

TAXATION SECTION OF THE DISTRICT OF COLUMBIA BAR
EXECUTIVE SUMMARY OF COMMENTS ON SECTION 108(C)
PERTAINING TO QUALIFIED REAL PROPERTY BUSINESS INDEBTEDNESS

I. GENERAL

The Taxation Section of the District of Columbia Bar herewith submits recommendations for guidance regarding the cancellation of debt provision relating to qualified real property business indebtedness that was included in the Omnibus Budget Reconciliation Act of 1993.

II. AREAS WHERE GUIDANCE IS NEEDED

A. "Real Property Used In a Trade or Business"

For purposes of Section 108(c)(3)(A), the definition of "real property used in a trade or business" should be clarified as including dealer property and property held for one year or less.

B. Limitation of Relief to Principal Amount.

"Principal amount" for purposes of the limitation of relief under Section 108(c) to the principal amount of qualifying indebtedness should be defined to mean adjusted issue price within the meaning of Treas. Reg. § 1.1275-1(b) as adjusted for unamortized premium (plus accrued but unpaid interest in the case of an accrual basis taxpayer).

C. The "In Connection With" Requirement

The regulations should state that indebtedness was incurred or assumed "in connection with" real property used in a trade or business when either (i) the indebtedness was secured by the real property at the time it was incurred or assumed or (ii) the proceeds of the indebtedness were used in the trade or business in which the taxpayer used the real property, including but not limited to the acquisition, construction, reconstruction, or substantial improvement of such property.

D. Cross-Collateralization Abuse

The regulations should state that indebtedness secured by real property will be ignored for purposes of the Section 108(c)(2)(A) limitation when the principal purpose for granting the security interest was to circumvent the Section 108(c)(2)(A) limitation. Factors that might indicate that the principal purpose is abusive would include: (a) the indebtedness was already adequately secured by property, adequate security being defined as the value of the property available to satisfy the indebtedness (i.e., net of senior liens) exceeding the indebtedness by 50%, and (b) the security interest was valueless, in the sense that the amount of senior liens exceeded the additional property's entire value. We also recommend that all security interests granted at least one year before the debt is forgiven be treated as not granted for the principal purpose of circumventing the limitation.

E. Co-ordination of Section 1017(b)(3)(C) with Section 704(c)

A taxpayer's partnership interest is treated as depreciable real property "to the extent of such partner's proportionate interest" in such property for purposes of the reduction in basis mandated by Section 108(c)(1)(A). A partner's "proportionate interest" in the real property for Section 1017(b)(3)(C) purposes should reflect the effect of the taxpayer's choice of reasonable method to comply with Section 704(c).

June 30, 1994

COMMENTS ON I.R.C. SECTION 108(C)
PERTAINING TO QUALIFIED
REAL PROPERTY BUSINESS INDEBTEDNESS

The following comments represent the views of the Section of Taxation of the District of Columbia Bar Association. Primary drafting responsibility for this report was exercised by Blake D. Rubin, Charles Hwang, and Christian M. McBurney of the Committee on Pass-Throughs and Real Estate.¹ The contact person for this report is Blake D. Rubin, whose telephone number is (202) 429-6211.

I. Introduction

The Omnibus Budget Reconciliation Act of 1993 (the "1993 Act") provides a new exclusion for certain cancellation of debt ("COD") income, effective for cancellations occurring after December 31, 1992. Under new Internal Revenue Code ("Code") Section 108(c), a taxpayer other than a C corporation may elect to exclude income arising from the discharge of "qualified real

¹ The views expressed herein represent only those of the Section of Taxation of the District of Columbia Bar and do not represent those of the District of Columbia Bar or its Board of Governors.

The comments expressed have been approved by the Steering Committee and the Tax Policy Task Force of the Section of Taxation of the District of Columbia Bar, which Section has approximately 1,500 members. The Steering Committee of the Section of Taxation is chaired by Patricia G. Lewis. The Section's Tax Policy Task Force is chaired by Roderick A. DeArment and William J. Wilkins. The Pass-Through Entities and Real Estate Committee is chaired by Blake D. Rubin.

property business indebtedness." Under the law prior to the 1993 Act, there was no exception from the recognition of COD arising from the discharge of debt associated with real estate unless the discharge occurred in a Title 11 (i.e., bankruptcy) case, while the taxpayer was insolvent, or with respect to certain farm indebtedness.² If one of these exceptions did apply, the amount of COD excluded from income was applied to reduce certain tax attributes of the taxpayer.³ New section 108(c) permits the taxpayer to elect to exclude COD income on the condition that the taxpayer reduce basis in depreciable real property in an amount equal to the excluded income.

The following comments address selected interpretive issues that we recommend be considered in regulations under Section 108(c).

II. "Real Property Used In a Trade or Business"

Qualified real property business indebtedness is indebtedness with respect to which the taxpayer elects that (i) was incurred or assumed in connection with real property used in a trade or business, (ii) is secured by such real property, and (iii) if incurred on or after January 1, 1993, is "qualified acquisition indebtedness" (i.e., indebtedness incurred to

² I.R.C. § 108(a)(1).

³ Section 108(b).

acquire, construct, reconstruct or substantially improve the real property secured by such debt).⁴ Qualified real property indebtedness also includes indebtedness resulting from refinancing qualifying debt, but only to the extent the new debt does not exceed the amount of indebtedness refinanced.⁵

Neither the statute nor the legislative history provides any guidance as to the meaning of "real property used in a trade or business." The phrase "real property used in a trade or business" occurs three times in the Code outside of Section 108(c). In Section 1221(a)(2), "real property used in [a] trade or business" is excluded from the definition of capital asset. Under Section 1231(b)(1), the term "property used in the trade or business" is defined to include "real property used in the trade or business," but only if the real property is held for more than one year and is not held primarily for sale to customers in the ordinary course of a trade or business (i.e., is not "dealer" property). The effect of this definition is to treat "real property used in the trade or business" as a Section 1231 asset. The third instance of this phrase is in Section 172(d)(4), in which gain or loss from the sale or exchange of "real property used in [a] trade or business" is treated as attributable to such trade or business for purposes of the Section 172 restriction on net operating losses discussed below.

⁴ I.R.C. § 108(c)(3) and (4).

⁵ I.R.C. 108(c)(3).

The regulations under Section 108(c) could define the term "real property used in a trade or business" by reference to Section 1231(b)(1), so that the one-year holding period requirement would apply and dealer property would be excluded. In that case, income from the cancellation of indebtedness incurred in connection with a homebuilding or other dealer activity would not qualify for the exclusion.

We recommend against such limitations on the definition of "real property used in a trade or business" for purposes of section 108(c). The other instances of this phrase do not carry such limitations. Moreover, no policy purpose would be served by such a narrow definition.

The phrase "real property used in a trade or business" apparently first came into the Code as part of the Revenue Act of 1942.⁶ The Revenue Act of 1942 enacted the predecessor provisions⁷ to Sections 1231(b) and 1221(a)(2), which predecessor provisions replicate in pertinent part the language in the current Code sections. The legislative history indicates that the 1942 change was conceived of as a shift of a single class of assets out of the capital asset definition and into the predecessor of Section 1231.⁸ As inspection of current Sections

⁶ Pub. L. No. 77-753, § 151, 56 Stat. 798, 846 (1942).

⁷ Former Sections 117(a)(1) and 117(j).

⁸ S. Rep. No. 1631, 77th Cong., 2d Sess., reprinted in 1942-2 C.B. 504, 545 ("Your committee has changed this rule by taking

(continued...)

1221(a)(2) and 1231(b)(1) indicates, the mechanism by which this shift was effected was somewhat different in the case of the exclusion from the capital asset definition and in the case of the inclusion in the category of assets treated under the predecessor to Section 1231. Section 1221(a)(2) excludes "real property used in [a] trade or business," while Section 1231(b)(1) includes only "real property used in [a] trade or business" that satisfies the holding period requirement and is not dealer property. This difference in language is only natural, since in 1942 dealer property was already excluded from the definition of capital assets, and since there would have been little point to including in the definition of capital assets property that would not receive preferential treatment under the capital gain rules by virtue of not meeting the long-term holding requirement. Thus, it is certainly not the case that "real property used in [a] trade or business" as used in Section 1221(a)(2) incorporates the holding period restriction of Section 1231(b)(1). If that were true, real property used in a trade or business but held for less than a year would be a capital asset, the gain or loss with respect to which would be short-term capital gain or loss.

The explicit "carve-outs" in Section 1231(b)(1) of property held for one year or less and dealer property may indicate that, absent such "carve-outs," the term "real property

⁸ (...continued)

buildings and real estate used in the trade or business of the taxpayer out of the definition of capital assets, and applying to them [the predecessor to Section 1231].")

used in the trade or business" includes such property. Since there are no such "carve-outs" in Section 108(c), arguably Section 1231(b) supports the conclusion that dealer property and property held for one year or less can qualify as "real property used in a trade or business." Moreover, from a policy perspective, it is difficult to see why dealer property and/or property held for one year or less should be excluded from the relief provision. Arguably, the trade or business requirement was intended to exclude only "personal use property" such as a personal residence.⁹

The phrase "real property used in the trade or business" also occurs in section 172(d)(4)(A). Section 172(d)(4) generally provides that, in computing the net operating loss of taxpayers other than corporations, deductions not attributable to a trade or business may only offset income not attributable to a trade or business. Section 172(d)(4)(A) provides, inter alia, that gains or losses from the sale of "real property used in the trade or business" shall be treated as attributable to a trade or business.¹⁰ Real property held for sale as a dealer has long

⁹ Cf. I.R.C. § 1275(b)(3).

¹⁰ Section 172(d)(4) was enacted as part of the 1954 Internal Revenue Code in order to overturn the result in Sic v. Comm'r, 10 T.C. 1096 (1948), aff'd, 177 F.2d 469 (8th Cir. 1949), cert. den., 339 U.S. 913 (1950). See H. Rep. No. 1337, 83rd Cong., 2d Sess. (1954), reprinted in 1954 U.S.C.C.A.N. 4025, 4052, 4193; S. Rep. No. 1622, 83rd Cong., 2d Sess. (1954), reprinted in 1954 U.S.C.C.A.N. 4629, 4663, 4849. In Sic, a loss arising out of the sale of a farm by a farmer was treated as not attributable to the farmer's trade or business because the farmer did not have a trade or business of selling real estate. 10 T.C. at 1098-99.

been recognized as "real property used in the trade or business" for purposes of Section 172(d)(4). See, e.g., Weber v. Kavanagh 52 F. Supp. 619 (E.D. Mich. 1943). Likewise, real property held for sale as a dealer should be included in definition of "real property used in the trade or business" for purposes of section 108(c).

III. Limitation of Relief to Principal Amount

Section 108(c)(2)(A) generally provides that the amount of income that may be excluded may not exceed the excess (if any) of the outstanding principal amount of the indebtedness over the fair market value of the property.¹¹ Under a literal reading of this provision, the amount of any accrued but unpaid interest at the time of cancellation would not enter into the computation of the limitation. However, for an accrual method taxpayer who has accrued and deducted the interest, cancellation of the interest gives rise to cancellation of indebtedness income, rather than some other form of income under a "tax benefit" theory.¹² In such a case, it is difficult to discern a policy rationale for excluding the accrued interest in computing the limitation. The issue is illustrated by the following example:

¹¹ If the property is subject to more than one qualified real property business indebtedness, the fair market value for this purpose is reduced by the outstanding principal amount of the qualified indebtedness that is not the subject of the cancellation of indebtedness transaction.

¹² See Rev. Rul. 67-200, 1967-1 C.B. 15, clarified by Rev. Rul. 70-406, 1970-2 C.B. 16.

Example 1. E owns a piece of real property subject to qualified real property business indebtedness in the principal amount of \$100. In addition, \$20 of interest has accrued but has not yet been paid. The fair market value of the property is \$60, and the lender is willing to cancel the accrued interest and reduce the principal down to \$60. If E has previously deducted the interest on the accrual method, then this transaction would give rise to \$60 of cancellation of indebtedness income. However, because the principal amount of the debt exceeds the fair market value of the property by only \$40, under a literal reading of the statute, only \$40 of COD could be excluded.

Arguably, if the applicable loan documents provide that accrued but unpaid interest is added to principal, then the \$20 accrued interest should be taken into account in determining the limitation. Moreover, even if the loan documents do not explicitly provide that accrued but unpaid interest is added to principal, the limitation based on principal only apparently could be avoided if E refinanced the indebtedness prior to the forgiveness transaction and issued a new note in the principal amount of \$120. Under the last sentence of Section 108(c)(3), the new debt qualifies as qualified real property business indebtedness so long as it does not exceed the "amount" of the refinanced debt. At least arguably, the term "amount" is

sufficiently comprehensive to include both principal and interest.

Moreover, where the taxpayer has previously deducted accrued but unpaid interest under the accrual method, there does not appear to be any policy reason to distinguish between interest and principal in computing the limitation. Like principal, accrued but unpaid interest must be taken into account both in determining potential COD income and in determining the economic amount by which the real property is "under water."

On the other hand, if the taxpayer uses the cash method of accounting and payment of the interest would give rise to a deduction, then cancellation of the interest will not give rise to cancellation of indebtedness income under Section 108(e)(2). In such a case, it would be appropriate to exclude the accrued but unpaid interest in determining the limitation.

Similar considerations arise with respect to the interaction of the Section 108(c)(2)(A) limitation based on the principal amount of the indebtedness with the rule under Section 108(e)(3) and Treas. Reg. § 1.108(a)-1(b) that the amount of COD income must be decreased for unamortized discount and increased for unamortized premium with respect to the indebtedness. Presumably, the policy behind the Section 108(c)(2)(A) limitation is to limit relief under Section 108(c)(2) to the excess of the amount of COD income that would be recognized if the debt were

cancelled over the value of the property. Consistent with this, the term "principal amount" for Section 108(c)(2) purposes should be defined as adjusted issue price within the meaning of Treas. Reg. § 1.1275-1(b) as adjusted for unamortized premium (and accrued but unpaid interest, as discussed above).

IV. The "In Connection With" Requirement

In order for indebtedness to qualify as qualified real property business indebtedness, the indebtedness must be incurred "in connection with" real property used in a trade or business. The precise scope of this requirement is unclear. Presumably, the "in connection with" requirement does not require that the debt constitute "qualified acquisition indebtedness"; any other conclusion would render redundant the "qualified acquisition indebtedness" rule applicable under Section 108(c)(3)(B) with respect to debts incurred or assumed after 1992.

The fact situation in which this issue is most likely to arise is the pre-1993 cash-out refinancing. To illustrate, assume that a taxpayer in 1987 borrowed \$100 and used the proceeds to construct a building used in a trade or business. In 1989, the taxpayer was able to refinance the debt for \$120, and used the \$20 excess proceeds for a purpose unrelated to the building. If, in 1993 or thereafter, a portion of the debt is forgiven, the issue of whether the \$20 excess amount constitutes qualified real property business indebtedness will turn on

whether such excess amount was incurred "in connection with" the real estate.

As noted above, Section 108(c)(3)(B) requires that post-1992 debt constitute "qualified acquisition indebtedness" in order to qualify for relief. Accordingly, an interpretation of "in connection with" that establishes a similar restriction on the use of debt proceeds for periods prior to 1993 seems inappropriate. If Congress intended such a restriction for pre-1993 debts, Congress would have made the restriction explicit, as it did in Section 108(c)(3)(B). On the other hand, in order to give content to the "in connection with" requirement, it should be interpreted to preclude Section 108(c) relief for taxpayers who incurred or assumed debt "unrelated" to real property that came to be secured by real property used in the taxpayer's trade or business.

Any such requirement of a nexus to the real property should be of minimal significance for debts incurred after 1992, since for those debts the more restrictive "qualified acquisition indebtedness" requirement applies. Moreover, for periods before 1993, satisfaction of the "qualified acquisition indebtedness" definition a fortiori should satisfy the "in connection with" nexus requirement.

We propose that the "in connection with" nexus requirement be satisfied when either (i) the indebtedness was secured by

the real property at the time it was incurred or assumed¹³ or (ii) the proceeds of the indebtedness were used in the trade or business in which the taxpayer used the real property, including but not limited to the uses specified in the definition of "qualified acquisition indebtedness." Our proposed definition permits debts incurred in connection with pre-1993 cash-out refinancings that were secured by the real property to qualify for relief. Our proposed definition also causes pre-1993 indebtedness that satisfies the "qualified acquisition indebtedness" definition to qualify for relief.

V. Cross-Collateralization Abuse

Section 108(c)(5) provides that "[t]he Secretary shall issue such regulations as are necessary to carry out this subsection, including regulations preventing the abuse of this subsection through cross-collateralization or other means." Cross-collateralization issues that might arise under Section 108(c) may be illustrated by the following example:

Example 2. F owns Blackacre and Whiteacre, two pieces of real property used in a trade or business. Blackacre is encumbered by a \$100 debt and is worth \$60.

¹³ Note that Section 108(c)(3)(A) requires that the indebtedness be secured by the real property at the time of cancellation, not that the indebtedness have been so secured at the time of incurrence or assumption.

Whiteacre is encumbered by a \$20 debt and is worth \$100. The lender on the Blackacre debt is willing to reduce the debt down to \$40. This would generate \$60 of COD income, of which only \$40 could be excluded under the limitation of Section 108(c)(2)(A). However, if F were to grant the lender on Whiteacre a \$20 second lien on Blackacre, the Section 108(c)(2)(A) limitation with respect to Blackacre would be increased to \$60, permitting all of the COD to be excluded (absent prohibition of this technique in the regulations).

It would appear that this type of "cross-collateralization" should not be permitted. The \$20 second lien on Blackacre is unlikely to serve a business purpose, since the lender on Whiteacre apparently has sufficient security without the second lien on Blackacre. On the other hand, it is certainly conceivable that, were the value of Whiteacre lower, the second lien on Blackacre would have independent economic significance.

Another example suggests a similar potential abuse:

Example 3. F owns Blackacre and Whiteacre, two pieces of real property used in a trade or business. Blackacre is encumbered by a \$100 debt and is worth \$60. Whiteacre is encumbered by a \$120 debt and is worth \$100. The lender on the Blackacre debt is willing to reduce the debt down to \$40. This would generate \$60 of COD income, of which only \$40 could be

excluded under the limitation of Section 108(c)(2)(A). However, if F were to grant the lender on Blackacre a second lien on Whiteacre with respect to the entire \$100 debt owed to such lender, the Section 108(c)(2)(A) limitation would be increased to \$60, permitting all of the COD to be excluded (absent prohibition of this technique in the regulations).

We propose that these abuses be addressed by a rule stating that, for purposes of the Section 108(c)(2)(A) limitation, indebtedness secured by real property will be ignored when the principal purpose for granting the security interest was to circumvent the limitation. Factors that might indicate that the principal purpose is abusive would include: (a) the indebtedness was already adequately secured by property, adequate security being defined as the value of the property available to satisfy the indebtedness (i.e., net of senior liens) exceeding the indebtedness by 50%, and (b) the security interest was valueless, in the sense that the amount of senior liens on the additional collateral exceeded the additional collateral's entire value. We also recommend that all security interests granted at least one year before the debt is forgiven be treated as not granted for the principal purpose of circumventing the limitation. We believe that the business constraints on lenders faced with workout situations make it unlikely that a security interest would be granted in anticipation of a forgiveness of indebtedness to occur one year thereafter.

VI. Coordination of Section 1017(b)(3)(C) with Section 704(c)

Section 1017(b)(3)(C) generally permits a "look-through" approach with respect to partnership interests held by a taxpayer eligible for Section 108(c) relief. That is, the taxpayer's partnership interest is treated as depreciable real property "to the extent of such partner's proportionate interest" in such property for purposes of the reduction in basis mandated by Section 108(c)(1)(A). However, this rule applies "only if there is a corresponding reduction in the partnership's basis in depreciable [real] property with respect to such partner."

We note here that Section 704(c) and the regulations thereunder, which generally require that allocations of depreciation and other income, gain, loss and deduction with respect to contributed property take account of pre-contribution gain or loss under a reasonable method, bear directly on what a partner's interest in depreciable real property held by the partnership should be. For example, a partner who contributed cash to a partnership to which the sole other (equal) partner contributed appreciated real property may have a greater than 50% share of the real property's depreciation deductions if the "traditional method" (Treas. Reg. § 1.704-3(b)) of compliance with Section 704(c) is elected by the partnership.¹⁴ Such a partner's "proportionate interest" in the real property for Section 1017(b)(3)(C) purposes should reflect the partner's share of

¹⁴ See Treas. Reg. § 1.743-1(b)(2).

depreciation deductions. Furthermore, if the partnership elects the "traditional method with curative allocations" (Treas. Reg. § 1.704-3(c)) or the "remedial allocation method" (Treas. Reg. § 1.704-3T(d)), such partner's interest in the real property may be more accurately described in terms of the partner's share of the partnership's book basis in the property rather than the tax basis.

We recommend that these interactions with Section 704(c) and the regulations thereunder be appropriately reflected in regulations implementing the "look-through" concept of Section 1017(b)(3)(C).