

**NAVIGATING THE ROCKS AND SHOALS OF A MIXED USE OR HOTEL WORKOUT
TAX CONSIDERATIONS**

May 6, 2010

Presenter

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I. APPLICABLE GENERAL PRINCIPLES OF TAX LAW.

A. GENERAL DEFINITIONS.

1. Discharge of Indebtedness or Cancellation of Indebtedness Income (“COD”) is ordinary income that is realized when the liability to repay a debt ceases or the debt is satisfied at less than its face amount.
2. Nonrecourse Debt is an obligation pursuant to which the lender may look only to specified security for repayment; the lender bears the risk of depreciation in the value of the property. Neither the borrower nor any other person has any personal obligation to repay the debt.
 - a. Special tax significance and use – A partner in a partnership may deduct losses up to the partner’s tax basis (and at-risk amount) for its partnership interest. A partner’s tax basis is calculated by adding the partner’s share of the partnership debt to the money and the tax basis for property the partner contributed to the partnership. If the partner is a limited partner, the partner’s tax basis is increased only by that partner’s share of partnership nonrecourse debt. However, a partner is not “at-risk” for nonrecourse debt except for “qualified nonrecourse financing.”
3. Purchase Money Debt is debt taken by a seller from a buyer in connection with the sale of property.
 - a. This is a narrower definition than the UCC definition. For example, if Buyer buys machinery from Seller by incurring a bank loan, the loan is not purchase money debt. However, if Buyer buys machinery from Seller by issuing to Seller its note, the note is purchase money debt.
4. Realization and Recognition. Gain or loss “realized” is the tax gain or loss inherent in the transaction. Gain or loss “recognized” is the tax gain or loss which must be reported on a tax return.
5. Sale or Exchange is a transfer in which gain or loss is realized. § 1001 of the Internal Revenue Code of 1986 (the “IRC”).
6. IRC § 1231 Property generally includes real property and depreciable property used in a trade or business that has been held for more than one year that is not inventory or held primarily for sale to customers in the ordinary course of the taxpayer’s trade or business, and certain other exclusions not here relevant. IRC § 1231(b).

B. CALCULATION OF TAX BASIS, AMOUNT REALIZED, AND GAIN OR LOSS.

1. Tax Basis for Purchased Property.

a. The tax basis for purchased property is its cost. IRC § 1012. Cost is determined by the consideration paid. The consideration paid generally includes cash, the fair market value of property exchanged (ordinarily, the tax basis of property exchanged plus any gain or minus any loss recognized on the exchange), purchase money debt, debt assumed or taken subject to, and capitalized costs.

b. Example: Buyer buys a parcel of real estate by delivering to Seller \$10,000 in cash that Buyer borrowed and a \$50,000 note with a market rate of interest. In connection with the acquisition, Buyer pays \$5,000 of capitalizable costs to parties other than Seller. The property is subject to a \$100,000 nonrecourse debt payable to a bank which Buyer does not assume and will not be paid off by Seller. Two years after Buyer acquired the property, Buyer refinances by borrowing \$200,000. Buyer's tax basis is:

Cash paid to Seller	\$10,000
Buyer's Note to Seller	50,000
Debt the Property was Subject to	100,000
Capitalized Cost	<u>5,000</u>
Tax Basis	<u>\$165,000</u>

The Buyer's tax basis is unaffected when the property is refinanced.

c. Tax basis for property, generally, is adjusted by reducing it for depreciation or cost recovery deductions and other statutory reductions and increasing it by capitalizable expenditures. IRC § 1016. Hereafter, tax basis is referred to as "tax basis," "basis," "adjusted tax basis," or "adjusted basis."

2. Amount Realized on Sale or Exchange of Property.

a. The amount realized on a sale or exchange of property includes cash, debt assumed or taken subject to, and the fair market value of property received, including purchase money debt.

b. In the above example, the Seller's amount realized is:

Cash Received	\$10,000
Buyer's Note	50,000
Debt the Property was Subject to	<u>100,000</u>
Amount Realized	<u>\$160,000</u>

3. Calculation of Gain or Loss.

- a. Gain or loss realized is the difference between the amount realized and the tax basis for the property on the date of the sale or exchange.
- b. Realized gain or loss must be recognized unless there is an explicit statutory or common law exception to recognition, *e.g.*, a shareholder who exchanges his stock in one corporation for stock in another corporation will recognize gain or loss on the exchange unless the exchange is pursuant to a transaction which qualifies as a reorganization under IRC § 368.

C. CHARACTERIZATION OF GAIN OR LOSS.

1. Ordinary income.

- a. COD. IRC § 61(a)(12).
- b. Market Discount. IRC § 1276.
- c. Depreciation recapture.
 - (1) Gain to the extent of depreciation taken on personal property is ordinary income. IRC § 1245.
 - (2) Gain to the extent of accelerated depreciation on real property (the excess of depreciation claimed over straight-line depreciation). IRC § 1250.
 - (3) Corporate taxpayers must recognize as ordinary income 20 percent of the excess of the depreciation taken on the property over the amount recaptured under IRC § 1250 limited by the amount of gain realized. IRC § 291.

2. Gain or Loss from Sales or Exchanges of Capital Assets.
 - a. Generally, gain or loss from the sale or exchange of a capital asset that is not depreciation recapture is capital gain or loss.
 - b. Capital gain or loss will be long-term capital gain or loss if the asset sold was held for more than one year. Two rates of taxation apply to long-term capital gain on real estate – 25 percent on the depreciation taken that is not recaptured as ordinary income and 15 percent on gain in excess of the depreciation.
3. Gain or Loss from Sales or Exchanges of IRC § 1231 Property.
 - a. Gains and losses from the sale or exchange of IRC § 1231 property are aggregated.
 - b. If the net result is a gain, the gain is capital gain; if the net result is a loss, the loss is ordinary loss; however, if a taxpayer reported net IRC § 1231 losses in any of the five years prior to the calculation year, his net IRC § 1231 gain, to the extent of those losses, is ordinary income.
 - c. Depreciation recapture (ordinary income) overrides net IRC § 1231 gain (capital gain).

D. TAX CONSEQUENCES OF BORROWING TO BORROWER/MORTGAGOR.

1. Receipt of borrowed funds produces no Federal income tax consequences; the increase in cash is not an increase in wealth because there is a corresponding liability to repay the borrowed funds.
2. Generally, a debt incurred, assumed, or taken subject to with respect to the acquisition of property, is included in the tax basis of the property. *Crane v. Commissioner*, 331 U.S. 1 (1947).
 - a. A prerequisite to inclusion of debt in tax basis is that the debt must be true debt, *i.e.*, the amount due must be reasonably ascertainable (*Albany Car Wheel v. Commissioner*, 40 T.C. 831 (1963), *aff'd per curiam*, 333 F.2d 653 (2d Cir. 1964); Rev. Rul. 55-675, 1955-2 C.B. 567); if the debt is nonrecourse, the principal amount of the debt must bear a reasonable relationship to the fair market value of the security (*Estate of Franklin v. Commissioner*, 544 F.2d 1045 (9th Cir. 1976)); and the time for payment must be reasonably ascertainable.
 - b. Debt that is not incurred in connection with the acquisition of property, *e.g.*, a refinancing or a later financing, is not included in

the tax basis of the property. *Woodsam Assoc., Inc. v. Commissioner*, 198 F.2d 357 (2d Cir. 1952).

E. TAX CONSEQUENCES OF LENDING TO LENDER/MORTGAGEE.

1. A lender has no Federal income tax consequences upon lending funds unless the loan is made in connection with purchase money debt, *i.e.*, the lender is the seller.
2. If the lender takes back purchase money financing, the lender has sold or exchanged property and will be required to recognize gain either currently or on the installment method (if the transaction qualifies for installment treatment). However, IRC § 453A requires a taxpayer to pay interest at the Federal underpayment rate on the deferred gain if the taxpayer holds, at the end of the tax year, installment obligations that arose during the tax year, the face amount of which exceed \$5,000,000. Also, if the holder of the installment obligation has pledged the obligation, there is a deemed payment in the amount of the loan secured by the installment obligation. IRC § 453A(d)(1).
3. See V, below for a general discussion of the OID rules.

II. TAX CONSEQUENCES TO BORROWER.

A. DISCHARGE OF INDEBTEDNESS INCOME.

1. COD – COD arises when the liability to repay a debt ceases or the debt is satisfied at less than its face amount. *United States v. Kirby Lumber Co.*, 284 U.S. 1 (1931). COD that is realized by an insolvent or bankrupt debtor, generally, will not be recognized. *See Dallas Transfer & Terminal Warehouse Co. v. CIR*, 70 F.2d 95 (5th Cir. 1934), *rev'g*, 27 B.T.A. 651 (1933) and IRC § 108. There remains an open question as to whether there is COD if debt is discharged pursuant to the terms of the debt instrument or other contemporaneous documents.
2. Debt.
 - a. COD only arises if the taxpayer first incurred a debt.
 - b. A contingent liability is not treated as a debt.
 - (1) Guarantees.
 - (a) Unless a guarantee has ripened into a primary liability, discharge thereof should not constitute COD. *See Terminal Investment Co.*, 2 T.C. 1004 (1943), *acq.*, 1944-1 C.B. 27; LTR 7953004. Release from a guarantee that is a primary

obligation should not produce COD because the guarantee was not an accretion to wealth. *Buehler*, 54 TCM 232 (1987), *Whitmer*, 71 TCM 2213 (1996), and *Landreth*, 50 TC 803 (1968). *But cf. Tennessee Securities, Inc. v. CIR*, 674 F.2d 570 (6th Cir. 1982). If release from a guarantee produces COD, it also would produce a corresponding bad debt deduction. Note: a nonbusiness bad debt deduction gives rise to a short term capital loss and COD is ordinary income. IRC § 166 and *see* Treas. Reg. § 1.166-9. (Short-term capital losses offset capital gains dollar for dollar and net short-term capital losses may be deducted against other income to the extent of \$3,000 per year with any excess carried over). *But see* Treas. Reg. § 1.1001-3(e)(4)(iv).

- (b) No debt exists if there is no obligation to repay, *i.e.*, a gift or equity. For factors to consider in debt vs. equity determination. *See Fin Hay Realty Co. v. U.S.*, 398 F.2d 694 (3rd Cir. 1968); *Federal Projects, Inc. v. CIR*, T.C. Memo 1987-202.
- (c) Discharge of a promise to make a capital contribution, generally, should not constitute COD. *See Whiting*, 47 TCM 1334 (1984) and TAM 8702006.
- (d) A discharge of debt in exchange for services rendered is compensation, not COD. *See* Rev. Rul. 83-60.
- (e) The acceptance by the IRS of an offer in compromise is not COD. *See* 98 Tax Notes Today 197-93.

3. Discharge.

- a. A discharge occurs if a creditor agrees to accept less than the face amount of a debt in satisfaction thereof.
- b. A discharge may occur if a creditor allows the statute of limitations on collection to expire without collecting. *Miller Trust*, 76 T.C. 191 (1981). *See also Bear Manufacturing Co. v. CIR*, 430 F.2d 152 (7th Cir. 1970), cert. denied, 400 U.S. 1021 (1971) (whether statute of limitations has run on collection of debt is a factor in determining when discharge occurs, but is not determinative).

- c. Set-off or settlement does not result in a discharge for this purpose. *See OKC Corp.*, 82 T.C. 638 (1984) (if discharge is result of settlement of matter unrelated to the debt then no COD income). For example, if Y agrees to paint X's house for \$1,000, Y paints X's house, X and Y have a dispute and agree that X will pay only \$800 for the paint job. X does not recognize COD. But See Treas. Reg. § 1.1001-3(e)(4)(iv).
 - d. Modification or Substitution of a Debt/Time Value of Money Issues. See IV, below, for a discussion of when a modification can be treated as discharge of the old obligation and issuance of a new obligation.
 - (1) If (i) debt is assumed in connection with or taken subject to a sale or exchange of property, (ii) the debt is modified in connection with the sale or exchange, and (iii) the modification of the debt instrument results in an exchange under Treas. Reg. § 1.1001-3, absent an election by the buyer and the seller, the modification is treated as if it occurred immediately before the sale. Treas. Reg. §§ 1.1274-5(b)(1) and (2). As a result, the seller bears the tax consequences of the modification.
 - (a) A debt instrument is not considered modified as part of a sale or exchange unless the seller knew or had reason to know of the modification. Treas. Reg. § 1.1274-5(b)(1).
 - (b) This could cause the seller to realize COD even if the debt is nonrecourse because the modification is deemed to occur before the sale.
 - e. Conversion of recourse debt into nonrecourse debt – This will be treated as a significant modification of a debt instrument if the original collateral changes and the change from recourse to nonrecourse changes payment expectation. Treas. Reg. § 1.1001-3(e)(5)(ii)(B)(2). See IV, below.
4. Exclusion of discharged debt for Hurricane Katrina victims. The Katrina Emergency Tax Relief Act of 2005 excludes from gross income debt if a Hurricane Katrina victim on that person's residence if it was his or her principal residence on August 25, 2005 and was located in the "core disaster area," or of a Hurricane Katrina victim whose principal residence was located in the "Hurricane Katrina disaster area" and who suffered economic loss by reason of Hurricane Katrina. To qualify, the debt must be forgiven by a governmental agency or a financial institution described in IRC § 6050P(c)(1).

5. Mortgage Forgiveness. There is no COD income from the forgiveness (in whole or in part) of mortgage indebtedness on a principal residence where the discharge occurs after December 31, 2006 and before January 1, 2013, provided the balance of the loan was less than \$2 million (or \$1 million in the case of married individuals filing separate returns). To qualify for this exclusion, the debt must have been used to buy, build or substantially improve the taxpayer's principal residence and must have been secured by such residence. This exclusion does not apply to the debt forgiven on second homes, rental property, business property, credit cards, car loans, home equity loans or refinancings. The basis of the residence is reduced by the amount excluded, but not below zero. This exclusion, however, does not apply to a taxpayer in a Title 11 bankruptcy (the Title 11 exclusion applies instead); the mortgage forgiveness exclusion *will* apply to an insolvent taxpayer *unless* the taxpayer elects to apply the insolvency exclusion. IRC § 108(a)(1)(E).

B. STATUTORY OVERLAY – IRC § 108.

1. Bankruptcy and Insolvency – Nonrecognition.

- a. No income is recognized from a discharge of indebtedness that occurs in a Title 11 Bankruptcy case (“Title 11 Case”) if the taxpayer is under the jurisdiction of the court and the discharge is granted by the court or is pursuant to a plan approved by the court. IRC §§ 108(a)(1)(A) and (d)(2). Note that Title 11 is broader than Chapter 11; it includes all bankruptcy cases.
- b. COD realized by an insolvent taxpayer who is not a party to a Title 11 Case is recognized only to the extent the taxpayer becomes solvent as a result of the discharge. IRC §§ 108(a)(1)(B) and (a)(3). The Title 11 exclusion takes precedence over the insolvency exclusion. IRC § 108(a)(2)(A).
- c. The amount of COD excluded under IRC § 108(a)(1)(A) and (B) reduces tax attributes of the taxpayer (in the case of an individual, the taxpayer is the bankruptcy estate (IRC § 1398(g)) in the following order:
 - (1) Net operating loss for the year of discharge and any net operating loss carryovers in the order they arose;
 - (2) Certain tax credits, certain tax credit carryovers, net capital losses for the year of discharge, and capital loss carryovers in the order they arose;
 - (3) The basis of the taxpayer's property (depreciable (see IRC § 1017(b)(3)) and nondepreciable), passive activity loss or

credit carryover under IRC § 469(b) and foreign tax credits;
and

- (4) The taxpayer may elect, in lieu of (1)-(3) above, first to reduce the basis of depreciable property or inventory. Such basis reduction will be treated as depreciation and, to the extent of any gain on a later sale, may be recaptured as ordinary income. IRC §§ 108(b)(5), 1017, 1245, and 1250.
- d. If COD exceeds the sum of (1)-(3), the excess is never taxed and does not affect future tax attributes. See Treas. Reg. § 1.108-7(a)(2).
- e. Filing Requirement – IRS Form 982 should be filed in the year of a COD to claim the benefits of IRC § 108 and must be filed to make the election described in II.B.c.1.(4) above (though the election may be revoked only with the Service’s permission). However, the bankruptcy and insolvency exclusions are not elective.

2. Qualified Real Property Business Indebtedness (“QRPBI”).

- a. A taxpayer (other than a C corporation, which includes a REIT) that is neither involved in a Title 11 Case nor insolvent, under certain circumstances, may exclude from gross income COD recognized from discharge of QRPBI so long as the taxpayer reduces its basis for depreciable real property. IRC § 108(c)(1).
- b. The amount of COD from the discharge of QRPBI that a taxpayer can exclude from gross income is the lesser of:
 - (1) the excess of the outstanding principal amount of the QRPBI (immediately before it is discharged) over the net fair market value of the real property (IRC § 108(c)(2)(A))
or
 - (2) the aggregate adjusted bases (as of the first day of the next taxable year or the disposition date, if earlier) of depreciable real property held by the taxpayer (net of reductions determined under IRC §§ 108(b) (the general tax attribute reduction provision) or 108(g) (farm indebtedness) (IRC § 108(c)(2)(B)). No election is available to treat dealer property as depreciable property for this purpose. IRC § 1017(b)(3)(F)(ii).
- (4) For this purpose, accrued but unpaid interest is added to principal if the loan documents require that accrued but unpaid interest be added to principal and interest accrues on such amount. Treas. Reg. § 1.108-6(a).

- (5) For this purpose, net fair market value is determined immediately before the discharge. Treas. Reg. § 1.108-6(a).
 - (6) Net fair market value is the fair market value of the qualifying real property (notwithstanding IRC § 7701(g)), reduced by the outstanding principal amount of QRPBI, other than the QRPBI being discharged, that is secured by the property immediately before and after the discharge. Treas. Reg. § 1.108-6(a).
- c. The cost for this benefit is that the taxpayer must reduce the aggregate bases of depreciable real property, but not below zero, by the amount of QRPBI discharged. Any excess COD must be recognized unless the debt is purchase money debt as defined in IRC § 108(e)(5). IRC §§ 108(c)(1)(A) and 108(c)(2)(B). If the taxpayer is insolvent or the discharge occurs in a Title 11 case, those exclusions apply before the QRPBI exclusion. IRC § 108(a)(2).
- (1) The basis of depreciable real property acquired in contemplation of a discharge cannot be reduced to obtain the benefit of the IRC § 108(c) exclusion. IRC § 108(c)(2)(B).
- d. Debt will be QRPBI if it is debt:
- (1) incurred or assumed by the taxpayer in connection with real property used in a trade or business that is secured by such real property (IRC § 108(c)(3)(A));
 - (a) Investment real estate is not eligible for this exclusion.
 - (2) incurred or assumed
 - (a) before January 1, 1993 or debt refinancing such debt so long as the refinancing debt does not exceed the amount of the original debt being refinanced (IRC § 108(c)(3)(B)); or
 - (b) on or after January 1, 1993 that is qualified acquisition indebtedness (IRC § 108(c)(3)(B));
 - (i) Qualified acquisition indebtedness is debt incurred or assumed to acquire, construct, reconstruct or substantially improve real property used in a trade or business. Debt

incurred to refinance such debt also qualifies *provided that the refinancing debt does not exceed the amount of the original debt being refinanced* (IRC § 108(c)(3)(B));

- (ii) Neither the Code nor the Committee Reports make clear what is a substantial improvement. See ADR rules (10%) Treas. Reg. § 1.167(a)-11(b)(5)(iii)(a) and low-income housing credit rules (25%) IRC § 42(d)(2)(D)(i)(III). See also IRC § 163(h)(3)(B)(i)(I) (no benchmark); and
- (3) with respect to which the taxpayer makes an election to apply IRC § 108(c) (IRC § 108(c)(3)(C)).
 - (a) This election is made on IRS Form 982 with the taxpayer's return for the taxable year in which the discharge occurs. IRC § 108(d)(9).
 - (4) Note: the testing date for qualification as QRPBI is the date the debt is incurred.
- e. QRPBI does not include qualified farm indebtedness. IRC § 108(c)(3).

f. Examples:

- (1) Assume that the basis of certain depreciable real property owned by a solvent individual is \$6,000,000 and its fair market value is \$15,000,000. If the QRPBI is \$25,000,000 and \$8,000,000 is forgiven, IRC § 108(c) applies as follows:

COD is \$8,000,000

The amount excluded from gross income is limited to the lesser of:

the excess of the principal amount of the debt immediately before it is forgiven (\$25,000,000) over the fair market value of the property (\$15,000,000) or \$10,000,000; or

the basis the taxpayer has for depreciable real property (\$6,000,000).

Thus, assuming that this property is the taxpayer's only depreciable real property, the taxpayer would exclude \$6,000,000 of the \$8,000,000 COD, recognize \$2,000,000 of the \$8,000,000 COD, and reduce basis for the property by the amount excluded (\$6,000,000).

- (2) Assume instead that the basis of the qualified real property is \$9,000,000 and its fair market value is \$15,000,000.

If the QRPBI is \$25,000,000 and \$8,000,000 is forgiven, this section is applied as follows:

COD is \$8,000,000

The amount excluded from gross income is limited to the lesser of:

the excess of the principal amount of the debt immediately before it is forgiven (\$25,000,000) over the fair market value of the property (\$15,000,000) or \$10,000,000 or

the basis the taxpayer has for depreciable real property (\$9,000,000).

Thus, assuming that this property is the taxpayer's only depreciable real property, the taxpayer would exclude all of the \$8,000,000 COD and reduce basis for the property by the amount excluded.

- g. The Secretary is mandated to issue such regulations as are necessary to carry out IRC § 108(c) and to prevent its abuse.

3. Basis Reduction Rules.

- a. The applicable basis reduction rules are found in IRC § 1017. IRC § 1017(a)(2).
- b. For this purpose, depreciable real property includes a partnership interest to the extent of the partner's proportionate interest in the partnership's depreciable real property. IRC §§ 1017(b)(3)(C) and (b)(3)(F)(i).
- c. No election is available to treat inventory as depreciable real property. IRC § 1017(b)(3)(F)(ii). This means that the basis for condominiums, houses, or lots held for sale may not be reduced by COD from QRPBI.

- d. Basis is to be reduced at the beginning of the taxable year following the taxable year of the discharge. IRC § 1017(a). As a result, the taxpayer can use its tax attributes in the year of the discharge even if the attributes would be reduced or eliminated in the succeeding year. However, if the taxpayer disposes of the property subject to the basis reduction before the beginning of the following taxable year, the basis reduction is made immediately before the disposition of such property. IRC § 1017(b)(3)(F)(iii).
- e. A basis reduction under IRC § 1017 is treated as a depreciation deduction. IRC § 1017(d). Thus, under IRC §§ 1245 and 1250, there will be depreciation recapture from the basis reduction under IRC § 1017.
- f. Basis reduction rules for elections for COD realized by Partnership with respect to QRPBI.
 - (1) If the taxpayer elects under IRC § 108(c) to exclude COD from the discharge of QRPBI, the taxpayer must treat a partnership interest as depreciable real property to the extent of the partner's proportionate share of the partnership's basis in depreciable real property, provided the partnership consents to a corresponding reduction in the partnership's basis ("inside basis") for such property with respect to such partner. Treas. Reg. § 1.1017-1(g)(2)(i).
 - (2) Subject to (f)(2)(b) and (c), below, a taxpayer may choose whether to request that a partnership reduce the inside basis of its depreciable real property with respect to the taxpayer and the partnership may choose whether to grant or withhold its consent, in its sole discretion. Treas. Reg. § 1.1017-1(g)(2)(ii)(A).
 - (a) A request must be made by the taxpayer before the due date (including extensions) for filing the taxpayer's Federal income tax return for the taxable year in which the taxpayer has COD that is excluded under IRC § 108(a).
 - (b) A partner must request a partnership's consent to reduce inside basis if, at the time of the discharge, (1) the taxpayer owns (directly or indirectly) a greater than 50 percent interest in the capital and profits of the partnership or (2) reductions to the basis of the taxpayer's depreciable property (or depreciable real property) are being made with respect to the taxpayer's distributive share of COD

of the partnership. Treas. Reg. § 1.1017-1(g)(2)(ii)(B).

- (c) A partnership must consent to reduce its partners' shares of inside basis with respect to a discharged indebtedness if consent is requested by (1) partners owning (directly or indirectly) an aggregate of more than 80 percent of the capital and profits interests of the partnership or (2) five or fewer partners owning (directly or indirectly) an aggregate of more than 50 percent of the capital and profits interests of the partnership. Treas. Reg. § 1.1017-1(g)(2)(ii)(C).
- (3) A consenting partnership must include with its Form 1065 for the taxable year following the year that ends with or within the taxable year the taxpayer excludes the COD under IRC § 108(a) and must provide the taxpayer on or before the due date of the taxpayer's return (including extensions) for the taxable year in which the taxpayer excludes COD income from gross income, a statement that (1) contains the name, address, and taxpayer identification number of the partnership and (2) states the amount of the reduction of the partner's proportionate interest in the adjusted bases of the partnership's depreciable property or depreciable real property, whichever is applicable. Treas. Reg. § 1.1017-1(g)(2)(iii)(A).
- (4) For taxable years beginning after December 31, 2002, taxpayers must retain the statements described in (f)(3) above and keep them available for inspection in the manner required by Treas. Reg. § 1.6001-1(e), but are not required to attach the statements to their returns. Treas. Reg. § 1.1017-1(g)(2)(iii)(B).
- (5) A partner's proportionate share of the partnership's basis for depreciable property or depreciable real property is equal to the sum of (1) the partner's IRC § 743(b) basis adjustments to items of partnership depreciable property or depreciable real property and (2) the common basis depreciation deductions (not including remedial allocations of depreciation under Treas. Reg. § 1.704-3(d)) that, under the terms of the partnership agreement effective for the taxable year in which the discharge occurs, are reasonably expected to be allocated to the partner over the property's remaining useful life. The partnership must make consistent assumptions *vis-à-vis* all of its partners. Treas. Reg. § 1.1017-1(g)(2)(iv). Basis reductions are recovered

as if they were adjustments under Code § 743(b) to depreciation otherwise allowable to the electing partner.

4. Other Rules.

a. Purchase Money Debt.

- (1) If the debtor is neither involved in a Title 11 Case nor insolvent, reduction of purchase money debt will be treated as a reduction of the purchase price of the property. IRC § 108(e)(5).
- (2) The legislative history of the Bankruptcy Tax Act of 1980 indicates that this rule applies only if the debtor still owns the property and the seller still holds the debtor's purchase money debt at the time the debt is reduced. 1980-2 C.B. 628. *See also* Rev. Rul. 92-99, 1999-2 C.B. 35.

b. Acquisition of Debt by Parties Related to the Debtor.

- (1) IRC § 108(e)(4) provides that to the extent provided in regulations, an acquisition of outstanding indebtedness by a person related to the debtor from a person unrelated to the debtor is treated as the acquisition of the indebtedness by the debtor. To the extent that the debt is acquired at a discount, the will be COD to the debtor. Consequently, if the related party acquires the debt at a discount, the debtor has COD. These rules are relevant only for the debtor, not the holder.
- (2) For this purpose, related parties are defined broadly by IRC § 108(e)(4)(B) to include: a spouse, child, grandchild, parent or spouse of a child or grandchild and entities under common control pursuant to IRC §§ 414(b) or (c). See IRC §§ 267(b) and 707(b).
- (3) Regulations under IRC § 108(e)(4):
 - (a) Direct Acquisitions – An acquisition of debt from a person unrelated to the debtor by a person related to the debtor. Treas. Reg. § 1.108-2(b).
 - (b) Indirect Acquisitions – A transaction in which a holder of debt becomes related to the debtor, if the holder acquired the debt in anticipation of becoming related to the debtor. Whether debt is acquired in anticipation of becoming related is determined by all relevant facts and circumstances. A holder is

treated as having acquired the debt in anticipation of becoming related to the debtor if the holder acquired the debt less than 6 months before becoming related to the debtor. If on the date the holder becomes related to the debtor, the debt represents more than 25 percent of the fair market value of the total gross assets of the holder of the holder group the debtor must attach a disclosure to its tax return for the year in which the relationship occurs unless the debtor reports COD as a result of such relationship. Disclosure also is required if a holder acquired the debt 6 or more but less than 24 months before becoming related to the debtor. Treas. Reg. § 1.108-2(c)(4)(iii). If the holder fails to make the disclosure, the holder is presumed to have acquired the debt in anticipation of becoming related unless facts and circumstances clearly establish the contrary. Treas. Reg. § 1.108-2(c)(4)(v).

(c) See Treas. Reg. § 1.108-2(c)(4)(iv) for the contents of the disclosure.

- c. COD and Deduction – No COD is realized on the cancellation of amounts which, if paid, would result in a deduction. IRC § 108(e)(2).
- d. Equity for Debt.
 - (1) A corporation is treated as if it satisfied its debt with an amount of money equal to the fair market value of the stock issued in exchange for the debt. An insolvent or bankrupt corporation can reduce tax attributes rather than recognize the discharge of indebtedness income. IRC § 108(e)(8).
 - (2) If a shareholder of a corporation contributes debt to the capital of the corporation, IRC § 118 does not apply but the corporation will be treated as if it satisfied the debt with an amount of money equal to the shareholder's basis for the debt. IRC § 108(e)(6).
 - (3) If a debtor partnership transfers a profits or capital interest in the partnership to a creditor in satisfaction of the indebtedness, the partnership will have satisfied such indebtedness with an amount of money equal to the fair market value of the interest. IRC § 108(e)(8). The value of the partnership interest is its liquidation value if the

partnership maintains capital accounts in accordance with Treas. Reg. § 1.704-1(b)(2)(iv), both the creditor and the partnership use liquidation value to determine their tax consequences, the exchange is arms length, and, subsequent to the exchange, there is no redemption of the creditor's or a related person's partnership interest as part of a plan the principal purpose of which is to avoid COD. Liquidation value is the amount a partner would receive if the all of assets of the partnership were sold at their fair market value and then liquidated. Prop. Reg. §§ 1.108-8(b)(1).

e. Indebtedness Satisfied by Issuance of Debt Instrument.

- (1) A debtor who issues a debt instrument in satisfaction of a debt obligation is treated as having satisfied the obligation with an amount equal to the issue price of the debt instrument. IRC § 108(e)(10)(A). See V, below for a discussion of how issue price is determined.
- (2) The issue price for purposes of IRC § 108(e)(10) is determined under IRC §§ 1273 and 1274. For purposes of applying IRC § 1273(b)(4), the stated redemption price of any instrument shall be reduced by the portion of such stated redemption price that is treated as interest. IRC § 108(e)(10)(B). This rule applies only to the debtor to enable the debtor to determine if there is COD; this rule does not apply to the holder of a debt instrument for purposes of determining the issue price of an instrument.

5. Rules Applicable to Partnership Debt.

- a. Relief of partnership debt and the determination of whether indebtedness is QRPBI and the application of the fair market value limitation is determined at the partnership level. However, exclusions and any applicable basis or tax attribute reduction applies at the partner level. IRC § 108(d)(6).
- b. A partner's partnership interest will be treated as depreciable property to the extent of the partner's proportionate share of the basis of the partnership's depreciable property if the partnership consents to a corresponding reduction in the basis of partnership property (*i.e.*, similar to an IRC § 754 election). IRC § 1017(b)(3)(C) and Committee Reports to the Bankruptcy Tax Act of 1980, 1980-2 C.B. at 631, n. 27. For this purpose, real property held by the taxpayer primarily for sale to customers in the ordinary course of its business is treated as depreciable property. However, such property or partnership interest (to the extent the

partnership owns dealer real property) does not qualify as depreciable real property for purposes of the QRPBI exclusion. See IRC § 1017(b)(3)(F)(ii).

- c. COD is a separately allocated item of income under IRC § 702(a)(8). Thus, treatment of the COD items will depend on the status of the partner, *i.e.*, solvent, insolvent, or bankrupt. As a consequence, solvent partners, subject to the QRPBI rules, will be forced to recognize COD since there is no basis reduction option available. See *Gershkowitz*, 88 T.C. 984 (1987). The allocation of debt discharge income will increase a partner's basis in the partnership even if that particular partner may exclude the income under § 108. See PLR 9739002. However, under IRC § 752(b), reduction in partnership debt is treated as a distribution to the partners. A basis reduction in a partnership interest resulting from a reduction of partnership debt is a separate basis reduction from that provided by IRC § 108(c). House Committee Report.
- d. COD will be allocated in accordance with the partnership agreement if the allocation in the agreement has substantial economic effect. See Rev. Rul. 92-97, 1992-2 CB 124. It appears that a partnership level basis reduction resulting from the discharge of nonrecourse debt will trigger a minimum gain chargeback. See Treas. Reg. § 1.704-2(f). Such a chargeback could minimize or eliminate the benefits provided by IRC § 108(c). See Rev. Rul. 94-4, 1994-1 C.B. 195 which provides that a deemed distribution of money under IRC § 752 resulting from a decrease in a partner's share of partnership liabilities is treated as an advance or drawing of money under IRC § 731 to the extent of the partner's distributive share of income for the partnership tax year. Also see new IRC § 108(i) at II.B.8., below.. Additionally, the benefits of IRC § 108(c) can be reduced by recapture of losses resulting from a reduction in the taxpayer's at-risk amount. See IRC § 465(e).

6. Rules applicable to S Corporation Debt.

- a. IRC § 108 is applied at the S corporation level. IRC § 108(d)(7).
- b. Any net loss or deduction allowed to shareholders under IRC § 1366(d) for the year in which COD arises is treated as an NOL for purposes of IRC § 108(b)(2)(A). As a consequence, the net loss or deduction is subject to reduction if the appropriate requirements are satisfied. Losses that a shareholder cannot deduct under IRC § 1366(d)(1) are treated as NOLs of the corporation in the succeeding taxable year. IRC § 1366(d)(2).

- c. For purposes of IRC § 108(e)(6) (indebtedness contributed to capital), a shareholder's basis in an S corporation's indebtedness to him is determined without regard to adjustments under IRC § 1367(b)(2).
- d. The United States Supreme Court held in *Gitlitz v. Commissioner*, 531 U.S. 206 (2001) that a shareholder's basis for his stock is adjusted by the amount of COD that is excluded at the corporate level. IRC § 108(d)(7)(A) overruled *Gitlitz* for discharges of indebtedness after October 11, 2001, unless the discharge occurs before March 1, 2002 pursuant to a plan of reorganization filed with a bankruptcy court on or before October 11, 2001. See Prop. Reg. § 1.108-7.

7. 2009 Stimulus Bill COD Deferral and Spread Provisions.

- a. IRC § 108(i) provides that a taxpayer may elect to defer recognition of COD occurring in 2009 and 2010 and then, after the deferral period, to spread out the recognition of the COD ratably over 5 years ("COD Deferral and Spread")
 - (1) For COD occurring in 2009, the deferral period is 5 years and for COD occurring in 2010 the deferral period is 4 years. IRC § 108(i)(1)(A).
 - (2) If a taxpayer makes this election to avail itself of the COD Deferral and Spread, the other COD exclusion rules do not apply. IRC § 108(i)(1)(B).
 - (3) If the COD results from an actual or deemed exchange of debt instruments, OID deductions also are deferred until the COD is recognized. IRC § 108(i)(2).
 - (4) The COD Deferral and Spread is accelerated and recognized in the year that a taxpayer (1) dies, (2) liquidates or sells substantially all of its assets, (3) ceases to do business, or (4) similar circumstances. IRC § 108(i)(5)(D).
 - (5) If a partnership or S corporation is the issuer of the debt, COD Deferral and Spread also ceases upon a holder's disposition of its interest in the entity by sale, exchange, or redemption. IRC § 108(i)(5)(B)(iii).
- b. The COD Deferral and Spread election is available for COD resulting from a "reacquisition" of any "applicable debt instrument" in 2009 and 2010.

- (1) An applicable debt instrument is a debt issued by any person in connection with the conduct of a trade or business by that person and any debt instrument issued by a C corporation. IRC § 108(i)(3).
- (2) The issuer, a person who otherwise is the obligor or a person related to the issuer or obligor must be the person who reacquires of the debt instrument. IRC § 108(i)(4).
- (3) The acquisition must be accomplished by virtue of (1) the acquisition of the debt instrument for cash, (2) an exchange of the debt instrument for another debt instrument or a deemed exchange of the debt instrument for another debt instrument as the result of a modification of the debt instrument, (3) an exchange of a debt instrument for stock or a partnership interest of the issuer, (4) a contribution of a debt instrument to the capital of a corporation or partnership, (5) the holder's complete forgiveness of a debt instrument, or (6) a similar transaction. IRC § 108(i)(4)(B).

c. Special Rules for Partnerships, S Corporations and other Pass Through Entities.

- (1) This new election for COD Deferral and Spread is made and applies at the entity level, including at the partnership level. IRC § 108(i)((5)(B)(iii).
- (2) A partnership considering this election may have partners with conflicting interests and, as a result, the sponsor of the partnership must carefully consider the consequences of this election before making it.
- (3) IRC § 752 treats a reduction in a partnership's debt as a distribution of cash to the partners. If that deemed distribution exceeds a partner's basis for its partnership interest, the partner recognizes gain. If a partnership elects COD Deferral and Spread, the deemed distribution to a partner that occurs upon the discharge of the partnership's debt is suspended (in part) to prevent current recognition of gain by a partner from such discharge. IRC § 108(i)(6).

d. The Election.

- (1) The COD Deferral and Spread election may be made by a taxpayer for any debt instrument to which it wants the election to apply. IRC § 108(i)(5)(B).

- (2) The election must (i) be attached to the taxpayer's tax return for the tax year of the reacquisition, (ii) clearly identify the debt instrument or instruments to which it applies, (iii) set forth the amount of the deferral, and (iv) include any other information required by the Secretary. IRC § 108(i)(5)(B).

e. Denial of Deduction for OID.

- (1) If the reacquisition results in the actual or deemed issuance of a new debt instrument, and there is OID with respect to the new debt instrument, no deduction is allowed to the issuer with respect to that portion of the OID that (a) accrues before the first taxable year of the recognition period that begins after the deferral period and (b) does not exceed the COD resulting from the reacquisition. IRC § 108(i)(2)(A)(i).

- (a) That portion of any debt the proceeds of which are used by an issuer, directly or indirectly, to reacquire an applicable debt instrument is treated as issued for the reacquired debt. IRC § 108(i)(2)(B).

- (2) The deductions disallowed during the deferral period are allowed ratably over the 5 year recognition period. IRC § 108(i)(2)(A)(ii).

- (3) If the OID accruing before the first year of the recognition period exceeds the COD with respect to the applicable debt instrument, the deductions are disallowed in the order the OID accrues. IRC § 108(i)(2)(A).

C. TAX CONSEQUENCES ON TRANSFER OF PROPERTY IN SATISFACTION OF DEBT.

1. General Rule – A transfer of property in satisfaction of debt is treated as a sale or exchange of the property. Treas. Reg. § 1.1011-2(c) Example 7; *Helvering v. Hammel*, 311 U.S. 504 (1941); Rev. Rul. 73-36, 1973-1 C.B. 372.
2. Foreclosure and Deed in Lieu – A borrower has the same tax results from a transfer pursuant to a foreclosure as from a deed in lieu of foreclosure. Rev. Rul. 76-111, 1976-1 C.B. 214; *Freeland*, 74 T.C. 970 (1980).
3. Recourse Debt.
 - a. A transfer of property in satisfaction of recourse debt may create both COD and gain or loss from a sale or exchange. Treas. Reg.

§ 1.1001-2(c) Example 8. *See also, e.g., Danenberg*, 73 T.C. 370 (1979), acq., 1980-2 C.B. 1 (bifurcation of transaction when debtor was relieved of recourse debt but debt was not satisfied).

- (1) The difference between the fair market value of the asset and its adjusted basis is gain or loss from a sale or exchange.
- (2) The excess, if any, of the liability forgiven over the fair market value of the asset is COD under IRC § 61(a)(12) and is subject to IRC § 108.

4. Nonrecourse Debt.

a. General Rules.

- (1) Transfer of an asset to a lender in satisfaction of a nonrecourse debt is considered a sale or exchange of the asset and not COD under IRC § 61(a)(12). *See* Treas. Reg. § 1.1001-2(c) Example 7; *Estate of Delman*, 73 T.C. 15 (1979); *CIR v. Tufts*, 461 U.S. 300 (1983); *Middleton*, 77 T.C. 310 (1981), *aff'd*, 693 F.2d 124 (11th Cir. 1983); *Coburn v. Commissioner*, TC Memo 2005-283.
 - (a) In *CIR v. Hoffman*, 117 F.2d 987 (2d Cir. 1941), the Court allowed a borrower who abandoned property subject to a nonrecourse debt to take an ordinary, as opposed to a capital, loss. This case has been cited for the proposition that if property subject to a nonrecourse debt is abandoned, an ordinary loss will result if: (a) the property is worthless, (b) the borrower relinquished all possession and control, (c) there was no threat of foreclosure, and (d) the borrower received no consideration from the lender.
 - (b) In *Middleton, supra*, the Tax Court refused to follow *Hoffman, supra*, thereby characterizing the loss on the abandonment of real property subject to nonrecourse debt as a capital loss.
 - (c) Where the lender forgives nonrecourse debt in connection with a transfer of the property that secures the debt as part of a single transaction, the entire amount of the debt before the forgiveness is part of the amount realized on the disposition and no COD income is realized. *2925 Briarpark Ltd. v. CIR*, 163 F3d 313 (5th Cir. 1999).

5. Part Recourse and Part Nonrecourse Debt.

- a. A settlement or transfer in satisfaction of partially recourse debt is allocated first to the nonrecourse portion of the debt, absent agreement to the contrary. LTR 8348001. Thus, the availability of IRC § 108 is maximized.

6. Purchase Money Debt.

- a. If a purchaser would realize COD upon the reduction of purchase money debt and the reduction does not occur in a Title 11 Case or when the purchaser is insolvent, the reduction is treated as a purchase price adjustment. IRC § 108(e)(5).
- b. Also, if the purchaser would not realize COD upon the reduction of a purchase money debt, the purchase price is adjusted to reflect the reduction. *Fulton Gold Corp.*, 31 B.T.A. 519 (1934), non acq Rev. Rul. 91-31, 1991-1 C.B. 19 and see n. 11 of *Tufts*, *supra*.

- (1) Arguably, if the COD occurred due to renegotiation as opposed to foreclosure, no sale or exchange has occurred and, therefore, if the debt is purchase money debt, IRC § 108 would apply to cause a purchase price adjustment.
- (2) If the amount of COD exceeds the purchaser's adjusted basis for the property, the tax results are unclear. With one exception (*Easson v. CIR*, 294 F.2d 653 (9th Cir. 1961)), courts have held that a taxpayer cannot have a negative basis for property; once a taxpayer's basis is reduced below zero, the taxpayer recognizes gain. If basis cannot be reduced below zero and the COD exceeds basis, if no gain is recognized, the gain attributable to the negative basis would remain untaxed.
- (3) In Rev. Rul. 91-31, 1991-1 C.B. 19, the IRS held that reduction of the principal amount of an undersecured nonrecourse debt by a holder of the debt who is not the seller of the property securing the debt results in realization of COD. See Section 108(e)(5).

7. Other Rules.

- a. Gain or loss on the transfer of property in satisfaction of debt is characterized by reference to the character of the property. Rev. Rul. 72-238, 1972-1 C.B. 65.
- b. To the extent that the proceeds of a foreclosure sale are used to satisfy interest arrearages and property taxes, the taxpayer should

be entitled to a deduction. *Nichols v. CIR*, 141 F.2d 870 (6th Cir. 1944) (if the fair market value of property foreclosed upon exceeds the principal of the debt, the excess is applied by the lender against accrued but unpaid interest).

(1) IRS position – Expenses that have been accrued but that are unpaid are recaptured in income as a tax benefit item and are characterized by reference to the previous deduction. Both before and after *Tufts, supra*, the IRS failed in its attempt to characterize a portion of the gain resulting from foreclosure of a nonrecourse debt as ordinary income. In *Allan*, 86 T.C. 655 (1986), *aff'd*, 856 F.2d 1169 (8th Cir. 1988), the court held that accrued items added to the principal of the debt are included in the amount realized on the sale or exchange, rejecting the IRS contention that such items are recaptured as ordinary income.

c. Expenses of foreclosure do not become deductible until redemption rights of the borrower have expired. *See* Treas. Reg. § 1.166-6. Where a borrower exercises a right of redemption, no loss is allowable to the borrower. *Holtz*, 42 B.T.A. 432 (1940).

D. If (i) debt is assumed or taken subject to in connection with a sale or exchange of property, (ii) the debt is modified in connection with the sale or exchange, and (iii) the modification of the debt instrument results in an exchange under Treas. Reg. § 1.1001-3, absent an election by the buyer and the seller, the modification is treated as if it occurred immediately before the sale. Treas. Reg. §§ 1.1274-5(b)(1) and (2). As a result, the seller bears the tax consequences of the modification.

1. A debt instrument is not considered modified as part of a sale or exchange unless the seller knew or had reason to know of the modification. Treas. Reg. § 1.1274-5(b)(1).
2. This could cause the seller to have COD even if the debt is nonrecourse because the modification occurred before the sale.
3. When the buyer acquires the property subject to or assumes nonrecourse debt in excess of the fair market value of the property, *Estate of Franklin v. Commissioner*, 544 F.2d 1045 (9th Cir. 1976) may limit the buyer's basis for the acquired property to the fair market value of the property. This rule may allow the buyer to avoid COD income if the election is made. But, there is no clear answer to this. *Cf* IRC § 7701(g) which provides that in determining the amount of gain or loss with respect to any property, the fair market value of such property is treated as being not less than the amount of any nonrecourse debt to which the property is subject.

III. TAX CONSEQUENCES TO LENDER.

A. FIRST MORTGAGEE.

1. General Rules.

- a. Borrower and lender are treated differently. A voluntary conveyance, *i.e.*, deed in lieu of foreclosure and a foreclosure are treated as sales or exchanges for the borrower but are treated as a debt collection for the lender.
 - (1) The lender is treated as if it received the fair market value of the property as payment.
 - (2) If the debtor is solvent and no further payments are anticipated, the fair market value of the property generally is applied first against the principal and then accrued interest.
- b. Insolvent Borrower – compromise or settlement of a debt of an insolvent borrower by a lender ordinarily results in a bad debt, assuming that the unrecovered portion is worthless.
- c. Solvent Borrower – compromise of a debt of a solvent borrower by a lender results in a loss, not a bad debt, to the lender. *Estate of Theodore Gutman*, 18 T.C. 112 (1952), *acq.*, 1952-2 C.B. 2 and *Manville Jenckes Co.*, 4 B.T.A. 765 (1926). Also see IRC § 1271 for character of gain or loss with respect to a retirement of obligations issued by other than natural persons.

2. Accrual of Interest – Generally, interest is taken into account under the taxpayer’s overall method of accounting (cash or accrual) unless the interest is original issue discount (“OID”). IRC § 1272 in effect places all taxpayers on an accrual method of accounting for OID. Even if a borrower is in default of its obligation to pay interest to the lender, until there is reasonable doubt that the interest ever will be paid due to the financial condition of the borrower, the lender must accrue interest income. See *Clifton Mfg. Co. v. Commissioner*, 137 F.2d 290 (4th Cir. 1943). The relevant time for testing reasonable doubt is at the time of the accrual. *Spring City Foundry Co. v. United States*, 292 U.S. 182 (1934). The IRS position is that OID, unlike interest generally, must be accrued as income even if it is unlikely the OID will ever be paid. TAM 9538007.

- a. Reasonable doubt exists only if there is a significant degree of uncertainty. Inability to pay at the time due is not sufficient. *Georgia School Book Depository, Inc.*, 1 T.C. 463 (1943), *Koehring Company v. United States*, 421 F.2d 715 (Ct. Cl. 1970) (applying the same principles to royalty income). Relevant factors

include: reasonable attempts to collect, inquiries into the borrower's ability to pay, the priority of the claim, the borrower's payment history to the lender and other lenders, etc.

- b. See Calvin and Farias, *When Can Holders of Defaulted Debt Cease Accruing Interest Income*, 73 Journal of Taxation 378 (1990).

3. Foreclosure.

- a. General – A lender who acquires the property securing its debt at a foreclosure sale is deemed to have collected on the debt to the extent of the bid price. *Community Bank*, 62 T.C. 503 (1974), *acq.* 1975-1 C.B. 1. See also Treas. Reg. § 1.166-6(b)(2).

- b. Bad Debt.

- (1) Except in situations involving real property purchase money debt covered by IRC § 1038, a lender who forecloses on a mortgage at a loss, generally, has a bad debt equal to the sum of (i) the excess of the lender's basis for the debt over the net proceeds from the foreclosure sale, to the extent the excess is worthless, (ii) the lender's legal and other expenses of foreclosure, and (iii) accrued but unpaid interest previously reported as income. Treas. Reg. § 1.166-6(a).

- (2) To claim a bad debt deduction after a foreclosure, the lender must show that the borrower's remaining obligation, if any, is worthless or that the debt was nonrecourse debt.

- (3) Character of the Deduction.

- (a) A business bad debt is deductible in full against ordinary income. IRC § 166.

- (b) A nonbusiness bad debt is a short-term capital loss. IRC § 166(d).

- (c) If a debt that (a) is issued by a corporation or by a government or political subdivision thereof, (b) is a capital asset in the hands of the lender, and (c) is evidenced by a bond, note, or other evidence of indebtedness with interest coupons or in registered form becomes worthless, the loss is a capital loss. IRC § 165(g). Code § 165(g)(1) provides that if security becomes worthless during the taxable year, it is deemed to be sold or exchanged on the last day of the holder's taxable year. IRC § 1091 disallows

a loss deduction from the sale or disposition of a security where a taxpayer acquires substantially identical securities either 30 days before or after the disposition. Thus, if a taxpayer exchanges debt for stock in conjunction with cancellation of existing stock, the wash sale rules can apply if the work-out takes place in the 61-day period (between December and January 30 for a calendar year taxpayer). If the debt was issued by a corporation and its original term exceeded 5 years, the debt probably would be treated as a security and generally, the exchange would be tax-free.

- c. Gain or Loss on Acquisition of Property Securing Loan.
- (1) Gain or loss is measured by the difference between the fair market value of the property received and the amount of the mortgage liability applied to the bid price. *Malden Trust Co. v. CIR*, 110 F.2d 751 (1st Cir. 1940); *Community Bank, supra*; Treas. Reg. §§ 1.166-6(a) and (b).
 - (2) The price at which the lender bids in the property is presumed to be the fair market value. Treas. Reg. § 1.166-6(b)(2). This presumption is rebuttable by clear and convincing proof to the contrary. *Id.*
 - (3) Character of Gain or Loss.
 - (a) The nature of the exchanged debt determines the character of the gain or loss recognized.
 - (b) In Rev. Rul. 80-56, 1980-1 C.B. 154, the IRS held that gain recognized when a lender bids in property is to be treated as ordinary income to the extent of any bad debt deduction taken with respect to the transaction, regardless whether the mortgage debt was a capital asset.
 - (c) A person who is in the business of lending, generally, will realize ordinary income or loss on foreclosures.
 - (i) In Rev. Rul. 72-238, 1972-1 C.B. 65, the IRS held that gain recognized by a bank as a result of a foreclosure sale was ordinary income.

- (4) The lender must report as interest income any interest that is collected from the proceeds or value received from the foreclosure that had not yet been accrued as income. Principal is recovered before any proceeds or value are applied to interest. *See Nichols, supra; Helvering v. Midland Mutual Life Ins. Co.*, 300 U.S. 216 (1937), *reh'g denied*, 300 U.S. 688 (1937). However, Treas. Reg. §§ 1.446-2(e)(1) and 1.1275-2(a)(1) provide that each payment under a loan is first treated as a payment of interest or original issue discount to the extent accrued and then as a payment of principal.
- d. Basis – The lender’s basis for property acquired by foreclosure is the fair market value of the property.
- e. Timing.
- (1) A bad debt on foreclosure, like any other bad debt, is deductible in the year the debt becomes wholly worthless. IRC § 166. Worthlessness cannot be established until the foreclosure and inability to collect is final and confirmed. The bad debt deduction is allowed in the year of the foreclosure sale if the debt is worthless at that time, even if the borrower has a statutory right of redemption that extends past the close of the lender’s taxable year. *Securities Mortgage Co.*, 58 T.C. 667 (1972); *William C. Heinemann & Co.*, 40 B.T.A. 1090 (1939). *See also Hadley Falls Trust Co. v. U.S.*, 110 F.2d 887 (1st Cir. 1940) (lender’s entry upon property to foreclose did not establish that the debt was worthless); *Heinemann & Co., supra* (foreclosure established that a recourse debt was worthless where the borrower’s debt was worthless); *W.G. Duncan Coal Co. v. Glenn*, 36 F. Supp. 834 (W.D. Ky. 1941) (pursuant to local law, a foreclosure sale was not final until confirmed; worthlessness could not be established until confirmation occurred); *Edward Dalton*, 2 B.T.A. 615 (1925), acq., IV C.B. 2 (debt from a borrower was worthless when the borrower disappeared).
- (2) Worthlessness.
- (a) A bad debt that was not created or acquired in or in connection with the taxpayer’s trade or business is deductible only when it becomes totally worthless. No deduction for partial worthlessness is available. IRC § 166(d)(1)(A).

- (b) A corporate taxpayer, generally, will be deemed to have created or acquired debt in or in connection with its trade or business. Corporate taxpayers generally are not subject to the nonbusiness bad debt rule from IRC § 166(c).
 - (c) Business bad debts may be deductible when they are worthless or partially worthless. IRC §§ 166(a)(2) and (d)(2).
- f. Examples – See Tax Management Portfolio 592-1st, Real Estate Mortgages, p. 67:
- (1) B borrows \$600 from A secured by property. A's basis for this debt is \$600. B defaults and A bids in the property at \$600. Absent clear and convincing proof that the fair market value of the property is other than \$600, \$600 is applied to the debt and no gain or loss is recognized.
 - (2) Same as (1), above, except A bids in the property at \$400. \$400 is applied to the debt. A has a bad debt of \$200. Absent clear and convincing evidence that the fair market value is other than \$400, no gain or loss is recognized.
 - (3) Same facts as (1), above, except that there is clear and convincing evidence that the fair market value of the property is \$750. \$600 is applied to the debt. A has gain of \$150.
 - (4) Same facts as (1), above, except that there is clear and convincing evidence that the fair market value of the property is \$400. \$600 is applied to the debt. A has a loss of \$200.
 - (5) Same as (2), above, except that there is clear and convincing evidence that the fair market value of the property is \$750. \$400 is applied to the debt. A has a bad debt of \$200 and a gain of \$350.
 - (6) Same as (2), above, except that there is clear and convincing evidence that the fair market value of the property is \$300. \$400 is applied to the debt. A has a bad debt of \$200 and a loss of \$100.

4. Voluntary Transfer/Deed in Lieu of Foreclosure.

- a. A lender who accepts conveyance of mortgaged property in satisfaction of mortgage debt is treated as if he had collected an

amount equal to the fair market value of the property. *Bingham v. CIR*, 105 F.2d 971 (2nd Cir. 1939). The debt is not considered sold or exchanged. *Fairbanks v. U.S.*, 306 U.S. 436 (1939); *CIR v. Spreckels*, 120 F.2d 517 (9th Cir. 1941); and *Pender v. CIR*, 110 F.2d 477 (4th Cir. 1940); *cert. denied*, 310 U.S. 650 (1940). The excess of the debt over the fair market value of the property is a bad debt treated as described at III.A.2.b. above. See also IRC § 1271.

- b. Expenses of the acquisition of the property should reduce the amount realized by the lender in the transaction or could be deductible against ordinary income under IRC §§ 162 or 212.
- c. Basis – The lender’s basis for property acquired by deed in lieu of foreclosure is the fair market value of the property.
- d. Timing.
 - (1) The tax consequences are determined as of the date of settlement.

5. Purchase Money Debt – Repossession.

- a. IRC § 1038 – IRC § 1038 governs the tax consequences to the seller/lender when he repossesses real property in partial or full satisfaction of purchase money debt secured by the real property. Typically, in circumstances where IRC § 1038 would apply, the seller is reporting gain on the installment method. IRC § 1038 applies only where the original seller (or the seller’s estate or beneficiary) repossesses property. IRC § 1038(g). However, the reacquisition need not be from the original buyer. IRC § 1038 is not applicable to banks. IRC § 1038(f).
- b. Gain Recognized – Gain is recognized by the seller/lender to the extent of the lesser of (i) the excess of cash and other property received before repossession over gain previously recognized on the sale or (ii) gain realized on the original sale, less the sum of the gain previously recognized on the sale and expenses of repossession. IRC §§ 1038(b)(1) and (b)(2).
- c. Basis for Repossessed Property.
 - (1) The seller/lender’s adjusted basis for the repossessed property is his adjusted basis for the debt of the buyer plus gain recognized under IRC § 1038 and expenses of repossession. IRC § 1038(c).

- (a) If the purchase money debt is secondary financing and the first mortgage survives a repossession, the first mortgage debt is treated as money paid by the seller/lender. Treas. Reg. § 1.1038-1(c)(4)(ii).
- d. Holding Period – Treas. Reg. § 1.1038-1(g) (3) provide that the seller/lender includes in his holding period for the property the time he previously held it.
- e. No Deduction – No deduction for total or partial worthlessness is allowed either before the repossession or as a result of a deficiency existing after the repossession. IRC §§ 1038(d) and 1038(c).
 - (1) Any prior deduction taken by the seller/lender for partial or total worthlessness is recaptured as ordinary income and reflected in the basis of the repossessed property. IRC §§ 1038(d)(1), 1038(d)(2) and 1038(c).

B. SECONDARY MORTGAGEE.

- 1. A secondary mortgagee is not entitled to a bad debt deduction upon the foreclosure of the first mortgage unless the secondary mortgagee can demonstrate the actual worthlessness of its debt. *Berenson*, 39 B.T.A. 77 (1939), *aff'd*, 113 F.2d 113 (2nd Cir. 1940).
- 2. If the secondary mortgagee acquires the property at foreclosure, its tax treatment is as described above and its basis for the property is the sum of the bid price, any surviving liens, and the costs of the foreclosure.

C. INFORMATION, NOTICE, AND OTHER REPORTING REQUIREMENTS.

- 1. Form 1099 Requirements.
 - a. Foreclosures and Abandonments. Pursuant to IRC § 6050J, a person who, in connection with its trade or business, lends money secured by property and (a) acquires an interest in the secured property in partial or full satisfaction of the indebtedness or (b) has reason to know that property in which he has a security interest has been abandoned, must file an information return. The appropriate Forms are Form 1096 and a Form 1099-A. These forms must be filed with the IRS on or before February 28 (March 31 if filed electronically) and sent to the borrower on or before January 31 following the year in which the event occurred.
 - (1) The information reporting described above, does not apply with respect to a loan to an individual secured by an interest in tangible personal property that is not held by the

individual for investment or used in his trade or business.
IRC § 6050J(b).

- b. COD – IRC § 6050P requires the filing of IRS Form 1099-C on or before February 28 (March 31, if filed electronically) of the year following a discharge of \$600 or more and notice to the debtor by January 31 of that year.
- (1) Persons required to file IRS Form 6050P are: (i) financial institutions described in IRC §§ 581 or 591(a), (ii) credit unions, (iii) the FDIC, RIC, NCOA, or any other Federal executive agency and any successor or subunit thereof, (iv) any corporation that is a direct subsidiary of an entity described in (iii) but only if, by virtue of its affiliation with such entity, the subsidiary is subject to supervision and examination by a state or Federal agency that regulates the other entities, and (v) organizations significantly engaged in the trade or business of lending money.
 - (a) If multiple creditors are considered to hold interests in an indebtedness by virtue of holding ownership interests in an entity and the entity is required to report a discharge of that indebtedness under (e)(5), then the multiple creditors are not required to report the discharge of indebtedness. Treas. Reg. § 1.6050P-1(e)(2)(v).
 - (2) In the event a discharge reportable under IRC § 6050P and a foreclosure or abandonment is reportable under IRC § 6050J, the creditor can file one Form 1099-C and still satisfy IRC § 6050J. Treas. Reg. § 1.6050P-1(e)(3).
 - (3) COD reporting is required upon the occurrence of an “identifiable event.” Treas. Reg. § 1.6050P-1(b)(2)(i).
 - (a) Discharge in bankruptcy provided the creditor knows the debtor incurred the debt for business or investment purposes;
 - (b) Discharge in a receivership, foreclosure or similar proceeding;
 - (c) Expiration of statute of limitations for collecting debt;
 - (d) Discharge in a probate or similar proceeding;

- (e) Discharge for less than full consideration by agreement;
- (f) Discharge pursuant to a decision by creditor or policy of creditor to discontinue collection;
- (g) Cancellation or extinguishment arising from creditors election to pursue foreclosure thereby statutory, extinguishing further collection; and
- (h) Expiration of 36 months increased by number of months the creditor was stayed from collection activity. This is only a rebuttable presumption and can be rebutted if collection had been engaged in during last 12 month period.

2. Federal Notice Requirements for Discharge of Tax Liens.

a. Judicial Proceedings.

- (1) If the U.S. has a Federal tax lien against property and the U.S. is not joined as a party, a judgment in a civil suit described in 28 U.S.C. § 2410 (Judiciary and Judicial Procedure, United States as a Party) or a judicial sale pursuant to such a judgment with respect to the property (i) shall be subject to the tax lien (*i.e.*, the tax lien is not disturbed) if the lien was properly filed or (ii) shall be governed by local law vis-à-vis the tax lien if the tax lien was not properly filed or if the local law makes no provision for filing such a lien. IRC § 7425(a).
- (2) If a U.S. tax lien is discharged and the U.S. was not a party to the action, the U.S. tax lien attaches to the proceeds of the sale. IRC § 7425(a).

b. Other Sales.

- (1) U.S. Tax Lien – If the U.S. has a tax lien or title derived from enforcement of a tax lien with respect to a sale of property made pursuant to (i) an instrument creating a lien on the property, (ii) a confession of judgment on the obligation secured by an instrument creating a lien on the property, or (iii) a statutory lien on the property,
 - (a) the tax lien is not disturbed if it was validly recorded more than 30 days before such sale and the U.S. is not given adequate notice of such sale (IRC § 7425(b)(1)) or

- (b) the disposition of the tax lien is governed by local law if the tax lien was not recorded more than 30 days prior to the sale, local law makes no provision for recording, or adequate notice is given to the U.S. IRC § 7425(b)(2).
- (2) Adequate Notice.
 - (a) Notice must be written, sent by registered or certified mail or by personal service to the IRS official, office and address specified in IRS Publication 786, "Instructions for Preparing a Notice of Nonjudicial Sale of Property and Application for Consent to Sale," or any successor publication, not less than 25 days prior to the date of the sale. Treas. Reg. § 301.7425-3(a)(1). Notice of postponement is given to the U.S. in the same manner as notice must be given, under local law, to other creditors. Treas. Reg. § 301.7425-3(a)(2)(i).
 - (b) The notice must include (a) the name and address of the person submitting the notice, (b) a copy of each Form 668, Notice of Federal Tax Lien, affecting the property to be sold or the Internal Revenue office named on the Form 668, the name and address of the taxpayer against whom the lien was filed, and the date and place of filing of the notice, (c) the address, city, state, and legal description of the property to be sold, and, if available, the title abstract, (d) the date, time, place, and terms of the proposed sale, (e) if the property is perishable, a statement of why the property is perishable, and (f) the approximate principal amount, including interest, of the lien sought to be enforced and a description of other costs that will be charged against any proceeds of the sale such as legal expenses, selling costs, etc. Treas. Reg. § 301.7425-3(d).
- (3) If real property is sold to satisfy a lien senior to a tax lien, the Secretary may redeem the property within the longer of 120 days of the date of sale or the period permitted by local law. The redemption price must be the sum of the amount paid for the property being redeemed, including the amount of the lien if the buyer is the lien holder, interest at the rate of 6 percent per annum from the date of the sale, the amount by which expenses to maintain the property exceed

income from the property during the period from the sale, and the amount, if any, paid to a senior lienor. If required by local law, the Secretary must file a certificate of redemption. IRC § 7425(d) and Treas. Reg. § 301.7425-4.

- (4) The U.S. can consent, prior to a sale, to a sale free and clear of a tax lien although adequate notice was not given if the tax lien is adequately protected. IRC § 7425(c)(2) and Treas. Reg. § 301.7425-3(b)(1). Application for consent must be submitted to the IRS at the office and address specified in Publication 4235, in triplicate, under penalties of perjury. The application must include the information required in an adequate notice and the reason for the request. Treas. Reg. § 301.7425-3(b)(2).
- c. Special rules apply with respect to perishable goods. See IRC § 7425(c)(3) and Treas. Reg. § 310.7425-3(c).

3. FIRPTA Withholding.

- a. Nonforeign Affidavit – If the transferor provides the transferee with a non-foreign affidavit, the transferee does not have to withhold. A partnership with foreign partners must pay FIRPTA withholding with respect to income from the transfer of a U.S. real property interest (“USRPI”) equal to percentage of such income allocable to the foreign partners. IRC § 1445(b)(1), Treas. Reg. § 1.1445-2(b)(2). Absent a non-foreign affidavit, the following rules apply:
 - b. Foreclosure.
 - (1) A transferee who acquires a USRPI by repossession or foreclosure must withhold 10 percent of the amount realized on the sale. Such amount must be reported on and paid over with Form 8288 and 8288-A by the 20th day after the date of the transfer. IRC § 1445(a) and Treas. Reg. §§ 1.1445-2(d)(3)(i) (A) and -1(c).
 - (2) However, if the transferee provides the notices described below to the court or trustee with jurisdiction over the foreclosure (hereafter “court or trustee”) and to the IRS, then the transferee can report and pay over the lesser of (i) 10% of the amount realized or (ii) the alternative amount, *i.e.*, the entire amount determined by a court or trustee that accrues to the debtor out of the amount realized from the foreclosure. Termination, extinguishment, assumption, etc. of any mortgage, lien, or other security agreement is not

treated as an amount accruing to the debtor. Treas. Reg. § 1.1445-2(d)(3)(i)(A).

- (a) Notice to Court or Trustee: Such notice must be provided on the day of the transfer and must include the following information: the transferee's name, home address (for an individual), office address (for an entity), a brief description of the property, the date of the transfer, the amount realized, the amount withheld under IRC § 1445(a), and whether the amount withheld or the alternative amount has been or will be reported and paid over to the IRS and the amount that will be (or has been) paid over to the court or trustee. Treas. Reg. §§ 1.1445-2(d)(3)(ii)(A) and (B).
- (b) Notice to the IRS: On or before the 20th day following the final determination by a court or trustee, the transferee must provide the following information to the Ogden Service Center, P.O. Box 409101, Ogden, UT 84409: a statement that the notice is a notice of a foreclosure action under Treas. Reg. § 1.1445-2(d)(3); the name, address (home or office, accordingly), and identification number of the transferee and the transferor; the date of the final determination of a court or trustee; a brief description of the property; the amount realized; and the alternative amount. However, if the transferee must file a Form 1099-A pursuant to IRC § 6050J, the transferee is not required to file the notice with the IRS if the alternative amount is -0-. Treas. Reg. § 1.1445-2(d)(3)(iii).

c. Deed in Lieu of Foreclosure.

- (1) Generally, a transferee must withhold 10% of the amount realized. IRC § 1445(a).
- (2) However, there is no withholding requirement if the transferee is the only person with a security interest in the property, no cash or other property (other than incidental fees) is paid, directly or indirectly, with respect to the transfer, and the IRS notice requirement described above, substituting the words "deed in lieu of foreclosure" for "foreclosure," is satisfied. Treas. Reg. § 1.1445-2(d)(3)(i)(B).

- d. If the principal purpose of a transfer of a USRPI in foreclosure or pursuant to a deed in lieu of foreclosure is avoidance of the withholding requirements of IRC § 1445, the transferee must withhold. A bad purpose is presumed if: (i) the transferee or a related party has a security interest in the property acquired, (ii) the security interest did not arise in connection with the debtor's (or its predecessor in interest's) acquisition, improvement, or maintenance of the property, and (iii) the total of all debts secured by the property exceeds 90 percent of the fair market value of the property. Treas. Reg. § 1.1445-2(d)(3)(v).

D. SPECIAL ISSUES FOR PURCHASER OF DEBT AT A DISCOUNT.

1. Market Discount.

- a. Market discount generally is the excess of an instrument's stated redemption price at maturity over the holder's tax basis for the instrument. IRC § 1278(a)(2)(A).
- b. Absent an election to recognize market discount currently, accrued market discount is ordinary income that is deferred until maturity of the instrument or until the instrument is disposed of. IRC §§ 1278(b) and 1276(b).
 - (1) Market discount accrues ratably (on a daily basis) over the remaining term of the debt instrument or, if elected by the holder, on a constant yield to maturity basis. IRC § 1276(b). However, if principal may be paid in two or more installments, regulations will provide how market discount is to be accrued, and absent regulations, the legislative history requires use of the constant yield to maturity method or other permitted method. IRC § 1276(b)(3) and H.R. Rep. No. 99-841, at 842 (1986). Also, it is possible for market discount and OID to accrue with respect to the same debt instrument.
- c. A portion of the deduction for any interest expense on debt incurred to acquire debt with market discount is deferred until the market discount is recognized. IRC § 1277.
 - (1) The amount of the interest allowed as a deduction is the amount by which "net direct interest expense" exceeds the accrued market discount. IRC § 1277(a).
 - (2) The net direct interest expense is the excess of (i) the interest paid or accrued during the taxable year on indebtedness incurred to continue or carry one or more market discount obligations over (ii) the interest (including

OID) includible in the holder's gross income with respect to such market discount obligations. IRC § 1277(c).

(3) The deferred interest expense is allowed as a deduction upon the disposition of the market discount instrument or, upon the election of the holder, in a year when there is net interest income. IRC § 1277(b)(1).

(a) Net interest income is the excess of (i) the interest (including OID) includible in the holder's gross income with respect to such market discount obligations over (ii) the interest paid or accrued during the taxable year on indebtedness incurred to continue or carry one or more market discount obligations. IRC § 1277(b)(1)(C).

d. Actual or Deemed Dispositions of Market Discount Obligations.

(1) General Rule: Upon a disposition of a market discount obligation, gain in the amount of the accrued market discount is recognized as ordinary income. IRC § 1276(a)(1).

(2) Under regulations to be prescribed, rules similar to those found in IRC § 1245(b) (with certain modifications) will apply to defer recognition. In relevant part, IRC § 1245(b) excludes inter alia transfers at death, and transactions where the transferee's basis is determined by reference to the basis of the transferor by reason of IRC §§ 332, 351, 361, 721, or 731. However, IRC § 1276(d)(1)(C) explicitly requires recognition in the event of a transfer under IRC § 351 and IRC § 1276(d)(1)(B) explicitly provides for nonrecognition in the event of transfers governed by IRC §§ 354(a), 355(a), and 366.

(3) If a debt instrument with market discount is transferred in a nonrecognition transaction described in (2), the transferee succeeds to the market discount of the transferor, as adjusted for gain recognized by the transferor. IRC § 1276(c)(1).

(4) If a debt instrument is exchanged for another debt instrument (actually or as a result of a significant modification (See IV, below), accrued market discount is recognized. If the market discount debt instrument is publicly traded or the exchange is a potentially abusive

situation, the unaccrued market discount can become OID.
IRC § 1274.

2. Workout of Debt.

- a. A workout may result in a significant modification under Treas. Reg. § 1.1001-3. See IV, below for when a change in a term or terms of a debt instrument is a significant modification.
- (1) To the extent that the issue price of the new debt (the worked out obligation) exceeds the holder's tax basis for the old debt, the holder has gain or loss if the exchange is not a reorganization governed by IRC § 354. See V, below for how issue price is determined.
 - (2) If the interest rate after the workout is more than or equal to the applicable AFR, the issue price is deemed to be the stated redemption price at maturity, i.e., the face amount of the debt if a fixed or floating rate is paid at least annually over the term. Gain or loss would be realized in an amount equal to the difference between the face amount of the debt and the holder's basis for the debt instrument.
 - (3) If the interest rate after the workout is less than the applicable AFR, the issue price is deemed to be the present value of the noncontingent payments. Gain or loss would be realized in an amount equal to the difference between the present values of the noncontingent payments and the holder's basis for the debt instrument. Planning tool for holder – try to negotiate an interest rate less than the applicable AFR with contingent payments based in cash flow. (However, this technique could cause the issuer to recognize COD.)
- b. Even when the workout does not result in a significant modification under Treas. Reg. § 1.1001-3, OID still could result if the debt is modified to defer one or more payments. See Treas. Reg. § 1.1275-2(j) and V.C.

IV. MODIFICATION OF DEBT INSTRUMENTS.

- A. RENEgociATION – Renegotiation of any one or more of the following terms (1) the interest rate on the debt, (2) the payment schedule for interest and/or principal, (3) the security for the debt, (4) priority, (5) obligor or (6) the principal amount of the debt can result in Federal income tax consequences for the borrower and/or the lender.
- B. TAX ISSUES RAISED UPON RENEgociATION OF A DEBT INSTRUMENT.
1. Is the change in terms a modification that is significant?
 2. Is the modification treated as an exchange?
 3. Do the time value of money rules apply to create OID?
 4. Does the debtor realize COD as a consequence of the change in terms, and, if so, how is the COD calculated?
 5. Does the holder of the debt realize income or loss as a result of the modification?
- C. MODIFICATIONS THAT ARE TREATED AS EXCHANGES.
1. In General – Pursuant to Treas. Reg. § 1.1001-1(a), an exchange has occurred if property is converted into “other property differing materially either in kind or in extent....” See Treas. Reg. § 1.1001-3 issued in response to *Cottage Savings Association*, 499 U.S. 554 (1991). These Regulations attempt to explain when a modification differs materially in kind or extent. The regulations are applicable to modifications made on or after September 24, 1996.
 2. Treas. Reg. § 1.1001-3 – Modification Regulations.
 - a. If a debt is substantially modified:
 - (1) Deemed Exchange – There is a deemed exchange by the borrower and holder of the original obligation for a new obligation, if the new obligation is debt for tax purposes. If the new instrument is no longer debt, e.g., equity, an exchange also is deemed to occur.
 - (2) Borrower’s Results.
 - (a) If the issue price for the new debt is less than the adjusted issue price for the old debt, there will be COD to which the IRC § 108 rules apply.

- (b) The adjusted issue price of a debt instrument is its issue price plus any OID previously included in gross income of the holders less any amortized premium included in the borrower's gross income.
 - (c) If neither the new nor old debt is publicly traded, and the new debt bears adequate stated interest, the new debt's issue price is equal to the new debt's stated redemption price. IRC § 1273(b)(4).
 - (d) If neither the new or old debt is publicly traded and the new debt does not bear adequate stated interest, the adjusted issue price of the new debt is equal to the present value of all payments due under the new debt determined under the OID rules. IRC § 1274(a)(2).
 - (e) If either the old or the new debt is publicly traded, the issue price of the new debt will be the trading price of the debt. Treas. Reg. § 1.1273-2(b)(1).
 - (f) If the transaction is a potentially abusive transaction, the issue price of the new debt is its fair market value. Treas. Reg. § 1.1274-2(b)(3).
 - (g) As a general rule, absent a reduction in the principal amount, if the interest rate is at least the AFR there should be no COD under the IRC § 1001 rules.
 - (h) A prerequisite to inclusion of debt in tax basis is that the debt must be true debt, *inter alia*; if the debt is nonrecourse, the principal amount of the debt must bear a reasonable relationship to the fair market value of the security (*Estate of Franklin v. Commissioner*, 544 F.2d 1045 (9th Cir. 1976)). Another potential issue in the event of a significant modification is a testing event under *Estate of Franklin*.
 - (i) The applicable high yield debt obligation ("AHYDO") rules found in IRC §§ 163(e)(5) and (i) could apply to disallow a deduction for a portion of the interest on the "new" debt.
- (3) Holder's Tax Results.
- (a) The holder recognizes gain or loss based on the difference between the holder's tax basis for the old

debt and the issue price of the new debt unless the borrower is a corporation and the exchange is a tax-free recapitalization under IRC § 368(a)(1)(E). See IRC § 1001. Any gain potentially may be reportable on the installment method under IRC § 453, but any accrued market discount must be recognized immediately as ordinary income under IRC § 1276. However, IRC § 453A requires a taxpayer to pay interest at the Federal underpayment rate on the deferred gain if the taxpayer holds, at the end of a tax year, installment obligations that arose during the tax year, the face amount of which exceed \$5,000,000. Also, if the holder of the installment obligation has pledged the obligation, there is a deemed payment in the amount of the loan secured by the installment obligation. IRC § 453A(d)(1).

- b. The regulations apply only to the modification of debt instruments; they do not apply to equity instruments, to determine if there has been a disposition of an installment obligations under IRC § 453B, or to the exchange of debt instruments between holders. See Preamble.
- c. The Regulations apply a two part test: do the changes constitute a modification and is the modification a significant modification? Treas. Reg. § 1.1001-3(b).

3. What is a modification?

- (1) A modification is any change in a legal right or obligation of the issuer or holder of the debt instrument. Treas. Reg. § 1.1001-3(c)(1)(i).
- (2) The following are not modifications:
 - (a) The exercise of a right to change the terms of a debt instrument pursuant to the debt instrument's original terms. Treas. Reg. § 1.1001-3(c)(1)(ii). However, the change will be a modification if the change (1) results in an instrument that no longer is debt, (2) adds, substitutes, or removes an obligor, or (3) changes a recourse debt instrument into a nonrecourse debt instrument or vice versa. Treas. Reg. § 1.1001-3(c)(2)(i) and (ii).
 - (b) The exercise of an option that is unilateral.

- (i) An option is not unilateral if (1) it provides a right of the other party to alter or terminate the instrument or put the instrument to a person related to the issuer, (2) requires the consent of the other party or a person related (under IRC. §§ 267(b) or 707(b)(1)) to the other party (unless the consent may not be unreasonably withheld), a court or an arbitrator, or (3) requires the payment of consideration (and the consideration is not *de minimus* or is based on a formula that uses objective financial information as defined in Treas. Reg. § 1.446-3(c)(4)(ii)). Treas. Reg. § 1.1001-3(c)(3).
- (ii) However, in the case of an option exercisable by a holder the exercise of an option that results in the deferral of, or a reduction in, any scheduled payment of interest or principal is a modification. Treas. Reg. § 1.1001-3(c)(2)(iii)(B).
- (iii) Similarly, a modification to a variable or contingent payment debt instrument will be treated as a modification unless the exercise of the holder's option is not reasonably expected to result in a deferral or reduction of interest or principal. Treas. Reg. § 1.1001-3(c)(2)(iii)(B).
- (c) An issuer's failure to perform its obligations under a debt instrument (including a delay in making payments). Also, a failure to exercise a voluntary option is not a modification. Treas. Reg. § 1.1001-3(c)(4) and (5).
- (d) A holder's agreement to temporarily stay collection or waive default rights for up to two years following the date that the issuer fails to perform is not a modification. However, if the issuer and holder agree (in writing or orally) to alter other terms of the instrument during the two year period, such forbearance will be a modification. The two year period is extended while the parties are in good faith negotiations or throughout the pendency of bankruptcy proceedings. Treas. Reg. § 1.1001-3(c)(4)(ii).

4. When does a modification occur?

- (1) A modification is deemed to occur on the date of an agreement between the issuer and the holder regardless of the effective date. Treas. Reg. § 1.1001-3(c)(6).
- (2) The date on which a modification is deemed to occur is deferred until reasonable closing conditions to the agreement are satisfied and the agreement closes and a modification under a bankruptcy plan is not deemed effective until the bankruptcy plan's effective date. Treas. Reg. § 1.1001-3(c)(6).

5. When is a modification significant?

- (1) General Rule: A modification is significant if the legal rights or obligations that are modified and the degree to which they are altered are economically significant based on the facts and circumstances. This general rule applies only (A) if a specific rule does not and (B) if a specific rule applies and (i) the modification results from the occurrence of a substantial contingency set forth in the instrument or (ii) is effective on a substantially deferred basis. Treas. Reg. § 1.1001-3(e)(1) and Preamble.
- (2) Change in Payment Expectations.
 - (a) A change in payment expectations occurs if the obligor's capacity to satisfy the debt is (a) enhanced and the adjustment reduces the debt instrument's credit risk from speculative to adequate or (b) impaired and the change results in an increase in the credit risk from adequate to speculative. Treas. Reg. § 1.1001-3(e)(4)(vi).
 - (b) Payment expectations are not changed if the new obligor has the financial ability to satisfy the debt. See Preamble. Whether the new obligor has the financial ability to satisfy the debt is determined by looking to any source for payment. Treas. Reg. § 1.1001-3(e)(4)(vi)(B).
- (3) Changes in Yield.
 - (a) Any changes in yield that causes the annual yield to change by more than the greater of (a) 25 basis points or (b) 5 percent of the annual yield of the

unmodified debt instrument is a significant modification. Treas. Reg. § 1.1001-3(e)(2).

- (b) See Treas. Reg. §§ 1.1001-3(e)(2)(iii) and (iv) for rules regarding calculation of yield.
- (4) Changes in Timing and Amount of Payments.
- (a) A modification is significant if it materially defers scheduled payments due under an instrument, *i.e.*, by virtue of an extension of the final maturity date or a deferral of payments due. Materiality depends on the facts and circumstances, such as length of deferral and original term of the instrument. Treas. Reg. § 1.1001-3(e)(3).
 - (b) A safe harbor is provided for an extension of the maturity date that is shorter than the lesser of (a) five years or (b) 50 percent of the instrument's original term. Treas. Reg. § 1.1001-3(e)(3)(ii).
 - (c) If the debt instrument is accelerated, there is no safe harbor. The general rule that provides a facts and circumstances test applies to determine if the acceleration is a significant modification.
- (5) Change in Obligor.
- (a) Replacement of the obligor on a recourse debt is significant unless the change results from (1) a tax-free reorganization or liquidation or (2) an acquisition of substantially all of the obligor's assets. Treas. Reg. § 1.1001-3(e)(4)(i). These exceptions apply only if the debt instrument is not otherwise modified and the transaction does not result in a change in payment expectations. *Id.*
 - (b) Neither the filing of a 338 election nor the filing of a bankruptcy proceeding results in a change in obligor. Treas. Reg. §§ 1.1001-3(e)(4)(i)(F) and (G).
 - (c) The change in the obligor of a nonrecourse debt is not significant nor is the change in obligor of a tax-exempt bond to a related party to the issuer unless the collateral is released or replaced. Treas. Reg. §§ 1.1001-3(e)(4)(ii) and (i)(D).

- (d) Addition or Deletion of Co-Obligor.
 - (i) The addition or deletion of a co-obligor is a significant modification if such change results in a change in payment expectations. Treas. Reg. §§ 1.1001-3(e)(4)(iii).
- (6) Change in Security or Credit Enhancement.
 - (a) Release, replacement, addition or alteration of the collateral, including guarantees or other credit enhancements, securing a recourse debt is a significant modification if the change results in a change in payment expectations. Treas. Reg. § 1.1001-3(e)(4)(iv)(A).
 - (b) Release, substitution, addition, or other alteration of a substantial amount of the collateral, including a guarantee or other credit enhancement, for a nonrecourse debt is a significant modification. Treas. Reg. § 1.1001-3(e)(4)(iv)(B). This rule is inapplicable if the collateral is fungible.
 - (c) An improvement to collateral securing a nonrecourse debt is not a significant modification.
- (7) Change in Priority of Debt.
 - (a) A change in the seniority or subordination of a debt instrument is a significant modification if the change results in a change in payment expectations. Treas. Reg. § 1.1001-3(e)(4)(v).
- (8) Changes in Nature of Debt Instrument.
 - (a) An adjustment resulting in a conversion of the instrument to equity for tax purposes is a significant modification. Treas. Reg. § 1.1001-3(e)(5)(i).
 - (b) A change in the obligor's financial condition is not taken into account unless a new obligor or co-obligor is added or deleted. *Id.*
 - (c) The release of a tax-exempt issuer is not significant if (a) the issuer defeases the bonds with government securities reasonably expected to yield a sufficient amount to satisfy principal and interest under the original bonds and (b) the defeasance occurs by

operation of the terms of the original bonds. Treas. Reg. § 1.1001-3(e)(5)(ii)(B).

- (d) A change from recourse to nonrecourse is not significant if (a) the instrument continues to be secured **only** by the original collateral and (b) the change does not result in a change in payment expectations. Treas. Reg. § 1.1001-3(e)(5)(ii)(B)(2).

(9) Change in Covenants.

- (a) Addition, deletion, or alteration of customary financial covenants is not significant. Treas. Reg. § 1.1001-3(e)(6)

(10) Multiple Modifications.

- (a) Two or more modifications must be considered together. Treas. Reg. § 1.1001-3(f)(3).
- (b) If together the modifications are economically significant, the debt instrument will be significantly modified. Treas. Reg. § 1.1001-3(f)(3).

D. SPECIAL RULES FOR DEBT INSTRUMENTS HELD BY REMICS.

1. Unless the modified debt instrument constitutes a “qualified replacement mortgage,” a significant modification of a debt instrument held by a REMIC will subject the REMIC to the 100% penalty tax on prohibited transactions occasioned by the deemed disposition of the unmodified obligation, or in some cases to outright disqualification of the entire mortgage pool, thereby subjecting all of REMIC’s income to corporate income tax. Treas. Reg. § 1.860G-2(b)(1) and (2).
2. The following modifications of a debt instrument do not constitute significant modifications under the REMIC rules, even if they would be treated as significant modifications under IRC § 1001 and the related Treasury Regulations:
 - a. Changes to a debt instrument occasioned by a default or a reasonably foreseeable default of the issuer.
 - b. Substitution of a new obligor under the debt instrument regardless of whether the debt instrument is a recourse mortgage and regardless of whether:

- (1) The buyer acquires the property subject to an existing mortgage without assuming any personal liability under the mortgage;
 - (2) The buyer becomes liable under the mortgage, but the seller also remains liable; or
 - (3) The buyer becomes liable under the mortgage, but the seller is released from liability.
- c. Waiver of a due-on-sale clause or a due-on-encumbrance clause,
 - d. Conversion of an interest rate pursuant to the terms of a convertible mortgage even if the obligor is required to make a payment to the REMIC. Treas. Reg. § 1.860G-2(b)(3).
3. Proposed regulations would add several additional categories of modifications that would not constitute significant modifications under the REMIC rules.
 - a. A modification that releases, substitutes, adds or otherwise alters a substantial amount of the collateral for, a guarantee on, or other form of credit enhancement for a recourse or nonrecourse obligation, so long as the obligation continues to be principally secured by an interest in real property following such release, substitution, addition or other alteration.
 - b. A change in the nature of the obligation from recourse (or substantially all recourse) to nonrecourse (or substantially all nonrecourse), so long as the obligation continues to be principally secured by an interest in real property following such change.
 - c. A release of a lien that secures a qualified mortgage if the mortgagor pledges substitute collateral that consists solely of “governmental securities;” the debt instrument allows such a substitution; the lien is released to facilitate a disposition of the property or any other customary commercial transaction; the release is not part of a plan to collateralize the REMIC with obligations that are not real estate mortgages; and the release does not occur within 2 years of the REMIC “start up day.” Prop. Reg. § 1.860G-2(a)(8), (b)(3)(iii)-(vi), (b)(7).
 4. Rev. Proc. 2008-28, 2008-23 I.R.B. 1, provides an additional safe harbor for certain modifications of mortgages held by REMICs (or certain investment trusts) that are secured by fewer than five residential units. To come within this safe harbor:

- a. Payments due on not more than 10% of the mortgages in the pool were overdue by 30 days or more on either the start-up day or the three-month period beginning on the start-up day (or in the case of an investment trust on all dates on which assets were contributed to the trust);
 - b. The modification is made between May 16, 2008 and December 31, 2010;
 - c. The holder or servicer must reasonably believe that there is a significant risk of foreclosure of the original loan;
 - d. The terms of the modified loan must be less favorable to the holder than the unmodified terms of the original loan; and
 - e. The holder or servicer must reasonably believe that the modified loan presents a substantially reduced risk of foreclosure, as compared with the original loan.
5. Rev. Proc. 2008-47, 2008-31 I.R.B. 272, *amplifying and superseding* Rev. Proc. 2007-72, 2007-52 I.R.B. 1257, offers additional relief for securitized pools of subprime mortgages held by REMICs or investment trusts that were originated between January 1, 2005 and July 31, 2007 and that have interest resets between January 1, 2008 and July 31, 2010.

E. INSTALLMENT OBLIGATIONS.

- 1. Generally – Generally, gain or loss is recognized on the satisfaction or disposition of installment obligations at other than face value. IRC § 453B. The IRS has been quite liberal in interpreting this rule, and, in fact, rarely finds that an installment obligation has been disposed of. However, where there is a deemed exchange, the tax consequences are the same as those that result from a disposition of an installment obligation.
- 2. Modifications that Amount to a Disposition or Satisfaction.
 - a. Change of obligor, interest rate, and term. *Burrell Groves v. CIR*, 223 F.2d 526 (5th Cir. 1955).
 - b. Increase in face amount of obligation in exchange for waiver of conversion right. Rev. Rul. 82-188, 1982-2 C.B. 190.
- 3. Modifications that are Not Dispositions or Satisfaction.
 - a. Extension of maturity date. *Rhombar Co.*, 47 T.C. 75 (1966), *aff'd on other grounds*, 386 F.2d 510 (2d Cir. 1967), *acq.*, 1967-2 C.B. 3.

- b. Extension of term and one point increase in interest rate. Rev. Rul. 68-419, 1968-2 C.B. 196, *amplified by* Rev. Rul. 72-570, 1972-2 C.B. 241.
- c. Change in original sales price and re-computation of profit participation. Rev. Rul. 55-429, 1955-2 C.B. 252, *amplified by* Rev. Rul. 72-570, 1972-2 C.B. 241 (reduction in sales price and installment payments). Modification of original sales price, recomputation of participation, and extension of term. *Soter*, 27 TCM 194 (1968).
- d. Increase of interest rate and new obligor. Rev. Rul. 82-122, 1982-1 C.B. 80, *amplifying* Rev. Rul. 75-457, 1975-2 C.B. 196.
- e. Substitution of obligor. Rev. Rul. 75-457, 1975-2 C.B. 196, *amplified by* Rev. Rul. 82-122, 1982-1 C.B. 80.
- f. Change of security. Rev. Rul. 55-5, 1955-1 C.B. 331.
- g. Substitution of two notes and two deeds of trusts for single note and deed of trust, no other change in terms. Rev. Rul. 74-157, 1974-1 C.B. 115 and *Kutsunai*, 45 TCM 1179 (1983).
- h. Change of interest rate from floating to fixed and change of security. LTR 8545010. Deferring interest payments if yield remains the same: LTRs 8606052 and 8739045.
- i. Decrease in principal and moratorium on payments. LTRs 8739045 and 8606052.
- j. Change in interest rate and elimination of conversion feature (provided it was of no economic value). LTR 9412013.

V. ORIGINAL ISSUE DISCOUNT (“OID”) RULES – IN GENERAL.

- A. OID is the excess of the stated redemption price at maturity (“SRPM”) over the issue price (“IP”) of a debt instrument. IRC § 1273(a)(1).
 - 1. SRPM is the “amount fixed by the last modification of the purchase agreement and includes interest and other amounts payable at that time” other than qualified stated interest. IRC § 1273(a)(2) and Treas. Reg. § 1.1273-1(c).
 - 2. Qualified stated interest is interest that is unconditionally payable in cash or property at least annually at a single fixed rate. Treas. Reg. § 1.1273-1(c).
 - 3. IP.

- a. Nonpublicly Traded Debt Instruments Not Issued for Property.
 - (1) The IP is the price paid by the first buyer. IRC § 1273(b)(2).

- b. Nonpublicly Traded Debt Instruments Issued for Property.
 - (1) IRC Reg. § 1274 governs if (i) some or all of the payments due under the debt instrument are due more than 6 months after the exchange and (ii) (x) there is adequate stated interest and the SRPM exceeds the stated principal amount or (y) there is not adequate stated interest and SRPM exceeds the imputed principal amount. Treas. Reg. § 1274 does not apply if the total payments are \$250,000 or less or if the exchange involves publicly traded debt instruments or property. IRC. § 1274(c). In addition, IRC § 1274 does not apply to a debt instrument if (i) all interest payable under the instrument is qualified stated interest, (ii) the stated rate of interest is at least equal to the test rate set forth in Treas. Reg. § 1.1274-4, (iii) the debt instrument is not issued in a potentially abusive transaction as defined in Treas. Reg. § 1.1274-3, and (iv) no payment from the buyer/borrower to the seller/lender designated as points or interest is made at the time of issuance of the debt instrument. Treas. Reg. § 1.1274-1(b).
 - (2) If the interest rate is equal to at least the AFR – IP is stated principal amount. IRC § 1274(b)(4). See also Treas. Reg. § 1.1274-2(c).
 - (3) If the interest rate is less than the AFR – IP is imputed principal amount. IRC § 1274(a)(2).
 - (a) The imputed principal amount is the sum of the present values of all payments due under the debt instrument, using the AFR as the discount rate. Treas. Reg. § 1.1274-2(c).
 - (4) If the instrument is issued in a potentially abusive situation – IP is the fair market value of the debt instrument. IRC § 1274(b)(3)(A).
 - (a) A potentially abusive situation is a tax shelter as defined in IRC § 6662(d)(2)(C)(iii) and any other situation which by reason of recent sales, nonrecourse financing, financing with a term exceeding the economic life of the property, or other circumstances as specified by the Secretary

have the potential for tax abuse. IRC § 1274(b)(3)(B). See Treas. Reg. § 1.1274-3.

(5) Contingent Payment Instruments.

- (a) IP is the lesser of (i) the instrument's noncontingent principal payments or (ii) the sum of the present values of the noncontingent payments, using the AFR as the discount rate. However, if the debt instrument is issued in a potentially abusive situation, the IP is its fair market value. Treas. Reg. § 1.1274-2(g).

c. Publicly Traded Debt Issued for Property and there is Public Trading.

- (1) If either the debt is publicly traded or is issued for publicly traded property (*e.g.*, publicly traded debt) – IP is the fair market value of the new debt instrument. IRC § 1273(b)(3).

- (a) The definition of publicly traded is found at Treas. Reg. § 1.1273-2(f).

d. Publicly Offered Debt Instruments Not Issued for Property.

- (a) IP is the initial offering price to the public at which a substantial amount of such debt instrument was sold. IRC § 1273(b)(1).

B. OID must be accrued using the constant yield to maturity method. IRC § 1272. The IRS position is that OID must be accrued even when it is unlikely that such amounts ever will be paid. TAM 9538007.

C. OID can arise as a result of a modification of a debt instrument that does not result in a modification under Treas. Reg. § 1.1001-3. "If the terms of a debt instrument are modified to defer one or more payments, and the modification does not cause an exchange under section 1001, then, solely for purposes of section 1272 and 1273, the debt instrument is treated as retired and then reissued on the date of the modification for an amount equal to the instrument's adjusted issue price on that date. This paragraph (j) applies to debt instruments issued on or after August 13, 1996." Treas. Reg. § 1.1275-2(j).

D. If (i) debt is assumed or taken subject to in connection with a sale or exchange of property, (ii) the debt is modified in connection with the sale or exchange, and (iii) the modification of the debt instrument results in an exchange under Treas. Reg. § 1.1001-3, absent an election by the buyer and the seller, the modification is treated as if it occurred immediately before the sale. Treas. Reg. §§ 1.1274-

5(b)(1) and (2). As a result, the seller bears the tax consequences of the modification.

1. A debt instrument is not considered modified as part of a sale or exchange unless the seller knew or had reason to know of the modification. Treas. Reg. § 1.1274-5(b)(1).
2. This could cause the seller to have COD even if the debt is nonrecourse because the modification occurred before the sale.

VI. CERTAIN UNIQUE ISSUES FOR CERTAIN TAXPAYERS

A. REITs.

1. REITs are not eligible to make use of the QRPBI exclusion. IRC § 108(a)(1)(D) and Treas. Reg. § 1.856-1(e).
 - a. Thus, if a REIT is solvent (and not in a bankruptcy), its only opportunity to avoid current recognition of COD is the deferral and spread provisions of IRC § 108(i).
 - b. Query: Does a REIT that is the partner that makes the decision whether to elect under IRC § 108(i) have a conflict of interest because its preferred tax treatment may well be different from that of the other partners in the partnership (*i.e.*, those that are either insolvent or bankrupt or eligible to exclude QRPBI by reducing basis). The partnership agreement granting the REIT the right to make tax elections should be studied carefully.
2. If at the time the debt is acquired by the REIT, default was anticipated and the REIT intended to foreclose, the property acquired in the foreclosure cannot qualify as foreclosure property. Treas. Reg. § 1.856-6(b)(3).
3. COD is not taken into account for the REIT income qualification tests. IRC § 108(e)(9).
4. A REIT is required to distribute 90 percent of its REIT taxable income each year and the amount required to be distributed does not include COD. IRC § 857(e)(2)(D). However, a REIT pays tax on a portion of its COD if it does not distribute an amount at least equal to its REIT taxable income. IRC § 857(e)(1).
5. To qualify as a REIT, a corporation must, *inter alia*, satisfy certain asset and income tests.
 - a. 75 percent of a REIT's assets must be real estate assets (IRC § 856(c)(4); and

- b. 75 percent of a REIT's gross income must be from, *inter alia*, rent from real property and interest secured by obligations secured by mortgages on real property or interests in real property. IRC § 856(c)(3).
- c. If a mortgage covers both real property and other property, an apportionment of interest income must be made for purposes of determining if the interest satisfies the 75 percent gross income test. If the loan value equals or exceeds the amount of the loan, all of the interest income is apportioned to real property. If the amount of the loan exceeds the loan value of the real property, the interest income apportioned to the real property is equal to a fraction the numerator of which is the loan value of the real property and the denominator is the amount of the loan. Treas. Reg. § 1.856-5(c)(1).
 - (1) The loan value is the fair market value of the property determined as of the date on which the REIT first is committed to buy or make the loan. Treas. Reg. § 1.856-5(c)(2).
 - (2) The amount of the loan means the highest principal amount of the loan outstanding during the taxable year. Treas. Reg. § 1.856-5(c)(3).
 - (3) Thus, if a REIT purchases a debt at a discount, its purchase price is irrelevant to the determination of how much of the interest income satisfies the 75 percent gross income test.

B. TAX EXEMPT ENTITIES AND TAX EXEMPT PARTNERS.

- 1. It is not clear whether COD is unrelated business taxable income ("UBTI").
- 2. IRC § 514(a) provides that debt financed income is UBTI. Income is debt financed if the property producing the income was acquired with acquisition indebtedness. IRC § 514(c). IRC § 514(c)(9) provides rules permitting a qualified organization to avoid UBTI with respect to certain debt financed real property.
 - a. A qualified organization includes a qualified trust under IRC § 401 (qualified plan trusts), an educational organization and its affiliated support organizations, a title holding company under IRC § 501(c)(25), and a church retirement account described in IRC § 403(b)(9).

- b. For purposes of the IRC § 514(c)(9) rules for avoiding UBTI with respect to debt financed real property, an interest in a mortgage is not real property. IRC 514(c)(9)(A).
 - (1) As a consequence, debt financed acquisitions of debt instruments produce UBTI.
- 3. An exempt organization that is a partner in a partnership is treated as if it owned its share of the partnership's assets, incurred the partnership's liabilities, and earned its share of the partnership's income directly. IRC § 512(c).