

IRS AND TREASURY DEPARTMENT CLARIFY COD INCOME EXCLUSIONS"

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By: Mitchell W. Goldberg

Internal Revenue Code (the "Code") § 108 excludes cancellation of indebtedness income ("COD income", i.e. income realized upon the discharge of a debt) to the extent the debt discharge occurred in a bankruptcy case under title 11 of the United States Code (the "bankruptcy exclusion"), to the extent the taxpayer was insolvent immediately prior to the discharge (the "insolvency exception"), or, for taxpayers other than a C corporation, to the extent the debt discharged is qualified real property business indebtedness (the "QRPBI exception", subject to certain limitations), among other exclusions.

On June 9, 2016, the Treasury Department released final regulations which clarify the application of the bankruptcy exception and insolvency exception to single member limited liability companies taxed as a disregarded entity ("SMLLC") and grantor trusts. The final regulations provide that, in order to exclude COD income under the bankruptcy exception, the owner of the grantor trust or SMLLC must be under the jurisdiction of the bankruptcy court as the "debtor" in a title 11 case; it is insufficient for the only grantor trust or SMLLC to be under the jurisdiction of the bankruptcy court. When the owner of the grantor trust or SMLLC is a partnership, the partner to whom the COD income is allocable must be a "debtor" in a title 11 bankruptcy proceeding subject to the court's jurisdiction for the bankruptcy exception to apply to such partner.

The final regulations further provide that the insolvency exception only applies to the extent the owner of the SMLLC or grantor trust is insolvent. If the SMLLC or grantor trust is insolvent but the owner thereof is solvent, the insolvency exception does not apply. The Treasury Department noted in the preamble to the final regulations that indebtedness of a SMLLC or grantor trust is treated as nonrecourse debt with respect to the owner thereof (to the extent such owner is not a guarantor or otherwise liable for repayment) for purposes of determining whether such owner was insolvent and, further, that the Treasury Department and IRS anticipate publishing additional guidance on this issue.

Qualified real property business indebtedness generally refers to indebtedness incurred or assumed in connection with real property used in a trade or business and secured by such real property. A taxpayer who excludes COD income under the QRPBI exception is required to reduce her basis in other depreciable real property to the extent COD income is excluded, starting first with the property securing the discharged debt and then other depreciable real property. This makes the QRPBI exception a deferral rather than a true exclusion and such deferral is generally not meant to extend beyond the period the taxpayer holds the subject property.

On June 10, 2016, the IRS released Rev. Rul. 2016-15, 2016-26, clarifying the application of the QRPBI exception. In Rev. Rul. 2016-15, 2016-26, the IRS analyzed two factual scenarios: (1) a taxpayer (other than a C corporation) acquired an apartment building to lease in connection with such taxpayer's leasing business by borrowing funds and granting a mortgage on the building, and (2) a taxpayer (other than a C corporation) acquired real property to develop and hold for sale in connection with such taxpayer's business of developing and holding real property for sale by borrowing funds and granting a mortgage on the real property. The IRS determined that, where the lender in scenario (1) discharges the debt, the QRPBI exception applies to the real property developed and held by a taxpayer for lease in its leasing business. However, the IRS determined that, where the lender in scenario (2) discharges the debt, the QRPBI exception does not apply to real property

held by a taxpayer primarily for sale to customers in the ordinary course of business. The IRS' determination that scenario (2) does not qualify for the QRPBI exception was based primarily on the fact that, unlike the real property in scenario (1) which is subject to depreciation, the real estate in scenario (2) is held primarily for sale to customers and therefore is not subject to depreciation. The IRS reasoned that, to allow the taxpayer in scenario (2) to avail herself of the QRPBI exception, despite not being able to reduce the basis in the applicable real estate, would be incongruous with congressional intent that the deferral resulting from the QRPBI exception not extend beyond the period the taxpayer holds the applicable real estate.

If you have any questions on this topic, please contact the author, Mitchell W. Goldberg, on the firm's Business, Finance & Tax Team.

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