Congress Passes Tax Relief through 2010 for Solvent Debtors Holding Real Estate

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We are all aware of the economic crisis affecting real estate and other businesses. Many in the real estate bar are also somewhat or passingly familiar with tax issues that can arise from restructuring, retiring or otherwise modifying the underlying debt of an enterprise favorable to the debtor. In short, we have to deal with aspects of cancellation of indebtedness income ("COD") at the time of such event, i.e. does it apply, if it applies are there any exemptions or other rules to lessen the tax impact.[2] The American Recovery and Reinvestment Act of 2009 (the "2009 Act"), signed into law by President Obama on February 17, 2009, includes a provision that adds tax relief for the solvent real estate debtor (and in certain circumstances the insolvent debtor) for COD realized in 2009 and 2010. Thus, there is a short window of opportunity presently available to use this new tool.

Background

COD in General

So what exactly is COD and how is it taxed for federal income tax purposes? Section 61(a)(12) of the Internal Revenue Code of 1986, as amended (the "Code") provides that gross income includes income from discharge of indebtedness. It is treated as ordinary income and not capital gains. COD is generally equal to the excess of the adjusted issue price of the debt being satisfied (in general, for debt without original issue discount ("OID"), the current outstanding principal balance amount or, if there is OID, the original issue price plus accrued unpaid interest less payments of principal) over the amounts paid to satisfy such debt.[3]

> **Example 1** – Assume that a limited liability company ("LLC") held equally by five U.S. resident members owns a single rental building acquired in 2003 for $90 million with its sole mortgage of $80 million outstanding. Two of the members are insolvent to the extent of $5 million each and the other three are very solvent. Assume further the property has dropped in value to $55 million today and that the lender agrees with the owner to reduce the principal amount of the loan to $60 million.

As real estate counsel for the LLC in Example 1, you may be feeling great about the debt restructuring you have negotiated for your client. That is, until you speak with your tax

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[2] This report does not consider tax consequences to the debtor arising from foreclosure, deed in lieu, or similar transactions which are very different from those arising from COD (where the debtor remains owner).

[3] For simplicity, unless otherwise noted, this report assumes that non-publicly traded debt arising from a third party loan and not seller financing is: (a) retired for cash or, (b) reduced in principal amount without other economic changes to the terms of the debt instrument. Such other economic changes (interest rates, payment dates, security, etc.) favorable to the debtor arising from the restructuring or modification of the debt increase the complexity as to the amount of the COD. Whether the debt that is considered retired or reissued is publicly offered within the meaning of section 1273 of the Code also affects the amount of COD.

partner. In Example 1, the LLC would recognize $20 million of COD ($80 million former principal amount less $60 million revised principal amount), allocated among its owners in 2009 unless exemptions or other rules come into play. It is worth noting that this diminution in value likely corresponds to reduced income from the property and an otherwise distressed financial situation in the company, although it may also arise from cap rate changes at maturity of a balloon instrument. Nonetheless, the company, or since it is an LLC, its owners, will have to pay tax on $20 million of income ($4 million for each member) without generating any corresponding funds from the transaction to pay such taxes.[4]

Is there any relief to the owners of the LLC from the recognition of $20 million in income in 2009 in Example 1?

Section 108 of the Code in General

Section 108 of the Code is designed to ameliorate some of the harsh effects of COD recognition, particularly when the taxpayer is in a troubled economic condition. Section 108(a)(1)(A) of the Code provides that COD does not arise if the taxpayer is under the jurisdiction of the court in a U.S. Title 11 bankruptcy case. Section 108(a)(1)(B) of the Code provides that COD does not arise to the extent the taxpayer is insolvent (the excess of taxpayers' liabilities over the fair market value of their assets just prior to the debt release).[5] Another rule provides that in determining whether the taxpayer is under the jurisdiction of a court or insolvent, ownership of the property by a partnership is disregarded and the determination is made at the partner level.[6]

In Example 1, the LLC is clearly insolvent (debt of $80 million exceeds the fair market value of the assets $55 million, by $25 million). But the insolvency of the LLC is not relevant to the COD analysis. Three of its members, on the other hand, are not under the jurisdiction of a court in a Title 11 case and are solvent, so the two main exemptions are not applicable to such members. Prior to the 2009 Act, and still remaining in the Code, other exemptions include: qualified farm indebtedness (not relevant in Example 1), qualified real property business indebtedness (relevant and discussed below), qualified principal residence indebtedness (not relevant in Example 1), interest indebtedness of a cash basis taxpayer (not relevant in Example 1), seller financing indebtedness (not relevant in Example 1), and contribution of indebtedness to corporate capital (not relevant in Example 1).[7]

> **Example 2** – We change the facts of Example 1 to provide that the loan is made to an LLC whose business is not the ownership, operation or development of real property; such as to a wholesaler of goods whose $80 million loan is secured by its receivables.

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[4] An LLC is treated as a partnership for federal income tax purposes unless it has made an election to be treated as a corporation. We assume, consistent with the great majority of LLCs, that the LLC has not made the corporate election and is treated as a partnership. Thus, it is a nontaxable "flow-through" entity and its members are taxed on their distributive share of its income.

[5] Establishing insolvency and its extent typically requires a competent appraisal. There is no guarantee that the IRS will agree with the appraisal or taxpayer's independent evaluation.

[6] Section 108(d)(6) of the Code.

[7] The bankrupt, insolvent and farm exemptions are not pure exemptions in the sense that they come with a tax cost. The tax cost is loss of certain future tax benefits of the taxpayer, in the amount of such COD, such as net operating loss carryovers ("NOLs") and reduction in basis in property, in a prescribed order. Section 108(b) of the Code.

In Example 2, the three solvent owners, prior to the 2009 Act, would be required to include $4 million each of the $20 million COD into income in 2009. However, the 2009 Act, establishing section 108(i) of the Code, could provide some welcome relief to the owners of such wholesale enterprise.[8] The two insolvent owners, on the other hand, would receive tax protection under the insolvency exemption (they are insolvent to the extent of $5 million each in our example) and would not need any further tax relief.

Section 108(i) Deferral Relief

The LLC in Example 2 may elect under section 108(i) of the Code to defer the owners' share of the 2009 COD income to 2014 and to include such income ratably over the five year period 2014 to 2018 ($800,000 per year). Thus, the owners get a ten year interest free deferral of their tax obligations.[9] While this looks attractive to the solvent members, the insolvent members may object to any such election since all of their COD income is excluded under the insolvency exemption on a permanent basis.[10] Let us take a look in more detail at how section 108(i) of the Code works.

Section 108(i) of the Code permits a taxpayer to elect to defer the recognition of COD income from the reacquisition of an applicable debt instrument in the years 2009 and 2010 only. Thus, it has a very limited life. The election is made (on a debt by debt basis) by the issuer of the debt, in this case by the LLC. The COD income is deferred until the year 2014 and included in income ratably over the five year period 2014 to 2018.[11] A reacquisition includes any acquisition of the debt instrument for cash, the exchange of the instrument for a new instrument favorable to the debtor (including a deemed exchange resulting from a reduction in the principal amount of the debt and other modifications), and certain restructuring changes. An applicable debt instrument is any debt instrument issued by a C corporation, and any other person (which would include an individual or an LLC) but such other person must hold the debt in connection with the conduct of a trade or business. If the taxpayer dies, the business is terminated, or the taxpayer terminates its interest in a partnership or other pass-through entity, the balance of any deferred amount not yet included in income is accelerated to the year of such termination.

We have posited in Example 2 that the LLC taxpayer debtor is engaged in a wholesale business, which would constitute the conduct of a trade or business within the meaning of section 108(i) of the Code. In the real estate setting, operating the rental business of a large commercial or residential office building, as in Example 1, would likely qualify as the conduct of a trade or business, although there is some question whether an owner's building operations under a triple net lease rise to the level of the conduct of a trade or business or merely

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[8] We are digressing from the focus of this report, tax relief for debtors holding real estate, to provide background on the COD tax relief for debtors in most other businesses. Such background will aid in understanding the relief provided to real estate concerns.

[9] Although the election appears to make sense for the three solvent owners, there are a number of factors to consider, one of which is whether one anticipates that tax rates will be significantly higher in the out years. As discussed further, the election generally makes no sense for the two insolvent owners.

[10] The insolvent members must take into account loss of any NOLs or depreciable tax basis in their properties arising under the statute from the insolvency exemption, but in most cases the trade-off for loss of these tax benefits is outweighed by permanent avoidance of the COD.

[11] For fiscal year taxpayers, the COD is includable in the fifth taxable year following the taxable year in which the reacquisition occurs for reacquisitions occurring in 2009 and the fourth taxable year following the taxable year in which the reacquisition occurs for 2010 reacquisitions.

constitute a passive investment activity. It seems unlikely that a debt reacquisition arising from the ownership of undeveloped land would qualify.[12]

The section 108(i) election trumps the other section 108 exemptions so that any bankruptcy or insolvency protection a taxpayer may otherwise be entitled to is lost. In a nutshell, this means that such persons must include COD in income in the sixth through tenth year following reacquisition when they may never have had to include such amounts into taxable income in the first instance because of the insolvency or bankruptcy exemption in the year of reacquisition or in any of the years six through ten. Once the election is made, it is irrevocable.

On August 17, 2009 the IRS issued Rev. Proc. 2009-37 (the "2009 procedure") to flesh out the taxpayer election procedure. Under the statute, the election is made, in our examples, by the LLC in its 2009 annual tax return filed on partnership Form 1065. The election must contain the identity of the specific applicable debt instruments,[13] and the amount of the related COD. The 2009 procedure thankfully avoids some of the rancor that might arise from an election at the LLC level otherwise applicable to all members by permitting the LLC to effectively elect on a member by member basis. So in Example 2, the election would be made for the three solvent members only. Detailed information must be included on the K-1 of each member and detailed information must be filed with each subsequent year of the LLC until all the deferred income has been recognized. The election concerns at the LLC level, while abated somewhat by the 2009 procedure, raise interesting questions about the LLC manager's obligations to the company and its members that may not be addressed in the company operating agreement and is beyond the scope of this report.

Section 108(c) Real Estate Special Exemption

In Example 2 a wholesale operation debt discharge is described giving rise to COD income to its solvent owners. In Example 1, however, the debt arises from a real estate transaction. Unlike most other business activities which have no specific section 108 exemptions available,[14] there is an exemption for distressed real estate at the enterprise level, termed the qualified real property business indebtedness ("QRPBI") exemption, similar in nature to the insolvency exemption at the owner level. If applicable, it provides tax relief to the solvent owners.[15]

QRPBI (applicable to solvent individuals and solvent individual owners or beneficiaries of trusts, S corporations and other entities, but not C corporations, holding distressed real estate) arises when the following factors are present: (1) the debt was incurred or assumed in connection with real property used in a trade or business and is secured by the realty; (2) the

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[12] There are also rules under section 108(i) of the Code dealing with any OID that might arise from the reacquisition and with certain esoteric provisions applicable to C corporations known as the AHYDO rules that are not applicable to our fact patterns.

[13] As indicated, the taxpayer can elect to defer COD on some debt instruments but not others that may have been discharged or otherwise adjusted.

[14] The other business which enjoys a COD exemption is farming. It may be applicable to certain of your real estate clients so engaged, but applies to far fewer taxpayers than the general real estate exemption and is not discussed. Section 108(a)(1)(C) and (g) of the Code.

[15] The insolvent owners must rely on the insolvency exemption to avoid recognition of COD. Section 108(a)(2)(B) of the Code.

debt was incurred or assumed to acquire, construct, reconstruct or substantially improve such real estate or to refinance such debt (debt raised to cash out partners would not qualify) and subject to the following limitations: (3) on a property by property basis it applies only to the extent of the excess of the outstanding principal amount of the debt over the fair market value[16] of the property (that is, only to the extent the property is "under water") and further limited to (4) the aggregate tax basis of any depreciable real property, including the secured realty subject to the debt discharge to the extent it constitutes depreciable property, held by the member or other owner immediately prior to the debt discharge.[17]

In Example 1 the debt exceeds the value of the LLC real estate by $25 million ($80 million debt less $55 million fair market value). The LLC's tax basis in the depreciable property is well in excess of the $20 million being discharged (assuming most of the $90 million original cost is attributable to the building and not the land), so each member should have sufficient tax basis in the secured depreciable property alone to meet tests 3 and 4 above. Therefore, an election by a solvent member of the LLC[18] can be made under section 108(c) of the Code to have the QRPBI exemption apply. The election would result in complete exemption of such member's $4 million share of COD in 2009 at a loss of only $4 million in future tax depreciation deductions in this or other properties held by the member. Loss of tax depreciable deductions in Example 1, if a commercial building, with 33 years to run on its depreciable life means that the $4 million in income will eventually be reported to the IRS, but over 33 years. In the tax field, we call this a pretty good deal.

By contrast, if the solvent members permit the LLC to make a section 108(i) election on their behalf, they must include $800,000 in income in each of the years six to ten. This is not nearly as good as the QRPBI election under these facts.

Why Make the Section 108(i) Election?

Since real estate has its own favorable debt relief provision in the tax Code which is superior in many respects to the new 2009 Act provision, why would any real estate related concern make the new election and why did I bother you with all this discussion?

As noted, not all real estate debt relief transactions will qualify.

> **Example 3** – We change the facts of Example 1 to provide that the loan on the building was used to cash out prior members and not for acquisition, construction, reconstruction or substantially improving such property.

The QRPBI exemption does not apply in Example 3 because of the impermissible use of the borrowed funds.

> **Example 4** – We change the facts of Example 1 to provide that the project is for the sale of condominium units[19] rather than commercial rental property, and that the members do not own any depreciable real property.

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[16] Less, in effect, any other mortgage on the property meeting these QRPBI requirements.

[17] Thus, if the business consists of selling condominiums (nondepreciable assets) and the partner has no depreciable real property assets, the QRPBI election provides no tax relief from COD. Section 108(c)(2)(B) of the Code.

[18] The election is made on a partner by partner basis on IRS Form 982.

[19] See footnote 17.

Example 4 will fail to qualify for the QRPBI exemption because it fails test 4 of the rules above (the aggregate tax basis in depreciable real property).

> **Example 5** – We change the facts of Example 1 to provide that the owner of the realty is not an LLC, but rather is a C corporation.

Example 5 fails to qualify for the QRPBI exemption because real estate held by a C corporation, whether publicly or privately held,[20] is not eligible for the QRPBI exemption. The section 108(i) provision, moreover, expressly permits C corporations to make the election. The C corporation can make the election regardless whether it conducts a trade or business within the meaning of the tax law.

> **Example 6** – We change the facts in Example 5 and Example 1 to provide that the underlying real estate held by the corporation consists of undeveloped land.

In Example 6 the C corporation should be able to make the election for section 108(i) debt relief in connection with undeveloped land, whereas the LLC could not.

There may be other instances where the technical rules of the QRPBI provisions can not be met, or its use is not very favorable,[21] and a section 108(i) 10 year deferral option is available and advisable.

The QRPBI election assumes a distressed real estate situation. It is clear that the new section 108(i) deferral election can be made for the solvent owner and the solvent real estate enterprise. But what lender is providing debt relief to a solvent debtor with solvent property unless the debt is a balloon instrument that can not be renewed at maturity due to interest or cap rate changes?

The legislative history to the 2009 Act provision indicates that it was primarily designed to assist companies that can otherwise deleverage by reacquiring their debt at a discount. It was also designed to give financial firms holding such debt more liquidity. The assistance, as discussed in this report, is in the form of the five year deferral and the subsequent five year pay-out of taxes. In effect, the discount may arise not necessarily because the debtor is delinquent in payments or otherwise in default, or is insolvent, or the property has lost value, but rather the market is concerned about the issuer's ability to pay and is willing to take a haircut to get its cash back. Alternatively, the lender in today's economic climate may simply prefer to be bought out and is prepared to take a significant discount to get cash back, even though it may not be concerned about the issuer's ability to pay. Where might a repurchase arise in a non-public company setting?

> **Example 7** – $200 million of debt of an LLC is privately placed with institutional lenders in 2005 for the purpose of acquiring and enlarging by new construction a large residential rental development project. In 2009, as a result of the economic downturn and after a number of the new residential buildings are constructed and rented and the

[20] Yes, there are still a few privately held C corporations out there holding real estate. The C corporation can take advantage of the insolvency exemption, however, if applicable to its financial condition. Under Example 1, as revised in Example 5, the corporation would be insolvent.

[21] If the debt discharge occurs toward the end of the life of the building, the loss of tax depreciation arising from the insolvency exemption may have to be recovered over a shorter period than the ten year period under section 108(i) of the Code, for example.

existing buildings remain rented, the development is downsized and $50 million of the funds are no longer needed for the revised new construction project. The borrower is otherwise fully capable of meeting its loan obligations. The project has not lost value, or at least has not lost value beyond the equity put into the deal. The institutional lenders are willing to accept $40 million for the $50 million piece of the loan.

In Example 7 the QRPBI exemption is not available since the property is not under water. The section 108(i) election should provide a welcome 10 year relief to the solvent members of the LLC on their share of the $10 million of COD generated by this transaction.

There are doubtless variations on these examples where new section 108(i) of the Code comes into play. As with any new statute, there will be issues raised concerning its application not expressly covered by the statutory language, such as the proper withholding obligation of an LLC on the COD deferred amounts attributable to a foreign member. We can expect further guidance from the IRS and Treasury Department soon, given the short life of this statute. For now, I simply want to make the reader aware of the limited time availability of, and the potential tax benefits derived from, new section 108(i) of the Code.

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