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In this article, McMahon explains the income tax consequences for borrowers that are looking to refinance their properties, restructure existing debt, or walk away from an asset.

According to the Mortgage Bankers Association, at the beginning of 2024, 20 percent of the $4.7 trillion of outstanding commercial mortgages held by lenders and investors was scheduled to mature during the year, a staggering sum of $929 billion.[1] This represents a 28 percent increase from the $729 billion that matured in 2023[2] and a 40 percent increase from the $659 billion[3] that was originally scheduled to mature in 2024 at the beginning of 2023, indicating that both lenders and borrowers are simply kicking the can down the proverbial road.

In June 2023 the FDIC along with other federal agencies, perhaps recognizing this potential crisis, issued a policy statement on commercial real estate loan accommodations to provide guidance on commercial real estate loan workouts and short-term accommodations, suggesting that banks "work prudently and constructively with creditworthy borrowers during times of financial stress."[4]

Current commercial real estate interest rates are generally higher than rates on expiring debt, and for many segments of the market, values are lower because of a combination of higher vacancy and cap rate expansion. This article examines the tax ramifications to borrowers who are looking to refinance their properties hoping for a soft landing by restructuring existing debt or in some cases just walking away.

General Framework

Let's start with a general tax framework: If you sell property, your taxable gain or loss is the difference between your basis and your amount realized. Generally, in a real estate context, that often gives rise to section 1231 gain or loss, resulting in either capital gain or possibly ordinary loss (depending on the magnitude of other section 1231 gains or losses recognized by the taxpayer). If your loan is forgiven, however, you generally realize cancellation of debt income (CODI), which is ordinary. What if the property is foreclosed on or surrendered in a deed-in-lieu transaction? Well, that depends on whether the debt is recourse or nonrecourse. Recourse loans generally result in CODI (equal to the difference

[1] Falen Taylor, "20 Percent of Commercial and Multifamily Mortgage Balances Mature in 2024," Mortgage Bankers Association (Feb. 12, 2024).

[2] *Id.*

[3] Jamie Woodwell, "MBA Chart of the Week: 2024 Commercial Mortgage Maturities Pushed Up by 2023 Extensions," Mortgage Bankers Association (Feb. 27, 2024).

[4] Treasury Office of the Comptroller of the Currency, Board of Governors of the Federal Reserve System, Federal Deposit Insurance Corporation, and National Credit Union Administration, "Policy Statement on Prudent Commercial Real Estate Loan Accommodations and Workouts," 88 F.R. 43, 115 (July 26, 2023).

between the value of the property and the adjusted issue price of the debt), while properties secured by nonrecourse loans are treated as being sold for the amount of the debt, resulting in gain or loss equal to the difference between the amount of the debt and the basis of the property. For purposes of determining recourse debt versus nonrecourse debt, the rules under section 752 may not be determinative.[5] The IRS has ruled in at least two instances[6] that debt held in a disregarded limited liability company should be treated as nonrecourse debt under section 1001 and the accompanying regs because the lender's recourse is typically limited to the assets held in the disregarded LLC.[7] In this article we will assume that all debt secured by real property is nonrecourse.[8]

Why would you ever want to generate CODI if you could instead have a capital gain or ordinary loss? Well, stay tuned as we run through three different scenarios: (1) walk away, (2) restructure the existing debt, and (3) refinance.

Assume the following facts: We'll start with a structure that is somewhat typical in the private equity world of commercial real estate, but we'll get into some variations to try and cover other common situations. A disregarded LLC (Borrower) was formed in 2014 by a private equity sponsor to acquire an office building for $500 million. The building was financed with a $350 million five-year nonrecourse loan from a bank and $150 million of common equity from its sole member, a real estate investment trust LLC. REIT LLC made an election to be taxed as a corporation and has been filing Form 1120-REIT, "U.S. Income Tax Return for Real Estate Investment Trusts," since its initial tax year in 2014. A real estate private equity fund (REIT Parent LP) formed in 2014 is taxed as a partnership and owns 100 percent of the common equity in REIT LLC. (REIT LLC has 125 holders of preferred equity to meet the 100-plus shareholder requirement under section 856(a)(5).) The owners of REIT Parent LP (also formed in 2014) include U.S. individuals, U.S. tax-exempts, qualified foreign pension funds, and section 892 investors (generally entities controlled by foreign governments). REIT LLC is not domestically controlled. Borrower is REIT LLC's only asset.

The initial loan matured in 2019. The building was worth $800 million at that time, and Borrower refinanced the loan for another five years. In connection with the refinancing, Borrower increased the loan balance to $550 million, and the partners pulled out an additional $200 million of proceeds. Of the $200 million of proceeds, $180 million was distributed to the indirect owners of REIT LLC. REIT LLC has had tax losses since 2014, building up a $160 million net operating loss ($90 million before 2018). REIT LLC made no prior distributions, so $150 million of the $180 million distribution was treated as a return of capital, and $30 million was treated as a taxable gain on the sale of REIT shares (because it exceeded the capital invested into REIT LLC). It is 2024, and the loan is due. The building is now worth $450 million and has an adjusted tax basis of $400 million.

Lenders don't want to hold assets, particularly office assets. Valuations are difficult to assess because of a lack of transactional activity caused by large bid and ask spreads, since many properties are underwater with equity completely wiped out and, in many cases, such as this one, the debt impaired. Borrower isn't deterred though. It has decades of experience managing office properties and has gone through many up-and-down cycles. It has a lease in hand that, once signed, will immediately increase the value of the asset. Borrower calls you as its tax adviser and provides you with the details of the workout. Now it's your job to explain the tax consequences. Oh boy!

Scenario 1: Walk Away

You set up a meeting with the CFO, members of the investment team, and the tax director in their office the next day and start by explaining the tax consequences of Borrower getting to the end of the road and deciding to bandage its wounds and walk away from the asset — just in case things with that "lease in hand" go awry. You

[5] *Compare Great Plains Gasification Associates v. Commissioner*, T.C. Memo. 2006-276, *with* ILM 201525010.

[6] LTR 201644018; LTR 202050014.

[7] *See* CCA 20152501, FAA 20150301F, and LTR 201644018.

[8] For an excellent discourse on this topic, see James Sowell, "Debt Workouts: The Partnership and the Partners," Practising Law Institute, at Section II.E (2015).

say, "Because the loan is nonrecourse, regardless of whether the lender forecloses, accepts a deed-in-lieu, or participates in a short sale transaction, the tax consequences will likely be the same. Transferring the building to the lender is treated as a sale of the asset, with the sale proceeds equaling the amount of the debt that is forgiven (that is, $550 million).[9] Given that the adjusted tax basis is only $400 million, this will result in section 1231 gain on sale of $150 million with no cash, since the building was used in a trade or business."

"Wait, $150 million of phantom gain? *Yikes*!" screams the CFO.[10]

"Yes," you continue. "Unfortunately, besides losing the building, REIT LLC would need to address the $150 million of section 1231 gain to maintain its REIT status for the year. Obviously, REIT LLC has no cash to pay a dividend."

"But wait, what about the $160 million of NOLs?" asks the CFO. "Can't we use those to offset the gain?"

"Well, the short answer is yes, but unfortunately the NOLs would not fully offset the $150 million gain because of limitations that were enacted with the 2017 passage of the Tax Cuts and Jobs Act. The TCJA included rules that allow REITs to fully deduct NOLs generated before 2018, while NOLs arising after 2017 are limited to 80 percent of the REIT's taxable income, computed for this purpose without regard to the dividend paid deduction.[11] This means you would be able to deduct the $90 million of pre-2018 NOLs, leaving $60 million of gain to which you would then be able to apply $48 million of the $70 million of post-2017 NOLs. The result would be $12 million of income that still needs to be addressed."[12]

So what is a REIT to do in that situation? You continue to explain: "There is a concept in section 565 called a 'consent dividend,' which could be used to generate a dividend paid deduction for the REIT. The consent dividend creates a fictional distribution that is then deemed recontributed to the REIT. A consent dividend requires unanimous approval from all common shareholders." (This is one reason why, in our example, the sponsor set up REIT Parent LP as the sole investor in REIT LLC — so REIT Parent LP could approve a consent dividend at the sponsor's sole discretion.)

"This would require REIT LLC's indirect investors to recognize capital gain dividends totaling $12 million.[13] They would, however, receive $12 million of basis in their stock because of the dividend income, which would result in an offsetting capital loss when written off upon the worthlessness of the investment."[14]

"Then it doesn't matter that the NOLs can't offset the entire gain if our investors get an offsetting loss. No harm, no foul, right?" chimes in the CFO.

"Well, not so fast," you go on to say. "While most investors won't care, your section 892 investors certainly will. Given that REIT LLC is not domestically controlled, IRS Notice 2007-55, 2007-27 IRB 13,[15] treats that gain as being attributable to the sale of an interest in U.S. real property, which is taxable under section 897.[16] The relevant regime is referred to as 1980 Foreign Investment in Real Property Tax Act gain. Under FIRPTA, that gain cannot be offset with the capital loss on the disposition of the worthless investment, so a section 892 investor will have a U.S. tax obligation on its share of the $12 million capital gain. Under section 1445(e)(6), REIT Parent

[9] Reg. section 1.1001-2(a). For a short-sale transaction, similar tax consequences to a foreclosure will result even though the lender does not want to take possession of the building and instead works with the borrower to sell the building directly to a third party for an amount that is less than the amount owed, with the lender accepting all net proceeds of the sale as payment in full on the loan. *2925 Briarpark Ltd. v. Commissioner*, 163 F.3d 313 (5th Cir. 1999).

[10] The gain essentially relates to the $150 million prior return of capital distribution, though presumably the money has been spent and the distribution forgotten by investors and apparently the CFO.

[11] Section 172(d)(6)(A).

[12] Section 172(a)(2)(A).

[13] Section 857(b)(3)(B). A REIT must designate a capital gain dividend in a written notice to its shareholders within 30 days of the close of its tax year or its annual report mailed to shareholders for the tax year.

[14] Rev. Rul. 2003-125, 2003-2 C.B. 1243 (sections 331 and 332 do not apply if a shareholder receives no payment for its stock in liquidation of a corporation).

[15] Notice 2007-55 has been a thorn in the side of real estate investors and practitioners since its issuance, with multiple efforts to modify or repeal it over the years. See bills introduced in Sept. 2011 by both the House (H.R. 2989) and Senate (S. 1616); and the New York State Bar Association, "NYSBA Report on Notice 2007-55 and Possible Administrative Guidance Addressing Sections 897(h)(1) and 1445(e)(6)(1)" (Jan. 7, 2014); and Real Estate Roundtable, "Bipartisan Senate Letter Urges Treasury to Withdraw IRS Notice Hindering Foreign Investment in U.S. Real Estate," Roundtable Weekly (Dec. 21, 2019) to name only a few.

[16] *See* section 897(a)(1) and (h)(1).

LP is required to withhold 21 percent tax on any gain allocated to those section 892 investors."

You continue, "Since there is no cash being distributed to the section 892 investor, let's hope you had some really good attorneys draft the limited partnership agreement for REIT Parent LP, as then you may then need the section 892 investors to send cash to pay the withholding tax."

"Let's hope we don't get there," says the CFO. "As we mentioned, we have a lease in hand that we think will immediately and significantly increase the value of the building. We've had some discussions with our lender, and there's a willingness on both sides to restructure the loan."

Scenario 2: Restructure the Existing Debt

OK, so let's work with the same basic facts as our first example, but in this case, our "creditworthy" Borrower wants to retain the asset. They have agreed to terms with a potential new tenant on a deal that will require an investment of roughly $33 million to cover the free rent period and tenanting costs. A discounted cash flow model shows that the lease will immediately add multiples of that amount to the value of the building. Borrower approaches the lender and works out a deal with them in which the lender agrees to extend the $550 million loan by three years but subordinate $100 million of the loan (the B Note) to $50 million of new preferred equity (which includes a partial reserve for interest on the new $450 million A Note). All other terms of the loan are unchanged.

This is a typical A/B Note restructuring, which is extremely commonplace in today's environment. Interest on the A Note is paid each month, with any remaining cash perhaps paying some of the preferred return on the preferred equity, though more typically, remaining cash flow, if any, is held in escrow. In our facts, upon reversion, the cash flow waterfall is as follows: (1) principal on the A Note (and unpaid accrued interest, if any), then (2) the preferred equity and the balance of the preferred return, then (3) principal and accrued interest on the B Note, then (4) 100 percent to the common equity.

You start by explaining: "The extension and subordination of a portion of the loan are modifications to the loan that, if determined to be 'significant modifications'[17] would result in a deemed transfer of the original note for a new note.[18] Given the extension of three years and subordination of the B Note, I'm pretty confident the note will be treated as significantly modified."[19] The CFO stares at you blankly and asks what that means. You go on to tell her, "Well, when the lender issues new debt in satisfaction of the old debt, the borrower is treated as if they paid off the old debt with cash in an amount equal to the issue price of the new debt."[20]

"Phew!" the CFO exclaims. "Good thing the new debt is equal to the old debt." Everyone starts to rise, happy to think they have no income to worry about and ready to reclaim the remaining 40 minutes of the meeting to work out other loan issues.

You gulp and ask them to sit down. You explain that the bifurcation of the original $550 million note into a $450 million A Note and a $100 million B Note doesn't necessarily mean that the new debt is equal to the original note. If the old or new debt were publicly traded,[21] the issue price of the new debt would be the fair market value of the debt, which could result in the recognition of CODI.[22]

"Assuming that the note is not publicly traded and that the $100 million B Note will be subordinate to the new $50 million of preferred equity that you will be raising from your investors, the B Note will most likely be treated as equity, given it would be difficult to argue that you have debt that is junior in priority to your preferred equity."[23]

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[17] Reg. section 1.1001-3(e).

[18] Reg. section 1.1001-3(b).

[19] *See* discussion in reg. section 1.1001-3(e)(2) on "change in yield" and (e)(3) on "changes in timing of payments."

[20] Section 108(e)(10).

[21] Regulations finalized in 2012 alter the rules regarding the determination of when debt will be treated as publicly traded. *See* reg. section 1.1273-2(f); T.D. 9599.

[22] Section 1273(b)(3).

[23] Although one might try to argue the application of reg. section 1.1001-3(b)(7)(ii), which states, "In making a determination as to whether an instrument resulting from an alteration or modification of a debt instrument will be recharacterized as an instrument or property right that is not debt, any deterioration in the financial condition of the obligor between the issue date of the debt instrument and the date of the alteration or modification (as it relates to the obligor's ability to repay the debt instrument) is not taken into account." Note that the subordination of the instrument to equity is thought to be fatal to debt characterization for income tax purposes.

A hush falls over the room as you continue: "If the B Note is treated as equity, then the exchange of the original note worth $550 million for a new note worth $450 million could result in $100 million of CODI. Alternatively, the lender could be treated as acquiring an interest in the property from the debtor in a deemed-sale transaction, with the debtor and lender then each contributing their interests in the property to a newly formed partnership."[24]

Now you've lost the room and perhaps a client. The CFO stands and pounds the table, asking, "How can we have cancellation of debt when we still have an obligation to pay off the B Note?" She looks at the director of investments and asks what the projections show. The director of investments tells her that the B Note and accrued interest are paid in full in the upside scenario, but the base-case scenario shows that only a portion of the B Note gets repaid. The CFO is flustered and looks back at you. "So how do we manage this?" she asks.

"Well, this is the only asset in REIT LLC, for which you and the lender have agreed should be valued at $450 million. I mean, that's why you are setting the A Note at $450 million, correct?" The CFO nods her head in agreement. You go on. "The total debt is $550 million. Therefore, REIT LLC is insolvent by $100 million."[25] You can see the CFO is getting impatient.

"There's an exclusion from gross income aptly called the 'insolvency exclusion' that allows an insolvent taxpayer to exclude CODI to the extent they are insolvent.[26] In exchange for the exclusion, however, a taxpayer must reduce certain tax attributes." The impatient CFO chimes in, "Are you talking about reducing tax basis? Won't that just mean we'll have higher gain when we eventually sell the asset?" The CFO is pretty tax savvy but not the expert that you are.

"Well, that's one potential attribute that can be reduced. However, the code contains ordering rules that you must follow when reducing attributes, and the first attribute is NOLs,"[27] you state. The CFO now gives you a big smile. "NOLs? Interesting. We can't use them to offset the full amount of gain if we give back the property, but we can use them to fully offset CODI if we're insolvent. That's great." (I told you she was tax savvy!) "Yep, and the reduction would occur after you have determined REIT LLC's tax liability for the year in which the discharge occurs," you state.[28]

There are still 20 minutes left in your scheduled meeting. You ask the CFO whether there are any other deals that they're working on for which perhaps you can lend your assistance. You might be sorry you asked.

Scenario 3: Refinance

The CFO describes another asset that they are looking to refinance. "You know, we have this fund of mostly high-net-worth investors. Just a simple, straight-up partnership structure. There's a residential building in there that we acquired in late 2019 for around $225 million. It was financed with a senior loan and mezzanine debt totaling $170 million. The property suffered a loss of occupancy during the COVID-19 pandemic but has since mostly recovered, though net operating income (NOI) is lower. We received some covenant relief from our lenders and managed to stay current on debt service."

The $120 million senior loan was a floating rate, interest-only loan at the U.S. secured overnight financing rate (SOFR) plus 110 basis points. Borrower purchased an interest rate cap at 3.5 percent. The $50 million mezzanine loan was a 12 percent fixed rate loan, with 6 percent paid current and 6 percent accrual until maturity. The NOI at the time was about $9 million, so the total debt service coverage ratio (which is NOI divided by interest expense paid) was right around 1.25x at the inception of the loans. The current

[24]Because the borrower is a disregarded entity, the treatment of the transaction is not entirely clear. It could fall under Rev. Rul. 99-5, 1999-1 C.B. 434, in which case there is a possibility that it would be treated as a part sale, part forgiveness. There are varied viewpoints on the tax treatment; *compare* David Friedline, "Debt-for-Equity Exchange of a Disregarded Entity," 39 *J. of Real Est. Tax'n* 52 (2012), *with* Philip Gall and Franny Wang, "The Mysterious Case of Disappearing Debt in Partnership Transactions," 90 *Taxes* 157 (2012).

[25]Under Rev. Rul. 2012-14, 2012-24 IRB 1012, in determining whether the REIT is insolvent, the REIT is allocated its share of the excess liability (*i.e.*, liability exceeding the value of property securing the liability) that existed immediately before the discharge of the indebtedness in the same ration that CODI is allocated.

[26]Section 108(a)(3).

[27]Section 108(b)(2)(A).

[28]Section 108(b)(4)(A).

mezzanine loan balance with accrued interest is around $67 million.

Although occupancy has mostly recovered, NOI is only around $8.5 million, $500,000 less than it was when the building was acquired. Further, because exit cap rates have increased by about 150 basis points, the property value has dropped by over $45 million to about $155 million.

"The equity has been completely wiped out. The mezzanine loan is clearly impaired. We've had discussions with the mezzanine lender, and they've indicated that they don't want to go through the time and hassle of foreclosing on the ownership interest in Borrower; they simply want this loan off their books ASAP. They've tried quietly marketing the loan and have received some indicative bids for plus/minus $20 million. I think we could acquire it from them for plus/minus $25 million. We have some cash in the fund for that. I imagine that would result in over $40 million of CODI though, right? Obviously no NOLs to help us here," she states with an exasperated sigh.

The CFO continues: "Another challenge is the interest rate on the senior loan going up from 3.5 percent to around 6.5 percent. The senior lender won't go above 65 percent leverage and wants a minimum 1.25x debt service coverage ratio, so with a little wiggle room, we're talking about a senior loan of about $100 million. We'll need to call capital to pay down the senior loan. We have a great relationship with our investors, but they aren't going to be happy with me calling $20 million and sticking them with over $40 million of cancellation of debt on which they'll need to pay tax."

"That's certainly a dilemma," you say to her. "I may not have a perfect solution, but there are some potential mitigants." You sit with her and discuss some thoughts on how to approach the investors.

"OK, so as you mentioned, there are no NOLs to help us offset any CODI from the potential discounted paydown on the mezzanine loan, since the high-net-worth investors are all current taxpayers. There is, however, a code section that provides, in the case of a partnership, that certain rules are applied at the partner level, not at the partnership level.[29] Specifically, the exclusions from gross income,[30] such as the insolvency exception (and any accompanying reduction of tax attributes),[31] apply at the partner level. Now, since you are looking to call capital from your investors, let's hope the insolvency exception doesn't apply," you say with a slight smile.

"Instead, let's focus on an exception that applies to qualified real property business indebtedness (QRPBI). There is a special provision in section 108(c) that deals with the treatment of QRPBI,[32] which is defined as indebtedness that was incurred or assumed by the taxpayer in connection with real property used in a trade or business and is secured by that real property, is qualified acquisition indebtedness, and for which the taxpayer makes an election to treat the debt as QRPBI.[33] Qualified acquisition indebtedness is indebtedness incurred or assumed to acquire, construct, reconstruct, or substantially improve that property.[34] Essentially, it's debt proceeds that you invested into a building used in your trade or business. It would not, for instance, cover a situation like the one we discussed earlier in which you distributed loan proceeds to your investors in the office asset," you explain.

You continue: "The exclusion for discharge of QRPBI has two limitations, one of which is very important, as it will likely result in an exclusion amount that is less than the total cancellation of debt recognized on the discounted payoff. It's referred to as the 'equity limitation,' as it essentially limits the exclusion of income to an amount that would not create equity in the partnership, determined as if the qualified acquisition indebtedness was the only indebtedness of the partnership.[35] So using the

[29] Section 108(d)(6).
[30] Section 108(a).
[31] Section 108(b).
[32] Section 108(a)(1)(D).
[33] Section 108(c)(3).
[34] Section 108(c)(4).
[35] Section 108(c)(2)(A); reg. section 1.108-6(a).

numbers we discussed, you have about $187 million of debt on the property and the property is worth about $155 million. This would generally indicate that your total exclusion amount would be $32 million. Again, the theory is that you should not be able to exclude debt to the extent that it creates equity in the asset; $32 million brings the total debt down to the FMV of the asset. It's very much like the insolvency exception on an asset-specific basis in that respect" (and again, considering only debt that is QRPBI).

"I see," says the CFO. "So if I pay anything less than $35 million for the mezzanine loan, that discount would represent CODI that my investors would be unable to exclude."

"Exactly," you state. "And if you think about it, it really makes sense, because if you were to buy the note for $25 million and sell the asset for $155 million the next day, your investors would net a $10 million benefit. They contribute $25 million to buy back the $67 million mezzanine loan, reducing total debt to $120 million. Then they get back $35 million on the sale, netting them a $10 million profit."

"Understood. What else do I need to know?"

"As I mentioned, there is a second limitation: a basis limitation.[36] Now, I know you aren't a big fan of reducing basis knowing that it will need to be recaptured (generally as ordinary income) upon a sale of the asset, but that is the cost of obtaining an exclusion for QRPBI. Note that the basis limitation won't be an issue for this asset, as there is plenty of basis to cover the potential reduction of $32 million. And although you are correct in your assertion that the basis reduction is recaptured upon a sale, there are two things to keep in mind. First, the investors get the benefit of deferring the recognition of income until you sell the asset or they sell their interest in the partnership."

"And if an investor dies in the interim, their estate gets a step-up in basis, so they avoid tax entirely," the CFO gleefully chimes in.

"Yes," you say as you laugh. "Although, personally, I try to avoid using 'death' in my tax planning strategies." You both start laughing.

You then continue, "The second thing to keep in mind is that, at least under current tax law, there is a rate differential on the gain from a sale of the property or partnership interest versus the rate that would be due on CODI today. The reduction in basis caused by the CODI is taxed as ordinary income, but a portion of that amount allocable to the real property (that is, the building) amortizes over the remaining hold period[37] and converts into what is referred to as unrecaptured section 1250 gain, which is taxed at a 25 percent rate[38] (versus ordinary rates). So besides the deferral of $32 million, depending on when you sell and the rules in effect, your investors could pay a lower rate on the sale gain, if they're still alive at the time."

"OK, so if I get my lender to agree to a $42 million discount on the loan, my investors can elect to exclude $32 million, but there will be $10 million of CODI that they'll need to recognize."

"Correct, but let's discuss that for a second. Unless your investors are real estate professionals, any losses that they've been allocated from the partnership would likely represent passive activity losses that get carried over until there is income from the partnership. The $10 million that they cannot exclude would represent income that would free up those passive losses, likely offsetting most, if not all, of the $10 million."[39]

"Awesome!" says the CFO. "Anything else?"

You state that the partnership makes the determination of whether and how much of the debt is QRPBI and that it is then up to each individual partner to determine whether they wish to take advantage of the exclusion. You explain that attribute reduction upon the discharge of QRPBI doesn't follow the same ordering rules that other items of cancellation of debt follow. Specifically, cancellations of debt from QRPBI require the taxpayer to reduce basis

[36] Section 108(c)(2)(B).

[37] Section 1017(d)(2) provides that, when computing the recapture of prior depreciation deductions on section 1250 property, the determination of what would have been the depreciation adjustments under the straight-line method will be made as if there had been no reduction under this section.

[38] Section 1(h)(1)(E).

[39] *See* Rev. Rul. 92-92, 1992-2 C.B. 103, which says that CODI is characterized as passive to the extent that, at the time of the discharge, the debt was allocated to passive activity expenditures. A more detailed discussion of the rules involving passive losses for real estate professionals is beyond the scope of this article. (Besides, our tax-savvy CFO knows the rules!)

of depreciable real property,[40] starting with the property secured by the debt that has been discharged.[41]

You mention that in a partnership context there are rules that treat the partnership interest as depreciable real property to the extent of each investor's proportionate share of the partnership's depreciable property.[42] A partner that elects to treat the partnership interest as depreciable real property must request that the partnership make a corresponding reduction to the partnership's property,[43] and the partnership is required to make the corresponding reductions to partners' shares of inside basis if requested by partners that own, in the aggregate, a greater than 80 percent interest in the capital and profits of the partnership or if five or fewer partners owning more than 50 percent of the capital and profits interests make that request.[44] Investors need to file IRS Form 982, "Reduction of Tax Attributes Due to Discharge of Indebtedness (and Section 1082 Basis Adjustment)," with their federal tax returns to report the exclusion of cancellation of debt and reduction of attributes. Finally, there are some other restrictions on what constitutes depreciable real property for purposes of the QRPBI rules[45] along with timing rules if the property is sold before year end,[46] none of which seems to be of concern to our client.

"Well, I realize we ran a few minutes over our scheduled meeting time."

"No worries," the CFO interrupts. "This was definitely time well spent!"

As the CFO walks you out to the lobby, you tell her, "I'll be sure to follow up with the tax side to make sure we are all on the same page." You get in the elevator, happy that you were able to assist your client in thinking through the structural alternatives and understanding the tax results that follow from those options.

Conclusion

Obviously, it's not hard to see how quickly this brewing crisis could soon boil over. Taxpayers in general, other than corporations, typically look for capital gain treatment over ordinary income treatment because of the preferential rate on capital gains. Counterintuitively, however, the rules found in section 108 can provide a salve for the wounded or a parachute for those who are in a free fall. It's important to make sure knowledgeable tax professionals are involved from start to finish, as one seemingly small change in a deal can have significant consequences for the end results. ■

[40] Section 108(c)(1)(A).

[41] Reg. section 1.1017-1(c)(1).

[42] Section 1017(b)(3)(C).

[43] Reg. section 1.1017-1(g)(2)(ii)(B).

[44] Reg. section 1.1017-1(g)(2)(ii)(C).

[45] Section 1017(b)(3)(F)(ii); reg. section 1.1017-1(f).

[46] Section 1017(b)(3)(F)(iii).