

Accounting

Revenue Ruling 2016-15 – Clarity on a specific area of cancellation of debt income

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In June 2016, the IRS promulgated Revenue Ruling 2016-15. Its purpose (within the context of the exclusion of cancellation of debt income as it relates to qualified real property business indebtedness) is to make a keen distinction between real property developed and held for rental and real property developed and held for sale. The IRS based its rulings on the two fact patterns as follows.

Situation 1: C is a sole proprietor in the business of developing and leasing real property. C obtains a construction loan of \$10 million to develop and lease an apartment building. On the loan's maturity C was unable to repay the \$8 million principal balance remaining. C had only \$5.5 million in cash. At that time, the fair market value of the building was \$5 million and the adjusted basis was \$9.4 million. Post negotiation, the bank canceled

the loan settling for \$5.25 million in cash. For that taxable year, C who is neither bankrupt nor insolvent elects to exclude \$2.75 million (\$8 million – \$5.25 million) of cancellation of debt (COD) income under IRC Code Section 108(a)(1)(D), qualified real property business indebtedness (QRPBI).

Situation 2: The facts are the same as in Situation 1, except that C is in the business of developing and holding real property for sale. The original \$10 million loan was used to construct a residential community and subdividing it into lots held for sale.

Background

Discharge of indebtedness occurs when a lender forgives all or a part of a loan. The amount discharged is taxable income to the borrower. However, Internal Revenue Code (IRC) Section 108 provides for exclusion from income if certain conditions are met. One such condition is if the indebtedness discharged is QRPBI and the taxpayer is not a C Corporation. The code 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

IRC Sections 108(c)(1) and 1017(b)(3) stipulate that if the taxpayer excludes income under

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which the taxpayer makes an election to exclude from gross income. "Qualified acquisition indebtedness" is indebtedness incurred or assumed to acquire, construct, reconstruct, or substantially improve the real property. If the taxpayer elects to exclude the cancellation of debt (COD) income, the taxpayer must reduce the basis of qualifying property (subject to the indebtedness first then other depreciable real property). In effect, the income gets deferred until the qualifying property is disposed of.

Rev. Rul. 2016-15 Analysis

Based on the fact patterns above, the IRS makes the following analyses:

the assertion that the discharge is QRPBI, the taxpayer must make an offsetting basis reduction in depreciable real property.

Section 167 and associated regulations provide that residential rental property is depreciable real property but inventory or stock in trade is not.

Although §1017(b)(3)(E) allows a taxpayer to elect to treat real property stock in trade as depreciable property, §1017(b)(3)(F) disallows it in the case of QRPBI.

Reg. Sec. 1.1017-1(c)(1) provides that in the case of discharge of QRPBI, the taxpayer must first reduce the adjusted basis of the real property subject to the indebtedness before

reducing the adjusted bases of other depreciable real property.

Conclusion

In Situation 1, since the real property is being used in a trade or business and is subject to depreciation, the debt is QRPBI and, therefore, the taxpayer can exclude the \$2.75 million COD income and reduce the basis of the building.

In Situation 2, because the residential community lots are inventory or stock in trade, they do not constitute depreciable real property. And, since QRPBI rules require a corresponding reduction in the basis of the property, they cannot be applied to property not depreciable in the hands of the taxpayer. Consequently, the taxpayer cannot exclude \$2.75 million COD income under the QRPBI provision of IRC Sec. 108 (a)(1)(D).

Final Note

Rev. Rul. 2016-15 dealt with a sole proprietor, but most real estate rental businesses are held in partnerships where the procedures for exclusion of COD income are initiated at the partner level.

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