DISCHARGE OF QUALIFIED REAL PROPERTY BUSINESS INDEBTEDNESS (QRPBI)

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The COVID-19 crisis has brought uncertainty to the commercial and residential real estate industry. The ultimate impact on values is unknown, but instances may arise where they decrease to a point where mortgage principal owed will exceed the fair market value of the real estate it secures. Borrowers could be looking at cancellation of indebtedness income in the event of foreclosure or loan modification.

Fortunately, there is an income exclusion under IRC Section 108(a)(1)(D), under which a taxpayer that is not a C corporation can elect to exclude cancellation of indebtedness (COD) income from gross income if the canceled debt is qualified real property business indebtedness (QRPBI). A taxpayer can reduce the basis of its depreciable property under IRC Section 1017 by the amount of cancellation of indebtedness income, thus deferring the recognition of income to a later date.

QRPBI, pursuant to IRC Section 108(c)(3), is defined as indebtedness which 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; was incurred or assumed before January 1, 1993, or, if incurred or assumed after such date, is qualified acquisition indebtedness and the taxpayer elects to exclude from gross income.

Qualified acquisition indebtedness is defined under IRC Section 108(c)(4) as indebtedness incurred or assumed to acquire, construct, reconstruct or substantially improve the real property. When a taxpayer excludes COD income under this code section, the amount is applied to reduce the basis of the real property under IRC Section 1017. This reduction effectively defers the income recognition to a later date. Gain subsequently recognized with respect to the disposition of the real property will be recaptured as ordinary income.

The COD income excluded cannot exceed the excess of the outstanding principal amount over the fair market value of the real business property, reduced by the outstanding principal amount of any other QRPBI secured by the property. Consider the following example:

Taxpayer (T) purchased a commercial real estate property for $500,000 for use in T's real trade or business. T financed it with a $400,000 bank loan which was secured by the property. Three years after the purchase, T entered into an agreement with the bank to cancel $50,000 of the debt, at which time the loan's outstanding principal balance was $300,000, the fair market value was $250,000, and the adjusted basis of the commercial real estate property was $450,000.

T elects to exclude the canceled debt from income under the QRPBI exclusion. The limitation on the excluded amount is $50,000, which is the excess of the outstanding principal balance over the fair market value of the business real property securing the debt ($300,000 less $250,000). T would reduce the adjusted basis of the commercial real estate property to $400,000. If the fair market value of the business real property was $275,000, the limitation on the excluded amount would be $25,000, and T would have to recognize $25,000 as income in the taxable period of cancellation. T would reduce the adjusted basis of the commercial real estate property to $425,000.

A second limitation exists under IRC section 108. The amount of canceled debt that can be excluded from income cannot exceed the total adjusted basis of the depreciable real property held immediately before the cancellation of the qualified debt, other than depreciable real property acquired in contemplation of the cancellation.

The exclusion for the COD income exception applies at the partner, rather than the partnership, level. This election is made by filing Form 982, Reduction of Tax Attributes Due to Discharge of Indebtedness (and Section 1082 Basis Adjustment).

One very important distinction is to recognize the differences between taxpayers who develop and hold real business property versus those who hold it primarily for sale to customers in the ordinary course of business. Real property used in a trade or business is depreciable, while real property held for sale is considered inventory and thus not depreciable. Since one of the provisions of the income exclusion on QRPBI requires a reduction of the depreciable basis, this would exclude real property held for sale from getting the QRPBI income exclusion.