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Tax Issues in Real Estate Workouts

Peter J. Genz

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Peter J. Genz
King & Spalding LLP
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I. CANCELLATION OF DEBT INCOME

A. Introduction

1. Cancellation of debt ("COD") income is includable in gross income under section 61(a)(12). See Reg. § 1.61-12(a); U.S. v. Kirby Lumber, 284 U.S. 1 (1931). This is a corollary of the longstanding rule that receipt of the proceeds of a borrowing is not gross income because the borrower is under an obligation to repay the amount borrowed. Reg. § 1.61-12(c)(1). When the borrower ceases to be obligated to repay all or a portion of a debt, the tax law deems the taxable year in which that cessation event occurs as the appropriate year of reckoning. Unless certain statutory COD exclusions apply -- e.g., where the borrower is bankrupt or insolvent or a special election for "qualified real property business indebtedness" is available -- the borrower must include in gross income the loan proceeds that it no longer has to repay. The borrower does not recompute its tax liability for the year in which the obligation was incurred. COD income is always includable as ordinary income, even if the underlying loan collateral is a capital asset. In addition, lenders may have a 1099 reporting obligation with respect to COD income under section 6050P.

2. Sometimes it is easy to tell when a borrower has recognized COD income, such as where the lender agrees to cancel part of the principal. However, there are other circumstances where COD income can arise that are not so obvious. A debt restructuring, for example, can produce counterintuitive and often unexpected tax consequences for both lender and borrower. Under Treasury Regulations issued under section 1001, a "significant modification" of a debt triggers a deemed, or constructive, exchange of the "old" debt for a newly issued debt instrument. A holder that acquired debt of a troubled issuer at a discount can recognize gain on such a deemed exchange even if the principal amount and interest rate on the new debt remain unchanged. Conversely, if the issue price of the new (modified) debt is less than the adjusted issue price of the "old" debt, the issuer can recognize COD income. These tax consequences can come as a shock to the parties who believe they are conducting a routine debt renegotiation, particularly in the case of a debtor who does not believe his obligations have materially changed in the economic sense.

3. In today’s market, the primary loan workout pressures are emanating not as much from inability to service the debt -- although that is on the rise as tenants go under and/or renegotiate their leases and projections of reduced vacancy rates fail to materialize -- as the inability to refinance the acquisition debt when due. In the white hot commercial real estate market in the five years preceding 2007, lenders allowed highly leveraged purchases on the assumption of ever-increasing cash flows and property values, often with a combination of senior bank debt and subordinated or mezzanine debt achieved through structural subordination. A great deal of acquisition debt was structured as short-term bridge debt which is now coming due, and mezzanine financing is scarce or nonexistent. In addition, a higher default rate is expected for construction debt on projects undertaken or completed in the last two to three years relative to other first mortgage debt.

4. Many mortgage loans are now being restructured or a workout is looming. Depending on the nature and extent of the modifications, this can result in a deemed exchange of debt instruments under section 1001, which in turn requires a determination of the "issue price" of the
modified debt under the original issue discount ("OID") rules. The issue price determination is extremely important, because it determines whether the debtor recognizes COD income, the extent to which OID is created in the new instrument, and, in the case of a corporate debtor, whether the debt instrument is an "applicable high yield discount obligation" ("AHYDO") subject to the interest deduction limitations of section 163(e)(5).

5. Special rules apply if the debt discharge occurs in connection with a transfer by the borrower of the collateral for the loan. In general terms:

a. If the debt is nonrecourse, the entire amount of the debt is treated as an amount realized by the borrower on the sale of the property (often taxable as capital gain) and the borrower does not recognize any COD income (ordinary). Sale gain, unlike COD income, cannot be excluded under one of the section 108 exclusionary rules.

b. If the debt is recourse, the borrower is deemed to have sold the property for an amount of the debt equal to the property's fair market value, and the discharge of the remaining portion gives rise to COD income.

6. In workouts, lenders and borrowers often have competing tax interests and a multitude of different options for addressing the business and tax issues. There is no substitute in these transactions for collaborative discussions with the parties' tax advisors early in the process. This was true in the last wave of workouts in the early 1990s, and it remains true today.

B. Illustrative Cases That May, or May Not, Produce COD Income

1. In Cozzi v. Commissioner, 88 T.C. 435, 445 (1987), the Tax Court held that COD income had to be recognized when it became clear that the collateral supporting the nonrecourse debt was worthless. The facts involved a nonrecourse loan incurred by a partnership formed to provide technical services in connection with the making of a film. The debt was secured by a production agreement with a third party. The Tax Court upheld the IRS' determination that the collateral became worthless no later than 1980 and that the partnership recognized COD income in such year.

   a. This case is noteworthy in that there was no specific event, such as a formal discharge, to which the COD income could be attributed.

2. COD income does not arise if the liability from which the taxpayer is relieved is too contingent or indefinite to constitute true debt. See Central Paper Co. v. Commissioner, 158 F.2d 131, 133 (6th Cir. 1946); Terminal Inv. Co. v. Commissioner, 2 T.C. 1004, 1015 (1943), acq., 1944 C.B. 27. If acquisition debt was too contingent to be included in the basis of acquired property originally, its reduction should not lead to the realization of income. Compare Reg. §1.1001-2(a)(3) with CRC Corp. v. Commissioner, 693 F.2d 281, 283 (3d Cir. 1982).

3. The reduction of the amount of a promissory note delivered by a limited partner to a partnership evidencing his contribution obligation should not constitute COD income if the partner did not receive any economic benefit in consideration for execution of the note. See Whiting v. Commissioner, 47 T.C.M. 1334, 1336-1337 (1984); Commissioner v. Rail Joint Co., 61 F.2d 751 (2d Cir. 1932).

4. Relief of a partner's obligation to restore a deficit capital account in connection with the partner's sale of his interest or withdrawal from the partnership should not result in COD income.
to the partner or an additional amount realized on sale of the interest. Rather, such deficit obligation should be viewed as an intrinsic part of the property being exchanged -- i.e., the partnership interest -- and the tax consequences to the partner should be determined solely under the framework of Subchapter K.

5. Generally, a partner should not realize COD income if the partner is released from his obligation as a guarantor of the partnership’s debt, and the debt remains outstanding. The theory is that the guarantor did not receive the loan proceeds and has not had a real accession to wealth. See Bradford v. Commissioner, 233 F.2d 935 (6th Cir. 1956), nonacq., 1958-2 C.B. 9 (taxpayer gratuitously executed note to bank whereby she agreed to pay the debt of her husband; subsequently, taxpayer, through an agent, purchased her debt from the bank for half of its face amount; held, no COD income realized because she had not received any of the loan proceeds initially and received no consideration for substituting her note for her husband’s note); Landreth v. Commissioner, 50 T.C. 803 (1968) (release of guarantor’s contingent liability by way of payment by primary obligor or release by creditor does not cause the guarantor to realize COD income); Zappo v. Commissioner, 81 T.C. 77 (1983) (replacement of a debt with a loan guarantee not respected as a continuation of old debt and therefore does not avoid COD income with respect to the debt cancellation); Tech. Adv. Mem. 7953004 (Aug. 20, 1979) (limited partner guarantor did not have COD income upon release of guarantee by lender because lender’s release of guarantor occurred before a default by the principal obligor).

a. The IRS could assert, however, that COD income results if the settlement or discharge of the guarantor’s obligations occurs when the guarantor has already become primarily liable on the debt by reason of the debtor’s default, or could otherwise impute income to the taxpayer if the guarantee obligation is discharged by a third party. See Tennessee Securities, Inc. v. Commissioner, 674 F.2d 570 (6th Cir. 1982) (corporation’s payment of shareholder’s guarantee resulted in dividend income to shareholder). But if relief from the guarantee produces COD income, it would seem that it should also give rise to a bad debt deduction for the guarantor for its worthless claim against the borrower (paid for by taking on the borrower’s liability to the lender).

b. In Whitmer v. Commissioner, 71 T.C.M. 2213 (1996), the taxpayer was the sole shareholder of a corporation (the “Company”) engaged in the business of selling life insurance products underwritten by ITT Life Insurance Corp. (“ITT”). The Company had entered into an “Advance Commission and Loan Agreement for General Agent” with ITT (the “Agreement”) which provided for the following: When one of the Company’s agents sold a policy, he received a payment from ITT that approximated the total commissions that would be earned over the life of the policy, including renewals. The unearned portion of the payment was considered a loan. If a policy was renewed, the commission that otherwise would have been paid on renewal was applied to reduce the advance to the agent. Conversely, if the policy lapsed or was canceled, the portion of the advance reflecting unearned premiums was treated as a liability of the Company. The taxpayer personally guaranteed the Company’s performance under the Agreement. When the Company and ITT broke off their relationship, ITT filed suit against the Company and the taxpayer as guarantor to collect $237,000 of advance commissions relating to policies whose cancellation was imminent. The Company asserted counterclaims, and the case was settled in 1987 with the taxpayer paying ITT $25,000.

(1) The IRS, citing Bradford and Tennessee Securities, contended that the taxpayer realized $212,000 of COD income as a result of the settlement. The taxpayer argued that he had no COD income because (i) the debts were unenforceable due to improper conduct by ITT and (ii) the amount of the debt was subject to a bona fide dispute.

(2) The Tax Court rejected the IRS’s contention because it determined that the taxpayer was not the primary obligor on the debt. The court stated that it was the Company’s assets that were increased on account of the advance commissions, and the cancellation of the
loan only augmented its net worth, not the taxpayer’s net worth. The fact that the value of the taxpayer’s Company stock was enhanced was deemed irrelevant. The Tax Court, citing Landreth, supra, stated that the cancellation merely prevented the taxpayer’s net worth from being decreased. Compare Plantation Patterns, Inc. v. Commissioner, 462 F.2d 712 (5th Cir. 1972) (debt of corporation guaranteed by shareholder treated as a debt of shareholder, followed by equity contribution of loan proceeds to corporation, because lender looked primarily to shareholder’s credit for repayment).

(3) The findings of fact indicate that the Company had dissolved long before the settlement was reached; yet, the Tax Court did not explain the basis for its conclusion that the taxpayer was not “primarily liable” for the advance commission debt of the dissolved corporation.

c. In Marcaccio v. Commissioner, 69 T.C.M. 2420 (1995), the Tax Court found that a settlement of the taxpayer’s guarantee obligations created COD income. The taxpayer was a 7.5% general partner in a joint venture that acquired real property financed, in part, by a first and second loan (apparently recourse) from a bank (“Lender”). Lender took a security interest in the property and required each partner to personally guarantee its pro rata share of the debt. The development failed and in 1986 the property went back to the lender in a foreclosure sale. Lender bid $2.4 million in the sale, but the face amount of debt was $3.2 million, leaving a deficiency of $800,000 (these are rounded figures). The partnership reported a long-term capital loss equal to the difference between the sale price of the property in the foreclosure sale ($2.4 million) and the tax basis of the property ($2.9 million), or $500,000. The partnership also reported the amount of the deficiency as outstanding partnership debt on its 1986 return. In early 1988, Lender sued the partners individually, based on their status as general partners and guarantors of the debt, to collect the deficiency. The taxpayer settled the suit by agreeing to pay $31,000 in full satisfaction of all claims by Lender, although the taxpayer’s pro rata share of the debt was $63,000. The taxpayer did not report the $32,000 difference as COD income on his 1988 tax return. The IRS challenged this position, and the Tax Court agreed.

(1) The taxpayer contended that the fair market value of the property at the time of the 1986 foreclosure sale was equal to the amount of debt outstanding, rather than the amount bid in by Lender. He contended that, while the bid price is normally presumed to reflect fair market value (see Community Bank v. Commissioner, 79 T.C. 789, 792 (1982), aff’d., 819 F.2d 940 (9th Cir. 1987)), the presumption did not apply because the foreclosure sale was unlawfully conducted under Texas law. The Tax Court found no evidence to support this contention or the contention that the property was worth more than the bid price.

(2) The taxpayers also argued that COD income does not arise when a disputed indebtedness is compromised by the parties, and that there was a legitimate dispute between the taxpayer and Lender as to the value of the property. The Tax Court rejected this argument, stating that the taxpayers did not object to the allegedly low bid price at the time of sale.

(3) It would appear from the Tax Court’s opinion that it regarded the taxpayer as the primary obligor on the partnership’s debt and that the discharge caused him to recognize COD income at the partner level. The opinion does not address the status of Lender’s claims against the partnership or the other partners and guarantors.

d. The Service distinguished Marcaccio in Private Letter Ruling 9619002 (Jan. 31, 1996). The taxpayer was an individual who owned a one-third interest in a general partnership comprised of three partners. The partnership incurred approximately $278,000 of recourse debt (the “Third Party Note”). In addition, as a result of the partnership’s purchase of certain property from the taxpayer, the partnership owed the taxpayer approximately $49,000 (the “Purchase Money Note”). In 1992, the following events occurred: the taxpayer personally filed a voluntary bankruptcy petition which
listed his share of the Third Party Note as a liability (but not his share of the partnership’s obligation as to the Purchase Money Note which he held); taxpayer was then discharged from his liability as to the Third Party Note; and finally, prior to year-end, the bankruptcy court closed the taxpayer’s bankruptcy estate. In 1993, one of the other partners paid the taxpayer $9,000, which the payor contended was full payment for both the taxpayer’s partnership interest and the Purchase Money Note. The rulings requested related to the tax treatment of the taxpayer’s bankruptcy discharge as to the Third Party Note, and the proper tax treatment of the $9,000 cash payment.

(1) The National Office ruled that, because (i) the court-ordered discharge only applied to discharge the taxpayer’s liability as to the partnership’s Third Party Note and (ii) the partnership (and its other two partners) continued to be fully liable with respect to such Note, the partnership did not realize any COD income. Instead, the other two partners assumed liability as to the taxpayer’s share.

(2) The National Office distinguished Mareaccio (where a partner was held to realize COD income upon the cancellation of a partnership debt as to which the partner had become the primary obligor following the termination of the partnership), from the facts of the ruling on the ground that the partnership was the primary obligor on the Third Party Note, and the taxpayer was only secondarily liable by reason of his general partner status.

(3) However, the National Office ruled that the debt discharge did trigger a constructive distribution of money to the taxpayer under section 752(b) equal to his allocable one-third share of the Third-Party Note, or $92,000. The taxpayer had a negative capital account equal to $91,000, and his one-third share under section 752 of the Third Party Note and the Purchase Money Note (prior to the bankruptcy discharge) totaled $109,000. Thus, his basis in his partnership interest was $18,000 ($109,000 - $91,000), and the constructive distribution of $92,000 resulted in recognized gain under section 731 of $74,000.

C. Measurement of COD Income

1. COD income is realized (but not necessarily recognized) when a debt is paid or repurchased for less than its “adjusted issue price,” as defined in Reg. § 1.1275-1(b), or becomes unenforceable by reason of the expiration of the statute of limitations. Reg. § 1.61-12(c)(2)(ii). The COD income equals the excess, if any, of the adjusted issue price of the old debt over the amount of cash and fair market value of property plus the issue price of any new debt transferred to the creditor. Section 108(e)(10); Reg. § 1.61-12(c)(2)(ii).

   a. The adjusted issue price of a debt instrument is the issue price of the instrument, increased by the amount of OID previously accrued, decreased by the amount of payments previously made on the instrument other than qualified stated interest, and decreased by the amount of bond issuance premium previously amortized under Reg. § 1.163-13(d)(3). Reg. § 1.1275-1(b).

      (1) OID equals the excess of the stated redemption price at maturity (“SRM”) of a debt instrument over its issue price. Section 1273(a)(1); Reg. § 1.1273-1(a). Unless a de minimis exception applies, accrued OID is taken into account as interest income by the holder on a constant accrual basis, regardless of the holder’s method of accounting. Section 1272(a)(1); Reg. § 1.1272-1(a)(1). The issuer’s interest expense deduction for accrued OID is determined on the same basis, except that de minimis OID is deducted on a constant accrual basis unless the issuer chooses one of several alternative methods. Sections 163(e)(1) and (e)(2)(B); Reg. § 1.163-7(a) and (b).
Bond issuance premium equals the excess of the issue price over the SRM. This means the borrower received more loan proceeds than it is obligated to repay, effectively lowering the borrower's interest cost and the lender's yield. Reg. § 1.163-13(c). Bond issuance premium is taken into account as an offset to the lender's interest income attributable to qualified stated interest and as an offset to the borrower's deduction for qualified stated interest. Reg. § 1.171-2(a); Reg. § 1.163-13(d).

b. Measuring COD income by reference to adjusted issue price gives effect to the mandate in section 108(e)(3) that the "amount taken into account with respect to any discharge [of indebtedness] shall be properly adjusted for any unamortized premium and unamortized discount with respect to the indebtedness."

2. If an obligation is modified so as to create a deemed exchange of a new debt instrument for the unmodified debt instrument under section 1001, the debtor is treated under section 108(e)(10) as having paid the old debt with an amount of money equal to the issue price of the new debt, as determined under the OID provisions. Thus, the issue price of the new debt controls the amount of the debtor's COD income. See H.R. Rep. No. 881, 101st Cong., 2d Sess. 354 (1990).

3. For example, an interest rate reduction that results in the modified obligation having inadequate stated interest (an effective yield below the AFR) and which gives rise to a section 1001 exchange will require the issue price of the modified debt to be determined under the applicable OID provisions (generally, section 1274). In such a case, the new debt’s issue price will equal its imputed principal amount rather than its face amount, and if that amount is less than the adjusted issue price of the old debt, the debtor has COD income. (Debt-for-debt exchanges are discussed in detail later in this outline.)


1. In Revenue Ruling 92-92, 1992-2 C.B. 103, the IRS ruled that COD income is treated as income from a passive activity if the related debt is allocated to passive activity expenditures under the interest-tracing rules of Reg. § 1.163-8T -- essentially linking the COD income to the activity to which the debt relates.

2. Surprisingly, the law is unclear whether COD income constitutes "unrelated business taxable income" under section 512 if derived by, or allocated to, a tax exempt organization, such as a private pension plan. It seems clear that it should not, particularly since section 514(c)(9) expressly acknowledges that a qualifying pension plan is exempt from debt-financed UBTI if the obligor partnership’s allocations meet the fractions rule and certain other requirements are met. This is a case where virtually every tax advisor knows the advice he is going to give the client (don’t report as UBTI), and yet he may struggle if asked to write a reasoned opinion.

3. It is also unclear whether COD income is treated as "qualifying income" for purposes of section 7704(c) and (d), which provide that a publicly traded partnership will not be treated as a corporation if at least 90% of its gross income for the year consists of the types of income specified in section 7704(d), such as dividends, interest and real property rents. Neither the statute nor the regulations reference this type of income. Again, COD income should be treated as qualifying income for this purpose.

II. SECTION 108 EXCLUSIONARY RULES AND ATTRIBUTE REDUCTION

A. Overview
1. In general, section 108(a) permits COD income to be excluded from income and effectively recognized on a deferred basis through reduction of certain tax attributes if certain conditions are met. If there are insufficient tax attributes to reduce, the COD income escapes taxation entirely.

2. In the case of a partnership, the COD exclusions apply at the partner level. Any partnership COD income properly allocated to a partner under section 704(b) is excluded from the partner’s income if (i) the discharge occurs in a title 11 case of the partner or (ii) to the extent that the partner is insolvent immediately prior to the discharge. Sections 108(a)(1)(A) and (B). In a non-bankruptcy case, COD income in excess of the partner’s insolvency is includable in gross income under section 61(a)(12). Whether the partnership itself is in bankruptcy or insolvent has no impact on the partners’ recognition of COD income.

   a. Section 706(a) provides that the taxable income of a partner for a taxable year includes the various items of partnership income, loss deduction and credit for any taxable year of the partnership ending with or within the taxable year of the partner. Reg. § 1.706-1(a)(1). Notwithstanding that COD income may be allocated to a partner on a date later than the discharge (and perhaps in a subsequent taxable year of the partner), the discharge date is presumably the proper date to analyze whether the partner qualifies for an exclusion to the later-recognized COD income under sections 108(a)(1)(A) or (B).

3. In the case of an affiliated group of corporations filing a consolidated return, the COD exclusions under section 108(a) are determined on a member-by-member basis. However, attribute reduction under section 108(b) with respect to any excluded COD income of a member may apply on a group-wide basis in certain cases. Reg. § 1.1502-28.

4. Solvent taxpayers who are not in a title 11 case can claim an exclusion with respect to COD income only in the following circumstances:
   a. The debt is “qualified real property business indebtedness” under section 108(c). Section 108(a)(1)(D). This exclusion, which is not available to C corporations (including partners that are C corporations), applies even if the partner is not bankrupt or insolvent.
   b. There is a special exclusionary rule for “qualified farm indebtedness.” Sections 108(a)(1)(C) and (g).
   c. A new exclusionary rule applies to COD income resulting from the discharge of “qualified principal residence indebtedness” (“Qualified Residence Debt”) which is discharged on or before December 31, 2012, provided the taxpayer is not already in bankruptcy. Sections 108(a)(1)(E) and (h). This temporary exclusionary rule was first enacted by the Mortgage Forgiveness Debt Relief Act of 2007 (Pub. L. 110-142) and was extended for two more years by the Emergency Economic Stabilization Act of 2008 (Pub. L. 110-343).

   (1) A homeowner will realize COD income upon a reduction in the principal amount of the mortgage debt or upon a transfer of the property in foreclosure accompanied by discharge of the portion of the debt in excess of the property’s value. (As discussed later in this outline, the debt discharge is treated as an amount realized on sale of the mortgaged property to the extent of its value, and the balance is treated as COD income, assuming, as is nearly always true for a residential mortgage, that the debt is recourse to the borrower.)

   (2) Qualified Residence Debt means acquisition indebtedness with respect to the principal residence (as defined in section 163(h)(3)(B)), except that the qualifying amount is
increased from $1 million to $2 million ($1 million in the case of a married taxpayer filing separately). Section 108(h)(2). This generally applies to mortgage debt incurred to buy, build, or substantially improve the taxpayer's principal residence.

3. The term "principal residence" is defined in section 121. Section 108(h)(5).

4. The amount of COD income excluded under this provision is applied to reduce the basis of the principal residence (but not below zero). Section 108(h)(1).

5. If only a portion of the discharged debt constitutes Qualified Residence Debt, the section 108(a)(1)(E) exclusion applies only to the extent that the amount discharged exceeds the nonqualified portion. Section 108(h)(4). Assume the taxpayer originally incurred $100 of qualifying acquisition indebtedness and later refinanced it with a $120 loan, pocketing $20 of loan proceeds. If the lender discharges $50 of the debt, the Qualified Residence Debt applies only to $30 of the resulting COD income ($50 discharge - $20 of nonqualified debt).

6. If the taxpayer is insolvent, the Qualified Residence Debt exclusion takes priority over the insolvency exclusion unless the taxpayer makes an election to claim the insolvency exclusion. Section 108(a)(2)(C).

d. There is no COD income to the extent payment of the liability would have been deductible by the debtor. Section 108(e)(2).

e. A reduction of purchase money debt will be treated as a purchase price reduction provided the purchaser/debtor is not in bankruptcy or insolvent. Section 108(e)(5). Thus, the debtor takes a basis reduction as opposed to COD income recognition.

5. The American Recovery and Reinvestment Tax Act of 2009 (P.L. 111-5) ("ARRTA"), which was included as Title I of Division B of the American Recovery and Reinvestment Act of 2009 signed by the President on February 17, 2009, made two significant pro-taxpayer changes intended to facilitate debt restructurings (discussed later in this outline).

a. Section 1231 of ARRTA provides taxpayers with an election to defer COD income recognized upon a reacquisition of an "applicable debt instrument" in 2009 and 2010. Section 108(i). Taxpayers must amortize the deferred COD income over a five-year period beginning in 2014, except that the deferred income is accelerated upon the death of an individual taxpayer or if the taxpayer sells substantially all of its assets, liquidates, enters bankruptcy, or otherwise ceases business. Section 108(i)(5)(D)(i). An electing taxpayer is precluded from claiming the exclusions in section 108(a)(1) for bankruptcy, insolvency, qualified real property business indebtedness, and qualified farm indebtedness with respect to the deferred COD income when it is ultimately recognized. Such taxpayers must also forego the benefit of the COD exclusions as to the deferred income and under certain circumstances must also defer the deduction of an equivalent amount of OID on the same basis.

b. The IRS has issued Revenue Procedure 2009-37, 2009-36 I.R.B. 309, which contains a number of rules relating to the making of section 108(i) elections and requiring electing taxpayers to provide certain information on their returns.

c. Section 1232 of ARRTA provides for a temporary suspension of the AHYDO rules for new debt issued in restructurings during a window period beginning September 1, 2008 and ending December 31, 2009.
B. Measurement of Insolvency

1. A taxpayer's insolvency is measured by the excess of his liabilities over the fair market value of his assets immediately prior to the discharge. Section 108(d)(3).


   a. Under the then existing case law, no income arose from discharge of indebtedness if the debtor was insolvent both before and after the transaction. See Dallas Transfer & Terminal Co. v. Commissioner, 70 F.2d 95 (5th Cir. 1934). If the transaction left the debtor with assets whose value exceeded remaining liabilities, income was realized, but only to the extent of the excess. See Lakeland Grocery Co. v. Commissioner, 36 B.T.A. 289 (1937).

   b. To the extent the judicial exception to COD income can be viewed, in part, as based upon a "financial ability" to pay taxes, there may be a basis for defining "liability" differently to determine whether the deferral privilege of the insolvency exception is appropriate as compared with defining "indebtedness" for the purpose of measuring the amount of COD income realized.

3. The law is unclear as to whether a taxpayer is permitted to include a reasonable estimate of contingent liabilities in measuring insolvency.

   a. A divided Ninth Circuit Court of Appeals has held that contingent liabilities are taken into account for this purpose only if the taxpayer is able to establish by a preponderance of the evidence that it is more likely than not that it will be called on to satisfy the liability. Merkel v. Commissioner, 192 F.3d 844 (9th Cir. 1999), aff'g 109 T.C. 463 (1997) (court determined that shareholder guarantees of corporate debt were not likely to be called on and therefore were disregarded in determining whether the shareholders were insolvent for purposes of applying the insolvency exclusion to COD income arising from the discharge of partnership debt).

   b. See also Conestoga Transportation Co. v. Commissioner, 17 T.C. 506 (1951) (facts indicate that reserves for contingencies were taken into account by the parties in determining the extent of the taxpayer's insolvency); cf. Xonics Photochemical, Inc. v. Mitsui & Co., Inc., 841 F.2d 198, 200 (7th Cir. 1988) (in determining whether a debtor is insolvent within the meaning of the Bankruptcy Code, the Seventh Circuit held that contingent liabilities should be taken into account for insolvency purposes at their present, or expected value); but cf. Zappo v. Commissioner, 81 T.C. 77, 89 (1983) (dicta stating that swap of old debt for new debt that is "highly contingent and has no presently ascertainable value" does not refinance or substitute for the old debt and thus does not avoid COD income).

4. Excess Nonrecourse Debt. While the section 108(d)(3) insolvency definition does not define the term "liabilities," the plain meaning of the provision would seem to include any indebtedness of the taxpayer, including nonrecourse debt.
a. For purposes of section 108 generally, section 108(d)(1) defines the term "indebtedness of the taxpayer" as any indebtedness for which the taxpayer is liable, or subject to which the taxpayer holds property. The phrase "subject to which the taxpayer holds property" indicates that the term "indebtedness" includes nonrecourse indebtedness. It does not appear from the statute or legislative history that the term "liability" for purposes of section 108(d)(3) has a different meaning from "indebtedness" that may give rise to COD income, as defined under section 108(d)(1).

b. Notwithstanding the foregoing analysis, in view of the purposes of the insolvency exception, it is doubtful that a taxpayer would be permitted to include the amount by which nonrecourse debt exceeds the value of any property securing the debt ("excess nonrecourse debt") in the insolvency calculation where, for example, the taxpayer is discharged from other recourse debt and such discharge actually increases the debtor's economic net worth.

c. The IRS adopted this view in Revenue Ruling 92-53, 1992-1 C.B. 48. It ruled that excess nonrecourse debt secured by property A is treated as a liability of the taxpayer for purposes of determining insolvency only if the excess nonrecourse debt is being discharged in the workout. Excess nonrecourse debt relating to property B that is not discharged in the workout is disregarded in determining the taxpayer's insolvency.

5. Assets Beyond the Reach of Creditors. In Carlson v. Commissioner, 116 T.C. 87 (2001), the Tax Court held that, in determining whether a taxpayer is insolvent under section 108(d)(3), assets of the taxpayer which are exempt from the claims of creditors under state law (e.g., personal residences, pension plan accounts) are taken into account. Pre-Carlson authorities supported the contrary view. See Priv. Ltr. Rul. 9130005 (Mar. 29, 1991), citing Hunt v. Commissioner, 57 T.C.M. 919 (1989), Marcus Estate v. Commissioner, 34 T.C.M. 38 (1975); Priv. Ltr. Rul. 9125010 (Mar. 19, 1991). See also Cole v. Commissioner, 42 B.T.A. 1110 (1940). The rationale employed by these authorities is that only "free" assets that are potentially available to satisfy creditors claims should be taken into account in measuring insolvency. The Tax Court distinguished these authorities in Carlson on the basis that Congress meant to change the definition of insolvency when it enacted the BTA by including all assets.

6. Effect of Partnership Interests on Insolvency. A partner's interest in a partnership has a value and should be included in the insolvency determination. It is unclear, however, how the partner's share of partnership liabilities under section 752 should affect the determination.

a. In the case of a limited partner who has no personal liability for partnership debts, presumably only the fair market value of the partnership interest is taken into account. In the case of a general partner, however, his share of the recourse liabilities of the partnership ought to be taken into account because the partner has economic risk as to such liabilities under state law. For example, if A is the sole general partner of a partnership whose recourse liabilities exceed the fair market value of its assets by $200, A should include $200 of partnership liabilities on his personal insolvency balance sheet. Of course, the general partner must account for any capital contribution obligations by other partners and any other potential claims for reimbursement he may have against other persons.

b. Another way to analyze the issue is to determine the liquidation value of the partnership interest by positing a hypothetical sale of the partnership's assets, payment of partnership liabilities, and distribution of the remaining proceeds in liquidation. To the extent the partnership interest has a positive value, it is an asset in the insolvency determination; to the extent the partner would be required to restore a negative capital account on the liquidation, it is a liability.

c. Such an approach would not give effect to a partner's allocable share of partnership nonrecourse liabilities to the extent they exceed the value of the property securing such
liabilities, except in the case where the COD income arises from a reduction of nonrecourse debt. In that event, the rationale of Revenue Ruling 92-53 would indicate that the partner’s share of that nonrecourse liability should be included in the insolvency determination.

C. **Tax Attribute Reduction “Toll Charge”**

1. The amount excluded under section 108(a) is applied to reduce the taxpayer’s tax attributes in the following order: (i) current year net operating losses (“NOLs”) and NOL carryovers, (ii) general business tax credits, (iii) minimum tax credits, (iv) current year net capital losses and capital loss carryovers, (v) the basis of the taxpayer’s property (whether or not depreciable), except that such basis is generally not reduced below the amount of the taxpayer’s remaining liabilities, (vi) passive activity losses and credit carryovers, and (vii) foreign tax credits and credit carryovers. Sections 108(b) and 1017(b)(2); Reg. § 1.108-7(a).

2. All credits are reduced at a rate of 33-1/3 cents for each dollar of excluded COD income. Section 108(b)(3).

3. The tax liability for the taxable year in which the discharge occurs is computed before making the required attribute reductions. Thus, for example, NOL carryforwards to the discharge year are available to offset any recognized COD income, and an NOL arising in the discharge year may be carried back to prior years. Section 108(b)(4)(A); Reg. § 1.108-7(b).

4. Similarly, the property whose basis is subject to reduction is the property held by the taxpayer at the beginning of the taxable year following the year in which the debt discharge occurs. Sections 108(b)(2)(E)(ii), 1017(a), and 108(b)(5)(B); Reg. § 1.1017-1(a). (The basis reduction rules are further addressed below.)

5. The amount of any basis reduction under section 108(b)(2)(E) cannot exceed the excess of the aggregate adjusted basis of property and the amount of money held by the taxpayer immediately after the discharge over the taxpayer’s aggregate liabilities immediately after the discharge. Section 1017(b)(2); Reg. § 1.1017-1(b)(3). Stated differently, the basis of the taxpayer’s assets cannot be reduced below the amount of the taxpayer’s remaining aggregate liabilities.

a. This “floor limit” on basis reduction may come into play where a company has done a leveraged restructuring and distributed excess proceeds to its owners.

b. The IRS has indicated in a field service advice that assets contributed to an entity at the time of the debt discharge are taken into account for this purpose, but are not taken into account in determining the extent to which the debtor entity was insolvent immediately prior to the debt discharge. FSA 200135002 (Aug. 31, 2001).

6. To the extent the excluded COD income exceeds available tax attributes, the excess is permanently eliminated from the taxpayer’s gross income. Reg. § 1.108-7(a)(2).

D. **Section 1017 Basis Adjustment Rules**

1. Reg. § 1.1017-1(a) defines the following order of priority for basis reductions:

a. Real property used in a trade or business or held for investment (other than dealer real property) that secured the discharged debt immediately before the discharge.
b. Personal property used in a trade or business or held for investment (other than inventory and accounts and notes receivable) that secured the discharged debt immediately before the discharge.

c. Other property used in a trade or business or held for investment (other than inventory, accounts and notes receivable, and dealer real property). This would include, for example, business real estate that did not secure the discharged indebtedness.

d. Inventory, accounts and notes receivable, and dealer real property.

e. Property that is neither used in a trade or business nor held for investment.

2. The basis reductions are made in proportion to the adjusted bases of the assets in each category. Reg. § 1.1017-1(a). For example, if the discharged debt is secured by both land and building, the basis reduction is made proportionately to both items of property based on their relative adjusted bases.

a. By requiring basis reductions to real estate before personalty, the rules make it more likely that the taxpayer will be able to absorb the basis reduction hit in a few large real property assets rather than a myriad of real and personal property assets.

3. In applying these basis reduction rules, a partner’s share of partnership COD income is treated as attributable to a debt secured by the partner’s partnership interest. Reg. § 1.1017-1(g)(1).

a. Because Reg. § 1.1017-1(a)(1) and (2) give first basis reduction priority to the basis of real property securing the discharged debt and second priority to personal property securing the debt, this rule effectively forces the partner to reduce the basis of his partnership interest (which is personalty) with respect to his share of excluded partnership COD income before reducing the basis of his other directly held property.

b. The partnership interest basis adjustment is not accompanied by a correlative inside adjustment to the debtor’s share of the partnership’s basis in its property unless the partner makes the election under section 108(b)(5) (making property basis the first tax attribute to be reduced instead of last) or section 108(c) (qualified real property business indebtedness exclusion), as discussed further below. See Reg. § 1.1017-1(g)(2)(i).

4. Under an anti-abuse rule, any change in the property securing a debt during the one-year period preceding the discharge of the debt is disregarded if a principal purpose of the change is to affect the taxpayer's basis reductions under section 1017. Reg. § 1.1017-1(d).

5. In a title 11 or insolvency case, the basis reduction is limited to the excess of (i) the aggregate of the adjusted bases of property and the amount of money held by the taxpayer immediately after the discharge, over (ii) the aggregate of the liabilities of the taxpayer immediately after the discharge. Section 1017(b)(2); Reg. § 1.1017-1(b)(3). However, this rule only provides an aggregate limit on the amount of the deduction; it does not limit the specific properties to which the basis reduction attaches. Rather, the adjustment is made only as to those properties held on the first day of the taxable year following the year of discharge.
6. Section 108(b)(5) allows the debtor to elect (on Form 982) to modify these ordering rules by first reducing the basis of depreciable property and (pursuant to an additional election) dealer real property prior to reducing other tax attributes. Reg. § 1.108-4; Reg. § 1.1017-1(c)(1).

a. This election could be beneficial, for example, if the debtor has NOL carryovers that can be used more rapidly than depreciation deductions on long-lived assets. Conversely, if the debtor has short-lived NOLs that are expected to expire unused, it would make more sense to burn those attributes first as opposed to depreciable basis that could be recovered over time.

b. If the election is made, however, the liability limitation does not apply. Thus, basis can be reduced below the amount of the taxpayer's remaining liabilities. Section 1017(b)(2) (flush language). However, the reductions under this election are still limited to the aggregate adjusted basis of the taxpayer's depreciable property as of the beginning of the taxable year following the year of the discharge. Section 108(b)(5)(B).

c. The taxpayer is not required to utilize the section 108(b)(5) election to the maximum extent possible. Rather, the taxpayer can elect to reduce only part of the available depreciable basis, in which case he must reduce his other tax attributes by the remaining amount of COD income in accordance with the normal attribute ordering rules. Reg. § 1.1017-1(c)(2).

d. A partner making the election is required to treat a partnership interest as depreciable property to the extent of his proportionate share of the partnership's depreciable property. However, the partnership must also consent to reduce its basis in depreciable property with respect to such partner. Section 1017(b)(3)(C); Reg. § 1.1017-1(g)(2). The same rules apply if the partner makes an election to exclude COD income from qualified real property business indebtedness under section 108(c), except that the partnership interest is treated as depreciable real property to the extent of the partner's share of the partnership's depreciable real property.

(1) Under Reg. § 1.1017-1(g)(2)(v), a section 1017 basis reduction is treated in the same manner and has the same effect as a negative adjustment to the basis of partnership property under section 743(b). See S. Rep. No. 1035, 96th Cong., 2d Sess. 22 n. 28 (1980), accompanying the Bankruptcy Tax Act of 1980 (the “BTA Senate Report”). The adjustment is treated as an adjustment with respect to the partner only and does not affect the partnership's common basis in the depreciable property. Reg. § 1.1017-1(g)(2)(v)(A).

(2) A partner's share of the partnership's basis in depreciable property is equal to the sum of the partner's section 743(b) adjustments to items of depreciable partnership property and the common basis depreciation deductions (excluding remedial section 704(c) allocations) that are reasonably expected to be allocated to the partner over the property's remaining useful life. Reg. § 1.1017-1(g)(2)(iv).

(3) The partner is required to request the partnership's consent to the basis reduction if (i) the partner owns (directly or indirectly) more than 50% of the capital and profits interests in the partnership, or (ii) reductions to the basis of depreciable property (real or personal) are being made with respect to the partner's distributive share of COD income from that particular partnership. Reg. § 1.1017-1(g)(2)(ii)(B).

(4) The partnership generally may decline or accept the partner's request in its sole discretion. Reg. § 1.1017-1(g)(2)(ii)(A). However, the partnership is required to consent to an inside basis adjustment if (i) partners owning (directly or indirectly) more than 80% of the
capital and profits interests in the partnership, or (ii) five or fewer partners owning (directly or indirectly) more than 50% of the capital and profits interests, make such requests. Reg. § 1.1017-1(g)(2)(ii)(C).

(5) The consent rules are intended to prevent a partner from contributing depreciable property to a partnership with intent of shielding the property from basis reductions as to such property -- that is, using the partnership as a blocker. See T.D. 8787 (preamble), 1998-2 C.B. 621.

(6) If the partnership does not consent to an inside basis adjustment, or the partner does not request such an adjustment, only the basis of the partner’s partnership interest is reduced under the normal ordering rules. To the extent such basis reflects a share of partnership liabilities that would be taken into account by the partner upon disposition of the interest under section 752(d), such share of liabilities arguably also is counted in determining the section 1017(b)(2) liability limitation on reduction of property basis.

(7) The partner is required to make the request of the partnership before the due date (including extensions) for filing the partner’s tax return for the taxable year in which the partner has COD income excluded under section 108(a). Reg. § 1.1017-1(g)(2)(ii)(A). The consenting partnership is required to include a statement with its Form 1065 for the taxable year following the taxable year that ends with or within the taxable of the partner in which the COD income is excluded. The statement must identify the amount of the reduction in the partner’s proportionate interest in the adjusted bases of the partnership’s depreciable property or depreciable real property, as applicable. Reg. § 1.1017-1(g)(2)(iii)(A). A copy of the statement must be provided to the partner before the due date (including extensions) for the partner’s return for the year in which he claims a COD income exclusion. Reg. § 1.1017-1(g)(2)(iii)(B).

7. Any reduction in the basis of property (whether depreciable or nondepreciable) under section 108(b)(2)(E), or of depreciable property under section 108(b)(5) or (c)(1), is treated as a depreciation deduction for purposes of applying the depreciation recapture provisions of section 1245 and 1250 upon subsequent disposition of the property. Section 1017(d)(1).

a. In addition, the property whose basis is reduced is treated as section 1245 property if it would not otherwise be classified as section 1245 or 1250 property (this would include land, for example). Id.

b. In the case of depreciable real estate, section 1250(b) is applied by computing straight-line depreciation as if there had been no basis reduction under section 1017. Section 1017(d)(2).

c. Such amounts thus constitute an “unrealized receivable” within the meaning of section 751(c) and may cause gain recognized on the sale of a partnership interest to be recast as ordinary income.

III. EXCLUSION FOR COD ARISING FROM “QUALIFIED REAL PROPERTY BUSINESS INDEBTEDNESS”

A. Definition of Qualified Real Property Business Indebtedness

1. The Omnibus Budget and Reconciliation Act of 1993, Pub. L. 103-66 (the “1993 Act”) added sections 108(a)(1)(D) and (c), which exclude from gross income any COD income attributable to “qualified real property business indebtedness” (“QRPBI”). This relief provision does not
require the taxpayer to be insolvent or in a chapter 11 proceeding; indeed, the statute expressly limits its application to solvent partners not in a title 11 proceeding. Section 108(a)(2)(A) and (B).

2. Section 108(c) applies to all taxpayers other than C corporations. In the case of an S corporation, the election, exclusion and basis reduction toll charge are all done at the S corporation level. Because S corporations are infrequently used to hold real estate, the principal beneficiaries of the new provision are partnerships and their partners. Section 108(d)(6) provides that section 108(c) applies at the partner level rather than the partnership level.

3. The debt must have been "incurred or assumed by the taxpayer in connection with real property used in a trade or business" and must be secured by such real property. Section 108(c)(3)(A). In this context, the term "real property" includes both land and buildings.

4. If the debt was incurred or assumed after December 31, 1992, the debt must also constitute "qualified acquisition indebtedness," which means it must have been "incurred or assumed to acquire, construct, reconstruct, or substantially improve" the real property. Section 108(c)(3)(B) and (C)(4).

   a. It would appear from the statute that pre-January 1, 1993 debt qualifies even though it was placed on the property after its acquisition or construction, as long as it meets the basic requirement that it be incurred "in connection with real property used in a trade or business" and is secured by such real property. Section 108(c)(3)(A).

   b. However, the preamble to the final section 108 regulations states that the IRS and Treasury believe that simply establishing that the debt was secured by real property used in a trade or business as of January 1, 1993 is not enough to establish the requisite debt-to-property "nexus" for pre-1993 debt -- the "in connection with" language means something more is required. See T.D. 8787 (preamble), 1998-2 C.B. 621, 622; Tech. Adv. Mem. 200014007 (Dec. 13, 1999) (ruling that the "in connection with" requirement was satisfied where the debt was incurred after the acquisition of the real property later pledged to secure it and distinguishing the preamble language by citing the fact that the debt in question was secured by other business real property when it was incurred).

   c. Suppose the loan is a junior loan that is structurally subordinated in the sense that it is secured by an interest in a real property-owning LLC or partnership rather than the property itself. There appears to be no direct authority indicating that an indirect interest of this sort satisfies the requirement that the loan be secured by real property. Cf. Rev. Proc. 2003-65, 2003-2 C.B. 336, discussed later in this outline (IRS safe harbor under which a loan secured by an LLC or partnership interest is treated as a loan secured by an interest in real property for REIT asset test purposes).

5. Suppose a developer of condominiums realizes COD income attributable to acquisition debt for a condominium property and wants to avail itself of the section 108(c) exclusion (assume the developer has other depreciable real property available to absorb the basis reduction toll charge). Since the development and sale of condominiums is a trade or business, the real property arguably can be viewed as "used" in that business notwithstanding that it is held for sale to customers, although this is an open question. However, no election is available to treat dealer property as depreciable property for this purpose. Section 1017(b)(3)(F)(ii).

   a. Section 1231(b)(1) defines the term "property used in a trade or business" to include depreciable real property held for more than 1 year as well as "real property, used in the trade or business, held for more than 1 year" which is not property that is includable in inventory or property held primarily for sale to customers in the ordinary course of a trade or business. The specific
exclusions of inventory and dealer real property in section 1231(b)(1)(A) and (B) support the argument that such property would be property “used in a trade or business” but for the specific statutory exclusions for such property.

b. Similarly, Reg. § 1.1017-1(a), which provides ordering rules for reducing the basis of property under section 108(b)(2)(E), describes the first category of property as “real property used in a trade or business or held for investment, other than real property described in section 1221(1), that secured the discharged debt immediately before the discharge.” Reg. § 1.1017-1(a)(1). The wording of this rule, as well as similar language in Reg. § 1.1017-1(a)(3), suggests that inventory and dealer property would, absent the specific exclusions, be considered property “used in a trade or business.”

c. The developer’s efforts to develop the property as a condominium property must also have progressed to the point that the activities constitute a “trade or business” as opposed to simply holding the property for investment. Case law under section 1231 indicates that real property acquired for development is treated as used in a trade or business even though the development plans are later abandoned. Carter-Colton Cigar Co. v. Commissioner, 9 T.C. 219 (1947), acq., 1947-2 C.B. 1 (taxpayer corporation bought land for purpose of building new headquarters and warehouse building; taxpayer procured plans and specs but then abandoned the project, holding the land for a number of years before selling it at a loss; held, taxpayer was entitled to an ordinary loss because the property was “used in a trade or business” under the predecessor to section 1231, even though the development plans were abandoned).

6. The taxpayer must make an election to have this new provision apply. Section 108(c)(3)(C).

a. The election to apply section 108(c) is made at the partner level rather than at the partnership level. Section 108(d)(6). However, the determination of whether indebtedness constitutes QRPBI is made at the partnership level. H.R. Rep. No. 111, 103d Cong., 1st Sess. 622-25 (1993).

b. The election is made by filing Form 982 with a timely-filed tax return (taking into account extensions) for the taxable year in which the discharge occurs. Reg. § 1.108-5(b). A taxpayer who fails to file a timely election must request relief under Reg. § 301.9100-3. See T.D. 8688 (preamble), 1997-1 C.B. 12. The election is revocable with the consent of the Commissioner. Reg. § 1.108-5(b).

c. In Priv. Ltr. Rul. 9637038 (June 14, 1996), the partners of a partnership which had undergone a debt discharge in 1994 were not advised by their tax advisors of the availability of the section 108(c) election. One tax advisor believed (erroneously) that the election was not available if the partnership’s basis in its real property was less than the amount of the debt reduction. Shortly after the return was filed, the tax advisor realized the error and within a month filed a request for extension of time to file the election. The IRS allowed the extension.

7. The IRS has the authority to issue regulations preventing the abuse of section 108(c) “through cross-collateralization or other means.” Section 108(c)(5).

B. **Equity Limitation on Section 108(c) Exclusion**

1. The exclusion is limited to the excess of the “outstanding principal amount” of the debt immediately prior to the discharge over the fair market value of the “real property” securing the debt (reduced by the amount of any other QRPBI secured by the property). Section 108(c)(2)(A); Reg. §
1.108-6(a). This rule is intended to prevent taxpayers from claiming a section 108(c) exclusion to the extent the debt cancellation creates net equity value in the property.

a. Reg. § 1.108-6(a) refines this rule somewhat by using the excess of the QRPBI over the real property’s “net fair market value,” which is defined to be the fair market value of the qualifying real property (without taking into account section 7701(g)) reduced by the outstanding principal amount of any other QRPBI secured by the property immediately before and after the discharge.

b. Note that the value of both land and improvements is taken into account in determining the amount by which the debt exceeds the value of the collateral.

2. When section 108(c) was enacted, it was unclear whether the words “outstanding principal amount” included a liability for accrued interest.

a. Reg. § 1.108-6(a) resolves this issue by including in “principal amount” any additional amounts that are “equivalent to principal, in that interest on such amounts would accrue and compound in the future.” Thus, as long as accrued and unpaid interest accrues interest at the stated rate, the accrued amounts are included as principal (making it unnecessary for the taxpayer to refinance the debt in order to convert the accrued interest to “principal” under the loan agreement).

b. Unpaid interest that is described in section 108(e)(2) cannot be counted as “principal.” Section 108(e)(2) provides that COD income is not realized to the extent that payment of the discharged liability would give rise to a deduction. Interest that is owed either by (i) a cash basis debtor, or (ii) an accrual basis debtor that has stopped accruing interest expense due to a substantial likelihood that it will not be paid, would fall within the scope of section 108(e)(2) and thus cannot be treated as principal for purposes of Reg. § 1.108-6(a).

c. Finally, the outstanding principal amount must be adjusted for unamortized premium and discount consistent with section 108(e)(3). Reg. § 1.108-6(a).

C. Basis Limitation on Section 108(c) Exclusion

1. The statute limits the amount that can be excluded under section 108(a)(1)(D) to the aggregate tax basis of the taxpayer’s “depreciable real property” held immediately before the discharge, after taking into account any other basis reductions required under sections 108(b) or (g) (which contain the toll charge rules that apply to the COD exclusions under the insolvency, bankruptcy and qualified farm indebtedness provisions). Section 108(c)(2)(B). For this purpose, the “taxpayer” is the partner, not the partnership. Section 108(d)(6) (providing that section 108(c) applies at the partner level). This rule ensures that the partner has adequate depreciable property basis to fully absorb the section 108 toll charge.

a. Any excess COD income is recognized unless the taxpayer can qualify for the purchase price reduction exception in section 108(e)(5) (discussed later in this outline).

2. Note that this limitation does not require that the property securing the QRPBI be depreciable. Thus, a taxpayer can claim a section 108(c) exclusion as to debt secured only by land used in a trade or business, as long as the taxpayer has sufficient tax basis in other depreciable real property available to absorb the write-down.

3. Reg. § 1.108-6(b) provides that, for purposes of determining the basis limitation, the basis of depreciable real property is reduced by depreciation claimed for the taxable year in which the
taxpayer excluded COD income under the QRPBI exclusion and also for reductions to the basis of such property otherwise required under sections 108(b) or (g) for such taxable year.

4. Depreciable real property acquired in contemplation of the discharge does not count for purposes of this limitation. Section 108(c)(2)(B); Reg. § 1.108-6(b).

D. Section 108(c) Basis Reduction Toll Charge

1. The taxpayer is required to reduce the basis of his “depreciable real property” by the amount of COD income excluded under the QRPBI exclusion. Section 108(c)(1)(A). The basis reduction rules are similar to those discussed previously, but there are certain differences. These are noted below.

2. Section 1017(a) provides, in relevant part, that if an amount is excluded under section 108(a) and a basis reduction is required under section 108(c)(1), then the reduction applies to the basis of the depreciable real property held by the taxpayer at the beginning of the taxable year following the year in which the discharge occurs. See also section 1017(b)(3)(A) and (b)(3)(F)(i).

   a. If the depreciable real property is disposed of before the basis reduction would otherwise take effect, the adjustment is made immediately before the disposition. Section 1017(b)(3)(F)(iii). This is an exception to the general rule that basis reductions take effect at the beginning of the year following the discharge year.

3. The section 1017 ordering rules require the taxpayer to reduce the adjusted basis of the depreciable real property with respect to which the debt is QRPBI under section 108(c)(3) (referred to in the regulations as “qualifying real property”) before reducing the basis of the taxpayer’s other depreciable real property. Reg. § 1.1017-1(c)(1).

4. Because the real property must be depreciable, dealer real property referred to under section 1221(1) does not qualify. Further, section 1017(b)(3)(F)(ii) provides that the special election provided in section 1017(b)(3)(F) to treat dealer real property as “depreciable property” for purposes of the section 108(b)(5) election does not apply in the case of a basis reduction mandated by section 108(c)(1). Reg. § 1.1017-1(f)(1).

5. A partner’s interest in the partnership is treated as depreciable real property to the extent of the partner’s interest in the partnership’s depreciable real property, provided the partner and the partnership so elect. Section 1017(b)(3)(C). (These rules are discussed earlier in this outline.)

6. In Priv. Ltr. Rul. 9426006 (March 25, 1994), the IRS addressed the application of these rules in the context of tiered partnerships. A partnership (the “Property Partnership”) owned an office building (the “Property”) which was managed by a third-party property manager. The tenant leases required the Property Partnership to pay all operating expenses up to a base amount, and the tenant bore expenses in excess of the base amount (hence, the leases were not net leases). The Property Partnership was indebted to a bank on a nonrecourse mortgage secured by the Property which was incurred to purchase and renovate the Property. The Property Partnership filed for bankruptcy, and the debt was restructured in a way that caused a section 1001 exchange of new debt for old. The Partnership realized COD income equal to the difference between the issue price of the new debt and the adjusted issue price of the old debt.

   a. The interests in the Property Partnership were held by four upper-tier limited partnerships (the “Upper-Tier Partnerships”). The issue was the availability of section 108 to the
partners of the Upper-Tier Partnerships. Because none of the individual partners of the Upper-Tier Partnerships was insolvent or in bankruptcy, the only way the partners could avoid recognizing COD income was to seek refuge under section 108(c).

b. The National Office determined that the office building was held in a “trade or business” and therefore the Property Partnership’s debt constituted QRPBI as to the ultimate individual partners. Thus, each partner could make a section 108(c) election. However, the ruling’s reference to the fact that the leases were not “net leases” may suggest that the IRS views net leased real property as possibly not constituting a trade or business.

c. The National Office further ruled that, for purposes of section 1017(b)(3)(C), the interests in Property Partnership held by the Upper-Tier Partnerships constituted “depreciable property” to the extent of the Upper-Tier Partnership’s proportionate interest in the depreciable property held by the Property Partnership, provided there was a corresponding reduction in the Property Partnership’s basis in its depreciable property with respect to the Upper-Tier Partnerships. Similarly, it ruled that the interests of each individual partner in the Upper-Tier Partnerships constituted depreciable property to the extent that the Upper-Tier Partnership reduced the basis of its “depreciable property” (namely, it interests in Property Partnership).

7. Special attribute reduction rules relating to S corporations are discussed elsewhere in this outline.

IV. APPLICATION OF COD RULES TO PARTNERS AND PARTNERSHIPS

A. Exclusions and Attribute Reduction Occur at Partner Level

1. Section 108(d)(6) provides that the COD income exclusion and attribute reduction rules of sections 108(a) and (b) are applied at the “partner level.” Thus, if a partner is in a title 11 case or is insolvent, his distributive share of COD income is excluded under section 108(a), and his individual tax attributes are reduced to the extent provided in section 108(b). The amount of COD income is determined at the partnership level.

2. Further, if the section 108(c) exclusion is elected by a partner, the determination of whether a particular debt qualifies as QRPBI and the fair market value limitation are applied at the partnership level. H.R. Rep. No. 111, 103d Cong., 1st Sess. 186 (1993).

3. The statute is poorly drafted in terms of how the bankruptcy exclusion applies to a partner. Section 108(a) applies at the partner level, which includes the bankruptcy exclusion. Section 108(d)(6). However, that exclusion by its terms applies only if “the discharge occurs in a title 11 case.” Section 108(a)(1)(A). In addition, section 108(d)(2) defines “title 11 case” as a case under title 11 of the bankruptcy code, “but only if the taxpayer is under the jurisdiction of the court in such case and the discharge of indebtedness is granted by the court or is pursuant to a plan approved by the court.”

a. Since the partner is not the debtor, these provisions do not synch up properly. They could be interpreted to require that both the partnership and the partner must be in a title 11 case in order for a partner to claim the bankruptcy exclusion.

b. The BTA Senate Report suggests that only the partner needs to be in a bankruptcy proceeding. It states (p. 21) that the “tax treatment of the amount of discharged partnership debt which is allocated as an income item to a particular partner depends on whether that partner is in a bankruptcy case, is insolvent (but not in a bankruptcy case), or is solvent (and not in a bankruptcy
case)... for example, if the particular partner is bankrupt, the debt discharge amount is excluded from gross income pursuant to amended section 108.” On the other hand, note 28 (p. 22 of the BTA Senate Report) illustrates the rules with an example that assumes that both the partnership and one of its three partners are in a bankruptcy case. See also Rev. Rul. 92-97, 1992-2 C.B. 124 (stating that “[u]nder section 108(d)(6), the section 108(a) exclusions are applied at the partner level to the COD income”).

c. On the other hand, if the partner is not in a title 11 case, it appears that it cannot claim the bankruptcy exclusion as to its share of partnership COD even though the partnership is itself a debtor in a title 11 case. See BTA Senate Report at p. 22, n. 28 (example denies bankruptcy exclusion to partner not in bankruptcy even though partnership was in bankruptcy proceeding); but see Price v. Commissioner, 87 T.C.M. (CCH) 1426 (2004) (Tax Court held that general partner could claim bankruptcy exclusion because bankruptcy court supervising partnership bankruptcy proceeding asserted jurisdiction over general partner and discharged it from liability as to partnership debt).

4. COD income is realized at the partnership level and allocated to the partners in the manner in which they share profits under the partnership agreement, consistent with section 704(b). The COD income retains its character as such at the partner level. Sections 702 and 108(d)(6).

5. The income allocation increases the basis of the partner’s partnership interest. Section 705(a)(1)(A); BTA Senate Report at 21-22; cf. Gershkowitz v. Commissioner, 88 T.C. 984, 1016 (1987). The basis increase under section 705(a)(1)(A) occurs even though the income is excluded from the partner’s income by reason of his insolvency or bankruptcy.

6. In Revenue Ruling 92-97, the IRS described post-BTA law in the partnership context as follows: “If an allocation of a share of a partnership’s COD income is made to a partner, and the allocation has substantial economic effect, the partner increases outside basis under section 705(a)(1)(A) of the Code, receives a capital account increase under section 1.704-1(b)(2)(iv)(b)(3) of the regulations, and must determine, based on the partner’s own circumstances, if all or part of the distributive share may be excluded from gross income under section 108(a).”

B. Section 752 Liability Shift From Debt Discharge

1. The debt discharge triggers a corresponding constructive distribution under section 752(b) to the extent that the partner’s share of the liability (as determined under the section 752 regulations) immediately prior to the discharge exceeds his share immediately after the discharge. The constructive distribution will be offset by a basis increase for the allocated COD income, provided the COD income is allocated among the partners in the same manner as the discharged debt was allocated for section 752 purposes. This is generally the case, but not always — partners could share the liability in accordance with the manner in which they share losses, but share the COD income in the manner in which they share profits. Rarely does a partnership agreement contain a specific provision as to how COD income will be allocated.

a. Note that if the taxpayer makes a section 108(i) election to defer COD income recognition, the constructive distribution under section 752(b) is not taken into account until the COD income is recognized, to the extent it would cause the taxpayer to recognize gain under section 731. Section 108(i)(6).

b. Reg. § 1.731-1(a)(1)(ii) provides that, for purposes of determining whether a “current distribution” results in gain, any advances or drawings against a partner’s distributive share of income are treated as current distributions made on the last day of the partnership taxable year with respect to the partner. In Revenue Ruling 92-97, the IRS ruled that due to the “integral relationship
between the COD income and the section 752(b) distribution of money from the canceled debt," the section 752 distribution is treated as an advance or drawing against the partner's distributive share of COD income under such regulation and therefore is treated as occurring at the end of the taxable year to that extent.

c. This result is consistent with the legislative history of section 108, which indicates that the section 705 basis adjustment will be treated as occurring at the same time as the section 752 deemed distribution. BTA Senate Report at 21.

d. As further discussed below, situation (2) of Revenue Ruling 92-97 appears to hold that a constructive distribution of money arising from a liability reduction in a workout is taken into account at the end of the taxable year, even though the amount of the distribution exceeds the distributee partner's allocable share of COD income resulting from the workout.

e. In Revenue Ruling 94-4, the IRS expanded the theory of Revenue Ruling 92-97 to debt reductions occurring outside the workout context. 1994-1 C.B. 196. The ruling holds any constructive distribution of money under section 752(b) "is treated as an advance or drawing of money under Reg. § 1.731-1(a)(1)(ii) to the extent of the partners' distributive share of income for the partnership taxable year." The ruling further states that "an amount treated as an advance or drawing of money is taken into account at the end of the taxable year." Thus, a constructive distribution from a liability shift is taken into account on the last day of the taxable year (rather than when the reduction in liability occurs), but apparently only to the extent of the partner's distributive share of partnership income for such taxable year, including minimum gain chargebacks (if any) triggered by the liability reduction. The ruling can be read to imply that, to the extent the constructive distribution exceeds the partner's share of partnership income for the year, it is deemed to occur at the time of the liability reduction. However, this is inconsistent with the apparent holding of situation (2) of Revenue Ruling 92-97. See also Priv. Ltr. Rul. 9619002 (Jan. 31, 1996) (interpreting Revenue Ruling 94-4 as requiring a section 752(b) constructive distribution resulting from a bankruptcy discharge of a general partner's share of the partnership's recourse debt to be taken into account at year-end under Reg. § 1.731-1(a)(1)(ii), with no mention of whether the distribution exceeded the partner's distributive share of partnership income for the year). If, however, the amount of COD income allocated to the partner matches the amount of his section 752(b) distribution, the two will wash and the partner will have only COD income to contend with.

f. Example. Partnership P is in a title 11 case. A, a 50% general partner, is also in a bankruptcy proceeding. B, a 50% limited partner, is solvent and not in a bankruptcy proceeding. P owns real estate which it purchased for $200 cash plus a nonrecourse debt of $500. The property's tax basis and value have declined to $200. Assuming no principal amortization has occurred, each of A and B has a negative capital account of $150 ($100 cash contribution - $250 depreciation deduction) and a tax basis in his partnership interest of $100 ($100 cash contribution - $250 depreciation deduction + $250 share of nonrecourse debt). B is not obligated to restore his deficit. In the bankruptcy proceeding, P's debt is modified by reducing the principal and interest rate and deferring payment of most of the interest
until maturity. The issue price of the modified debt instrument under section 1274 is $200. The tax consequences of the discharge are as follows (assuming the partners do not elect to apply section 108(c)).

(1) P has realized COD income equal to the difference between the adjusted issue price of the old debt ($500) and the issue price of the new debt ($200), or $300. Section 108(e)(10). The profit sharing allocations of the partnership agreement, including the minimum gain chargeback provision, cause such income to be allocated equally to A and B. (It is assumed that the lender is not the seller of the property, so that the purchase price adjustment exception of section 108(e)(5) is not available.)

(2) The COD income allocation increases the basis of each partner’s partnership interest under section 705, regardless of whether the income is excludable by the partner under section 108(a).

(3) The income retains its character as COD income at the partner level. Section 702. A excludes his share under section 108(a) and reduces his individual tax attributes to the extent required under section 108(b). B recognizes $150 of COD income because B is not insolvent or in a bankruptcy proceeding.

(4) The debt reduction results in a $150 constructive distribution to each of A and B under section 752(b). No gain is recognized by A and B under section 731, however, because the basis increase from the COD income allocation exactly offsets the basis decrease from the constructive distribution under section 733.

C. Section 704(b) Allocation Considerations

1. If the discharged debt is nonrecourse, the manner in which the resulting COD income is allocated may be affected by the minimum gain chargeback rules.

2. Minimum gain is the amount of gain the partnership would recognize if it disposed of the property subject to each nonrecourse debt for no consideration other than satisfaction of the debt and by then aggregating all such amounts. Reg. § 1.704-2(d)(1). If there is a net decrease in partnership minimum gain, each partner must be allocated items of partnership income and gain for that year (and, if necessary, subsequent years) equal to the partner’s share of the net decrease in minimum gain. Reg. § 1.704-2(f)(1). A partner’s share of minimum gain at the end of any taxable year equals the sum of (i) nonrecourse deductions allocated to that partner up to that time, and (ii) the proceeds of any nonrecourse liability distributed to such partner up to that time that were allocable to an increase in minimum gain, reduced by the partner’s share of any prior net decreases in partnership minimum gain, including decreases attributable to book-ups.

3. In effect, this application of tax benefit principles requires an amount of income equal to the decrease in minimum gain to be allocated to the partners in accordance with the manner in which they shared nonrecourse deductions and distributions of proceeds of nonrecourse refinancing that increased minimum gain. Reg. § 1.704-2(g)(1).

4. The IRS has indicated that COD income arising from the discharge of nonrecourse debt at a time when there is partnership minimum gain or partner minimum gain must be allocated in accordance with the minimum gain chargeback rules. Rev. Rul. 99-43, 1999-2 C.B. 506 (footnote 1). The same is true of sale gain recognized by the partnership on transfer of the collateral back to the lender in satisfaction of the debt.
a. The Preamble to the proposed partnership debt-for-equity regulations asks for comments on whether COD income arising from a debt-for-equity exchange should be treated as a first-tier minimum gain chargeback item under Reg. § 1.704-2(f)(6). See REG-164370-05, 2008-46 I.R.B. 1157.

5. It may be possible to specially allocate partnership COD income to one or more partners (e.g., to those partners who are insolvent or in bankruptcy and who therefore may be indifferent to the receipt of such income). Such allocations must satisfy the substantial economic effect rules of section 704(b), including the “substantiality” requirement of Reg. § 1.704-1(b)(2)(iii). See Rev. Rul. 99-43, supra (addressing the substantiality requirement in the context of COD income arising from nonrecourse debt where the income is not subject to minimum gain chargeback provisions).

6. In Revenue Ruling 92-97, the IRS applied the section 704(b) rules to two situations involving debt discharge income realized by a general partnership comprised of partners A and B who contributed $100 capital ($10 by A, $90 by B) and share losses in a 10/90 ratio but profits 50/50. 1992-2 C.B. 124. The facts state that there is no chargeback of prior loss allocations (not a typical economic deal). In situation 1, A and B do not have any obligation to restore deficits in their capital accounts, but are treated under Reg. § 1.704-1(b)(2)(ii)(c) as having a limited obligation to restore deficits by reason of their state law liability to creditors. The partnership purchases real property for $1,000 using $100 of equity and $900 of recourse bank financing. Over the next five years the partnership incurs net losses totaling $1,000, which are allocated 10/90 to A and B, leaving A with a $90 negative capital account and B with an $810 negative capital account. At the beginning of year 6, the debt is canceled by the bank in a workout.

a. The ruling hold that a 50/50 allocation of the $900 of COD income would not have substantial economic effect because it would leave B with a deficit of $360 for which he has no contractual obligation to restore, while partner A would be left with a positive $360 capital account. Thus, the ruling holds that the COD income must be allocated 10/90, consistent with the manner in which the partners shared the economic risk of loss of the liability.

b. The ruling also holds that A and B recognize no section 731 gain as a result of the deemed distribution of money under section 752(b) caused by the liability reduction because “the integral relationship” between the COD income and the section 752(b) distribution makes it appropriate to treat the constructive distribution as an advance or drawing against the partners’ distributive shares of COD income which is taken into account at the end of year 6, at the same time the COD income gives rise to a step-up in the bases of the partners’ interests under section 705(a)(1)(A).

c. In situation 2 of the ruling, A and B each assume an unlimited contractual obligation to restore the deficit balance of their capital accounts to the partnership on liquidation. The ruling holds that a 50/50 allocation of COD income has substantial economic effect if “substantiality is independently established.” However, since B receives only 50% of the COD income, but receives an $810 constructive distribution of money under section 752(b), B recognizes section 731 gain of $360 ($810 - $450).

d. Interestingly, the ruling appears to state that the entire constructive distribution to B is deemed to take place at the end of the taxable year under Reg. § 1.731-1(a)(1)(ii), even though it exceeds B’s allocable share of COD income. This conclusion may be inconsistent with the “integral relationship” rationale cited in situation 1 for treating the section 752(b) distribution as an advance against distributive share. It is also arguably inconsistent with Revenue Ruling 94-4, discussed earlier in this outline, which states that the treatment of a constructive distribution as an advance or draw applies “to the extent” of the partner’s distributive share of income for the year.
7. The allocation of COD income under the terms of the partnership agreement can, under certain circumstances, seriously distort the intended economic consequences of the partnership because the COD income allocated may not (and typically would not) result in any economic gain at the partnership level. Indeed, when partnership recourse debt is canceled because of a decline in value of the partnership’s property, the economic gain -- i.e., the freeing up of net worth -- occurs at the partner level with respect to those partners who are liable to pay the debt out of their separate assets. Nevertheless, the partnership agreement may allocate COD income to limited partners who bear no economic risk as to the debt and who receive no economic benefit from the cancellation. It could be argued that, under the substantial economic effect test, such income should be allocated only to the at-risk partners. On the other hand, the allocation of such COD income to the at-risk partners could result in possibly unexpected economic consequences if the allocation is reflected in their capital accounts and the partnership’s property subsequently appreciates in value. Thus, the parties should carefully review the profit and loss allocation provisions in light of the discharge and determine whether amendments are needed.

V. NEW DEFERRAL ELECTION FOR COD INCOME -- SECTION 108(i)

A. General

1. New 108(i) provides taxpayers with an election to defer COD income recognized as a result of a “reacquisition” of an “applicable debt instrument” that occurs in either 2009 or 2010. Section 1231(a) of ARRTA. Taxpayers must amortize the deferred COD income ratably over a five-taxable-year period beginning in 2014 and ending in 2018. Section 108(i)(1).

2. Revenue Procedure 2009-37 provides guidance on how the election is made and addresses a number of related issues.

3. Definition of “applicable debt instrument.” An “applicable debt instrument” means any debt instrument issued by a C corporation or by any other taxpayer “in connection with the conduct of a trade or business by such person.” Section 108(i)(3)(A). In general, rental real property should meet the trade or business standard. See, e.g., Hazard v. Commissioner, 7 T.C. 372 (1946), acq., 1946-2 C.B. 3 (Tax Court held that a lawyer who rented out his former residence could claim an ordinary loss on sale by reason of the exclusion, under then applicable law, from capital asset status for "real property used in the trade or business of the taxpayer").

4. Making the election. The election is made by attaching a statement to the taxpayer’s timely filed (including extensions) return for the taxable year in which the reacquisition occurs. Rev. Proc. 2009-37, Section 4.01(1)(a). However, the Revenue Procedure grants an automatic 12-month extension of the due date (i.e., an additional 12 months after the extended due date of the return) in accordance with the rules provided in Reg. § 301.9100-2(a), which require the filing of an amended return if the original return was filed without the election and identifying that the election is filed under Reg. § 301.9901-2. Rev. Proc. 2009-37, Section 4.01(2).

a. The election must clearly identify the debt instrument, the amount of deferred income, and such other information as the Secretary may prescribe. Section 108(i)(5)(B); H.R. Conf. Rep. No. 16, 111th Cong., 1st Sess. at 566 (2009) (“ARRTA Conference Report”). The election is irrevocable. Section 108(i)(5)(B)(ii). Under Revenue Procedure 2009-37, Section 4.05(2), the statement must contain:

(1) a general description of the taxpayer’s trade or business (unless the taxpayer is a C corporation) to which the debt instrument is connected;
a general description of the debt instrument;

(3) a general description of the reacquisition transaction;

(4) the total amount of COD income realized;

(5) the amount of COD income as to which the deferral election is being made, a list of the partners that have deferred COD income allocated to them, and the amounts of such income;

(6) if a new debt instrument is issued or deemed issued in the reacquisition transaction, the identity of the issuer and the amount of OID (if any) that will accrue each taxable year on the instrument and the amount of OID that the issuer expects to defer under section 108(i)(2) each year.

b. A taxpayer can elect to defer all or any portion of the COD income arising from a particular debt instrument reacquisition, and can make an entirely different election as to another reacquired debt instrument, even if it is part of the same issue as the other instrument. Rev. Proc. 2009-37, Section 4.04.

c. In the case of partnership debtors, the election is made by the partnership, not the partners, even though the section 108 exclusionary and attribute reduction rules apply at the partner level. Section 108(i)(5)(B)(iii); Rev. Proc. 2009-37, Section 2.05. It is understood that Congress provided for a partnership election to ensure that individual partners would ultimately receive a schedule K-1 disclosing the required amortization of COD income and thus prevent the deferred income from falling through the cracks.

d. The taxpayer is permitted to make a protective election under section 108(i) if the taxpayer concludes that a particular transaction does not result in COD income being realized, but the IRS later disagrees with that conclusion. Rev. Proc. 2009-37, Section 4.11. The protective election then becomes a binding, irrevocable election, even if the statute of limitations has expired for the taxable year in which the COD income was realized.

(1) Example. The taxpayer re-acquires an applicable debt instrument in 2009, incorrectly determines no COD income was realized, but makes a protective election with its 2009 return. The IRS audits the taxpayer's return for 2016 and determines that additional COD income should have been reported in the 2009 return. Because the taxpayer made a protective election, the IRS can assert an adjustment to its taxable income for 2016 for the portion of such COD income (one-fifth) that would be properly includable in income in 2016.

(2) Holding the statute of limitations open for a redetermination of additional COD income in the year of the debt reacquisition is a reasonable quid pro quo for allowing a protective election in the first place.

(3) The taxpayer must attach a copy of the protective election to its federal income tax return for each of the taxable years following the election year and through the end of the amortization period (2018).

5. Allocation of deferred COD income among partners. When the deferred COD income and any deferred OID deductions (as discussed below) are ultimately included or deducted by the partnership, the statute requires that such amounts be "allocated to the partners in the partnership
immediately before the discharge in the manner such amounts would have been included in the
distributive shares of such partners if such income or deduction were recognized at such time.” Section
108(i)(6) (first sentence). The reference to “at such time” apparently means the time of the discharge, and
the pre-discharge partners’ “distributive shares” are presumably determined based on the allocation
waterfall provided in the partnership agreement (taking into account the section 704(b) regulations) for
the partnership’s taxable year in which the discharge occurred.

a. This view is confirmed by Revenue Procedure 2009-37. Section 2.08
states that all of the COD income realized (without regard to the deferral election) is required to be
allocated to those persons who are partners immediately before the reacquisition in the manner in which
the income would be included in their distributive shares under the section 704(b) regulations. But
Section 4.04(3) of the Revenue Procedure goes on to provide additional flexibility not explicitly provided
for in the statute: the partnership can also specify in its election how the portion (if less than all) of the
aggregate COD income being deferred is to be allocated among the partners. In other words, to the extent
a partner is validly allocated a share of COD income under the partnership agreement and the section
704(b) regulations, the partnership’s election can specify how much, if any, of a particular partner’s
section 704(b) share is deferred and how much is currently includable. The amounts so specified do not
have to be pro rata in accordance with their section 704(b) shares of the COD income.

b. Example. A two-person equal partnership realizes $100 of COD income
in 2009. (Assume the section 108(c) exclusion for COD income attributable to qualified real property
business indebtedness is not available.) Partner A owns a 50% interest and is insolvent. Allocations and
distributions are “straight-up.” Partner B owns the other 50% interest and is not eligible for either the
insolvency or bankruptcy exclusion. The partnership can elect under section 108(i) to defer $50 of COD
income and allocate such deferred income solely to Partner B. The remaining $50 of income can be
allocated to Partner A who excludes it under section 108(a) and suffers attribute reduction commencing
with the beginning of the following taxable year. Thus, the partnership can accommodate the tax
objectives of both partners.

c. Consequently, a partnership that realizes COD income can consult its
partners, find out who wants a deferral of all or a portion of the partner’s section 704(b) share and who
doesn’t, and can then specify in its election how the aggregate deferred COD income and the aggregate
“included” COD income are to be apportioned among the partners.

d. Practitioners were greatly concerned as to how general partners and LLC
managing members would sort out the competing tax positions of their members while keeping in mind
fiduciary duty obligations, but the flexibility afforded by the Revenue Procedure should substantially
alleviate such concerns. However, those in charge may feel compelled to poll their members to ascertain
their tax wishes, and doing so may not be feasible or practicable in every case.

e. Non-corporate partners who are not insolvent or in bankruptcy will need
to evaluate the relative merits of electing section 108(c) (qualified real property business debt exclusion)
at the partner level and taking the basis write down to depreciable property (assuming the discharge meets
the requirements of that exclusionary rule), or persuading the partnership to elect to defer at the
partnership level under section 108(i).

6. The Revenue Procedure also deals with the case where the partnership
determines COD income in year 1 to be X, and the IRS later concludes on audit that the amount was
really X + 2. The partnership is permitted to specify in advance, by way of a provisional election on its
year 1 return, how much of the additional COD income, if any, is deferred and how much is currently
includable, and how the deferred and included amounts would be allocated among the partners.
7. The term "reacquisition" includes any "acquisition" of an applicable debt instrument by the debtor which issued the debt instrument (or is otherwise the obligor under such instrument), or by a person related to the debtor under section 108(c)(4). Sections 108(i)(4) and (i)(5)(A). It also includes an "indirect acquisition" within the meaning of Reg. § 1.108-2(c). Rev. Proc. 2009-37, Section 2.03.

a. Section 108(i)(4)(B) provides that "the term ‘acquisition’ shall, with respect to any applicable debt instrument, include an acquisition of the debt instrument for cash, the exchange of the debt instrument for another debt instrument (including a deemed exchange resulting from a modification of the debt instrument), the exchange of the debt instrument for corporate stock or a partnership interest, and the contribution of the debt instrument to capital," and also includes a complete forgiveness of the debt by the holder.

b. This definition is broad enough on its face to include virtually any event giving rise to COD income, but it does not specifically reference transfers of debt in exchange for "property," except where the property is stock, a partnership interest, or another debt instrument. Assume, for example, that a debtor conveys property worth $500 that secures an $800 recourse liability to the lender. The lender forgives the remaining portion of the debt and generates $300 of COD income for the debtor. There is no apparent policy reason why the deferral election should not apply in such a case. Further, both sentences of section 108(i)(4)(B) use the word "include," indicating that the types of acquisitions listed in such paragraph are not exclusive. The ARRTA Conference Report (p. 564) goes further, stating that the statute "includes, without limitation" the various types of acquisitions listed in the statute.

c. In Revenue Procedure 2009-37, Section 2.03, the IRS stated that the term "acquisition" includes an acquisition of debt "for cash or other property," which puts this issue to bed.

8. A taxpayer that makes the section 108(i) election is precluded from claiming the exclusions in section 108(a)(1) for bankruptcy, insolvency, qualified real property business indebtedness, and qualified farm indebtedness with respect to the deferred COD income. Section 108(i)(5)(C).

a. This means, for example, that an insolvent taxpayer could choose to defer the COD income (and ultimately pay tax on it) instead of excluding it under section 108(a) and being forced to reduce its tax attributes.

b. If the attribute reduction rules would otherwise require the basis of the taxpayer's property to be reduced, any gain recognized on a subsequent sale of the property would have to be recaptured as ordinary income under section 1017(d) to the extent of the basis reduction. Thus, if the taxpayer contemplates selling such property before the deferred COD income is recognized, the deferral election is more tax-efficient.

9. A taxpayer is permitted to make a "partial election" under which it can elect to defer a part, but not all, of the COD income arising from the reacquisition of any applicable debt instrument, and can also elect to defer COD income from one reacquired debt instrument but not as to another. Rev. Proc. 2009-37, Section 4.04.

10. A taxpayer can also make a protective election if the taxpayer concludes that a particular transaction does not result in COD income. Rev. Proc. 2009-37, Section 4.11. If a protective election is made, and the IRS subsequently determines that the taxpayer concluded incorrectly, the protective election becomes a valid, irrevocable election and the taxpayer is required to report deferred
COD income as required by section 108(i) even if the statute of limitations has expired for the year in which the COD income was realized and the protective election was made.

11. Section 108(i)(7) gives the IRS the authority to issue rules and regulations as are necessary or appropriate for the application of section 108(i) to partnerships, S corporations, and other pass through entities.

B. Acceleration Rule

1. The deferred COD income and any deferred OID deductions are accelerated upon “the death of an individual taxpayer, the liquidation or sale of substantially all the assets of the taxpayer (including in a title 11 or similar case), the cessation of business by the taxpayer, or similar circumstances.” Section 108(i)(5)(D)(i). In a title 11 case, the income and deductions are taken into account the day before the petition is filed. Id. The acceleration rule does not apply where the taxpayer reorganizes and emerges from the title 11 case. ARRTA Conference Report at 565.

   a. It is unclear whether the proper frame of reference for measuring “substantially all the assets” is a snapshot of the taxpayer’s business on the date the COD was realized or the date on which a contraction of the business takes place.

   b. If an LLC or partnership gives back property to a recourse lender in a deed in lieu or foreclosure proceeding, it cannot take advantage of the deferral election to defer any resulting COD income if that property represents substantially all of its assets or the entity otherwise ceases business.

2. Section 108(i)(5)(D)(ii) provides that the acceleration rule also applies “in the case of a sale or exchange or redemption of an interest in a partnership, S corporation, or other pass through entity” by the owner of such interest. Thus, a selling or redeeming partner’s allocable share of the deferred COD income and any deferred OID deductions is accelerated as to that partner at the time of the sale or redemption.

   a. As noted above, the partner’s share of such deferred items is based on the amount that would have been allocated to the partner if the income or deduction had been recognized at the time of the discharge. Section 108(i)(6) (first sentence).

   b. Since there really is no concept of a “partial redemption” in the case of a partnership interest, it would appear that acceleration should be triggered only when the partner’s interest in the partnership is completely redeemed.

   c. The deferral of the decrease in the partner’s section 752 share of liabilities under section 108(i)(6) (last two sentences) is accelerated at the same time as the partner’s deferred COD income and OID deductions.

3. Section 108(i)(7) gives the IRS the authority to issue rules and regulations that extend the application of the acceleration rule of section 108(i)(5)(D) “to other circumstances where appropriate.”

4. Treasury reportedly is considering whether to provide an exception to the acceleration rule for a liquidation or reorganization of a corporate debtor where the tax attributes carry over to the successor under section 381. See Comments of Donald Bakke reported at Highlights & Documents, p. 1550, March 12, 2009; cf. Reg. § 1.1001-3(e)(4)(i)(B) and (C) (providing exceptions to the
substitution-of-new-obligor section 1001 modification rule for section 381(a) transactions and transactions where the new obligor acquires substantially all the assets of the original obligor, provided that there is no change in payment expectations).

C. Relief for Subchapter K Tax Effects of Debt Reduction

1. Section 108(i)(6) provides, in the penultimate sentence, that “[a]ny decrease in a partner’s share of partnership liabilities as a result of [the discharge of debt] shall not be taken into account for purposes of section 752 to the extent that it would cause the partner to recognize gain under section 731.” Section 108(i)(6). The last sentence states that “[a]ny decrease in partnership liabilities deferred under the preceding sentence shall be taken into account by such partner at such time, and to the same extent, as income deferred under this subsection is recognized.”

2. Without this provision, a taxpayer whose negative tax capital account was protected by the discharged liability would not find the COD deferral particularly helpful because the discharge would still cause him to recognize gain (which could be capital rather than ordinary) under sections 731 and 752(b). Deferring the constructive distribution of money until the COD income is recognized allows the basis step-up attributable to the COD income to offset the constructive distribution, so that the partners recognize COD income but no additional “outside” partnership interest gain.

3. Note that section 108(i) will not prevent the taxpayer’s basis from being reduced (potentially to zero) as a result of a debt reduction -- it only defers the constructive distribution of money to the extent it exceeds the partner’s basis.

4. The statute does not mention section 465. Section 465(e) can trigger ordinary income recapture when a partner’s at-risk amount decreases, including a debt discharge that reduces a partnership liability included in his at-risk amount. Nevertheless, the last sentence of section 108(i)(6) seems broad enough to cover section 465 as well as section 752, and Treasury should make this clear in regulations.

D. Mandatory Deferral of OID Deductions Where Deferred COD Income Arises in Debt-For-Debt Exchange

1. COD income arises in a debt-for-debt exchange when the issue price of the new debt is less than the adjusted issue price of the old debt (e.g., because the new debt trades at a discount). At the same time, an offsetting amount of OID is ordinarily created because the principal amount of the debt remains unchanged. Thus, the debtor’s immediate COD income recognition is typically offset over time by increased OID deductions.

2. Because section 108(i) permits a deferral of COD income, Congress did not want to give the debtor the tax benefit of OID deductions before the related COD income was recognized. Thus, section 108(i)(2)(A) provides that the portion of OID accruing before 2014 (the first taxable year of the five-year COD income amortization period) must be deferred and amortized ratably over such five-year period. The deferred OID is limited to the amount of COD income deferred.

3. The OID deferral rule applies to OID in respect of (i) any debt instrument issued (or treated as issued under section 108(e)(4)) for the applicable debt instrument being acquired, and (ii) any debt instrument issued by the borrower where the proceeds are used, directly or indirectly, to reacquire an applicable debt instrument. Sections 108(i)(2)(A) and (B). In the latter case, if only a portion of the new loan proceeds are used to reacquire the debt, the OID deferral rules apply to a corresponding portion (in percentage terms) of the OID on the new loan. Section 108(i)(2)(B).
4. If the modified debt matures before the end of the five-year COD amortization period, all of the OID under the debt instrument (to the extent not in excess of the COD income) will be deferred and amortized over the five-year period, which generally should eliminate the timing mismatch.

E. Special Partnership Information Reporting Requirements

1. For the taxable year in which the section 108(i) election is made, the partnership must report on each partner’s Schedule K-1 the following information (Section 4.07(1)):

   a. The amounts of the partner’s deferred COD and deferred OID from prior taxable years that are required to be included in the partner’s income for the current taxable year, and the remaining deferred amounts; and

   b. the amount of the partner’s deferred section 752(b) distribution that has to be treated as a distribution of money to the partner under section 752 for the current taxable year and the remaining deferred section 752(b) distribution.

2. For the election year only, the partnership must also include with each partner’s Schedule K-1 a statement (which is not filed with the Schedule K-1s provided to the IRS) containing the following information (Section 4.07(2)):

   a. the partner’s aggregate COD income amount, deferred amount, and included amount, as well as the amount of deferred COD income includable in the current taxable year;

   b. the partner’s share of OID deductions that is deferred in the current taxable year, and the partner’s share of deferred OID deductions that is allowable as a deduction in the current taxable year;

   c. the partner’s share of each partnership liability issued (or deemed issued) in exchange for the applicable debt instrument;

   d. the partner’s share of the decrease in partnership liability resulting from the reacquisition of the applicable debt instrument;

   e. the partner’s share of such decrease that is treated as a distribution of money in the current taxable year; and

   f. the partner’s deferred section 752 amount.

3. The partnership must know the partners’ tax bases in their interests in order to determine the deferred section 752 amounts. Accordingly, Section 4.07(3) of the Revenue Procedure requires the partnership to make “reasonable efforts,” prior to making the section 108(i) election, to secure a written statement, signed under penalties of perjury, as to the partner’s tax basis. The partnership does not need such a statement if it already has the information necessary to compute such basis. Partners must provide the statement within 30 days after receiving the request from the partnership. As long as the partnership makes reasonable efforts to get the statement, a partner’s failure to comply does not invalidate the election.

4. The Revenue Procedure also imposes an annual information reporting requirement for each taxable year beginning with the year in which an actual (not a protective) election is made under section 108(i) and ending with the first taxable year in which all deferred items have been
recognized. Section 5.01. The statement is attached to the partnership’s Form 1065. The partnership is also required to attach a statement to each partner’s Schedule K-1 for such taxable years containing the information required in Section 5.03.

VI. WHEN DOES A MODIFICATION OF A DEBT INSTRUMENT GIVE RISE TO A DEEMED SECTION 1001 EXCHANGE?

A. Background

1. An exchange of debt instruments occurs under section 1001 if the terms of the new and old debt instruments differ “materially either in kind or extent.” Reg. § 1.1001-1. As interpreted by the Supreme Court, this standard is met if the debt instruments “embody legally distinct entitlements.” Cottage Savings Ass’n v. Commissioner, 499 U.S. 554 (1991). This decision can be interpreted to mean that even relatively minor debt modifications create an exchange.

2. The regulations under section 1001 provide that a “significant modification” of a debt instrument creates a section 1001 exchange of the old debt for a new (modified) debt instrument. Reg. § 1.1001-3(b).

3. The deemed debt-for-debt exchange created by a significant modification to a debt instrument has a number of potential tax consequences for both borrowers and lenders. These include:

a. recognition of COD income by the borrower, if the new debt has an issue price that is less than the adjusted issue price of the old debt;

b. recognition of gain by the holder, which may occur where the holder has a basis in the old debt that is less than face due to prior partial bad debt write-offs or the acquisition of the debt in a secondary market transaction at a market discount;

c. creation of OID in the new debt instrument where the face amount of the new debt exceeds its issue price, which in turn could trigger the application of the AHYDO rules of section 163(i) if the borrower is a corporation (or a partnership with a corporate partner);

d. the possible need to re-identify a hedge established on the old debt as a hedge of the modified debt under section 1221(a)(7) and Reg. § 1.1221-2(f); and

e. if the debt has been securitized through a REMIC (a not uncommon situation with commercial mortgage debt), it could also adversely affect the REMIC’s tax status and raise prohibited transaction concerns. Modifications sought by a borrower may be blocked if REMIC counsel is unable to opine that the modification will not cause REMIC tax problems.

B. Definition of “Modification”

1. A “modification” is broadly defined to mean any alteration, in whole or in part, of a legal right or obligation of the issuer or holder of a debt instrument, whether oral, written, or evidenced by the parties’ conduct or otherwise. Reg. § 1.1001-3(c)(1)(i).

2. Alterations That Occur Automatically Under Terms of Instrument. An alteration in a debt instrument that occurs pursuant to its terms (i.e., an internal or “pre-wired” modification, such as an interest rate reset keyed to a decline in value of collateral) is disregarded unless it results in (i) the
substitution of a new obligor, (ii) the addition or deletion of a co-obligor, (iii) a change from recourse to nonrecourse or vice versa, or (iv) a change which causes the instrument to lose its status as debt for federal income tax purposes, unless the change occurs pursuant to the holder’s right to convert the debt instrument into equity of the issuer. Reg. § 1.1001-3(c)(2)(i) and (ii). These changes were thought to be so fundamental that they should be viewed as modifications even though they occur pursuant to the terms of the original instrument.

3. Alterations Resulting From Exercise of Unilateral Option. An alteration resulting from the exercise of an option exercisable by the holder or issuer is a modification unless the option is unilateral and, in the case of a holder option, the option does not result in a deferral of, or reduction in, any scheduled payments of principal or interest (or in the case of a variable or contingent payment, is not reasonably expected to have such a result). Reg. § 1.1001-3(c)(2)(iii).

a. In order to be a unilateral option, the other party cannot have the right to alter or terminate the instrument or to put it to a person who is related to the issuer; the exercise of the option cannot be conditioned on the consent of the other party, a person related to the other party, or a court or arbitrator; and the exercise of the option cannot require consideration unless it is either de minimis, a specified amount, or based on a formula that uses objective financial information. Reg. § 1.1001-3(c)(3).

b. If a provision allows the issuer to defer payments, the issuer’s election to defer does not create a modification. However, the issuer’s election to defer may cause a deemed retirement and reissuance of the debt instrument solely for purposes of computing OID on the debt instrument. Reg. §§ 1.1272-1(c)(6), 1.1275-2(h)(6), 1.1275-2(j).

c. An option on the part of the holder to increase the interest rate (e.g., when borrower’s credit rating drops) is a unilateral option and therefore not a significant modification when exercised, even if it creates a material yield change. Reg. § 1.1001-3(d), Example (9).

d. Example 1 (Right to Substitute Collateral). Assume the loan documents permit the borrower to substitute other real property collateral of a similar type to the property securing a nonrecourse loan. Although a “mid-stream” modification of loan documents to permit the substitution of new collateral for a substantial portion of the collateral for a nonrecourse loan is a significant modification under Reg. § 1.1001-3(c)(4)(iv)(B), it is not a problem if the right to substitute was provided in the original loan documents. The borrower’s subsequent exercise of that right is the exercise of a unilateral option and is therefore not an alteration, provided the lender has no rights that could be construed as consent or waiver rights with respect to the nature of the property substituted.

e. Example 2 (In-Substance Defeasance Not a Modification). The regulations contain two examples regarding the exercise of a borrower’s option to place government securities in trust in order to defease the bonds. The first one deals with an “in-substance” defeasance (also referred to as an “economic” or “covenant” defeasance) of a 30-year recourse bond. The terms of the bond provide that the borrower can obtain a release of the financial and restrictive covenants by placing government securities in trust sufficient to provide for all future debt service, but the borrower remains legally obligated to pay the bond and is required to put additional securities in trust if necessary to service the debt. The example concludes that this is the exercise of a unilateral option and therefore does not create a modification. Reg. § 1.1001-3(d), Example (5); Rev. Rul. 85-42, 1985-1 C.B. 36 (“in-substance” defeasance did not create deemed exchange because debtor was not legally released).

f. Example 3 (Legal Defeasance is a Modification). The second example involves a “legal defeasance,” where the terms of the bond permit the borrower to be legally released
from its obligation to pay upon placing sufficient government securities in trust to pay the debt, with no obligation to put additional securities into trust if the trust funds later prove to be insufficient for that purpose. Reg. § 1.1001-3(d), Example (6).

(1) The example concludes that this is an alteration (and therefore a modification) because it changes the nature of the obligation from recourse to nonrecourse and thus falls under one of the exceptions to the unilateral option rule in Reg. § 1.1001-3(c)(2)(i). Further, it is a significant modification because the collateral changes. Reg. § 1.1001-3(e)(5)(ii)(B)(2).

(2) An exception is provided for a defeasance of tax-exempt bonds with a release of legal liability, provided the defeasance was provided for in the original loan documents. Reg. § 1.1001-3(e)(5)(ii)(B)(1).

4. Safe Harbor for Waiver of Default Remedies. The failure of the issuer to perform (a default) is not an alteration of a legal right or obligation and therefore is not a modification. Reg. § 1.1001-3(c)(4)(i).

a. An agreement by the parties pursuant to which the holder waives default remedies is a modification unless a safe harbor applies.

b. Under the safe harbor, the agreement of the holder not to exercise its default remedies (e.g., in a standstill agreement or other waiver of default rights) is not a modification unless and until the forbearance has remained in effect for a period which exceeds (i) two years following the debtor's initial failure to perform plus (ii) any additional period during which the issuer and holder are conducting good faith negotiations or the issuer is in bankruptcy. Reg. § 1.1001-3(c)(4)(ii).

5. Time When Modification is Deemed to Occur. A modification is deemed to occur when the holder and issuer enter into an agreement to change the debt instrument, even though the change is not yet effective, unless it is conditioned on “reasonable closing conditions,” including shareholder, regulatory, or senior creditor approvals. In the latter case, the change is deemed to occur on the closing date of the agreement. Reg. § 1.1001-3(c)(6)(i) and (ii). In addition, a change pursuant to a plan of reorganization in a title 11 or similar case is deemed to occur only upon the effective date of the plan. Reg. § 1.1001-3(c)(6)(iii).

a. IRS officials have indicated informally that, under the above rule, a modification that creates contingent payments -- such as an agreement by the creditor to forgive a certain amount of principal if the debtor makes certain minimum payments within a prescribed time frame -- causes a section 1001 deemed exchange at the time the modification is entered into (assuming it is “significant” under the rules set forth below). This, in turn, requires a determination of the issue price of the modified instrument. Since contingent payments are generally ignored in determining issue price under Reg. § 1.1274-2(g) (assuming the contingency is not remote or incidental), COD income could result at the time the agreement is entered into, rather than under a more sensible “wait and see” approach.

(1) This result is arguably contrary to Shannon v. Commissioner, 66 T.C.M. 1418 (1993), where the taxpayer was in default on a debt instrument and entered into an agreement with the creditor to forgive a certain amount of principal if he paid $X on or before March 1, 1987, the creditor would forgive $Y of the debt. The taxpayer made the payment in 1987 and the forgiveness occurred. The taxpayer initially reported the COD income in 1987, but then filed an amended return reporting the COD income in 1986 (so that the taxpayer’s real estate losses could be used to offset the COD income without limitation by the newly enacted passive loss rules). The Tax Court held that COD income was not realized until the cancellation actually occurred in 1987.
(2) Note that if the modification produces alternative payment schedules, within the meaning of Reg. § 1.1272-1(c)(2), and a particular payment schedule is significantly more likely than not to occur, the yield and maturity are computed on the basis of that payment schedule and the contingent payment OID regulations do not apply. Reg. § 1.1272-1(c)(1) and (2); Reg. § 1.1275-4(a)(2)(iii). If no payment schedule is significantly more likely than not to occur, then the contingent payment OID regulations contained in Reg. § 1.1275-4 will likely apply. Special rules (discussed later in this outline) apply to contingent payment debt instruments that have an issue price determined under Reg. § 1.1274-2 (for example, contingent payment debt instruments issued in exchange for non-traded debt). Reg. § 1.1275-4(c).

C. When is a Modification “Significant”?

1. General Significance Rule; Rules of Application. The regulations state a general rule that a modification is “significant” only if the legal rights or obligations that are altered, and the degree to which they are altered, are “economically significant.” Reg. § 1.1001-3(e)(1). The preamble to the final section 1001 regulations refers to this as the “general significance” rule. T.D. 8675 (preamble), 1996-2 C.B. 60. The regulations then set out a number of specific rules (some of which are “bright-line” rules or safe harbors) as to what constitutes a significant modification in the context of specific terms of the debt instrument. Any modifications not covered by a specific rule must be aggregated and tested under the “general significance” rule. Reg. § 1.1001-3(e)(1). The general significance rule might apply, for example, to a change from a fixed rate instrument to a variable rate instrument (which would not necessarily be subject to one of the specific rules).

a. If a particular modification is specifically covered by one of the specific rules and is not treated as a significant modification, it is not tested a second time under the general significance rule. Reg. § 1.1001-3(f)(1)(i); Reg. § 1.1001-3(f)(4). On the other hand, if a modification falls within more than one specific rule, it must be tested separately under each one. Reg. § 1.1001-3(f)(1)(i). For example, a deferral of interest payments must be tested under both the change-in-yield rule and the change-in-timing rule (each of which is discussed below).

b. Modifications of different terms of the instrument (such as yield and collateral) which are dealt with in a bright-line rule in Reg. § 1.1001-3(e)(2) through (6), but which do not separately rise to the level of a significant modification, do not create one in the aggregate. Reg. § 1.1001-3(f)(4).

2. Cumulative Modification Rule

a. The regulations depart from this concept in one important respect, which is the “cumulative modification” rule. Under this rule, two or more modifications, none of which is significant by itself, that occur over any period of time are treated as causing a significant modification (as of the date of the last such modification) if they would constitute a significant modification under Reg. § 1.1001-3(e) had they been done as a single change. Reg. § 1.1001-3(f)(3).

b. An example would be two yield changes that in the aggregate are more than 25 basis points and more than 5% of the annual yield of the unmodified instrument. However, under a special exception, in testing for a change in yield under Reg. § 1.1001-3(e)(2), modifications that are more than five years apart are not combined. Id. Another example would be successive extensions of the maturity date of the instrument. Thus, changes subject to a specific rule or to the general significance rule that are not significant when tested on a one-off basis must also be tested on a cumulative basis.
The cumulative modification rule means that the parties need to consider not only the immediate effect of the current modification under the specific rule, but also the effect of prior changes and anticipated subsequent changes of the same type. In some cases, it may be advisable to build in a cushion that takes into account future possible amendments.

3. Specific Rule: Change in Yield

a. A change in yield is a significant modification if the yield on the modified debt instrument differs from the yield of the unmodified instrument by more than the greater of (i) 25 basis points, or (ii) .05 times the annual yield of the unmodified instrument. Reg. § 1.1001-3(e)(2)(ii). The yield on the modified debt instrument is determined by assuming the debt instrument has (i) an adjusted issue price equal to that of the unmodified debt instrument and (ii) the payment schedule of the modified debt instrument. Reg. § 1.1001-3(e)(2)(iii).

b. Any fees paid as consideration for the modification are taken into account in the yield calculation. Reg. § 1.1001-3(e)(2)(iii)(A)(1).

c. As noted, a unilateral option of a holder to increase the interest rate (for example, upon breach of a financial covenant) is not a significant modification when exercised, even if the rate increase exceeds the yield change safe harbor.

d. While a reduction in stated interest that produces a more-than-de minimis yield change can cause a deemed section 1001 exchange, it will not create COD income for the debtor as long as the issue price of the modified debt is not less than the adjusted issue price of unmodified debt. Assuming neither the old debt nor the new debt is traded on an established market, this will generally be the case if the modified instrument bears stated interest at a rate at least equal to the AFR in effect at the time of modification. Thus, for example, if the AFR for the modified instrument is 4%, the interest rate could be reduced from 12% to 4% without producing COD income to the issuer. However, the tax effects of the section 1001 exchange on the lender also need to be considered; for example, the lender would recognize gain if it has a low basis in the debt (unless the transaction qualifies as a tax-free recapitalization of corporate debt securities).

e. Yield may be affected by, among other things, a change in interest payments or a cancellation of principal. Thus, if the holder and issuer agree to cancel part of the principal in a workout, yield will be reduced and the “yield” bright line may be crossed, creating a deemed exchange of new debt for old. Reg. § 1.1001-3(g), Example 3. From a policy standpoint, one could argue that a principal reduction should not have any tax consequences to the parties other than COD income to the issuer, but the IRS did not adopt that view.

(1) This specific rule is consistent with the Service’s prior position that a negotiated change in interest rate (as distinguished from an “internal” rate change that occurs under the terms of the instrument) results in a deemed exchange, except where the change is de minimis. See, e.g., Rev. Rul. 87-19, 1987-1 C.B. 249; Rev. Rul. 89-122, 1989-2 C.B. 200 (Situation 1). Note that in Situation 2 of Revenue Ruling 89-122, a reduction in the principal amount of a debt instrument was held to create a section 1001 exchange of the entire instrument.

(2) A similar result occurred in Revenue Ruling 2004-37, 2004-1 C.B. 583, although the focus of the ruling was on the section 83 consequences of an employer’s reduction in the principal amount of a note issued by an employee on exercise of a nonstatutory stock option.
(a) The employee tendered a recourse, nontransferable note to the employer in payment of the option strike price in year 2. At that time, the shares had a FMV of $100,000 but the strike price, and the principal amount of the employee’s note, was $75,000. The employee had $25,000 of section 83(a) income in the year of exercise because the shares were acquired free of any vesting restrictions. In year 3, when the shares' value had declined to $50,000, the employer agreed to reduce the principal amount of the note to $50,000.

(b) Citing Reg. § 1.83-4(c), the IRS ruled that the principal reduction caused the employee to recognize an additional $25,000 of compensation income in year 3 (not cancellation of indebtedness income) that was also wages for purposes of FICA, FUTA and income tax withholding. The IRS stated that whether a reduction in principal amount constitutes a cancellation, forgiveness, or satisfaction for an amount less than the amount of the note under Reg. § 1.83-4(c) is dependent on whether the reduction is a “significant modification” that causes a deemed exchange of debt instruments under Reg. § 1.1001-3. The $25,000 reduction in principal in the ruling clearly was a material yield modification under Reg. § 1.1001-3(e)(2). Thus, the IRS ruled that the amount of section 83(a) income equaled the excess of the adjusted issue price of the old note over the issue price of the modified note.

(c) The ruling also observes that if the employer and employee had instead agreed “to reduce the interest rate on the [n]ote or change the [n]ote from recourse to nonrecourse, that modification also generally would result in compensation income” for the employee.

f. In applying the yield test to floating rate debt instruments, the instrument’s yield is the annual yield of an equivalent fixed rate instrument (within the meaning of Reg. § 1.1275-5(e)) which is constructed based on the terms of the instrument as of the date of the modification. Reg. § 1.1001-3(e)(2)(iv). Thus, the variable rate in effect on the date of the loan modification is used for yield testing purposes.

g. A change in yield of a contingent payment debt instrument is not subject to the yield rule, but rather is tested under the general significance rule. Reg. § 1.1001-3(e)(2)(i).

h. A waiver or reduction of a prepayment penalty in connection with a loan prepayment can also produce a change in yield and a deemed exchange.

(1) Example. Assume that a borrower has a five-year loan outstanding bearing 6% interest. The loan is voluntarily prepayable at any time, in whole or in part, with the payment of a penalty of .5% of the amount prepaid. Assume that on November 1 of year 2, the borrower notifies the lender of its desire to prepay the loan in full on January 1 of year 3 and asks for a waiver of the penalty (this reflects the typical commercial practice of asking for the waiver in advance of prepaying so that the borrower has certainty). The yield comparison of the modified and unmodified instrument is made on the date the modification is agreed to. Thus, the yield on the modified instrument as of November 1 (with no prepayment penalty and an assumed payoff on January 1) is compared to the yield of the unmodified instrument as of November 1 (with a .5% prepayment penalty and an assumed payoff on January 1). Since the yield on the modified instrument is lower than the yield of the unmodified instrument by more than the greater of 25 basis points or 5% of the yield of the unmodified instrument, a deemed exchange occurs on November 1 when the prepayment penalty is waived.

(2) The section 1001 regulations provide that a commercially reasonable prepayment penalty for a pro rata prepayment under Reg. § 1.1272-2(f) is not treated as consideration for the modification of a debt instrument and is not taken account in determining the yield of an instrument. Reg. § 1.1001-3(e)(2)(iii)(B). However, this rule is irrelevant to the facts of this
example, because its focus is the yield effect of a penalty waiver where the borrower has indicated its intention to prepay.

(3) As a practical matter, the deemed exchange in the example probably is of a concern only if the lender is a REMIC, because the modified mortgage will not be a qualified mortgage. (See the discussion of REMIC workout tax issues later in this outline.)

4. Specific Rule: Change in Timing of Payments

a. A change in the timing of payments (either through deferral of payments due prior to maturity or through extension of the maturity date) is a significant modification if it results in a “material deferral of scheduled payments” based on all the facts and circumstances. Reg. § 1.1001-3(e)(3)(i). Under a safe harbor, a delay in payment is not a material deferral if the deferral does not extend beyond the lesser of (i) five years, or (ii) 50% of the original term of the instrument. Reg. § 1.1001-3(e)(3)(ii).

b. For example, if a scheduled interest payment is deferred until maturity and maturity is more than five years off, a payment deferral occurs and must be analyzed to determine whether it is material.


d. The deferral of a payment pursuant to an issuer’s option to defer that is part of the original loan agreement is deemed to occur by operation of the terms of the instrument and is not a modification. Reg. § 1.1001-3(d), Example 10.

e. The special rule under Reg. § 1.1001-3(e)(3) applies only to deferrals of scheduled payments. The acceleration of a scheduled payment (occurring other than pursuant to the terms of the debt instrument) generally should be tested under the general significance rule.

5. Specific Rule: Change in Obligor

a. The general rule is that a change in obligor on a recourse debt instrument is a significant modification. Reg. § 1.1001-3(e)(4)(i)(A). This concept was also embodied in prior law. See Rev. Rul. 69-142, 1969-1 C.B. 107 (substitution of debentures of acquiring corporation for outstanding debentures of target treated as a taxable exchange); Cottage Savings Ass’n v. Commissioner, 499 U.S. 554 (1991) (swap of mortgages held to be a taxable exchange because the mortgages had different obligors and were secured by different residences). The regulations provide a number of exceptions to the general rule.

b. An important exception is a substitution of obligor that occurs in an acquisition transaction where the new obligor on the recourse debt is the acquiring corporation in a section 381(a) transaction or acquires substantially all of the assets of the original obligor (which could be in a taxable or nontaxable transaction). Reg. § 1.1001-3(e)(4)(i)(B) and (C). In order for this “acquisition” exception to apply, the transaction cannot result in a change in “payment expectations” or a “significant alteration.”
A change in payment expectations is deemed to occur if either (i) there is a “substantial enhancement” of the obligor’s capacity to meet the payment obligations and that capacity was “primarily speculative” before the modification and “adequate” after the modification, or (ii) there is a “substantial impairment” of the obligor’s capacity to meet the payment obligations and that capacity was adequate before and primarily speculative after. Reg. § 1.1001-3(e)(4)(vi)(A).

A “significant alteration” is one that would be an “alteration” but for the rule that changes which occur pursuant to a provision in the original debt instrument do not constitute alterations. Reg. § 1.1001-3(e)(4)(i)(E). Note that the acquisition transaction must actually cause the significant alteration, such as a change in interest rate triggered by an acquisition event. If the alteration would have occurred anyway in the normal course of events (e.g., an annual interest rate reset which coincides with the date of the acquisition), the alteration will not affect the availability of the acquisition exception. Reg. § 1.1001-3(g), Example 7.

c. Other events which do not produce a significant modification are (i) the substitution of a new obligor on a tax-exempt bond where the new obligor is a related entity to the original obligor under section 168(h)(4)(A) and the collateral securing the debt continues to include the original collateral; (ii) the filing of a petition in a title 11 or similar case; (iii) the substitution of a new obligor on a nonrecourse debt instrument, and (iv) the making of a section 338 election with respect to the stock of an issuer. Reg. § 1.1001-3(e)(4)(i)(D), (F) and (G); Reg. § 1.1001-3(e)(4)(ii).

d. The addition or deletion of a co-obligor is a significant modification if it results in a change in payment expectations. Reg. § 1.1001-3(e)(4)(iii).

e. Section 1274(c)(4) and Reg. § 1.1274-5(a) and (b)(1) provide that the assumption of a debt instrument in connection with a sale or exchange of property is not subject to section 1274 unless the terms of the debt are modified in connection with the transaction in a manner that results in an exchange under section 1001. Thus, even though an assumption of recourse debt by a purchaser of the property gives rise to a significant modification under the above rule that triggers a section 1001 exchange, the debt instrument will not have to be retested for adequate stated interest under section 1274 (which could result in a lower issue price if interest rates have increased since the instrument’s original issuance) unless there is some other significant modification to the terms of the debt that would give rise to a section 1001 exchange of debt instruments independently of the substitution of a new obligor. Reg. § 1.1001-3(g), Example 6.

f. In Priv. Ltr. Rul. 200630002 (April 24, 2006), the IRS ruled that the conversion of a corporate debtor to an LLC under a state law conversion statute as part of an “F” reorganization did not result in a significant modification of its recourse debt under Reg. § 1.1001-3(e).

6. Specific Rule: Change in Collateral, Credit Enhancement, or Priority

a. In the case of recourse debt, a modification that releases, substitutes, adds or otherwise alters the collateral for a debt instrument, or similarly affects any guarantee or other credit enhancement, is a significant modification if it results in a change in payment expectations. Reg. § 1.1001-3(e)(4)(iv)(A); Reg. § 1.1001-3(g), Example 8. It is not clear why the drafters decided that a change in a third-party guarantee or other external credit enhancement should cause the debt to be subject to a deemed exchange.

b. In the case of nonrecourse debt, a modification that releases, substitutes, adds or otherwise alters a “substantial amount” of the collateral, guarantee or other credit enhancement is automatically deemed a significant modification, unless it merely reflects the substitution of fungible
collateral or a similar commercially available credit enhancement. Reg. § 1.1001-3(e)(4)(iv)(B). The fact that the debtor improves the property securing the debt is ignored for this purpose.

c. A change in priority relative to other debt of the issuer is a significant modification if it results in a change in payment expectations. Reg. § 1.1001-3(e)(4)(v).

7. Specific Rule: Change in Nature of Debt

a. From Debt to Equity. The regulations provide that a change that results in a “debt instrument or property right that is not debt” for federal income tax purposes is a significant modification. Reg. § 1.1001-3(e)(5)(i). However, in making this determination, any deterioration in the issuer’s financial condition between the original issue date and the date of the modification is ignored unless there is a change in obligor in connection with the modification. Id.

(1) The preamble to the final regulations suggests that this rule is intended to have a broader scope than its literal language would suggest, namely, to disregard the financial condition of the issuer in testing the debt-equity status of the “new” debt following any modification that triggers a section 1001 exchange. T.D. 8675 (preamble), 1996-2 C.B. 60.

(2) The regulation is awkwardly drafted to achieve this purpose, however, because it literally does not apply if the change in the debt instrument (e.g., decrease in interest rate) otherwise constitutes a significant modification without regard to whether it causes the instrument to lose its debt status.

(3) An IRS official who was involved in the project reportedly stated that the drafters’ intention was to ignore the financial condition of the obligor in testing debt-equity status after any type of significant modification. See Highlights & Documents at 2474-75 (Aug. 21, 1996) (quoting Thomas J. Kelly).

b. Change From Recourse to Nonrecourse. A change in the nature of a debt instrument from recourse (or substantially recourse) to nonrecourse (or substantially nonrecourse), or vice versa, is generally a significant modification. Reg. § 1.1001-3(e)(5)(ii)(A). As an example, the regulations state that a “legal defeasance,” whereby the issuer is released from liability to make payments on the debt instrument (including the obligation to contribute additional securities to a trust to provide for sufficient funds to make payments under the instrument), is a significant modification.

(1) A change from recourse to nonrecourse is not a significant modification, however, if the debt instrument continues to be secured only by the original collateral and there is no change in payment expectations. Reg. § 1.1001-3(e)(5)(ii)(B)(2).

(2) A special defeasance rule is provided for tax-exempt obligations. Reg. § 1.1001-3(e)(5)(ii)(B)(1).

(3) The possibility that a debt instrument has changed from recourse to nonrecourse should be considered where recourse debt issued by a corporation becomes the obligation of a limited liability company that is disregarded as an entity separate from the corporation under Reg. § 301.7701-3.

8. Specific Rule: Change in Customary Accounting or Financial Covenants
a. A modification that adds, deletes, or alters “customary accounting or financial covenants” is not a significant modification. Reg. § 1.1001-3(e)(6).

b. In the current market, it is not uncommon for a company to agree to pay fees or a higher interest rate to obtain covenant waivers or amendments to avoid an impending default. Such payments may cause a significant modification under the yield change bright-line rule. For example, debtors may seek waivers of a covenant to maintain cash flow in excess of a certain multiple of annual debt service, and lenders may want fees and higher margins in exchange. In today’s environment, such inducements will usually cause the yield to maturity to increase by a lot more than the greater of 25 basis points or 5%.

c. Modifications to noncustomary covenants (including the addition of noncustomary covenants) must be tested under the general significance rule. The problem lies in determining when a covenant is customary (protected by the safe or harbor) or noncustomary (evaluated under the general significance rule).

D. **Tax Consequences of Modifications That Are Not Significant**

1. If the terms of a debt instrument are modified to defer one or more payments, and the modification does not cause a deemed section 1001 exchange, then, solely for purposes of sections 1272 and 1273, the debt is deemed to have been retired and reissued on the date of the modification for an amount equal to the instrument’s adjusted issue price. Reg. § 1.1275-2(j).

2. An issuer may make a payment to a lender to obtain the lender’s consent to modify the loan. In such a case, the payment is not for lender “services” so it may be considered a payment under the debt instrument as opposed to a consent fee that is simply ordinary income. If it is not treated as a consent fee (taxable to the holder, deductible by the issuer), the treatment of the payment under the OID rules raises some complex issues as to which there is not much guidance. See Garlock, Federal Income Taxation of Debt Instruments, par. 1303.06, pp. 13,029-13,030 (2006).

3. If a consent payment is classified as a separate fee rather than a payment of principal or interest on the debt instrument, it generally will be (if determined to be U.S. source income) subject to U.S. withholding tax at a 30% rate (or lower treaty rate if applicable) if paid to a non-U.S. person. A borrower that does not withhold tax from such payments could face potential liability as a withholding agent if U.S.-source fee characterization prevails.

4. A lender conceivably might want to pay a borrower an additional amount to consent to certain mid-stream loan modifications (e.g., to permit the debt to be securitized). If the payment does not create a material yield change and is not otherwise accompanied by a significant modification to the debt instrument, a reasonable approach is to treat the amount as creating bond issuance premium (amortizable against the debtor’s interest expense under Reg. § 1.163-13(c)). This is consistent with the treatment of front-end lender-to-borrower cash payments that are treated under Reg. § 1.1273-2(g)(3) as an additional amount loaned, even though there is no obligation to repay it. Alternatively, the amount may be viewed as a consent fee that is currently taxable to the borrower, although it would seem that such fee should still be treated as interest income or an offset against interest expense since no services are being provided by the borrower.

**VII. DETERMINATION OF ISSUE PRICE OF NEW DEBT IN AN ACTUAL OR CONSTRUCTIVE DEBT-FOR-DEBT EXCHANGE**

A. **General**
1. Section 108(e)(10) (added to the Code by the 1993 Act) provides that if a debtor (whether a partnership, corporation or individual) issues a debt instrument in satisfaction of indebtedness, the debtor is treated as having satisfied the old debt with an amount of money equal to the issue price of the new debt instrument, with issue price being determined under sections 1273 and 1274.

2. If the issue price of the new debt is less than the adjusted issue price of the old debt, the debtor recognizes COD income equal to such excess. See Reg. § 1.61-12(c) (providing that an issuer recognizes COD income if it repays a debt instrument for an amount less than its adjusted issue price). The adjusted issue price of the old debt is generally equal to the issue price of the old debt increased by accrued OID and decreased by payments on the debt other than qualified stated interest. Reg. § 1.1275-1(b)(1).

3. Debt of an issuer undergoing a debt restructuring often trades at a discount from face, and in these horrendous credit markets it is likely to trade at a substantial discount. Further, due to the evolution of markets and the availability of pricing and trading information over various internet sources, today it is much more likely that debt will be considered to be publicly traded than in 1994 when the issue price rules were promulgated. Application of the “traded debt” issue price rules (discussed below) can result in creation of OID, COD income, and potential application of the AHYDO rules for corporate borrowers. The IRS recently announced safe harbor relief from the AHYDO problem for debt instruments of corporate issuers meeting certain criteria, but unfortunately the safe harbor does not apply for COD income purposes.

4. The debtor's COD income may be offset by OID deductions over time, but the mismatch is a big problem. The IRS has been urged to permit the COD income to be amortized over the period during which the related OID deductions are claimed, but thus far that has not happened. Instead, Congress enacted section 108(i) (discussed earlier in this outline), which permits taxpayers to defer inclusion of COD income that they realize in 2009 and 2010 as a result of reacquisitions of debt.

a. Though only a temporary fix, this is a fairly good solution if the debt matures by the end of the 5-year section 108(i) amortization period, because the inclusion of deferred COD income will be offset by amortization of the related OID over roughly the same time period.

b. If commercial mortgage debt has a term in excess of 10 years, then section 108(i) is only a partial solution to the COD problem because a portion of the OID will be amortized beyond the expiration of the 5-year COD income period.

c. It is unfortunate that Congress chose to adopt a temporary two-year relief measure. First, the section 1001/traded debt/COD income problem is a significant tax issue and a major impediment to workouts of debt that may be traded, and there is no reason to think the problem will be gone in two years. Second, it has probably taken the heat off IRS and Treasury to come up with an improved, permanent solution.

B. Issue Price Determination

1. Substantial Amount Sold for Cash. If a substantial amount of the debt instruments in an issue is issued for money, the issue price of the instruments equals the first price for which a substantial part of the instruments is sold. Section 1273(b)(1); Reg. § 1.1273-2(a)(1).

a. For this purpose, sales to bond houses, brokers, or similar persons acting in an underwriter capacity are ignored. Reg. § 1.1273-2(e). This rule is intended to exclude from the determination of issue price any discount that would typically be reflected in the underwriter’s price at
which it initially purchases debt instruments from the borrower, and to determine issue price based on the cash proceeds received by the underwriter on resale.

b. The “cash proceeds” issue price rule ordinarily does not apply to a debt-for-debt exchange because the modified debt is property, not cash. However, if the lender sells the modified debt to third parties in connection with the exchange, it is conceivable the lender might be viewed as acting in an underwriting capacity in that resale transaction. In that event, the cash proceeds received from the ultimate purchasers would determine the issue price of the modified debt, and any purchase discount reflected in the resale transaction (relative to the face amount of the modified notes) would create OID in the modified notes, COD income for the borrower, and a recognized loss for the lender on the deemed exchange of the old debt for the new debt (or the cash proceeds received from the sale of the new debt). Note that the borrower recognizes COD income even though the amount it is obligated to repay under the modified debt is the same as the old debt.

c. If the lender is viewed as acting in a principal capacity on the resale, no OID or COD income would be created (assuming the modified notes are not traded on an established market and bear interest at the AFR or higher), and the resale purchase discount would give rise to market discount with respect to the purchasers of the modified debt.

2. Either the Old Debt or the New Debt is Traded on Established Market. If a substantial amount of the new debt is “traded on an established market” (“traded debt”), the issue price is the fair market value of the instrument on the issue date. If new debt is not so traded, but a substantial amount of the new debt is issued for old debt that is traded, the issue price is the fair market value of the old debt on the issue date. Reg. § 1.1273-2(b)(1) and (c)(1).

a. The theory for this rule is that if the debt is traded, the borrower in theory could have taken out a new loan in an amount equal to the traded value of the outstanding debt and then bought in such debt for cash equal to the traded value. Since it would recognize COD income under this cash-exchange scenario, it should recognize COD income in a deemed section 1001 exchange as well. Of course, this hypothetical borrowing and repurchase may not comport with the economic reality of the debtor’s circumstances—e.g., a distressed debtor that restructures a loan may not have the capacity to take out a refinancing loan, and there is no guarantee that the debtor can buy in all of the old debt at the so-called “traded value.”

3. Default Rule -- Section 1274. If neither the old debt nor the new debt is traded on an established market, and the “cash proceeds” rule does not apply, the issue price of the new debt is determined under section 1274. Reg. § 1.1273-2(d)(1).

4. Cash Payments Made by Borrower in a Private Lending Transaction. Amounts paid by the borrower to the lender (other than payments for services provided by the lender, such as loan processing costs and commitment fees) reduce the issue price of the debt. Stated differently, issue price equals the net cash proceeds derived by the borrower. Reg. § 1.1273-2(g)(2).

5. Debt Issuance Costs. Solely for purposes of determining the timing of deductibility, debt issuance costs are treated by the debtor as if they adjusted the yield on the debt instrument by reducing the instrument’s adjusted issue price, thus increasing OID (or reducing bond issuance premium). Reg. § 1.446-5(b)(1). Any resulting OID is taken into account by the debtor under the constant yield method as provided in Reg. § 1.163-7.

a. As a technical matter, the adjusted issue price of debt is determined without regard to debt issuance costs for purposes of measuring COD income on retirement of debt at a
discount, but the unamortized portion of the costs should be allowed as an offsetting deduction. Alternatively, section 108(e)(2) may apply to exclude an amount of COD income equal to the unamortized costs because payment of the debt in full would have given rise to a deduction to that extent.

b. Under case law, in a debt-for-debt exchange, unamortized debt issuance costs relating to the “old” debt continue to be amortized over the term of the “new” debt, unless the facts and circumstances indicate that the “new” debt is a separate and independent financing from the old debt. See, e.g., Buddy Schoellkopf Products, Inc. v. Commissioner, 65 T.C. 640 (1975); Wilkerson v. Commissioner, 70 T.C. 240 (1978), rev’d on another issue 655 F.2d 980 (9th Cir. 1981). Reg. §§ 1.446-5(b) and 1.163-7(c) can be interpreted as permitting the deduction of such costs at the time of the exchange where either the old debt or the new debt is traded on an established market.

C. Nontraded Debt

1. Under section 1274 and Reg. § 1.1274-2, the issue price of a nontraded debt instrument that has adequate stated interest is its stated principal amount, unless the potentially abusive situation rule applies. Reg. § 1.1274-2(b)(1).

2. An obligation has adequate stated interest if its effective yield to maturity equals or exceeds the AFR, as determined under section 1274(d) and Reg. § 1.1274-4. See Reg. § 1.1274-2(c)(1).

a. For example, the applicable federal rates in effect for September 2009 are .84% for short-term instruments, 2.85% for mid-term instruments, and 4.33% for long-term instruments (assuming semiannual compounding). Rev. Rul. 2009-29, __ I.R.B. __; Section 1274(d). These rates are so low that is highly unlikely that a debt instrument issued in today’s economic climate will fail to have adequate stated interest.

3. If a debt instrument does not provide for adequate stated interest, its issue price equals the “imputed principal amount” of the instrument. Reg. § 1.1274-2(b)(2).

4. The imputed principal amount is the sum of the present values of all payments due under the debt instrument, including payments of stated interest, determined by discounting the payments at the test rate of interest determined under Reg. § 1.1274-4. If the imputed principal amount is less than the face amount, the debt instrument will have OID equal to the difference. Section 1273(a)(1) (OID equals the excess of a debt instrument’s SRM over its issue price); Reg. § 1.1273-1(b) (a debt instrument’s SRM equals the sum of all payments provided under the debt instrument other than qualified stated interest); Reg. § 1.1273-1(c)(1)(i) (defining qualified stated interest as interest that is unconditionally payable in cash or property (other than debt instruments of the issuer) at least annually at a single fixed rate).

5. If the principal amount of the debt is left unchanged, but the interest rate is reduced, the issue price of the new debt will equal its face amount provided that the yield to maturity of the new debt is at least equal to the test rate.

6. Note that a debt instrument that provides for deferral of scheduled interest payments and compounding of unpaid interest will have the same yield to maturity and issue price as a current-pay debt instrument with the same interest rate.

7. These rules tend to favor debtors with nontraded debt. As long as the modified nontraded debt’s principal amount is not reduced and the debt bears an interest rate at least equal to the
test rate, its issue price will equal the principal amount. This means the debtor will not have to worry about COD income recognition, even though the true fair market value of the modified debt is substantially less than its face amount. However, because debt instruments are frequently bought and sold in connection with a restructuring, the parties must determine whether those sales transactions invoke the issue price rules applicable to traded debt, which could result in a lower issue price if the debt is traded at a discount.

D. Traded Debt

1. Under Reg. § 1.1273-2(f)(1), a debt instrument is treated as traded on an established market if, at any time during the 60-day period ending 30 days after the issue date, it meets one of four trading criteria, listed below:

   a. Exchange Trading. It is traded on a national securities exchange, an interdealer quotation system sponsored by a national securities association, or certain foreign exchanges. Reg. § 1.1273-2(f)(2).

   b. Interbank Market. It is property of a kind traded on an “interbank market” or on a board of trade designated as a contract market by the Commodities Futures Trading Commission. Reg. § 1.1273-2(f)(3). While there is no statutory or regulatory definition of “interbank market,” the IRS interpreted the term in another statutory context to mean “not a formal market, but rather a group of banks holding themselves out to the general public as being willing to purchase, sell or otherwise enter into certain transactions.” FSA 200025020 (June 3, 2000). If this means that a debt instrument is traded merely because a group of banks hold themselves out as willing to buy or sell such instruments, this definition appears overbroad and arguably would subsume the “readily available price quotations” test in Reg. § 1.1273-2(f)(5).

   c. Quotation Medium. This is the test that is most likely to create a trading issue for debt that is not listed on an exchange. It requires that the debt appears on a “system of general circulation” that provides a reasonable basis to determine fair market value by disseminating either recent price quotations (including rates, yields or other pricing information) of one or more identified brokers, dealers or traders, or actual prices of recent sales transactions. Reg. § 1.1273-2(f)(4). The regulations state that the term does not include a directory or listing of brokers, dealers or traders for specific securities, such as “yellow sheets,” that do not provide price quotations or actual prices of recent sales transactions. Id.

   (1) It is often difficult to determine whether electronically disseminated information meets this standard.

   (2) There are any number of web sites that provide current pricing and trading information for debt instruments, and, depending on the quality and currency of the information, may constitute a quotation medium as to a particular debt issue. This is especially true for corporate debt. Yet, no matter what pricing information the “system” may provide, it still must provide “a reasonable basis to determine fair market value.” Particularly in these turbulent markets, one may be able to reasonably conclude that the system does not meet that standard.

   d. Readily Available Price Quotations. This test applies if “price quotations are readily available from dealers, brokers or traders.” Reg. § 1.1273-2(f)(5)(i). However, a debt instrument will not be considered to be traded debt under this test if any one of four conditions is met (see Reg. § 1.1273-2(f)(5)(ii)):
(1) Its original principal amount does not exceed $25 million.

(2) The issuer (and any guarantor related to the issuer) does not have any other debt outstanding that is considered to be traded on an established market under one of the first three trading tests (paragraphs (f)(2), (f)(3) or (f)(4) of the regulation, referred to as "other traded debt").

(3) The conditions and covenants relating to the issuer's performance are materially less restrictive than the conditions and covenants included in the issuer's other debt.

(4) The maturity date of the instrument is more than three years after the latest maturity date of the issuer's other traded debt.

e. While the $25 million safe harbor makes some sense as a de minimis rule, the rationale for the other three safe harbors under the Readily Available Price Quotations test is elusive. It may be that such instruments tend to be riskier or more equity-like and therefore are less likely to trade.

2. The 60-day trading window is problematic, because debtors may not have any basis to determine what kind of trading of the modified debt will take place in the 30-day post-modification period.

3. These regulations were finalized in 1994. Since then, markets have evolved and the internet has emerged as an important new source of current price and trading information. As a result, the task of determining whether a debt instrument is traded under one of the four rules discussed above can be quite difficult and entails a fair amount of due diligence, uncertainty, and difficult judgment calls. Tax lawyers often seek advice from investment bankers about the application of these legal tests to the facts at hand. See T. Maynes, Distressed Debt in Disorderly and Dysfunctional Markets, Taxes Magazine, March 2009, p. 55; New York State Bar Association Tax Section Report No. 1066, Report on Definition of “Traded on an Established Market” Within the Meaning of Section 1273, August 12, 2004, reprinted at 2004 TNT 159-7.

4. If temporary restrictions are imposed on trading that have "a purpose" of avoiding the traded debt issue price rules (whether such restrictions are dictated by the issuer or not), the debt is deemed to be traded on an established market. Reg. § 1.1273-2(f)(6). Thus, a self-imposed temporary lockout on trading during the 60-day window will not avoid these rules. Moreover, even restrictions imposed by lenders or a bankruptcy court are ignored if "a purpose" is to avoid the tax characterization of the debt as traded on an established market.

5. A debt instrument is not considered to be traded on an established market solely because it is convertible into property that is so traded. Reg. § 1.1273-2(f)(7).

6. A debt instrument that has been securitized should not be viewed as traded simply because the ownership interests in the pool (e.g., REMIC regular interests, fixed investment trust certificates) are so traded.

E. Determination of Issue Price of Nontraded Debt in Potentially Abusive Transactions

1. In the case of a "potentially abusive situation," section 1274(b)(3)(A) and Reg. § 1.1274-2(b)(3) limit the "imputed principal amount" of debt received in exchange for property (and thus the issue price of the debt) to the fair market value of the property. If a contingent payment debt
instrument is issued in a potentially abusive situation, the issue price of the instrument is the fair market value of the noncontingent payments. Reg. § 1.1274-2(g).

2. Reg. § 1.1274-3(a)(1) and (2) provide that a potentially abusive situation includes a tax shelter as defined in section 6662(d)(2)(C)(ii) and any other situation involving:
   a. A "recent sales transaction."
   b. A nonrecourse financing.
   c. A financing with a term in excess of the property’s useful life.
   d. A debt instrument issued with "clearly excessive interest."

3. A debt instrument is issued with clearly excessive interest if it is clearly greater than the arm’s-length rate that would have been charged in a cash lending transaction between the same two parties, taking into account the terms of the instrument and the credit-worthiness of the borrower. Reg. § 1.1274-3(b)(3). This prevents a holder from structuring a new debt instrument with excessive interest and a lower principal amount so as to reduce the holder’s gain (or increase the holder’s loss) that would otherwise be recognized in a debt restructuring.

4. The issuer’s determination that a debt instrument is not issued in a potentially abusive situation is binding on all holders (but not the IRS, of course) unless the holder discloses the contrary position in his tax return. Reg. § 1.1274-3(d).

5. The “recent sales transaction” rule may engender some concern for tax advisors when a debt modification occurs in close proximity with a prior purchase of the debt at a discount by a new lender from an existing lender. If that purchase counted as a “recent sales transaction,” the “new” debt’s issue price could be fixed at that purchase price, which could cause the debtor to recognize COD income. However, such an interpretation would make the traded debt issue price rules largely irrelevant. Thus, tax advisors generally pay little heed to the potentially abusive situation rule in this context.

6. The OId regulations, as originally proposed, provided that a “nonrecourse financing” was a “potentially abusive situation” that must be tested under section 1274(b)(3)(B). Section 1274(b)(3)(B)(ii)(II); Prop. Reg. § 1.1274-4(g)(2)(ii)(B). Thus, if property subject to nonrecourse financing was underwater, and the debt was restructured, it was arguable under the proposed regulation that the issue price of the modified debt was limited to the fair market value of the “property” for which it was deemed to have been exchanged -- namely, the old debt instrument, whose value presumably would reflect the value of the collateral. This, in turn, would have resulted in substantial COD income to the debtor under section 108(e)(10), even though the principal amount of the obligation remained unchanged.

7. The final OID regulations provide that the term “nonrecourse financing” under the potentially abusive situation rule does not include the exchange of a nonrecourse debt instrument for an outstanding recourse or nonrecourse debt instrument. Reg. § 1.1274-3(b)(1). This regulatory exception for nonrecourse financings presumably found favor within the IRS because the potentially abusive situation rule was directed at concerns generally not relevant to debt restructurings, i.e., the overstatement of basis in purchase transactions to maximize depreciation deductions and investment tax credits.

   a. Example. Partnership X acquires real property for $100 million with $90 million financed through a nonrecourse borrowing from a lender unrelated to the seller bearing interest at
The issue price of the $90 million note equals the amount loaned under Reg. § 1.1273-2(a)(1). Seven years later, when principal amortization was scheduled to begin, the fair market value of the property has declined to $80 million. The partnership negotiates with the lender to reduce the interest rate to the prevailing AFR, which is 3%, leaving the principal amount unchanged at $90 million. The reduction in interest rate constitutes a significant modification and triggers a section 1001 deemed exchange. Absent additional facts, the nonrecourse refinancing is not subject to section 1274(b)(3)(A) by virtue of the exception in Reg. § 1.1274-3(b)(1), and therefore the issue price of the new debt equals its principal amount. Since the issue prices of the new and old debt are the same, the borrower does not recognize COD income even though the borrower’s economic obligations have been reduced.

b. Reg. § 1.1275-1(d) provides that an instrument is not a debt instrument for purposes of the OID rules unless it constitutes valid indebtedness under general income tax principles, and that nothing in the OID regulations “shall influence whether an instrument constitutes debt” for tax purposes. Thus, the IRS might still assert an Estate of Franklin argument in appropriate cases where the refinanced debt substantially exceeds the fair market value of the collateral. See Estate of Franklin v. Commissioner, 64 T.C. 752 (1975), aff’d, 544 F.2d 1045 (9th Cir. 1976). Compare Pleasant Summit Land Corp. v. Commissioner, 54 T.C.M. 566 (1987), aff’d, 860 F.2d 55 (2d Cir. 1988), with Prussin v. Commissioner, 863 F.2d 263 (3d Cir. 1988), aff’d in part and rev’d in part sub nom., Pleasant Summit Land Corp. v. Commissioner, 54 T.C.M. 566 (1987).

c. The better view is that debt/equity status ought to relate back to the original debt issuance, and is not retested merely because a debt is restructured. See Reg. § 1.1001-3(e)(5)(i) (providing that any deterioration in the financial condition of the obligor which occurs between the issue date and the date of a debt modification and which affects the obligor’s ability to repay the debt is not taken into account in determining whether the modification causes the debt to become equity for tax purposes).

F. AHYDO Issue Arising in Modifications of Corporate Debt — Revenue Procedure 2008-51

1. A debt modification can raise an OID deduction issue for a corporate debtor (or a corporate partner of a partnership debtor) if the debt is publicly traded at a discount, so that the issue price of the “new” debt is set at a market value that is substantially less than face.

2. One scenario where this can be a problem is a temporary bridge financing incurred by a corporate borrower (e.g., to acquire real estate on an expedited basis) that expects to syndicate the debt as a permanent financing at a later date. The terms of the permanent financing are embedded in the terms of the bridge financing and the bridge simply rolls into the permanent financing, as modified in accordance with the prearranged terms. Such modifications may not, by themselves, create a deemed exchange of debt instruments at the time of the syndication, either because they are “wired” into the instrument at the outset or because they result from the exercise of a “unilateral option” by the holder. Because of the credit crisis, many bridge borrowers are finding they are unable to sell the replacement permanent financing based on the terms contemplated by the bridge financing and cannot arrange alternative permanent financing in the credit markets. Thus, the borrower and lender may renegotiate the embedded terms of the permanent financing in order to make the debt more saleable. These negotiated changes often involve a “significant modification” that triggers a section 1001 deemed exchange of debt instruments. This, in turn, will require the issue price of the modified debt instrument (the replacement permanent financing) to be determined. This could produce an issue price that is substantially below face amount if either (i) the modified debt is “traded on an established market” under Reg. § 1.1273-2(f) at a discount (e.g., the lender begins making a market in the replacement notes through bid and ask quotations within 30 days after the exchange of the bridge financing for replacement notes) or (ii) the lender sells a
substantial amount of the replacement loan to third parties at a discount and is viewed as acting in an underwriter capacity (within the meaning of Reg. § 1.1273-2(e)) rather than as principal, so that issue price equals the net sales proceeds received by the lender.

3. Alternatively, the bridge lender may have agreed in its financing commitment to provide replacement permanent financing in an entirely new loan, but when the bridge matures the lender finds that it can only sell the new permanent debt to third parties at a substantial discount relative to the amount loaned. Again, if the lender is viewed as acting in an underwriter capacity, the sale proceeds realized on sale of permanent debt to investors could dictate the issue price determination.

4. In either case, the reduced issue price of the permanent debt creates OID which, if large enough, can cause the yield on the new debt to increase to the point where it qualifies as an AHYDO, thus deferring (or disallowing a portion) of the corporate borrower’s interest deduction while recognizing current COD income. The borrower’s COD income will eventually be offset by additional OID deductions over the term of the instrument, but distressed borrowers are often stunned to learn that they have an immediate tax cost at a time when they can least afford it. This problem is being encountered far more frequently than in the past because much of corporate debt is being traded at substantial discounts. Further, section 1001 deemed exchanges are occurring more frequently — e.g., a company may default on its financial covenants or be concerned about a near-term default and ask its lender to waive or modify covenants, and the lender extracts its own concessions in the form of interest rate hikes and fees that cause a significant yield change.

a. Section 163(e)(5) limits a corporation’s interest deduction on “applicable high yield discount obligations,” or AHYDOs. The interest is deductible only when paid and, if the AHYDO has a yield in excess of the AFR plus six percentage points, the OID attributable to such excess yield (the “disqualified portion”) is nondeductible by the issuer but is still includable by the holder under section 1272 as OID, in the case of a noncorporate holder, and as a dividend eligible for the dividends received deduction, in the case of a corporate holder. Section 163(e)(5)(A).

b. An AHYDO is a debt instrument with a term of more than five years which has a yield to maturity that exceeds the sum of the AFR for the month of issuance plus five percentage points and has “significant OID.” Section 163(j)(1). A debt instrument has significant OID if the aggregate amount of interest and OID that will be includable by the holder “before the close of any accrual period (as defined in section 1272(a)(5)) ending after the date 5 years after the date of issue” exceeds the sum of the aggregate amount of interest required to be paid before the close of such accrual period plus the product of the issue price of the debt instrument and its yield to maturity. Section 163(j)(2). In simpler terms, an instrument has significant OID if it defers the payment of more than one year’s worth of yield for more than five years.

c. Reg. § 1.701-2(e) contains a partnership “entity abuse rule” which provides that a partnership will be treated as an aggregate of its partners for purposes of other Code provisions under certain circumstances. One of the examples states that the AHYDO rules apply on a look-through basis to the corporate partners of partnerships that have debt that would qualify as an AHYDO. Reg. § 1.701-2(f), Example (1) (partnership comprised of two corporate partners engaged in “substantial bona fide business activities” for several years, then issued high yield debt obligations to unrelated third party which would have been subject to AHYDO rules if issued by a corporation; the Example observes that while section 163(e)(5) does not prescribe the treatment of a partnership as an entity for purposes of that provision, entity treatment could permit corporations to circumvent the provision by forming a partnership and having it issue the debt; thus, the entity abuse rule is invoked to treat the partnership as an aggregate of its partners, with each corporate partner being treated as issuing its share of the obligations and subject to the limitations on deductibility at the partner level).
5. The adverse impact of the AHDYO rules in a workout can be mitigated by including in the loan documentation a requirement for catch-up interest payments after the fifth anniversary sufficient to prevent the instrument from becoming an AHDYO, but this obviously means an additional cash flow drain for the borrower.

6. In Revenue Procedure 2008-51, 2008-35 I.R.B. 562, the IRS announced that, effective August 8, 2008, it will not treat a debt instrument as an AHDYO in certain circumstances similar to the bridge financing problem discussed above. The Revenue Procedure applies to:

a. Debt instruments issued for money consistent with the terms of a financing commitment obtained from an unrelated party prior to January 1, 2009, provided that the debt instrument would not be an AHDYO if its issue price equaled the net cash proceeds actually received by the borrowing corporation. Rev. Proc. 2008-51, Section 4.01. This rule avoids a potential AHDYO problem that could occur if the issue price of the debt were the price at which the lender sells the debt to third parties (the underwriter rule) rather than the amount of funds actually transferred to the borrowing corporation. (Note that this safe harbor has nothing to do with debt-for-debt exchanges, actual or deemed.)

b. Debt instruments issued in an exchange (whether actual or deemed) for a debt instrument that qualifies under Section 4.01 (i.e., issued before January 1, 2009 pursuant to a financing commitment), provided (i) the new debt is issued within 15 months after the issuance of the old debt, (ii) the new debt would not be an AHDYO if its issue price were the net cash proceeds actually received by the borrowing corporation when the old debt was issued, (iii) the maturity date of the new debt is not more than one year later than the maturity date of the old debt, and (iv) the SRM of the new debt does not exceed the SRM of the old debt. Rev. Proc. 2008-51, Section 4.02.

c. The third safe harbor by its terms merely extends the AHDYO relief to a follow-on actual or deemed exchange of a new debt for a debt that was previously issued in exchange for old debt under the second safe harbor. Rev. Proc. 2008-51, Section 4.03. Thus, literally read, the Revenue Procedure gives borrower and creditor two bites at the apple only, even though it is not uncommon to have more than two loan crises and modifications occurring in close proximity.

d. Section 6 of the Revenue Procedure states that the 1-year maturity extension limit and limitation on the SRM of the new debt do not apply to debt instruments (which presumably means the “new” debt in a debt-for-debt exchange) issued before August 9, 2008.

7. The Revenue Procedure applies to debt issued by corporations. It does not address debt issued by partnerships having corporate partners.

8. As to the question of whether the IRS had the authority to issue Revenue Procedure 2008-51, this falls into the “don’t ask, don’t tell” category. Congress’ enactment in ARRTA of a temporary suspension of the AHDYO rules for debt instruments issued in debt-for-debt exchanges occurring on or after September 1, 2008 and on or before December 31, 2009 presumably has the effect of overriding and supplanting the more expansive relief offered by the Revenue Procedure (see the discussion below).

9. As noted, the Revenue Procedure does not apply for purposes of determining either COD income or OID. Moreover, the 15-month rule is a major restriction on its application for AHDYO purposes, because in many cases the original debt will have been outstanding for more than 15 months before being modified or exchanged. The New York State Bar recommended that the IRS expand the safe harbor relief by allowing corporate issuers to amortize COD income realized in the circumstances.
described in the Revenue Procedure over the term of the modified debt (based on section 446(b) clear reflection of income principles), so that the COD income is recognized at the same time as the corresponding OID deductions are claimed. See New York State Bar Association Tax Section, Report on Revenue Procedure 2008-51, January 20, 2009, reprinted in Highlights & Documents, p. 487, January 22, 2009.

10. Congress responded to this concern by providing in section 108(i) an election to defer COD income arising in “reacquisitions” of applicable debt instruments occurring in 2009 and 2010, including debt-for-debt exchanges, and by requiring in section 108(i)(2)(A) that an equivalent amount of the issuer’s OID deductions in respect of the “new” debt be deferred on the same basis.

G. ARRTA Provides Temporary Suspension of AHYDO Rules In Debt-For-Debt Exchanges

1. Section 1232(a) of ARRTA provides an exemption from the AHYDO limitations in section 163(e)(5) for certain debt instruments issued in an actual or deemed exchange for previously outstanding debt of the same issuer, provided that (i) the new debt was issued during the period beginning on September 1, 2008 and ending on December 31, 2009 (the “window period”), and (ii) the old debt was not subject to the AHYDO rules. Section 163(e)(5)(F)(i).

2. Section 1232(c)(1) of ARRTA provides that the AHYDO suspension rules are effective for obligations issued after August 31, 2008 in taxable years ending after such date. Note that the effective date of this amendment is several weeks after the effective date of Revenue Procedure 2008-51. The ARRTA Conference Report (pp. 567-68) makes no mention of the Revenue Procedure.

3. The exemption does not apply to debt obligations issued to a person related to the issuer under section 108(e)(4) or to debt that bears contingent interest within the meaning of section 871(h)(4) (providing an exception to the portfolio interest exemption for contingent interest debt).

4. If the exemption applies to the issuance of a debt instrument in a debt-for-debt exchange, it is treated as not being subject to the AHYDO rules for purposes of again applying the exemption in a successive debt-for-debt exchange involving such debt instrument during the window period. Section 163(e)(5)(F)(ii).

5. The Secretary has the authority to extend the window period if the Secretary determines that such action “is appropriate in light of distressed conditions in the capital markets.” Section 163(e)(5)(F)(iii).

6. Section 1232(b) of ARRTA also made a permanent change to the provisions that determine the AHYDO test rate. Section 163(i)(1) provides that the test rate is the AFR plus five percentage points, and the last sentence of the provision states that the Secretary can use a rate higher than the AFR if it determines that the rate is appropriate in light of the term of the instrument. ARRTA gives the Secretary additional authority to use a higher rate if it determines that doing so is appropriate in light of distressed conditions in the capital markets. This amendment is effective for debt instruments issued after December 31, 2009 in taxable years ending after such date. Section 1232(c)(2) of ARRTA.

H. Modification of Nonrecourse Debt In Connection with Sale of Property Securing the Debt

1. Section 1274 does not apply if a person acquires property subject to a debt instrument or assumes the debt instrument in connection with the sale or exchange of property unless the...
terms of the instrument are modified in a manner that would constitute an exchange under section 1001. Section 1274(c)(4); Reg. § 1.1274-5(a).

2. The assumption of nonrecourse debt by the buyer is not, by itself, a “significant modification” that triggers a section 1001 exchange. Reg. § 1.1001-3(e)(4)(ii).

3. If the debt instrument is modified “as part of the sale or exchange,” section 1274(c)(4) and Reg. § 1.1274-5(b) provide that, unless the buyer and seller jointly elect, the modification is treated as a separate transaction taking place immediately before the sale which is attributed to the seller, provided the seller knew or had reason to know of the modification. The modification will be deemed to occur immediately after the sale in a separate transaction if the buyer and seller make a joint election to do so or if the seller did not know or have reason to know of the modification. The election must be signed by the buyer and seller of the property not later than the extended due date of their respective returns, whichever occurs first.

   a. If the modification is deemed to occur prior to the sale, the seller may have COD income and a corresponding reduction in the amount realized on the sale. The buyer takes the property subject to the modified debt instrument with the new issue price included in basis. Reg. § 1.1274-5(d).

   b. Example. Assume that a debt modification occurs in connection with a sale of property and the seller/debtor and buyer do not elect to treat the modification as occurring after the sale. As a consequence of the modification, the instrument, which originally had an issue price of $1,000,000, has an issue price of $800,000. The seller is treated as repaying the original $1,000,000 instrument for $800,000, resulting in $200,000 of COD income. The seller’s amount realized is $800,000 plus the cash consideration received from buyer. The buyer is treated as assuming debt of $800,000 and has a basis in the property equal to such amount plus the cash paid.

   c. If the modification is treated as occurring after the sale of the property, and the issue price of the modified debt is less than its SRM, the buyer has really strange tax consequences: COD income recognition in connection with a purchase of property (odd) coupled with a basis in the property equal to the unmodified debt, which may exceed the property’s current value (even odder), even though such basis is determined by reference to a nonrecourse financing. Such basis would, however, be subject to possible Estate of Franklin limitations.

   d. If the interest rate is reduced as part of a workout and causes a section 1001 exchange of debt instruments, the debtor will not recognize any COD income if the principal remains the same and the adjusted interest rate remains at or above the AFR.

I. Contingent Payment Debt Instruments: a Potential COD Income Trap

1. Section 108(c)(10)(B) expressly incorporates section 1274 principles for purposes of determining the amount of COD income recognized in a debt-for-debt exchange. However, if the modified debt instrument has contingent payments, a problem arises under the OID regulations that could increase the amount of the debtor’s COD income.

2. Under Reg. § 1.1274-2(g), the issue price of a debt instrument which provides for one or more contingent payments and is subject to section 1274 -- i.e., one that is issued for “property,” in this case the “old” debt instrument -- equals the lesser of (i) the total noncontingent principal payments due under the debt instrument, or (ii) the sum of the present values of the noncontingent payments. See also Reg. § 1.1275-4(c)(3). Thus, the value of contingent payments of interest or principal is not taken
into account in determining issue price, which may result in an issue price that is materially less than the value ascribed to the instrument by the creditor.

3. Present values are determined by discounting the payments back from their due date to the date of the deemed exchange at the "test rate" appropriate to the term of the payment in question, as provided in Reg. § 1.1274-4. Reg. § 1.1274-2(c).

4. The determination and reporting of OID under a contingent payment debt instrument issued in exchange for nonpublicly traded property (here, the nonpublicly traded "old" debt instrument) is governed by Reg. § 1.1275-4(c). (Separate, complex rules are provided for contingent payment debt instruments issued for cash or publicly traded property in Reg. § 1.1275-4(b) -- the "noncontingent bond method" -- and are not dealt with in this outline.)

5. The noncontingent payments due under the debt instrument are treated as a separate debt instrument whose issue price is the issue price of the "overall debt instrument" (as determined under Reg. § 1.1274-2(g) above). In determining OID on this separate debt instrument, no payments in respect of the separate debt instrument are considered to be qualified stated interest and the OID de minimis rule does not apply. Reg. § 1.1275-4(c)(3). Thus, all of the payments are included in the SRM of the separate debt instrument, and the difference between the SRM and the issue price is reported as OID.

6. A contingent payment is divided into a principal component and an interest component when made. The principal component equals the present value of the payment, determined by discounting the payment at the test rate from the date it is made to the issue date. Reg. § 1.1275-4(c)(4)(ii)(A). The balance of the payment is treated as OID. Id.; Reg. § 1.1275-4(e).

7. The test rate generally is the rate that would be the test rate for the overall debt instrument under Reg. § 1.1274-4, except that solely for this purpose the term of the instrument is deemed to end on the date the contingent payment was made. Reg. § 1.1275-4(c)(4)(ii)(B).

a. A special rule is provided for contingent payments of principal that are accompanied by a payment of stated interest at a rate that exceeds the test rate (as determined in the manner described above). In that event, the test rate is the stated rate. Id.

b. Thus, for example, if a debt instrument is issued with fixed interest at a 5% rate (assumed to be less than the test rate) and an additional 7% which is contingent on the debtor's meeting specified cash flow targets, the issue price of the debt instrument would be determined by discounting only the fixed interest and principal payments at the test rate, producing an issue price of less than the face amount. The debtor would have COD income equal to the difference between such issue price and the adjusted issue price of the old debt instrument. Section 108(e)(10).

8. The holder's tax basis in the debt instrument is allocated to the noncontingent component first, but not in excess of the adjusted issue price of the noncontingent component. The remaining basis is allocated to the contingent component. Reg. § 1.1275-4(c)(5)(i). All amounts received under the contingent component that are characterized as principal (under the rules described above) are treated as a return of basis first, and when the basis assigned to the contingent component has been fully recovered, the excess principal payments are treated as gain from the sale or exchange of the debt instrument (and any basis not recovered when all payments of principal have been received is deductible as a loss from the sale or exchange of the debt instrument). Reg. § 1.1275-4(c)(5)(iii). If, however, the holder is reporting income on the installment method under section 453 with respect to the debt instrument, the special basis allocation rules of Reg. § 15a.453-1(e) govern. Reg. § 1.1275-4(c)(5).
9. If the contingent payments are ultimately paid, the prior amounts of COD income would have been overstated because the issue price determination failed to account for payments actually made. Thus, the debtor theoretically ought to receive ordinary deductions as such payments are made equal to the amount of additional COD income that would have been avoided in the year of modification by taking into account the resolution of the contingency. Such deductions would be independent of the interest deductions allowed to the debtor at the time contingent interest is paid. Alternatively, the Service could permit the COD income to be deferred until such time as the contingency is resolved. While the latter approach might be perceived as subject to taxpayer manipulation, the former approach fails to give taxpayers credit for the time value of money. That flaw could be remedied if amended returns could be filed reflecting an issue price for COD purposes that includes the contingent payments actually made. The Service was aware of these collateral issues when it issued Reg. § 1.1274-2(g), but decided not to deal with them as part of the contingent payment OID regulations.

10. If the debt instrument provides that all interest will accrue and compound at the applicable federal rate and will be unconditionally payable at maturity, there will be no contingent interest and issue price will equal face, thus avoiding COD income.

11. If all payments under the modified debt instrument are contingent, the debt instrument is almost certainly no longer a debt instrument and the lender will recognize gain or loss equal to the difference between the fair market value of the contingent instrument and the lender's tax basis in the old note. Reg. § 1.1001-1(a).

J. Definition of Contingent Payments

1. The regulations provide that a payment is not contingent merely because of a contingency that, as of the issue date, is either remote or incidental. Reg. § 1.1275-4(a)(5). In addition, a payment is not contingent merely because of the possibility of impairment by insolvency, default, or similar circumstances. Reg. § 1.1275-4(a)(3).

2. A conforming change was also made to the definition of “qualified stated interest.” Under the final OID regulations issued in 1994, qualified stated interest had to be “unconditionally payable,” which meant either that late payment or nonpayment had to be penalized or there had to be reasonable remedies to compel payment. The OID regulations were amended in 1996 to provide that interest is “unconditionally payable” only if (i) “reasonable legal remedies exist to compel timely payment, or (ii) the debt instrument otherwise provides terms and conditions that make the likelihood of late payment (other than a payment that occurs within a reasonable grace period) or nonpayment a “remote contingency,” as defined in Reg. § 1.1275-2(h). Reg. § 1.1273-1(c)(1)(ii).

3. “Remote” and “incidental” contingencies are defined in Reg. § 1.1275-2(h).

4. A contingency is remote if there is a remote likelihood that it will occur or will not occur. Reg. § 1.1275-2(h)(2). In either case, the regulations require the parties to assume that the more likely scenario will occur.

5. A contingency relating to the amount of a payment is incidental if, under all reasonably expected market conditions, the potential amount of the payment is insignificant relative to the total expected amount of the remaining payments on the debt instrument. Reg. § 1.1275-2(h)(3)(i). Such a payment is disregarded for OID purposes until it occurs. However, even though the payment is disregarded until it occurs, the instrument is not subject to the contingent payment rules of Reg. § 1.1275-4 because the contingency is incidental.
6. A contingency relating to the timing of a payment is incidental if, under all reasonably expected market conditions, the potential difference in timing of the payment (from the earliest date to the latest) is insignificant. Reg. § 1.1275-2(h)(3)(ii). In that event, the payment is treated as made on the earliest date that the payment could be made pursuant to the contingency for purposes of computing OID on the debt instrument.

7. Variable rate debt instruments subject to the special rules under Reg. § 1.1275-5 are also exempt from the contingent payment OID regulations. Reg. § 1.1275-4(a)(2)(ii).

8. Debt instruments which provide for alternative payment schedules (depending on the occurrence of a contingency) are also subject to special rules, provided the timing and amounts of the payments under each schedule are known as of the issue date. Reg. § 1.1272-1(c)(1). An example would be a debt instrument which provides for an increase in the stated interest rate, effective as of a specified date, if a contingency occurs or fails to occur as of that date.

a. If a particular payment schedule is “significantly more likely than not to occur,” the parties are required to compute yield and maturity of the instrument based on such payment schedule, and the contingent payment OID regulations do not apply. Reg. § 1.1272-1(c)(2); Reg. § 1.1275-4(a)(2)(iii). It should be noted, however, that the issue price rule contained in Reg. § 1.1274-2(g) does not appear to mesh well with these rules, because it literally requires all contingent payments to be excluded in determining issue price, even if there is an alternative payment schedule which is significantly more likely than not to occur. This appears not to have been the drafters’ intent.

b. If the alternative payment schedule rules under Reg. § 1.1272-1(c) do not apply, the debt instrument generally is taxed under the contingent payment OID regulations (assuming that the contingencies to which the alternative payment schedules are linked are more than “remote” or “incidental”).

VIII. POTENTIAL COD INCOME UPON ACQUISITION OF DEBT BY PERSON RELATED TO DEBTOR

A. Background

1. An obvious tax planning maneuver to avoid COD income by a distressed debtor would involve the acquisition of the debtor’s obligations at a discount by friendly parties or persons in the same economic family. Congress thought this was abusive and enacted section 108(e)(4), which provides that an acquisition of debt by a party related to the debtor will cause the debtor to realize COD income.

2. In Revenue Ruling 91-47, 1991-2 C.B. 16, the debtor and an unrelated party agreed that the unrelated party would form a corporation (“Newco”) to acquire the debtor’s $100 debt for $70, and thereafter would sell the stock of Newco to the debtor for $70. The primary purpose for forming Newco was to prevent the debtor from recognizing COD income that would otherwise result if the debtor acquired its debt directly or through a related party. Newco served no important business purpose. The IRS ruled that under substance-over-form principles, the formation of Newco would be disregarded and the debtor treated as if it had acquired its debt directly or through a related party (in the latter case section 108(e)(4) would apply).

3. As discussed below, under regulations issued after the ruling, the Newco gambit is treated as an “indirect acquisition” of debt to which section 108(e)(4) applies.

B. Direct and Indirect Acquisitions
1. An acquisition of debt can take one of two forms: a "direct" acquisition or an "indirect" acquisition. Reg. § 1.108-2.

   a. **Direct acquisition.** A direct acquisition is one in which a person related to the debtor (or who becomes related on the date of acquisition) acquires the debt directly from a party unrelated to the debtor. Reg. § 1.108-2(b). The preamble to the final regulations stated that the IRS was considering whether to provide an exception to the direct acquisition rule where the holder acquires the debt and an ownership interest in the debtor at the same time, and the person from whom the holder acquires such debt and equity interests was previously related to the debtor. T.D. 8460 (preamble), 1993-1 C.B.19.

   b. **Indirect acquisition.** An indirect acquisition is a transaction in which a holder of debt becomes related to the debtor, if the holder acquired the debt with the intention of becoming related to the debtor. Reg. § 1.108-2(c)(1). The "acquisition date" of an indirect acquisition is the date on which the parties become related, not the date on which the debt was acquired. Reg. § 1.108-2(d)(1) and (c)(1).

2. Persons are considered to be related if they are related within the meaning of section 267(b) or 707(b)(1) or if they are treated as a single employer under sections 414(b) or (c). Reg. § 1.108-2(d)(2). For this purpose, the regulations modify the family attribution rule in section 267(c)(4) so that an individual’s family consists only of his spouse, children, grandchildren, parents, and any spouse of his children or grandchildren.

3. The determination of whether a holder acquired a debt in anticipation of becoming related to the debtor is based on all of the relevant facts and circumstances, including the intent of the parties at the time of acquisition, the nature of any contacts between the parties (or their affiliates) before the acquisition, the period of time during which the holder held the debt, and the significance of the debt in proportion to the total assets of the "holder group." Reg. § 1.108-2(c)(2).

   a. A holder of debt is treated as having acquired the debt in anticipation of becoming related to the debtor if the holder acquired the debt less than six months before the date on which the holder becomes related. Reg. § 1.108-2(c)(2). This is a conclusive presumption.

4. If a person becomes related to a debtor during the period that is at least six months but less than 24 months after the person acquired the debt, the debtor is required to report this "relationship" transaction to the IRS with a statement attached to its return for the taxable year in which the holder becomes related to the debtor. Reg. § 1.108-2(c)(4)(i) and (iii). Disclosure is also required if, on the date the holder becomes related to the debtor, the debt constitutes more than 25% of the fair market value of the total assets of the holder group. Reg. § 1.108-2(c)(4)(i) and (ii).

   a. The disclosure statement must include, among other things, (i) a caption identifying the disclosure as one made under Reg. § 1.108-2(c); (ii) identification of the debt to which the disclosure relates; (iii) the amount of such debt and the amount of COD income that would be recognized if section 108(e)(4) were to apply; and (iv) a statement describing the debtor’s position that the holder did not acquire the debt in anticipation of becoming related to the debtor.

   b. Disclosure is not required if the debtor takes the position that the holder acquired the debt in anticipation of becoming related to the debtor.

5. Under a regulatory exception that is missing from the statute, section 108(e)(4) does not apply if, on the date of the direct or indirect acquisition, the debt is scheduled to mature within
one year after the acquisition date, provided it is actually retired within that time frame. Reg. § 1.108-2(e)(1).

C. Deemed Retirement and Reissuance of Debt

1. If section 108(e)(4) applies, the debt is treated as having been reissued for an amount equal to (i) the holder’s adjusted basis in the debt, if the debt was acquired by purchase within six months of the acquisition date, and (ii) the fair market value of the debt on the acquisition date if the holder acquired the debt more than six months before the acquisition date. Reg. § 1.108-2(f).

2. The debtor recognizes COD income to the extent the SRM of the new debt exceeds the issue price (e.g., holder’s adjusted basis or fair market value of the debt, as applicable). Id. In addition, the difference between the issue price and SRM gives rise to OID, which is includable by the holder and deductible by the debt in accordance with the OID rules. Reg. § 1.108-2(f)(1). The debtor may take advantage of any COD exclusions that are available. Reg. § 1.108-2(a).

3. Notwithstanding the foregoing, if a principal purpose of a direct or indirect acquisition is the avoidance of federal income tax, the determination of COD income is based on the fair market value of the debt on the acquisition date. Reg. § 1.108-2(f)(4).

4. The related holder does not recognize gain or loss on the deemed reissuance. Reg. § 1.108-2(g)(2). However, the deemed reissuance is treated as a purchase by the holder for purposes of applying sections 1272(a)(7) (acquisition premium) and 1276 (market discount). Id.

IX. TAX CONSEQUENCES TO BORROWER WHERE DEBT DISCHARGE OCCURS IN FORECLOSURE OR OTHER DISPOSITION OF PROPERTY

A. Nonrecourse Debt

1. A discharge of nonrecourse debt that occurs pursuant to the transfer of the property to the lender in bankruptcy or in a foreclosure proceeding (or a deed in lieu of foreclosure) gives rise to sale gain rather than COD income, even though the fair market value of the property is less than the amount of the debt. Reg. § 1.1001-2(a)(4); Commissioner v. Tufts, 461 U.S. 300 (1983); section 7701(g) (providing that, for purposes of determining actual or deemed gain or loss with respect to property subject to a nonrecourse debt, the property’s fair market value is deemed to be not less than the amount of the debt). As to the lender, however, the transfer is treated as a debt repayment with a bad debt deduction allowable to the extent of the deficiency (that is, the lender is not treated as if it had sold the debt in exchange for the property).

2. By contrast, a discharge of all or part of nonrecourse debt that is not accompanied by a transfer of the collateral gives rise to COD income. See Gershkowitz v. Commissioner, 88 T.C. 984 (1987) (Tax Court held that the settlement of $250,000 nonrecourse debt for a $40,000 cash payment, with the borrower retaining the $2,500 of collateral, resulted in $210,000 of COD income); Rev. Rul. 91-31, 1991-1 C.B. 19 (IRS ruled that the negotiated reduction of a nonrecourse loan from $1 million to $800,000, which was the then value of the collateral, coupled with the borrower’s retention of the collateral, gave rise to COD income of $200,000); Rev. Rul. 82-202, 1982-2 C.B. 36 (taxpayer was indebted to a bank on a nonrecourse mortgage loan secured by the taxpayer’s residence; lender offered a 10% discount to the taxpayer to induce him to prepay the mortgage, which had a low interest rate; taxpayer had to include the discount amount as ordinary COD income).
3. In *Fulton Gold Corp. v. Commissioner*, 31 B.T.A. 519 (1934), the Tax Court held that where property is purchased subject to a nonrecourse debt which is not assumed by the purchaser and the debt is satisfied by the purchaser for less than its face amount, upon the subsequent sale of the property the basis for determining loss or gain will be the amount paid to satisfy the debt plus the other consideration paid for the property. Thus, the court concluded that the prior discharge of the nonrecourse debt did not result in COD income, because there was no "release of assets" upon its satisfaction, but instead gave rise to a basis reduction. Note, however, that the facts of the case do not indicate that the value of the property had declined below the purchase price at the time of the debt discharge; thus, it would appear that the discharge increased the debtor's net worth even though no personal debt was liquidated.

a. Language in the opinion suggests that, perhaps because the value of the property seemed to exceed the debt on all relevant occasions, the court believed that from the initial transfer the parties intended the property to have been subject to the modified debt instrument.

b. In contrast to the purchase price adjustment exception of section 108(e)(5), *Fulton Gold* is not confined to financing provided by the seller of the property.

c. *Fulton Gold* was, however, expressly rejected by the Service in Revenue Ruling 91-31 on the grounds that it is inconsistent with *Gershkowitz* and *Tufts*. It would appear that the only route to avoiding COD income in such cases is compliance with the purchase price adjustment exception of section 108(e)(5) or its common law predecessor. In the IRS's view, however, a reduction of nonrecourse debt triggers COD income in all cases not involving seller-financing.

d. The Tax Court, citing *Gershkowitz* and Revenue Ruling 91-31, rejected a taxpayer's attempt to rely on *Fulton Gold* to avoid COD income. See *Parker Properties Joint Venture v. Commissioner*, 71 T.C.M. 3195, 3196 (1996).

4. A debtor that is insolvent or in bankruptcy may prefer to recognize COD income with attendant attribute reduction rather than taxable sale gain, while a debtor that is clearly solvent may prefer to accelerate foreclosure in order to recognize capital gain taxed at a lower rate than ordinary COD income.

**B. Discharge of Nonrecourse Debt Coupled With Sale of Property to Third-Party Purchaser**

1. Assume that debtor holds property with a fair market value of $100 which is subject to a nonrecourse loan from bank of $150. What is the result if debtor conveys property to purchaser for $100 pursuant to a prearranged agreement with lender to assign the sales proceeds to lender in full satisfaction of the nonrecourse debt? Can the debtor argue that he has $50 of COD income, or does he have *Tufts* sale gain of $50? The debtor may prefer COD income to sale gain if it can qualify for a COD income exclusion.

2. In *2925 Briarpark, Ltd. v. Commissioner*, 73 T.C.M. (CCH) 3218 (1997), aff'd, 163 F.3d 313 (5th Cir. 1999), a property partnership held an office building subject to approximately $25.5 million of nonrecourse debt owed to lender. One of the partners had individually guaranteed $5 million of the debt. The partnership found a buyer for the property who agreed to pay $11.6 million in cash for the property, provided it could be acquired free and clear of the existing debt. The partnership then entered into an agreement with lender whereby lender agreed to release its lien in exchange for the partnership's agreement to assign all of the net sales proceeds to lender, and to release the guarantor partner from his guarantee in exchange for a cash payment of $175,000.
a. The partnership reported the difference between the face amount of the debt and the net sales proceeds paid to the lender as COD income. The IRS contended, however, that the partnership had to include the full face amount of the debt in its amount realized in computing gain on sale of the property.

b. The Tax Court held that the transaction was the functional equivalent of a foreclosure, abandonment, or repossession, and therefore the relief of debt had to be treated as an amount realized on sale of the property, notwithstanding that the purchaser of the property acquired it free and clear and the lender never took title to the property. As further support, the Tax Court cited Reg. § 1.1001-2(a), which requires a seller to include in amount realized “liabilities from which the transferor is discharged as a result of the sale or disposition” without limiting such liabilities to those assumed by the purchaser. See also Sands v. Commissioner, 73 T.C.M. (CCH) 2398 (1997), aff’d without opinion sub nom., Murphy v. Commissioner, 164 F.3d 618 (2d Cir. 1998) (holding that the discharge of nonrecourse debt and release of ownership of the property that secured the debt was a sale or exchange even though the lender did not take title to the property).

C. Recourse Debt

1. When recourse debt is discharged in connection with the conveyance of property, whether voluntarily or in a foreclosure proceeding, and the amount of the debt discharged exceeds the fair market value of the property conveyed, Reg. § 1.1001-2(a) bifurcates the transaction as follows:

   a. First, the taxpayer has a gain or loss resulting from a “sale” equal to the difference between the fair market value of the property and the taxpayer’s adjusted basis in the property.

   b. Second, the amount of the discharge exceeding the fair market value of the property is treated as COD income.

2. The theory for not including a recourse debt in amount realized is that, upon the sale of the asset, the liability is not extinguished. The creditor continues to have a claim against any current or future assets of the taxpayer.

3. The bifurcation approach was applied by the Service in Rev. Rul. 90-16, 1990-1 C.B. 12, in which the taxpayer transferred property with an adjusted basis of $8,000 and a fair market value of $10,000 in satisfaction of a $12,000 recourse debt. The ruling holds that the taxpayer recognized sale gain of $2,000 and COD income of $2,000. The COD income was fully excludable under section 108(a). See also Reg. § 1.1001-2(c), Example (8).

4. Example. A owns property with a fair market value of $100 and a tax basis of $120 which is subject to a debt of $150. A conveys the property to the lender in full satisfaction of the debt. A has no other assets or liabilities.

   a. Recourse Debt. If the $100 debt is recourse, the conveyance gives rise to a section 1001 sale of the property and a capital loss of $20 ($100 amount realized $120 tax basis). In addition, A realizes $50 of COD income, which is fully excludable under section 108(a) since A is insolvent by that amount. Unless the capital loss is used during the year of the discharge, the capital loss (or other tax attributes) will be reduced by the amount of excluded COD income. Section 108(b)(2) and (4). Accordingly, it may be advantageous for taxpayer to accelerate capital gain into the year of the discharge.
b. **Nonrecourse Debt.** If the debt is nonrecourse, A is treated as having sold the property for the amount of the debt, resulting in a $30 capital gain on the sale ($150 amount realized - $120 tax basis). A does not recognize any COD income or capital loss. Since A is insolvent, it may be advantageous to negotiate a debt reduction and to continue to operate the property so that the gain can be converted into COD income. Of course, the step transaction doctrine may present an obstacle to this strategy if reconveyance occurs shortly after a discharge of some portion of the debt (or pursuant to a plan existing at the time of discharge).

5. As discussed elsewhere in this outline, it is not clear whether the section 108(i) election to defer COD income arising in the reacquisition of an applicable debt instrument in 2009 and 2010 is available where the COD income arises from the transfer of property in satisfaction of a recourse debt, because section 108(i) does not specifically identify a transfer of debt in exchange for property as a qualifying "acquisition." There is no policy reason, however, why it should not be.

**D. Characterization of Debt as Recourse or Nonrecourse**

1. Neither section 108, the legislative history to the BTA, nor Reg. § 1.1001-2(a) defines the terms "recourse debt" and "nonrecourse debt." The examples under the section 1001 regulations indicate that a debt will be considered nonrecourse if the debtor/purchaser is not personally liable for repayment of the liability and the seller's only recourse in the event of default is to the purchased property which secures the debt. See Reg. § 1.1001-2(c), Example (6) and (7) (debt for which individual purchaser is not personally liable and which is secured solely by the acquired property constitutes nonrecourse debt for purposes of section 61(a)(12); compare Reg. § 1.1001-2(a) and (c), Example (8) (debt for which an individual purchaser is personally liable in the event of a default constitutes recourse debt for purposes of section 61(a)(12)).

2. Other Code provisions define "nonrecourse" for purposes unrelated to the COD rules. Reg. § 1.752-1(a)(2) defines a "nonrecourse liability" as any liability to the extent that no partner or related person bears economic risk for the liability under Reg. § 1.752-2. The section 704(b) regulations adopt the same definition. Reg. § 1.704-2(b)(3).

3. Defining "recourse" and "nonrecourse" for purposes of the section 1001/COD analysis is complicated by the fact that the rationale for limiting the "bifurcation" approach of Reg. § 1.1001-2(a)(2) to the discharge of recourse debt but not nonrecourse debt is elusive.

4. **Illustrative Cases**

   a. **Partnership Recourse Debt With Well-Capitalized Corporate GP.** Partnership debt for which a corporate or LLC general partner with a substantial net worth (or an individual general partner) is fully liable in the event of a default should constitute recourse debt for section 1001/COD purposes.

   b. **Partnership Recourse Debt Where Corporate GP is Thinly Capitalized.** Partnership debt for which a thinly capitalized corporate or LLC general partner is fully liable, but for which the lender, as a practical matter, only may recover against the partnership’s property in the event of a default, is substantially equivalent, in economic terms, to nonrecourse debt from the member’s perspective and therefore arguably should be treated as nonrecourse, if one concludes that section 752 principles are imported into the section 1001/COD analysis. Cf. Reg. § 1.752-2(j)(4), Example (corporate partner’s deficit make-up obligation held insufficient to cause portion of general partnership’s recourse debt, which was guaranteed by other partner, to be allocated to corporate partner for section 752 purposes;
fact that corporate partner had no assets other than its partnership interest indicated a plan to circumvent or avoid the corporate partner’s deficit make-up obligation).

(1) The examples in Reg. § 1.1001-2(c) do not provide any facts indicating whether, at the time the debt is incurred, the debtor is an individual, an entity with a substantial net worth, or a thinly capitalized entity. Taxpayers routinely take the position that debt is recourse (including for section 752 purposes) despite a thinly capitalized corporate GP. On the other hand, if the GP is a single member disregarded LLC, debt which is recourse to the partnership is converted to nonrecourse debt for purposes of applying section 752. See Reg. § 1.752-2(k)(1) (providing that, in determining the extent to which a partner bears the economic risk of loss for a partnership liability, obligations of the partner’s disregarded entity are taken into account only to the extent of the net value of the disregarded entity as of the liability allocation date (exclusive of the entity’s interest in the partnership), unless the partner/owner is required to make a payment with respect to the payment obligations of the disregarded entity).

(2) The author is aware of one examination where the revenue agent contended that recourse debt of a limited partnership with a shell corporate general partner was in substance nonrecourse debt, so that the conveyance of partnership property to the lender with a value well below the amount of the debt, in full satisfaction thereof, produced Tufts gain equal to the face amount of the debt over the value of the property instead of COD income (which would otherwise be excludable by the insolvent general partner under section 108(a)).

c. Partnership Recourse Debt Guaranteed by a Partner. Partnership debt which is nonrecourse but which is personally guaranteed, in whole or in part, by an individual partner and which requires the seller/creditor to recover against the acquired property in the event of a default prior to seeking satisfaction under the guarantee arguably should be treated as recourse debt to the extent of the guaranteed portion.

d. Recourse Debt of an LLC: Exculpatory. Debt of a Partnership. Recourse debt of an LLC and recourse debt of a partnership where all partners are exculpated from liability arguably should be treated as recourse debt under an entity approach, since the partnership determines gain or loss and COD income at the entity level. On the other hand, applying the aggregate approach that is a common theme in subchapter K and manifest in the partner-level section 752 liability sharing rules, a very persuasive argument can be made that it should be treated as nonrecourse debt for section 1001/COD purposes since none of the members has any personal liability.

(1) The preamble to the final nonrecourse debt regulations under section 704(b) states that such “exculpatory” debt should be treated as partnership nonrecourse debt that is secured by all of the partnership’s assets for purposes of section 704(b). T.D. 8385 (Section V.B. of the preamble), 1992-1 C.B. 199, 203. The section 752 regulations lead to the same conclusion. However, these provisions focus on the treatment of the debt at the partner level, whereas the question of whether an LLC obligor recognizes COD income or section 1001 gain from a debt discharge would appear to be made at the partnership level.

(2) Some commentators view state law recourse liabilities of an LLC as recourse liabilities under section 1001. See Burke, Exculpatory Liabilities and Partnership Nonrecourse Allocations, 57 Tax Law. 33, 37 (2003); Reynolds, Treatment of Recourse Liabilities in the Context of a Limited Liability Company, 74 Taxes 397, 398 (June 1996); Cuff, Indebtedness of a Disregarded Entity, 81 Taxes 303, 342 (March 2003). Although the section 1001 regulations do not provide detailed definitions of recourse and nonrecourse liabilities, the regulations focus on whether the
debtor is personally liable to the creditor or whether the creditor’s rights are limited to specific assets of the debtor.

e. Recourse Debt of Disregarded LLC. Assume an individual owns property through a disregarded LLC, and the LLC has pledged the debt to secure a recourse liability as to which the individual has no personal liability. Such debt presumably would be treated as nonrecourse for purposes of section 1001 and the COD rules, consistent with the disregarded entity rules in Reg. § 1.752-2(k) and Reg. § 1.465-27(b)(5) (which treat recourse debt of a disregarded LLC as nonrecourse debt as to the taxpayer). This result seems correct as a policy matter because there is no tax-recognized entity that separately determines its taxable income, unlike the partnership obligor case discussed above.

f. In Great Plains Gasification Assoc. v. Commissioner, 92 T.C.M. (CCH) 534 (2006), one of the issues was whether a general partnership recognized sale gain or COD income upon conveyance of a coal gasification project back to its lender (a federal agency). The government’s position was that the loan was nonrecourse under the section 752 regulations and therefore the foreclosure should be treated as a sale. The loan was secured by a pledge of all of the partnership’s project assets (whether owned or thereafter acquired), was guaranteed by the U.S. Department of Energy, and specifically provided that the general partners were exculpated from personal liability.

(1) The Tax Court began by stating that “[i]ndebtedness is generally characterized as ‘nonrecourse’ if the creditor’s remedies are limited to particular collateral for the debt and as ‘recourse’ if the creditor’s remedies extend to all the debtor’s assets” and that “for indebtedness incurred by a partnership, Treasury regulations that were in effect at relevant times defined a nonrecourse liability as one with respect to which ‘none of the partners have any personal liability,’” citing Reg. § 1.752-1(e).

(2) The Tax Court observed that the partnership had no other significant non-project assets and that the credit agreements and partnership agreement prohibited it from acquiring any such assets or conducting any other business. The court concluded that “the partnership's liability on the debt was effectively limited to the project assets that collateralized the indebtedness, and the partners' liabilities were effectively limited to their interests in those project assets,” and that “the debt was in substance nonrecourse against the partnership and the partners.” The court appears to have viewed the limitations on acquiring other assets as making the debt tantamount to a traditional nonrecourse loan secured by the assets acquired with the loan proceeds.

(3) This case can be cited in support of the proposition that exculpatory debt of a limited partnership, or recourse debt of an LLC, is nonrecourse debt for purposes of analyzing the effect of the debt discharge. However, it is not clear that the section 752 regulations’ partner-level approach to determining the nonrecourse nature of a liability should apply in the section 1001/COD income context.

g. In Priv. Ltr. Rul. 200630002 (April 24, 2006), a transitory subsidiary of a newly formed holding company ("HoldCo") merged into an existing publicly traded debtor corporation ("Parent"), and then Parent converted to an LLC under a state law conversion statute and became a disregarded entity of HoldCo. The transaction was intended to qualify as an "F" reorganization. The IRS ruled that the LLC conversion did not result in a significant modification of its recourse debt under Reg. § 1.1001-3(e) and stated that the conversion did not “result in a change in the recourse nature of the [debt] for purposes of section 1.1001-3(e)(2)(i).” (The latter regulation provides that a change in the recourse nature of a debt instrument is a “modification.”) This conclusion arguably is inconsistent with the notion that LLC recourse debt should be treated as nonrecourse for purposes of section 1001.
E. **Mezzanine Debt**

1. **Example.** Taxpayer owns real property worth $1,000 in a single member LLC which is a disregarded entity for tax purposes. LLC has given a first lien on the property to secure a $600 nonrecourse loan from a senior lender. Taxpayer has also incurred a $200 nonrecourse loan from a mezzanine lender secured by a pledge of 100% of the LLC interests. Under an intercreditor agreement between taxpayer, the mezzanine lender, and the senior lender, the mezz lender has the right, upon a default or foreclosure proceeding relating to the senior loan, to either cure the default, purchase the LLC interest and take over operation of the property, or to acquire the senior loan. Assume the property's value declines to $400 and the LLC defaults on the senior loan. The mezz lender elects not to cure the default or to acquire the senior loan. The LLC gives a deed in lieu of foreclosure to the senior lender. At this point, the liquidation provisions in the LLC agreement would require a dissolution of the entity, causing collateral for the mezz loan (now worthless) to be extinguished.

   a. Reg. § 1.1001-2(a) provides that the amount realized on a sale of property "includes the amount of liabilities from which the transferor is discharged as a result of the sale or disposition." It would appear that the taxpayer's amount realized on the foreclosure ought to include the mezz loan, notwithstanding that there is no conveyance of property to the mezz lender.

   b. This conclusion draws some support from the holding in 2925 Briarpark, Ltd. v. Commissioner, 73 T.C.M. (CCH) 3218 (1997), aff'd, 163 F.3d 313 (5th Cir. 1999). In that case, the debtor realized the full amount of nonrecourse debt in a Tufts sale where the lender agreed to release its lien on the collateral so that the debtor could sell it to a third party for an amount less than the debt, in exchange for the debtor's agreement to pay over the proceeds to the lender.

X. **EQUITY-FOR-DEBT SWAPS**

A. **Corporate Debtors**

1. Under pre-BTA law, the courts had held that no COD income was incurred when stock was issued by a corporate debtor in exchange for its own debt, even where the face amount of the debt substantially exceeded the fair market value of the stock. See, e.g., Capento Securities Corp. v. Commissioner, 47 B.T.A. 691 (1942), aff'd, 140 F.2d 382 (1st Cir. 1944).

2. The common law stock-for-debt exception was based on two theories:

   a. **Substitution of Liability Theory:** When a corporate debtor exchanges equity for debt, the liability has not been discharged. Rather, a capital stock liability has been substituted for the debt liability.

   b. **Subscription Theory:** No gain is recognized by a corporation under section 1032 when it receives the subscription price of its shares, including cash received pursuant to the issuance of a debt that is later canceled in exchange for stock.

3. The BTA subjected "the stock for debt exception" to two limitations:

   a. The ratio of stock-to-canceled debt for any given unsecured creditor could not be less than 50 percent of the same ratio computed for all unsecured creditors. Section 108(e)(8)(B).
b. The exception did not apply to the issuance of “token or nominal shares.” Section 108(e)(8)(A).

c. A further limitation was imposed in 1984 with the enactment of old section 108(e)(10)(B), which limited the stock-for-debt exception to debtors in a title 11 case or to the extent the debtor is insolvent. In all other cases, the debtor corporation was treated as having satisfied its debt with an amount of money equal to the fair market value of the stock issued.

4. In Rev. Rul. 90-87, 1990-2 C.B. 32, the IRS rejected the subscription price theory as the basis for the stock-for-debt exception. It interpreted the case law as affording nonrecognition upon the retirement of corporate debt only to the extent of the capital stock liability substituted for the outstanding corporate debt. To the extent the capital stock liability was limited by the redemption price and liquidation preference, so too was the stock-for-debt exception.

5. Having steadily chipped away at the common law stock-for-debt exception, Congress finally repealed it in the 1993 Act. As amended, section 108(e)(8) provided that if a corporation transfers its stock to a creditor in satisfaction of its debt, it is treated as having satisfied the debt with an amount of money equal to the fair market value of the stock. Thus, to the extent the fair market value of the stock is less than the adjusted issue price of the debt as determined under Reg. § 1.1275-1(b), the corporation recognizes COD income equal to such excess.

6. The amended provision was silent about partnerships, although that was eventually remedied in 2004, as discussed below.

B. Treatment of Contributions of Partnership Debt for Equity Prior to 2004

Amendment to Section 108(e)(8)

1. The case law does not establish an explicit equity-for-debt exception for partnerships. The legislative history of the stock-for-debt exception in the BTA, however, sheds some light on Congress' view of whether an equity for debt exception exists for partnerships.

2. The House version of the BTA, which contained a provision repealing the stock-for-debt exception, specifically stated that the repeal also was to apply to partnerships. H.R. 5043, 96th Cong., 2d Sess. § 2(a) (as passed by the House, Mar. 24, 1980).

3. The Senate version, which was adopted as section 108(e)(8), never mentioned partnerships. This could be read to indicate either that the Senate did not intend the restrictions to apply to partnerships or did not feel that any exception existed for partnerships. H.R. 5043, 96th Cong., 2d Sess. (as passed by the Senate, Dec. 13, 1980).


5. The repeal of the corporate stock-for-debt exception did not mean that the partnership equity-for-debt exception was dead. The Code never created the stock-for-debt exception to begin with; it was a creature of common law and the Code merely imposed limits on its use. Thus, its repeal as to corporations did not necessarily preclude its application to partnerships. Indeed, the Conference Report accompanying the 1993 Act states that “the conferees clarify that no inference is
intended with the enactment of this provision as to the treatment of any cancellation of the indebtedness
of any entity that is not a corporation in exchange for an ownership or equity interest in such entity.”
did not exist, then the partnership presumably would be deemed to have satisfied its debt with an amount
equal to the fair market value of the partnership interest issued to the creditor.

6. Under a pure aggregate view of partnerships, one could argue that no such
exception should be allowed since no similar exception is available to individuals or, after the 1993 Act,
to corporations. Under an entity theory, however, the creditor’s claim against the partnership is merely
being recharacterized, not reduced, with the creditor retaining a substituted economic claim against the
partnership in the form of a partnership interest. There may not be full substitution, however, if the
partnership interest has only a limited and preferred claim to partnership assets. Cf. Rev. Rul. 90-87,
1990-2 C.B. 32 (preferred stock qualifies for stock-for-debt exception only to the extent of redemption
price/liquidation preference).

7. Section 721 arguably also applied to prevent COD income recognition by
partnerships that exchange partnership interests for debt. It provides that “no gain or loss shall be
recognized to a partnership or to any of its partners in the case of a contribution of property to the
partnership in exchange for an interest in the partnership.”

a. The discharged debt is “property” and is exchanged for a partnership
interest.

b. The Service, however, had refused to rule as to whether section 721
applied to partnership equity-for-debt exchanges. See, e.g., Priv. Ltr. Ruls. 8444069 (July 31, 1984) and

c. The preamble to the March 22, 1991 proposed regulations under section
108(e)(4) stated that the final regulations would provide that COD income will be recognized where the
debtor acquires its debt in certain nonrecognition transactions, including exchanges under sections 721,
731, 332, 351, and 368, effective for any transaction on or after March 21, 1991. Notice of Proposed

d. To ease practitioners’ concerns about this extremely vague language, the
Service issued Notice 91-15, 1991-1 C.B. 319, which provides that the March 21, 1991 effective date will
apply to nonrecognition transactions only if (i) the creditor or its predecessor acquired the debt or became
related to the debtor in a transaction that occurred prior to the nonrecognition transaction and that would
have been a “direct or indirect acquisition” under Prop. Reg. § 1.108-2 if the prior transaction had
occurred on or after March 21, 1991, and (ii) the debtor did not report COD income as a result of the
creditor’s acquisition of the debt or becoming related to the debtor. The Notice also states that “...in
general, the transfer of partnership debt to a partnership in exchange for a partnership interest is not
within the scope of the preamble.” This clarification literally only confirmed that the final regulations
under section 108(e)(4) would not retroactively cause COD income to be recognized on a partnership
debt-for-equity swap; it did not confirm that a debt-for-equity exception exists.

e. The final regulations under section 108(e)(4) reserve the treatment of
debt acquired in nonrecognition transactions. Reg. § 1.108-2(f)(3). The preamble to the final regulations
states that Treasury intends to issue regulations “clarifying the measurement and treatment of income
from discharge of indebtedness in certain nonrecognition transactions in which the debtor acquires its
own indebtedness, or the creditor assumes a debtor’s obligation to the creditor.” T.D. 8460 (preamble),
1993-1 C.B. 19.
8. To summarize, prior to the American Jobs Creation Act of 2004, Pub. L. 108-357 (the “2004 Act”), partners had a reasonable position that the equity-for-debt exception applied, even if the fair market value of the partnership interest was less than the amount of debt discharged, subject to possible de minimis or sham transaction arguments. Nevertheless, most tax advisors prepared their clients for an IRS challenge if the value of the partnership interest received was demonstrably less than the exchanged debt.

9. In Parker Properties Joint Venture v. Commissioner, 71 T.C.M. 3195 (1996), the issue was whether cancelled partnership debt was properly treated as a tax-free contribution to the capital of the partnerships in question. The Tax Court properly held for the IRS.

   a. The case involved two real estate partnerships (Parker Properties Joint Venture and Twenty Mile Joint Venture). In 1983, Parker Properties borrowed $12 million from the infamous Empire Savings & Loan in Colorado (“Lender”). Lender also acquired a 50% interest in Parker Properties, which it held through a special purpose corporate subsidiary (“Lender Sub”), for a nominal cash contribution. The note was secured by the property and was nonrecourse as to Parker Properties, but was recourse as to the three individual owners of the corporate joint venturers (other than Lender Sub) to the extent of 25% of the loan balance. No significant capital contributions were made over the course of the joint venture. Twenty Mile was essentially a cookie-cutter deal involving the same partners and Lender, and the financing and partial guarantees of the individual owners of the corporate joint venturers were structured in the same way. Both real estate investments went sour. In 1987, Lender (now a successor in interest to Empire, which had gone bankrupt) met with the partners to negotiate a buyout of Lender’s debt and equity investments using funds provided to be provided by a new lender. The deal they ultimately agreed to (using the figures applicable to the Parker Properties deal for illustrative purposes) called for the $12 million debt of the joint venture to be discharged as follows: (i) a cash payment to Lender (financed by the new lender) equal to $2.9 million, (ii) the issuance of a new promissory note to Lender by the joint venture in the amount of $3 million, and (iii) a “contribution to capital” by Lender of the remainder of the debt. In addition, immediately following the discharge, Lender Sub sold its equity interests in the joint ventures to the other joint venture partners for $10,000.

   b. Lender sent Parker Properties a Form 1099-A (Acquisition or Abandonment of Secured Property) reflecting COD income equal to the amount of debt allegedly contributed to the capital of the joint ventures. To deal with this problem, the joint ventures reported COD income on their fiscal 1988 tax returns equal to the amounts shown of the Form 1099-A, but claimed an offsetting “other deduction,” accompanied by a return disclosure stating that the amount was in fact a contribution to capital and therefore nontaxable. (It is clear that the reporting on Form 1099-A was not unexpected, because the facts state that the joint venture partners agreed to hold Lender harmless from any claims that might arise from the issuance of the Form 1099-A.) Lender, on the other hand, reported an ordinary loss on its tax return for the year of the discharge equal to the amount of debt forgiven.

   c. The taxpayers argued that the forgiveness was a tax-free contribution to capital under section 721. The Tax Court did not expressly address the issue of whether a partnership debt-for-equity exception existed, but merely stated that the issue was whether the form of the transaction (i.e., as a contribution to capital) was in accord with its substance. The Tax Court found that the sale of the equity interests by Lender Sub for a nominal amount immediately following the reduction in debt did not evidence an intent to become a new investor, but rather reflected a unilateral debt cancellation which still left Lender with a virtually worthless equity interest. (It did not help the taxpayers’ cause that the evidentiary record included a memorandum prepared by the Lender’s accountant which stated that the transaction would give rise to COD income.)
d. Having determined that the joint ventures recognized COD income, the Tax Court next addressed the tax consequences to the partners. The taxpayers sought to argue, on the basis of Fulton Gold, that the cancellation of a nonrecourse debt did not produce an accession to wealth because it did not free up any assets for their use. The Tax Court rejected this theory, citing Gershkowitz, Tufts, and Revenue Ruling 91-31. Thus, it held that the COD income was includable in the partners' income as a separately stated item under section 702(a)(7), with section 108 applying at the partner level as required by section 108(d)(6).

e. Finally, the taxpayers argued that the COD income realized by the joint ventures should be reduced as a result of the purchase of certain apartment mortgages from Lender as part of the workout by a partnership of which one of the ultimate individual investors was a partner. The parties stipulated that these mortgages were purchased from Lender for a price that was $650,000 in excess of true fair market value. Thus, the taxpayers contended that such excess should be netted against their COD income. The Tax Court found, however, that these were two separate transactions involving different entities and refused to allow the offset.

C. Partnership Equity-For-Debt Swaps After 2004 Act

1. As discussed above, there were substantial arguments that section 721 prevented the recognition of COD income by a partnership under the circumstances described herein, even if the partnership interest received in exchange for the contribution had a value demonstrably less than the face amount of the note contributed. The 2004 Act amended section 108(e)(8) to foreclose this argument.

2. As amended, section 108(e)(8) provides that, "[f]or purposes of determining income of a debtor from discharge of indebtedness, if ... a debtor partnership transfers a capital or profits interest in such partnership, to a creditor in satisfaction of its recourse or nonrecourse indebtedness, such ... partnership shall be treated as having satisfied the indebtedness with an amount of money equal to the fair market value of the ... interest." (Section 108(e)(8) continues to provide a parallel rule for corporate debtors that transfer stock in satisfaction of an indebtedness, as described above.)

3. The last sentence of section 108(e)(8) makes clear that any resulting COD income is includable in the income of those persons who were partners immediately prior to the discharge.

4. A significant issue under section 108(e)(8) was how to determine the value of the partnership interest. Does a conventional "willing buyer, willing seller" test apply, taking into account discounts for minority interest, lack of marketability, etc. that would increase the amount of COD income? Or should a taxpayer apply a liquidation value approach, under which the partnership's assets are deemed sold for their fair market values, the partnership's liabilities paid, and the remaining net proceeds distributed in accordance with the distribution waterfall?

a. The IRS permitted taxpayers to use the latter approach in valuing compensatory partnership interests, provided certain conditions are satisfied. Rev. Proc. 93-27, 1993-2 C.B. 343.

b. The liquidation value approach results in a zero value for an interest in future partnership profits as distinguished from an interest in existing partnership capital (including unrealized capital appreciation). It is not clear that Congress intended such an approach. Since section 108(e)(8)(B) refers to "a capital or profits interest," and a profits interest generally is understood to mean an interest in future profits as distinguished from existing capital value, the liquidation value approach
would always result in a zero value for the profits interest and full recognition of COD income by the
debtor partnership.

c. One could argue that the liquidation value should apply only in the case of “hard to value” profits interests (recall that the Revenue Procedure 93-27 safe harbor is not available for certain “easy to value” profits interests, such as where the partnership is publicly traded).


a. The Proposed Regulations treat the value of the partnership interest issued by a debtor partnership to a creditor in satisfaction of the partnership’s debt as being equal to the liquidation value of the interest, if certain requirements are met. Liquidation value equals the amount the creditor would receive if the partnership sold its assets for their fair market values immediately after the transfer of the interest and then liquidated. See Prop. Reg. § 1.108-8(b)(1). In that event, the lender receives a capital account increase under Reg. § 1.704-1(b)(2)(iv)(b) equal to the fair market value of the debt contributed. This results in aggregate capital accounts being equal to the post-contribution net value of the partnership’s assets.

6. The liquidation value approach applies only if four conditions are met: (i) the debtor partnership maintains capital accounts in accordance with Reg. § 1.704-1(b)(2)(iv); (ii) the creditor, debtor partnership and its partners treat the value of the debt as being equal to the liquidation value of the partnership interest exchanged for purposes of determining the tax consequences of the exchange (in other words, consistent tax treatment by all parties); (iii) the exchange is an arm’s length transaction; and (iv) after the exchange there is no redemption of the interest by the partnership or a related person that is part of a plan which, at the time of the debt-for-equity exchange, had a principal purpose of avoiding COD income recognition by the partnership. Prop. Reg. § 1.108-8(b)(1). If any of these requirements is not met, the Proposed Regulations require that the value of the interest be determined based on “all the facts and circumstances.” Prop. Reg. § 1.108-8(b)(2).

7. Example 1. (The following example is based on Prop. Reg. § 1.108-8(c), Example.) A creditor of a partnership cancels debt with a face amount of $1,000 and value of $700 in exchange for a partnership interest with a liquidation value of $700. The partnership agreement complies with the section 704(b) capital account maintenance rules, and the creditor receives a capital account credit of $700 under Reg. § 1.704-1(b)(2)(iv)(b) equal to the value of the debt. The partnership is treated as satisfying the $1,000 debt with an interest worth $700 and thus recognizes COD income of $300.

a. Reg. § 1.704-1(b)(2)(iv)(b) is the basic capital account maintenance rule that requires a partner’s capital account to be credited with the amount of money and fair value of all property contributed by him to the partnership, net of liabilities that the partnership assumes or takes subject to. Since the partnership’s debt is “property” in the lender’s hands, the Proposed Regulations require the lender’s capital account to be credited with the value of the debt. In an arm’s length transaction, one would expect the value of the partnership interest received (taking into account the debt cancellation) to be more or less equal to the value of the debt immediately prior to the exchange. (Note that Reg. § 1.704-1(b)(2)(iv)(c) also requires a partner’s capital account to be credited with “the amount of any partnership liabilities that are assumed by such partner.”)

b. Example 2. Assume that the partnership in the Example had originally borrowed $1,000 on a nonrecourse basis and used such funds, plus $200 of cash contributed by its pre-
existing partners, to acquire nondepreciable real property for $1,200 which it pledged to secure the debt. Thereafter, the property declines in value to $700. At that point, the value of the $1,000 nonrecourse debt should reflect the current collateral value of $700. In connection with the lender’s admission to the partnership, the partnership does a book-down of its assets in accordance with Reg. § 1.704-1(b)(2)(iv)(f). Under the section 704(b) regulations, property cannot be booked down below the amount of any nonrecourse debt to which it is subject. See Section 7701(g) (for purposes of determining gain or loss under Subtitle A of the Code, value of property deemed to be not less than the amount of nonrecourse debt to which the property is subject); Reg. § 1.704-1(b)(2)(iv)(f)(1) (requiring a revaluation of partnership property to be based on the fair market value of partnership property, taking into account section 7701(g)). Since the debt is extinguished upon the lender’s admission, however, the section 7701(g) limitation does not apply. The property is booked down to its value of $700, creating a $500 book loss which is allocated equally to the pre-existing partners. Such partners also are allocated $300 of partnership COD income, leaving their capital accounts at zero ($200 initial contribution, minus $500 book loss, plus $300 COD income). The lender has a $700 capital account which equals the booked-down value of the property. The pre-existing partners have a reverse section 704(c) built-in loss of $500.

c. The liquidation method is, in practical effect, an elective safe harbor, because the second of the four conditions requires all relevant parties to treat the fair market value of the debt as being equal to the liquidation value of the partnership interest for purposes of determining the tax consequences of the debt-for-equity exchange. If the parties agree that COD income and capital account credit will be determined using some other valuation method, this second condition is not satisfied and value must be determined based on all the facts and circumstances.

d. To take a highly unusual circumstance not likely to occur in the real world, assume a profits interest is issued to a creditor in satisfaction of a partnership debt. The profits interest would have a zero value under the liquidation value method, causing the partnership to recognize COD income equal to the cancelled debt. Consequently, the parties might agree to value the profits interest under a “willing buyer, willing seller method” to reduce the amount of COD income, even though the parties’ business deal means that the lender gets no capital account credit (i.e., profits interest partners by definition do not receive an interest in current capital and therefore should have a zero capital account balance at the outset).

8. Example 3. Assume a disregarded LLC is wholly owned by an individual (“Developer”) and holds title to property worth $700 subject to a $600 third party nonrecourse loan. The maturity date is approaching and Developer is unable to service the debt. Lender agrees to cancel $200 of the debt in exchange for a two-thirds interest in the LLC with an initial capital account of $200 while Developer retains a one-third interest with an initial capital account of $100 ($700 value - $400 remaining debt = $300 equity). Lender’s admission causes LLC to become a tax partnership since it has two owners. Assume the liability is a qualified liability under the disguised sale regulations.

a. It does not appear that the Proposed Regulations apply to this transaction because they, along with section 108(e)(8), contemplate a pre-existing partnership that is the obligor under a pre-existing debt.

b. Under Revenue Ruling 99-5, 1999-1 C.B. 434, the IRS addressed two situations where property was held in a disregarded LLC that was wholly owned by member A. B acquired a 50% interest in the LLC for cash. In Situation 1, B paid the cash directly to A and acquired the 50% LLC interest by purchase. In Situation 2, B paid the cash to the LLC, which was then used in the LLC’s business.
The IRS ruled that in Situation 1, A sold an undivided interest in the property to B, and immediately thereafter A and B contributed their respective undivided interests to a newly constituted tax partnership.

In Situation 2, it ruled that A should be viewed as contributing the property and B as contributing the cash to a newly constituted partnership under section 721. Thus, in Situation 1, A recognizes some gain on an asset sale, whereas in Situation 2 the transaction is tax free to A.

c. It would appear that the facts of Example 3 fall are closer to Situation 2 than Situation 1. Lender is effectively contributing property to a previously disregarded entity -- the “property” being a portion of the debt -- while Developer contributes real property worth $700 subject to a nonrecourse debt of $600. Because the liability is a qualified liability, Developer does not recognize gain on this contribution under the disguised sale rules. Developer does not retain any consideration in this transaction, which distinguishes these facts from those of Situation 1. The result is the same as if lender had contributed $200 in cash to the LLC and the LLC had applied the cash to pay down the debt. Under this analysis, the $200 debt cancellation is fully tax free to A -- which, incidentally, is the same result (on these facts) as if section 108(e)(8) had applied and the liquidation value approach were used. The LLC (tax partnership) would have paid $200 of debt with $200 of equity, so that no COD income would be recognized.

d. Developer must also have sufficient basis to absorb the $200 constructive distribution of money under section 752(b).

e. The preamble to the proposed regulations under section 721 dealing with compensatory partnership interests discuss a somewhat analogous situation where a person transfers an interest in a disregarded entity to a service provider in a compensatory transfer. See Partial Withdrawal of Notice of Proposed Rulemaking and Notice of Proposed Rulemaking, REG-105346-03, 2005-2 C.B. 1244. It states that the section 721(a) nonrecognition rule does not apply to the transfer of substantial vesting of an interest in an eligible entity (as defined in the check-a-box rules) where the formation of the tax partnership occurs simultaneously with the transfer or vesting of the interest. In support, the preamble cites McDougal v. Commissioner, 62 T.C. 720 (1974), acq. 1975-2 C.B. 2, where a service recipient recognized gain upon transfer of a one-half interest in a racehorse to the service provider, and the service recipient and service provider were then treated as having contributed their respective interests in the horse to a tax-recognized partnership. The preamble compensatory situation, however, cannot be recast as a “Situation 2 transfer” in Revenue Ruling 99-5 because the service provider conveys no property or cash to the entity. Thus, the preamble language seems to have no bearing on the proper tax treatment of the lender situation discussed above.

f. Example 4. Now assume that the disregarded LLC in Example 3 owes lender $600 and the property (originally worth $700) is worth only $400. Lender agrees to reduce the principal amount by $300 (creating positive net equity in the property of $100) in exchange for an interest in the LLC with a $100 capital account, while Developer gets a zero capital account and a residual profits interest. Assume the property has a tax basis of $500.

Assuming section 108(e)(8) does not apply and the transaction is covered by Situation 2 of Revenue Ruling 99-5, arguably the only tax consequence to Developer is a reduced basis in its partnership interest. Developer’s basis in the LLC is increased by the $500 of property basis, decreased by the assumption of $600 of debt, and increased by his allocable share of the $300 remaining liability, which is assumed here to be $100 under Tier 3 of the nonrecourse debt allocation rules. Thus, Developer has a net basis of zero in its partnership interest and does not recognize...
any taxable gain from liability relief or under the disguised sale rules (because the liability is a qualified liability). If this analysis is correct, the potential COD income is converted to a basis reduction.

(2) If, contrary to the analysis above, section 108(e)(8) applied to the transaction, the LLC would recognize $200 of COD income because it is paying for $300 of debt reduction with a partnership interest worth $100. That income would presumably be allocated to Developer. The IRS would likely argue that, one way or the other, Developer must recognize $200 of COD income (e.g., as if $200 of the debt had been discharged in a separate transaction immediately prior to the lender’s admission to the partnership).

9. Can the partner/lender claim a loss to the extent the debt is not fully “paid” with the partnership interest? Arguably, a lender should be allowed a loss to the extent a debtor partnership recognizes COD income in the cancellation/admission transaction (i.e., to the extent the debt is not deemed “paid” by the issuance of a partnership interest). The loss might be allowed as a partial bad debt deduction under section 166 or a loss under section 1001 (ordinary if the note is characterized as a non-capital asset under section 1221(a)(4)). This would provide for symmetrical tax treatment of the partner lender and partnership borrower when the debt is extinguished by contribution. However, the Proposed Regulations take a contrary view: “notwithstanding § 1.108-8(a), ... section 721 applies to a contribution of a partnership's recourse or nonrecourse indebtedness by a creditor to the debtor partnership in exchange for a capital or profits interest in the partnership.” Prop. Reg. § 1.721-1(d)(1).

a. The Preamble to the Proposed Regulations makes it clear that the IRS and Treasury believe that this means no gain or loss is recognized by the creditor-partner on the transfer:

Because the proposed regulations provide that section 721 applies to a debt-for-equity exchange, the basis of the creditor's interest in the partnership is determined under section 722. Section 722 provides that the basis of an interest in a partnership acquired by a contribution of property, including money, to the partnership shall be the amount of such money and the adjusted basis of such property to the contributing partner at the time of the contribution, increased by the amount (if any) of gain recognized under section 721(b) to the contributing partner at such time.

The IRS and the Treasury Department believe that a creditor should not recognize a loss in a debt-for-equity exchange subject to section 721 in which the liquidation value of the debt-for-equity interest is less than the outstanding principal balance of the indebtedness. Rather, the creditor's basis in the debt-for-equity interest received in the debt-for-equity exchange that is subject to section 721 will be increased by the adjusted basis of the indebtedness. The IRS and the Treasury Department request comments on alternative approaches.

b. The result of the no-loss rule is that the lender takes a tax basis in the acquired partnership equal to the tax basis of the cancelled debt under section 722. If the lender’s basis in the debt exceeds the value of the partnership interest received, a disparity is created between the inside basis of the partnership's assets and the aggregate outside basis of the partners’ (including the lender’s) partnership interests.

c. Example 5. Assume a partnership’s inside basis in land is $700, of which $600 was financed with a nonrecourse loan from lender and the balance with $100 of equity contributed by partners A and B. The land is now worth $400. Lender cancels $300 of the debt in exchange for a $100 partnership interest, leaving the land encumbered by a $300 liability. Lender takes a $300 basis in its partnership interest. The partnership recognizes $200 of COD income ($300 debt discharge - $100 partnership interest). The $200 of COD income steps up the outside basis of A’s and B’s interests by $200. A’s and B’s aggregate outside basis thus equals $300 ($100 contributions + $200
COD income), and lender's outside basis equals $600 ($300 contributed debt + $300 allocation of remaining debt under section 752). Thus, outside basis totals $900, while inside basis is $700. If the lender were allowed a current loss of $200 equal to the partnership's COD income instead of an increase in its partnership interest basis over its value, equality of inside and outside basis would be preserved.

d. Although the lender is contributing a built-in loss asset (the note) to which section 704(c) ordinarily would apply, the contributed asset disappears upon contribution, so section 704(c) cannot apply to force the allocation of a $300 built-in loss back to the lender. The lender will recognize the loss only when it sells or liquidates its partnership interest (generally as a capital loss due to section 741).

e. The no-loss rule of the Proposed Regulations is arguably at odds with section 108(e)(7), a special ordinary loss recapture rule enacted by the BTA. Section 108(e)(7)(A) through (D) provides that if a creditor acquires stock of a corporation in satisfaction of the corporation's debt, then the stock is treated as section 1245 property and any losses taken by the creditor under section 166 or otherwise as an ordinary loss on the exchange are treated as deductions for depreciation. Thus, when the stock is subsequently sold, any gain is ordinary to the extent of ordinary losses taken in respect of the contributed debt. Section 108(e)(7)(E) states that, under regulations to be prescribed by the Secretary (none have been issued to date), "[similar rules] shall apply with respect to the indebtedness of a partnership." Thus, the partnership interest would be treated as section 1245 property having prior depreciation deductions equal to any previously claimed bad debt deductions plus any ordinary loss recognized on the equity-for-debt exchange. The drafting of these provisions permits an inference that a creditor can take a loss deduction in connection with a partnership debt-for-equity swap.

f. If an existing partner forgives a debt owed to the partner by the partnership which is completely worthless, and the partner receives no incremental partnership interest in the exchange, it would seem that section 721 should not apply to the debt cancellation and that the partner ought to be allowed a bad debt deduction under section 166. The case law on this issue in the corporate context is mixed. Compare Lidgerwood Manufacturing Co. v. Commissioner, 229 F.2d 241 (2d Cir. 1956), cert. denied, 351 U.S. 951 (1956) (holding that a parent's cancellation of debt owed to it by its wholly owned subsidiaries in exchange for newly issued shares of stock was a contribution to capital because it allowed the subsidiary to enhance its balance sheet and assist it in obtaining further financing; thus, the parent could not claim a bad debt deduction under section 166 even if the facts showed that the subsidiaries remained insolvent after the cancellation); Giblin v. Commissioner, 227 F.2d 692 (5th Cir. 1955) (cancellation of a portion of corporate debt owed by a corporation to the taxpayer, who was a large stockholder of the corporation, was deductible by the taxpayer as a business bad debt); Santa Monica Pictures, LLC v. Commissioner, 89 T.C.M. (CCH) 1157 (2005) (partner's contribution of worthless third-party receivable to a partnership was not a contribution of "property" within the meaning of section 721, and thus the partnership did not inherit the partner's tax basis in the receivables under section 722). Of course, if the partner is entitled to a bad debt deduction because the debt is completely worthless and section 721 is inapplicable, the partnership should recognize an equal amount of COD income.

g. It would appear that a creditor should still be able to write off a portion of the debt as long as it is an independent transaction and not done in connection with a debt-for-equity swap.

10. Section 453B rules apply notwithstanding section 721. The Preamble also states that the section 721 nonrecognition rule "does not supersede the rules under section 453B relating to dispositions of installment obligations." Thus, any deferred installment sale gain embedded in the cancelled debt would be triggered as a result of the cancellation, notwithstanding section 721. This view is consistent with the rationale of Revenue Ruling 73-423, 1973-2 C.B. 161, where the IRS ruled that the
taxpayer's contribution of an installment note to the obligor corporation in exchange for stock of that corporation constituted a taxable disposition of the note under former section 453(d)(1)(A) instead of a tax free contribution of property under section 351(a). The IRS reasoned that because the transfer resulted in a satisfaction of the obligation (as a result of the debtor and creditor becoming the same person), the normal nonrecognition rule of Reg. § 1.453-9(c) did not apply. See also Utley v. Commissioner, 906 F.2d 1033 (5th Cir. 1990) (shareholder sold property to his controlled corporation for an installment note and subsequently contributed the note to the corporation; court held that the shareholder disposed of the note when it was contributed to the corporation and recognized gain under former section 453(d), notwithstanding section 351).

11. Section 721 not applicable to the extent partnership interest is transferred to pay accrued interest. Prop. Reg. § 1.721-1(d)(2) provides that section 721 does not apply to a transfer of a partnership interest to a creditor in satisfaction of a partnership's recourse or nonrecourse debt "for unpaid rent, royalties or interest on indebtedness (including accrued original issue discount)," and cross-reference Reg. §§ 1.446-2(e) and 1.1275-2(a) for the rules governing the determination of whether a partnership interest is transferred to a creditor as payment of interest or accrued OID.

a. Many distressed loans have substantial accrued and unpaid interest. To the extent the partnership interest issued to the lender is applied first to pay the accrued interest, then the proposed regulation suggests that the partnership may recognize taxable gain or loss in a section 1001 exchange, perhaps as if it had transferred an undivided interest in its assets in exchange for the interest claim.

b. It is not clear what significance this has for the partnership from a COD standpoint. Since the accrued interest and principal are both debt for tax purposes, treating a portion of the partnership interest as applied to pay interest typically would not impact the amount of COD income realized. If the debtor partnership is on the cash method, the partnership would get an interest deduction.

c. The section 446 and 1275 regulations generally require a payment to a creditor to be applied first to accrued and unpaid interest and then to principal, but do not specifically address the case where distressed debt is paid off at less than the accreted amount. Many commentators have criticized this regulation to the extent it is interpreted to require the allocation of a payment in satisfaction of a distressed debt as ordinary interest income where the creditor does not recover his principal.

(1) There is substantial case law indicating that interest need not be accrued when it is reasonably certain it will not be collected. Corn Exchange Bank v. United States, 37 F.2d 34 (2d Cir. 1930); Chicago and Northwest Railway Co. v. Commissioner, 29 T.C. 989 (1958), acq., 1960-2 C.B. 4; IDI Management, Inc. v. Commissioner, 36 T.C.M. 1482 (1977); Cappuccilli v. Commissioner, 40 T.C.M. 1084 (1980), aff'd, 668 F. 2d 138 (2d Cir. 1981); Atlantic Coast Line Railroad Co. v. Commissioner, 31 B.T.A. 730 (1934), acq., XIV-2 C.B. 2 (1935); Rev. Rul. 80-361, 1980-2 C.B. 164. But see Tech. Adv. Mem. 9538007 (June 13, 1995) (IRS National Office ruled that a creditor had to accrue OID in respect of a distressed debt instrument, even though collectibility was substantially in doubt, because the OID accrual regime is statutory and provides no exceptions).

(2) In Priv. Ltr. Rul. 2000035008 (Sept. 1, 2000), the IRS ruled that the parties' agreement to allocate a final payment in respect of tax-exempt bonds ratably between accrued interest and principal would be respected. However, the ruling does not mention Reg. § 1.446-2(e).
(3) Prop. Reg. § 1.721-1(d)(2) re-surfaces this longstanding allocation issue in a new context, where the distressed debt is satisfied with a partnership interest having a value less than the accreted amount of the debt.

12. Capital account maintenance rules. The Proposed Regulations require the partnership to comply with the capital account maintenance rules of Reg. § 1.704-1(b)(2)(iv), but strangely enough do not require the partnership to liquidate in accordance with capital accounts. It has been reported that this was intentional.

a. If a partnership agreement provides (as many partnership agreements do) that liquidation proceeds are distributed in accordance with the distribution waterfall rather than positive capital account balances, the tax allocations of profit and loss, if properly drafted (or if "forced" allocations are used), should produce capital account balances that correspond to the amounts required to be distributed in liquidation and therefore ordinarily should satisfy the section 704(b) economic effect rules. Moreover, the accounting firm that handles the partnership's tax return typically will maintain worksheets that reflect year-to-year capital account balances that conform (hopefully) to the regulations. Still, an allocation scheme can be crafted that does not specifically reference capital accounts and yet still produce allocations consistent with the sharing of economic risk and reward. Forced allocations, by contrast, aim to build a "target capital account" balance that corresponds to the proceeds that would be distributed at year end under the distribution waterfall if the partnership sold its assets for book value and liquidated, and thus specifically incorporate the capital account concept and regulatory maintenance rules.

b. While the matter is not free from doubt, it would seem that taxpayers should not run afoul of this requirement as long as the partnership's tax allocations give proper effect to the contribution to capital that arises from the debt cancellation.

13. Finally, the Preamble asks for comments on (i) whether any special allocation rules for COD income should apply where the lender is a pre-existing partner, (ii) whether COD income arising from a debt-for-equity exchange should be treated as a first-tier item under Reg. § 1.704-2(f)(6) for purposes of the minimum gain chargeback rules (the "first tier" being gain from the disposition of the property subject to the nonrecourse debt), and (iii) how the convertible debt rules contained in the noncompensatory option regulations should interact with the Proposed Regulations.

XI. PURCHASE PRICE REDUCTION EXCEPTION TO DISCHARGE OF INDEBTEDNESS

A. Common Law Purchase Price Adjustment Doctrine

1. The purchase price adjustment doctrine effectively integrates the tax consequences of the borrowing made to purchase a property with the investment in the property. One commentator has summarized its effect as follows: "[T]he unrealized loss due to the decline in value of the property is permitted to offset the cancellation of indebtedness income by reducing the debtor’s basis for the property." Eustice, Cancellation of Indebtedness and the Federal Income Tax: A Problem of Creeping Confusion, 14 Tax. L. Rev. 225, 244-46 (1959). Thus, to the extent of the unrealized economic loss, COD income effectively is deferred under this doctrine by decreasing future allowable depreciation and increasing gain (or decreasing loss) that will be recognized when the property is sold.

2. In Hextell v. Huston, 28 F. Supp. 521 (S.D. Iowa 1939), one of the earliest cases in the area, land purchased for $20,000 later declined in value to $6,500. Payment of $6,500 in cancellation of a $10,000 mortgage note, which represented part of the purchase price, did not give rise to any income. Similarly, in Hirsch v. Commissioner, 115 F.2d 656 (7th Cir. 1940), the debtor purchased real estate for $29,000, paying $10,000 in cash and assuming a mortgage indebtedness of $19,000. The
property later declined in value to $8,000 when the balance due on the mortgage was $15,000. The court found a purchase price reduction because “. . . until the property is disposed of, there is no way of knowing whether the transaction as a whole will result in gain or loss.” 115 F.2d at 658. See also Helvering v. A.L. Killian Co., 128 F.2d 433 (8th Cir. 1942) (debt obligation satisfied upon maturity 15 years after the acquisition at $20,000 less than amount due treated as purchase price adjustment).

3. Typically, the common law purchase price adjustment doctrine has been applied to solvent debtors, presumably because insolvent debtors typically could rely upon the common law insolvency exception. See, e.g., Helvering v. A.L. Killian Co., supra. The courts, however, have not distinguished the doctrine’s application based on whether the debtor is solvent, insolvent, or bankrupt. See, e.g., Allen v. Courts, 127 F.2d 127 (5th Cir. 1942) (involving an insolvent debtor made solvent as a result of the purchase price adjustment).

4. In testing for true purchase price adjustment, some courts may require the debt reduction to follow from face-to-face negotiations between the debtor and the creditor who was the original seller of the property. Fifth Avenue-Fourteenth St. Corp. v. Commissioner, 147 F.2d 453, 457 (2d Cir. 1945). Some courts, however, do not take such a restrictive view and apply the doctrine to a reduction of both seller and non-seller financing, provided the debt in fact is incurred to purchase the property and is secured by the property. See Hirsch, 115 F.2d at 658 (the mortgage reduced was a mortgage the proceeds of which were used to satisfy the first mortgage). See also Nutter v. Commissioner, supra.

5. By contrast, the statutory purchase price adjustment exception provided in section 108(e)(5) (discussed in detail below) applies only to seller financing.

6. The doctrine generally is not available in the case of subsequent borrowings secured by the property or where the property could be sold free of the encumbrance. See Edwards v. Commissioner, 19 T.C. 275, 280 (1952) (IRS unsuccessfully argued that gain on sale of property was increased by virtue of prior purchase price reduction; debtor paid cash for the purchase of stock and several days later debtor borrowed money from two banks; the debtor and the banks were held not to have a vendor-vendee relationship, nor were the loans the equivalent of purchase money borrowing; the debtor was able to sell the stock free of any encumbrance; also distinguished purchase price cases where debtor first offered to reconvey the devalued property); compare with Hirsch v. Commissioner, supra (debt assumed in purchase may be adjusted under purchase price doctrine); Nutter v. Commissioner, 7 T.C. 480 (1946) (distinguished in Edwards on grounds that are not entirely clear; creditor was not the original seller of the securities, but rather was a bank that loaned money to the debtor to make the purchase of securities which were pledged as collateral; borrowing regarded as in the nature of a purchase money borrowing; although the court improperly failed to treat disposition of collateral as a sale or exchange, the decision nevertheless supports the view that the purchase price adjustment doctrine is not limited to seller financing).

7. The value of the property must have declined at least to the point where it does not exceed the amount remaining due on the debt before the reduction. See L.D. Coddon & Bros., Inc. v. Commissioner, 37 B.T.A. 393, 398-399 (1938); Montgomery v. Commissioner, 65 T.C. 511, 521 (1975).

8. If, after the reduction, the value of the property exceeds the amount of the reduced debt, the results under the purchase price adjustment doctrine are uncertain.

a. Example. Assume P owns property with a fair market value of $2,500,000 but subject to an indebtedness of $3,000,000. If P negotiates with the creditor and obtains a reduction of the indebtedness to $2,400,000, the value of the property would exceed the amount of the
restructured debt by $100,000. Under these facts, the debt reduction amount may be fully tax-free, or fully taxable, or taxable only to the extent value exceeds the amount of the restructured debt.

B. **Section 108(e)(5)**

1. In contrast to the common law purchase price adjustment rules, a statutory purchase price adjustment exception is available under section 108(e)(5) only if: (i) the debt of a purchaser of property to the seller arising out of such purchase is reduced, (ii) the reduction does not occur in a title 11 case or when the purchaser is insolvent, and (iii) the reduction of debt would be treated as income to the purchaser from the discharge of indebtedness but for section 108(e)(5). If a debt reduction qualifies under section 108(e)(5), there is no realized COD income, but instead the reduction is treated as a reduction of the basis of the debtor’s property equal to the amount of the debt reduction.

2. The legislative history places further limits on the application of section 108(e)(5). It provides that the statutory exception does not apply where (i) the seller transfers the debt to a third party (including a related party), (ii) the buyer transfers the property to a third party (including a related party), or (iii) the debt is relieved because of factors unrelated to a direct agreement between the buyer and the seller. BTA Senate Report at 16.

3. In Revenue Ruling 92-99, 1992-2 C.B. 35, the Service ruled that section 108(e)(5) was not available where the taxpayer purchased property with the proceeds of third-party nonrecourse financing and the principal of the debt was later reduced by the holder, because the debt was not a debt of the purchaser “to the seller” as required by section 108(e)(5)(A). See also Preslar v. Commissioner, 167 F.3d 1323, 1331-33 (10th Cir. 1999) (same).

4. Section 108(e)(5) does not prevent the buyer from recognizing sale gain where the buyer reconveys the purchased property to the seller in full satisfaction of a nonrecourse purchase money debt of buyer owed to seller. Gershkowitz v. Commissioner, 88 T.C. 984, 1016 (1987) (section 108(e)(5) not applicable to gain on sale of property in exchange for release of liability); Sands v. Commissioner, 73 T.C.M. 2398 (1997) (same).

C. **Application of Section 108(e)(5) to Partnership Debtors**

1. The application of section 108(e)(5) to a partnership purchaser/debtor is unclear on the face of the statute. The statute requires that the “purchaser” must not be insolvent or in a title 11 case, which would suggest that the partnership itself must not be in that status. Such an approach, however, is inconsistent with the aggregate approach of section 108(d)(6), which applies section 108(a) at the partner level.

   a. The prohibition on not being insolvent or in a title 11 case may be predicated on the notion that section 108(a) is already available to exclude any COD income to the extent of insolvency (with full exclusion in title 11 cases), with attribute reduction occurring under the auspices of section 108(b) rather than section 108(e)(5). If that is the rationale, the purchase price reduction exception ought to be available to the extent that the debt discharge renders a previously insolvent debtor solvent. This would also suggest, however, that insolvency and title 11 status must be tested at the partner level, rather than the partnership level, for purposes of section 108(e)(5), because sections 108(a) and (b) are applied at the partner level.

   b. This issue was resolved in Revenue Procedure 92-92, 1992-2 C.B. 505, in which the IRS announced that it will not challenge a bankrupt or insolvent partnership’s treatment of a debt reduction as a purchase price adjustment under section 108(e)(5), provided the transaction otherwise
qualifies for the exception. The revenue procedure warns, however, that such relief is not available if any partner in the partnership adopts a federal income tax reporting position that is inconsistent with the partnership's federal income tax treatment of the discharge. Possibly this reflects a concern that an insolvent or bankrupt partner might prefer to exclude the income under section 108(a) (with corresponding attribute reduction under section 108(b)) and take a position inconsistent with the partnership's treatment of the discharge as a purchase price adjustment. The revenue procedure does not, however, indicate whether the partners must be solvent and not in bankruptcy in order to claim the benefit of section 108(e)(5), and if so, how the required basis reduction would be implemented if only some, but not all, of the partners so qualify. It is doubtful that the IRS meant to write the solvency requirement out of the statute altogether where partnership debtors are involved.

2. The debt reduction causes a constructive distribution to the partners under section 752(b), to the extent the partners included the discharged liability in the basis of their partnership interests. Because the discharge is treated as a purchase price adjustment, however, a partner would not be allocated COD income that would give rise to an offsetting basis increase under section 705.

3. Where the partners of a partnership in bankruptcy are individually either insolvent or bankrupt, they may be better served by reliance on the general rule of exclusion under section 108(a) rather than the statutory or common law purchase price adjustment exception. On the other hand, the availability of the insolvency exception depends upon factual determinations regarding the extent of insolvency that may create uncertainty in particular cases.

a. Different tax consequences may result depending on which statutory exclusion applies. If the section 108(a) insolvency exclusion applies, section 108(d)(6) directs that attribute reduction with respect to section 108(b) occur at the partner level. Also, the COD income allocated among the partners (and excluded under section 108(a)) may offset the deemed distribution under section 752(b) from the debt discharge. In contrast, the required attribute reduction is made only with respect to the purchased property under section 108(e)(5), and no COD income is available to offset the deemed distribution from the debt discharge.

4. Section 108(e)(5) is mandatory. A debtor favoring the insolvency exception should be careful to disqualify itself from the statutory purchase price adjustment relief.

5. It is not clear whether accrued interest on a purchase money debt is within the scope of section 108(e)(5), which by its own terms applies to reductions of debt that "arose out of the purchase of [the] property."

a. In Priv. Ltr. Rul. 9037033 (June 18, 1990), the Service seemed to suggest that accrued interest is not subject to section 108(e)(5). In that ruling, A and B entered into purchase money sales contracts to acquire the stock of Target. A and B immediately thereafter transferred their shares of Target subject to the purchase money obligations to Holding Company, an accrual method taxpayer organized for the purpose of holding Target stock. Holding Company subsequently fell in default on the obligations and became insolvent. The creditors then agreed to discharge the unpaid accrued interest and principal for less than face. The parties agreed that the amounts paid by Holding Company would be applied first to principal and then to accrued interest.

b. The Service ruled as follows:

(1) The amount forgiven would be treated first as a forgiveness of accrued interest, and then of principal, consistent with the parties' "principal first" allocation of the amount paid.
(2) Holding Company was entitled to exclude under section 108(a) an amount of forgiven accrued interest equal to Holding Company's insolvency.

(3) The remaining forgiven accrued interest was taxed to Holding Company under the tax benefit rule doctrine to the extent the accrued but unpaid interest gave rise to a tax benefit in prior years. The Service presumably addressed the tax benefit rule because the discharge of a liability for accrued interest is excludable under section 111 -- regardless of whether section 108(a) applies -- if the debtor did not derive a tax benefit from the deduction of the interest in prior years. While no analysis is provided, the ruling's conclusion that the discharged interest was taxable (at least to the extent section 111 did not apply) appears to reject implicitly the argument that discharged accrued interest qualifies for exclusion as a purchase price adjustment under section 108(e)(5).

(4) The balance of the debt forgiveness was treated as a purchase price adjustment under section 108(e)(5). Holding Company was evidently deemed to satisfy the statutory requirement that it not be insolvent because, under the Service's pro-taxpayer ordering approach, the forgiveness of interest was deemed to have occurred prior to the principal reduction, thus eliminating the insolvency. Note that the Service permitted such treatment even though Holding Company technically was not the original purchaser of the stock; however, since A's and B's participation in the purchase appears to have been merely transitory, it would be unwise to draw any conclusions from this ruling in other cases.

(5) It is debatable whether section 108(e)(5) should apply only to debt that originally was reflected in the basis of the purchased property. As an economic matter, interest and principal are fungible obligations and both encumber the underlying property. It seems unreasonable to confine section 108(e)(5) to principal reductions. To the extent the aggregate amount of principal and interest discharged exceeds the basis of the property, the excess would simply be taxable COD income.

D. **Current Status of Common Law Purchase Price Adjustment Doctrine**

1. Many of the purchase price adjustment cases have cited and relied on the application of the unitary transaction doctrine set forth in **Bowers v. Kerbaugh-Empire Co.**, 271 U.S. 170 (1926). However, in **Vukasovich Inc. v. Commissioner**, 790 F.2d 1409 (9th Cir. 1986), the Ninth Circuit concluded that **Bowers v. Kerbaugh-Empire Co.** had been implicitly overruled by subsequent Supreme Court decisions, including **United States v. Kirby Lumber Co.**, 284 U.S. 1 (1931), and **Burnet v. Sanford & Brooks Co.**, 282 U.S. 359 (1931). Because there was an overall loss with respect to the investment made with the borrowed funds, taxpayers in **Vukasovich** as in **Kerbaugh-Empire** argued for an income exclusion. The purchase price adjustment cases, however, provide taxpayers with income deferral rather than an income exclusion. Although the cases derive from an application of **Kerbaugh-Empire**, they require a close nexus between the debt and the purchased property. Thus, such cases may not be so inconsistent with the annual accounting principle that the long-standing doctrine should be abandoned. Compare **Estate of Newman v. Commissioner**, 934 F.2d 426 (2d Cir. 1991) (acknowledging the discredited rationale of **Kerbaugh-Empire** and **Kirby Lumber**, but respecting the existence of the insolvency exception); **Fifth Avenue-Fourteenth St. Corp. v. Commissioner**, supra (separately addressing the purchase price adjustment case law and the **Kerbaugh-Empire** doctrine).

2. **Impact of the BTA.** Assuming the common law purchase price adjustment doctrine has not been overturned by more recent judicial precedent, the doctrine appears to have survived the enactment of section 108(e)(5).

   a. The relevant Senate Report language states: "This provision is intended to eliminate disagreements between the Internal Revenue Service and the debtor as to whether, in a
particular case to which the provision applies, the debt reduction should be treated as discharge income or a true price adjustment.” It goes on to state that, if the debt or property has been transferred, “this provision does not apply to determine whether a reduction in the amount of purchase-money debt should be treated as discharge income or a true price adjustment.” BTA Senate Report at 16 (emphasis added).

b. This indicates an intention to create a “safe harbor,” and a desire to avoid factual disputes in cases coming within the terms of section 108(e)(5).

c. In contrast to the treatment of the common law insolvency exception which Congress expressly preempted in section 108(e)(1), no similar preemption is expressed in this area.

d. Support for the survival of common law purchase price adjustments is also found in the BTA Senate Report explanation of section 1017(c)(2) (providing a reduction in basis required under section 108(b) shall not be treated as a disposition). It states that “[a] purchase price adjustment (whether or not described in new section 108(e)(5) of the Code, as added by this bill) continues to constitute an adjustment for purposes of the investment credit rules of the Code.” Id. at 20 n.24 (emphasis added). It is not likely that Congress would have so caveated the operation of section 1017(c)(2) if it intended to preempt the common law purchase price adjustment doctrine.

e. No court has had to resolve the question of whether the common law purchase price adjustment exception was preempted by the BTA. In one case that had occasion to consider a purchase price reduction under section 108(e)(5), the debtor taxpayer cited cases that involved a reduction in the purchase price of the property, but only where the value of the property had fallen below the unpaid principal amount of the debt. The court concluded that the cited cases were factually inapposite, but did not conclude that section 108(e)(5) supplanted existing case law. Sutphin v. United States, 88-1 U.S.T.C. ¶ 9269 (Cl. Ct. 1988). But see Juister v. Commissioner, 53 T.C.M. 1079 (1987), aff’d, 875 F.2d 864 (6th Cir. 1989) (section 108(e)(5) held applicable without discussion of the common law purchase price adjustment doctrine).

3. IRS Position

a. In Revenue Ruling 91-31, 1991-1 C.B. 19, the IRS implicitly rejected the judicial purchase price adjustment exception as applied to debt not issued by the seller. In that ruling, even though the taxpayer incurred the debt in connection with the purchase of the property which thereafter declined in value to an amount less than the debt to which the property was subject, the IRS ruled that “[t]he reduction of the principal amount of an undersecured nonrecourse debt by the holder of a debt who was not the seller of the property securing the debt results in the realization of discharge of indebtedness income under section 61(a)(12) of the Code.”

b. In Revenue Ruling 92-99, the Service expressly ruled that the common law purchase price adjustment exception did not extend to third-party nonrecourse financing (i.e., non-seller financing) incurred by the buyer to purchase the property. It specifically rejected the holdings of Hirsch v. Commissioner, 115 F.2d 656 (7th Cir. 1940) and Allen v. Courts, 127 F.2d 127 (5th Cir. 1942), which had permitted such an exception in the case of third-party financing. However, it stated that it would treat a debt reduction in third-party lender cases as a purchase price adjustment “to the extent that the debt reduction is based on an infirmity that clearly relates back to the original sale (e.g., the seller’s inducement of a higher purchase price by misrepresentation of a material fact or by fraud).” On the facts in the ruling, the Service concluded that the debt reduction was due to a decline in value of the property subsequent to the purchase rather than an infirmity in the purchase transaction itself, and thus ruled that COD income was realized.
c. A taxpayer clearly has substantial authority that the common law exception survives, particularly in view of Revenue Ruling 92-99's apparent acknowledgment that some form of common law exception exists.

XII. TAX CONSEQUENCES TO CREDITORS

A. Acquisition of Collateral by Deed in Lieu of Foreclosure

1. Deed in Lieu

a. A transfer of mortgaged property by deed from the debtor to the lender in full satisfaction of the debt is treated as a sale of the property from the debtor's standpoint. If the loan is nonrecourse, the borrower's amount realized equals the face amount of the loan.

b. The lender is allowed a bad debt deduction under section 166(a) equal to the difference between the amount of the debt and the fair market value of the property. Reg. § 1.166-6(a)(1); Bingham v. Commissioner, 105 F.2d 971 (2d Cir. 1939); Rev. Rul. 74-621, 1974-2 C.B. 405. The lender takes a tax basis in the property equal to its fair market value. Feathers v. Commissioner, 8 T.C. 376 (1947).

c. Note that section 1271(a)(1) treats amounts received on the retirement of a note as "received in exchange therefor." Section 1271(a)(1). Thus, if the debt is a capital asset, section 1271(a)(1) could treat a loss on retirement or settlement of the debt as a capital loss. This creates a potential conflict with the section 166 regulations; nevertheless, it seems clear that section 166 governs in the deed in lieu/foreclosure context. See also Rev. Rul. 2003-125, 2003-2 C.B. 1243 (IRS ruled that when a corporation that owed money to its parent distributed all of its assets to the parent in a liquidation, and the amount of the distribution was less than the amount of the intercompany debt, the parent "may be entitled to a deduction for partially or wholly worthless debt under § 166"; IRS did not allude to the possibility that the parent might be viewed as having a capital loss on a deemed section 1271(a)(1) exchange of its debt for the subsidiary's assets).

d. Note the odd asymmetrical tax consequences to lender and borrower in this situation (and in the foreclosure case discussed below): the lender has an ordinary bad debt deduction while the borrower recognizes gain on sale (assuming the debt is nonrecourse) rather than COD income.

2. Foreclosure

a. The consequences of an actual foreclosure proceeding are not as straightforward because the amount bid in by the lender can affect the tax results. In practice, however, this additional wrinkle rarely changes the tax results relative to a conveyance by deed in lieu of foreclosure.

b. If the lender bids in at the foreclosure sale at a price less than the amount of the debt, and the balance of the debt is uncollectible, the lender is entitled to deduct the difference as a bad debt deduction under section 166(a). Reg. § 1.166-6(a).

c. The regulations provide that the fair market value of the property is presumed to be the amount bid in by the lender, absent clear and convincing proof to the contrary. Reg. § 1.166-6(b)(2); Community Bank v. Commissioner, 79 T.C. 789, 792 (1982), aff'd, 819 F.2d 940 (9th Cir. 1987). However, if the price bid in by the lender is not the same as the fair market value of the property, the lender is treated as having a second taxable event (in addition to the bad debt deduction), which is the
recognition of gain or loss equal to the difference between the bid price and the property’s fair market value. Reg. § 1.166-6(b)(1).

d. The taxpayer (either the debtor or creditor) can rebut the lender’s bid price by other evidence of value, such as an appraisal. Frazier v. Commissioner, 111 T.C. 243 (1998). The valuation issue becomes important when recourse debt is discharged in connection with the foreclosure proceeding and the transaction is bifurcated into a property sale and a cancellation of the portion of the debt in excess of the property’s value. In Frazier, the debtor-taxpayer was able to prove a lower fair market value than the lender’s bid price at foreclosure and thus received a capital loss on sale of the property (instead of a taxable gain) coupled with additional COD income which the debtor excluded under the insolvency exception.

e. Assume the lender has a nonrecourse debt of $100 secured by property with a current fair market value of $60. If the lender bids in $90 at foreclosure to ensure that no other bidder gets the property, even though the facts clearly demonstrate that it is only worth $60, the lender recognizes an ordinary bad debt deduction of $10 ($100 face amount - $90 bid price) and a $30 loss equal to the difference between the amount of obligations applied to acquire the property ($90) and the fair market value ($60). Reg. § 1.166-6(b)(1).

(1) The character of the $30 loss is uncertain. If the lender had bid in at a price less than fair market value (say, at $40), the lender would recognize a $60 bad debt deduction and a $20 gain, which the IRS has ruled is an ordinary gain under tax benefit rule principles because it effectively offsets an “excess” bad debt deduction — excess in the sense that it was generated by an artificially low bid price. Rev. Rul. 80-56, 1980-1 C.B. 154. However, when the bid price exceeds value, as in the facts of the above example, the IRS appears to take the position that the loss is ordinary only if the loan is properly characterized as a noncapital asset. Rev. Rul. 72-238, 1972-2 C.B. 65. If the loan is a capital asset, a portion of the lender’s economically realized loss is converted from ordinary to capital.

3. The lender’s basis in the property is its fair market value. Reg. § 1.166-6(c).

B. Debt-For-Debt Exchange

1. The creditor recognizes no gain or loss if the debt is issued by a corporation and the deemed debt-for-debt exchange qualifies as a recapitalization under section 368(a)(1)(E). This requires that both the old debt instrument and the new debt instrument qualify as “securities.” However, gain is recognized to the extent of interest or OID paid in the exchange. Section 354(a)(2)(B).

a. The term “securities” is not defined under the Code but generally is believed to include debt instruments with a term of more than five years.

b. In determining whether a debt instrument issued in a debt-for-debt exchange is a security, the term of the original debt instrument may be taken into account in certain circumstances. See Rev. Rul. 2004-78, 2004-31 I.R.B. 108 (concluding that two-year debt instruments issued by an acquiring corporation in a reorganization in exchange for a target corporation’s outstanding debt instruments — which had substantially identical terms and that were “securities” based on their original term of 12 years — qualified as securities despite their relatively short term).

2. In general, if the exchange does not qualify as a recapitalization, the holder recognizes gain or loss on the deemed sale, with the amount realized being the issue price of the new debt as determined under the OID rules. Reg. § 1.1001-1(g)(1). The holder would recognize gain to the extent the issue price of the new debt exceeds the holder’s tax basis.
a. Basis may be less than face if the holder acquired the debt at a discount, as many distressed debt funds are doing on a regular basis.

b. Gain recognition may surprise a lender that thought it gave up valuable rights in a workout and believes it is economically worse off as a result. A lender who bought debt at a discount may seek to argue that the modified debt is traded on an established market in order to lower the debt’s issue price and thus the lender’s amount realized on the deemed sale.

c. The gain is ordinary income to the extent of accrued market discount as of the date of the exchange. The balance of the gain is capital gain if the debt instrument is held as a capital asset.

(1) Gain on the exchange of a debt instrument for a nonpublicly traded debt instrument generally would be reported on the installment method unless the holder elects out under section 453(d).

(2) The interest charge rules of section 453A(a) and (c) would be applicable, and if the new debt is pledged as collateral for another loan, the gain will be triggered under section 453A(d).

3. If the holder elects not to report income from the exchange under the installment method, the holder’s amount realized is the issue price of the new debt instrument (as determined under Reg. § 1.1274-2(g)) plus the fair market value of any contingent payments. Reg. § 1.1001-1(g)(2)(ii). The regulations state that this rule does not apply if the fair market value of the contingent payments is not “reasonably ascertainable” and that “only in rare and extraordinary cases” will this standard be met. Id.

4. If the holder recognizes a loss and the exchange is not a recapitalization, the loss is deductible under section 165. Section 165(a) allows a deduction for any “loss sustained during the taxable year and not compensated for by insurance or otherwise.” Losses incurred by individuals are deductible only if they are incurred in a trade or business, in a transaction entered into for profit, or from theft or casualty losses. Section 165(c). Because the sale or exchange requirement is met in a debt-for-debt exchange, the character of the loss depends on whether the debt is a capital or ordinary asset.

a. If the loan was made in the course of a lending trade or business, there is case law indicating that the loan is excluded from capital asset status under section 1221(a)(4). See Burbank Liquidating Corporation v. Commissioner, 39 T.C. 999 (1963) (acq. sub nom. United Assocs. Inc., 1965-1 C.B. 3, aff’d in part and rev’d in part on other grounds, 335 F.2d 125 (9th Cir. 1964) (Tax Court held that a loss on the sale by a savings and loan of mortgage loans made in the ordinary course of its business was ordinary because the loans were acquired through the rendering of a “service” and thus were excluded from capital asset status by reason of the section 1221(4) (now section 1221(a)(4)); Federal National Mortgage Association v. Commissioner, 100 T.C. 541 (1993) (the “Fannie Mae case”) (Tax Court held that losses realized by Fannie Mae on certain hedging transactions were ordinary losses because they served as a surrogate for the underlying mortgages held by Fannie Mae, and the mortgages themselves were ordinary assets under section 1221(4) because, under the Burbank rationale, Fannie Mae provided a "service" when it purchased mortgage loans from lenders in that it provided stability to the secondary market for home mortgages and liquidity for originating lender; fact that Fannie Mae did not originate the loans did not distinguish its case from the S&L in Burbank or negate the service element of its business). There are also a series of rulings involving commercial lenders, such as banks and REITs, where the IRS ruled that loans were ordinary assets when held by the original lender. See Rev. Rul. 72-238, 1972-1 C.B. 65; Rev. Rul. 73-558, 1973-2 C.B. 298; Rev. Rul. 80-56, 1980-1 C.B. 154; Rev. Rul.
80-57, 1980-1 C.B. 157. (Revenue Rulings 72-238 and 73-558 were superseded by the enactment of section 582(c) in 1986.)

b. The IRS issued a proposed regulation in August 2006 that would have adopted a construction of section 1221(a)(4) contrary to the above authorities on the basis that their holdings are inconsistent with the original Congressional purpose behind the enactment of section 1221(a)(4)’s predecessor. Thus, the proposed regulation would have prevented a loan of money from qualifying as a noncapital asset under section 1221(a)(4). Prop. Reg. § 1.1221-1(e), REG-109367-06, 2006-2 C.B. 683. In April 2008, after much protest from taxpayers, the IRS withdrew the notice of proposed rulemaking and announced that it will not challenge return reporting positions under section 1221(a)(4) based on existing law, including Burbank and the Fannie Mae case, although it will continue to study the issue. Announcement 2008-41, 2008-19 I.R.B. 943.

5. It appears that the lender must treat the loss on deemed section 1001 exchange as a section 165 loss and not as a section 166 bad debt deduction. The IRS has ruled that any bad debt deduction must be based on a charge-off that is independent of a deemed debt-for-debt exchange. See Rev. Rul. 89-122, 1989-2 C.B. 200. Contrast this with the tax result where the lender takes back the collateral in a deed in lieu or foreclosure proceeding. In that case, the lender is entitled to claim a bad debt deduction for any shortfall. For many lenders that are in the business of lending money, this is a distinction without a difference because the section 165 loss will be ordinary anyway.

6. If the amount of the loss deductible under section 165 equals or exceeds certain specified thresholds (in general, $10 million for corporations or partnerships with only corporations as partners, or $2 million for other taxpayers), the loss may be a “reportable transaction” subject to disclosure by the taxpayer on IRS Form 8886 and by any “material advisor” on IRS Form 8918.

a. In general, a loss will not be reportable if the holder has a “qualifying basis” in the debt instrument. See Rev. Proc. 2004-66, 2004-2 C.B. 966. In the simple case, where the holder’s basis is equal to the amount paid in cash for the debt instrument, the basis will be a qualifying basis. Id. (Section 4.02(2)(a)).

b. In addition, a holder will have a qualifying basis notwithstanding basis adjustments under section 1272(d)(2) (requiring basis to be increased by the amount of OID includible in income) or section 1278(b)(4) (requiring basis to be increased by the amount of market discount includible in income under section 1278(b)). Id. (Section 4.02(2)(g)).

c. However, other basis adjustments do not appear to be protected under the Revenue Procedure, including for example adjustments for amortized bond premium under section 1016(a)(5) and adjustments for payments other than qualified stated interest payments under Reg. § 1.1272-1(g). There is no apparent policy reason why these basis adjustments should not also be covered under the qualifying basis safe harbor.

7. Where partnership debt was originally issued in exchange for property and the seller reported its gain under the installment method, a subsequent restructuring of the debt that gives rise to a deemed exchange under section 1001 does not necessarily constitute a taxable disposition of the note by the seller-creditor for purposes of section 453B.

a. The preamble to the final debt modification regulations under section 1001 states that Reg. § 1.1001-3 does not apply for purposes of determining whether a modification to an installment note causes a section 453B disposition of the note. T.D. 8675 (preamble), 1996-2 C.B. 60. Instead, that issue is resolved under the cases and rulings under section 453B, which are significantly
more liberal than the standards for a section 1001 exchange of debt instruments. See, e.g., Rev. Rul. 68-419, 1968-2 C.B. 196 (extension of maturity date and increase in interest rate not a section 453B disposition); G.C.M. 25 (April 27, 1984) (acknowledging that different standards apply in testing for a section 453B disposition and a section 1001 exchange).

b. Query whether a taxpayer can take the position that the deemed exchange of the old installment note is a second installment sale of “property” under section 453(a) -- the old note for a new note -- as to which the holder can make an election out under section 453(d) if the taxpayer wants to accelerate the installment sale gain deferred in the first installment sale. The section 1001 regulations, after all, clearly create a section 1001 sale of an old note for a new note. Reconciling this view with Treasury’s deference to section 453B authorities in the preamble to the section 1001 regulations is difficult -- one would have to argue that the issue of whether the modification constitutes a gain accelerating “disposition” is tested under the far more liberal section 453B disposition authorities, but that there is still a second installment sale of old note for new note within the meaning of section 453(a).

8. A reduction of an installment obligation that qualifies as a purchase price adjustment under section 108(e)(5) should not constitute a disposition of the note under section 453B. See Jerpe v. Commissioner, 45 B.T.A. 197 (1941); Rev. Rul. 55-429, 1955-2 C.B. 252. Rather, the contract price with respect to the installment sale is recomputed and gain reportable over the remaining installment payments is adjusted prospectively. Rev. Rul. 72-570, 1972-2 C.B. 241.

C. Loss on Partial or Complete Worthlessness of Debt

1. A lender is permitted to deduct an ordinary loss on complete worthlessness of a business debt under section 166(a)(1), provided the debt is not a “security.” The lender bears the burden of proving worthlessness through identifiable events such as bankruptcy or debt forgiveness (where the forgiveness is not intended to be a gift or capital contribution) and other factors. Reg. § 1.166-2.

2. A lender is permitted to take a deduction for a partial worthlessness of a business debt. Section 166(a)(2). The lender must charge off the amount for book accounting purposes in order to deduct it. Reg. § 1.166-3(a)(2). An increase in a bad debt reserve is not sufficient to meet the charge-off requirement unless the reserve is debt-specific.

3. A nonbusiness bad debt can be deducted by a noncorporate taxpayer only when the debt becomes completely worthless, and then only as a short-term capital loss. Section 166(d).

4. The regulations contain a special rule to deal with the following problem that can arise from a deemed section 1001 exchange of debt instruments.

a. Assume a lender makes a $100 loan in year 1 and charges off $40 of the debt for book and tax purposes in year 3. The lender’s basis in the debt is now $60. In year 5, the lender and borrower agree to a significant modification of the debt, resulting in a deemed section 1001 exchange. Assume the issue price of the “new” debt equals its face amount because the new debt has adequate stated interest and is not traded, but the fair market value of the debt remains unchanged at $60.

b. The lender has a taxable exchange of old debt with a basis of $60 and an amount realized of $100 (the issue price of the new debt), thus recognizing $40 of gain, which increases the lender’s basis in the new debt to $100.
Because the lender cannot do a second bad debt charge-off for book purposes in year 5 (it already did one in year 3), the regulations deem a charge-off to have occurred in the taxable year of the deemed exchange equal to the amount by which the tax basis of the debt (now $100) exceeds the greater of the fair market value of the debt or the amount of the debt recorded on the taxpayer’s books and reduced as appropriate for a specific allowance for loan losses. Reg. § 1.166-3(a)(3). This deemed charge-off then supports a second partial worthlessness deduction under section 166(a)(2). While the deduction is ordinary, the recognized gain that created the basis that supports the second deduction may be capital depending on the lender’s circumstances.

5. Section 165(a) and section 166 appear to have overlapping jurisdiction when a creditor sustains a loss on a non-security debt. However, the Supreme Court has held that the predecessors of those two provisions are mutually exclusive, and that where a loss is incurred on indebtedness, the provisions of section 166 govern. Spring City Foundry Co. v. Commissioner, 292 U.S. 182 (1934); Rev. Rul. 69-458, 1969-2 C.B. 33.

a. If a loan is a “security” within the meaning of section 165(g)(2)(C), a loss on the security from worthlessness is deductible only under section 165(a) and not section 166. Section 166(e). A debt is a “security” only if it is issued by a corporation or governmental subdivision and is issued with interest coupons or in registered form. Section 165(g)(2)(C). Most privately held debt is not issued with interest coupons and is not issued in registered form and thus is a non-security.

b. A loss from worthlessness of a “security” that is classified as a capital asset is deductible as a loss from the sale or exchange of a capital asset. Section 165(g)(1). However, a loss on a security in a domestic or foreign corporation that is affiliated with a domestic corporation is not treated as a capital asset. Section 165(g)(3).

D. When Can a Lender Stop Accruing OID and Interest Income on Distressed Debt?

1. An accrual basis lender is not required to accrue interest income (other than OID) in respect of a distressed debt instrument if it is reasonably certain it will not be collected. See Corn Exchange Bank v. United States, 37 F.2d 34 (2d Cir. 1930); Greer-Robbins Co v. Commissioner, 119 F.2d 92 (9th Cir. 1941). This is a fairly high standard of proof -- evidence of a default or postponement of maturity date is not necessarily enough. See Rev. Rul. 2007-32, 2007-1 C.B. 1278 (bank required to continue accruing interest on a defaulted loan where it reasonably expected the borrower to make some, but not all, payments under the loan, notwithstanding that the bank was permitted to cease accruing the interest for bank regulatory purposes).

2. OID accruals are different because section 1272 and Reg. § 1.1272-1(a)(1) require such amounts to be accrued on a constant yield to maturity basis and do not provide for any exceptions relating to likelihood of payment. In Tech. Adv. Mem. 9538007 (June 13, 1995), the IRS National Office took the position that, because section 1272(a)(1) imposes a statutory accrual method for OID, the doubtful collectability exception does not apply to such accruals. The facts of that Technical Advice involved junior subordinated debentures issued by a corporation that had defaulted on its senior debt. The junior debt traded at less than 10% of its face value and in the last year in issue the corporation underwent a bankruptcy reorganization.

a. The National Office’s position may be driven by fear of whipsaw -- the debtor deducting OID while the lender has suspended inclusion. On the other hand, the IRS is also known to create whipsaws for taxpayers: in GCM 39668 (Sept. 24, 1987), the Office of Chief Counsel expressed the view that an obligor could deduct OID on a distressed nonrecourse debt only if the property’s value exceeded the amount of the debt at the time of accrual.
b. In practice, holders of distressed debt with OID often take the position that accrual is not required where it is reasonably certain that the debt or a substantial portion thereof will not be repaid.


E. Tax Treatment of Market Discount

1. Sections 1276-1278 provide special tax treatment for "market discount bonds." A bond has market discount if its stated redemption price at maturity exceeds the tax basis of the bond immediately after its acquisition by the taxpayer by more than a de minimis amount. Section 1278(a)(2).

2. The market discount rules do not apply to (i) bonds issued on or before July 18, 1984, (ii) obligations with a fixed maturity date of one year or less from the date of issue, (iii) tax-exempt obligations, (iv) U.S. savings bonds, and (v) installment obligations resulting from a sale of property to which section 453B applies. Section 1278(a)(1)(B); section 1276(e).

3. The tax treatment of a market discount bond is as follows:

   a. Gain recognized upon disposition (including a retirement or sale to a third party) of a market discount bond is treated as ordinary interest income to the extent of the accrued market discount as of the disposition date. Section 1276(a)(1). If the bond is disposed of in a nonrecognition transaction, section 1276(c) provides for special rules to preserve the ordinary income taint as to the nonrecognition property received in exchange for the discount bond. The discount is accrued on a straight-line basis or, if the holder elects, on a constant yield to maturity basis. Section 1276(b)(1) and (2).

   b. Any "partial principal payment" on a market discount bond is required to be included in gross income as ordinary interest income to the extent of the accrued market discount as of the payment date. Section 1276(a)(3). The remainder of the payment is simply treated as a payment of principal and is tax-free except to the extent that it exceeds the holder's basis in the bond.

   c. If no partial principal payments are received, the holder is not required to accrue market discount as ordinary income over the term of the bond. The holder, however, elects to accrue market discount currently. Section 1278(b).

   d. If the purchase of a market discount bond is leveraged, the taxpayer's interest deduction with respect to the financing is deferred to the extent of the accrued market discount for the year in question (unless the taxpayer elects to report market discount income on a current basis). Section 1277(a).

   e. The purpose of the market discount rules is to prevent the purchaser of debt at a discount from recognizing capital gain on the discount when its economic effect is to increase the stated yield of the instrument, just as OID does. The market discount rules have no impact on issuers.

4. The statute as written does not provide any exception to the market discount rules for distressed debt. The Section of Taxation of the American Bar Association has urged Treasury to provide such an exception in regulations. See Section of Taxation, American Bar Association, Comments
5. The theory of the market discount rules is that market discount is a substitute for interest and therefore should be taxed similarly. This rationale does not necessarily apply, however, when a highly speculative bond is purchased at a substantial discount from face. In such a case, a substantial part of the discount compensates the investor for the unusual credit risk associated with the investment and arguably should not be taxed like interest. While the legislative history of the market discount rules does not address the situation of a bond in default when acquired, it does state that regulations will provide that the market discount rules will not apply to a bond that is payable upon demand when issued. See H.R. Conf. Rep. No. 861, 98th Cong., 2d Sess. 806 (1984). This provides a rationale for excluding speculative bonds that are in default when acquired, to the extent that the terms of the bond provide that the bond becomes payable on demand by reason of the default. In addition, a defaulted bond whose maturity date has come and gone no longer has a maturity date over which market discount can be accrued. This gives investors acquiring distressed debt in default reasonable arguments for not applying the market discount rules in circumstances where they clearly ought not apply.

XIII. HOLDERS OF SECURITIZED DEBT – REMICS AND OTHER PASS-THROUGH ENTITIES

A. Overview of Securitization Vehicles

1. Much of the residential and commercial real estate mortgage debt issued in the last few years has been securitized, most commonly through a REMIC or investment trust (grantor trust) structure or as collateralized debt obligations ("CDOs"). Securitized commercial mortgage debt is typically referred to as "CMBS." Residential mortgage loan pools often contain thousands of mortgage loans. Commercial mortgage pools, on the other hand, generally consist of only a few loans, typically large in amount. A REMIC is often formed to acquire or originate the loans, with the investors holding "tranched" REMIC regular interests that are treated as debt for tax purposes. In other cases, the entity may be an investment trust that is treated as a grantor trust for tax purposes, where the investors hold interests in the trust and are treated as the tax owners of the underlying mortgages. Alternatively, the loans may be securitized in a "debt for tax" structure involving an "owner trust" where the sponsor retains tax ownership of the mortgages and the bonds are treated as debt of the sponsor.

a. In securitization deals, a servicer is retained to collect the mortgage payments, enforce the terms of the debt, and distribute the cash proceeds to the certificate holders according to their relative priority and terms. The originating lender(s) disappear from the scene and in their place are hundreds or even thousands of certificate holders who look to the servicer to protect their interests.

2. A REMIC is a special type of tax-recognized pass-through entity which is generally not subject to tax at the entity level. Section 860A(a). The REMIC is treated as the tax owner of the mortgage pool. The investors hold regular REMIC interests that are treated as debt for tax purposes under section 860B, and the sponsor or a third party holds the REMIC residual interest that is entitled to all net cash (if any) remaining after the regular interests are serviced. The residual interest holder reports the net taxable income of the REMIC, which equals the interest income and OID received in respect of the qualified mortgages and permitted investments, less interest expense and OID paid in respect of the regular interests, as well as servicer fees and other expenses. Section 860C(a). A REMIC must meet a number of complex requirements to be classified as such and is also subject to a 100% tax on certain prohibited transactions. It can be used to invest in either residential or commercial mortgages.
3. Different tax rules apply in "investment trust" structures.

a. Reg. § 301.7701-4(c)(1) states that an "investment trust," a term undefined in the regulation, "will not be classified as a trust if there is a power under the trust agreement to vary the investment of the certificate holders."

b. In addition, an investment trust with multiple classes of ownership interests ordinarily will be classified as a business entity under Reg. § 301.7701-2. However, a trust with multiple classes of ownership will be classified as a trust (assuming there is no power in the trustees to vary the investment) "if the trust is formed to facilitate direct investment in the assets of the trust and the existence of multiple classes of ownership interests is incidental to that purpose."

c. An investment trust is usually classified as a grantor trust, with the beneficiaries being the grantors and treated as owning their ratable shares of the trust's assets and income. Rev. Rul. 84-10, 1984-1 C.B. 155; Rev. Rul. 90-7, 1990-1 C.B. 153.

d. Similar to the REMIC regulations' "default or imminent default" rule (discussed below), the IRS has ruled that a trust can accept an offer of the debtor to exchange old debt for new debt where the debtor is in default or default is likely to occur in the foreseeable future. Rev. Rul. 73-460, 1973-2 C.B. 424. See also Rev. Rul. 90-63, 1990-2 C.B. 270 (IRS ruled that the power of a trustee to consent to changes in the credit support for debt obligations held by an investment trust was not a power to vary the investment).

1. These authorities provide strong support that a trustee can restructure debt held by a fixed investment trust without jeopardizing the trust's tax status.

2. These authorities, as well as others, are discussed in IRS Notice 2009-79, __ I.R.B. __, where the IRS stated that it was continuing to study the issues relating to modifications of commercial mortgage loans held by investment trusts and requested comments as to (i) the types of structures involving commercial mortgage loans held through investment trusts, including loans held by REMICs through an investment trust, (ii) whether there are fact patterns not described in the newly finalized REMIC regulations (which permit certain modifications of debt by REMICs without putting REMIC status at risk) in which the modifications permitted by such regulations would be consistent with existing case law and rulings if carried out by an investment trust, and (iii) whether there are alternative structures that would allow modified mortgage loans to be held in an investment trust consistent with existing law.

4. In a CDO or debt-for-tax (owner trust) structure, a sponsor (such as a mortgage REIT) acquires or originates a pool of mortgages, contributes them to an owner trust while retaining a relatively small trust interest therein (e.g., representing 4% of the total pool). The owner trust is treated as a disregarded entity for tax purposes and the pooled mortgages as being owned by the sponsor, while the senior trust certificates are treated as debt of the sponsor. The sponsor equity must be sufficient to permit the senior trust interests to be treated as indebtedness of the owner for tax purposes. For financial accounting purposes, the transaction is treated as a sale; hence, the "debt-for-tax" appellation.

5. The owner trust sponsor must also contend with the taxable mortgage pool ("TMP") rules of section 7701(i). These rules generally treat an entity (or portion thereof) that issues multiple classes of debt obligations backed by mortgage loans as a corporation that cannot be included in a consolidated return. The policy of the TMP rules is to ensure that at least one tax is collected on the income of non-REMIC issuers of multiple-class mortgage backed securities.
a. If the sponsor is a REIT, the TMP becomes a disregarded “qualified REIT subsidiary” of the REIT, so that the adverse tax effects for a REIT TMP are confined to passing through the REIT’s “excess inclusion income” to its shareholders, and causing the REIT to be subject to tax at the entity level on excess inclusion income allocated to a “disqualified organization” shareholder Sections 860E(d) and (e)(6).

B. Workout Issues Applicable to Holders of Securitized Mortgage Debt

1. Servicers of residential mortgage pools are in full crisis mode as they cope with an extraordinary number of nonperforming loans and foreclosures caused by the plunging housing market and resets of adjustable rate loans. With the lenders (the REMIC regular interest holders or trust certificate holders) being completely detached from the borrowers, the servicer is in an awkward middleman position. The terms of most servicing agreements require the servicer to advance out of its separate funds the amount of any defaulted payments for the benefit of the bondholders. The servicer typically is allowed to recoup its advances out of the cash flows from that defaulted debt once the loan has been reworked (modified) or the collateral foreclosed upon. This concept was intended to incentivize the servicer to address quickly nonperforming loans, but it was devised at a time when foreclosures were expected to be an isolated or sporadic event in the life cycle of the pool. With defaults and foreclosures now coming in waves, servicers are scrambling to rework loans or foreclose in assembly line fashion, and have been criticized for acting in their short-term interest (recouping advances) as opposed to doing so in a manner that minimizes risk of eventual foreclosure and protects the long-term interests of the bondholders.

2. Commercial mortgage pools are also under stress due to the credit market gridlock. Borrowers are finding it difficult to refinance maturing loans, and nonperforming loans are on the rise. The bonds (the REMIC regular interests or investment trust certificates) in many cases are trading at a substantial discount from face. The servicer is the party charged with dealing with defaulted debt and working it out or foreclosing on the collateral. As the servicer negotiates with the borrower to modify the terms of the defaulted debt, the returns of the investors on their REMIC regular interests or investment trust certificates also change and may have to be renegotiated as well. However, unlike pooled residential loans, commercial pools are much smaller and more intensely serviced, and debt restructurings are typically done in close consultation with the bondholders.


4. If investors have acquired fixed investment trust certificates at a discount (as is typical in the current abysmal market conditions), significant modifications of the underlying mortgages as to which the investors are treated as owning undivided interests (under the grantor trust rules) may cause the investors to recognize taxable gain.

5. To be a qualified REMIC for tax purposes, the REMIC must meet a variety of tax tests, including a requirement that substantially all of its assets consists of “qualified mortgages” and “permitted investments,” including foreclosure property. Section 860G(a)(3). A REMIC generally cannot acquire or exchange a mortgage after its startup date unless an exception applies.
a. The REMIC regulations make it clear that if a loan is modified in a manner that causes a deemed section 1001 exchange of debt instruments, the exchange is treated as the acquisition of a new mortgage. Reg. § 1.860G-2(b)(1) and (2). If the deemed exchange occurs outside the three-month window, then, subject to several important exceptions, it will be a nonqualifying mortgage and the deemed disposition will be a prohibited transaction under section 860F(a)(2) -- a REMIC catastrophe. Id. Because a REMIC can only hold a de minimis amount of nonpermitted assets, a deemed exchange of a REMIC mortgage loan puts REMIC qualification at risk. Reg. § 1.860D-1(b)(3)(ii).

b. Borrowers often are blissfully ignorant of a REMIC's tax concerns, but sometimes loan modifications sought by the borrower may cause REMIC problems. Because the consequences of a deemed exchange may be dire, REMIC servicers may require an opinion of counsel before agreeing to a loan modification, which, even if it can be obtained, may delay the transaction. Investment trusts also have to be concerned with the effect of modifications on the "power to vary the investment" issue.

(1) Example. Assume that one or more partners of a commercial pool borrower, in order to increase their section 752 shares of the debt, want to guarantee a nonrecourse loan in a commercial pool after the three-month window. Because this would constitute a significant modification of the REMIC debt instrument under the section 1001 regulations, REMIC tax counsel would decline to render an opinion that the guarantee does not create REMIC tax problems (assuming that the mortgage is not a qualified replacement mortgage). See Reg. § 1.1001-3(e)(4)(iv)(B) (modification that adds a guarantee to nonrecourse debt is significant).

c. Default Exception. Prior to recent amendments to the regulation, the loan modification prohibition in the REMIC regulations was subject to four exceptions. The first permitted a REMIC to make loan modifications "occasioned by default or a reasonably foreseeable default." Reg. § 1.860G-2(b)(3)(i). The regulations did not provide guidance as to when a default is reasonably foreseeable. In addition, the regulations allowed (i) mortgaged property to be sold to a buyer that assumes the mortgage loan, without regard to whether the assumption (change in obligor) would be a significant modification; (ii) a waiver of a due-on-sale clause; and (iii) a conversion of an interest rate by a mortgagor under the terms of a convertible mortgage. Reg. § 1.860G-2(b)(3). (The amendments in September 2009, discussed below, added two more exceptions.)

d. The "default or imminent default" exception is critically important in the current environment as REMIC-held distressed commercial mortgage debt starts to get worked out, because modifications that comply with the default exception do not present REMIC status issues or prohibited transaction issues. Nevertheless, they still can create a section 1001 deemed exchange of debt instruments as to which the REMIC recognizes gain or loss for purposes of computing REMIC taxable income.

e. The original REMIC regulations were issued in 1992 when mortgage securitizations involved primarily residential loans. The four exceptions were included to deal with loan modifications commonly sought for residential mortgages. Increasingly, however, REMICs hold commercial mortgage loans for which modifications are often requested under circumstances that do not clearly comply with one of the four exceptions.

C. New Regulations Permitting Additional REMIC Loan Modifications

1. In response to lobbying from the securitized debt industry, intensified by the subprime crisis and the increasing need to restructure securitized loans, the IRS solicited guidance from
the industry on modification exceptions for securitized commercial mortgages. IRS Notice 2007-17, 2007-1 C.B. 748. Based on input from the Mortgage Bankers Association and others, the IRS issued proposed regulations in November 2007 that would permit additional types of modifications to REMIC-held debt that are commonly made to commercial mortgage loans. See Notice of Proposed Rulemaking, Modifications of Commercial Mortgage Loans Held by a Real Estate Mortgage Investment Conduit (REMIC), REG-127770-07, 2007-2 C.B. 1171. Final regulations were issued on September 15, 2009. See T.D. 9463, _I.R.B. _.

2. The preamble to the final regulations states that they are intended to provide relief for modifications of loans held by REMICs but do not apply to loans held by investment trusts (where loan modifications raise the issue of whether the trustee has the power to vary the investment of the trust's assets). In Notice 2007-79, _I.R.B. _, the IRS stated that it was continuing to study the issues posed by investment trusts and solicited comments on the subject.

3. As added by T.D. 9463, Reg. § 1.860G-2(b)(3)(v) and (vi) now permit the following additional significant modifications (in the section 1001 sense) without creating a prohibited acquisition of a non-qualified mortgage and a prohibited transaction:

   a. a modification that "releases, substitutes, adds, or otherwise alters a substantial amount of the collateral for, a guarantee on, or other form of credit enhancement for, a recourse or nonrecourse obligation," and also a change in the nature of an obligation from recourse (or substantially all recourse) to nonrecourse (or substantially all nonrecourse).

   b. In both of these cases, however, the final regulations require that the obligation must continue to be principally secured by an interest in real property as of the date of the modification. This means the value of the real property collateral must be at least 80% of the adjusted issue price of the modified obligation, determined as of the date of the modification. _Id._

(1) Under the proposed regulations, proving this would have required a current appraisal of the collateral by an independent appraiser. The final regulations dispense with the mandatory appraisal requirement if the servicer reasonably believes that the obligation meets the 80% test, provided that the reasonable belief is based on either (i) a current appraisal performed by an independent appraiser, (ii) an appraisal that was obtained when the loan was originated, and, "if appropriate, that has been updated for the passage of time and for any other changes that might affect the value of the interest in real property," (iii) the sales price of the real property in the case of a substantially contemporaneous sale in which the buyer assumes the mortgage, or (iv) some other commercially reasonable valuation method. Reg. § 1.860G-2(b)(7)(ii).

(2) If this 80% test is not met, then (i) the value of the real property collateral immediately after the modification must equal or exceed the value of the real property collateral immediately before the modification, and (ii) the servicer must obtain a new appraisal, update an old appraisal, or use some other commercially reasonable valuation method to bear this out. Reg. § 1.860G-2(b)(7)(iii). The preamble observes that this alternative rule is consistent with the general rule that a decline in value of the collateral does not cause a mortgage to fail to be secured principally by real property.

4. These regulations apply for purposes of Reg. § 1.860G-2(b)(1), thus avoiding the "qualified mortgage" and the prohibited transactions tax issues, but the modification still gives rise to a taxable exchange of debt instruments if it constitutes a significant modification under section 1001 (which means the REMIC could recognize taxable gain on the deemed exchange, for example).
5. The REMIC regulations also make other changes dealing with release of liens. Prior to amendment by the new regulations, Reg. § 1.860G-2(a)(8) had a defeasance rule which provided that if a REMIC released its lien on real property that secures a qualified mortgage, the mortgage ceased to be a qualified mortgage unless either (i) the REMIC pledges government securities as substitute collateral pursuant to an existing provision in the loan documents, (ii) the release does not occur within two years of the REMIC startup day, and (iii) the lien release facilitates the disposition of the property or any other customary commercial transaction and is not part of an arrangement to collateralize a REMIC offering with obligations that are not real estate mortgages. This special defeasance rule applied regardless of whether the release of lien constitutes a significant modification under the section 1001 regulations.

a. The final regulations provide an additional exception to this rule. A release of lien no longer causes the mortgage to become disqualified (assuming the four-part defeasance exception described does not apply, which was unchanged by the final regulations) provided that (i) the release is not a significant modification under the section 1001 regulations, and (ii) following the modification, the obligation continues to be principally secured by an interest in real property within the meaning of Reg. § 1.860G-2(b)(7) (see the discussion of these rules above).

6. The regulations are effective for modifications made to the terms of an obligation on or after September 16, 2009. Reg. § 1.860A-1(b)(6).

D. Modifications of Securitized Residential Mortgages -- IRS Revenue Procedures

1. Many servicers, working in conjunction with federal and state authorities, have adopted foreclosure prevention programs. Because Treasury has been eager to remove tax impediments to their implementation, the IRS has issued several revenue procedures providing relief for modifications of residential mortgage loans. The principal significance of this guidance is that it eliminates the need (under the existing REMIC regulations) to do loan-by-loan evaluations of default risk.

2. In Revenue Procedure 2008-28, 2008-23 I.R.B. 1054, the IRS provided relief for certain modifications of REMIC residential mortgages pursuant to servicer programs devised to identify high-risk loans in the pool. The relief applies if the debt is secured by a residence containing no more than four dwelling units, the property is owner-occupied, the servicer or holder believes there is a significant foreclosure risk and that the modified debt presents a substantially reduced foreclosure risk, and certain other requirements are met. If the Revenue Procedure applies, the IRS will not (i) challenge REMIC qualification or assert a prohibited transaction based on a section 1001 deemed exchange, (ii) challenge REMIC qualification on the grounds that the modification resulted in a deemed reissuance of REMIC regular interests to the investors, or (iii) challenge an investment trust’s classification as a trust on the ground that the modifications evidenced a prohibited power to vary the investment of the certificate holders.

a. One of the requirements of the Revenue Procedure is that no more than 10% of the qualified mortgages contributed to a REMIC are more than 30 days delinquent at the time of contribution. This is intended to restrict the relief to REMICs that were not formed to acquire defaulted debt with the intent of restructuring it -- so-called “subprime REMICs.” The IRS has expressed concerns about REMICs being used for this purpose. (A distressed debt REMIC may be advantageous for certain types of investors that hold REMIC regular interests, such as non-US investors seeking a shield from potential effectively connected income that could result from loan workout activities.)

3. In December 2007, the IRS issued Revenue Procedure 2007-72, 2007-2 C.B. 1257, which sets forth certain conditions under which the IRS will not challenge the tax status of
securitization vehicles holding first-lien residential adjustable rate subprime loans as a result of certain modifications made to such loans. These applied to fast-track modifications done in conformity with a foreclosure-prevention framework published by the American Securitization Forum (“ASF”) on December 6, 2007.

4. The ASF released a revised framework on July 8, 2008. The IRS then issued Revenue Procedure 2008-47, 2008-31 I.R.B. 272, which incorporates the revised framework and amplifies and supersedes Revenue Procedure 2007-72. If the conditions are met, the IRS will not (i) challenge a REMIC’s tax status as a result of the modifications or assert that the modifications are prohibited transactions, (ii) challenge REMIC status on the ground that the transactions result in a deemed reissuance of REMIC regular interests, or (iii) challenge a securitization trust’s classification as a trust on the ground that the modifications evidence a power to vary the investment of the certificate holders.

5. The mortgage industry lobbied IRS and Treasury to extend similar relief to modifications of securitized commercial mortgages, loans secured by condominiums, second lien mortgage loans, and any actual or deemed modifications of REMIC regular interests and trust certificates resulting from modifications of the underlying pooled loans. In response, the IRS issued Revenue Procedure 2009-45, I.R.B., which sets forth a number of modifications to commercial mortgage loans which will not cause the IRS to challenge the securitization vehicle’s tax status or to assert that the modifications give rise to REMIC prohibited transactions.

E. Modifications of Securitized Commercial Mortgages -- Rev. Proc. 2009-45

1. Section 5 of the Revenue Procedure states that it applies to a modification of a mortgage loan if the following conditions are met:

   a. The loan is not secured by a residence that contains fewer than five dwelling units and that is the principal residence of the issuer (i.e., it is a commercial mortgage loan and not a residential loan).

   b. In the case of a REMIC, at the end of the three-month REMIC start-up period not more than 10% of the stated principal of the REMIC’s total assets was represented by loans as to which the payments either were at least 30 days in default or a default was reasonably foreseeable. In the case of an investment trust, the test is the same, except that it is applied as of all dates when assets were contributed to the trust.

   c. The holder or servicer reasonably believes, based on all facts and circumstances, there is a “significant risk of default ... upon maturity of the loan or at an earlier date.” (The Revenue Procedure provides some additional guidance on applying this condition.)

2. These conditions are intended to broaden the scope of relief for modifications beyond modifications occasioned by an imminent default (which are already blessed by the REMIC regulations).

3. If the loan is within the scope of the Revenue Procedure, the IRS will not challenge REMIC status on the ground that the modifications are not among the exceptions listed in Reg. § 1.860G-2(b)(3); will not contend that the modifications create a prohibited transaction issue for a REMIC; will not contend that a deemed reissuance of REMIC regular interests has occurred; and will not challenge an investment trust’s status as a trust on the ground that the modifications manifest a power to vary the investment. Section 6.
F. Other REMIC-Related Tax Issues

1. As a REMIC restructures its loans, the cash flows to the REMIC regular interest holders are altered as payments of principal and/or interest are reduced or deferred or prepayment penalties are reduced. This raises a number of potential tax issues for the investors.

2. One issue is whether the REMIC regular interests (which are debt for tax purposes) have themselves effectively undergone a significant modification to the extent that their cash flow entitlements are adversely affected -- for example, junior classes of regular interests may bear the entire economic hit while the senior classes may be unaffected. Since a REMIC must issue all of its regular interests on the startup day, a deemed section 1001 exchange raises a potential REMIC qualification risk. See also Reg. § 1.860G-1(a)(4) (REMIC’s organizational documents must irrevocably specify the principal amount, interest rate, and maturity date of the regular interests). This is why the Revenue Procedures discussed above (relating to residential loans) state that the IRS will not take the position that the REMIC interests are reissued if the requirements of the Revenue Procedures are met.

3. In any event, a REMIC can argue that, because the servicer is empowered from the outset to rework troubled loans, any such modifications are attributable to servicer arrangements that are hardwired into the terms of the regular interest at inception, and therefore any economic changes resulting from a loan workout are not “alterations” to the regular interests by reason of Reg. § 1.1001-3(c)(2). This argument is undercut, however, if the consent of the REMIC regular interest holders is needed to effect a particular restructuring.

4. Even if a significant modification of REMIC regular interests does not occur, the restructuring of the REMIC’s loans may cause the REMIC regular interests to be deemed to be retired and reissued under Reg. § 1.1275-2(j) and cause an adjustment of OID accruals under the regular interests (if issued with OID).

5. Alternatively, the reduction in cash flows might simply be ignored, in which case the REMIC regular interest holders would be obligated to continue to accrue stated interest and OID in respect of the regular interests unless the holder is no longer obligated to accrue such amounts under the doubtful collectability standard (discussed earlier in this outline). The holder may be able to claim a partial bad debt deduction.

6. A REMIC conceivably could recognize COD income if regular interests are deemed to be retired and reissued under section 1001 and the issue price of the new interest is less than the issue price of the old. An insolvent REMIC should be able to claim a section 108 exclusion as to such COD income.

XIV. SPECIAL CONSIDERATIONS FOR S CORPORATION DEBTORS

A. COD Determined at Entity Level

1. Unlike partnerships, the tax consequences of COD income realized by an S corporation are determined at the entity level. Section 108(d)(7)(A). Such income is excluded from taxable income under section 108(a) if the S corporation is in a chapter 11 proceeding or to the extent of the corporation's insolvency.

2. An S corporation can also elect (i) to exclude COD income with respect to qualified real property business indebtedness under section 108(c), and (ii) to defer COD income under
section 108(i) as long as the debt instrument giving rise to such income was issued in connection with the conduct of a trade or business by the S corporation.

3. The S corporation generally is required to reduce its tax attributes by the amount of the excluded COD income (unless the COD income is merely deferred under new section 108(i)). Section 108(b)(2).

B. "Deemed NOL" Subject to Attribute Reduction

1. Although an S corporation itself generally will not have NOL carryovers, section 108(d)(7)(B) treats any pass-through losses or deductions (including current year losses or deductions) that have been suspended at the shareholder level by reason of the section 1366(d)(1) basis limitation as a "deemed" NOL of the S corporation for the taxable year of the debt discharge which is subject to attribute reduction under section 108(b)(2)(A). See Prop. Reg. § 1.108-7(d)(1). After any such suspended shareholder losses have been fully reduced, any remaining exempt COD income reduces the tax basis of the S corporation's property. Section 108(b)(2)(D). Such tax basis may not be reduced, however, below the amount of the S corporation's post-discharge liabilities. Section 1017(b)(2).

2. The effect of section 108(d)(7)(B) is to expose all suspended losses of the S shareholder to attribute reduction -- including any suspended losses carried forward from prior taxable years -- since section 1366(d)(2) treats all suspended losses as being newly incurred in each succeeding taxable year with respect to the shareholder.

3. Proposed regulations issued in 2008 require shareholders of an S corporation to provide information to the S corporation regarding their section 1366(d)(1) suspended losses for the taxable year of the debt discharge. See Prop. Reg. § 1.108-7(d)(4), REG-102822-08, 2008-38 I.R.B. 744. The proposed regulations also provide rules for allocating "excess" deemed NOLs (those suspended losses that survive attribute reduction) among the shareholders. Prop. Reg. § 1.108-7(d)(2)(i). In general, these rules allocate the excess deemed NOLs in proportion to the amounts by which each shareholder's suspended NOLs exceed the amount of COD income that would have been allocated to the shareholder in the absence of section 108(a). Prop. Reg. § 1.108-7(d)(2)(ii).

4. Passive activity loss and credit carryovers from the taxable year of the discharge under section 469(b) are treated as tax attributes of the debtor subject to attribute reduction. Section 108(b)(2)(F). To the extent an S shareholder has suspended passive losses arising from S corporation activities, they are not subject to attribute reduction because section 108(d)(7)(B) treats as tax items of the S corporation (and thus subject to attribute reduction) only shareholder losses that are suspended under section 1366(d)(2), not passive losses suspended under section 469. However, Reg. § 1.469-2T(d)(6)(i) provides that items of deduction that are disallowed for the taxable year under section 1366(d) are not treated as a passive activity deduction, which indicates that the section 1366 basis limitation applies before section 469. Consequently, if items of deduction that would otherwise be attributable to a passive S corporation activity are suspended under section 1366(d), they become suspended NOLs rather than suspended passive losses and are subject to attribute reduction.

5. The reduction of attributes does not occur until after the determination of tax liability for the year in which the discharge occurs. Section 108(b)(4)(A). See also section 1017(a) (reduction in basis of property applies only to property held by the taxpayer at the beginning of the taxable year following the debt discharge year).
6. To the extent that the COD income exceeds the S corporation's available tax attributes (including deemed NOLs), the excess is exempt under section 108(a) and no toll charge is exacted. Reg. § 1.108-7(a).

C. Debt-For-Equity Swaps; Contributions to Capital

1. Under section 108(e)(8), an S corporation that issues its stock to creditors in a workout will be deemed to have satisfied its debt with an amount of money equal to the fair market value of the stock. If the lender is a corporation or other ineligible shareholder, the S election terminates.

2. If an existing S shareholder contributes debt owed by the S corporation to the corporation as a contribution to capital, the S corporation is treated as if it had acquired the debt for an amount equal to the shareholder's tax basis in the debt. Section 108(e)(6). Solely for this purpose, the shareholder's basis in the debt is not reduced by any S corporation losses or deductions that were previously passed through to the shareholder. Section 108(d)(7)(C).

D. No Stock Basis Adjustment for COD Income

1. Under sections 1366(a) and 1367(a), a shareholder's basis in his S stock is increased by COD income that is not excluded from income under section 108(a) at the corporate level. However, to the extent the COD income is excluded from the S corporation's taxable income under section 108(a), it cannot be included in the basis of the shareholder's S stock. This result follows from section 108(d)(7)(A), which provides that sections 108(a), (b), (c) and (g) are applied at the S corporation level, "including by not taking into account under section 1366(a) any amount excluded under [section 108(a)]."

2. The quoted language was added to the Code by Section 402(a) of the Job Creation and Worker Assistance Act of 2002, Pub. L. 107-147, in order to reverse the contrary Supreme Court holding in Gitlitz v. Commissioner, 531 U.S. 206 (2001).

3. If excluded COD income could be included in the shareholders' tax basis (as the Supreme Court held in Gitlitz), it could free up the shareholder's suspended S corporation NOL carryforwards for use in the taxable year of the debt discharge (since such carryforwards technically are not subject to attribute reduction until the taxable year following the year in which the debt discharge occurs) or increase a taxable loss upon sale or worthlessness of the shares. In other words, under Gitlitz, the suspended losses were freed up by the additional share basis attributable to the excluded COD income and available to be utilized in determining the shareholder's tax for the year of the discharge, in which case they escaped section 108(b) attribute reduction. The shareholder would thus enjoy the benefit of both (i) COD income exclusion, and (ii) the NOLs attributable to the cancelled debt, even though the losses funded by the cancelled debt were economically borne by the creditor rather than the S shareholders.

XV. SPECIAL CONSIDERATIONS FOR REITS

A. REIT as Lender

1. A REIT has to meet a number of tests regarding the makeup of its assets as of the end of each calendar quarter. The tests are designed to ensure that the REIT (i) invests primarily in real estate assets, (ii) does not invest in debt or equity securities (other than mortgage loans) of a single issuer that constitute more than 5% of the REIT's total gross assets, and (iii) does not own securities that represent more than 10% of the voting power or value of the issuer's outstanding securities. If a REIT
makes a loan that is not classified as a “real estate asset,” it must comply with the 5% test, 10% of vote test, and 10% of value test or, in the case of the 10% of value test, qualify for one of several safe harbors. In a debt restructurings, a REIT must ensure that the modified debt complies with these tests.

2. Asset values must be determined in good faith by the REIT’s board. Reg. § 1.856-3(a). It is not necessary, however, to do a formal appraisal or company-wide valuation every quarter.

3. A REIT has to meet the asset tests only on the last day of each calendar quarter. Section 856(c)(4). It can violate them freely during the quarter.

4. A REIT has 30 days after the end of the quarter to cure any “discrepancy” that otherwise would result in an asset test violation. Id. Thus, if a REIT is doing its quarterly asset test schedules on a timely basis and paying attention to acquisitions during the quarter, it has a grace period to dispose of sufficient securities to eliminate a problem.

5. A “bad” security can be insulated from the REIT by moving it to a “taxable REIT subsidiary ("TRS") of the REIT. A TRS is not subject to the asset test limitations because it is taxed like a regular taxable corporation. This also means, however, that the income from the security is subject to corporate tax, which is not what REITs are about.

6. **75% Asset Test**
   
   a. At least 75% of the value of the REIT’s total gross assets must consist of real estate assets, cash and cash items (including receivables arising in the ordinary course of the REIT’s business), and certain government securities. Section 856(c)(4)(A). This test is usually easy to meet for a garden variety REIT.

   b. Real estate assets include (i) interests in real property, (ii) loans secured by a mortgage on real property, (iii) shares of other REITs, and (iv) qualified temporary investment assets (generally, a temporary investment in stock or debt instruments of new capital raised by the REIT in a stock offering or a public offering of debt with a term of five years or more, but only for the one-year period following the capital raise). Section 856(c)(5)(B).

7. **25% Securities Test.** No more than 25% of the REIT’s gross assets can be in securities of one or more issuers. Section 856(c)(4)(B)(i).

8. **5% Asset Test**
   
   a. The total value of any non-mortgage debt and equity securities held by the REIT that are issued by any single corporate issuer (other than a TRS or a “qualified REIT subsidiary,” or QRS), cannot exceed 5% of the REIT’s total gross assets. Section 856(c)(4)(B)(iii)(I).

   b. Non-mortgage debt securities issued by a partnership are also subject to the 5% asset test.

9. **10% of Vote and 10% of Value Tests**
   
   a. The total value of any non-mortgage debt and equity securities held by a REIT in respect of any single corporate issuer cannot exceed 10% of the total voting power or value of the issuing corporation’s outstanding securities as of the end of the quarter. Section 856(c)(4)(B)(iii)(II)
and (III). Unlike the 5% asset test, which is REIT-focused (the denominator is the REIT's total gross assets), the 10% of vote and 10% of value tests are issuer-focused (the denominator is the issuer's outstanding securities).

b. The 10% of value test also applies to non-mortgage debt securities issued by a corporation, partnership or other tax-recognized entity. Equity interests in a partnership are not subject to the 10% of vote and 10% of value tests. See Reg. § 1.856-3(g) (providing that a REIT is deemed to own its proportionate share of each of the assets of a partnership for purposes of the asset tests); see also section 856(m)(3)(A)(i) (providing that a REIT's interest as a partner is not considered a "security" for purposes of applying the 10% of value test; it is not clear why Congress did not also carve out an exemption from the 10% of voting power test, although it would appear that Reg. § 1.856-3(g) already does so).

10. **Best Case Outcome: Debt is Classified as a “Mortgage Loan”**

a. The 5% test and 10% of vote/value tests do not apply to mortgage loans, because “interests in mortgages on real property” are classified as “real estate assets” rather than “securities.” Section 856(c)(5)(B); Reg. § 1.856-3(e).

b. The Code does not define “interest on mortgages on real property” as used in section 856(c)(3) or “interests in mortgages on real property” as used in section 856(c)(5)(B). However, Reg. § 1.856-5(c) requires that, for purposes of the 75% gross income test, interest income on a loan secured by both real property and other property must be apportioned between qualifying and nonqualifying gross income. The methodology compares the “loan value of the real property” to the “amount of the loan” as of the date the commitment to originate the loan became binding. Under a rule that is favorable to REITs, no apportionment is required if the loan value of the real property equals or exceeds the amount of the loan, even if the loan is secured by substantial non-real estate collateral. Reg. § 1.856-5(c)(1)(i). In that event, the REIT can hold the loan with impunity as long as the terms of the debt and the collateral remain unchanged.

c. If the loan is undersecured by real property when originated, then the interest is treated as mortgage loan interest to the extent attributable to an amount of the loan equal to the value of the real estate collateral, and the balance is treated as non-mortgage loan interest. (Note that Treasury chose not to adopt a rule that required apportionment based on relative values of real estate and non-real estate collateral.)

d. There is no Code or regulatory authority providing a similar methodology for purposes of classifying a mortgage loan for purposes of the 75% asset test. However, the IRS applied an approach similar to Reg. § 1.856-5(c) for this purpose in Priv. Ltr. Rul. 199923006 (Feb. 19, 1999), and Revenue Procedure 2003-65, 2003-2 C.B. 36, which addresses the classification of mezzanine loans for REIT testing purposes (discussed below), also piggybacks on the principles set forth in such regulation.

e. If the loan is not classified in its entirety as a real estate asset, then the portion that is not so classified must be analyzed to determine whether it complies with the 5% and 10% asset tests (e.g., does the nonqualified portion comply with the straight debt exception to the 10% of value test).

11. **Status of Mezzanine Loans as “Real Estate Assets”**
a. Suppose the REIT makes a mezz loan secured by an interest in a real estate partnership or wholly owned LLC subsidiary of the borrower that owns the property. Is the loan secured by an “interest in real property” and therefore a real estate asset?

b. Until the IRS provided a safe harbor in Revenue Procedure 2003-65, 2003-2 C.B. 336, many tax advisors were not comfortable assuming that a loan secured by a real property partnership interest was “secured by an interest in real property.” This was true even if the loan was secured by 100% of the interests in a disregarded LLC that owned real property. The IRS had issued some favorable private letter rulings, but there was no published guidance on which taxpayers could rely.

c. To qualify under the revenue procedure, all of the following requirements must be met:

1. the loan is nonrecourse and secured only by the interest in the entity (the “Member Interest”),
2. the lender has a first priority security interest in the Member Interest,
3. upon default, the lender will replace the borrower as the partner or member of the entity, and the other members (if any) must have agreed that they will not unreasonably oppose the admission of the lender as a member,
4. on the date the lender makes a binding commitment to make the loan, the entity holds real property as defined in Reg. § 1.856-3(d), and the loan becomes due and payable if the property is sold or otherwise transferred,
5. the value of the real property held by the entity is at least 85% of the value of the entity’s total assets,
6. the net equity value of the entity’s real property (after deducting any third party debt of the entity, whether or not secured by the property) that is attributable to the Member Interest equals or exceeds the amount of the loan as of the date a binding loan commitment was made, and
7. the interest is not contingent on the borrower’s profits or income. This means that an equity kicker or participating loan secured by a partnership interest likely will not qualify, even if the kicker is limited to gain recognized by the partnership on the sale of the property and has nothing to do with the borrower’s income or profit from non-partnership sources.

d. In the case of the 85% requirement, the test is applied at the end of the first calendar quarter in which the loan commitment becomes binding and also at the end of each subsequent quarter in which the entity acquires any assets, other than real estate assets, cash, cash items (including receivables), government securities, and equipment and materials customarily used for the maintenance and repair of real property.

B. Safe Harbor Exceptions to 10% of Value Test

1. 75% real estate partnership exception. Any debt instrument issued by a partnership is exempt from the 10% of value test if at least 75% of the partnership’s gross income (excluding gross income from prohibited transactions) is derived from sources that qualify for the 75%
gross income test, such as rents from real property, gain from the sale of real property, and mortgage interest.

a. This rule is based on the idea that a REIT that makes a loan to a real estate partnership is not abusing the policy of the REIT rules as long as it does not indirectly participate in substantial amounts of non-real estate income.

b. Note, however, that the REIT must still comply with the 5% asset test as to such loan.

2. “Straight debt” safe harbor. If the debt issuer is a corporation or an entity classified as a partnership for tax purposes, the debt is exempt from the 10% of value test if:

a. it qualifies as “straight debt,” and the aggregate value of any securities of the issuer held by the REIT and its “controlled” TRS subsidiaries that do not comply with the straight debt safe harbor (or some other safe harbor) do not exceed 1% of the issuer’s outstanding debt and equity securities.

b. To qualify as “straight debt,”

   (1) The debt must be in writing.

   (2) It must be an unconditional promise to pay on demand or on a specified date a sum certain in money.

   (3) The debt cannot be convertible into stock.

   (4) The interest rate and interest payment dates cannot be contingent on profits, the borrower’s discretion, or similar factors. A payment contingency is disregarded if it does not have the effect of changing the effective yield to maturity (disregarding de minimis changes). Thus, for example, a debt instrument that requires interest to be paid only when the issuer has sufficient cash flow, but provides that all unpaid interest accrues and compounds at the stated rate, will qualify as straight debt even though the timing of interest payments is subject to a contingency. Under the de minimis rule, a change in effective yield is disregarded if it does not exceed the greater of 25 basis points or 5% of the annual yield to maturity. A payment contingency is also disregarded if the aggregate issue price and face amount of all of the debt instruments of the issuer held by the REIT do not exceed $1 million and “not more than 12 months of unaccrued interest can be required to be prepaid” under such debt.

   (5) A contingency relating to the timing or amount of payment upon (i) a default, or (ii) the exercise of a prepayment right by the issuer, is disregarded if the contingency is consistent with customary commercial practice.

   (6) If the debt instrument is issued at a discount, contingencies that change the term of the instrument would change the effective yield to maturity. This must be taken into account when evaluating whether the payment contingency causes a yield change that exceeds the de minimis amount.

3. “Self-lending exception” for Non-Safe Harbor Partnership Debt Securities

a. For purposes of the 10% of value test, any debt instrument issued by a partnership that does not fall within an exception is not considered to be a security to the extent of the
REIT’s interest as a partner in the partnership. In other words, to the extent the REIT is economically lending to itself, the loan is disregarded for purposes of the 10% of value test.

b. The IRS had previously taken this position in a private letter ruling. See Priv. Ltr. Rul. 200234054 (May 21, 2002) (REIT made a non-mortgage loan to a partnership in which it was a partner which apparently did not satisfy the straight debt safe harbor; IRS ruled that since the REIT partner-lender was already treated under Reg. § 1.856-3(g) as owning its proportionate share of the assets financed with the loan and the income of the borrowing partnership that would be used to repay the loan, the loan is disregarded for purposes of the asset tests to the extent of the REIT’s ownership interest in the partnership).

C. Tax Issues For Lending REIT When Debt is Restructured

1. The safe harbors described above -- straight debt, self-lending exception, 75% real estate partnership exception -- apply only for purposes of the 10% of value test in section 856(c)(4)(B)(iii)(III). They do not apply for purposes of the 10% voting securities test. Thus, if a REIT acquires voting or control rights in a debt restructuring, the debt security must be evaluated for compliance with the 10% voting securities test, even if it otherwise meets a safe harbor relating to the 10% of value test.

2. The restructured debt needs to be analyzed to determine that it is properly classified as debt for tax purposes and not as equity. This can change the tax analysis significantly for REIT qualification purposes. If the debt is treated as an interest in a partnership debtor, for example, the REIT would be treated as owning a proportionate interest in the partnership’s assets and income, which could be problematic if the partnership generates nonqualifying income or owns nonqualifying assets, or if it owns dealer property.

3. If the restructured loan can be converted to equity, it will no longer qualify for the straight debt safe harbor. Further, if a mezzanine loan secured by an LLC or partnership interest is modified to provide an equity kicker or shared appreciation provision, the loan will not meet the requirement of Revenue Procedure 2003-65 that interest not be based on the borrower’s income or profits.

4. If the loan modifications trigger a deemed section 1001 exchange of debt instruments, it is arguable that the loan must be re-tested under Reg. § 1.856-5(c) to determine if there is adequate real property collateral value to support classification of the loan as a mortgage loan. If the modified loan is treated for tax purposes as secured by real property having a value at least equal to the loan amount as of the date of modification, it should be classified as a “real estate asset” and the REIT can relax.

a. This re-testing could produce dire consequences if, for example, the amount of personalty securing the loan has increased, in proportionate terms, relative to the total current value of the real and personal property collateral (e.g., a loan secured by a hotel and associated personal property, where the value of all collateral has fallen below the principal amount of the debt). This could result in a significant portion of the loan being treated as a non-real estate asset, which means such portion would be a “security” and would have to satisfy the 5% and 10% of value asset tests. In addition, part of the interest would become nonqualifying gross income for purposes of the 75% gross income test.

b. On August 12, 2009, NAREIT submitted a letter to IRS and Treasury requesting relief guidance to the effect that a significant modification will not cause a re-testing of the loan for purposes of the asset tests and the 75% gross income test if the modification occurs at a time
when the loan is in default or default is reasonably foreseeable (similar to the exception provided in the REMIC regulations).

5. If a REIT agrees to defer interest payments under a loan, the OID rules may still require current inclusion of the interest, which means the REIT will have phantom income that it needs to distribute to avoid REIT-level tax. (More about the phantom income issue shortly.)

D. Special Tax Issues When a REIT Lender Forecloses on Collateral

1. Two REIT tax issues are presented when a REIT forecloses on a mortgage loan and acquires the underlying property.

   a. The first is whether income and gain from the property will satisfy the REIT gross income tests. Ordinarily, leased real property collateral will generate qualifying rents from real property for the REIT, but not always (e.g., a hotel is problematic).

   b. The second issue is whether gain from a subsequent sale of the foreclosed property by the REIT could potentially subject to the 100% prohibited transactions tax.

2. The REIT rules deal with these issues by providing that income and gain from “foreclosure property,” as specially defined, is qualifying gross income, and gain from the sale of such property is not subject to the prohibited transactions tax, for a limited period of time.

   a. Specifically, sections 856(c)(2)(F) and (c)(3)(F) provide that income and gain from “foreclosure property,” as that term is defined in section 856(e), is treated as qualifying gross income for purposes of the 95% and 75% gross income tests.

   b. Section 857(b)(6)(B)(iii) provides that net income from the sale or other disposition of “foreclosure property” is not subject to the 100% prohibited transactions tax.

   c. Section 857(b)(4)(A) imposes corporate income tax on a REIT’s “net income from foreclosure property.” This term, however, is narrowly defined to include only (i) gain from sale of the foreclosure property if it is held by the REIT in a dealer capacity (e.g., the REIT foreclosed with the intent to do a quick resale), and (ii) any other net income from the property that does not otherwise constitute qualifying gross income under the 75% gross income test.

      (1) Thus, for example, no corporate tax is imposed on qualifying rents from real property derived from leasing the foreclosed property.

      (2) To maintain its REIT status, the REIT must distribute at least 90% of the “net income from foreclosure property” less the tax imposed on such net income. Section 857(a)(1)(A)(ii).

3. Foreclosure property is defined as any real property, and any personal property incident to such real property, acquired by a REIT as a result of having bid in at foreclosure, or having otherwise reduced the property to ownership and possession by agreement or process of law, after a default (or imminent default) under an indebtedness secured by such property. Section 856(e)(1). Property ceases to be “foreclosure property” as of the close of the third taxable year following the year in which the REIT acquired the property. Section 856(e)(2).
a. Property does not qualify as foreclosure property if the loan was made by the REIT with the intent to foreclose or when the REIT knew or had reason to know that default would occur. Reg. § 1.856-6(b)(3). Thus, a REIT cannot acquire a portfolio of nonperforming loans with the intent to foreclose and quickly dispose of the collateral and claim the benefit of the foreclosure property rules (if the REIT recognized gain on sale of the collateral, it could be subject to the 100% dealer tax). Consequently, a REIT generally is not a suitable vehicle for a distressed debt fund.

b. On the other hand, a REIT is not precluded from acquiring a real estate mortgage in order to foreclose and obtain the property, as long as it intends to hold the property for investment or for lease and the property generates REIT-suitable income.

c. The REIT must make an election on its tax return for the year of foreclosure to treat the property as foreclosure property. Section 856(e)(5).

4. Property loses its status as foreclosure property on the occurrence of certain events. Section 856(e)(4). For example, if the property is used in a trade or business conducted by the REIT directly and not through an independent contractor, and the income does not qualify as rents from real property due to the nature of the services provided (e.g., a hotel), the property ceases to be foreclosure property after 90 days. Section 856(e)(4)(C).

E. Application of Reg. § 1.856-5(c) When REIT Acquires Distressed Debt

1. The application of Reg. § 1.856-5(c) when a REIT acquires distressed debt at a discount from its principal amount is also unclear.

2. A distressed debt acquisition generally gives rise to market discount, which is defined as the excess of the stated redemption price of the debt over its basis immediately after the acquisition (generally its purchase price). Section 1278(a)(2). If the discount is more than de minimis, the REIT must include the accrued market discount in income as ordinary income when the debt is sold or retired or a partial principal payment is received. Section 1276(a)(1) and (3). The accrued discount is generally treated as interest income. Section 1276(a)(4).

3. The issue is how the "amount of the loan" is determined for purposes of Reg. § 1.856-5(c) -- is it the purchase price or the stated principal amount? The regulations refer to the "highest principal amount outstanding during the taxable year." Reg. § 1.856-5(c)(3). The correct answer should be the purchase price. Otherwise, if the loan is underwater and is also secured by personal property, a literal application of the apportionment rule could cause a significant part of the loan to be treated as a non-real estate asset. NAREIT has asked for guidance on this issue as well.

F. Tax Issues of Restructuring Where REIT is the Debtor

1. In general, the COD income recognition rules apply to REITs in the same manner as they apply to C corporations. A REIT can claim the benefit of the insolvency and bankruptcy exclusions under section 108(a) and must reduce tax attributes as provided in section 108(b).

2. To the extent the REIT gives back to the lender property that secures a nonrecourse debt, the entire amount of the debt is treated as an amount realized on the sale of the property rather than COD income, even if the fair market value of the property is less than the debt.

3. A REIT cannot claim the section 108(c) exclusion for COD income recognized in respect of qualified real property business indebtedness because (i) section 108(a)(1)(D) limits the
provision to taxpayers “other than a C corporation,” (ii) section 1361(a)(2) defines a “C corporation” for purposes of the Code as a corporation which is not an S Corporation, and (iii) section 856(a)(3) requires that a REIT be a domestic corporation.

4. If a REIT recognizes COD income which is not excludable under section 108(a), the income will be not be subject to entity-level tax as long as the REIT distributes such income currently in the form of actual or consent dividends.

5. A REIT is entitled to make the new section 108(i) election to defer COD income realized on a reacquisition of its debt occurring in 2009 and 2010. This means it does not have to distribute the COD income in cash until it is required to be taken into income under the deferral rules, which may be a useful cash retention strategy. However, an important issue is the effect of the election on a REIT’s earnings and profits.

a. Under section 857(d)(2), a REIT is deemed to have sufficient earnings and profits to treat as a dividend any distribution that the REIT determines to treat as a dividend, but this rule only applies to the extent of the REIT’s “required distribution” necessary to avoid the excise tax under section 4981.

b. COD income increases a corporation’s earnings and profits, except to the extent that the corporation reduces the basis of its property as a section 1017 toll charge. Section 312(l)(1). Arguably, COD income deferred under section 108(i) should not increase earnings and profits until it is required to be taken into income. See Reg. § 1.312-6(a) (earnings and profits accounting methods generally follow the methods used in determining taxable income).

c. In Section 2.11(2) of Revenue Procedure 2009-37, 2009-36 I.R.B. 309, the IRS announced that it intends to issue regulations providing that deferred COD income and deferred OID deductions do not affect a REIT’s earnings and profits until the taxable year in which such amounts are includible in gross income, as opposed to the year in which such income or deductions are realized (this is the opposite of the rule that the regulations will apply to non-REIT corporations).

6. Section 108(e)(9) provides that COD income recognized by a REIT is not taken into account for purposes of the 95% and 75% gross income tests.

7. If a REIT obligor’s liability is modified and a deemed section 1001 exchange occurs, and the REIT engaged in a hedging transaction with respect to the “old” liability and properly identified the hedge and related liability, it would appear that it needs to re-identify the hedge as hedging the modified liability. The consequences of an identification failure can be significant because it could cause the hedge income and gain to be treated as nonqualifying income for purposes of the REIT gross income tests.

a. Section 856(c)(5)(G) provides that income or gain from a “hedging transaction” which is “clearly identified pursuant to section 1221(a)(7)” is not treated as gross income for purposes of the 95% and 75% gross income tests. A hedging transaction must meet the requirements of section 1221(b)(2)(A)(ii) or (iii) and also must hedge indebtedness incurred or to be incurred by a REIT “to acquire or carry real estate assets.” Section 856(c)(5)(G)(i).

b. Section 1221(b)(2)(A)(ii) and (iii) define a hedging transaction as any transaction entered into by the taxpayer in the normal course of its trade or business primarily to manage risk of interest rate or price changes or currency fluctuations with respect to borrowings made, or to be
made, or ordinary obligations incurred, or to be incurred, by the taxpayer, or to manage such other risks as are prescribed in regulations.

c. Generally speaking, proper identification of a hedging transaction requires that it be identified by the taxpayer on the same day it is entered into. Reg. § 1.1221-2(f)(1). In addition, the risk being hedged must be identified “substantially contemporaneously” with entering into the hedging transaction, and the identification does not this standard if it is made more than 35 days after entering into the hedging transaction. Reg. § 1.1221-2(f)(2)(ii). (Special cure provisions apply where the failure to timely identify is inadvertent, although it is not entirely clear that these cure provisions are picked up by section 856(c)(5)(G)’s cross reference to section 1221(a)(7).)

Because there is a strong likelihood of a complete whiff on this issue when restructuring a REIT’s indebtedness, it may make sense to provide in the original hedge ID that it applies not only to the original hedged liability but also to any successor liability that may be exchanged therefor.

G. Dealing with Phantom Income attributable to COD, OID or Market Discount

1. To qualify as a REIT for a taxable year, a REIT must distribute as ordinary dividends at least 90% of its “real estate investment trust taxable income” for the taxable year as defined in section 857(b)(2) (“REIT taxable income”), except that, for this purpose, REIT taxable income is determined by not taking into account the deduction for dividends paid and by excluding any net capital gain. Section 857(a)(1)(A)(i).

2. The amount otherwise required to be distributed under the 90% test is reduced by the amount of any “excess noncash income” as defined in section 857(e).

a. Excess noncash income means the excess of (i) COD income, (ii) gain recognized from a “busted” section 1031 exchange where the bust was due to reasonable cause, (iii) non-cash OID, and (iv) amounts of income accelerated by section 467, over (ii) 5% of REIT taxable income, again determined without regard to the dividends paid deduction and by excluding any net capital gain. Section 857(a)(1)(B) and (e)(2)(D).

b. While this provides a measure of relief for a REIT that otherwise would have to finance the distribution of noncash income, any retained excess noncash income is still subject to tax at the REIT level.

3. In short, a REIT is not required to distribute taxable income arising from COD income and OID accruals, but it must pay corporate level tax on any retained income. Market discount income accrued by a REIT under section 1276 is not included as “excess noncash income” and therefore has to be taken into account in meeting the 90% distribution requirement. However, the recognition of market discount income on a constant accrual basis is elective, and a REIT can generally manage its way around this issue.

4. One way for a REIT to conserve cash and avoid incurring corporate tax liability is through the consent dividend procedure. However, the procedure has practical utility only for private REITs.

a. Section 565 provides that, if a REIT shareholder consents, the REIT is deemed to pay a deductible dividend under section 561 and the shareholder is deemed to receive (on December 31 of the taxable year) a taxable dividend, which the shareholder is then deemed to contribute.
to the REIT as a contribution to capital on such day. Section 565(c); Reg. § 1.565-3(a). Where only a portion of the distribution is a consent dividend and the other part consists of cash or other property, the entire amount specified in the consent and the amount of cash or other property are considered together for purposes of determining dividends paid during the year. Section 565(d); Reg. § 1.565-4. The deemed re-contribution of the consent dividend increases the tax basis of the shareholder's shares. Reg. § 1.565-3(a).

b. The consent dividend is not a viable cash conservation measure for listed REITs because of the obvious practical problems in trying to secure consents from the public shareholders. Further, in the case of a private REIT, a consent dividend generally is utilized only when all or most of the shareholders are tax exempt and thus indifferent to the receipt of phantom income.

c. Further, it is doubtful that a REIT could use the consent dividend procedures to create a hypothetical deductible liquidating distribution, because (i) section 565(b)(2) provides that consent dividends do not include amounts "which would not constitute a dividend (as defined in section 316)" if actually paid on the last day of the taxable year, and (ii) distributions following the adoption of a plan of liquidation are not "dividends" (although section 562(b) treats certain liquidation distributions as deductible dividends at the REIT level only).

5. A REIT can choose to retain capital gains and pay tax on them at the REIT level.

a. Both capital gains dividends and ordinary dividends are deductible by a REIT in computing "real estate investment trust taxable income" ("REIT taxable income"). Section 857(b)(2). While a REIT must distribute at least 90% of its ordinary REIT taxable income as ordinary dividends in order to maintain REIT qualification, it is not required to distribute capital gains (whether as ordinary or capital gain dividends). Section 857(a)(1). Instead, any retained capital gains and any undistributed ordinary REIT taxable income are subject to tax at the REIT level. Thus, a REIT can always elect to conserve cash by retaining and paying tax on long-term capital gains. The tax generally reduces "funds from operations," or FFO.

b. Section 857(b)(3)(D) provides an election whereby the retained, taxed capital gains are treated as having been distributed to the shareholders as capital gain dividends, who are then deemed to have reinvested such amounts in the REIT. The shareholder includes the deemed dividend in income (as capital gain), is treated as having paid its proportionate share of the REIT-level capital gains tax, and obtains a basis step-up in its REIT shares equal to the amount deemed distributed less the REIT tax deemed paid by the shareholder. The deemed tax payment is fully refundable to the extent it exceeds the shareholder's tax liability (i.e., it is not merely a tax credit). Thus, even a pension trust shareholder that is fully exempt from tax on REIT dividends can file a claim for refund of the full amount of the deemed paid tax. The same would be true of a taxable shareholder that can offset the deemed capital gain dividend with capital losses.

c. The net result is to give the shareholders a basis step-up for the retained capital gains (less the tax paid by the REIT), while the REIT and its shareholders collectively bear a single tax consisting of the capital gains tax (if any) that would have been imposed on the shareholders if they had received an actual capital gain dividend. Economically, the difference between a consent dividend and the deemed capital gain dividend is that in the latter case, the REIT is out-of-pocket by the amount of the tax liability. With a consent dividend, the corporation can retain all of its cash flow from sales or operations, at the cost of only a shareholder-level dividend tax (if the shareholder is subject to tax on dividends). If the REIT's shareholders are tax exempt and not subject to the pension-held REIT rules, the consent dividend is tax-efficient and maximizes the REIT's cash retention.
d. The deemed capital gain dividend procedure has been infrequently utilized.

(1) Pension trust investors must file a tax return to claim the credit and many are averse to filing tax returns with the IRS, although this view is not as prevalent as it once was.

(2) The tax paid by the REIT has to be reflected as an expense for financial accounting purposes, even though the shareholders get a credit.

(3) If the REIT is a pension-held REIT, a portion of the deemed capital gain dividend may be taxed to the pension trust shareholders as UBTI.

(4) The implications of state income taxes at both the REIT level and shareholder level must be considered. State taxes paid by REITs on their retained capital gains will not necessarily be creditable by the shareholders for state income tax purposes.

e. Since the deemed dividend procedure applies only to capital gains, a REIT cannot use it for COD income, which is always ordinary in character.

6. Cash/Stock Dividend as Cash Retention Strategy. As noted, the consent dividend option is not a practical alternative for listed REITs. An alternative approach to cash retention is for the REIT to give its shareholders a choice between a cash or stock dividend and limit the aggregate amount of cash that can be paid out in the distribution. The distribution needs to be structured so that both the cash and stock dividends are deductible for REIT tax purposes, which also means the REIT must have sufficient E&P to support the distribution. As discussed below, the IRS has taken a pro-taxpayer approach in this area.

a. Priv. Ltr. Rul. 200832009 (May 9, 2008) is illustrative. The terms of the dividend declaration in that ruling were as follows: The shareholders have the right to elect to receive all cash, all stock, or a combination of cash and stock, except that the total amount of cash available to be distributed to cash-electing shareholders is limited to 20% of the total distribution. This limit is both business-driven and tax-driven: business-driven because the REIT doesn’t want to pay out more than 20% of the distribution in cash, and tax-driven because the IRS takes the position that the stock portion is a taxable, deductible dividend only if at least 20% of the consideration is available to be paid in cash to those shareholders who elect cash. If too many shareholders elect to receive cash, the amount of cash that each cash-electing shareholder receives is scaled back so that the total cash paid does not exceed 20% of the distribution. There is no requirement, however, that the REIT pay a minimum 20% cash distribution in the aggregate, but to the extent cash elections are made, the REIT must honor them up to 20% of the total distribution. For example, if 90% of the shareholders elected all stock, the REIT would simply honor their elections, even if that meant that less than 20% of the overall distribution was paid in cash. If no election is made, a default rule is provided whereby the shareholder is deemed to have elected all stock.

(1) The ruling states that the cash-equivalent value of the common stock -- meaning the number of shares to be issued in lieu of cash -- is to be determined “as close to the distribution date as reasonably practicable.”

(2) This “reasonably practicable” standard is also used in Revenue Procedure 2009-15, discussed below (which requires the cash-equivalent value to be determined “as close as practicable to the distribution date”).

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In practice, the common stock is usually distributed shortly after the election deadline, and the number of shares issued is based on a share value equal to the average of the trading price over a specified period (the "Valuation Period") preceding the distribution date (say, 2 to 5 business days). In Priv. Ltr. Rul. 200852020 (Sept. 23, 2008), the value was determined as the average closing price over the three business day period following the election deadline, with the actual distribution of shares and cash presumably occurring shortly thereafter.

Thus, the total number of shares of common stock to be issued in the distribution equals (i) the excess of the stated dollar amount of the distribution over the cash portion, divided by (ii) the average price per share during the Valuation Period. The shareholders have to make their election before this valuation is determined.

The economic position of the shareholders who receive shares in the distribution is much the same as if they had received a cash dividend and reinvested the cash in the REIT for additional shares. Their proportionate interest in the REIT is increased slightly because some shareholders receive cash. Institutional REIT shareholders often are indifferent to the receipt of stock (tax exempts pay no taxes on the dividend) and in any event can always sell the shares if necessary.

b. The IRS ruled in Priv. Ltr. Rul. 200832009 that, as long as the cash component is at least 20% of the total distribution, (i) the distribution of cash and shares is treated as a section 301 dividend by reason of section 305(b), and (ii) the amount of the share dividend is equal to the cash per share that could have been received instead of the stock (the IRS cited Reg. § 1.305-1(b)(2) as its authority). See also Priv. Ltr. Ruls. 200852020 (Sept. 23, 2008) (public REIT intended to declare two special dividends with a cash/stock election, with at least 20% of the consideration being available in cash; the value of the shares was to be determined using the average closing price over the three business day period following the election deadline); 200850022 (Sept. 10, 2008) (public REIT intended to declare special dividend for fourth quarter of 2008; shareholders had right to elect all cash, all stock, or 20% cash and 80% stock, subject to the requirement that at least 20% of the aggregate distribution would be available to cover the cash elections; 200817031 (Jan. 28, 2008) (also indicating that the cash component would be at least 20%, assuming sufficient cash elections were made); 200618008 (Nov. 2, 2005) (cash/stock dividend declared for the purpose of purging C E&P; cash portion of dividend limited to 20%); 200615024 (Jan. 26, 2006) (20% minimum cash, but in this ruling the IRS states that the amount of the stock dividend is the value of the stock on the date of distribution rather than the amount of cash the shareholder could have received); 200406031 (Oct. 29, 2003) (20% minimum cash); 200348020 (Aug. 26, 2003) (same); and 200122001 (Dec. 5, 2000) (same).

Section 305(a) provides a general rule that a stock dividend is nontaxable. However, under section 305(b)(1), a stock distribution is treated as a taxable dividend if the distribution is payable in cash or stock, at the shareholder's election. In addition, under section 305(b)(2), a distribution is treated as a dividend if it results in the receipt of property by some shareholders and an increase in the proportionate interest of other shareholders in the corporation's assets or E&P.

Ordinarily, the value of a taxable stock dividend is the value of the shares on the date of distribution. Reg. § 1.305-1(b)(1). However, the regulations provide that where a corporation regularly distributes its earnings and profits (citing a regulated investment company as an example), and declares a distribution pursuant to which the shareholders may elect to receive either money or stock of the corporation "of equivalent value," the amount of the stock distribution is considered to be equal to the amount of money that could have been received instead. Reg. § 1.305-1(b)(2).
Section 305(b)(2) requires that the shareholder have an "election" to receive cash or stock in order for the shares to be taxable. In the rulings discussed above, the shareholder clearly has an election to receive some cash, but cannot be assured of receiving all cash. Such an election literally appears to meet the requirements of the Code and regulations, but carry it further and assume the declared dividend is $100 and the cash portion is only $1. Does the shareholder's election to receive cash or stock have substance? Also, section 305(b)(2) requires that the issuance of shares result in an increase in the proportionate interest of the recipient and a decrease in the proportionate interest of those who receive cash or property, but a shareholder who receives all stock does not increase its proportionate interest vis-à-vis other shareholders who receive stock; rather, the increase occurs only as to those who receive cash, which is limited to 20% in the rulings.

The rulings reflect what seems to be a generous ruling position by the IRS, notwithstanding that the same aggregate amount of dividend income reported by the REIT's shareholders is the same as if an all cash dividend were paid. Nevertheless, because of the uncertainty, it was not advisable for a REIT to take this position without obtaining its own ruling.

In a letter dated October 31, 2008, NAREIT asked Treasury to issue published guidance confirming the 20% minimum cash position adopted in the private rulings and permitting a temporary reduction of the IRS' 20% minimum cash requirement to 5% for distributions through the end of 2010 to assist REITs facing liquidity problems in the current crisis. The IRS responded on December 9, 2008 by issuing Revenue Procedure 2009-15, 2009-4 I.R.B. 356, which approves a minimum cash requirement of only 10% for distributions declared on or after January 1, 2008 and on or before December 31, 2009 by a publicly held REIT (or RIC). The Revenue Procedure sets out certain requirements for the cash/stock election. Specifically, Section 3 of the Revenue Procedure states that the IRS will treat a distribution of stock by a REIT as a section 301 dividend, and the amount of the stock distribution will be considered to equal the amount of money that could have been received instead, if the following requirements are met:

1. The distribution is made by the REIT to its shareholders with respect to its stock;
2. The stock of the corporation is publicly traded on an established securities market in the United States.
3. The distribution is declared with respect to a taxable year ending on or before December 31, 2009.
4. Under the declaration, each shareholder can elect to receive its entire entitlement under the declaration in either money or stock of "equivalent value" subject to a limitation on the amount of money to be distributed in the aggregate to all shareholders (the "Cash Limitation"). The Cash Limitation must meet the following requirements:
   a. It is not less than 10% of the aggregate declared distribution.
   b. If too many shareholders elect to receive money, each such shareholder will receive a pro rata amount of money corresponding to its entitlement under the declaration, but will not receive less than 10% of its entire entitlement in money.
5. The value of the number of shares to be received by any shareholder will be determined "as close as practicable to the payment date" based on a formula utilizing
market prices that is designed to equate in value the number of shares to be received with the amount of money that could have been received.

(6) If a shareholder participates in a dividend reinvestment plan ("DRIP"), "the DRIP applies only to the extent that, in the absence of the DRIP, the shareholder would have received the distribution in money" under its cash election, subject to the Cash Limitation. This simply means that the shareholder can avail itself of the DRIP only to the extent that it would otherwise have received cash under the cash election formula, taking into account all other shareholder elections.

d. Revenue Procedure 2009-15 does not specifically state that the stock distribution is deductible by the REIT, although that conclusion necessarily follows from the conclusion that the stock distribution is a section 301 distribution. It also does not state that the dividend is non-preferential, which continues the IRS's mysterious no-comment stance in the private rulings.

e. A few observations/questions:

(1) Could a shareholder reasonably take the position that a dividend on these terms (10% minimum cash) is nontaxable, based on the existing statute and regulations?

(2) Although the Revenue Procedure is available only to public REITs, the theory would seem to apply equally to non-REIT public corporations.

(3) How far back from the distribution date can a REIT go to determine the cash-equivalent value of the stock?

(4) If the Revenue Procedure correctly interprets the law, then why isn't it an equally valid position for taxpayers to take after the Revenue Procedure expires?

(5) Under what circumstances, if any, could the distribution be viewed as preferential under section 562(c)?