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Real Estate Workouts: Cancellation of Indebtedness Income, Part IV

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The past three columns¹ discussed cancellation of indebtedness income (COD Income) in the context of restructuring or workout of a troubled property or a mortgage securing the property (referred to here as a "troubled loan") where the property does not generate sufficient cash to service the troubled loan or maintain the troubled property. This column furthers the analysis, discussing additional exceptions to the realization of COD Income.

Qualified real property business indebtedness exception. The Revenue Reconciliation Act of 1993² added Code Section 108(c), allowing taxpayers, other than C corporations, to elect to exclude income from the discharge of "qualified real property business indebtedness" (QRPBI). QRPBI is indebtedness that is incurred in connection with real property used in a trade or business, is secured by such real property and is either (a) incurred or assumed before Jan. 1, 1993 (or debt incurred on or after that date to refinance such debt); or (b) incurred or assumed on or after that date to acquire, construct or substantially improve the real property by which it is secured (or debt incurred to refinance such debt).

The amount of discharged QRPBI that may be excluded from income may not exceed (i) the excess of the principal amount of the debt over the fair market value (FMV) of the taxpayer's depreciable real property that secures such debt (which value, for these purposes, is reduced by any other QRPBI secured by the real property) or (ii) the aggregate adjusted bases of the taxpayer's depreciable real property as of the first day of the following taxable year or, if earlier, the date of disposition of any such real property. A taxpayer who elects to exclude any amount of cancelled QRPBI under this rule must reduce the basis of its depreciable real property by any such amount.

For example, assume Taxpayer A is solvent and owns a building, used in a trade or business, with an FMV of \$150,000. The building is encumbered by a first mortgage of \$110,000 and a second mortgage of \$90,000; both mortgages were incurred in 2007. A's adjusted basis in the building is \$70,000. On Dec. 21, 2009, A and the second mortgagee agree to reduce the outstanding balance of the second mortgage from \$90,000 to \$30,000, an action that would generally result in \$60,000 of COD Income being recognized by A.

Under Code Section 108(c), however, a portion of the \$60,000 may be excluded from A's income, equal to the lesser of (1) the excess of the principal amount of the debt being discharged over the FMV of the taxpayer's depreciable real property securing such debt (reduced by any other qualified indebtedness)—i.e., \$90,000 minus [\$150,000 minus \$110,000] which equals \$50,000; or (2) the aggregate of the adjusted basis of the taxpayer's depreciable real property as of the first day of the following taxable year, \$70,000. Accordingly, \$50,000 of the \$60,000 COD Income may be excluded, and the remaining \$10,000 must be included, in A's gross income for 2009.

A must reduce the basis of his depreciable real property by \$50,000. The exception, however, does not provide much of a benefit to partners in a Partnership with QRPBI. Code Section 108(d)(6) specifically provides that the exceptions contained in, inter alia, Code Sections 108(a) and 108(c) apply at the individual partner rather than the partnership level.

Accordingly, under the deemed partnership distribution rules of Code Section 752, the reduction in a partner's share of the partnership's debt will be treated as a deemed distribution to such partner which will result in immediate gain to the partner to the extent such distribution exceeds his basis in his partnership

interest. Similarly, the minimum gain chargeback provisions of the regulations under Code Section 704 may require the recognition of gain by the partners as a result of the reduction in partnership debt.

Capital contribution exception. If a debtor corporation owes money to one of its shareholders and the shareholder discharges the debt by contributing it to the capital of the corporation, Code Section 108(e)(6) provides that the corporation will be treated as having satisfied the debt with an amount of money equal to the shareholder's adjusted tax basis in the debt. Neither Code Section 108 nor its legislative history indicate whether such a rule would apply to partnerships.

There is an argument, however, that a general, common law capital contribution exception to COD Income exists with respect to creditor/equity holders and that this exception should apply to partnerships as well. If the common law capital contribution exception is applied to partnerships, some commentators have argued that it is logical to extend the application of Code Section 108(e)(6) to partnerships. Accordingly, if a debtor partnership owes money to one of its partners and the partner cancels the debt by contributing it to the capital of the partnership, the partnership will be treated as having satisfied the debt with an amount of money equal to the partner's adjusted basis in the debt.

Even if it is determined that Code Section 108(e)(6) applies to partnerships, Code Section 108(d)(6) does not indicate whether the 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 distribution of money occurs with no offsetting increase in basis for COD Income. Accordingly, the partners could 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 debt would have to be treated as being held by the partners directly and the exception would then be applied by the partners to eliminate the recognition of their share of COD Income passed through by the partnership. In this case, however, the partners' adjusted bases in their partnership interests will be increased by their share of COD Income. As a result, they should not recognize phantom gain as a result of the deemed distribution of money pursuant to Code Section 752(b).

The tax consequences of the Code Section 752(b) deemed distribution of money will also depend on the manner in which the debt owed to the partner was allocated by the partnership under Code Section 752. If the lending partner who forgave the debt was allocated all of the debt under Code Section 752, then only that partner would be treated as receiving a deemed distribution of money under Code Section 752(b). However, if the partnership has allocated the debt to the basis of other partners, a Code Section 752(b) deemed distribution of money to the other partners will occur upon the lending partner's contribution of the debt to the partnership's capital.

Proposed regulations on COD Income in debt-for-equity exchanges by partnerships. Code Section 108(e)(8), as amended, provides that for purposes of determining COD Income of a partnership debtor from discharge of indebtedness, if a debtor partnership transfers a capital or profits interest in the partnership to a creditor in satisfaction of its recourse or nonrecourse indebtedness, the partnership shall be treated as having satisfied the indebtedness with any amount of money equal to the FMV of the interest. Any COD income recognized shall be included in the distributive shares of the partners in the partnership immediately before such discharge.

In October 2008, the IRS issued proposed regulations on determining the COD Income of a partnership that transfers a partnership interest to a creditor to satisfy a debt (a "debt-for-equity" exchange).³ Code Section 108(e)(8) provides that a partnership is treated as satisfying the indebtedness for an amount equal to the FMV of the partnership interest transferred to the creditor for purposes of determining COD Income. The amount by which the indebtedness exceeds the FMV of the transferred partnership interest immediately before the discharge is the amount of COD Income that is required to be included in the distributive shares of the partners.

Value of the partnership interest. The proposed regulations provide that the appropriate measure of the FMV of the transferred partnership interest is its liquidation value, assuming certain requirements are satisfied. For this purpose, liquidation value equals the amount of cash that the creditor would receive with respect to the debt-for-equity interest if, immediately after the transfer, the partnership sold all of its assets (including all intangible assets) for cash equal to the FMV of those assets and then liquidated.

The FMV of a debt-for-equity interest is the liquidation value of that interest if the following conditions are met:

- 1) The debtor partnership determines and maintains capital accounts of its partners in accordance with the rules of Reg. §1.704-1(b)(2)(iv);
- 2) The creditor, debtor partnership, and its partners treat the FMV of the indebtedness as being equal to the liquidation value of the debt-for-equity interest for purposes of determining the tax consequences of the debt-for-equity exchange;
- 3) The debt-for-equity exchange is an arm's length-transaction; and
- 4) Subsequent to the debt-for-equity exchange, neither the partnership redeems, nor any person related to the partnership purchases, the debt-for-equity interest as part of a plan at the time of the debt-for-equity exchange that has as a principal purpose the avoidance of COD Income by the partnership.

If these conditions are not satisfied, all of the facts and circumstances are considered in determining the FMV of the debt-for-equity interest for purposes of Code Section 108(e)(8).

Value of the indebtedness. The proposed regulations further provide that the nonrecognition rule under Code Section 721 will generally apply to debt-for-equity exchanges, where the creditors contribute a partnership's recourse or nonrecourse indebtedness to the partnership in exchange for a capital or profits interest in the partnership. The creditor's basis in the debt-for-equity interest received in the debt-for-equity exchange that is subject to Code Section 721 would be increased by the adjusted basis of the indebtedness.

The proposed regulations also provide that Code Section 721 does not apply to the transfer of a partnership interest to a creditor in satisfaction of a partnership's indebtedness for unpaid rent, royalties, or interest on indebtedness (including accrued original issue discount). The proposed regulations do not supersede the rules under Code Section 453B relating to dispositions of installment obligations.

Effective date. The proposed regulations are proposed to apply to debt-for-equity exchanges occurring on or after the date that the final regulations are published in the Federal Register.

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Endnotes:

1. NYLJ, [Feb. 2, 2011](#), [April 6, 2011](#), [June 3, 2011](#).
2. Revenue Reconciliation Act of 1993, Pub. L. No. 101-508, 104 Stat. 1388.
3. See, REG-164370-05, (Oct. 30, 2008); 73 Fed. Reg. 64,905 (Oct. 31, 2008).