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EDITOR'S NOTE: CONSENT RIGHTS

Victoria Prussen Spears

**ARE WE ALL FIDUCIARIES NOW? CONSENT RIGHTS AFTER
PACE INDUSTRIES—PART I**

David S. Forsh, Corby J. Baumann, and Matthew J. Kerschner

**AN OVERVIEW OF THE RULES REGARDING THE REALIZATION AND
RECOGNITION OF DEBT CANCELLATION INCOME—PART II**

Thomas J. Gallagher and Dennis L. Cohen

**PROTECTING THE SUPPLY CHAIN: U.S. GOVERNMENT STUDIES THE ROLE OF
FEDERAL AGENCIES IN OCEAN CARRIER BANKRUPTCIES**

Rick Antonoff and Evan Jason Zucker

**THE MARK HOTEL BORROWER GRANTED INJUNCTION DELAYING
MEZZANINE LENDER'S FORECLOSURE SALE**

Melissa C. Hinkle, Christopher J. Dickson, Nathan Bull, and Howard R. Hawkins Jr.

CANNABIS INVESTMENTS AND EXIT STRATEGIES: A CASE STUDY

Robert C. Kern, Jr., and Marc S. Ullman

A PRIMER ON MUNICIPAL BANKRUPTCY

Hugh M. McDonald, Francis J. Lawall, and Gary Marsh



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Editor's Note: Consent Rights Victoria Prussen Spears	321
Are We All Fiduciaries Now? Consent Rights After <i>Pace Industries</i>—Part I David S. Forsh, Corby J. Baumann, and Matthew J. Kerschner	324
An Overview of the Rules Regarding the Realization and Recognition of Debt Cancellation Income—Part II Thomas J. Gallagher and Dennis L. Cohen	342
Protecting the Supply Chain: U.S. Government Studies the Role of Federal Agencies in Ocean Carrier Bankruptcies Rick Antonoff and Evan Jason Zucker	356
The Mark Hotel Borrower Granted Injunction Delaying Mezzanine Lender's Foreclosure Sale Melissa C. Hinkle, Christopher J. Dickson, Nathan Bull, and Howard R. Hawkins Jr.	363
Cannabis Investments and Exit Strategies: A Case Study Robert C. Kern, Jr., and Marc S. Ullman	367
A Primer on Municipal Bankruptcy Hugh M. McDonald, Francis J. Lawall, and Gary Marsh	371

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An Overview of the Rules Regarding the Realization and Recognition of Debt Cancellation Income—Part II

*By Thomas J. Gallagher and Dennis L. Cohen**

In this two-part article the authors describe how the income tax rules relating to debt cancellation income (“COD income”) work. The first part of the article, which appeared in the September 2020 issue of Pratt’s Journal of Bankruptcy Law, focused on the general COD income rules and pointed out some of the decisions and judgments that must be made in navigating these rules. This second part of the article focuses more precisely on the COD income rules that apply to real estate indebtedness.

The first part of this article explored how the income tax rules applied to taxpayers recognizing cancellation of indebtedness income (“COD”). It laid out the myriad rules applicable to solvent and insolvent taxpayers, how to ascertain solvency in the case of multitiered ownership entities, how the rules attempt to create a symmetrical approach to the recognition of income and loss, and the broad reach of the related party debt acquisition rules. Taxpayers that navigate the rules carefully should be able to emerge relatively unscathed. Those who rush headlong into debt restructurings without the necessary planning are likely to recognize income in cases where it was least expected.

This second part of the article turns to the question of COD income in connection with debt restructurings and other transactions in connection with real property. What sets these transactions apart from those discussed in Part I is that: (i) in most cases, the borrower owns real estate that serves as collateral for the borrowing and may be held or surrendered in connection with the discharge of some or all of the borrower’s debt, and (ii) there is a special rule for debt discharge income recognized in connection with certain real property indebtedness of borrowers.

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WHAT HAPPENS IF THE BORROWER JUST WALKS AWAY FROM PROPERTY THAT SECURES INDEBTEDNESS OF THE BORROWER, I.E., ABANDONS THE PROPERTY OR CONVEYS THE PROPERTY TO THE LENDER BY A DEED IN LIEU?

If the borrower has concluded that it will be unable to turn the property around and that it cannot achieve a satisfactory work-out of its debt obligation with its lender, the borrower may think that it can simply surrender the property to its lender. This is particularly true where the property is owned in a separate, bankruptcy-remote, entity. In that case, the holder of the debt secured by the property would then foreclose or acquire the property by a deed in lieu of foreclosure. The common understanding is that the borrower recognizes a taxable gain from the sale of the property of an amount equal to the outstanding balance of the debt obligation and that gain is generally a Code Section 1231(b) gain, i.e., no COD income.

That conclusion is correct in most, but not all cases. This is another example of a circumstance where operating under a superficial understanding of the COD income rules could lead to catastrophe. Taxpayers need to be alert concerning the cases where the taxable gain on sale is not a function of the excess of the debt over the taxpayer's adjusted basis in the property so that they can avail themselves of alternative planning strategies.

Taxpayers should also recognize that, where the property is treated as conveyed in exchange for the satisfaction of nonrecourse debt, no COD income is generated and none of the COD income exclusions from gross income are available, including COD income generated while the borrower is in a Chapter 11 bankruptcy. The transfer to the creditor will generate a taxable gain in most cases. Further, the general rule is that all taxes due within the three years before the bankruptcy petition are priority claims and non-dischargeable in a bankruptcy of an individual.

The Code and regulations have relatively simple rules for dealing with the transfer of property securing an obligation in full or partial satisfaction of the obligation. Which set of rules applies depends on whether the obligation is a "recourse" obligation or a "nonrecourse" obligation.

If the indebtedness secured by the property is *nonrecourse* indebtedness and is transferred in a foreclosure proceeding or by means of a deed in lieu of foreclosure, the borrower does not recognize COD income. Rather, the borrower is treated as having transferred the property in exchange for an amount realized equal to the outstanding balance of the debt secured by the property. In most relevant cases the outstanding amount of the debt will exceed the borrower's adjusted basis in the property so that the transfer will result in

taxable gain. No portion of the gain is treated as COD income. The gain is ordinary income, capital gain, or Section 1231(b) gain, depending on the underlying classification of the property. The fair market value ("FMV") of the collateral is not relevant to the amount of the borrower's gain. It is simply the outstanding amount of the debt over the adjusted basis of the property securing the debt. In the case of a transfer of a partnership interest in such circumstances, a partner's share of the nonrecourse liabilities encumbering property owned by a partnership is treated as the amount realized on the sale, exchange, other disposition (including abandonment) of the partnership interest.

If the indebtedness is a recourse liability, however, the analysis is more complicated and the consequences to the borrower (and its members) may be catastrophic unless they have planned properly. The amount realized by the borrower on transfer of the property securing a recourse obligation to the lender in foreclosure or by deed in lieu includes only the amount of the liabilities from which the borrower is discharged as a result of the transfer. In the usual case, the sale would discharge the borrower of liability under the debt obligation only up to the FMV of the property. In that case, if the holder discharges the balance of the debt, i.e., the excess over the FMV of the property, that excess is COD income.

This very important distinction is illustrated below.

Example One

AB LLC owns commercial real estate that secures indebtedness incurred to acquire the real property. The outstanding amount of the indebtedness is \$1,000,000 and AB's adjusted basis in the property is \$625,000. In Case No. 1, the borrower's liability on account of the indebtedness is limited to the collateral and there is an express exculpation clause in the promissory note. In Case No. 2, there is no exculpation clause and the indebtedness is recourse to the LLC by its terms. Because AB is a special purpose entity ("SPE"), the only assets owned by AB are items that would otherwise be pledged to the lender as collateral and, under state law, no member of the LLC is otherwise liable for the debts and obligations of the LLC. The FMV of the property is \$800,000.

Under the straightforward language of the regulations, the following appear to be the results if AB simply conveys the property to the holder of the debt:

	Case No. 1	Case No. 2
Amount realized on the transfer of the property to the holder of the debt in satisfaction of debt	1,000,000	800,000

Amount of taxable gain from the sale or exchange of the property realized on transfer to lender	375,000	175,000
Amount of COD income	0	200,000

The fact that the amount of the liability or indebtedness is greater than the FMV of the collateral is not relevant in determining the total amount of COD income and gain on the transfer of the property where the debt is recourse. The borrower will recognize taxable gain or COD income equal to the excess of the amount of the debt over the adjusted basis of the property. What Example One tells us is that the character of the income and gain will be determined by whether the debt secured by the property and discharged by the transfer is recourse or nonrecourse. If you thought that the answer to the nature of the obligation is found in the regulations under Code Section 752, you would be wrong. At least in the view of the Internal Revenue Service (“IRS”).

In 2015, the IRS released informal guidance whether, for purposes of determining if an LLC taxed as a partnership had COD income under Code Section 61(a)(12) or gain from the sale or exchange of property under Code Section 61(a)(3) upon the transfer of its property upon a foreclosure, the regulations under Code Section 752 determined if the indebtedness was recourse or nonrecourse to the LLC? The borrower was a typical SPE. The debt obligations did not have any express limitation of liability nor express, unconditional personal liability language. The IRS determined that the combination of the members’ pledges, general assignment of rights, and guarantees, in addition to the loan being secured by all assets of the taxpayer as a result of its status as an SPE, could be sufficient for the loan to be classified as a recourse liability of the SPE. The lender’s recourse was not limited to the assets immediately acquired with the debt but extended to all assets of the taxpayer, i.e., the debt was recourse to the SPE. The IRS concluded that “express unconditional personal liability language may not be necessary to make the debt recourse to an entity under these facts.” The combination of members’ pledges, general assignment of rights, and guarantees, in addition to the loan being secured by all assets of the taxpayer [LLC] as a result of its status as an SPE, could be viewed as sufficient in the eyes of the IRS for the loan to be a recourse liability of the entity.

In other guidance, the IRS looked to state law rather than Code Section 752 principles to determine whether there had been a material modification of the borrower’s indebtedness. In those cases, taxpayers reorganized certain corporate entities into LLC SPE’s without modifying the state law creditors’ rights of the debt holders. Even though the obligor under the loan became an SPE with

limited assets, the IRS concluded that there was no material modification of the recourse liabilities. Implicitly, the IRS looked to the parties' rights under state law to determine the recourse versus nonrecourse nature of the indebtedness. Other guidance issued by the IRS appears to have reached a different conclusion, although the rulings concerned different issues.

The different tax consequences associated with discharges involving recourse versus nonrecourse debt could be an unanticipated issue in debt restructurings. For example, a change in the obligor of a debt instrument is typically a significant modification of a recourse debt instrument but not in the case of a nonrecourse debt instrument. The standard applicable to when changes in the security for a debt result in a significant modification are different. Changes in the security of a recourse debt instrument result in a significant modification where there is a change in the payment expectations for the debt instrument. On the other hand, a significant modification of a nonrecourse debt instrument occurs where there is a release, substitution, addition, or other alteration of a "substantial amount" of collateral for, or guarantee on, the debt or other form of credit enhancement. Finally, a change from a nonrecourse debt to a recourse debt or vice versa is a significant modification.¹

These same issues can arise in connection with indebtedness of a disregarded entity ("DRE"). If the debt is recourse to the DRE, is the debt recourse for purposes of the gain and COD income recognition rules? Parsing the authorities on this issue requires care. The IRS has clarified how DRE's and grantor trusts are treated for the purposes of the bankruptcy and insolvency exceptions in Code Section 108. For purposes of applying the bankruptcy and insolvency exclusions to COD income of a grantor trust or a DRE, neither the grantor trust nor the DRE are considered to be the taxpayer. Rather, for purposes of the bankruptcy and insolvency exclusions, the owner of the grantor trust or the owner of the DRE is the taxpayer. The IRS guidance on this point does not address the question of how to determine the status of the debt of the grantor trust or DRE, i.e., recourse versus nonrecourse.

Finally, consider the added complication if, following a monetary default and, the lender asserts that the guarantors are liable under the nonrecourse carveouts. Is the indebtedness now recourse because of the liability of the guarantors under the Code Section 752 rules? The absence of guidance may create COD income issues on a subsequent transfer of the property when the borrower's counsel obtains a release from liability for the carveout guarantors.

¹ For a fuller discussion of the income tax effects of a significant modification of a debt instrument, see Part I of this article in the September 2020 issue of *Pratt's Journal of Bankruptcy Law*.

HOW DO THE COD INCOME RULES APPLY TO INDEBTEDNESS SECURED BY REAL PROPERTY?

Typically, financing transactions, particularly real estate financing transactions, make use of entities formed for the specific purpose of reducing the likelihood that assets owned by those entities will be involved in a bankruptcy proceeding, whether of the entity or an affiliate of the entity. These special purpose entities or “bankruptcy-remote entities” and their organizational, operational, and financing documents are subject to structures and covenants that are intended and designed to reduce the likelihood that the entity will file for bankruptcy protection or be dragged into the bankruptcy case of an affiliate. Whether and to what extent these provisions are effective is a matter beyond the scope of this article. What is relevant, however, is that the IRS has finalized regulations that the insolvency or bankruptcy of the SPE or bankruptcy-remote entity does not permit the owner to avail itself of the bankruptcy or insolvency escape from COD income. As a practical matter, that puts the members of the SPE or bankruptcy-remote entity (and the members of the owners) in the position of relying on their individual bankruptcy or insolvency exclusion, or the exclusion available for COD income attributable to “qualified real property business indebtedness.”

Part I of this article discussed how the COD income rules apply in the case of partnerships and the requirement that the availability of the insolvency exclusion be tested at the partner, not partnership, level. Absent an insolvent partner, a partner in a Chapter 11 proceeding, or purchase money indebtedness owed to the seller of the property (where the purchase money debt basis reduction exception applies), it is likely that the only exclusion for COD income arising from a restructuring of indebtedness secured by real estate is the exclusion in cases of the discharge of “qualified real property indebtedness.” As described in the first article, the purchase money debt reduction exception applies only in the case of a solvent borrower and for debt that was owed to the seller of the property and that is held by the seller at the time of the discharge. The fact that the debt was incurred incident to the acquisition of the property is not enough.

Dealing with COD income in the case of indebtedness that is secured by real property requires two levels of analysis. First, what are the tax consequences when a lender holding a secured interest in the real property acquires the collateral by foreclosure or by a deed in lieu of foreclosure? Those issues include whether recourse indebtedness of a DRE is regarded as recourse or nonrecourse in measuring COD income upon the transfer of an underwater property to the lender or other person. Second, what are the tax consequences where a lender

restructures the borrower's indebtedness without taking the property in foreclosure? When does COD income arise in these situations?

The cases in the preceding section involved circumstances where the holder of the indebtedness acted to divest the borrower of the ownership of the property. As a result, the borrower recognized either gain from the sale of the property or COD income from the discharge of the liability, or both. Suppose, instead, that the holder of the debt agreed to modify the terms of the indebtedness to reduce the principal amount of the debt, defer the unpaid interest, and leave the borrower in possession of the property subject to the restructured indebtedness? That modification generally would be classified as a significant modification and would lead to a deemed reissuance of the debt instrument in exchange for the pre-modification debt.

Although the deterioration in the financial condition of the borrower generally is not a basis on which to conclude that the debt has been transformed into an equity interest in the borrower, a modification of the debt that adds features, such as a right to cash flow payments and management-like rights, could cause the modified debt to be classified, in whole or in part, as an equity interest in the borrower or the property.

Assuming that the debt continues to be treated as debt of the borrower for income tax purposes and not as equity in the borrower or the property following the modification, the borrower would recognize COD income equal to the excess of the outstanding amount of the pre-modification debt over the issue price of the post-modification debt. If the borrower (or, in the case of a partnership or LLC, its partners or members) is otherwise solvent is that the end of the story? Report COD income and pay tax? Not necessarily.

Code Section 108 contains a special rule that permits borrowers (other than C corporations) to avoid recognizing COD income otherwise arising from the discharge, in whole or in part, of a qualified real estate borrowing. This exclusion applies to debt discharge income and not to gain otherwise recognized from the conveyance of the property to the lender, i.e., the borrower must remain the owner of the property and the creditor the holder of the debt. In the usual case, the COD income will arise from the significant modification of the debt secured by the real estate.

If this provision applies (see below for some unexpected circumstances where the relief is unavailable), the amount of the COD income is excluded from the borrower's gross income. (This exclusion does not apply to gain recognized from the sale or other disposition of the property, e.g., a transfer in foreclosure.) The cost of the income tax exclusion from gross income is that the borrower (the partner in the case of a partnership) must reduce its adjusted basis in depreciable real property. The basis reduction applies to the basis of depreciable

real property held by the taxpayer at the beginning of the taxable year following the year of the discharge and, at the election of the taxpayer, to reduce the basis of an interest of a partner in a real estate partnership. The partnership interest is treated as depreciable real property to the extent of the partner's proportionate interest in the depreciable real property held by the partnership. The partnership's basis in depreciable real property with respect to that partner is correspondingly reduced.

Do real estate property owners hear the Hallelujah chorus (for trumpet in B \flat and French horns) in the background? Or is that just the sound of the horns of the oncoming train? The first question to ask is whether the debt discharge income is eligible for exclusion under Code Section 108.

First, is the debt that was discharged (in whole or in part) qualified real property business indebtedness? In order to qualify, the debt must have been incurred or assumed by the borrower in connection with a real property trade or business, be secured by the real property, and (for debt incurred or assumed post-January 1, 1993), the debt must qualify as qualified acquisition indebtedness. (There is uncertainty whether property subject to a triple-net lease is real property "used in a trade or business" and eligible for the COD income exclusion or "property held for investment" and ineligible.)

An unsecured line of credit is not qualified real property business indebtedness.

In order to meet the definition of qualified acquisition indebtedness, the proceeds of the debt must have been used to acquire, construct, reconstruct, or substantially improve the property securing the debt obligation. In simple terms, if the borrower pledged Asset No. 1 to secure a loan and used the proceeds of the loan to acquire or improve Asset No. 2 (without Asset No. 2 serving as collateral), the indebtedness would not be qualified acquisition indebtedness. Assuming that the debt meets the above conditions, the amount that can be excluded from the borrower's gross income is limited to the excess of the outstanding amount of the qualified real property business debt over the FMV of the property securing the debt (reduced to the extent of the amount of superior liens); provided, however, that the amount that can be excluded under this provision cannot exceed the taxpayer's adjusted basis of depreciable real property held immediately before the discharge. This limitation effectively means that the borrower cannot utilize the special real property indebtedness safe harbor to create equity in the secured property.

Example Two

G, an individual, formed a single-member LLC to acquire and lease a free-standing drugstore as the replacement property in a like-kind exchange. Assume that the lease is not triple-net. The property cost \$2 million and was

financed with an \$800,000 nonrecourse mortgage loan. The relinquished property had a FMV of \$2 million, was subject to nonrecourse debt of \$800,000, and had an adjusted income tax basis of \$250,000 (allocated land \$200,000 and buildings \$50,000). This is the only income-producing real estate owned by G, directly or indirectly. Subsequent to G completing the exchange, the drugstore ran into financial difficulties (the FMV of the property was thought to have declined to \$1.75 million). The drugstore negotiated a reduction in its annual rent and also a corresponding reduction in the outstanding balance of the LLC's debt, of \$250,000.

Under the rules described above, the debt should be treated as real property business indebtedness that is qualified acquisition indebtedness. Nevertheless, because of the very low adjusted basis of the depreciable real property (resulting from the carryover basis in the Code Section 1031 exchange), the maximum that G can exclude from her gross income under the special rule for COD income from qualified real property business indebtedness is limited to the adjusted basis of the depreciable real property (likely less than \$50,000 at the beginning of the next taxable year). The balance would be includible in her gross income as COD income, unless G were insolvent. G's accountant is shocked!

In a private letter ruling, the IRS ruled that the determination of whether debt is qualified real property business indebtedness is made at the partnership level. For example, if partnership debt is discharged, the determination of whether debt was incurred or assumed in connection with real property used in a trade or business is made by reference to the trade or business of the partnership and real property owned by the partnership. The election to apply the qualified real property indebtedness exclusion is made by the partners, however.

Example Three

DC LLC is a limited liability company with six equal members that is taxable as a partnership for income tax purposes. The debt incurred to acquire the property was interest-only with a 10-year term. All income, gains, loss, deductions, and distributions were allocated among the members equally. DC acquired an office building for \$6 million and, after several years, was able to refinance the property, on a nonrecourse basis, and distribute \$2.4 million of excess proceeds to the members. Some of the members used the cash to acquire another commercial real estate property, some invested the cash in investment assets, and one (a surgeon) used the cash to purchase a sailboat. Two years later, the principal tenant in the building encountered significant economic problems and DC needed to restructure its indebtedness.

After some negotiations, the lender agreed to restructure the indebtedness in a way that involved a significant modification of the debt for income tax purposes. This made the restructuring fall within the constructive reissuance rules discussed above. As a result of the restructuring, DC realized \$1.5 million of COD income. Under the rules of Code Section 108, the applicability of any of the exclusions, including the exclusion for COD income of qualified real property business indebtedness, is determined at the member level so that the K-1s of each member reported \$400,000 of COD income and instructed them to discuss with their tax professional whether any exceptions to the recognition of the income applied to them.

To the extent that the prior refinancing generated cash that was distributed to the members, the portion of the indebtedness corresponding to the excess proceeds would not be treated as qualified real property indebtedness because the excess proceeds were distributed and not used to acquire, construct, reconstruct, or substantially improve the property securing the debt obligation. The members of DC would recognize COD income and could not avail themselves of the qualified real property indebtedness safe harbor to the extent of the excess proceeds. That would be true even if all of the proceeds were used to acquire another property if the new property did not secure the new indebtedness.

Where borrowers opportunistically refinanced indebtedness and used the excess proceeds to acquire other properties or for operating cash flow or capital improvements on properties other than the collateral, some portion of the refinanced debt will not qualify for the qualified real property business indebtedness rule. The narrowness with which the exclusion is drafted would likely be viewed as a surprise by many real estate professionals. Nevertheless, the statute is drafted with little flexibility and a casual approach to borrowing and investing loan proceeds could disqualify COD income from the exclusion. A question for which no answer is provided in the statute or IRS guidance is whether the members of DC could take the view that the portion of the indebtedness discharged related back to the original loan, which was qualified acquisition indebtedness.

Guidance issued by the IRS under this special rule has been limited.

In one published ruling, the IRS concluded that the Code Section 108(c) exclusion of the COD income attributable to qualified real property business indebtedness did not apply to debt secured by real property owned by a residential developer and held for sale. Consistent with its general view regarding mezzanine debt of real estate entities, the IRS concluded that debt secured by 100 percent of the interests in a DRE, 90 percent or more of the assets of which consist of real property used in a trade or business, can

constitute qualified real property business indebtedness to which the COD income rules can apply. Although the strictures of the IRS guidance are pretty narrow, the IRS did note that the rule was only a safe harbor and that taxpayers were permitted to argue that the indebtedness qualified based on their facts and circumstances.

REITS, TAX-EXEMPT INVESTORS, BLOCKERS, AND COD INCOME

Larger real estate funds are generally organized as entities that are taxed as partnerships for U.S. income tax purposes. They often have pension plans, non-U.S. investors, and public and private foundations as investors. Real estate investment trusts ("REITs") have been a staple of real estate investments since their creation in the early 1960s. Lately, many real estate funds have organized private REITs as a preferred real estate vehicle, particularly where the funds have tax-exempt entities that are adverse to reporting unrelated business taxable income and non-U.S. investors interested in minimizing their Foreign Investment in Real Property Tax Act ("FIRPTA") exposure. Minimizing FIRPTA exposure and U.S. income tax liabilities attributable to income that is effectively connected ("ECI") with a U.S. trade or business can also drive non-U.S. investors to utilize corporate "blockers." Typically, blockers are U.S. business entities organized as corporations (or eligible business entities that elect to be taxed as corporations). A blocker structure prevents the flow-through of ECI to the non-U.S. investor. The cost of this insulation is that the blocker is fully subject to U.S. taxation, and any dividends may be subject to U.S. withholding. Blockers manage their U.S. taxable income through a variety of means.

As a result of these developments, it is not unusual for real estate funds to have one or more significant investors that are organized as C corporations. In addition, the fund may have organized a private REIT that is a captive of the fund and used by the fund to make investments where the income or gain from the investment would be unrelated business taxable income ("UBTI") in the hands of tax-exempt investors. Finally, REITs and exempt organizations are significant sources of real estate investment capital in their own right.

What is the interplay of the COD income rules with these forms of real estate investor entities? In a word, it is complicated.

Because many of the real estate borrowers are organized as business entities that are partnerships, or DREs owned by partnerships, the first rule of real estate fund club is that the members of the investment entity are likely the ones that will have to address the COD income issues, not the business entity formed as a partnership.

The very favorable rule discussed above for COD income attributable to qualified real property business indebtedness does not apply to business entities that are taxed as C corporations. Blocker entities and REITs are taxable as C corporations. Therefore, real estate funds making their investments through owned-private REITs will be unable to take advantage of the COD income qualified business indebtedness relief and be forced to report that income as ordinary taxable income. Blocker entities will likewise be unable to avail themselves of the special relief and may be put in the position where they recognize ordinary taxable income that is incapable of being sheltered.

All is not lost, at least in the case of REITs. The recognition of COD income should not increase the distributions required to be made by the REIT in order to maintain the entity's REIT election. Under a special rule for a REIT's noncash income (which includes COD income of the REIT), in determining the base amount on which the 90 percent distribution requirement is calculated the REIT excludes its noncash income. Meaning, the REIT can incur COD income without increasing the amount of its required REIT dividend distributions. Although that provision reduces the impact of the COD income on the amount of the REIT's required dividend (and the amount required to be reported as dividend income by the shareholders), the COD income is still required to be reported as taxable income by the REIT and could give rise to an income tax payment by the REIT at the corporate income tax rate. Blockers, assuming that they remained solvent, would simply be required to pay income taxes, likely both to the IRS and to the state or local jurisdictions in which the properties were located.

In the case of tax-exempt entities realizing COD income, either from debt discharges on investments made directly by them, or as their distributive share of the income from a partnership in which they made an investment, the classification of the income as, or as not, UBTI is unclear. COD income is not included in the list of the categories of income explicitly excluded from UBTI by the Code. Some commentators have suggested applying a "transactional approach" that measures whether the expenditures funded by the discharged gave rise to tax benefits to the exempt organization that produced a tax benefit. In other cases, the IRS has looked at whether a source of income not otherwise excluded from UBTI under the Code was sufficiently similar to other ordinary forms of investment income to justify extending the Code exclusion from UBTI in the absence of a specific exclusion. Perhaps the only generalization that can be made is that the classification of UBTI in the hands of an exempt organization will depend on a principled analysis of the facts and circumstances surrounding the investment and the debt discharge.

Finally, suppose that the fund (taxed as a partnership) excluded COD income from the gross income reported to the members on the grounds that the debt discharge met the purchase money debt exception discussed in Part I of this article. Subsequent to the year in which the discharge occurred, partners owning a 55 percent interest in the fund redeemed their interests and new investors were admitted. On an examination of the year of the discharge, the IRS inquired into the holder of the debt at the time of the discharge and determined that the holder was not the seller so that the discharge did not meet the statutory test for exclusion. If the IRS assessed tax on account of the mistake, the fund would be the IRS's first stop for payment. If the partners that withdrew are unwilling to reimburse the fund, the fund could elect to make a push-out election, of course, and push the amount of the underpayment to the reviewed year partners. The push-out election must be accompanied by significant information reporting to the IRS with respect to each partner to whom a push-out is made and the election must be made within a relatively narrow window of time. In the absence of a provision in the fund agreement requiring that the withdrawn partners cooperate, the required information may not be available in time to make the push-out election. Worse yet for the fund, the withdrawing members and the fund may have negotiated for mutual blanket releases.

CONCLUSION

Navigating the COD income rules can be treacherous. Taxpayers can find that they have generated taxable gain from the sale of an asset secured by a nonrecourse liability rather than COD income, with the result that they have generated an income tax liability rather than an exclusion from gross income. In the real estate space, an expectation that COD income can be avoided by reducing the adjusted basis of real estate assets could be problematic where the taxpayer's assets are predominately raw land, where the debt subject to discharge is not qualified acquisition indebtedness, or where a real estate owning partnership that has significant depreciable real property assets (and is thus a prime object to implement a basis reduction) refuses to consent to the inside basis reduction that is a requirement for the qualified real property business indebtedness exclusion. Careful planning is required up-front and not as an afterthought.

Proper advance planning may improve the taxpayer's after-tax outcome, however. Two examples illustrate the advantages of such planning.

The taxpayer may be able to choose to reduce the basis of real property owned in partnerships by carefully working with the partnerships to select those with the longest-lived assets, thereby avoiding basis reductions in partnerships

with little remaining basis. Because most treatments of partnership interests as depreciable real property require consent from the partnership in order to elect to reduce basis, the failure of a partnership to consent may be advantageous.

Where there is a substantial basis reduction in a particular asset, the taxpayer should be very careful regarding the sale of that asset in a taxable disposition and should, instead, seek to dispose of those assets only in connection with a Code Section 1031 exchange where possible. Further, where the basis reduction is made to an asset or assets in a high-tax state jurisdiction, finding a method to relocate that deferred gain into a low-tax state could also be useful.