money debt); (2) where the fair market value of the property is not less than the amount of debt outstanding at the time of the cancellation or reduction of the debt; and (3) where the debtor previously sold the property which gave rise to the debt now being cancelled and the debt had been reflected in the debtor's basis in the property for purposes of determining gain or loss on the sale.

The Bankruptcy Tax Act codified the judicial purchase price exception, with certain modifications, when it added Code Section 108(e)(5). In general, Code Section 108(e)(5) provides that the reduction of indebtedness of a taxpayer that is attributable to a reduction in the purchase money debt owed by the taxpayer to the seller of the underlying property is treated as a purchase price adjustment rather than COD income, provided the purchase money debt reduction (1) is between the original seller/creditor of the property and the original buyer/debtor of the property, and (2) does not occur in either a Title 11 bankruptcy case or when the debtor is insolvent. Thus, if the purchase money debt exception applies, the debtor's basis in the underlying property is decreased in lieu of the debtor realizing COD income or having his tax attributes reduced.

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In Rev. Rul. 92-99,<sup>4</sup> however, the IRS held that it would not follow the pre-Bankruptcy Tax Act holding of the *Hirsch* and *Allen* decisions that no COD income resulted from a reduction of third-party debt. (See note 3.) The IRS reasoned that an agreement to reduce a debt between a purchaser and a third-party lender is not a true adjustment of the purchase price paid for the property because the seller does not receive the entire purchase price from the purchaser and is not a party to the debt reduction agreement. Accordingly, the IRS position seems to prohibit all reductions of debt by a third-party creditor even if the reduction is accomplished pursuant to an arrangement between the seller of the property and a new purchaser.

In Rev. Proc. 92-92<sup>5</sup> the IRS stated that it would not challenge a bankrupt or insolvent partnership's treatment of a reduction of a debt of the partnership to a seller as a purchase price adjustment under Code Section 108(e)(5), provided that all the partners of the partnership adopted a consistent federal income tax reporting position with respect to the treatment. Thus, Rev. Proc. 92-92 produces two favorable results for the taxpayers: (1) it permits characterization of a debt reduction as a purchase price adjustment at the partnership level thereby eliminating the need to examine whether each partner of the partnership is in a bankruptcy proceeding or insolvent; and (2) in the case of partnerships, it disregards the normal requirement of Code Section 108(e)(5) that the taxpayer claiming the purchase money debt exception be neither in a bankruptcy proceeding nor insolvent.

**Lost Deduction Exception.** Code Section 108(e)(2) provides that the discharge of a debt will not give rise to COD income to the extent that payment of the liability would have given rise to a deduction. Accordingly, debt owed to trade creditors and certain liability claims that are discharged will not give rise to COD income. The lost deduction exception generally applies to cash method taxpayers who have incurred a deductible obligation but have not yet paid the obligation. It is presently unclear to what extent, if any, the lost deduction exception would apply to accrual method taxpayers who claimed a deduction prior to the discharge of the obligation, when the deduction did not result in a tax benefit to the taxpayer. If a real estate partnership or LLC has a corporation as a general partner or as a managing member, and is required to use the accrual method of accounting, the issue must be considered before relying on the exception to avoid COD income. Code Section 448(a)(3).

Similarly, it is also unclear whether the lost deduction exception should be applied at the partner or at the partnership level. If the exception is applied at the partnership level, a Code Section 752(b) deemed cash distribution occurs with no offsetting basis increase for COD income. Consequently, the partners may recognize phantom income to the extent the deemed cash distribution exceeds their adjusted bases in their partnership interests. Conversely, if the exception is applied at the partner level, a portion of the partnership indebtedness must be treated as being held by the partners directly and it is unclear how such an allocation of the debt should be made.

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