

**Internal Revenue Service**

Department of the Treasury  
Washington, DC 20224

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Legend

Taxpayer =  
Property =  
LLC 1 =  
LLC 2 =  
PR 1 =  
PR 2 =  
FX =  
LLC 3 =  
Borrower LLC =  
Owner LLC =  
MM =  
ML =  
Subtenant =  
Year 1 =  
Year 2 =  
Date 1 =  
a =  
b =  
c =  
d =

Dear :

This responds to your authorized representative's letter and submissions of March 24, 2009, in which he requested on your behalf a ruling on the proper treatment of income arising from the cancellation of indebtedness under section 108 of the Internal Revenue Code of 1986 (Code).

ISSUE

Taxpayer has requested a ruling that indebtedness collateralized by an ownership interest in an entity owning real property is “secured by such real property” within the meaning of section 108(c)(3)(A).

FACTS

Taxpayer is a domestic limited liability company, currently classified as a partnership for federal income tax purposes. Taxpayer is owned by two domestic limited liability companies: LLC 1 and LLC 2. LLC 1 is owned by two members, PR1 and PR2, each a domestic resident of the United States for federal income tax purposes. LLC 2 is owned by FX through several wholly-owned subsidiaries. FX is a foreign corporation that has elected to be treated as a partnership for federal income tax purposes. Each subsidiary in FX’s chain of ownership of LLC 2 is disregarded as an entity separate from its owner for federal income tax purposes.

In Year 1, after 1992, Taxpayer and its subsidiaries were formed to acquire the Property. Taxpayer is the sole owner of LLC 3, a domestic limited liability company. Together, LLC 3 and Taxpayer own all of the interests in Borrower LLC, which is also a limited liability company. Both LLC 3 and Borrower LLC are disregarded entities for federal income tax purposes. Borrower LLC is the sole member of Owner LLC, a domestic limited liability company that is also a disregarded entity.

Owner LLC holds legal title to the entire fee interest in the Property. Purchase of the Property was financed in Year 1 with equity contributions from members of Taxpayer and funds borrowed by Owner LLC from third party lenders (“Original Debt”). The Original Debt was secured by a mortgage on the Property as well as other collateral. In Year 1 the Property was comprised of both office and retail commercial rental property. The Property has operated exclusively as a rental property since acquisition. Taxpayer represents that neither Taxpayer nor any of the related parties in the ownership chain engages in any significant business activity other than those related or incidental to the acquisition, ownership and operation of the Property. For federal income tax purposes, Taxpayer is treated as owning the Property through the foregoing series of disregarded entities.

In Year 2, Taxpayer’s subsidiaries commenced a project to renovate and convert a portion of the Property into residential rental units and to rehabilitate the remaining portion. To pay off the Original Debt, to secure funding for the renovations and to obtain cash for distributions to the owners, Taxpayer and its subsidiaries borrowed new funds on Date 1. MM, ML and Subtenant were formed on Date 1. Concurrently, Owner LLC leased the Property to ML as master-lessee, and ML subleased the Property to Subtenant. All ownership interests in both MM and Subtenant are held by Owner LLC. Both MM and Subtenant are domestic limited liability companies and are disregarded

entities for federal income tax purposes. MM is the managing member of ML. The other member is an unrelated third party.

The funds for the refinancing were acquired from three separate sources: a Senior Refinance Loan to Owner LLC, an unsecured loan to Owner LLC and a \$a mezzanine loan (Mezz Debt) to Borrower LLC. The total refinance indebtedness exceeded the Taxpayer's outstanding obligations on the Original Debt. The unsecured loan is subordinated to both the Senior Refinance Loan and the Mezz Debt. The Senior Refinance Loan is comprised of two notes, each secured by a mortgage on the property in the face amount of the note as well as other security.

The Mezz Debt consisted of \$b in principal. The lender retained the remaining \$c of the loan as reserves for the payment of interest and fees for various credit supports for the Senior Refinance Loan. In accordance with the Mezz Debt loan agreement, \$d of the Mezz Debt principal was deposited into a \_\_\_\_\_ Account. Ultimately some of the proceeds of Mezz Debt were released for disbursement at closing while the funds held in the \_\_\_\_\_ Account were not released until some months later.

The Mezz Debt is secured by the following: a perfected, first priority security interest in 100 percent of the ownership interests in Owner LLC, MM and Subtenant, and MM's minority ownership interest in ML, ii) five springing guaranties from various parties; and iii) a subordinated assignment of certain other income, rights and claims associated with the Property and the renovation and conversion project.

The loan agreements restrict the use of funds and the transfer and issuance of ownership interests in the pledged entities. The springing guarantors guaranteed to pay for losses incurred by the mezzanine lender if any of the entities whose ownership interests are pledged file for bankruptcy or a similar legal procedure before the lender can foreclose on the ownership interests assigned as collateral for the Mezz Debt. In the event of a default on the Mezz Debt, among other things, the mezzanine lender can step into the shoes of the borrower/pledgor on a pre-agreed basis.

Taxpayer is negotiating to refinance the Mezz Debt. Current economic conditions have significantly and adversely affected the value of the Property and Taxpayer's ability to secure financing. Taxpayer anticipates future refinancing will result in a discharge of some of the Mezz Debt.

### LAW AND ANALYSIS

Under § 61(a)(12) of the Code, gross income includes income from the discharge of indebtedness. See also § 1.61-12(a) of the Income Tax Regulations. Section 108 of the Code, however, excludes discharge of indebtedness income from gross income under certain circumstances. The Omnibus Budget Reconciliation Act of 1993

amended § 108(a)(1) to provide that, in certain instances, the gross income of a taxpayer does not include income from the discharge of Qualified Real Property Business Indebtedness (QRPBI). Section 108(a)(1)(D).

Section 108(c)(3) sets forth the criteria for a debt to be QRPBI. First, the debt must have been incurred or assumed “in connection with” real property used in a trade or business. Whether the “in connection with” requirement is satisfied is determined as of the time the debt was incurred or assumed. Second, at the time the debt is forgiven, it must be secured by the real property used in the trade or business. Third, the debt must have been incurred or assumed prior to 1993, or, if incurred or assumed after 1992, the debt must be qualified acquisition indebtedness as defined in § 108(c)(4). Qualified acquisition indebtedness is defined as indebtedness “incurred or assumed to acquire, construct, reconstruct or substantially improve” business real property. Finally, the taxpayer must elect to exclude the discharge of indebtedness income and reduce the basis of depreciable property.

Under section 108(c)(2)(A), the amount excluded is limited to the difference between the principal amount of the debt and the fair market value of the property at the time of discharge (less the amount of any senior, qualified debt).

With respect to the ownership and management of the Property, Taxpayer represents the following: i) that through its managing member, Taxpayer has been actively engaged in the acquisition of the Property and in the renovation and conversion project on a continuous basis; ii) a management company controlled by PR1 provides the day-to-day management of the operation and maintenance of the Property; and iii) Taxpayer supervises the management activities. The Taxpayer further represents that the Property is used in a trade or business. Based on Taxpayer’s representations, we conclude that the Mezz Debt meets the first requirement for QRPBI status—it was incurred in connection with real property used in a trade or business. We therefore consider whether the Mezz Debt is secured by the real property, the second requirement.

The legislative history of section 108(c) describes the prevailing economic circumstances causing Congress to enact section 108(c):

The committee 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.

H.R. REP. NO. 103-111, at 622 (1993).

The legislative history, as well as the statutory provision limiting relief to the amount by which the debt exceeds the value of the security, indicate that Congress intended for the exclusion to apply when debt secured by real property becomes undersecured due to a decline in the property's value. Under these circumstances, rather than requiring a taxpayer to report discharge of indebtedness income when the debt is modified, the Code allows a taxpayer to reduce the basis of depreciable property (and take smaller depreciation deductions). The Taxpayer's circumstances in this case are those contemplated by Congress. The Mezz Debt is junior debt that has become undersecured due to declining property value and which the parties wish to renegotiate.

Neither the statute nor the legislative history contains any explanation of or definition for the term "secured by such real property." Mortgages are the most common mechanism by which lenders take a secured interest in real estate. But the legislative history of the Omnibus Budget Reconciliation Act of 1993 does not state that indebtedness is secured by real property only when that security is a mortgage. The Conference Report makes reference to mortgages in its explanation of how the new provision will work but the legislation does not use the term mortgage. "We must assume that Congress had a reasonable understanding of the terms it employed to express its intention." United States v. Van Nostrad, 94 F.2d 510 (1<sup>st</sup> Cir. 1938). The fact that Congress used the more general term "secured by" rather than limiting the section 108 security interest to mortgages is indicative of its intent to include a broader range of security interests.

In other areas of the Code, e.g., those governing REITS, the Service has interpreted the term debt secured by real property so as to include debt secured indirectly by real property, where the lender can, if necessary, acquire the property to satisfy the obligation. Rev. Proc. 2003-65, 2003-1 C.B. 1035, allows a REIT to treat debt secured by an interest in a partnership or disregarded entity holding real property as debt secured by real property. See *also* Rev. Rul. 80-280, 1980-2 C.B. 207 (loans secured by other loans that were secured by mortgages qualified as debt secured by real property); and Rev. Rul. 77-459, 1977-2 C.B. 239 (loan secured by interest in an Illinois land trust whose sole beneficiary assigned its interest in the land to simplify foreclosure treated as secured by real property).

Economically, the Mezz Debt is secured by real property, as the only assets held by Owner LLC are the Property and related personal property. Upon default, the creditor steps into the shoes of Owner LLC and thereby acquires control of the Property. The transaction was so structured to limit cost associated with the financing, to prevent delays in foreclosure of the pledged real property for the senior mortgage debt holder and to facilitate remarketing or securitization of the senior debt and related bonds. Any foreclosure on the Mezz Debt will produce a transfer of all of the equity interest in the Property, leaving no minority interest. The only difference between this structure and that of a mortgage or deed of trust is the method of foreclosure.

Owner LLC is a special purpose, disregarded entity holding the real property. For Federal income tax purposes, Taxpayer is treated as owning the Property through a series of disregarded entities. The entity that incurred the Mezz Debt is itself a disregarded entity. Thus, for federal income tax purposes, the Taxpayer owns the real property at issue and incurred the debt at issue. It would be incongruent to give significance to the two disregarded LLCs for purposes of determining whether the debt is secured by the real property and disregard them for all other purposes. The Taxpayer's Mezz Debt is secured by the Property.

While the flush language of section 108(c)(3) indicates that the proceeds of a refinancing constitute qualified acquisition indebtedness only to the extent they do not exceed the amount of qualified acquisition indebtedness that is refinanced, here a portion of the excess proceeds are used for reconstruction, a purpose that qualifies independently. While not all of the excess proceeds qualify, as explained below, the flush language of section 108(c)(3) supports the notion that debt can qualify under section 108(c) in part. The fact that a portion of a single debt does not meet the requirements of the statute does not disqualify the entire debt.

Not all of the indebtedness was incurred to acquire, construct, reconstruct or substantially improve the property. For example, some of the indebtedness was incurred for the purpose of making distributions to owners. Such indebtedness is not qualified acquisition indebtedness within the meaning of section 108(c)(4). No opinion is expressed regarding the allocation of the Mezz Debt between qualified acquisition indebtedness and nonqualifying indebtedness. In the absence of guidance on this issue, Taxpayer must use a reasonable allocation method.

Section 108 places a limit on the amount eligible for exclusion, and no determination is made with respect to what amount of the Mezz Debt may be eligible for exclusion in the year any portion of it is discharged. Relief for QRPBI is limited to the excess of the outstanding principal amount of such debt (immediately before the discharge) over (2) the fair market value immediately before the discharge of the business real property which is security for the debt (less the amount of senior, qualified debt). Section 108(c)(2)(A); Treas. Reg. § 1.108-6(a).

No opinion is expressed about the federal income tax treatment of the transaction under other provisions of the Code and the regulations or about the tax treatment of any conditions existing at the time of, or effects resulting from, the transaction that are not specifically covered by this ruling. Further, except as specifically set forth in this ruling, no opinion is expressed about the application to the proposed transaction of any other provision of § 108. Except as expressly provided herein, no opinion is expressed or implied concerning the tax consequences of any aspect of any transaction or item discussed or referenced in this letter.

This ruling is directed only to the taxpayer requesting it. Section 6110(k)(3) of the Code provides that it may not be used or cited as precedent.

Temporary or final regulations pertaining to one or more of the issues addressed in this ruling have not yet been adopted. Therefore, this ruling will be modified or revoked by the adoption of temporary or final regulations, to the extent the regulations are inconsistent with any conclusion in the letter ruling. See section 11.04 of Rev. Proc. 2009-1, 2009-1 I.R.B. 1, 48. However, when the criteria in section 11.06 of Rev. Proc. 2009-1, 2009-1 I.R.B. 1, 49 are satisfied, a ruling is not revoked or modified retroactively except in rare or unusual circumstances.

In accordance with the Power of Attorney on file with this office, a copy of this letter is being sent to your authorized representative.

A copy of this letter must be attached to any income tax return to which it is relevant. Alternatively, taxpayers filing their returns electronically may satisfy this requirement by attaching a statement to their return that provides the date and control number of the letter ruling.

The rulings contained in this letter are based upon information and representations submitted by the taxpayer and accompanied by a penalty of perjury statement executed by an appropriate party. While this office has not verified any of the material submitted in support of the request for rulings, it is subject to verification on examination.

Sincerely,

John M. Aramburu  
Senior Counsel, Branch 5  
Associate Chief Counsel  
(Income Tax & Accounting)

cc: