

Section 108.--Income from Discharge of Indebtedness

Rev. Rul. 2016-15

ISSUES

(1) Is real property that a taxpayer develops and holds for lease in its leasing business "real property used in a trade or business" for purposes of § 108(c)(3)(A) of the Internal Revenue Code?

(2) Is real property that a taxpayer develops and holds primarily for sale to customers in the ordinary course of business "real property used in a trade or business" for purposes of § 108(c)(3)(A)?

FACTS

Situation 1—Real property developed and held for lease. C is a sole proprietor engaged in the business of developing and leasing real property. In 2016, C obtains a loan of \$10,000,000 from a bank and uses the entire loan proceeds to construct an apartment building for use in C's leasing business. C secures the loan with the apartment building. C leases units in the apartment building through C's leasing business.

Before the loan's maturity date, C reduces the principal of the loan to \$8,000,000. On the loan's maturity date, C is unable to repay the full \$8,000,000 of principal that C owes to the bank because C has only \$5,500,000 in cash. The fair market value of the apartment building is \$5,000,000 and C's adjusted basis is \$9,400,000. After negotiations, the bank agrees to cancel the loan on the apartment building in exchange for \$5,250,000 in cash. At the time of the loan cancellation, C is neither under the jurisdiction of a bankruptcy court nor insolvent.

For the taxable year in which the bank cancels the loan, C elects to exclude under § 108(a)(1)(D) the \$2,750,000 (\$8,000,000 – \$5,250,000) of cancellation of debt (COD) income arising from the cancellation of the loan.

Situation 2—Real property developed and held for sale. The facts are the same as those in Situation 1, except in Situation 2, instead of constructing and leasing units in an apartment building, C is engaged in the business of developing and holding real property for sale. C obtains the \$10,000,000 loan from a bank to construct a residential community and subdivides the residential community into lots and holds the lots primarily for sale. C secures the loan with the residential community real property.

LAW

Section 108(a)(1)(D) provides that a taxpayer that is not a C corporation may exclude COD income from gross income if the cancelled debt is "qualified real property business indebtedness" (QRPBI). Section 108(c)(3) defines QRPBI as indebtedness which (A) is incurred or assumed by the taxpayer in connection with real property used in a trade or business and is secured by such real property, (B) was incurred or assumed before January 1, 1993, or, if incurred or assumed on or after that date, is

qualified acquisition indebtedness, and (C) with respect to which the taxpayer makes an election to exclude from gross income. Section 108(c)(4) generally defines "qualified acquisition indebtedness" as indebtedness incurred or assumed to acquire, construct, reconstruct, or substantially improve the real property.

Section 108(c)(1) provides that if a taxpayer excludes COD income under § 108(a)(1)(D), the taxpayer must reduce basis in depreciable real property by the same amount in accordance with § 1017. See also § 1017(b)(3)(F)(i) (basis reductions under § 108(c)(1) apply only to depreciable real property). In some circumstances, § 1017(b)(3)(E)(i) allows a taxpayer to elect to treat real property described in § 1221(a)(1) as depreciable property for purposes of § 1017, even though such property is not usually treated as depreciable property. See § 1.167-2 of the Income Tax Regulations. Section 1221(a)(1) pertains to stock in trade or other property included in inventory or held by a taxpayer primarily for sale to customers in the ordinary course of its trade or business. However, § 1017(b)(3)(F)(ii) provides that the election to treat such property as depreciable property does not apply in the case of any amount applied to reduce basis under § 108(c)(1) (relating to QRPBI).

Under § 108(c)(2)(A) the amount of COD income that a taxpayer may exclude is limited to the excess of the outstanding principal amount of the QRPBI immediately before the cancellation over the fair market value of the real property securing the debt, as reduced by the outstanding principal amount of other QRPBI secured by the property. Further, the amount of COD income that a taxpayer may exclude under § 108(a)(1)(D) may not exceed the aggregate adjusted bases (after basis reduction

under §§ 108(b) and (g)) of depreciable real property held by the taxpayer immediately before the cancellation. See § 108(c)(2)(B).

Section 1.1017-1(c)(1) provides that, for basis reduction under § 108(c)(1), a taxpayer must reduce the adjusted basis of the qualifying real property to the extent of the discharged QRPBI before reducing the adjusted bases of other depreciable real property. For this purpose, "qualifying real property" means real property with respect to which the indebtedness is QRPBI.

Section 167(a) allows as a depreciation deduction, a reasonable allowance for the exhaustion, wear and tear, and obsolescence of property used in the taxpayer's trade or business or held by the taxpayer for the production of income. Residential rental property is depreciable property. See § 168(e)(2)(A). However, § 1.167(a)-2 provides that no depreciation deduction is allowed for inventories, stock in trade, or land separate from the physical improvements made to the land.

ANALYSIS

Sections 108 and 1017 operate together to allow a taxpayer that is not a C corporation to elect to defer the recognition of COD income resulting from the cancellation of QRPBI by excluding COD income under § 108 and making a corresponding basis reduction under § 1017. The legislative history underlying these QRPBI provisions is instructive:

The [House Budget] [C]ommittee understands that real property has declined in value in some areas of the nation, in some cases to such a degree that the property can no longer support the debt with which it is encumbered. The committee believes that where an individual has discharge of indebtedness that results from a decline in value of business real property securing that indebtedness, it is appropriate to provide for deferral, rather than current inclusion, of the resulting income. Generally, that deferral should not extend beyond the period that the taxpayer owns the property.

H.R. Rep. No. 103-111, at 622-623 (1993).

The Code and the regulations further Congress' intent to provide only for a deferral of income that generally corresponds to the period the taxpayer holds the property securing the debt. The Code and the regulations also indicate that debt secured by § 1221(a)(1) property is outside the scope of the QRPBI provisions.

Sections 108(c)(1) and 1017(b)(3) provide that a taxpayer that excludes COD income under § 108(a)(1)(D) must make an offsetting basis reduction in depreciable real property. Under § 167 and the associated regulations, residential rental property is depreciable real property, but inventories or stock in trade is not depreciable property. Although § 1017(b)(3)(E) generally permits a taxpayer to elect to treat § 1221(a)(1) real property as depreciable property, § 1017(b)(3)(F)(ii) specifically precludes a taxpayer from making this election in the case of QRPBI. Regulations under § 1017 provide ordering rules that further Congressional intent that the deferral period generally should correspond to the period that the taxpayer holds the property securing the cancelled debt. Specifically, § 1.1017-1(c)(1) provides that a taxpayer must reduce basis first in the property securing the cancelled debt, and then in similar depreciable real property. If debt associated with § 1221(a)(1) property were treated as QRPBI, a taxpayer would be unable to reduce the basis of the property securing the debt, much less reduce the basis of that property prior to reducing the bases of depreciable real property used in the taxpayer's trade or business. This result would be inconsistent with Congressional intent and § 1.1017-1(c)(1). Moreover, the inability to reduce the basis of the § 1221(a)(1) property securing the debt would create deferrals of COD income that extend well beyond the period the taxpayer holds the § 1221(a)(1) property because the

taxpayer would need to reduce the basis of depreciable real property unrelated to the indebtedness, and typically a taxpayer holds depreciable business property substantially longer than it holds § 1221(a)(1) property. Accordingly, debt incurred in connection with, and secured by, § 1221(a)(1) real property cannot be treated as QRPBI.

This revenue ruling obsoletes Rev. Rul. 76-86, 1976-1 C.B. 37, which relied on prior law under §§ 108 and 1017 in concluding that an individual taxpayer could exclude income arising from the discharge of indebtedness incurred in purchasing merchandise for resale. The current versions of §§ 108 and 1017 are materially different from §§ 108 and 1017 as in effect when Rev. Rul. 76-86 was issued; thus, Rev. Rul. 76-86 no longer reflects current law.

Based on the foregoing, C must account for the discharge of indebtedness as follows:

Situation 1. C holds the apartment building for use in C's business and is allowed to depreciate the apartment building in accordance with the Code and regulations. Accordingly, the debt C incurred to construct the apartment building is QRPBI. C may elect to defer the \$2,750,000 of COD income under § 108(a)(1)(D) in the taxable year of discharge by excluding this amount from gross income and reducing C's basis in the apartment building by the same amount.

Situation 2. Because C holds the residential community lots primarily for sale to customers in C's business, C is not allowed to depreciate the lots in accordance with the Code and regulations. Accordingly, the debt C incurred to construct the residential

community may not be treated as QRPBI. C may not elect to exclude the \$2,750,000 of COD income under § 108(a)(1)(D).

HOLDINGS

(1) Real property developed and held by a taxpayer for lease in its leasing business is "real property used in a trade or business" for purposes of § 108(c)(3)(A).

(2) Real property developed and held by a taxpayer primarily for sale to customers in the ordinary course of business is not "real property used in a trade or business" for purposes of § 108(c)(3)(A).

EFFECT ON OTHER REVENUE RULING

Rev. Rul. 76-86 is obsoleted.

DRAFTING INFORMATION

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