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FEDERAL TAXATION OF REAL ESTATE DEBT WORKOUTS

By

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David has vast experience advising clients on the U.S. tax aspects of a wide array of domestic and cross-border investments, including formation of partnerships and joint ventures, M&A transactions, capital raising and fund-formation, debt-workouts and purchases of debt portfolios, sale-leaseback transactions and tax-deferred exchanges. He commonly advises investment managers on the unique tax considerations of institutional investors, including with respect to FIRPTA, ECI, the Section 892 and qualified foreign pension fund exemptions, and UBTI and common strategies to manage the associated risks, and advises homebuilders and land developers on long-term contracts, capital gain planning, and land-banking.

David is the current Vice Chair of Tax Policy Advisory Committee of The Real Estate Roundtable and is a very active member of the Real Estate Committee of the American Bar Association's Tax Section and Chair of the Subcommittee on Cancellation of Debt. On behalf of the real estate industry, David has led several legislative and regulatory projects on FIRPTA, carried interest, debt-modification, and REITs. David has been a frequent speaker at programs and conferences for the ABA Tax Section, PLI, NYU, USC Tax Institute, Real Estate Roundtable, and other forums and has authored articles on a variety of partnership, international, and real estate tax topics for the Journal of Real Estate Taxation, Journal of Taxation of Financial Products Financial Products, and Major Tax Planning. He serves on the editorial board of the Journal of Real Estate Taxation and is a former Adjunct Professor of Partnership Taxation at Fordham University.

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I. Introduction

The current environment seems ripe for the resolution of certain troubled commercial real estate mortgage debt in the aftermath of COVID19 and the remote workplace environment. A staggering figure of some $5 trillion of commercial real estate debt is coming due during 2025 and 2026.[2] In particular, debt secured by commercial real estate, hotels, and warehouses is in trouble, $1.5 trillion estimated during 2025, and interest rates and insurance costs have become much more expensive since much of the debt was originated and the real estate was purchased.[3] This might be spell catastrophe for many real estate owners and borrowers, but, for those who are adept at the federal income taxation of real estate debt-workouts, at least some of the pain can be relieved. To that end, the environment presents the astute advisor an opportunity to add value.

As in prior cycles of economic and real estate distress, some taxpayers will be endeavoring to harvest tax losses and avoid income from the cancellation of indebtedness ("COD income"). For others who have held their property for much longer, the planning opportunity is around deferring recognition of gain. There's a balancing of tax policy goals (or perhaps the need to resolve conflicting tax goals) in distressed real estate transactions. Chief among them is a long-standing policy on the one hand to achieve symmetry in basis and recapture of unpaid debt (i.e., the amount of nonrecourse debt is included in the basis of the property acquired with the proceeds of such debt and any unpaid amount of the debt is fully recaptured upon a disposition of the property subsequent to its decline in value)[4] and on the other hand a "fresh start" policy around bankruptcy and insolvency.[5]

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[1] The views expressed herein are the author's own and do not necessarily reflect the position of Deloitte Tax LLP. The author acknowledges and thanks Mark Van Deusen, Nick Galatas, and Keith Sieverding for their helpful comments, with a special thanks to Helen Yanchisin for her contributions, each of whom is in Deloitte Tax LLP's Washington National Tax.

[2] "Commercial real estate delinquencies could be a massive problem soon" May 2, 2025. https://www.mpamag.com/us/specialty/commercial/commercial-real-estate-delinquencies-could-be-a-massive-problem-soon/534300. Compare that to records amount of money being raised to invest in the distressed pricing. "New Real-Estate Fund Hauls in Billions to Buy Distressed Properties", Peter Grant, May 6, 2025, The Wall Street Journal, Dow Jones and Company.

[3] "$1.5 Trillion of Commercial Real Estate Debt is Due Next Year, and Refinancing Won't be Easy," Callahan, Carpenter, Bloomberg, Fortune (Sept. 1, 2024).

[4] See generally *Comm'r v. Tufts*, 461 U.S. 300 (1983); T.D. 7741 (1980) (preamble), Reg. §1.1001-2.

[5] S. Rep. No 96-1035, 2d Session, at 9-10 (1980). *See also* text at n. 222.

The benefit of classifying income-recognition as COD income is that such income generally may be excluded or deferred under section 108,[6] whereas realized gain generally must be recognized.[7] If the taxpayer does not qualify for the benefit of section 108, recognition of gain may be preferred because the resulting gain may be taxed at favorable rates as compared to ordinary income tax rates applicable to COD income. In other cases, the taxpayer may be seeking to harvest a tax loss. Lastly, as will be discussed *infra*, the most elegant resolution to the overindebted real estate collateral, in many cases, may be to leave the real estate in the hands of the operator so that value may be restored. However, the debt may need to be modified to improve the creditor's recovery. The structure of the debt's resolution, however, can result in the recognition of gain and taxes at a time when any available cash funds need to be invested in the restoration or renovation of the real estate.

Determining the proper classification of a transaction's income as COD income or gain often is far from clear and may require harmonization of several federal tax ("tax")[8] issues. Chief among them are (i) whether debt is classified as recourse or nonrecourse and under which rules, (ii) whether a transaction is a foreclosure or waiver of debt, (iii) whether an event that triggers the recognition of income or loss occurs in a different year than the formal steps of a transaction, and (iv) whether the tax-classification of an entity should determine the tax-outcome of the transaction.

To that end, this outline is intended to shed light on the federal income tax consequences and planning opportunities for workouts of real estate debt. The transactions discussed herein are wide-ranging, including (i) reducing the amount of indebtedness to an amount closer to the current fair market value of the real estate collateral, (ii) injecting new capital into the structure, (iii) complex modifications to outstanding indebtedness that test whether modified debt is still debt for tax purposes, (iv) deed in-lieu of foreclosure, court appointed foreclosures, or short-sales, (v) equity for debt transactions, and (vi) transactions that have a disparity in state law and tax law treatment of the transaction.[9]

In discussing the tax landscape of real estate workouts, it is difficult to decide where to begin and end, as a workout is itself a freak of nature, i.e., the outcome is not at all what the parties expected and the tax law – well, is no different. There is not one cohesive body of law that applies exclusively to workouts[10] and many of the general tax principles require nuanced interpretations to make them apply to the situation, and a firm grasp of the tax treatment of partnerships[11] is a must in the context of real estate workouts.

Nevertheless, the outline begins with defining COD income and then discusses whether COD income is realized where collateral is transferred in connection with the discharge of debt. Next this outline addresses the application of the debt modification rules and the section 108 exclusions to cancellation of real estate debt. Lastly, the outline concludes by exploring the timing of COD income and losses with respect to distressed real estate. As discussed *infra*, workouts of debt require a solid understanding of such fundamental rules as defined in section 61 (gross income[12]), section 165 (losses), and section 1001

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[6] Unless otherwise indicated, all section ("section" or "§") references herein are otherwise to the Internal Revenue Code of 1986, as amended (the "Code") and the Treasury Regulations promulgated thereunder ("regulation section" or "Reg. §").
[7] §§61(a)(3) and 1001(c).
[8] Unless otherwise indicated, all references to "tax" are to federal tax or federal income tax, as the case may be.
[9] To that end, it is useful to have a general understanding of the formalities of ownership of real property, security interest therein, and the transfer thereof. Refer to *Exhibit V* for a summary of key terms and common security types.
[10] Gain / COD income dynamic, for starters.
[11] This outline is not intended to include a comprehensive discussion of the federal income tax aspects of partnership workouts. For additional coverage of partnership workout topics, see "Sowell, Debt Workouts: The Partnership and the Partners," William and Mary Tax Conf. Iss. 66 (2020).
[12] §61(a)(11) and Reg. §1.61-12 (COD income); §61(a)(3) and Reg. §1.61-6 (gain from dealings in property).

(realization), and more complex rules applied to determine whether debt has been sufficiently modified to constitute a materially different debt – or equity – for tax purposes.[13]

II. Cancellation of Indebtedness Income

A. Defined

Proceeds of a debt for federal income tax purposes ("true debt") are not included in the debtor's gross income because there is an expectation of repayment – i.e., there's no accession to wealth since the repayment obligation offsets the value of the proceeds.[14] The status of a true debt is tested at its inception.[15] Among other factors, true debt has a reasonable expectation of repayment.[16] If a reasonable expectation is missing, the putative debt instead could be regarded for tax purposes as having another form depending on the context, e.g., gift, compensation, equity, conditional sale. However, a subsequent decline in the debtor's ability to repay, without more, does not tend to change the status of true debt.[17]

Concomitantly, a purchaser's basis in property that is acquired using debt proceeds includes the amount paid for the property undiminished by the debt.[18] Regulation section 1.1012-1 generally provides that the basis of property is its cost, which is the sum of the amount paid in cash and any other property given to the seller, e.g., debt proceeds or debt issued by the purchaser for the property.[19] Further, regulation section 1.1012-1(g) generally provides that if a debt instrument is issued in exchange for property, the cost of the property that is attributable to the debt instrument is the issue price of the debt instrument as determined under regulation section 1.1273-2 or 1.1274-2 (whichever is applicable).

If debt of a taxpayer is subsequently not repaid in full or is otherwise cancelled or discharged with an unsatisfied balance, the taxpayer realizes COD income.[20] In *United States v. Kirby Lumber Co.*, a taxpayer's repurchase of its debt at a discount resulted in a gain because the taxpayer had an "accession to wealth"

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[13] Regulation section 1.1001-3(a) provides rules for determining whether a modification of the terms of a debt instrument results in an exchange for purposes of regulation section 1.1001-1(a).

[14] *James v. United States*, 366 U.S. 213 (1961).

[15] As discussed *infra* in section *III. Debt Modification*, a loan that undergoes a "significant modification" within the meaning of regulation section 1.1001-3(a) is deemed to be reissued and must be retested for its debt status. Reg. §1.1001-3(e)(5).

[16] See *Estate of Mixon v. United States*, 464 F.2d 394, 402 (5th Cir. 1972) (a facts and circumstances analysis of several factors, not one of which is controlling).

[17] Reg. §1.1001-3(f)(7). See also *Cuyuna Realty Co. v. United States*, 382 F.2d 298 (Ct. Cl. 1967) (mere decline in borrower's capacity to repay does not call debt status into question: however, a related creditor's repeated failure to enforce its rights against an insolvent borrower may call into question whether a loan retains its status as bona fide debt); *Frazier v. Comm'r*, 1975 T.C. Memo. 220 (1975); *Metropolitan Inv. Co. v. United States*, 72-2 U.S.T.C. (CCH) ¶9761 (N.D. Ohio 1972); and *W.B. Killhour Sons, Inc. v. Comm'r*, T.C. Memo. 1973-183.

[18] *Crane v. Comm'r*, 331 U.S. 1, 11 (1933) (the seller of property encumbered by a mortgage loan must include the unpaid amount of the mortgage loan in the seller's amount realized). Similarly, a partner's basis in a partnership that has obtained debt proceeds to fund the purchase of property is increased by the partner's share of the partnership's debt under section 752(a).

[19] §1012.

[20] The amount of the liability for purposes of determining the amount of COD income realized by a debtor is generally the obligation's issue price under section 1273 and 1274. The IRS's position in PLR 201220004 is that debt issuance costs, while capitalized to adjusted issue price, are not taken into account for purposes of determining the amount of COD income.

equal to the amount of the discount[21] – said differently, assets subject to the liability were "freed up."[22] Section 61(a)(11)[23] is the codification of the principle enunciated in *Kirby Lumber*.

The reduction of debt, whether recourse or nonrecourse, generally results in COD income, as well as does buying-in debt at a discount.[24] The amount of COD income is equal to the excess of the debt's adjusted issue price over the repurchase price.[25] These types of consequences also can result from a "significant modification" to an existing debt or a transfer of property securing recourse indebtedness.[26]

B. Character

COD income is ordinary income, not gain from the sale, exchange or other disposition of a capital asset,[27] nor income from, say, the performance of services or a constructive dividend.[28] While ordinary income tends to be taxed at higher rates[29] than capital gain, certain COD income can be eligible for exclusion from gross income under section 108 in certain contexts, while capital gain is not.

Often the distressed real estate in question is section 1231 property, which, subject to certain recapture rules applicable to prior section 1231 gains, results in an ordinary loss. For instance, an insolvent taxpayer that undergoes a foreclosure with respect to rental property having a basis higher than its fair market value at the time with respect to debt that is recourse, it is possible in certain circumstances the taxpayer will realize a section 1231 ordinary loss and the COD income qualifies for exclusion from gross income.[30]

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[21] *United States v. Kirby Lumber Co.*, 284 U.S. 1 (1931). See also *United States v. Centennial Savings Bank*, 499 U.S. 573 (1991) (Borrowed funds are excluded from income in the first instance because the taxpayer's obligation to repay the funds offsets any increase in the taxpayer's assets; if the taxpayer is thereafter released from his obligation to repay, the taxpayer enjoys a net increase in assets equal to the forgiven portion of the debt, and the basis for the original exclusion thus evaporates.")

[22] *Merkel v. Comm'r*, 109 T.C. 463 (1997); *Carlson v. Comm'r*, 116 T.C. 87 (2001).

[23] Section 61 was amended by The Tax Cuts and Jobs Act (P.L. 115-2017) ("TCJA") to move section 61(a)(12) to section 61(a)(11). Consequently, authorities and articles discussing COD income and section 61 often cite section 61(a)(12) (usually such materials pre-date TCJA, but not always!).

[24] See, also, Reg. §1.61-12 (gross income includes discharge of debt, in whole or in part, and discounted payoff), and Rev. Rul. 91-31 (COD income is realized where the discharge of debt is not in connection with the sale or exchange of property, whether or not recourse or nonrecourse). See *infra* section *IV. In Conjunction With the Transfer or Property* for a discussion of debt discharged in conjunction with property transfers.

[25] Reg. §1.61-12(c)(2)(ii) (an issuer realizes COD income upon the repurchase of a debt instrument for an amount less than its adjusted issue price within the meaning of regulation section 1.1275-1(b)). To determine the repurchase price of debt that is repurchased through the issuance of a new debt instrument, see section 108(e)(10)).

[26] See generally Reg. §1.1001-3 and §108(e)(10) and Reg. §1.1001-2.

[27] See §61(a)(3) and Reg. §1.61-6 (gross income includes gain realized from the sale or exchange of property, which is generally calculated under section 1001 as the excess of the amount realized over the property's basis). Real estate tends to fall within the definition of a capital asset under section 1221 or section 1231, which includes real property used in a trade or business such as the rental of property.

[28] Reg. §1.61-12(a). The characterization is driven by the relationship between the parties.

[29] See generally sections 1 and 1(h) (regular and capital gain rates for individuals) and 11 (corporations) and section 1411 (net investment income tax).

[30] Qualifying COD income for exclusion under section 108(a) can result in reduction of the taxpayer's attributes, pursuant to section 108(b), including basis of depreciable property under section 1017 and the applicable regulations. The analysis requires careful consideration of the special rules thereunder and section 108(d)(5)'s ordering rules.

1. Section 469

In Rev. Rul. 92-92, the IRS took a transactional approach[31] to characterize COD income as income from a passive activity to the extent that, at the time the indebtedness is discharged, the debt is allocated to passive activity expenditures, and as income from a nonpassive activity to the extent that, at the time indebtedness is discharged, the debt is not allocated to passive activity expenditures.

2. Section 163(j)

Section 163(j) generally limits a taxpayer's deduction of net business interest expense to 30 percent of "adjusted taxable income," subject to certain exceptions such as for an electing "real property trade or business." In determining the amount of allowed net business interest expense for a taxable year, section 163(j) segregates taxable income into business interest income and business interest expense, any NOL, the section 199A deduction, and depreciation, amortization, and depletion deductions.[32] Thus, business interest income and business interest expense for the current year offset each other and do not increase or decrease adjusted taxable income. Business interest expense includes carryforward amounts of business interest expense, and business interest income includes all amounts of interest income included in gross income that are allocable to a trade or business.[33]

As discussed *supra*, gross income generally includes any amount of COD income. COD income includes forgiven amounts of principal and accrued and unpaid interest.[34] As a general rule, COD income is not treated as interest for tax purposes, including for purposes of section 163(j). To the extent COD income includes an amount of "recaptured" interest expense deductions, could such amount of COD income be treated as interest income for tax purposes? It can be argued that it is not clear how to treat COD income for purposes of the section 163(j) limitation on net business interest expense.[35] The uncertainty can result in COD income being included in adjusted taxable income (and subject to the 30 percent limitation), even though COD income is gross income attributable to the taxpayer's financing activities, including recapture of accrued and unpaid business interest expense. Under current law, the answer is that COD income for accrued interest is not treated as interest income for purposes of section 163(j).

For example, assume an accrual basis taxpayer has an otherwise deductible amount of business interest expense that results from an accrual, i.e., unpaid amount, of $100 during year 1. Assume the $100 of business interest expense was fully disallowed and carried forward under section 163(j). During year 2, the accrued and unpaid interest is waived by the lender and is included by the taxpayer is gross income as COD income. Because such amount of COD income is not considered business interest income for purposes of section 163(j), in principle, the $100 of carryforward is year 2 net business interest expense that is allowed as a deduction only in an amount of $30 ($100 of COD income X 30%).

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[31] *Hillsboro Nat. Bank v. Comm'r*, 460 U.S. 370, 377 (1983) ("Strict adherence to an annual accounting system would create transactional inequities").

[32] Depreciation, amortization, and depletion deductions were not segregated for taxable years beginning in 2022, 2023, and 2024. P.L. 119-21. The One Big Beautiful Bill Act permanently restored the add-back of such items from 2025.

[33] See Temp. Reg. §1.469-2T(c)(3)(ii) (regarding when interest income is considered to be derived in a trade or business).

[34] *Cf.* §108(e)(2) (except to the extent payment would have given rise to the deduction).

[35] This issue was taken up at great length by the New York State Bar Association which discussed alternative approaches, including among others the allowance of disallowed business interest expense carryforward amounts to offset recapture of COD income. See NYSBA Report No. 1447 (Jan. 25, 2021).

3. Leasing Transactions

Certain leases may be characterized for tax purposes as debt, say, in the context of a sale-leaseback transaction whereby the seller of the property also enters into a long-term lease of the property that has a bargain purchase option.[36] For tax purposes, if the transaction is characterized as a financing, the "seller" is treated as having obtained a loan of the sales proceeds. If the lease is terminated early, any obligation to pay rent that is waived or discharged would be considered COD income for tax purposes unless the termination may be properly characterized as a transfer of property and the obligation to pay rent is considered nonrecourse. Similarly, a "section 467 rental agreement" (i.e., not a financing for tax purposes) may have prepaid or deferred rent that results in a "section 467 loan" which causes a portion of the "rent" to be imputed interest for tax purposes.[37] For example, a long-term lease of land that has a substantial payment of rent that is due at the end of the lease term. Under these rules, the deferred payment of rent is a deemed loan by the lessor to the lessee. If the lease is terminated early without the lessee paying the deferred rent, the lessee would otherwise realize COD income for the waiver of the deferred rent.

4. Cross-Border Transactions

In the cross-border context, there are some specific rules and other guidance to be taken into account in COD income determinations. For example, the repurchase, exchange, or retirement of debt that is denominated in a currency other than the US dollar generally can result in foreign-currency (aka "FX") gain or loss under section 988, which is distinguishable from COD income.[38] As the US dollar rises against the foreign currency, the debt essentially may be repaid for less, i.e., FX gain. For purposes of distinguishing between FX gain or loss and COD income with respect to a debt, regulation section 1.988-2(b)(13)(ii) provides that section 988 is applied before section 108.[39]

A creditor of a "controlled foreign corporation"[40] may discharge such entity's debt which can have FX consequences, COD income, as well as other consequences, and increase the entity's earnings and profits. In PLR 9729011, the IRS concluded that COD income generally is not "Subpart F income" to the CFC except to the extent of the amount of any prior accrued and unpaid interest that reduced earnings and profits. The logic arguably also would apply to COD income of a non-controlled foreign corporation, including a "passive foreign investment company."[41]

For purposes of withholding, regulation section 1.1441-2(d)(2) provides that a creditor who forgives any portion of a debt generally is deemed to have made a payment of income to the debtor under regulation section 1.61-12 at the time the event of forgiveness occurs. However, the creditor generally has no obligation to withhold on such amount to the extent that it does not have custody or control over money or property of the borrower at any time between the time that the debt is forgiven and the due date (including extensions) of Form 1042 for the year in which the payment is deemed to occur.[42] Note that a payment received in partial settlement of the debt does not, for this purpose, constitute an amount of money or property belonging to the debtor from which the withholding can be satisfied.[43]

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[36] See, e.g., Rev. Rul. 55-540, §4.01(e).
[37] §467 and Reg. §1.467-1(c) and (e)(3).
[38] Reg. §1.61-12(c)(2).
[39] Reg. §1.988-2(b)(13)(ii) (exchange gain realized by the obligor on certain stock for debt exchanges is not considered COD income, but is considered instead to reduce the amount of the liability for purposes of computing the obligor's income on the exchange under section 108(e)(4), section 108(e)(6) or section 108(e)(10)).
[40] See generally §§951-965 (Subpart F of the code).
[41] See generally §§1291-1298.
[42] Reg. §1.1441-2(d)(2).
[43] Id.

With respect to a foreign person, COD income generally is not subject to tax under Foreign Investment in Real Property Tax Act of 1980 ("FIRPTA"),[44] since the amount is not gain from the sale or other disposition of a "US real property interest."[45] However, gain realized under section 1001 and regulation section 1.1001-2, including amounts of discharged indebtedness that are not COD income are subject to FIRPTA if the transferred property is a US real property interest.[46]

For foreign persons, FIRPTA generally subjects certain real estate gains and losses to direct taxation, withholding, and reporting, as income "effectively connected with a U.S. trade or business" ("ECI").[47] The applicable gain or loss is defined as a gain or loss from the disposition of a U.S. real property interest ("USRPI"),[48] which includes land, real property improvements, and other specified types of interests in real property,[49] except most notably an interest "solely as a creditor," e.g., a mortgage loan.[50] A USRPI includes stock in certain domestic corporations, including real estate investment trusts ("REIT(s)") that hold mostly USRPIs, subject to several exceptions.[51]

In the context of distress, it is important to note that while no cash may be derived from the resolution of over-indebtedness, say, a foreclosure, FIRPTA nevertheless can apply to the direct or indirect foreign person. The tax and related withholding and reporting obligations apply to gain from a disposition of the USRPI, to which the general federal income tax principles apply.[52] Accordingly, the disposition gain includes the amount of discharge of indebtedness provided in regulation section 1.1001-2, but not the portion treated as COD income. FIRPTA also takes a look-through approach to certain pass-through entities such as a partnership or trust.[53] For example, a FIRPTA disposition-gain may occur from the transfer of interests in a partnership holding USRPIs to a creditor in satisfaction of the debt, including a UCC foreclosure by a mezzanine lender of interests in a limited liability company ("LLC") taxed as a partnership or disregarded entity ("DRE").[54]

With respect to REITs, a look-through approach applies to the REIT's disposition-gain from a USRPI.[55] The rule applies by treating the applicable portion of a REIT's distribution "attributable to" the gain as ECI to the foreign person.[56] Again, gain for this purpose includes the amount realized from the discharge of

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[44] P.L. 96-499.
[45] A "US real property interest" is an "interest in real property" in the United States and Virgin Islands and stock of certain domestic corporations. §897(c)(1).
[46] See generally §897 and Reg. §1.897-1(h) (the amount of gain or loss arising from the disposition of the U.S. real property interest shall be determined as provided in section 1001(a) and (b)).
[47] See generally §897 (codification of FIRPTA), §1445 (withholding), and §6039D (reporting); and §§881 and 882(c) for ECI.
[48] §897(c) and Reg. §1.897-1(c).
[49] See generally Reg. §1.897-1(b).
[50] See generally Reg. §1.897-1(d).
[51] §897(c) and Reg. §§1.897-1(c)(3) and 1.897-2.
[52] Reg. §1.897-1(g) and (h). See also §897(e) and Reg. §§1.897-5T and 6T for exceptions to the generally applicable nonrecognition provisions of the Code.
[53] §897(g).
[54] In many cases, the FIRPTA withholding is actually dealt with by the indirect owners of the debtor that are partners of a domestic partnership. See Reg. §1.1446-3(c)(2) (trumping rule that relieves FIRPTA withholding where ECI withholding is applicable).
[55] See generally §897(h)(1). See also Friedline, "Inbound Real Estate Taxation: Revisionist History of FIRPTA," Major Tax Planning (Matthew Bender, 2013) Ch. 5, ¶502.2.A.2.
[56] See also IRS Notice 2007-55 (where Treasury and IRS maintain that "any distribution" for this purpose includes distributions in redemption or liquidation).

indebtedness. Thus, gain recognized on a foreclosure or deed-in-lieu transaction might require a REIT to make a non-cash "consent dividend" to avoid tax on the gain.[57]

5. REIT Compliance

A REIT generally is required to distribute annually at least 90 percent of its taxable income (100 percent to avoid corporate tax) and must meet certain other requirements, including annual gross income tests and quarterly assets tests, to maintain its tax-favored status.[58] A REIT's COD income is excluded from gross income for purposes of the REIT's gross income tests, as provided under section 108(e)(9). Additionally, a REIT may not have to distribute all of its the COD income under the rule for "excess noncash income" in section 857(e).[59] For purposes of the REIT's 90 percent distribution requirement, a REIT in not required to distribute "excess noncash income," which is defined as certain types of non-cash income, such as COD income,[60] to the extent that non-cash income exceeds 5 percent of REIT taxable income, determined before taking into account the REIT's dividends paid deduction and excluding any net capital gain.[61] Gain recognized on the deemed sale of property in a foreclosure or deed-in-lieu transaction does not benefit from the rule for "excess noncash income." Any undistributed non-cash income, nevertheless, is subject to corporate tax.

For example, assume a REIT has taxable income during the year of $1,000 which is comprised of $1,000 of COD income and breakeven net rental income. For purposes of the distribution requirement, the REIT is required to distribute $50 of the COD income ($1,000 X 5%). If the REIT distributes only $50 for the year, the REIT is otherwise subject to corporate tax on the $950 of COD income that was not distributed.

C. Exceptions & Exclusions

It is possible for a creditor's reduction of indebtedness to be characterized as other than COD income. For instance, a debtor can "work off" his debt, which form of in-kind payment is charactered for tax purposes as compensation instead of COD income.[62]

The contested amount of a debt generally is not considered COD income and instead would result in basis reduction.[63] If an amount is contested, it is not considered true debt, so that the cancellation of a contested liability generally does not give rise to COD income.[64] As well, a "rebate" of the purchase price generally is not COD income or otherwise included in gross income; instead basis is reduced.[65]

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[57] See generally §§857(a)(1), 561(a), 565(a) (general rules of consent dividends); 565(e) (special withholding rules on consent dividends). The IRS has ruled that a "consent dividend" can also be used in a liquidation of a REIT if the liquidating distribution does not allow the REIT to satisfy the distribution requirement and avoid corporate tax. *See* PLR 201202014 (Oct. 13, 2011) (consent dividend is treated as an amount realized from the disposition of stock in the liquidating distribution and the shareholder increases basis of the stock, i.e., is not regular dividend distribution); PLR 201103001 (Sept. 28, 2010) (same).
[58] See §§856(c)(2)-(4), 857(a).
[59] §857(e)(1).
[60] §857(e)(2)(D). Other types of non-cash income include rent included in gross income by a REIT under section 467 in excess of the amount that would have been included in gross income without regard to that section. §857(e)(2)(A).
[61] §857(a)(1) and (e)(1).
[62] Reg. §1.61-12(a).
[63] *Zarin v. Comm'r*, 916 F.2d 110 (3d Cir. 1990), *rev'g*, 92 T.C. 1084 (1989); see also *Preslar v. Comm'r*, 167 F.3d 1323 (10th Cir. 1999).
[64] A mere contested liability would not provide a taxpayer with basis in the acquired property.
[65] *Pittsburgh Milk Co. v. Comm'r*, 26 T.C. 707, 717 (1956).

6. Tax Benefit Rule

Section 111, the codification of the judicially created tax benefit rule,[66] provides that gross income does not include income attributable to the recovery during the taxable year of any amount deducted in any prior taxable year to the extent such amount did not reduce tax.[67] For this purpose, an increase in an unexpired carryover is treated as reducing an amount of tax.[68] Thus, for instance, if a deduction of interest by an accrual basis taxpayer with respect to accrued and unpaid interest on a debt increased the taxpayer's NOL, the subsequent forgiveness of such accrued and unpaid amount is not excluded from gross income under the tax benefit rule.

Note that only the exclusionary prong of the tax benefit rule was codified by section 111. The tax benefit rule has historically included an inclusionary prong whereby if a deductible amount has not provided any tax benefit, the recovery of that amount is excluded from gross income.[69]

7. Purchase Price Reduction

Section 108(e)(5) provides that if debt of a purchaser of property to the seller of such property which arose out of the purchase of such property (i.e., seller financing) is reduced, such reduction is treated as a purchase price adjustment instead of COD income. The exception does not apply to reductions occurring in bankruptcy or when the purchaser is insolvent. Section 108(e)(5), a safe harbor, was an attempt by Congress to provide some certainty with respect to the judicial exception for purchase price adjustments. Congress also intended to make clear that if the debt has been transferred by the seller to a third party (whether or not related to the seller), or if the property has been transferred by the buyer to a third party (whether or not related to the buyer), the exception does not apply. [70]

Prior to the enactment of section 108(e)(5), the scope of the common law doctrine for purchase price reductions was unclear. In some cases, the courts were willing to extend the doctrine to financing provided by a third party, rather than limiting the doctrine to seller financing. Subsequent to the enactment of section 108(e)(5), the IRS in Rev. Rul. 92-99 asserted that *Hirsch* and *Allen* (cases cited for the common law exception)[71] were incorrect and that the reduction of a non-seller nonrecourse debt can never be viewed as a purchase price adjustment because the seller is not a party to the transaction. Rev. Rul. 92-99 also neglected to address whether a common law exception exists where seller financing is reduced and either the debtor or the creditor at the time of the reduction was not the original buyer or seller.

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[66] See, e.g., *Hillsboro Nat. Bank v. Comm'r*, 370 U.S. 130 (1983) (tax benefit rule explained in a case holding that a corporation did not have gross income when its shareholders received a refund for property taxes that had been paid and deducted by the corporation).
[67] §111(a).
[68] §111(c).
[69] See *Putoma Corp. v. Comm'r*, 66 T.C. 652, 664 n. 10 (1976), aff'd, 601 F.2d 734 (5th Cir. 1979).
[70] S. Rep. No. 1035, 96th Cong., 2d Sess. 15 n.16 (1980); H.R. Rep. No. 833, 96th; Cong., 2d Sess. 12 n.15 (1980); S. Rep. No. 1035, 96th Cong., 2d Sess. 20 n.24 (1980), Committee Reports on P. L. 96-589 (Bankruptcy Tax Act of 1980), Congress (United States) (The provision was intended to eliminate disagreements as to whether in a particular case the debt reduction should be treated as discharge income or a true price adjustment.)
[71] The IRS stated they generally will not follow cases permitting a purchase price adjustment by third-party lenders, such as *Hirsch v. Comm'r*, 115 F.2d 656 (7th Cir. 1940), and *Allen v. Courts*, 127 F.2d 127 (5th Cir. 1942), reasoning that an agreement to reduce a debt between a purchaser and a third-party lender is not a true adjustment of the purchase price paid for the property because the seller has received the entire purchase price from the purchaser and is not a party to the debt reduction agreement. Rev. Rul. 92-99.

8. Payment Deduction

Section 108(e)(2) provides that COD income does not include a debt the payment of which by the taxpayer otherwise would have resulted in a deduction. For example, a cash-basis taxpayer benefits from the use of this exception for the discharge of accrued interest or other expenses not already deducted by the taxpayer.[72]

9. Release of Guarantee

The release of a guarantee does not necessarily result in COD income because the liability for the guarantee is only contingent. Taxing a guarantor on a release of a guarantee could result in a double counting of the income if both the debtor and the guarantor realized COD income with respect to the same debt forgiveness. In *Landreth v. Commissioner*, the Tax Court reasoned that a guarantor does not realize income from being relieved of a guarantee because the guarantee was merely contingent:

> where the guarantor is relieved of his contingent liability, either because of payment by the debtor to the creditor or because of a release given him by the creditor, no previously untaxed accretion in assets thereby results in an increase in net worth[73]

By virtue of releasing the guarantee, the guarantor's net assets are not increased, but instead merely "a decrease in assets is prevented."[74] Moreover, it did not appear to matter in *Mylander v. Commissioner*[75] whether the borrower had defaulted, and the creditor had obtained a judgment against the guarantor. The taxpayer did not receive any untaxed accretion of assets from granting the guarantee or being relieved of the guarantee.[76]

10. Statutory Exclusions

In the case that COD income is otherwise realized by the taxpayer, section 108(a) sets forth a number of exclusions from gross income in the case of bankruptcy, insolvency, certain real estate indebtedness, among others. These exclusions and certain other special rules are discussed *infra* in section *V. COD Income Exclusions*.

D. Timing

Disputes often arise between debtor-taxpayers and the Internal Revenue Service ("IRS" or the "Service") as to the taxable year during which a discharge of debt occurs. Such taxpayers may take or avoid steps (as the case may be) to defer for as long as possible the recognition of COD income. The substance, however, is ultimately what matters to a judge.

According to the Tax Court in *Cozzi v. Commissioner*,[77] COD income is realized at the moment when it is clear the debt will never have to be repaid, requiring a practical assessment of the facts and circumstances relating to the likelihood of repayment and the "identifiable event" that fixes the loss with certainty may be taken into account. The Tax Court was persuaded by the substance of the underlying transactions, rather than by whether or not the note was surrendered by the creditor to evidence a release of the liability. The

[72] Prior to the enactment of section 108(e)(2), the IRS applied tax benefit concepts to hold that the cancellation of accrued interest owed by a cash-basis taxpayer did not represent taxable income. See PLR 7845004 (July 26, 1978).
[73] *Landreth v. Comm'r*, 50 T.C. 803, 812-813 (1968). See also *Zappo v. Comm'r*, 81 T.C. 77, 88 (1983) (no COD income on release of a contingency liability); TAM 7953004.
[74] 803 T.C. 813.
[75] T.C. Memo. 2014-191.
[76] *Id.*
[77] *Cozzi v. Comm'r*, 88 T.C. 435 (1987).

film rights served as the collateral for a nonrecourse loan made to a production company. Accordingly, the Tax Court held the taxpayer realized COD income in a taxable year prior to the year of settlement.[78]

In *K & S Electric Company, Inc. v. Commissioner*,[79] the Tax Court held that a borrower's removal of a liability from its books and record was not enough to demonstrate that the liability was discharged, because the borrower entered into a release agreement with the creditor subsequent to the year the liability was removed from the taxpayer's books and records.[80] Further, in *Milenbach v. Commissioner*,[81] the Ninth Circuit stated that the repayment of debt or its prospects need not be an "absolute impossibility" before the debt may be considered to have been discharged; a "slim possibility" that the debt may be repaid will not necessarily prevent the debt from being treated as having been discharged.[82]

In a related party context, the Tax Court, in *Big Hong Ng v. Commissioner*, held that a corporation realized COD income with respect to related party debt when the corporation distributed its sole asset, regardless of whether the debt was actually discharged.[83]

III. Debt Modification and Deemed Exchange of Debt[84]

Despite the modification of distressed debt being synonymous with COD income, in many cases, a "modification" does not necessarily lead to COD income. For this purpose, regulation section 1.1001-3 (the "modification regulation") defines a "modification" as any alteration, including any deletion or addition, in whole or in part, of a legal right or obligation of the issuer or a holder of a debt instrument, unless generally such alteration of a right or obligation occurs by operation of the existing terms of the agreement.[85]

There are several reasons for this in the real estate context. First, the modification regulation is fairly accommodating to "standstill agreements," whereby the parties agree to temporary non-enforcement or forbearance of the loan agreement's provisions even though the debtor may be in default. For this, the regulation allows for a standstill period or periods of up to two years (cumulative) before such non-enforcement could result in a deemed modification.[86] Note, however, that the allowance for temporary non-enforcement is in contrast to, say, an agreed modification that is not currently effective or has a deferred effective date. For example, the debtor and creditor could agree today to a reduction or subordination of debt to take effect in the future. Such a deferred modification must be taken into account and tested for its significance on the date of the agreement.[87]

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[78] *Id*. (citing, *Brountas v. Comm'r*, 74 T.C. 1062, 1074 (1980), supplemental opinion to 73 T.C. 491 (1979), vacated and remanded on other grounds, 692 F.2d 152 (1st Cir. 1982), aff'd in part and rev'd in part on other grounds sub nom. *CRC Corp. v. Comm'r*, 693 F.2d 281 (3d Cir. 1982); *Bickerstaff v. Comm'r*, 128 F.2d 366, 367 (5th Cir. 1942); *Kent Homes Inc. v. Comm'r*, 55 T.C. 820, 828-831 (1971), *rev'd. on other grounds* 455 F.2d 316 (10th Cir. 1972); *Cotton v. Comm'r*, 25 B.T.A. 1158 (1932); *United States v. S.S. White Dental Mfg. Co.*, 274 U.S. 398 (1927)).
[79] T.C. Memo. 1969-291.
[80] *Id*. See also *Eli D. Goodstein v. Comm'r*, 30 T.C. 1178 (1958), *aff'd* 267 F. 2d 127 (1st Cir. 1959).
[81] *Milenbach v. Comm'r*, 318 F.3d 924 (9th Cir. 2003).
[82] *Id*. at 936 (citing *Exchange Security Bank v. United States*, 492 F.2d 1096 (5th Cir. 1974)).
[83] T.C. Memo. 1997-248. The taxpayer argued the debt was discharged when it liquidated under state law.
[84] This section *III. Debt Modification and Deemed Exchange of Debt* is not intended to be exhaustive but instead is intended as selective background to facilitate an in-depth discussion of certain modifications of commercial real estate debt in the current market. For a more comprehensive discussion of debt modification, see Garlock, "Federal Income Taxation of Debt Instruments," Ch. 14 (CCH 2024).
[85] Reg. §1.1001-3(c).
[86] Reg. §1.1001-3(c)(4). In occasions such as default or other breach of a covenant by the borrower, the debt modifications allow a creditor to temporarily forebear for up to two years taking in action like enforcement of or modifying the existing terms of a loan agreement (aka a "standstill agreement").
[87] Reg. §1.1001-1(c)(6)(i). This rule has an exception for modifications that are subject to certain specified closing conditions that are considered "reasonable." Reg. §1.1001-3(c)(6)(ii).

Secondly, so long as the modification does not require a reduction in the amount of debt, COD income generally does not arise, unless the issue price of the modified debt is lower than the adjusted issue price of the unmodified debt. This result can occur if (i) the debt is "publicly traded" and is trading at a lower value, say, on account of the debtor's distress or (ii) the modified debt's issue price is lower than its face amount because the modified debt has an interest rate that is below the applicable federal rate ("AFR").[88] Lastly, if the modified debt is considered equity for tax purposes, COD income can arise but only if the fair market value of the equity is less than the unmodified debt's adjusted issue price.[89]

A. Significant Modification

1. Generally

A "significant modification" of debt results *per se* in a realization event for both the debtor and creditor,[90] i.e., a deemed exchange of the "old" debt for a "new" debt.[91] The exchange could lead to the debtor recognizing COD income, as previously discussed, and the creditor possibly recognizing gain, say, where the creditor had previously purchased the unmodified debt at a steep discount.[92]

Section 108(e)(10) provides that, in the case of an actual or deemed exchange of debt, COD income is determined by treating the old debt as being satisfied for an amount of cash equal to the issue price of the new debt, as determined under sections 1273 and 1274 of the rules on issue price and original issue discount ("OID").

2. Specific Tests and Rules

Regulation section 1.1001-3(e) sets forth a number of specific modifications that are considered "significant" for tax purposes and therefore would cause a deemed exchange of the debt.[93] There is also a general rule or overall significance test, which provides that a modification is a significant modification "only if, based on all facts and circumstances, the legal rights or obligations that are altered and the degree to which they are altered are economically significant."[94] In the case of a debt that undergoes multiple modifications at different times, all modifications are required to be considered collectively, so that a series of such modifications may be significant when considered together, though each modification, if considered alone, would not be significant.[95]

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[88] See Reg. §1.1273-2(b) (in certain cases the issue price of a debt is its fair market value). While the amount of a "publicly traded" debt that undergoes a significant modification may not in fact be reduced, its fair market value may be lower than its face amount. For this purpose, "publicly traded" is broader than the normal meaning of the term, so that a debt is considered publicly traded if there are quotes or reported trades on the debt. See Reg. §1.1273-2(b). Similarly, the issue price of nonpublicly traded debt that lacks adequate stated interest is not its stated principal amount, but instead its imputed principal amount. Reg. §1.1274-2(b). See §1274(d) (definition of the AFR).

[89] See §108(e)(8).

[90] For purposes of the discussion of modifications herein, the terms "debtor" and "issuer" and "creditor" and "holder" will be used interchangeably.

[91] Reg. §1.1001-3(b) (For purposes of regulation section 1.1001-1(a), a significant modification of a debt instrument results in an exchange of the original debt instrument for a modified instrument that differs materially either in kind or in extent).

[92] The regulations have a generous rule that allows the holder of the modified debt to take into account any prior bad debt deductions to offset the modified debt's higher adjusted issue price caused by the deductions. Reg. §1.166-3(a)(3) (deemed charge off of significantly modified debt).

[93] Reg. §1.1001-3(e).

[94] Reg. §1.1001-3(e)(1).

[95] Reg. §1.1001-3(f)(3).

a. Changes in Yield and Deferral of Payment

A change in yield by more than the greater of 25 basis points or 5 percent of the unmodified yield is a significant modification.[96] Note that fees paid to the lender for the modification are taken into account in calculating the change in yield.

A "material deferral" in scheduled payments is a significant modification. A safe harbor, however, is provided for deferral of a payment that does not exceed the lesser of 5 years and 50 percent of the original term.[97]

b. Changes in Obligor and Collateral

A modification can take the form of a change in the debt's obligor or collateral. The modification regulation addresses the significance of such a change by providing a set of rules that cover specific types of changes, and that make distinctions between recourse and nonrecourse debt in some but not all cases. Certain of the specified changes in obligor or collateral are treated by the regulation as *per se* significant modifications and others are conditioned on there being a "change in payment expectations" ("CIPE").[98] CIPE is defined for this purpose as occurring if, as a result of a transaction, (1) there is a substantial enhancement of the obligor's capacity to meet the payment obligations under a debt instrument and that capacity was primarily speculative prior to the modification and is adequate after the modification, or (2) there is a substantial impairment of the obligor's capacity to meet the payment obligations under a debt instrument and that capacity was adequate prior to the modification and is primarily speculative after the modification (the "CIPE test").[99]

A *per se* significant modification occurs if there is (i) a substitution of a new obligor[100] on recourse debt[101] (the "new obligor" rule) or (ii) an alteration of the collateral for, or a guarantee on, nonrecourse debt.[102] The new-obligor rule has exceptions, including, for instance, a substitution that arises in a section 381(a) transaction or the new obligor acquires substantially all of the assets of the original obligor, provided the substitution does not cause a CIPE.[103] As well, for nonrecourse debt, a new obligor does not result in a significant modification (which makes sense because an obligor would not tend to have personal liability beyond the debt's specified collateral).[104]

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[96] Reg. §1.1001-3(e)(2).
[97] Reg. §1.1001-3(e)(3).
[98] Reg. §1.1001-3(e)(4)(vi).
[99] Reg. §1.1001-3(e)(4)(vi) (the preamble specifies that there is no change in payment expectations if the obligor has at least an adequate capacity to meet its payment obligations before and after the modification); T.D. 8675 (Explanation of Provisions, D. Significant Modifications).
[100] The context of the rule implies there is only a single obligor on the debt before and after the modification.
[101] Reg. §1.1001-3(e)(4)(i)(A).
[102] Reg. §1.1001-3(e)(4)(iv)(B)(1) ("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 nonrecourse debt instrument). A substitution of collateral is not a significant modification, however, if the collateral is fungible or otherwise of a type where the particular units pledged are unimportant (for example, government securities or financial instruments of a particular type and credit quality); as well, the substitution of a similar commercially available credit enhancement contract is not a significant modification, and an improvement to the property securing a nonrecourse debt does not result in a significant modification. *Id*.
[103] See Reg. §1.1001-3(e)(4)(i)(B)-(G). These exceptions also require that no "significant alteration" has occurred (with the exception of an "F" reorganization). A significant alteration is an alteration that would be a significant modification except that it is occurring by operation of the terms of the debt Instrument. Reg. §1.1001-3(e)(4)(i)(E).
[104] Reg. §1.1001-3(e)(4)(ii).

By contrast to the new obligor rule, the approach to an addition or deletion of a co-obligor[105] (the "co-obligor rule") is different –there is a significant modification only if the change results in a CIPE.[106] A change to the collateral on a recourse debt is also a significant modification only if the altered collateral causes a CIPE.[107] Both the co-obligor rule and the CIPE test apply equally to recourse and nonrecourse debt. It is unclear how the co-obligor rule applies in the context of nonrecourse debt.[108]

The IRS previously concluded that co-obligor status can include a guarantor, in PLR 199904017. The ruling involved an assumption and a release among affiliated corporations and the determination of whether such changes amounted to a significant modification of the underlying debt. Corporation "Y" issued two notes that were guaranteed by Y's parent corporation "W". Y was the primary issuer of debt for W and its affiliates and Y's assets consisted of deposits with W and its affiliates, a small amount of real property, and stock in "Z," a holding finance subsidiary of Y. Y was later released from liability at the same time as W assuming and becoming fully liable on the debt. The IRS concluded that W's liability under the guarantee of the debt was "essentially that of a co-obligor." The guarantee provided that "W waives diligence, presentment, demand of payment, filing of claims with a court in the event of merger or bankruptcy of Y, and any right to require a proceeding first against Y" – i.e., a direct path. The IRS concluded the combination of the assumption and release was a deletion of a co-obligor, not the addition of a new obligor (the latter would have been *per se* a significant modification).

While the ruling is helpful, it leaves practitioners to do the job of line drawing with respect to a variety of other types of guarantees that possibly may not be "essentially that of a co-obligor." There could be instances where the creditor is not permitted to go straight to the guarantor to demand payment, unlike the ruling's facts of a direct path. According to one leading commentator, "[t]he better view, from both a technical and a policy perspective, is that a guarantor is a co-obligor if it is fully legally liable if the issuer of the debt defaults. A rule that attempts to draw a line between different gradations of guarantees, based on whether creditors first have to pursue remedies against the primary obligor, would be arbitrary and unadministrable and would accomplish no identifiable policy objective."[109]

Another perennial question is whether a change in an entity's tax classification should be viewed as a change in obligor. The IRS has ruled many times, albeit inconsistently, on what constitutes a "change in obligor."[110] Beginning with PLR 200315001, the IRS concluded that, because nothing happened to the creditor's rights under state law, a conversion of the debtor entity from a corporation to an LLC coupled with a check the box election changing the entity's status to a DRE for federal income tax purposes did not constitute a change in obligor (or change in the recourse nature of the debt) for purposes of regulation section 1.1001-3. For its reasoning, the IRS cited *Aquilino v. United States*[111] and *Morgan v. Commissioner*,[112] for the proposition that the tax law generally looks to state law to determine legal entitlements in property.

Additional authority for the proposition that state law governs the modification analysis may be found in the background from which the modification regulation stems. The modification regulation was intended

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[105] For example, a debt with a sole obligor is modified to add an obligor or a debt with co-obligors is modified to delete one of them.
[106] Reg. §1.1001-3(e)(4)(iii).
[107] Reg. §1.1001-3(e)(4)(iv)(A).
[108] See further discussion of the significance of a change in obligor for purposes of regulation section 1.1001-3(f)(7) in section *III.B.iii Nonrecourse Debt*.
[109] See Garlock, "Federal Income Taxation of Debt Instruments," ¶1404.02[C] (CCH 2024); c*f*. PLR 200742016 (significant modification because there had been a change in the "primary" obligor on debt guaranteed by the issuer's parent and sister corporation). See also Garlock, "Musings on Debt Modifications Inspired by PLR 200742016," 25 J. Tax'n Investments 18 (2008).
[110] See discussion of PLR 199904017 (guarantor having co-obligor status) at section *III.B.iii.*
[111] 363 U.S. 509, 513 (1960).
[112] 309 U.S. 78, 92 (1940).

to address at the time the uncertainty over when a modification of debt results in a deemed exchange.[113] Some of the uncertainty resulted from the impact *Cottage Savings Ass'n v. Commissioner*[114] may have had on the modification analysis. The impact may be understood by taking into account the precedential effect that prior Supreme Court cases involving a re-incorporation into a different state had on the Supreme Court's analysis in *Cottage Savings*.[115]

Under the facts of the re-incorporation cases, even though the shareholders had the same percentage interests in the corporation after the re-incorporation, the exchanges of common stock were held to be taxable because the re-incorporation into a different state gave the shareholders a different set of legal rights. Taking these holdings into account, the Supreme Court stated that these cases "stand for the principle that properties are 'different' in the sense that is 'material' to the Internal Revenue Code so long as their respective possessors enjoy legal entitlements that are different in kind or extent."[116] Accordingly, *Cottage Savings* and the re-incorporation cases on which the Supreme Court's decision was based provide further support for the conclusion that state law should control this question (hereinafter, the "state law impact"; by contrast to the "tax fiction" associated with a legal entity's tax status as a DRE or an election or transaction that causes a change to such status).

In subsequent private letter rulings, the IRS flip-flopped in its approach to taking into account the state law impact or the tax fiction in its modification analysis.[117] In GLAM 2011-001,[118] taking into account the tax fiction, the IRS concluded that a mere check the box election that changed the status of the debtor entity from a corporation to a partnership was deemed a change in obligor for purposes of regulation section 1.1001-3(c), and then applied one of the exceptions to change-in-obligor status to conclude there was no significant modification. The primary conclusion reached by the IRS under the GLAM was that the liquidation of the insolvent corporation resulted in a section 165(g) worthless stock deduction.[119] The IRS also concluded that the creditor was not entitled to a bad debt deduction.

Lastly and more recently, in PLR 202337007, the IRS concluded there was no change of obligor under regulation section 1.1001-3(c) with respect to legal steps that resulted in redemption of minority partners

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[113] T.D. 8675 (preamble).
[114] 499 U.S. 554 (1991).
[115] *United States v. Phellis*, 257 U.S. 156 (1921); *Weiss v. Stearn*, 265 U.S. 242 (1924); and *Marr v. United States*, 268 U.S. 536 (1925).
[116] 499 U.S. at 564-65.
[117] See also PLR 200630002 (state law impact: IRS held a legal restructuring that did not affect creditor's rights, but did cause the entity in question to become a DRE, was not a change in the recourse nature of the debt for purposes of regulation section 1.1001-3 and did not result in a significant modification. The IRS's analysis was perhaps a mix of tax fiction and state law impact, as the IRS held there was not a significant modification, but did not conclude that a modification did not occur.); i.e., the IRS was analyzing things based on a change in obligor); PLR 200709013 (tax fiction: With respect to an acquired target corporation that converted to a state law LLC that did not affect the creditors and made a check the box election to become a DRE, the IRS concluded there was a change in obligor for purposes of regulation section 1.1001-3(c) but concluded such modification was not significant under one of the regulation section 1.1001-3(e) exceptions for a change in obligor. *I.e.*, the IRS recognized the tax fiction of a change in obligor, then tested the change for its significance.); PLR 201010015 (tax fiction: the conversion of the corporation into an LLC had no effect on the creditors, and the entity in question became a DRE. Because the conversion resulted in a transfer of assets to which Section 381 applies, the IRS held that the change in obligor did not result in a significant modification under regulation section 1.1001-3(e)(4)(i)(B). Implicitly the IRS concluded that the tax change in obligor was a modification under regulation section 1.1001-3(c), since it felt compelled to apply an exception in order to conclude the modification was not significant.).
[118] Aug. 26, 2011.
[119] In other words, the change in obligor position was somewhat incidental, in that the debt to the corporation from the shareholder may have had an impact on the analysis of whether section 331 applied to the liquidation. Also, the IRS neglected to apply regulation section 1.1001-3(f)(7) in the determination of whether modified debt is still debt for tax purposes, which applies to any change in obligor, whether or not the change is deemed significant.

from tiers of LLCs coupled with a check the box election to treat the borrower LLC entity as a corporation, reasoning there was no change in the state law rights of creditors. Many commentators as well as the author would tend to agree with the IRS's latest position in PLR 202337007 and renewed commitment to the approach that the state law impact governs the analysis of rights and obligations under the modification regulation.

c. Subordination

A change in the priority of a debt instrument relative to other debt of the issuer is a significant modification if it results in a CIPE.[120] Changes in priority occur with some frequency in real estate workouts especially where new money is being contributed to the project but only if a portion of the existing indebtedness that is considered by the parties to be in excess of the current value of the property is subordinated. Subordination of debt to new money that is regarded by the parties as "equity" can be challenging to the classification of the subordinated debt as true debt. A modification that causes debt to no longer be considered true debt is itself a significant modification.[121]

The authorities on a subsequent subordination of debt to other debt appear to be favorable, i.e., the subordinated debt remains true debt.[122] In the case of a subordination of debt to equity, while one of the hallmarks of debt is that it is senior to equity, a reasonable argument could be made that the holder of the debt that undergoes a subordination to equity is still acting in his capacity as a creditor in deferring the payment of the obligation in order to increase recovery of the debt. Perhaps the confidence level of the analysis could be improved if the subordination is to a loan that is treated as "equity" only for federal income tax purposes, pointing to the fact that the state law impact is only a subordination to another debt. See section *III.C. Modification Example*.

d. Definitions of Recourse and Nonrecourse Debt

A modification that changes recourse debt to nonrecourse or vice versa is per se a significant modification.[123] Many of the previously discussed rules for modifications in the form of changes in obligor or collateral also hinge on whether the debt to which such modification is made is recourse or nonrecourse. Yet there are no special definitions of recourse or nonrecourse for purposes of section 1001 generally or the modification regulation section. Nevertheless, an approach is necessary to complete the modification-analysis, and, to that end, it is instructive to review the approach of the modification regulation to, and the IRS's current thinking on, analogous determinations.

Under the general significance test of regulation section 1.1001-3(e)(1), the regulation takes the approach that "a modification is a significant modification only if, based on all facts and circumstances, the legal rights or obligations that are altered and the degree to which they are altered are economically significant." This approach to testing the significance of a modification is highly suggestive that the legal form and contractual terms of the debt instrument, i.e., state law impact of the modification, should inform whether a modification is deemed "significant." Moreover, as discussed above with respect to determining whether

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[120] Reg. §1.1001-3(e)(4)(v).

[121] Reg. §1.1001-3(e)(5)(i) (the rules of regulation section 1.1001-3(f)(7) apply for purposes of the debt-equity determination).

[122] *Bullock v. Comm'r*, 26 T.C. 276 (1956) (subsequent subordination); *Tomlinson v. The 1661 Corp.*, 377 F.2d 291, 298 (5th Cir. 1967) (subordination to mortgage debt); *Bowersock Mills & Power Co. v. Comm'r*, 172 F.2d 904, 908 (10th Cir. 1949) (holding two contracts that had the effect of subordinating an outstanding related-party debt did not cause the debt to be treated as equity).

[123] Reg. §1.1001-3(e)(5)(ii) (A change in the nature of a debt instrument from recourse (or substantially all recourse) to nonrecourse (or substantially all nonrecourse) is a significant modification; and a change in the nature of the debt instrument from nonrecourse (or substantially all nonrecourse) to recourse (or substantially all recourse) is a significant modification. If an instrument is not substantially all recourse or not substantially all nonrecourse either before or after a modification, the significance of the modification is determined under the overall significance test.).

there has been a change in obligor for purposes of significance testing under regulation section 1.1001-3(e), the latest thinking of the IRS in PLR 202337007 was to ignore the change in tax classification of a legal entity, in favor of looking to whether the entity's change in legal status had any state law impact on the creditors. Arguably, and for the sake of consistency in the modification analysis, the state law impact should govern the determination of whether debt is recourse or nonrecourse as part of testing any modification for significance under regulation section 1.1001-3(e).

This approach is in stark contrast with the tax fiction approach of PLR 201644018. In the ruling, the IRS went beyond the four corners of the agreements and state-law classification, to conclude that debt was nonrecourse for purposes of regulation section 1.1001-2 because the taxpayer was not personally liable for indebtedness of its DRE-LLC. Under the facts of the ruling, taxpayer's DRE-LLC had outstanding third-party debt that was legally recourse to the DRE-LLC. The DRE-LLC transferred cash and property to its creditors in cancellation of the debt. The IRS ruled that the debt should be viewed as nonrecourse debt of the DRE-LLC's regarded owner. Therefore, the IRS ruled that the debt cancellation did not result in COD income but instead should be viewed as an amount realized with respect to the property transferred.

Regulation section 1.1001-2, however, has different tax policy objectives than regulation section 1.1001-3. The former is concerned with the taxpayer's symmetrical treatment of debt allowed as an increase in basis of property on the one hand and recapture of the debt as an amount realized from the sale of the property on the other.[124]

As discussed above, the policy goals of the modification regulation was to provide guidance to holders and issuers on when modified property has become so "materially different" as to deem an exchange of the debt.[125] In *Cottage Savings*, the Supreme Court explained that the standard that properties are "materially different" is if their respective possessors enjoy legal entitlements that are different "in kind or extent."[126] It would seem reasonable to infer from the stated policy objectives of the modification regulation that the significance of a modification should not hinge on a debtor's check-the-box election (or other tax classifications that are different than the state law form).

B. Retest Requirement

3. Background

Debt that is modified must be retested to determine whether its debt status for tax purposes has been sustained.[127] In prior distressed economic cycles, it would have been difficult to conclude that a modified debt was still debt for tax purposes in cases where the modified debt remained underwater. The lack of a reasonable expectation of repayment would point toward equity treatment if the status of the modified debt needed to be retested. Fortunately, regulation section 1.1001-3 was amended during 2011 to provide (or at least clarify an existing rule[128]) under regulation section 1.1001-3(f)(7) that the subsequent deterioration in

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[124] See text at *infra* n. 169.
[125] Reg. §1.1001-1(a) (the gain or loss realized from the conversion of property into cash, or from the exchange of property for other property differing materially either in kind or in extent, is treated as income or as loss sustained). See also 57 FR 57034 (Dec. 2, 1992) (explanation of proposed regulations on debt modifications).
[126] *Cottage Savings Ass'n. v. Comm'r*, 499 U.S. 554 (1991).
[127] Reg. §1.1001-3(c)(2)(ii) and (f)(7)(i) (the determination of whether an instrument resulting from an alteration or modification of a debt instrument will be recharacterized as an instrument or property right that is not debt for federal income tax purposes shall take into account all of the factors relevant to such a determination).
[128] REG-106-750-10 (75 FR 31736 Jun. 4, 2010), preamble ("The language in the preamble to the existing regulations suggests that for all purposes of § 1.1001–3 the financial deterioration of the issuer is generally not taken into account. Issuers and holders, however, are concerned that, as the existing regulations are currently drafted, a decline in the creditworthiness of the issuer, under certain circumstances, may be taken into account under § 1.1001–3."). T.D. 8675 (Jun. 25, 1996) (according to the preamble to the original regulation section 1.1001-3, "a number of commentators raised questions regarding the circumstances under which the modification of a debt instrument will require a

financial condition of the issuer of the modified debt be ignored in performing the retest (the "modified retest").[129] There is an exception, however, in the case of a modification that results in the substitution of a new obligor or addition or deletion of a co-obligor.[130]

4. Modified List of Factors

The point of the modified retest is to retest whether the modified debt is still true debt without taking into account the deterioration of financial condition of the issuer since the debt's inception.[131] It is not completely clear the limits of this relaxation of the usual debt-equity factors, however. Deterioration of the financial condition of the obligor would seem to imply that one would not take into account a debtor's ability to repay under the modified terms, e.g., expectation of repayment, capacity to repay, etc. However, many types of alterations of the existing debt, like subordination, could be perceived differently depending on whether one takes into account the ability to repay.[132]

Whether an instrument is debt or equity for tax purposes has been the subject of numerous court cases.[133] In general, the following factors are taken into account:

- an unconditional obligation to pay is sum certain,
- a fixed maturity date that is not unreasonably far in the future,
- whether there was a reasonable expectation of repayment or is repayment of the loan predicated on success of the venture,
- are the loans made in proportion to equity holdings,
- subordination of the debt,
- was the loan adequately secured,
- were the terms of the loan commercially reasonable,
- is the loan convertible,
- is the borrower under-capitalized (thin capitalization),
- the name given to the instrument, and
- intent of the parties.[134]

The overwhelming majority of debt-equity cases involve the lending of cash and not the modification of debt. There are authorities which treat debts originally held by a third-party to continue to be valid debt after being acquired by a related party even where the borrower's financial condition has deteriorated and

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determination of whether the modified instrument is debt or equity. Many expressed concern that a deterioration in the financial condition of the issuer between the date of original issuance and the date of the modification could lead to a determination that the modified instrument is not debt for tax purposes. The final regulations address this concern by providing a rule that for purposes of this regulation, unless there is a substitution of a new obligor, any deterioration in the financial condition of the issuer is not considered in determining whether the modified instrument is properly characterized as debt.").

[129] T.D. 9513; Reg. §1.1001-3(f)(7).

[130] Reg. §1.1001-3(f)(7)(ii)(B).

[131] It is not clear whether the rule takes into account debt capacity from the original issuance, or only since the last modification. The literal language would seem to apply only as far back as the last significant modification, although the intent was to reach back to the original issuance.

[132] *Cf.* T.D. 9513 (Explanation suggests subordination is taken into account).

[133] See, e.g., *Estate of Mixon* v. U.S. 464 F.2d. 394 (5th Cir. 1972); *J.S. Biritz Construction Co. v. Comm'r*, 387 F.2d 451 (8th Cir. 1967); *John Kelly Co. v. Comm'r*, 1 T.C. 457 (1943), *rev'd*, 146 F. 2d. 466 (7th Cir. 1944), *rev'd* 326 U.S. 521 (1946).

[134] See generally *Estate of Mixon v. United States*, 464 F.2d. 394 (5th Cir. 1972); §385(b); Notice 94-47, 1994-1 C.B. 357.

new debt was issued in its place.[135] In *First National Co. v. Commissioner*,[136] the Sixth Circuit held that a debt instrument purchased by a party related to the borrower, which was financially distressed, continued to be a debt instrument for tax purposes. The debt was originally issued to third-party banks and to a related party bank holding company. Ten years later, after payments had been missed, the lenders were considering forcing the borrower into bankruptcy. Before a bankruptcy petition was filed, a group of investors purchased the borrower's stock and outstanding debt. The borrower then issued new promissory notes to the investors.[137] The IRS challenged the characterization of the instruments as debt, as the investors had not taken any specific action to enforce payment. The Sixth Circuit held that the obligations continued to be respected as indebtedness:

> A valid note does not become invalid because its maker becomes insolvent and the note is no longer of any value. Nor does the added fact that the holder recognizes and conceded such lack of value by his failure to take action, authorize a Court to hold that the obligation was released and cancelled.[138]

This concept was placed in the modification regulation at regulation section 1.1001-3(f)(7)(ii). In determining whether a significantly modified debt is a debt instrument, any deterioration in the financial condition of the debtor is not considered unless there is a change in obligor or an addition of a co-obligor. Therefore, many of the debt-equity factors above would not apply in the distressed real estate debt situation because they examine the ability of the debtor to service the debt in a commercially reasonable fashion. A legal change in the terms of the instrument such as removal of a maturity date to make the instrument perpetual could cause the modified debt to be considered equity. But merely because the debtor is having financial difficulty, and a third-party lender would not lend on the terms of the modified debt, does not make what was originally debt into equity. This is consistent with cases such as *First National Bank* and *Imperial Car Distributors*.[139]

5. Application to Nonrecourse Debt

The modified retest provides that for purposes of the retest the subsequent deterioration in financial condition of the issuer is ignored.[140] The exception to this rule is for a modification that results in "a substitution of a new obligor or an addition or deletion of a co-obligor."[141] Notwithstanding that both the rule and exception are not limited recourse debt, they refer explicitly to the *issuer's* financial condition and the *obligor's* status.[142] References to such financial capacity and legal status in regard to recourse debt make sense because the issuer/obligor has personal liability. Without more, an attempt to apply these factual conditions to a borrower of nonrecourse debt seems challenging.[143] Thus, some further thought is warranted to determine precisely how to apply the modified retest to nonrecourse debt.

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[135] See *First National Bank Co., v. Comm'r*, 289 F.2d 861 (6th Cir. 1961); *Earl v. W.J. Jones & Sons, Inc. v. Comm'r*, 200 F.2d 846 (9th Cir. 1952) (worthless debt does not destroy its character as a debt); *Imperial Car Distributors, Inc. v. Comm'r*, 427 F.2d 1334 (3rd. Cir. 1970) *rev'g* T.C. Memo. 1969-12.
[136] 289 F.2d 861 (6th Cir. 1961).
[137] 32 T.C. at 809.
[138] 289 F.2d at 866. See also *Earle v. W.J. Jones & Sons, Inc. v. Comm'r*, 200 F.2d 846 (9th Cir. 1952) (holding that "failure to attempt to collect a debt does not per se destroy its character as such").
[139] *Imperial Car Distributions, Inc. v. Comm'r*, 427 F.2d. 1334 (3rd Cir. 1970) *rev'g* T.C. Memo. 1969-12; *First National Bank Co., v. Comm'r*, 289 F.2d 861 (6th Cir. 1961).
[140] Reg. §1.1001-3(f)(7)(A).
[141] Reg. §1.1001-3(f)(7)(B).
[142] Reg. §1.1001-3(f)(5)(i) states that the terms "issuer" and "obligor" are used interchangeably and mean the issuer of a debt instrument or a successor obligor.
[143] See also *Estate of Franklin v. Comm'r*, 544 F.2d at 1048-49 (9th Cir. 1976) (Ninth Circuit held nonrecourse debt was not bona fide intendedness because the borrower had no investment in the property).

First, the use of the terms "issuer" and "obligor" does not appear to be intended to make a meaningful distinction for purposes of whether or not to take into account the deterioration of the issuer's financing condition. The term "obligor" is used to ascertain for purposes of the exception whether the obligation created from the issuance of the debt has, for example, migrated to another person. The preamble to the proposed regulation section 1.1001-3(f)(7) explains that for purposes of the retest the regulations state that "any deterioration in the financial condition of the issuer between the issue date of the unmodified debt instrument and the date of modification (as it relates to the *issuer's obligation* to repay the debt instrument) is not taken into account, unless there is a substitution of a new obligor or the addition or deletion of a co-obligor."[144] Accordingly, the focus of this inquiry will be to refer to the two terms interchangeably.

As discussed *infra*,[145] regulation section 1.1001-3(e)(4) considers the substitution of a new obligor on recourse debt to be a significant modification, and, on nonrecourse debt, not to be a significant modification.[146] One could argue that, since the general approach of the aforementioned regulation is to ignore a substitution of a new obligor on nonrecourse debt, the exception under regulation section 1.1001-3(f)(7) for a substitution of a new obligor should not apply to nonrecourse debt. However, the approach under regulation section 1.1001-3(e)(4) to a co-obligor change is different, which rule applies to both recourse and nonrecourse debt. Moreover, the term "obligor" is defined for purposes of the CIPE test so as to make the test ostensibly relevant to nonrecourse. In particular, regulation section 1.1001-3(e)(4)(vi)(B) defines an "obligor's capacity" for purposes of the CIPE test to include any source for payment, including collateral, guarantees, or other credit enhancement. Because an obligor on nonrecourse debt does not tend to have personal liability, the creditor typically is granted recourse to specific collateral.

Thus, the modified retest's rule and exception would seem to apply to nonrecourse debt, and that reading is consistent with the drafter's non-exclusiveness in respect of the debt's recourse nature. Moreover, the decline in value of collateral for a nonrecourse debt should be taken into account within the meaning of subsequent deterioration in the financial condition of the obligor. Given the implied policy of regulation section 1.1001-3(f)(7) to apply to any and all debt instruments, it would make sense to interpret the exception broadly to apply to changes in collateral (and possibly certain guarantees) on debt that is nonrecourse. Most commentators tend to agree with this approach.[147]

C. Modification Examples

The following examples are intended to explain or suggest approaches to some of the more difficult tax issues raised by modifications of distressed real estate debt, in particular a modification taking the form of the creditor subordinating a portion of its debt to new money coming from the debtor.

Example I

An office property has declined in value to \$55 from its \$100 purchase price (now an adjusted basis of \$70) and the state-law nonrecourse mortgage loan obtained to purchase the property has a balance of \$60 plus accrued and unpaid interest of \$30, i.e., \$90 of total debt. Originally to acquire the property, X and Y had formed a limited partnership XY to which X and Y contributed cash equity. XY formed a single member LLC treated for federal income tax purposes as a DRE (the "Owner" and "Borrower") to hold the property and obtain the mortgage loan from Lender. The security for the mortgage loan was in the form of a lien.

[144] REG-106-750-10 (75 FR 31736 Jun. 4, 2010) (emphasis added).
[145] *See* discussion at section *III.A.2.b. Changes in Obligor and Collateral*.
[146] Reg. §1.1001-3(e)(4)(i) and (ii).
[147] See Garlock, "Federal Income Taxation of Debt Instruments," ¶1404.02[D] (CCH 2024) ("Since nonrecourse debt relies on the value of the property for payment and not on the financial condition of the owner of the property, the most sensible interpretation of the regulation is to interpret the financial condition of the obligor in the case of nonrecourse debt as meaning the value of the property securing the debt.").

The mortgage loan was not guaranteed by XY, X, or Y except for standard "bad boy" provisions to ensure that the equity owners did not undermine the lender's interests. Refer to *Exhibit I-A*.

Because the office space is significantly vacant for the foreseeable future, $20 of the new money is required for the capital expenditures necessary to convert office to residential, so that rental values can be restored. The parties propose the following resolution to work out the mortgage and improve the property:

- Reaffirmation of the mortgage loan;
- Bifurcation of the mortgage loan into an A note of $50 with a 5-year maturity and at the same interest rate as the original mortgage and a B note of $40 that has no interest rate, 5-year maturity and is subordinated to the $20 of new money;
- The new money is in the form of a loan from X and Y to XY that has a 5-year maturity and carries an interest rate of 10%; refer to *Exhibit I-B*
- Agreement to a waterfall on sale or refinancing:
    - Repayment of principal and accrued and unpaid interest on A note;
    - Repayment of the new money loan and accrued and unpaid;
    - Repayment of principal on B note;
    - Residual distribution to X & Y.

Projections at the time of the proposal demonstrate a current pay of the A note's interest plus interest on the new money loan. Projections also demonstrate a full repayment of the A & B notes and upon sale in 5 years, as well as repayment of the new money loan plus interest plus residual net cash flow to the Owner.

The federal income tax issue for X and Y is that they can't afford significant taxes from the proposed resolution of the debt, as they need every dollar they have to fund the required additional capital.

The bifurcation appears to be an alteration that is a modification of the original mortgage loan and likely a significant modification because of the extended terms of both notes and the change in interest rate of the B note. Accordingly, there is a deemed exchange of the unmodified mortgage loan for the modified A and B notes.

Because of the modification, the A and B notes must be retested for debt status for federal income tax purposes. Fortunately, the Borrower has not changed, so that the Borrower's deterioration in financial condition is ignored for purposes of retesting the A and B notes.

Under the facts in this case, the mortgage loan is still in the form of the debt, i.e., the loan is still legally debt with creditor's rights, a maturity date, and an unconditional obligation to repay. The extension of the debt by an additional 5 years should not be considered a non-debt feature of the notes. The zero-percent rate on the B note is still consistent with debt treatment.[148] Subordination of the B note would seem a factor that only matters if the Borrower's financial condition was in question.[149] Assuming the factor nevertheless must be taken into account, a subsequent subordination of debt to other debt arguably does not transform the B note to equity for federal income tax purposes.[150]

The $20 loan from X and Y must be tested for its status as true debt, to be sure that, among other things, the B note is subordinated to another debt. The normal debt-equity factors apply to this analysis, however. The $20 loan appears to have all of the hallmarks of debt for federal income tax purposes and for purposes of considering such factors as reasonable expectation of repayment, capacity, and arm's length pricing, the

[148] See *Kena, Inc. v. Comm'r*, 44 B.T.A. 217, 221 (1941); §§ 7872, 1274, 483.
[149] But see preamble to T.D. 9513 which published regulations amending regulation section 1.1001-3 to add regulation section 1.1001-3(f)(7) (under the modified retest, take into account "such factors as subordination").
[150] See, e.g., *Bullock v. Comm'r*, 26 T.C. 276 (1956) (subsequent subordination).

projections indicate a reasonable expectation of repayment and the parties are unrelated and adverse. Accordingly, the $20 would seem to be true debt.

The A and B notes have a strong case for being true debt under the retest. Consequently, the only amount of COD income would stem from the reduction in the adjusted issue price of the B note because the zero rate is below the AFR (i.e., COD income to the extent the adjusted issue price of the A & B notes is less than $90). The formula for that calculation is $PV = FV / (1 + r)^n$. Assume AFR of 4%. Since the A note is discounted at the same interest rate that applied to the unmodified mortgage loan, the adjusted issue price with respect to $50 of the loan is unchanged. The adjusted issue price for the B note is $33 v. the $40 portion and the COD income is $7.

Example II

Assume the same facts as *Example I* except the new money is in the form of capital contributions to XY. Refer to *Exhibit II-A*.

One motivation is that X and Y do not want taxable income from the accrual of the interest income, especially where the interest deduction of XY is subject to capitalization during the renovation.

The retest of the B note has become more difficult because it will be subordinated to equity. Reasonable arguments may be made that the B note is still true debt, as the notes are still in the form of debt,[151] and the intention of the parties to treat the modified debt as debt arguably is manifested in the reaffirmation of the mortgage loan. Additionally, the creditor is a third-party bank and is still acting as a creditor in attempting to maximize the recovery of its investment.[152] However, many can also reasonably argue that the hallmark of debt is that it is not subordinated to equity.[153]

Assuming the B note under the retest is equity, the result gets interesting – at least for the tax pros! – but still can result in significant taxes. Recall that the legal issuer of the mortgage loan is the Borrower, a DRE, yet for federal income tax purposes the regarded borrower is the partnership, XY. If the B note is treated as equity, the Lender becomes an owner of the Borrower, which causes the Borrower to become a partnership under Rev. Rul. 99-5.[154] In situation 1 of the ruling, the buyer of an interest in the single member LLC pays cash directly to A, rather than making a contribution to the LLC for an interest in the LLC. According to the ruling, A is deemed to sell a proportionate amount of the LLC's assets to B pursuant to a section 1001 sale or exchange transaction. By analogy, the unmodified debt and any relief of indebtedness from the unmodified debt would seem to be value to XY (the regarded owner of the Borrower of the unmodified loan). That would suggest, XY is treated as disposing of the office property to the Lender under a deed in-lieu of foreclosure, governed by section 1001 and regulation section 1.1001-2; followed by XY contributing $20 and the Lender contributing the office property subject to the A note to the Borrower (a new

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[151] See discussion of the role of state law impact in the modification analysis at section *III.A.ii.d. Definitions of Recourse and Nonrecourse Debt*.

[152] Additionally, to strengthen the position of debt status, the parties could agree to include an agreement to treat the B note according to its substance as true debt, an acknowledgement of their intentions that the B note is debt for all tax purposes, and agree to report consistently on their tax returns that the B note is debt. *Comm'r v. Danielson*, 378 F.2d 771 (3rd Cir. 1967) ("A party can challenge the tax consequences of his agreement as construed by the Commissioner only by adducing proof which in action between the parties to the agreement would be admissible to alter that construction or to show its unenforceability because of mistake, undue influence, fraud, duress, etc.")

[153] Subordination is just one factor, however, and one factor alone does not settle the score. See *Estate of Mixon v. United States*, 464 F.2d 394, 402 (5th Cir. 1972). In some cases, the parties agree that the subordination of the B note is subject to the debtor not being in breach of certain of the terms of the modified agreement, i.e., the subordination is not in all cases and arguably the creditor is behaving like a creditor in attempting to collect on a debt.

[154] See discussion of Rev. Rul. 99-5 at section *VI.C. Exchange of Debt for an Interest in a DRE.*

partnership). The Lender is issued the B note as equity in the Borrower, in this case.[155] Refer to *Exhibit II-B*.

Under this tax construct, XY recognizes a section 1231 gain in the amount of $20 (amount realized of $90 and basis in the property of $70). This result is generally worse than under *Example I* but the rate of tax is at least at the current capital gain rates.[156]

Example III

Assume same facts as *Example II* except that XY transfers the $20 (contributed by X and Y) to the Borrower in the form of a $20 loan (same form of loan as the described in *Example I* from X and Y to XY). Assume also that the waterfall is expressed in the Borrower's operating agreement and the B note is subordinate only to the $20 loan. Refer to *Exhibit III*.

In this case, the $20 loan is disregarded for federal income tax purposes and the retest arguably takes a turn for the better. The retest is under Regulation section 1.1001-3 and thus the subordination question is answered arguably by taking into account only the state-law impact of the subordination of the B note, which this time is to another debt of $20. Assuming the logic of PLR 202337007 applies in this case, the result is the same as *Example I* except X and Y do not have to reckon with the interest accruals because the $20 loan is disregarded.

Example IV

Assume the same facts as *Example I* except that the projections are far less rosy. The projection shows that there is a high probability the $20 loan from X and Y will not be repaid.

The B note is subordinated to the $20 loan that could be considered equity in XY for federal income tax purposes because of the lack of a reasonable expectation of repayment. Assuming the $20 loan is equity for federal income tax purposes, the B note arguably is also equity in XY for tax purposes as it stands behind the $20, which already has low prospects of recovery.

A reasonable question in this example is whether the Lender's B note is substantial enough to allow the Lender to be regarded as a partner in the Owner. If not, there should be COD income of $40 under section 108(e)(10) because the adjusted issue price of the modified loan includes only an amount for the A note. The B note is contingent debt.

IV. In Conjunction With Property Transfer

A. Nonrecourse Debt

The transfer of property subject to nonrecourse debt generally results in gain or loss. There is no COD income from the discharge of debt in conjunction with the transfer of the property because with nonrecourse debt the borrower never had personal liability for the debt. The lender's recourse typically is limited to a lien on the property securing the debt. In the case of subordinated debt that is nonrecourse, such as a mezzanine loan, the lender historically had a second lien on the property and for at least a few decades the lender is granted a pledge over the equity interests the issuer of the senior, mortgage loan.

Section 1001 provides that the amount of gain or loss is defined as the excess of the amount realized from a sale or other disposition of property over its adjusted basis.[157] The "amount realized" includes money

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[155] For an in-depth analysis of this example, see Friedline, "Debt for Equity Exchange of a Disregarded Entity," 39 Real Estate Tax'n 52 (2012).
[156] Subject to recapture any qualifying prior section 1231 losses. In cases where the basis of the property is higher than the debt, this example may be preferable because it would tend to trigger a section 1231 loss.
[157] §1001(a).

received plus the fair market value of any property received,[158] including the amount of debt from which the transferor is discharged as a result of the sale or other disposition, such as a foreclosure.[159] For this purpose, the sale or other disposition of property that secures a nonrecourse liability discharges the transferor from the liability.[160] This is true whether the transfer of the encumbered property is via a sale to a third-party buyer or a foreclosure, i.e., a transfer to the creditor in satisfaction of the liability.[161] In other words, it is immaterial whether nonrecourse debt relief takes the form of an assumption of debt by a purchaser or a cancellation by a lender.[162]

For example, assume the taxpayer purchases leased real estate for $100, funded by $80 of mortgage debt that is nonrecourse. The taxpayer subsequently defaults on the loan at a time when the property has a fair market value of $60 and a basis of $50. The lender forecloses on the loan and takes the real estate from the taxpayer. The taxpayer's amount realized includes the full amount of the debt, $80, and therefore the taxpayer has capital gain[163] of $30.

The section 1001 regulations specifically provide that the fair market value of the property is not relevant to the determination of gain or loss with respect to nonrecourse debt.[164] Thus, the fact that the fair market value of the property is less than the amount of the liabilities it secures does not prevent the full amount of those liabilities from being treated as money received from the sale or other disposition of the property. In *Tufts v. Commissioner*,[165] a case the facts of which predate the pertinent regulation on discharge of debt,[166] the taxpayers formed a general partnership in 1970 to construct an apartment complex and obtained a $1,851,500 nonrecourse mortgage loan. Because of the subsequent decline in rents from the complex, the partnership was unable to make the payments due on the debt and consequently the partners sold their interests to a third party, who assumed the liability. The fair market value of the property on the date of transfer did not exceed $1,400,000.

The taxpayer, who reported a loss from the sale because the value of the partnership's property was worth less than the partnership's debt, argued that section 1001 provides that the amount realized includes the fair market value of property received and the taxpayer received nothing from the sale. The taxpayer pointed to footnote 37 in the *Crane v. Commissioner,*[167]opinion to support his position that his amount realized was limited to the fair market value of the property. According to the footnote, the Supreme Court stated "Obviously, if the value of the property is less than the amount of the mortgage, a mortgagor who is not personally liable cannot realize a benefit equal to the mortgage. Consequently, a different problem might be encountered where a mortgagor abandoned the property or transferred it subject to the mortgage without receiving boot. That is not this case."[168]

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[158] §1001(b), Reg. §1.1001-1(a). Note that the amount realized generally includes any amount of accrued and unpaid interest. *Allan v. Comm'r*, 856 F.2d 1169 (8th Cir. 1988).
[159] *Tufts v. Comm'r*, 461 U.S. 300, 306 (1983) (as if money had been paid to the seller on behalf of the creditor), Reg. §1.1001-2(a)(1) and (c), Ex. 7.
[160] Reg. §1.1001-2(a)(4)(i).
[161] See, e.g., *2925 Briarpark, Ltd. v. Comm'r*, 163 F.3d 313 (1999) (partnership transferor).
[162] *Parker v. Comm'r*, T.C. Memo. 2023-104, 108-109 (citing *2925 Briarpark, Ltd. v. Comm'r*, 163 F.3d 319; *Simonsen*, 150 T.C. at 212-13).
[163] The leased real estate is section 1231(b) property.
[164] Reg. §1.1001-2(b) (The fair market value of the security at the time of sale or disposition is not relevant for purposes of determining under regulation section 1.1001-2(a) the amount of liabilities from which the taxpayer is discharged or treated as discharged).
[165] 461 U.S. 300, 307 (1983).
[166] Reg. §1.1001-2, T.D. 7741 (1980).
[167] 331 U.S. 1 (1947).
[168] *Crane v. Comm'r*, at n. 37.

The Supreme Court in *Tufts* revisited its holding in *Crane* and held in favor of the IRS's position that the nonrecourse loan was a "true loan" in this context.[169] Ergo, the amount of the nonrecourse loan is included in basis and the amount realized on disposition, as since expressed in regulation section 1.1001-2(a)(1).[170]

6. Foreclosure Transactions

For purposes of section 1001 and regulation section 1.1001-2, a transfer of property includes a transfer to a third-party buyer, who may or may not assume the debt, and a transfer to the creditor, such as a foreclosure.[171] The courts have been expansive in applying sale or exchange treatment to property transfers and discharges of nonrecourse debt and have tended to lump together any type of foreclosure transaction. In other words, any transaction that has the "practical effect"[172] of a foreclosure has been held to be a foreclosure, resulting in gain (or loss, as the case may be) from the sale or other disposition of property and the full amount of the debt is included in the amount realized.

In *2925 Briarpark Ltd*,[173] the taxpayer engaged in a "short sale" transaction with respect to its encumbered property that was worth less than the amount of the nonrecourse debt, whereby the creditor forgave the debt only as a condition of the sale and receipt of the proceeds. The Fifth Circuit, in summarizing the IRS's argument, stated:[174]

> Congress intended the words 'sale or exchange' to have a broad meaning, not to be limited to the standard transfer of property by one person to another in exchange for a stated consideration in money or money's worth. For example, it has long been established that a foreclosure sale constitutes a "disposition of property" within the meaning of § 1001(b). A nonjudicial foreclosure sale is also a transaction that triggers taxable gain. It is also well settled that the transfer of property by deed in lieu of foreclosure is the functional equivalent of a "sale or exchange" for federal income tax purposes.

The Fifth Circuit rejected the taxpayer's reliance on *Gershkowitz v. Commissioner*[175] for the argument that debt forgiveness and the sale of property should not be treated as a single transaction simply because the parties could achieve that, finding that the lender was not willing to forgive any part of the loan except as a condition of sale of the property to the buyer.[176]

In *Gershkowitz*, there was a separate discharge event that was independent of the disposition of the property, albeit a few months later, so the court chose not to integrate the separate steps.[177] Thus, the ultimate form that the parties use can matter. Relying on *Gerschkowitz* and Rev. Rul. 91-31[178] as a planning matter, a taxpayer threatened with gain on distressed property could seek to avail itself of section 108 to exclude COD income, if the debtor could negotiate a reduction of the debt ahead of a sale of the property to a buyer.

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[169] *Tufts v. Comm'r*, 461 U.S. 300, 307 (1983).
[170] T.D. 7741 (1980).
[171] As well as a transfer of an interest in a partnership. See Reg. §1.1001-1(a)(4)(v); §752(d).
[172] See *2925 Briarpark, Ltd. v. Comm'r*, 163 F.3d 313, 316 (1999); *Yarbro v. Comm'r*, 737 F.2d 479 (5th Cir. 1984).
[173] *2925 Briarpark, Ltd. v. Comm'r*, 163 F.3d 313 (1999).
[174] *Id*. at 318 (citations omitted).
[175] *Gershkowitz v. Comm'r*, 88 T.C. 984 (1987).
[176] *2925 Briarpark Ltd.*, 163 F.3d at 318; *cf*. Reg. §1.1274-5(b)(1) (generally if a debt instrument is assumed, or property is taken subject to a debt instrument, in connection with a sale or exchange of property, the terms of the debt instrument are modified as part of the sale or exchange, and the modification triggers an exchange under section 1001, the modification is treated as a separate transaction taking place immediately before the sale or exchange and is attributed to the seller of the property.) Note that *Briarpark's* facts predated the promulgation of the regulation.
[177] *Gerschkowitz*, 88 T.C. at 1016.
[178] Rev. Rul. 91-31 holds that unless there is a transfer of property the reduction of recourse or nonrecourse debt results in COD income.

However, as a practical matter, *Gershkowitz* did not involve real estate collateral (obsolete tax prep software, ultimately), so it might be more difficult to find a mortgagee willing to be so obliging.

7. Assumption Transactions

A common variant in the short-sale described in *2925 Briarpark, Ltd.* is a short-sale transaction whereby the creditor instead agrees to reduce the debt to an amount that is not in excess of the fair market value of the property securing the debt in conjunction with debtor's sale of the encumbered property to a third-party buyer who assumes the modified debt. Arguably, this short-sale transaction has the same practical effect as a foreclosure and thus would appear to result in the full amount of the nonrecourse debt being included in the seller's amount realized under regulation section 1.1001-2(a)(1).

Is it possible to have your cake and eat it too – an integrated transaction involving undersecured nonrecourse debt that results in COD income to the seller?[179] Applying the OID rules of section 1274 in the context of an assumed nonrecourse debt that is modified to facilitate the sale raises an interesting issue.

Section 1274 generally does not apply to a debt if the debt is assumed in connection with a sale of property, unless the terms of the debt as part of the sale are modified in a manner that would constitute an exchange of the debt.[180] In the case the debt is modified to such an extent, regulation section 1.1274-5(b)(1) generally provides that the modification of the debt is treated as a separate transaction taking place immediately before the sale of the property and is attributed to the seller.[181] The result of the regulation, which was published[182] after the tax year at issue in *2925 Briarpark, Ltd.*, is similar to result desired by the taxpayer in that case, arguing among other things that *Gershkowitz* applied to the sale to cause COD income. This result may not be the result intended by regulation section 1.1274-5(b)(1), and assumptions of distressed debt probably were not contemplated by this rule.[183] The regulation allows the parties to elect to treat the modification as occurring after the transfer of the property, which would result in a bizarre allocation of the seller's income consequence to the buyer, potentially a tax-neutral party.

On a somewhat related note, a buyer can purchase property subject to undersecured nonrecourse debt and subsequently negotiate with the creditor for a reduction in the debt to an amount that more closely reflects the real estate's current fair market value. Arguably the buyer should not realize COD income under the facts of the purchase, even though the IRS's position in Rev. Rul. 91-31 is that the reduction of any debt results in COD income where the property is not transferred. The nonrecourse debt in excess of the fair market value of the purchased property arguably is a contingent liability for federal income tax purposes, and therefore its subsequent release or reduction should not result in COD income. In this case, the buyer should not be entitled to basis in excess of the fair market value.[184]

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[179] A seller may prefer COD income if an exclusion under section 108 is available to the relevant taxpayer.
[180] Reg. §1.1274-5(a).
[181] For this purpose, a debt instrument is not considered to be modified as part of the sale or exchange unless the seller knew or had reason to know about the modification. Reg. §1.1274-5(b)(1). Under regulation section 1.1274-5(b)(2), an election may be jointly made by the buyer and the seller to treat the buyer as modifying the debt (taking place after the sale of the property). Reg. §1.1274-5(b)(2).
[182] T.D. 8517 (Feb. 2, 1994).
[183] For a discussion of the regulation, see Friedline, "Bifurcation of Nonrecourse Debt: Application of Reg. § 1.1274-4 to Transactions that are the Functional Equivalent of a Foreclosure," 9 J. Tax'n Fin. Products 17 (2011). See also 1995 FSA Lexis 437 (IRS stated that "an assumption of an existing debt by a buyer in conjunction with a reduction of indebtedness by the lender, would be subject to section 1.1274-5(b), which treats the modification of the debt separately from the disposition of the property.")
[184] *Pleasant Summit Land Corp. v. Comm'r,* 863 F.2d 263 (3d Cir. 1988), *cert. denied*, 493 U.S. 901 (1989); *Regents Park Partners v. Comm'r*, T.C. Memo. 1992-336. See also Reg. §1.1001-2(a)(3) (In the case of a liability incurred by reason of the acquisition of the property, regulation section 1.1001-2 does not apply to the extent that such liability was not taken into account in determining the transferor's basis for such property).

8. Partnership Interest Transfers

a. Section 752(d)

It is possible for an interest in a partnership to be transferred to a creditor or to the buyer in a short-sale transaction. A partner's sale or other disposition of his interest in the partnership must include the amount of partnership liabilities of which he is relieved in the amount realized for purposes of determining the gain or loss.[185] Section 752(d) provides that in the case of a sale or exchange of an interest in a partnership, liabilities shall be treated in the same manner as liabilities in connection with the sale or exchange of property not associated with partnerships. Regulation section 1.1001-2(a)(4)(v) also provides that the liabilities from which a transferor is discharged as a result of the sale or disposition of a partnership interest include the transferor's share of the liabilities of the partnership.

For example, assume an overindebted partnership holding leased real estate and having equal partners, A and B, and that the partnership has made a section 754 election and the partnership's debt is nonrecourse under section 1001. The partners, each of whom has a deficit capital account of $100 in the partnership and a share of the partnership's debt of $100, desire to transfer their partnership interests to C for nil consideration and after obtaining consent from the partnership's creditor and no modification to the debt. Assume further the partnership becomes a DRE as a consequence of all of its interests being acquired by C, and that the principles of Rev. Rul. 99-6 generally apply to the partnership and its partners, such that the partners are treated as transferring their interests in the partnership pursuant to section 741 and that the acquiror of all of the partnership interests is treated as receiving a distribution of the partnership's assets in redemption of the interests pursuant to section 732.[186]

Each of the partners recognizes a gain of $100, as each partner has an amount realized equal to its share of the partnership's debt of $100[187] and a basis of zero in the partnership interest. From C's perspective, C is treated as purchasing the partnership assets for nil consideration from A and B who are treated as being transferred the assets by the partnership in liquidation. The ruling under its stated facts would otherwise provide that C takes a cost basis under section 1012, i.e., nil consideration plus the amount of the partnership debt to which C takes the assets "subject to."[188]

The example could be modified and made more complex by making C the creditor of the partnership. As a substance over form matter, there is a question of whether C is acting in its capacity as a creditor of the partnership, i.e., since the interests in the partnership apparently are worthless, C, in substance, has foreclosed on the partnership assets. On these facts, there may not be a different result for federal income tax purposes. However, if the partnership debt was instead recourse under section 1001, the partnership could have COD income that is allocable to A and B.

b. Section 752(c)

By contrast, section 752(c) has a fair market value limitation; to wit: section 752(c) provides that a liability to which property is subject shall, to the extent of the fair market value of such property, be considered as a liability of the owner of the property. Thus, if a partner contributes overindebted property to a partnership pursuant to section 721, section 752(c) does not treat the partnership as assuming the excess liability (liability in excess of the property's fair market value). Section 752 is a set of rules for purposes of attributing partnership liabilities to its partners for basis purposes.[189] It is not clear whether section 752(c)

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[185] Reg. §1.1001-2(a)(4)(v).

[186] See Rev. Rul. 99-6, Situation 2 (the facts of the ruling assumes for purposes of simplicity the partnership has no liabilities).

[187] *Tufts v. Comm'r*, 461 U.S. 300 (1983); Reg. §1.1001-2(b) (there is no fair market value limitation).

[188] But see text at *supra* n. 183 regarding treatment of contingent debt in basis of acquired property.

[189] See, e.g., GLAM 2011-003 (a section 165(g) ruling in the context of a check the box election for an insolvent corporation that becomes a partnership, the deemed contribution under which of overindebted property to the newly

in the case of overindebted property causes COD income to the partner contributing the property subject to the liability to the partnership.[190]

c. Partner Loans

It is not uncommon for partners to fund their partnership with equity contributions and partner loans. As partnership assets become distressed, any partner loans that have been made to the partnership likely are distressed as well. If the partners of the distressed partnership endeavor to sell or transfer their interests in the partnership, resolution of the partner loans can be difficult[191] and potential COD income consequences should be considered upfront.

If the purchaser of the distressed partner loans is acquiring equity in the partnership, then consideration should be given to whether section 108(e)(4) would apply. Section 108(e)(4) treats a debt as being retired for fair market value when acquired by a party related to the borrower.[192] The regulations under section 108(e)(4) apply to an indirect acquisition, i.e., a situation where the lender acquires the debt and then becomes related to the borrower, or vice versa. Under the form of the transaction, section 108(e)(4) can apply to the partnership's debt if the buyer is considered a related party to the partnership,[193] causing COD income to the partnership generally in the amount of the discount applied to the partner loans.[194] However, in the case that a buyer purchases all of the interests in the partnership, such that the partnership becomes a DRE, the partner loans do not survive the transaction, i.e., the loans themselves become disregarded.[195] Even if the acquired debt does not survive the transaction the preamble to the proposed regulations under section 108(e)(4) expresses an intention that COD income should be realized.[196]

If the seller of the partner loan is himself a related party to the partnership, say, the seller is the majority owner of the partnership, section 108(e)(4) would not appear to be applicable to the partnership debt.

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formed partnership qualified for section 721 treatment; to which the IRS applied section 752(c) but COD income was not discussed).

[190] See Miller and Bowers, "Section 752(c): A Riddle Wrapped in a A Mystery Inside an Enigma," PLI Tax Planning for Domestic & Foreign Partnerships, for a discussion of the issues associated with the contribution, distribution, foreclosure and other topics related to over encumbered property; Gall and Wang, "The Mysterious Case of Disappearing Debt in Partnership Transactions," 90 Taxes 3 at n.112 (2012).

[191] Among other reasons, a tax-sensitive purchaser of the partnership interests and the partner loans would worry about a subsequent need to discharge or write down the partner loans.

[192] See generally Reg. §1.108-2. In most cases, the cost and fair market value standards should produce similar results. T.D. 8460, 57 FR 61805, 61806. The Service and Treasury believe that, where the two standards would differ, the correct economic measure of the cost of acquiring the debt (and, thus, of COD income) is by reference to fair market value. *Id.*

[193] Under section 108(e)(4)(A), relatedness to the debtor is tested section 267(b) or 707(b)(1), and regulation section 1.108-2 takes into account purchasers who anticipate becoming related to the debtor.

[194] See Reg. §1.108-2(f) for the amount of COD income realized. Note that there is an exception for debt that matures within one year of the purchase by the related party and the debt is retired on or before the maturity date. Reg. §1.108-2(e).

[195] Note that a termination of the partnership by a sale of at least 50% of the interests in partnership no longer occurs since the repeal of section 708(b)(1)(B) under TCJA.

[196] 56 FR 12135 (Mar. 22, 1991) ("The Treasury Department intends to issue regulations designed to prevent the elimination of income from discharge of indebtedness in certain nonrecognition transactions. In general, if assets are transferred in a tax-free transaction and the transferee receives the assets with a carryover (or, in certain cases, a substituted) basis, any built-in income or gain is taxed when the transferee disposes of the asset. If, however, the debtor acquires its own indebted-ness, the indebtedness is extinguished. In that case, the indebtedness in all cases should be treated as if it is acquired by the transferee and then satisfied. Similar treatment should apply if a creditor assumes a debtor's obligation to the creditor. In both cases, the debt is effectively extinguished, and current recognition of income from discharge of indebted-ness is appropriate. Thus, the regulations to be issued will provide for recognition of income from discharge of indebtedness in these cases."). Note that the IRS has not carried through with its intent to issue regulations except in the consolidated return context.

Section 108(e)(4) applies to purchases of debt by a related party to the debtor but only from a person who is not so related.[197]

Approaching the transaction's form from the substance of the transaction, if the partner loans in fact are worthless or worth substantially less than their face amount, i.e., the equity interests are worthless,[198] the transaction could be construed as a purchase of the partner loans coupled with a foreclosure of the partnership's assets by the buyer of the partner loans, followed by a reconstituted partnership (or DRE, as the case may be). If the partner loans are recourse debt, the selling partners would otherwise be allocated any COD income of the partnership under section 706.[199] Though possibly without materially different tax consequences, the transaction's substance could also be construed as the partners (i) first foreclosing on the partner loans, taking the partnership's assets, followed by a sale of the assets to the buyer or (ii) first contributing their loans to the partnership followed by the sale of the interests.[200]

B. Recourse Debt

1. Bifurcated Approach

The amount realized from the sale or other disposition of property that secures a recourse debt does not include amounts that are considered COD income.[201] In other words, for the portion of the recourse debt that goes unsatisfied by the transfer of the property and is nevertheless cancelled by the creditor, COD income is realized by the borrower. To the extent the fair market value[202] of the property satisfies a portion of the recourse debt, the regulation gives effect to the property transfer as a sale or other disposition under section 1001.[203]

For example, a taxpayer purchases leased real estate for $100 and funds $80 of the purchase price from the proceeds of a recourse loan secured by the real estate. The fair market value of the real estate subsequently declines to $70 at a time when the basis in the real estate is $50 and the amount of the loan is still $80. The taxpayer transfers the real estate to the lender and the lender agrees to forgive the entire amount of the loan. The loan is considered partly satisfied in the amount of $70. The taxpayer-transferor realizes a capital gain

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[197] See Reg. §1.108-2(a) and (b). *Cf.* T.D. 8460 (According to the preamble, in response to comments received, the Service intends to study the extent, if any, to which a direct acquisition should not occur if the indebtedness and an ownership interest in the debtor are acquired together from the same person, and that person was related to the debtor immediately prior to the transaction.)

[198] The IRS could assert that the sale of the worthless partnership interest is "fictitious." *DeLoss v. Comm'r*, 28 F.2d 803, 804 (2d Cir. 1928) (sale of worthless stock not required to sustain loss deduction). But see *Foxman v. Comm'r*, 352 F.2d 466 (3d Cir. 1965) ("Where the practical differences between a 'sale' and a 'liquidation' are, at most, slight, if they exist at all, as where the tax consequences to the partners vary greatly, it is in accord with the purpose of the statutory provisions to allow the partners themselves, through arm's-length negotiations, to determine whether to take the 'sale' route or the 'liquidation' route, thereby allocating the tax burden among themselves.").

[199] Assuming the partner loans are recourse debt for purposes of section 1001. It is possible that gain or loss is recognized by the partnership under the bifurcated approach of regulation section 1.1001-2(a).

[200] In the case of an insolvent corporation's debt to a shareholder, the IRS has ignored the pre-transaction contribution of the shareholder loan. Rev. Rul. 68-602. Apparently, it did not matter to the IRS that the contribution of a related party loan was required to enable a sale of the debtor corporation's stock to a third-party buyer, to which contribution step the IRS nevertheless acknowledged the economic significance thereof. CCA 200818005 (disregarding a capital contribution of intercompany debt that was a condition of a sale of the stock in the borrower to a third-party buyer in the context of a section 338(h)(10) election).

[201] Reg. §1.1001-2(a)(2) (a "bifurcated" approach, according to which the fair market value of the transferred property is relevant), Treas. Reg. §1.1001-2(c), Ex. 8; Rev. Rul. 90-16, 1990-1 C.B. 12.

[202] As a general matter, the "fair market value" of property for tax purposes is defined as "the price at which the property would change hands between a willing buyer and a willing seller, neither being under any compulsion to buy or to sell and both having reasonable knowledge of relevant facts." United States v. Cartwright, 411 U.S. 546, 551 (1973).

[203] See Reg. §1.1001-2(c), Ex. 8.

$20 from the sale or other disposition of the real estate. For the $10 portion of the loan that represents a deficiency from the which the lender relieves the taxpayer from his personal liability, the taxpayer realizes COD income. Had the loan been entirely nonrecourse, the taxpayer instead would have realized a capital gain[204] of $30 (the unified approach).

A partner does not realize COD income on the sale of other disposition of a partnership interest to the extent the amount realized includes recourse liabilities of the partnership, since the partner was not personally liable for the partnership's liability. It would appear that in the case of a partnership's nonrecourse debt that is recourse to its partners that, upon the discharge of the partnership's debt, the partnership includes the full amount of the debt in its amount realized (the partner's recourse on the loan is ignored).[205]

2. Fair Market Value in Foreclosure

In the case of a foreclosure involving recourse debt, where fair market value matters for purposes of the transferor's gain or loss, a transferor can attempt to overcome the presumption that the lender's bid-in price is fair market value,[206] say, for the sake of increasing the amount of COD income that could be excluded under section 108 and reducing capital gain. In *Frazier*,[207] the taxpayer secured a recourse debt with a mortgage on real estate. Subsequently the lender foreclosed on the real estate at a time when the taxpayer was insolvent. The lender did not attempt to collect the difference between the amount of the debt and the bid-in price for the real estate. The taxpayer's adjusted basis in the real estate was less than the amount of the debt. The real estate was later sold by the lender for an amount significantly less than the bid-in price. The IRS asserted that the taxpayer's amount realized was the bid-in price.[208] According to the court, the taxpayer rebutted this presumption with the required clear and convincing proof by introducing an appraisal opining that the fair market value of the real estate on the date of the foreclosure was much lower than the bid-in price.

C. Definitions of Recourse and Nonrecourse Debt

When property is transferred to a lender in cancellation of a loan, it is critical to determine whether the debt is recourse or nonrecourse. As discussed above, for nonrecourse debt, the cancellation is an amount realized on the sale or exchange of the property.[209] For recourse debt, the cancellation may generate COD income.[210] While significantly after the Supreme Court's decision in *Tufts*, the Tax Court in *Gehl* observed that section 61(a)(3) and (11) are "separate, independent, and not overlapping provisions with respect of the includability of a particular item of gross income … [o]nly after it is determined that the latter provision applies does one reach the question of the impact of insolvency and therefore the applicability of section 108."[211] The fate of many distressed taxpayers hangs in the balance while their practitioners wrestle with recourse/nonrecourse determinations.

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[204] The property is section 1231(b) property and it is assumed the loss recapture rule of section 1231(c) does not apply.

[205] *Tufts v. Comm'r*, 461 U.S. 300 (1983) (partnership was a general partnership, but the partners did not assume any personal liability for the debt's repayment).

[206] *Frazier v. Comm'r*, 111 T.C. 243 (1998) ("Absent clear and convincing proof to the contrary, the sale price of property at a foreclosure sale is presumed to be its fair market value." Citing *Community Bank v. Comm'r*, 79 T.C. 789, 792 (1982), *aff'd,* 819 F.2d 940 (9th Cir.1987); *Marcaccio v. Comm'r*, T.C. Memo. 1995–174.

[207] *Id*.

[208] Absent clear and convincing proof to the contrary, the sale price of property at a foreclosure sale is presumed to be its fair market value. See *Community Bank v. Comm'r*, 79 T.C. 789, 792 (1982), *aff'd,* 819 F.2d 940 (9th Cir.1987); *Marcaccio v. Comm'r*, T.C. Memo. 1995-174.

[209] §§1001 and 61(a)(3).

[210] §61(a)(11).

[211] *Gehl v. Comm'r*, 102 T.C. 784, 789 (1994), *aff'd,* 50 F. 3d 12 (8th Cir. 1995).

The classification of debt that is discharged in connection with the transfer of property essentially is the determining factor in whether a borrower has COD income or gain or loss. Yet the Code and regulations generally do not provide definitions of "recourse" or "nonrecourse" for this purpose. Regulation section 1.1001-2(c), however, suggests through its examples that a recourse debt is one for which the borrower is personally liable for repayment and a nonrecourse debt is one for which the borrower is not personally liable, where the creditor's recourse is limited to the asset securing the debt.

The first place to start in the analysis is with a review of the governing agreements with respect to the loan, including any guarantees, indemnifications, etc., and applicable state law. The analysis requires a practical assessment of whether a creditor's right of recovery is limited to a particular asset or assets of the borrower. If a creditor's right of recovery is limited to a particular asset securing the liability, the liability is nonrecourse. If a creditor's right of recovery is unlimited and extends to all assets of the borrower, the liability is recourse.[212]

For partnership liabilities, the determination is made at the partnership level.[213] However, it is irrelevant how the partnership debt may be classified under section 752 and the applicable regulations.[214] These rules address how to allocate partnership debt solely for purposes of determining the partner's basis in a partnership interest, by determining whether a partner or a related person bears the economic risk of loss for a partnership debt.[215] In real estate projects it is often the case that the borrower has a limited pool of assets and has covenants as to "special purposes entity" ("SPE") status under the applicable loan agreement. Such status can tend to make the partnership's debt in substance nonrecourse, even though the loan agreement may not have any express exculpatory provisions limiting the lender's recourse. However, the partner level pledges of interests in the partnership and guarantees of the partnership debt may cause the debt to be considered recourse debt for purposes of section 1001.

Great Plains Gasification is a case often cited for the erroneous proposition that the section 752 regulations determine whether partnership debt is recourse or nonrecourse for purposes of section 1001. In a footnote, the Tax Court in *Great Plains Gasification*, however, observed that the section 752 regulations were not effective as of the time of the facts of the case, and addressed the IRS's argument that the partnership's debts were nonrecourse because the partners did not sign personal guarantees.[216] The Tax Court decided whether the partnership debt was recourse or nonrecourse based on a factual analysis of the applicable agreements and relevant state law, and concluded that the debt was nonrecourse because lender's recourse was limited to assets of the partnership and the partner's interests in the partnership's assets (the partners pledged their interests as collateral for the loan).

In CCA 201525010, the IRS addressed the legal issue of whether the taxpayer's COD income should be reclassified as the amount realized from the sale or exchange of property. The debt in question was partnership debt and an open question was whether the debt was recourse or nonrecourse. In addition to a fulsome discussion of *Great Plains Gasification* and a conclusion that the determination of recourse or nonrecourse status of partnership is a facts and circumstances analysis that is not based on section 752, the

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[212] *Raphan v. U.S.*, 759 F.2d 879, 885 (Fed. Cir. 1985), *Great Plains Gasification Associates v. Comm'r*, T.C. Memo. 2006-276, CCA 201525010; *cf.* Reg. §1.861-10T(b)(2)(iii) (definition of "qualified nonrecourse debt").

[213] Reg. §301.6231(a)(3)-1(a)(1)(i) and (v). Assumes the partnership is the legal debtor, not a DRE of the partnership.

[214] See CCA 201525010 (The definition of a recourse liability found is regulation section 1.752-1(a) is limited to issues under section 752, rather than a definition intended to extend to issues under sections 61 and 1001).

[215] Reg. §1.752-1(a) (For purposes of section 752, the following definitions apply: (1) A partnership liability is a recourse liability to the extent that any partner or related person bears the economic risk of loss for that liability under regulation section 1.752-2, and a partnership liability is a nonrecourse liability to the extent that no partner or related person bears the economic risk of loss for that liability under regulation section 1.752-2.)

[216] *Great Plains Gasification Associates v. Comm'r*, T.C. Memo. 2006-276, n. 35.

memorandum includes several observations about the analysis that is required for the determination, including specific observations about the taxpayer's SPE status under the agreements.

For taxpayers that finance assets through DREs, COD income generally does not result from foreclosures or equivalent transactions unless the regarded taxpayer is personally liable on the debt.[217] In *Parker*,[218] the taxpayer, an S-corporation was treated as selling real estate subject to nonrecourse debt for purposes of section 1001. The real estate was owned by LLCs that were disregarded entities of the taxpayer, and the mezzanine loans were obtained by the LLCs. The loans were legally recourse by their terms, but effectively nonrecourse to the regarded taxpayer because the regarded taxpayer was not directly liable on the loan. The court reasoned that the taxpayer did not have COD income because mezzanine loans were nonrecourse to the taxpayer and the taxpayer was treated for tax purposes as transferring the real estate in conjunction with the cancellation of the mezzanine loans. The fact that the taxpayer's shareholder personally guaranteed the mezzanine loans was not a factor in the classification of the debt.[219]

In PLR 201644018, the IRS concluded that debt owed by a DRE was nonrecourse to the taxpayer for purposes of determining whether the taxpayer realized COD income when the DRE transferred its assets subject to the nonrecourse debt. It may be difficult to reconcile this position (taking into account the tax fiction for classifying debt as recourse or nonrecourse) with classifying debt for purposes of the debt modification rules under regulation section 1.1001-3. For purposes of the debt modification regulation, it may be more appropriate to take into account state law in determining whether rights of the holder and the issuer have changed.[220]

V. COD Income Exclusions

The Bankruptcy Tax Act of 1980[221] codified under section 108(a) of the 1954 Code a number of the existing common law exceptions to the realization of COD income, namely with respect to bankruptcy and insolvency. The guiding principle of the new rules was to accommodate both bankruptcy and tax policies and to preserve a debtor's "fresh start" after bankruptcy by providing that no income is recognized by reason of debt discharged in bankruptcy or to an insolvent debtor outside of bankruptcy so that a debtor is not burdened with an immediate tax liability.[222] It is instructive to keep this policy in mind when interpreting the some of the uncertainties in section 108 and later developments, such as the proliferation of disregarded entities in the wake of the "check the box" regulations.[223]

Many of the exceptions limit the exclusion of gross income to the amount of the taxpayer's insolvency at the time of the discharge and require a toll charge in the form of basis or attribute reduction.[224] There are also special rules setting forth the prioritization of the many exceptions[225] and for determining the amount

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[217] See also PLR 202050014 (debt of a disregarded LLC was nonrecourse to the taxpayer-owner even though the taxpayer had no other material assets other than the LLC interest).

[218] *Parker v. Comm'r*, T.C. Memo. 2023-104 (Aug. 10, 2023).

[219] See the preamble to Reg. §1.108-9, T.D. 9771 (Treasury and IRS are of the view that indebtedness of a grantor trust or a DRE is indebtedness of the owner for purposes of section 108(d)(1); assuming the owner has not guaranteed the indebtedness and is not otherwise liable for the indebtedness under applicable law, such indebtedness should generally be treated as nonrecourse indebtedness for purposes of applying the section 108(a)(1)(B) insolvency exclusion; and accordingly the principles of Revenue Ruling 92-53 apply to determine the extent to which such indebtedness is taken into account in determining the owner's insolvency under section 108(d)(3)).

[220] See discussion at *infra* n. 110. See also Michael Yaghmour, Bob Leonard, and Menna Eltaki, "Recourse, but Maybe . . . ," Tax Notes, Oct. 23, 2017, p. 529.

[221] P.L. 95-598.

[222] S. Rep. No 96-1035, 2d Session, at 9-10 (1980).

[223] See Reg. §§301.7701-2 and 3 (a "disregarded entity" is an entity that is disregarded as separate from its owner, for tax purposes).

[224] See §108(a)(3) and (c)(2) and §108(b)(4).

[225] See §108(a)(2).

of COD income from a modification of debt, purchase of debt by a related party, and discharge of debt by an owner.[226]

A. Bankruptcy

Bankruptcy filings with respect to distressed real estate assets have not been very common in the author's experience,[227] though there are some and at least by comparison to business bankruptcies. Real estate collateral is often held in LLCs that are "special purpose entities" ("SPE(s)"), i.e., the entity is limited in pursuing business beyond operating and managing the particular real estate asset that serves as collateral for a secured loan and limited in obtaining material financial beyond the single secured loan. Second liens are far less common than they used to be a few decades ago. Instead, for additional financing in the form of debt, a "mezzanine loan" may be obtained (the amount of the loan tends to be in the range of 60-85% loan to value, whereas a senior secured or mortgage loan is in the range of 50-60% loan to value). The additional financing is commonly issued by an LLC SPE (commonly referred to as the "mezz borrower") that is the owner of all of the interests of the "mortgage borrower" and can be recourse and/or secured by a pledge of the interests of mezz borrower. Both the mortgage borrower and mezz borrower are typically disregarded entities of the project owner or joint venture entity.[228]

When a borrower experiences distress and/or is in default, rather than incurring the time and expense of a federal or state bankruptcy filing and process (or judicial foreclosure), the lender will either pursue a mutually agreeable deal with the borrower or, if the distress is more dire, the borrower may leave the proverbial "keys in the mailbox" for the lender before heading out of town, i.e., the debtor is interested in transferring the deed to the lender in satisfaction of the debt. The tax consequences of these types of settlements are discussed supra section *IV. In Conjunction With a Property Transfer*.

A petition for bankruptcy in the case of distressed real estate assets may nevertheless be pursued for a variety of reasons, such as the borrower practically is not able work out a deal or get a sufficient response from a "special servicer" of a mortgage loan. In these cases, and where the borrower is a pass-through entity such as a DRE-LLC, the bankruptcy exception under section 108(a)(1)(A) is unavailable unless the regarded owner is under protection of a bankruptcy case. Regulation section 1.108-9 provides that indebtedness of a "title 11 debtor" that is a DRE or grantor trust that is discharged in a title 11 case the bankruptcy exception does not apply to any COD income. Additionally, under section 108(d)(6), the bankruptcy exception applies at the partner level. In other words, the bankruptcy exception only applies to a taxpayer that is the owner or partner of a passthrough entity.

Bankruptcy of a passthrough entity can have tax consequences that are substantially the same as those of a passthrough entity (and its owners) that undergoes a foreclosure transaction. Under a plan of bankruptcy of a passthrough entity that results in the owner (or owners) of the bankrupt entity being redeemed of its ownership in the entity, say, an LLC, the secured creditor may be given beneficial ownership of the interest in the LLC and control over the real estate asset. The court could appoint an agent for the benefit of the creditor to hold the interest in the LLC (aka "reorganized debtor") and manage and operate the real estate asset until it may be sold. Pursuant to this legal form, the creditor's loan has not been discharged and instead remains a claim over the reorganized debtor's assets. For tax purposes, a determination must be made as to whether to regard the form of the confirmed plan or its substance (which may or may not be different). On the one hand, the debt has not been discharged and is expected to be resolved when the agent sells the asset to a third party buyer (the debt could be partially repaid and the deficiency waived, or a buyer could assume the debt, which probably would be modified to bring the balance of the loan in-line with the asset's purchase

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[226] See §108(e)(10) (modification), (e)(4) (acquisition by related party), and (e)(6) and (8) (contribution of shareholder debt of a corporation and debt for equity exchange, respectively).
[227] The author's experience is based on his role as a tax practitioner and no opinions are expressed herein with respect to federal, state or local law.
[228] Refer to *Exhibit IV*.

price).[229] On the other hand, the reorganized debtor has no "equity" value, is beneficially owned by the creditor, and possibly remains a DRE. From this perspective, arguably the tax consequence is the same as a foreclosure by the creditor of the collateral.[230]

For individual and corporate taxpayers, including a REIT, the bankruptcy exception is available in the case where such taxpayer is a debtor in a title 11 case. Under section 108(a)(1)(A), the taxpayer is required to exclude from gross income the full amount of any COD income otherwise realized. The bankruptcy exception takes precedence over any other exception under section 108(a).[231] The tax cost of the exclusion from gross income is the requirement to reduce dollar for dollar[232] certain specified tax attributes of the taxpayer (such as an NOL, tax credits, capital loss carryover, tax basis, passive activity losses, and foreign tax credits).[233]

B. Insolvency and Real Estate Exception

In addition to the bankruptcy exception, there are exceptions for debt of insolvent taxpayers under section 108(a)(1)(B) and "qualified real property business indebtedness" ("QRPBI") under section 108(a)(1)(D).[234] The exception for QRPBI is not available to subchapter C corporations, including REITs.[235] Among these two exceptions the insolvency exception takes precedence over the QRPBI exception. In either case, the amount of the exclusion may not exceed the amount of the taxpayer's insolvency.[236] The QRPBI has another limitation or ceiling, which is that the amount excluded may not exceed the adjusted basis of depreciable property held by the taxpayer immediately before the discharge. Note that any attempt to purchase additional depreciable real property ahead of the discharge to ameliorate the QRPBI basis limitation is ignored.[237]

1. Measuring Insolvency

The term "insolvent" for purposes of section 108 means the excess of liabilities over the fair market value of assets.[238] The determination and the extent of insolvency is determined on the basis of the taxpayer's assets and liabilities immediately before the discharge, so as to not allow the taxpayer to "free up" equity in the encumbered property without immediate tax cost.[239] Insolvency for purposes of the QRPBI exception is defined in terms of qualifying "real property business indebtedness" and fair market value of qualifying

[229] Consider that regulation section 1.1001-3(f)(7) allows the parties to ignore the distressed economic position of the debtor for purposes of determining whether a modified debt is debt for tax purposes.
[230] Consider such authorities as *Estate of Franklin v. Comm'r*, 544 F.2d at 1045 (9th Cir. 1976), and *Grodt & McKay v. Comm'r*, 77 T.C. 1221 (1981), to determine whether the creditor is the tax owner of the real estate asset. See also a related discussion in section *VII.A.ii Worthlessness* on deduction of loss under section 165 on account of property being "worthless."
[231] §108(a)(2)(A).
[232] §108(b)(3)(A), and §108(b)(3)(B) (one-third of each dollar for a credit).
[233] See §108(b) generally and for the specified ordering of the reduction to attributions and an election to reduce tax basis first. See also §1017 for rules pertaining to reductions in tax basis.
[234] Additionally, under section 108(a), there are exceptions for "qualified farm indebtedness" and "qualified principal residence indebtedness" discharged before 2026. §108(a)(1)(C) and (E), respectively.
[235] §§108(a)(1)(D), 1361 (defining "C corporation" for purposes of the Code as "a corporation which is not an S corporation").
[236] §108(a)(3) and (c)(2)(A) (in the case of QRPBI, the exclusion generally is limited to the excess of outstanding principal amount immediately before the discharge over the fair market value of the real property securing the debt, i.e., the exclusion does not include a reduction in debt that frees up equity in the property).
[237] §108(c)(2)(B) (depreciable real property acquired in contemplation of the discharge is ignored).
[238] §108(d)(3).
[239] *Id*.

"real property used in a trade or business."[240] The limitation is reduced by the amount of any other qualifying debt that is secured by such property, i.e., there is no double counting of the collateral.

There are two helpful forms of guidance with respect to insolvency calculations. The first is Rev. Rul. 92-53, and the second is Rev. Rul. 2012-14 which is partnership specific guidance.

With respect to nonrecourse debt, a taxpayer generally is not personally liable for the amount of nonrecourse debt that is in excess of the property securing the debt. With a view aligning the insolvency limitation to "fresh start" policy, the IRS in Rev. Rul. 92-53 expanded the definition of insolvency under section 108(d)(3) to nonrecourse debt that is in excess of the fair market value of the property securing the debt, but only to the extent such excess nonrecourse debt is discharged. Rev. Rul. 2012-14 builds on the earlier ruling by applying the excess nonrecourse debt exception to a partner's share of partnership nonrecourse debt.[241] The ruling provides that a partnership's discharged excess nonrecourse debt is treated as a liability of the partners for purposes of measuring the partners' insolvency under section 108(d)(3) based upon how the COD income with respect to that portion of the debt is allocated among the partners.[242]

For example, assume a creditor cancels $175,000 of the partnership's $200,000 excess nonrecourse debt, generating $175,000 of COD income to the partnership. The partnership is owned 50:50 in all respects by X and Y. The $175,000 of COD income is allocated equally between X and Y. For purposes of measuring the insolvency of the partners, the partnership's discharged excess nonrecourse debt is treated as a liability of its partners based upon the COD income allocation. Thus, X treats $87,500 of the partnership's debt as a liability of X, and Y treats $87,500 of the partnership's debt as a liability of Y. X and Y treat their shares of the cancelled partnership excess nonrecourse debt as their own liabilities in determining whether, and to what extent, each is insolvent within the meaning of section 108(d)(3).

2. Qualified Real Property Business Indebtedness

To qualify as QRPBI, section 108(c)(3) requires that the indebtedness must be incurred or assumed by the taxpayer in connection with real property used in a trade or business[243] and be secured by such real property. The taxpayer must make an election to treat the indebtedness as QRPBI.[244] Section 108(c)(3)(B) requires the debt must be "qualified acquisition indebtedness."[245] Section 108(c)(3) also provides that indebtedness under section 108(c)(3)(B) includes indebtedness resulting from the refinancing of indebtedness under section 108(c)(3)(B), but only to the extent it does not exceed the amount of indebtedness being refinanced.[246] Section 108(c)(4) defines "qualified acquisition indebtedness" as indebtedness incurred or

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240 §108(c)(2)(A).

241 Rev. Rul. 2012-14 (According to the IRS, in order to properly apply Rev. Rul. 92-53 in a partnership context, "the partnership's discharged excess nonrecourse debt should be associated with the partner who in the absence of the insolvency or other section 108 exclusion would be required to pay the tax liability arising from the discharge of that debt.")

242 That is, allocations under section 704(b) and the regulations thereunder. See Rev. Rul. 99-43, 1999-2 C.B. 506, and Rev. Rul. 92-97 regarding the application of section 704(b) to such allocations.

243 While development and construction of for-sale property may be a trade or business, such property may not be considered as "used" in the trade or business of the taxpayer. See. Rev. Rul. 2016-15; *cf.* Rubin & Whiteway, "Rev. Rul. 2016-15 Holds Real Estate Dealers Cannot Exclude Cancellation of Indebtedness Income, But Is It Correct?," PLI Course Handbook, 19th Annual Real Estate Tax Forum (2017).

244 The election is made by filing Form 982 to report the amount of the excluded COD income of the taxpayer.

245 QRPBI must be indebtedness that was incurred or assumed before January 1, 1993, or if the indebtedness was incurred or assumed on or after January 1, 1993, it must be qualified acquisition indebtedness. §108(c)(3)(B).

246 §108(c)(3) (flush language). The IRS acknowledged in PLR 200953005 that a portion of a refinancing may not qualify as qualified acquisition indebtedness. Under the facts of the ruling, the taxpayer refinanced prior qualified acquisition debt and distributed some of the proceeds of the new debt to the owners. In the absence of guidance on apportionment of the debt as qualifying for this purpose, the IRS required that the taxpayer use a "reasonable allocation method."

assumed to “acquire, construct, reconstruct, or substantially improve real property used in a trade or business.”

Neither the statute nor the legislative history contains any explanation of or definition for the term “secured by such real property” for purposes of section 108(c)(3)(A). Mortgage loans are commonly used by lenders to secure an interest in real estate. The legislative history does not suggest, however, that mortgages are the exclusive form of security for section 108(c)(3)(A).[247]

In this respect, the IRS provided a helpful safe-harbor to debtors with respect to certain distressed mezzanine debt indirectly secured by qualifying real property, commonly seen in real estate debt workouts. In Rev. Proc. 2014-20, the IRS will, under certain, defined circumstances set forth below, treat indebtedness that is secured by 100 percent of the ownership interests in a DRE that holds real property as indebtedness that is “secured by real property” for purposes of QRPBI exception.

The ruling’s safe-harbor applies to the discharge of indebtedness of the taxpayer provided:[248]

- “The taxpayer or a wholly owned disregarded entity of the taxpayer (the “Borrower”) incurs indebtedness;
- The Borrower directly or indirectly owns 100% of the ownership interest in a separate disregarded entity owning real property (the “Property Owner”). Borrower is not the same entity as the Property Owner;
- Borrower pledges to the lender a first priority security interest in the Borrower’s ownership interest in the Property Owner. Any further encumbrance on the pledged ownership interest must be subordinate to the lender's security interest in the Property Owner;
- At least 90 percent of the fair market value of the total assets (immediately before the discharge) directly owned by the Property Owner must be real property used in a trade or business and any other assets held by the Property Owner must be incidental to Property Owner’s acquisition, ownership, and operation of the real property; and
- Upon default and foreclosure on the indebtedness, the lender will replace the Borrower as the sole member of the Property Owner.”

3. Basis Reduction

A few observations about attribute reduction involving real estate in view of the section 108 exceptions discussed herein. Under the bankruptcy and insolvency exceptions, any amount of COD income excluded under the exceptions results in a reduction in certain specified attributes of the taxpayer, to which the general ordering rules of section 108(b) apply.[249] For the amount of COD income excluded under the QRPBI exception, depreciable real property is required to be reduced (no other attributes are allowed to be reduced).[250]

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[247] See H.R. Rep. No. 103-111 (1993), 1993-3 C.B. 167, 622-625. The fact that the statutory language does not limit the section 108 security interest to a mortgage indicates an intent to include a broader range of security interests, according to the IRS. Rev. Proc. 2014-20, §2.08.
[248] Rev. Proc. 2014-20, §3.03. If a taxpayer does not meet the requirements of the safe harbor, the taxpayer is not precluded from arguing, based on facts and circumstances, that its debt satisfies the “secured by” requirement of §108(c)(3)(A). *Id*. at §3.04.
[249] Refer to *Exhibit VI* for a summary that compares and contrasts the different rules for attribute reduction that can apply to real estate.
[250] §108(c)(1).

The rules under section 1017 apply for purposes of determining reductions in basis of the taxpayer.[251] Under section 108(b)(5), there is an election to first reduce depreciable basis. Under this election, the basis may not exceed the basis held by the taxpayer at the beginning of the taxable year following the year of the discharge.[252]

Under section 1017, all basis reductions are applied to basis held at the beginning of the following year are made in the following order:[253]

1. Trade or business or investment ("TOBI") real property that secured the discharged debt
2. TOBI or investment personal property that secured the discharged debt
3. Other TOBI property
4. Inventory and section 1221(a)(1) property, accounts and notes receivable
5. Non-TOBI property

If a section 108(b)(5) election is made, the reduction is only to depreciable property in categories 1-3, and if with respect to an amount of QRPBI, the reduction is only to depreciable real property in categories 1-3 and must be applied to the basis of the qualified real property that secured the discharged debt before any other real property.[254] However, the basis reduction must be made immediately before the disposition of any depreciable real property if the disposition is before the beginning of the following year.[255] These rules can make it problematic if COD income is realized before or at the same time as gain is realized on account of the required basis reduction to the qualified real property securing the reduced or discharged debt.

For BK and insolvency reductions, basis may not be reduced below the amount of liabilities after the discharge.[256] This limitation does not apply if the section 108(b)(5) election is made, however.

For purposes of basis reduction under section 1017, a partner must treat a distributive share of a partnership's COD income as attributable to a discharged indebtedness secured by the taxpayer's interest in that partnership.[257] Moreover, a partner's interest in a partnership is treated as depreciable property to the extent of the partner's share of depreciable property (a reduction to the partnership's basis in such property is required).[258] There is an equivalent rule for stock of a consolidated subsidiary.[259] There are some mandatory / consent rules about reductions in partnership property.[260]

A section 1017(b)(3)(E) election may be made to treat section 1221(a)(1) property as depreciable. This election is not allowed for QRPBI's reductions.[261] Under a general recapture rule, section 1017 basis reductions are recaptured as section 1245 ordinary income (i.e., a basis reduction to section 1231 property that would otherwise result in capital gain is recaptured as ordinary income).[262]

[251] §108(b)(2)(E)(i).
[252] §108(b)(5)(B).
[253] Reg. §1.1017-1(a).
[254] Reg. §1.1017-1(c).
[255] §1017(b)(3)(F).
[256] Reg. §1.1017-1(b)(3).
[257] Reg. §1.1017-1(g)(1).
[258] Reg. §1.1017-1(g)(2)(i).
[259] §1017(b)(3)(D).
[260] Reg. §1.1017-1(g)(2)(ii)-(iii).
[261] §1017(b)(3)(F).
[262] §1017(d).

VI. Equity for Debt Exchanges

A. Stock for Debt

In the case of a shareholder's contribution of debt of the corporation to capital,[263] section 108(e)(6) generally applies and provides that the amount of COD income recognized by the corporation is the excess of the adjusted issue price of the debt at the time of the contribution over the shareholder's basis in the debt.[264] The exception applies only if the creditor is already a shareholder and it does not matter whether the corporation is insolvent or bankrupt.[265] For example, assume a shareholder makes a loan to the corporation of $1,000 in year 1, and in year 3 the shareholder transfers the loan to the corporation in a valid contribution to capital at a time when the balance of the loan is $1,200 inclusive of accrued and unpaid interest (the adjusted issue price). Assuming the shareholder is an accrual basis taxpayer, the shareholder's basis in the loan is also $1,200. Since the adjusted issue price of the loan and the shareholder's basis are the same, there is no COD income.

The math is different in the case of a non-shareholder creditor's exchange of debt of a corporation for its stock.[266] In this case, section 108(e)(8)(A) provides that if stock is issued to a creditor in satisfaction of its recourse or nonrecourse debt (i.e., an exchange), the corporation is treated as satisfying the debt with an amount of money equal to the fair market value of the stock. Section 108(e)(6) instead contemplates a "contribution to capital," not an exchange. In PLR 9830002, a debtor corporation that issued stock to three creditors in satisfaction of its indebtedness recognized COD income under section 108(e)(8) to the extent that the outstanding debt exceeded the stock's fair market value. The IRS concluded that section 108(e)(6) was not applicable to the transactions because a "contribution to capital" does not encompass a transaction in which the corporation issues consideration in return for the contribution. It did not matter that the corporate creditors were direct and indirect owners of the debtor corporation; instead, the IRS was persuaded by the legal relationships of the creditors changing with respect to debtor by the issuance of stock.

With respect to a shareholder's indebtedness that is cancelled by the corporation, regulation section 1.301-1(k) provides that the corporation's cancellation of the indebtedness is treated as a distribution property of the shareholder (provided the indebtedness has value). The IRS in Rev. Rul. 2004-79 addressed the federal income tax consequences of a distribution by a subsidiary corporation to its parent of parent-indebtedness that the subsidiary previously purchased from a party unrelated to the parent. The ruling provides that such distribution is a dividend to the parent corporation equal to the fair market value of the distributed indebtedness to the extent of the distributing corporation's earnings and profits in the year of the distribution is at least equal to the fair market value of the distributed indebtedness. Additionally, the parent corporation generally realizes COD income to the extent the fair market value of the indebtedness is less than its adjusted issue price (or a deduction to the extent the fair market value of the indebtedness is greater than its adjusted issue price). Said another way, the parent corporation is buying back its debt at fair market value. Lastly, the distribution of the indebtedness by the subsidiary corporation is subject to section 311(b) which

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[263] A qualifying "contribution to capital" is a facts and circumstances test.

[264] §108(e)(6) (such corporation shall be treated as having satisfied the indebtedness with an amount of money equal to the shareholder's adjusted basis in the indebtedness). See also Reg. §1.61-12(a) ("if a shareholder in a corporation which is indebted to him gratuitously forgives the debt, the transaction amounts to a contribution to the capital of the corporation to the extent of the principal of the debt").

[265] *Cf.* FSA 199915005 (the IRS took the position that the cancellation is not a contribution to capital except to the extent it makes the subsidiary solvent); *cf.* PLR 200537026 (applying exception to the full contributed loan that had a positive fair market value).

[266] Note also special rules under section 382(l)(5) and (6) with respect to such exchanges involving corporations that are bankrupt or insolvent.

causes gain (fair market value greater than basis in the debt) but not loss (fair market value less than basis) to the distributing corporation.

B. Interest in Partnership for Debt Exchange

By contrast to corporations, section 108 takes a more unified approach to debt-for-equity exchanges of a partnership, making no distinction between partner and non-partner holders of the partnership's debt; that is, there is no analog to section 108(e)(6).

Section 108(e)(8)(B) treats the partnership as having satisfied its recourse or nonrecourse indebtedness with an amount of money equal to the fair market value of the partnership interest transferred to the creditor. Accordingly, the partnership's COD income is the amount by which the debt exceeds the fair market value[267] of the partnership interest transferred to the creditor.[268] Any resulting COD income is required to be allocated solely to the partners that were partners in the partnership immediately before the discharge.[269]

The applicable regulations take the approach that the exchange is a contribution of the debt to the partnership in exchange for an interest in the partnership, to which section 721 applies.[270] The result is that the partnership does not recognize any gain or loss from the transfer of an interest to the creditor and the creditor generally does not realize any gain or loss.[271] Section 721, however, does not apply to the extent the transfer of the partnership interest to the creditor is in exchange for the partnership's indebtedness for unpaid rent, royalties, or interest (including accrued OID) that accrued on or after the beginning of the creditor's holding period for the indebtedness.[272] This exception does not apply to cause the partnership to recognize any income, gain, or loss.[273]

C. Exchange of Debt for an Interest in a DRE

COD income can be avoided in certain debt for equity exchanges in a DRE. The model for addressing the federal income tax treatment of the transaction is provided in Rev. Rul. 99-5, which describes the federal income tax consequences of an LLC DRE becoming a partnership.

Under *Situation 1* of the ruling, a LLC that was a DRE was converted to a partnership when a new member, B, purchased an interest in the LLC from its sole owner, A, for cash that was retained by A. The IRS concluded that B's purchase of 50% of A's ownership interest in the LLC was treated as the purchase of a 50% interest in each of the LLC's assets, which had been treated as held directly by A for tax purposes. Moreover, A was characterized as recognizing gain or loss under section 1001 from the sale or other disposition of property to B. Immediately thereafter, A and B were treated as contributing their respective interests in those assets to a partnership in exchange for ownership interests in the partnership.

In Situation 2 of the ruling, B instead made a contribution of cash to the LLC for its interest in the LLC, i.e., the LLC retained the cash for its business. Because the cash is transferred to the LLC instead of A, the IRS concluded that each of A and B contributed the LLC's assets and cash, respectively, pursuant to section 721 to a newly formed partnership in which A and B were issued interests.

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[267] Reg. §1.108-8(b)(1) (facts and circumstances determination required for fair market value; "liquidation value" safe harbor, which if met is deemed to equal fair market value).
[268] §108(e)(8)(B).
[269] §108(e)(8) (flush language). COD income arising from a discharge of a partnership or partner nonrecourse indebtedness is treated as a first-tier item for minimum gain chargeback purposes under regulation section 1.704–2. T.D. 9557; Reg. §1.704-2(f) and (j).
[270] T.D. 9557; Reg. §1.721-1(d)(1).
[271] Reg. §1.721-1(d)(1).
[272] Reg. §1.721-1(d)(1)(2). The regulation contemplates that a creditor could have purchased the debt from a previous holder who accrued interest prior to the existing creditor's holding period.
[273] Reg. §1.721-1(d)(2).

Although the Rev. Rul. 99-5 did not address any outstanding debt, the logic of the ruling could be applied to the following, albeit simple, workout example.[274] Assume, at a time when the LLC's assets are worth less than its nonrecourse debt (and consequently the LLC is in technical default on its debt because of the high loan-to-value ratio), the creditor agrees to acquire an interest in the LLC in exchange for contributing the debt to the LLC. Assume further that A agrees to contribute cash to the LLC in exchange for the debt's modification, and that the proportionate ownership of the LLC becomes 50:50.

According to the form of the workout example, instead of cash being contributed to the LLC for an interest, the LLC's debt is forgiven by the creditor for the interest – which, at some level, is in line with Situation 2's facts. For tax purposes, however, the LLC's nonrecourse debt would appear to not become debt of the newly formed partnership. Indeed, section 752(c)[275] would deny the assumption of A's nonrecourse debt because the amount of the debt is in excess of the fair market value of the LLC's assets. Moreover, section 108(e)(8) would not apply to the LLC's debt – at least not to cause any CODI to the partnership – since the debt is never debt of, or issued by, a partnership. Moreover, regulation section 1.1001-2(a)(1) would provide that, since A is a transferor of the LLC's assets subject to nonrecourse debt, the full amount of the debt is included in A's amount realized, i.e., for tax purposes, A benefits from the cancellation of the LLC's debt by the creditor. In view of the foregoing, the workout example also aligns closely with Situation 1, causing A to recognize gain or loss under section 1001.[276]

To close the loop with respect to a Situation 1 characterization of the workout example, it is at least clear that A is contributing cash to the newly formed partnership.[277] Given the insolvent position of the LLC (before taking into account the increase in the LLC's assets caused by A's contribution of cash[278]), it is at least possible to view the creditor as (i) discharging the full amount of the LLC's debt for an equity interest in the LLC that equals the fair market value of the LLC's unencumbered assets or (ii) first reducing the LLC's debt to an amount equal to the fair market value of the LLC's unencumbered assets so that for purposes of section 752(c) the debt may be assumed by the newly formed partnership, followed by a discharge of the remaining balance of the debt for an equity interest in the LLC equal to the second discharge amount.[279] The former of the two arguably is more likely since in substance there was no such bifurcation under the facts of the example.[280] See *section III.C. (Example II)* for an additional workout example.

[274] See Gall and Wang, "The Mysterious Case of Disappearing Debt in Partnership Transactions," 90 Taxes 3 at n.112 (March 2012) for an application of Rev. Rul. 99-5 to an example where the LLC's debt is not underwater.

[275] Section 752(c) provides that, for the purposes of section 752, a liability to which property is subject shall, to the extent of the fair market value of such property, be considered as a liability of the owner of the property. In other words, the partnership is deemed to not assume nonrecourse debt in excess of the fair market value of the collateral contributed to the partnership. See also *Estate of Franklin v. Comm'r*, 64 T.C. 752 (1975), *aff'd*, 544 F.2d 1045 (9th Cir. 1976).

[276] Furthermore, the transfer by A of assets to the newly formed partnership in conjunction with the release of by the creditor of its lien on the transferred assets (a "short sale" of sorts) is in keeping with the Ninth Circuit's integrated approach in *2925 Briarpark Ltd.* to transactions that are the function equivalent of a foreclosure.

[277] Although Situation 1's facts did not include a contribution by A of any new assets that were not held by the LLC.

[278] Commercially, A is not inclined to contribute cash to an insolvent LLC since A has no personal liability for the LLC's debt in this example.

[279] No COD income under section 108(e)(8)(A) since the fair market value of the interest issued by the newly formed partnership is equal to the amount of the partnership's debt that was discharged.

[280] For further commentary, see Friedline, *Debt for Equity Exchange of a Disregarded Entity*, Real Estate Taxation at 52-59 (Thomson Reuters 1st Qtr. 2012).

VII. Loss Deductions

A. Loss on Transfer of Real Estate

As a baseline, merely entering into a written contract to sell property does not result in a sale for tax purposes. A sale occurs on the earlier of the transfer of title or the lapse of any and all material conditions precedent expressed in the contract or under local law.[281] Merely agreeing to transfer property is not enough.[282] Moreover, certain transfers, even in-form, can be viewed as falling short of an effective transfer for tax purposes. In *Sage v. Commissioner*,[283] a transfer of properties to liquidating trusts for the benefit of lenders, where the transferor remained liable for the loans secured by the trusts and the properties transferred to the trusts were to be used to satisfy the transferor's legal obligations, was held to not result in realization of a loss. The court reasoned that the transferor and the trusts were not separate taxable entities and concluded that the liquidating trusts were grantor trusts. Because the transferor still owned the trusts beyond the close of the alleged loss year, the losses reported by the transferor for that year were not "evidenced by closed and completed transactions, fixed by identifiable events, and ... actually sustained during"[284] that year.

Determining the precise timing of a loss deduction from a purported transfer of property can be fraught with uncertainty, and a full grasp of the surrounding facts and circumstances is a must. Section 165, generally, allows for the deduction of a loss that is *sustained during the taxable year*.[285] Regulation section 1.165-1(b) provides further that, for a loss to be deductible, it must be evidenced by "closed and completed transactions,"[286] fixed by "identifiable events" and "actually sustained." Conversely, the mere fluctuation in value of property is insufficient to substantiate the loss deduction.[287] Thus, for instance, a loss deduction generally does not arise when the value of real estate collateral falls below the amount of nonrecourse indebtedness secured by such property.

As discussed *supra*, a loss may be recognized by a debtor from virtually any type of transfer of real estate in satisfaction of indebtedness.[288] *When*, however, is such transfer effective for purposes of sections 1001 and 165? The answer is largely driven by the surrounding facts and circumstances and the nature of the transfer.

As background, the transfer of distressed real estate collateral can take a variety of forms – both involuntary and voluntary. In terms of involuntary transfers, a "strict foreclosure" (in the states that allow it) is generally

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[281] *Merrill v. Comm'r*, 40 T.C. 66 (1963), *aff'd,* 336 F.2d 771 (9th Cir. 1964); *Kindschi v. Comm'r*, T.C. Memo. 1979-489; Rev. Rul. 69-93 (sale occurs at the time the deed passes or at the time possession and the burdens and benefits of ownership are, from a practical standpoint, transferred to the buyer, not when the sale contract is signed). See also FSA 1993-698.
[282] See, e.g., TAM 9510002 (payment for merely agreeing to enter into a partnership and transfer property to the partnership was not a payment for the transfer of the property).
[283] *Sage v. Comm'r*, 154 T.C. No. 12 (2020).
[284] See Reg. §1.165-1(b) (guidance with respect to nature of losses allowable as deductions under section 165).
[285] §165(a) (emphasis added). The basis for purposes of determining the amount of the loss is the same as the adjusted basis under section 1011 used for determining the amount of loss from the sale or other disposition of property. §165(b).
[286] The "closed and completed transactions" do not have to occur with respect to the owner of the real estate. For example, they may be manifested by a partner of the partnership that owns the real estate. See *Echols v. Comm'r*, 950 F.2d 209 (5th Cir. 1991).
[287] *United States v. S.S. White Dental Mfg. Co.*, 274 U.S. 398, 401 (1927). See also *Pugh v. Comm'r*, 17 B.T.A. 429 (1929), *acq.*, 1931 C.B. 53, *aff'd*, 49 F.2d 76 (5th Cir. 1931); *Hudspeth v. United States*, 519 F.2d 1055 (5th Cir. 1975); *cf.* §1256 for an exception for mark to market.
[288] §1001 (emphasis added), *Helvering v. Hammel*, 311 U.S. 504, 506-511 (1941) (foreclosure sale constitutes a disposition); *Chilingirian v. Comm'r*, 918 F.2d 1251, 1253 (6th Cir. 1990) (nonjudicial foreclosure sale); and *Allan v. Comm'r*, 856 F.2d 1169, 1172 (8th Cir. 1988) (deed in lieu transfer).

understood to be a court-ordered transfer of ownership of real estate collateral to the creditor; in contrast to an auction-sale of the real estate which is generally open to bids from third-party buyers and the creditor. Depending on the applicable state law and/or contractual arrangement, a foreclosure-sale of the real estate may be court ordered (judicial foreclosure) or the creditor may sell the real estate without court involvement (non-judicial). A court order compelling a foreclosure-sale of property does not fix the loss for purposes of section 165, but instead the loss is fixed for such purpose only when the foreclosure sale is considered final.[289] Some states allow for a right of redemption for a period following a foreclosure sale. In Rev. Rul. 70-63, the IRS stated that there is not an identifiable event until the redemption right has expired. The redemption date, however, arguably should be ignored if it is considered worthless (i.e., redemption price significantly exceeds the value of the property). Additional certainty with respect to fixing the time of the loss in this context could be obtained if the taxpayer took steps to release its equitable interest in the property to the buyer or by abandoning the property to the buyer.

The creditor with respect to a mezzanine loan, holding a pledge of all the interests of a mortgage borrower, may perfect and foreclose on its interest in the pledged collateral via a non-judicial UCC process that may take as little as 30-60 days.[290]-To ascertain the effective date of these transfers for purposes of establishing the date on which a loss was sustained by the debtor-taxpayer, a careful review of the decree or other documents is required, as often there are redemption periods and other remedies and conditions to which the transfer may be subject.

In terms of voluntary transfers, a transfer of the real estate to the creditor may be made voluntarily via a transfer of the deed to the creditor in-lieu of a foreclosure (aka a "deed in-lieu"). With a mezzanine loan, the transfer of the membership interests in the LLC borrower is the equivalent of a deed in-lieu of foreclosure. The effectiveness of voluntary types of transfers such as these, for purposes of ascertaining loss, may be determined by examining the terms and conditions of the governing agreements effectuating the transfer and noting when the deed is properly executed and recorded.

1. Abandonment

A taxpayer may abandon distressed property[291] to effectuate a "closed and completed" transaction for purposes of section 165. The abandoned property could include encumbered real estate or an interest in a partnership[292] or DRE owning the same. To establish abandonment of the property, a taxpayer must demonstrate an intent to abandon and take overt action to abandon the property.[293] For instance, the halting of construction of a building that was never resumed and did not reach the stage of construction of anything reasonably usable as a permanent improvement was found to be consistent with abandonment at the time of the liquidation of the corporation for which the building was intended.[294] Unpaid property taxes in excess of the property's fair market value can be considered behavior consistent with an intent to abandon the

[289] *Helvering v. Hammel*, 311 U.S. 504, 506-11 (1941).
[290] Collins, "Mezzanine Real Estate Loan Foreclosures: What is Commercially Reasonable During an Emergency?," Brook. J. Corp. Fin. & Com. L., Vol. 16, Issue 2, Article 5, at 194 (Jun. 2022). See also Stein, "Borrower Should Beware of Fast Foreclosures For Mezzanine Loans, Forbes" (Mar. 16, 2022), https://www.forbes.com/sites/joshuastein/2020/06/29/fast-foreclosures-for-mezzanine-loans--borrower-beware/.
[291] Or in the event the taxpayer's property becomes "worthless."
[292] See discussion of Rev. Rul. 93-80 (IRS analysis of abandonment and worthless partnership interests) in section *VII.B. Character*.
[293] *CRST, Inc. v. Comm'r*, 92 T.C. 1249 (1989), *aff'd*, 909 F.2d 1146 (8th Cir. 1990); *Dezendorf v. Comm'r*, T.C. Memo. 1961-280, *aff'd*, 312 F.2d 95 (5th Cir. 1963).
[294] *Hummell v. Comm'r*, 227 F. Supp. 30 (N.D. Cal. 1963).

property.[295] Certain acts are considered inconsistent with an effective abandonment, such as continuing to depreciate the distressed property[296] or continuing efforts to sell the distressed property.[297]

2. Worthlessness

Unlike abandonment, which requires an overt act by the taxpayer, the timing of "worthlessness" (another path to section 165) is largely "a judgment call" by a taxpayer.[298] A "closed and completed transaction" can include the date on which property has been determined to have become worthless. For this purpose, "worthlessness" occurs when in fact the property in question has no value.[299] This condition at first blush might seem impossible to achieve for property such as real estate which tends to always have value.

In *Echols*, the Fifth Circuit found the taxpayer's argument in support of a loss deduction on account of worthlessness as compelling as the abandonment of his interest in the partnership.[300] The asset being tested for worthlessness was the taxpayer's limited partner interest in a partnership that held unimproved real estate that had a value below the amount of the partnership's nonrecourse debt. The land was foreclosed upon in the taxable year subsequent to the taxable year in which the section 165 loss was deducted by the taxpayer.

The court found the following facts persuasive:

> [T]he Taxpayers manifested their subjective determination that their 75% interest in the Partnership had become worthless in that year. But they had also manifested their subjective determination of worthlessness contemporaneously when, at the Partnership meeting in 1976, Echols acknowledged - as found by the tax court - that (1) the Partnership's only asset was real estate with a fair market value less than the remaining balance on the non-recourse mortgage which encumbered it; (2) the Partnership's only independent source of income with which to service the non-recourse mortgage and pay ad valorem taxes had evaporated; and (3) Taxpayers declared that they would contribute no more funds to the Partnership to keep it afloat.[301]

The court observed that the worthlessness determination was not diminished by other investors "out there" who might have made a different determination or had their own "crystal ball."[302] Unlike abandonment, the timing of worthlessness is largely "a judgment call by a taxpayer based on his own particular, highly personal set of economic factors, including tax effects."[303] It is not determinative that the asset in question may have become "virtually valueless in a prior year, or that the value may have been restored unexpectedly

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[295] *Intercounty Operating Corp. v. Comm'r*, 4 T.C. 55, 58 (1944), *acq.*, 1944 C.B. 15; *Kahn v. Comm'r*, 44 B.T.A. 84, 88 (1941). However, the courts have had mixed views on this fact. See *Hopkins v. Comm'r*, 15 T.C. 160, 173 (1950), *acq.*, 1951-1 C.B. 2 ("Mere inaction when declining market values and increasing tax arrearages point toward worthlessness will not suffice.").

[296] *Lattimore v. United States*, 12 F. Supp. 895, 910 (Ct. Cl. 1935).

[297] *Golden Gate Disposal Co. v. Comm'r*, T.C. Memo. 1979-199, *aff'd*, 642 F.2d 455 (9th Cir. 1981); *Tucker v. Comm'r*, T.C. Memo. 2015-185, *aff'd*, 841 F.3d 1241 (11th Cir. 2016) (loss properties not abandoned or worthless because even after business's alleged dissolution, it continued to develop and sell allegedly worthless properties).

[298] *Echols v. Comm'r*, 935 F.2d 703 (5th Cir. 1991) (Tax Court failed to address the issue of worthlessness under section 165).

[299] *Laport v. Comm'r*, 671 F.2d 1028 (7th Cir. 1982); *Boehm v. Comm'r*, 326 U.S. 287 (1945).

[300] *Echols v. Comm'r*, 935 F.2d 703 (5th Cir. 1991) (Tax Court failed to address the issue of worthlessness under section 165).

[301] *Echols,* 935 F.2d at 707-08.

[302] *Id.* at 708.

[303] *Id*.

after being deemed worthless by the taxpayer."[304] The taxpayers were able to prove that the asset in question was in fact essentially worthless.[305]

By way of background, a determination of worthlessness under section 165 requires a subjective determination by the taxpayer that the property became worthless during the taxable year and the presence of objective factors reflecting a completed transaction and/or an identifiable event during such year.[306] For purposes of establishing subjectively that a loss for worthlessness has been incurred, a "write-off" in the financial statements of the entity that owns the property or interest of an entity that owns the property probably is not sufficient.[307] However, a taxpayer does not have to wait until an actual or deemed disposition of the property or interest in property to deduct the loss.[308]

To be entitled to a deduction for worthlessness, a taxpayer must demonstrate "his subjective determination of worthlessness in a given year, coupled with a showing that in such year the asset in question is in fact essentially valueless."[309] The taxpayer does not have to prove that a given asset is "absolutely, positively without any value whatsoever."[310] That said, the mere decline is not sufficient to establish a loss.[311]

In this area, the IRS has the advantage of hindsight and often asserts that a loss was incurred in a different taxable year than was reported by the taxpayer.[312] If the IRS is successful in its assertion, it may be difficult to impossible for the taxpayer to claim the loss if the applicable statute of limitations[313] for the year in question has run.[314] *Tejon Ranch v. Commissioner*[315] involved a dispute over the timing of a section 165 loss with respect to a partnership interest.

In *Tejon Ranch*, the taxpayer argued that its partner loans and partnership interest became worthless during 1977. Relying on section 165(a) for the proposition that the "loss must be evidenced by closed and completed transactions, fixed by identifiable events, which show the year in which such a loss was sustained," the Tax Court concluded that, although the partnership was in financial difficulty by the end of 1977, the loans had not yet become worthless. In so holding, the court noted that the partnership had not defaulted on its loans and there was "some possibility that [the partnership] could secure additional financing" to fund its operations, as well the partnership began selling its assets to raise cash. In the court's view, there had not been an identifiable event to "justify abandonment of any hope of recovery." Instead, the court held that the loans and the partnership interest became worthless in 1978 when the partnership exhausted its operating funds and the primary unrelated lender was considering foreclosing on the partnership's assets and ceased control of the partnership and restructured the partnership's debt. These were held to be identifiable events that demonstrated worthlessness in 1978; instead of earlier, as reported by the taxpayer.

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304 *Id*.
305 According to the facts, the "local opposition stalled plans for construction of the new highway, and the real estate market in the Houston area was in a 'slump,' so the partnership was unable to sell the land." *Id.* at 708.
306 *Id.* at 703.
307 *Cf*. FAA 20123002F where a contra account was held to be sufficient to establish a "charge off" for purposes of sustaining a partial bad debt deduction under section 166.
308 *DeLoss v. Comm'r*, 28 F.2d 803 (2d Cir. 1928).
309 *Hunter v. Comm'r*, T.C. Memo. 2015-185; *Echols v. Comm'r*, 935 F.2d at 708.
310 *Id*.
311 *Hunter v. Comm'r*, at *supra* n. 306; *Proesel*, 77 T.C. at 1006.
312 See, e.g., *Boehm v. Comm'r*, 326 U.S. 287 (1945).
313 See generally §6501 and Reg. §1.6501(a)-1. See also, §§1311-1314 (relief from certain inequities caused by the statute of limitations that would otherwise prevent equitable adjustment).
314 §1012 (basis in property is adjusted for losses allowed or allowable).
315 *Tejon Ranch Co. v. Comm'r*, T.C. Memo. 1985-207.

A creditor may seize control of real estate collateral by appointment of a receiver to manage, control, and sell the property (as was the case in the facts of *Tejon Ranch*).[316] Depending on the context, the creditor's assertion of such dominion and control over property such as in the case of overindebted real estate can be the "identifiable event" that establishes loss for purposes under section 165 or 166, as the case may be, for the owner and holders of the owner's equity or debt.[317] Under these circumstances, a reasonable question to ask is whether a sale or other disposition of the real estate also may be deemed to occur (e.g., a foreclosure by the creditor), rather just the ascertainment of worthlessness with respect to the encumbered interest in real estate. Apart from being susceptible to answer, the question raises other fair questions.

To illustrate the point, assume a DRE-LLC that owns only one interest in real estate that is subject to a single nonrecourse debt. There are several possible outcomes from a creditor's receivership or other assertion of control over the real estate, including, but not limited to, the following:

- Foreclosure of the real estate by the creditor (via credit-bid)
- Transfer to the creditor of all the equity interests of the DRE
- Foreclosure-sale proceeds going to the creditor
- Foreclosure-sale to a buyer who assumes the existing debt (possibly, as modified).

From the taxpayer's perspective, all of these outcomes are fundamentally the same (gain or loss from sale or other disposition of property, full amount of nonrecourse debt included in the amount realized). A taxpayer sitting on an unrealized loss may be in a rush to deduct it,[318] whereas a taxpayer with unrealized gain will tend to defer the consequence for as long as possible. From the creditor's perspective the outcomes are not all the same: acquisition of the real estate in satisfaction of a nonrecourse debt, cash payment and discharge of the remaining balance, and assumption by the buyer of the debt and possibly a significant modification of the debt in conjunction with the transfer of the real estate. A creditor could be wholly unaware of the taxpayer's tax planning position. Is consistency in reporting required or even possible? Could this situation result in a gap in the tax-ownership of the real estate, i.e., debtor-taxpayer's position that sale or other disposition occurs pre-final resolution of the encumbered real estate and creditor/buyer's position that it acquired the real estate when it placed the property in receivership?

If a creditor has seized control of a taxpayer's DRE-LLC, could the taxpayer claim a deduction for the worthless of its investment (i.e., its equity in the real estate) when there has been no sale or disposition. Assume the taxpayer claims a worthlessness deduction[319] but there has been no sale or other disposition of the real estate (such as an abandonment).[320] Without a sale or other disposition of the real estate, there is not otherwise a discharge of the nonrecourse debt to be included by the taxpayer as an amount realized for purposes of section 1001. Could this position result in the deferral of gain by a taxpayer having a basis in the real estate that is less than the amount of nonrecourse debt, or an increase to the recognized loss where the taxpayer's basis is greater than the nonrecourse debt? Could this position result in a current loss, with gain recognized later when the lender takes the property? Would the taxpayer need to recognize debt relief when it takes a worthlessness deduction, and what would be the character of that debt relief?

Alternatively, could the deemed-discharge doctrine in *Cozzi*[321] apply to the DRE-LLC's nonrecourse debt on account of it being clear the debt will never be repaid (by the taxpayer, at least), and, if so, and would

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[316] Or possibly by petitioning the bankruptcy court to obtain such relief.
[317] See discussion of Rev. Rul. 93-80 and *Echols* at section *VII.B.*
[318] Note that regulation section 1.166-6(b) allows the creditor to take a bad debt deduction at the time the credit makes a credit-bid whether or not the creditor actually is successful in acquiring the real estate at the conclusion of the foreclosure-sale.
[319] Assume other supporting facts, e.g., lack of operating funds, *a la Echols* and *Tejon Ranch*.
[320] See *Echols v. Comm'r*, 935 F.2d 703 (5th Cir. 1991); Rev. Rul. 93-80 (authorities making the distinction between worthlessness and disposition).
[321] See *supra* n. 77.

the taxpayer have COD income or gain or loss on a deemed disposition of the property?[322] At some level, the position would seem to align with the section 165 loss incurred with respect to the worthlessness of the DRE-LLC's over-encumbered real estate. Is *2925 Briarpark, Ltd.* distinguishable based on facts, i.e., there has not been a transfer of the real estate?

Establishing worthlessness, or an abandonment, of real estate subject to a recourse debt can be more challenging. In a case of overindebted real estate subject to recourse debt at the time of the 2007-2008 housing market collapse, the court in *Tucker v. Commissioner*[323] held that abandonment was insufficient to establish a loss. In *Tucker*, an individual whose real estate business collapsed was not entitled to deduct losses for the year at issue because his real estate properties were not completely worthless, had not been abandoned, and had not been foreclosed on. The taxpayer claimed a loss for the 2008 tax year, which preceded the taxable year during which debts were settled and the real estate was transferred. The court held that a section 165 loss is allowed only for losses stemming from "closed and completed transactions." Because the taxpayer's properties were secured by recourse obligations, he was not entitled to a loss deduction until the year of the foreclosure sale. This result applied regardless of whether the property was abandoned or became worthless. To boot, the taxpayer's own expert witness testified that the properties had some value and there was "some demand" for the properties at the end of 2008.

The *Tucker* court, however, observed:

> there is support for [the taxpayer's] contention that market events can sufficiently "fix" a loss such that the deduction may be taken in the year that the loss occurs. See Echols, 935 F.2d at 705-08; Helvering v. Gordon, 134 F.2d 685, 686-89 (4th Cir. 1943); Rhodes v. Comm'r, 100 F.2d 966, 970 (6th Cir. 1939); Denman v. Brumback, 58 F.2d 128, 129 (6th Cir. 1932); Tejon Ranch Co. & Subsidiaries v. Comm'r, 49 T.C.M. (CCH) 1357 (1985); Middleton, 77 T.C. at 320-24. None of these cases, however, involved recourse loans or a nominally defunct business that continued to develop and sell the allegedly worthless asset after its alleged dissolution.[324]

B. Character

By implication, section 165 generally provides that a loss is ordinary absent a sale or exchange of the property.[325] Losses with respect to leased real estate tend to be section 1231 losses which are otherwise ordinary losses,[326] and otherwise available to offset COD income. Same is the case for losses incurred with respect to "dealer" property.[327] However, the character of losses with respect to land held for investment, i.e., a capital asset, depend on whether there has been a sale or exchange at the time of the loss. Capital losses are subject to capital loss limitations under sections 1211 and 1212.[328]

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[322] Rev. Rul. 91-31 (reduction or cancellation of nonrecourse debt results in COD income unless the property is transferred).
[323] *Hunter v. Comm'r*, T.C. Memo. 2015-185.
[324] *Id.*
[325] §165(f). Section 165(f) generally provides that losses from the sale or exchange of a capital asset are otherwise capital losses. Section 165(g) generally treats a loss with respect to worthless stock as a capital loss from a deemed sale or exchange of the stock at the end of the taxable year.
[326] See generally section 1231 and sections 1221(a)(3) and 1231(b) (definition of property used in a trade or business). In the case of intended section 1231 property whose development was abandoned, see *Drew v. Commissioner* for the position that section 1231 status is not lost because the development may not have been able to be completed. *Drew v Comm'r*, T.C. Memo. 1972-40.
[327] §1221(a)(1) (property held for sale in the ordinary course of a trade or business).
[328] Note that there are other loss limitation provisions to consider. Section 165(c) limits an individual's deductible losses to a trade or business or a transaction entered into for a profit, and, if the loss is not connected with either, a loss arising from fire, storm, shipwreck, or other casualty, or from theft. Sections 465 and 469 limits losses with respect

The IRS has considered section 165(f) in the context of a loss from the worthless or abandonment of a partnership interest in Revenue Ruling 93-80.[329] In the ruling, the IRS reasoned that, whether a loss from the abandonment or worthlessness of a partnership interest is capital or ordinary, depends on whether or not the loss results from the sale or exchange of a capital asset.[330] The IRS held that the loss is an ordinary loss if there is not a deemed distribution to the partner under section 752(b) from a decrease of partnership liabilities, and if there is such a deemed distribution the loss is a capital loss.[331] A decrease of partnership liabilities under section 752(b) is deemed a distribution of money under section 731, which itself is deemed a sale or exchange of the partnership interest.[332]

However, in the ruling, the IRS provided no logic behind deeming a sale or exchange in the case of mere worthless without the partner abandoning or otherwise disposing of his interest. In other words, the IRS provided no rationale for treating an abandonment and mere worthlessness the same. In fact, a partner would continue to be allocated his share of partnership liabilities if he is still a partner of the partnership. The facts in the ruling were limited to a situation in which the partner disposed of his interest. The fact patterns in the ruling only addressed abandonments. Arguably, the IRS's statement in the ruling that a worthless partnership interest results in a capital loss, where there is a decrease in the partner's share of partnership liabilities, is merely dicta and does not constitute primary authority.

Further support for this position may be found in *Echols v. Commissioner*.[333] In *Echols*, the Fifth Circuit reasoned that, "[a]s a general proposition, a taxpayer may claim a loss deduction under [section 165] on either of two alternative grounds: abandonment or worthlessness." In the finding the partnership's sole asset was worth less than the debt encumbering it, the Fifth Circuit in *Echols* held that the taxpayer's interest in the partnership was worthless independent of an abandonment.[334]

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to amounts considered to be "at risk" and from a passive activity, respectively. Section 461(l) generally limits trade or business losses for certain taxpayers. Lastly, for individuals, since a section 165 loss is considered an itemized deduction, section 67 can apply to limit or disallow the deduction (other than loss from casualty, theft, or wagering, as provided in section 67(b)(3))).

[329] 1993-2 C.B. 239.

[330] *Id*.

[331] *Id*. Note that section 1234A deems capital gain or loss treatment for gain or loss attributable to the cancellation, lapse, expiration, or other termination of a right or obligation with respect to property which is a capital asset in the hands of the taxpayer. The Fifth Circuit, in *Pilgrim's Pride v. Commissioner*, 779 F.3d 311 (5th Cir. 2015), a case involving the abandonment of stock, interpreted section 1234A as applying to the termination of rights or obligations with respect to capital assets (e.g., derivative or contractual rights to buy or sell capital assets), not to the termination of ownership of the capital asset itself.

[332] §731(a) (flush language). It is assumed section 751(b) would not apply to deem the loss to be ordinary to the extent the underlying partnership held "inventory" or unrealized receivables. We understand the partnership held an interest in depreciable real estate.

[333] 935 F.2d 703 (5th Cir. 1991). See also *Tejon Ranch Co. v. Comm'r*, T.C. Memo. 1985-207.

[334] *Id*. For additional discussion of worthless partnership interests, see Sowell, "Worthless Partnership Interests: A Collision of Theories," 44 TMM 480 (Issue No. 23, 11/17/03).

Exhibits

Exhibit I-A

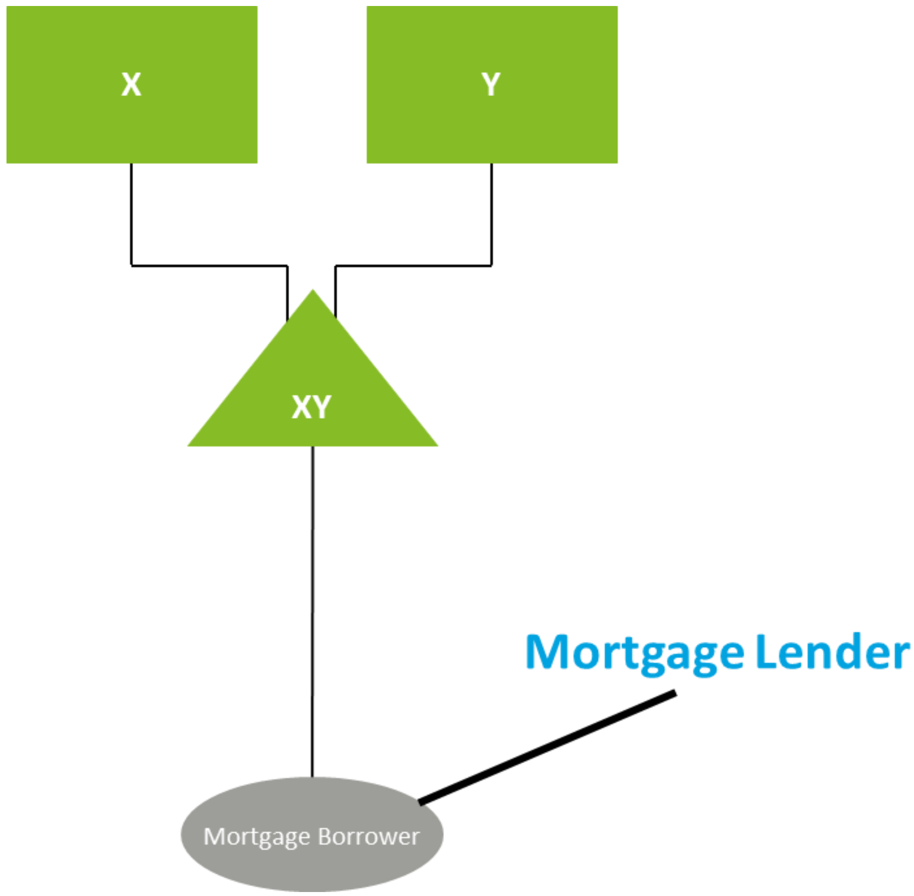


Exhibit I-B

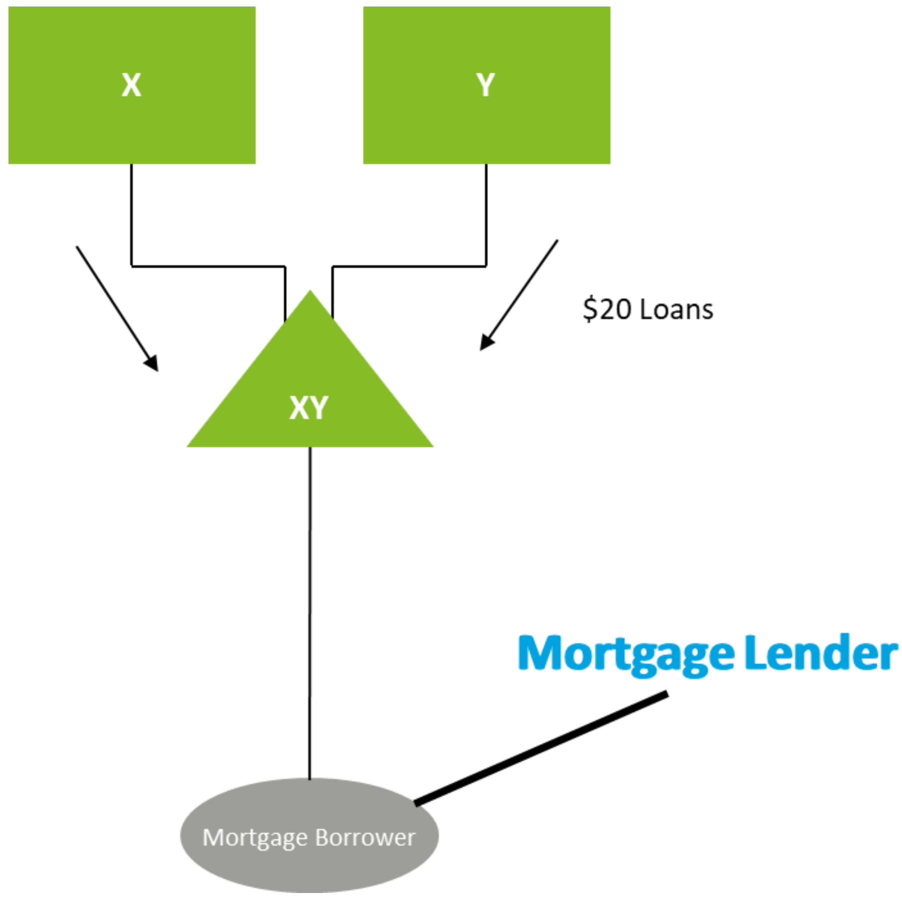
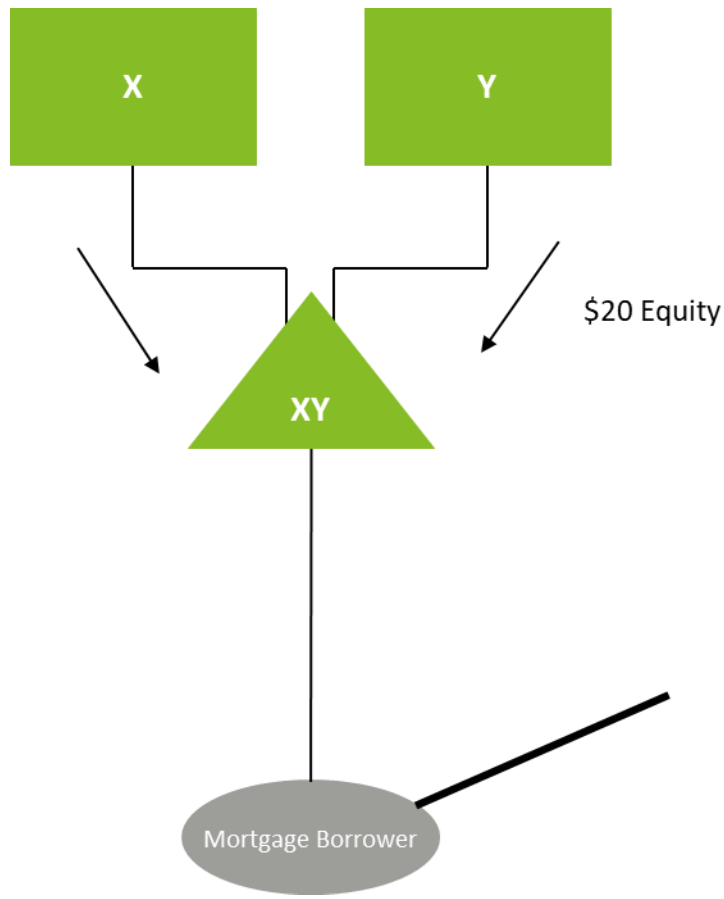


Exhibit II-A



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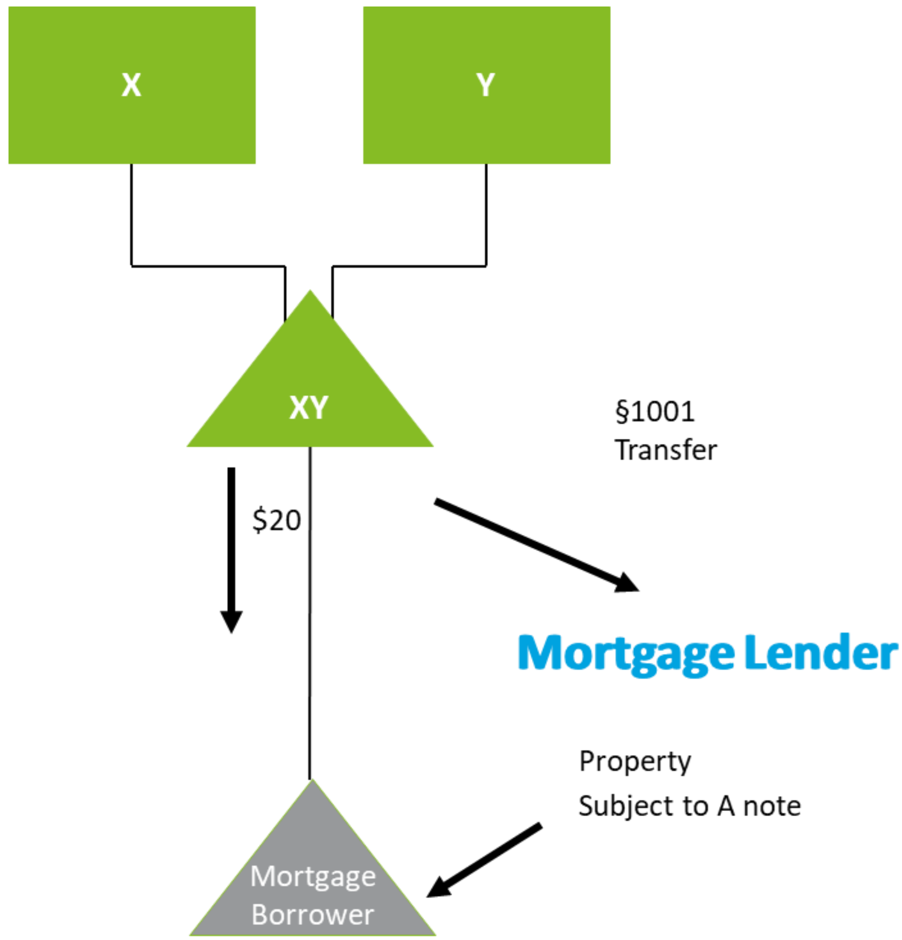
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Y
XY
§1001
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$20
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Property
Subject to A note
Mortgage
Borrower

Exhibit III

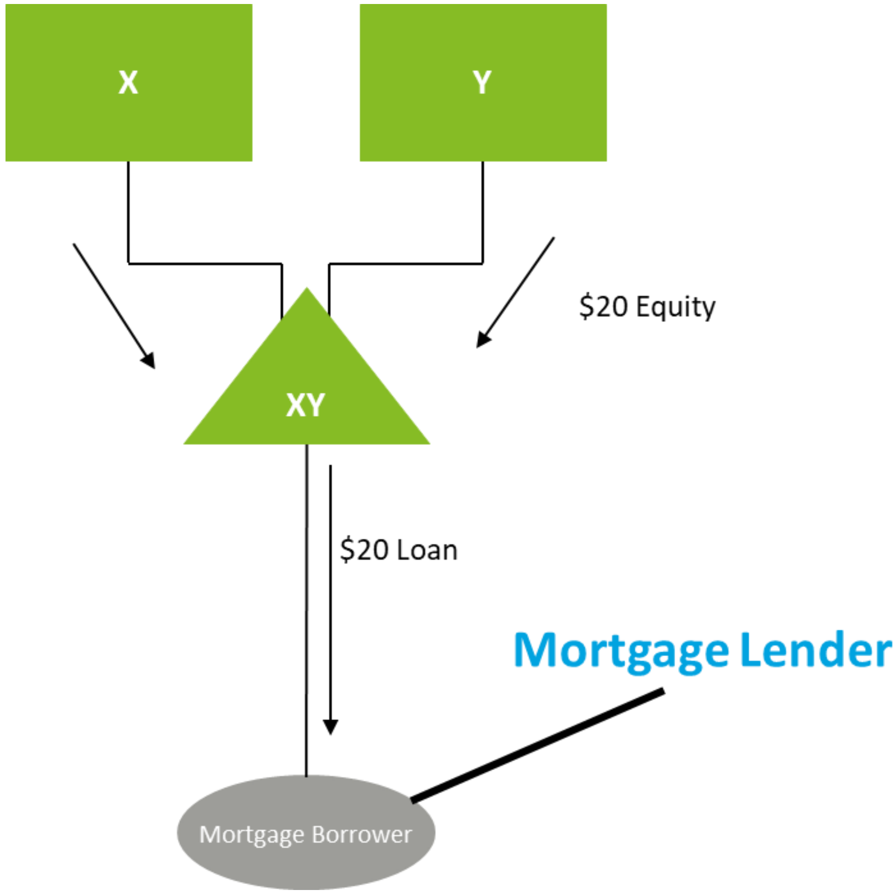


Exhibit IV

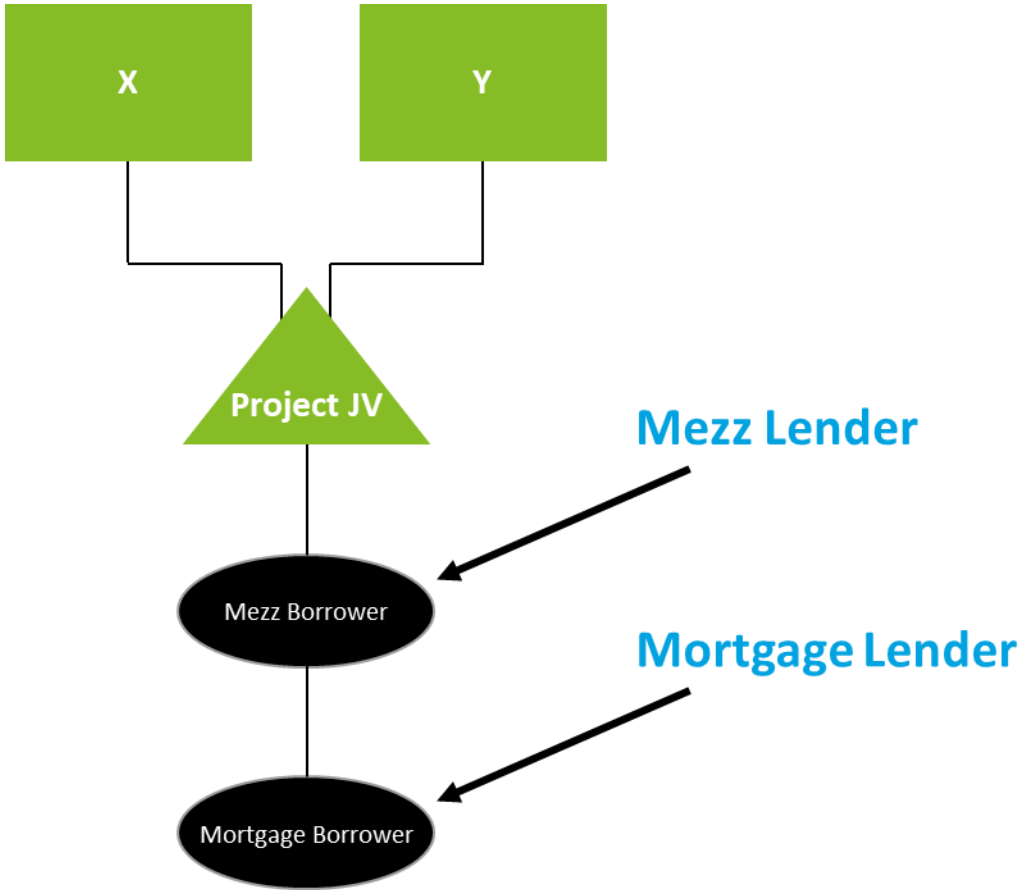
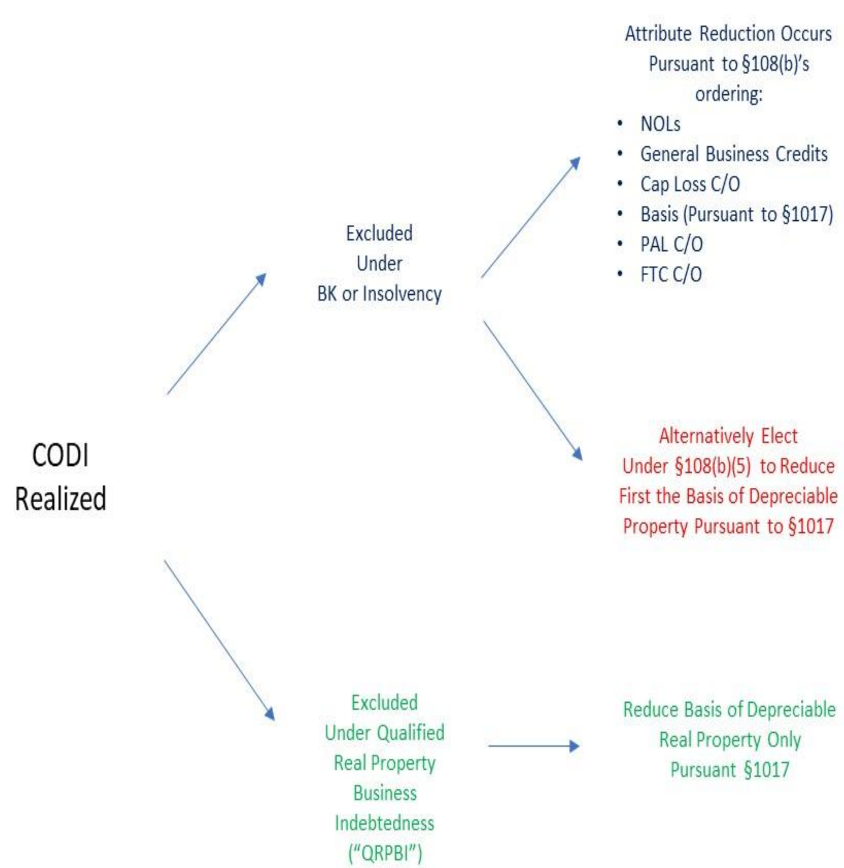

X
Y
Project JV
Mezz Lender
Mezz Borrower
Mortgage Lender
Mortgage Borrower

Exhibit V

- "Title," which is the legal right to own real property, is transferred via a deed
- "Deed" is the legal agreement that transfers ownership in real estate from seller to buyer
- Loan agreement sets forth the terms of the loan, including the agreement to pledge the collateral (aka a "promissory note")
- **Mortgage Contract**
  - Two party security agreement between the lender ("mortgagee") and the borrower ("mortgagor")
    - A mortgage is a contract that creates a lien
      - The lender records the mortgage contract which creates the lien
    - Lender has a lien over the property
      - The lien is a right in the property that allows the lender to force a sale
      - In the event of default, the lender sues for foreclosure ("judicial")
- **Deed of Trust**
  - Three party security agreement between the lender ("beneficiary"), borrower ("trustor"), and a trustee
    - Borrower transfers title to the trustee in exchange for a loan from the lender
    - The trustee holds legal title to the property until the loan is repaid
    - Trustee has the power to sell in the case of default
  - Foreclosure is non-judicial
    - A court is not involved (less expensive)
    - The trustee is in charge of the foreclosure sale

Exhibit VI



§1017 Basis Reduction Rules –

All basis reductions applied to basis held at the beginning of the following year, in the following order:

1. Trade or business or investment ("TOBI") real property that secured the discharged debt
2. TOBI or investment personal property that secured the discharged debt
3. Other TOBI property
4. Inventory and §1221(a)(1) property, accounts and notes receivable
5. Non-TOBI property

If a §108(b)(5) election is made, the reduction is only to depreciable property in categories 1-3.

If QRPBI, the reduction is only to depreciable real property in categories 1 - 3 and must be applied to the basis of the qualified real property that secured the discharged debt before any other real property. The basis reduction must be made immediately before the disposition of any depreciable real property if the disposition is before the beginning of the following year.

For BK and Insolvency reductions, basis may not be reduced below the amount of liabilities after the discharge. This limitation does not apply if the §108(b)(5) election is made.

A partner's interest in a partnership is treated as depreciable property to the extent of the partner's share of depreciable property (a reduction to the partnership's basis in such property is required). Equivalent rule for stock of a consolidated subsidiary. There are some mandatory / consent rules about reductions in partnership property.

A §1017(b)(3)(E) election may be made to treat §1221(a)(1) property as depreciable. This election is not allowed for QRPBI's reduction.

General recapture rule – basis reductions are recaptured as section §1245 ordinary income (i.e., a basis reduction to §1231 property that would otherwise result in capital gain is recaptured as ordinary income).