

Real Estate Attorney's Guide to Key Tax Issues - Acquiring, Holding and Disposing of Real Estate

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ACQUIRING, HOLDING AND DISPOSING OF REAL ESTATE

I. ENTITY SELECTION

A. General

Real estate owners sometimes conduct their activities as “sole proprietorships,” which do not involve a legal entity separate from the owner. However, the owner generally desires the protection from liability under state law to the owners of qualifying entities. As alternative to holding the property as a sole proprietor, the real estate owner should consider holding the property in a single-member limited liability company (“SMLLC”). Under Federal tax law, a SMLLC, which has not elected to be taxed as a corporation, is disregarded as an entity separate from its owner. Treas. Reg. § 301.7701-3(b)(1)(ii). Thus, for Federal tax purposes, the single-member is treated as directly owning the real estate while afforded state law liability protection.

The tax consequences of using a separate entity depend on the type of entity holding the real estate. Partnerships (general and limited), S corporations and limited liability companies that are treated as partnerships (i.e., multiple member limited liability companies) are considered for Federal income tax purposes as pass-through entities whose owners report their proportionate share of the entity’s income or loss.

In contrast, the income of a C corporation is taxed at the corporate level, and shareholders are taxed on dividend distributions to the extent of the corporation’s earnings and profits. Thus, the income of a C corporation will be subject to tax at both the corporate and shareholder levels.

B. Choice of Entity

1. C Corporations

A C corporation’s income generally is taxed when earned at the corporate level and is taxed again at the individual level when distributed as dividends to its shareholders. Distributions with respect to stock that exceed corporate earnings and profits (current and accumulated) are not taxed as dividend income to shareholders but are treated, first, as a tax-free return of capital that reduces the shareholder’s basis in stock, and, second, as amounts received in exchange for the stock which, in general, are taxed to the shareholder at capital gains rates. Corporate deductions and credits reduce only corporate income and are not passed through to shareholders. The gain on appreciated corporate assets generally is subject to corporate level tax if they are distributed to the shareholders, providing the same tax result as if the assets had been sold by the corporation and the proceeds distributed to the shareholders (i.e., double taxation).

In general, interest paid by a C corporation is deductible but dividends paid are not which could create a tax incentive establishing a preference of debt over equity in a corporation’s capital structure. Shareholders of a C corporation receive different treatment depending upon whether an instrument is characterized as equity or debt for tax purposes. Interest is subject to tax at ordinary income rates, whereas the rate reduction for dividends received by individuals may provide shareholder incentives to invest in stock rather than debt.

Shareholders receive different treatment depending on whether a corporate equity distribution is characterized as a dividend or as a payment in exchange for stock that is entitled to both capital gain treatment and basis recovery. While the tax rates for dividends and capital gains on stock are generally the same under present law, capital gain treatment permits basis recovery (i.e., tax-free return of capital). A number of provisions of the Internal Revenue Code have attempted to provide guidance in this area. For example, Section 302 provides rules to determine whether a shareholder whose stock has been partially redeemed has experienced a sufficient contraction in his or her interest to be treated as having sold the stock rather than as having received a dividend.

2. S Corporations

An S corporation provides the Federal income tax advantage of pass-through treatment, and allows the liability protection allowed a corporation under state law. To be eligible to elect S corporation status, a corporation may not have more than 100 shareholders and may not have more than one class of stock. Only individuals (other than nonresident aliens), certain tax-exempt organizations, and certain trusts and estates are permitted shareholders. A corporation may elect S corporation status only with the consent of all its shareholders, and may terminate its election with the consent of shareholders holding more than 50 percent of the stock. Section 1362.

For Federal income tax purposes, an S corporation is generally not subject to tax at the corporate level. Sections 1363 and 1366. Items of income, gain, loss, deduction and credit of the corporation are taken into account in computing the tax of the shareholders. A shareholder's deduction for corporate losses is limited to the sum of the shareholder's adjusted basis in the S corporation stock and the amount of any loans made by the shareholder to the corporation. The shareholder's basis in the S corporation stock (and debt) is reduced by the shareholder's share of losses and (in the case of stock) by distributions and is increased by the shareholder's share of the corporation's income and contributions to capital. Section 1367. In general, an S corporation shareholder is not subject to tax on corporate distributions unless the distributions exceed the shareholder's basis in the stock of the corporation or if the corporation was formerly a C corporation and has undistributed earnings and profits. Section 1368.

There are two principal exceptions to the pass-through treatment of S corporations which are applicable only if the corporation was previously a C corporation and are generally intended to prevent avoidance of otherwise applicable C corporation tax consequences. First, an S corporation is subject to tax on excess net passive investment income (but not in excess of its taxable income, subject to certain adjustments), if the corporation has subchapter C earnings and profits (i.e., earnings and profits while treated as a C corporation) and has gross receipts more than 25 percent of which are passive investment income for the year. Section 1375. Second, for the first 5 years after a corporation that was previously a C corporation elects to be an S corporation, certain net "built-in" capital gains of the corporation attributable to the period in which it was a C corporation are subject to tax at the corporate level. Section 1374.

3. Partnerships

Partnerships generally are treated for Federal income tax purposes as pass-through entities, not subject to tax at the entity level. Section 701. Items of income, gain, loss, deduction and credit of the partnership are taken into account at the partner level (based on the partnership's method of accounting and regardless of whether the income is distributed to the partners). Each partner takes into income such partner's distributive share of the partnership's taxable income and the separately allocable items of income, gain, loss, deduction and credit. Section 702(a). A partner's basis in the partnership interest generally equals the sum of (1) such partner's capital contribution to the partnership, (2) the partner's distributive share of partnership income, and (3) the partner's share of partnership liabilities, less (1) such partner's distributive share of losses allowed as a deduction and (2) any partnership distributions. Section 705.

Partnerships provide partners with a significant amount of flexibility to vary their respective shares of partnership income. Unlike corporations, partnerships may specifically allocate items of income, gain, loss, deduction and credit among the partners, provided the allocations have "substantial economic effect." Section 704. In general, an allocation is permitted to the extent the partner to which the allocation is made receives the economic benefit or bears the economic burden of such allocation, and the allocation substantially impacts the dollar amounts to be received by the partners from the partnership independent of tax consequences.

If (1) property is held by spouses as joint property; (2) the spouses file a joint return; (3) both spouses materially participate in the trade or business (joint ownership isn't enough); and (4) both spouses elect not to be treated as a partnership, the relationship will be treated for tax purposes as a "qualified joint venture" and not a partnership. Each spouse must file a separate Schedule C, C-EZ or F. In addition, each spouse must file a separate Schedule SE to pay self-employment taxes. If the property is rental real estate, each spouse must file a separate Schedule E. Rental real estate income generally is not subject to self-employment tax. Once qualified joint venture status is elected, it cannot be changed without IRS approval. Note: if the property is held by a limited liability company that is owned by spouses, the LLC is taxed as a partnership and not a single member LLC unless the LLC elects to be taxed as a corporation. If the spouses are residents of a community property state, the single member LLC rules apply.

4. Limited Liability Companies

A multiple member limited liability company is generally treated as a partnership for Federal income tax purposes. Any domestic non-publicly traded unincorporated entity with two or more members generally may elect to be treated as either a partnership or a corporation for Federal income tax purposes, while any single-member unincorporated entity may elect to be treated as a corporation or to be disregarded (i.e., treated as not separate from its owner) for Federal income tax purposes. Treas. Reg. § 301.7701-3.

5. Carried (Profits) Interest

Certain partners receive partnership/LLC interests in exchange for contributions of cash and/or property, while other partners may receive partnership/LLC interests in exchange for services. To the extent that the partnership/LLC recognizes long-term gain, the partners, including the service partners, report their proportionate share of the long-term gain. In addition, gain recognized on the sale of the partnership/LLC interest, whether it is received in exchange for property, cash or services, is generally treated as capital gain.

C. Preferred Entity to Hold Real Estate

Unless there are overriding business reasons, real estate, especially in the case of investment real estate, should be held in either a partnership or limited liability company. In the event that the owners of the entity want to have the real estate distributed to them, it is essentially impossible to distribute real estate from a corporation, whether a C corporation or an S corporation, without triggering the gain inherent in the property.

II. DEALERS

A person is a “dealer” in real estate if it holds real estate *primarily* for sale to customers in the ordinary course of its business. Persons selling real estate who are deemed to be a “dealer” in such property recognize gain as ordinary income, whereas those holding real property for investment purposes recognize capital gain on its sale. This result occurs because inventory is excluded from the statutory definition of a capital asset. Section 1221(a)(1). Furthermore, in order to obtain the benefits of a like-kind exchange under Section 1031, the property disposed of (“relinquished property”) and the property acquired (“replacement property”) must either be held for investment or for use in a trade or business. In either case, inventory property, such as property considered as “dealer” property, will not qualify for the benefits of Section 1031.

Dealer status does not automatically taint all property held by the dealer. A seller who is ordinarily a dealer can recognize capital gain or enter into a like-kind exchange transaction on the sale of property it holds for investment purposes. *See Scheuber v. Commissioner*, 371 F.2d 996 (7th Cir. 1967). Thus, a person can be a dealer with respect to some property and an investor with respect to other property.

The state of the law, in determining whether a person is a “dealer” or “investor” in real estate, is less than clear. The courts have developed many factors in determining whether a person holds real property as an investment or for sale in his trade or business. It is noted that none of these factors is solely determinative of the character of the property and that the courts have not always applied the factors in a consistent manner.

A person can hold property for sale without becoming a dealer in the property if it holds the property “primarily” for some other purpose. *Malat v. Riddell*, 383 U.S. 569 (1966). Courts, therefore, look to all the facts and circumstances of a sale to determine the seller’s primary intent. Courts tend to find that a person’s primary intent is that of a dealer if its sales are frequent and/or continuous. *See, e.g., Goodman v. United States*, 390 F.2d 915 (Ct. Cl. 1968)

(taxpayers were dealers due to “the magnitude of their holdings, the extensive, frequent and continuous sales of the same, frequent short holding periods, the large amounts of money involved in these transactions, segregation of proceeds of sales for purchase of other real estate interests, and the profits derived from such ownership and sales as compared to plaintiffs other income”). On the other hand, courts will find a person’s primary intent is other than that of a dealer if sales are infrequent, are made in response to an unsolicited offer, or are brought about by a change in circumstances. *See, e.g., Starke v. Commissioner*, 312 F.2d 608 (9th Cir. 1963) (taxpayer held property over a period of years, and then sold off in response to unsolicited offers during two different unexpected upturns in the market). *See also Byram v. United States*, 705 F.2d 1418 (5th Cir. 1983) (22 sales in three years did not give rise to dealer status because all sales were the result of unsolicited offers). The factors developed by the courts include the following: (1) the number, frequency and continuity of sales by the taxpayer; (2) the substantiality of the sales and relative amounts of income derived by the taxpayer from his regular business activities compared to the amount of gain from the sale of the property; (3) the purpose for which the property was originally purchased (that is, investment or sale); (4) improvements made to the property by the taxpayer; (5) methods used by the taxpayer to sell the property (that is, advertising, use of brokers or agents or substantial efforts by the taxpayer); (6) the length of time the taxpayer held the property; (7) the relationship of the property to the taxpayer’s business (that is, is the sale in furtherance of the taxpayer’s business or part of his regular business operations); and (8) acquisition of additional property from the sales proceeds.

Development activities, like subdividing the property and adding improvements such as roads or utilities, generally cause the seller to be treated as a dealer. *See* Rev. Rul. 59-91, 1959-1 C.B. 15. Mere subdivision to facilitate sale of land acquired and held for investment purposes, however, does not always rise to the level of dealer activity. *See, e.g., Gudgel v. Commissioner*, 273 F.2d 206 (6th Cir. 1959); *Yunker v. Commissioner*, 256 F.2d 130 (6th Cir. 1958); and *Buono v. Commissioner*, 74 T.C. 187 (1980). In an effort to create some uniformity in this area, Congress added Section 1237 to the Code, which provides certain specific circumstances under which mere subdivision of land prior to its sale will not result in the taxpayer being treated as a dealer. However, the provision does not provide protection for taxpayers who are otherwise “dealers” in real estate with respect to other property held at the same time as the sale in question. Section 1237(a)(1). The provision also does not apply to taxpayers who are C corporations. Section 1237(a). For transactions falling within Section 1237’s provisions, the first five parcels of a subdivided lot are afforded capital gain treatment, but every lot thereafter is subject to ordinary income rates up to, but not in excess of, an amount equal to five percent of the selling price; the balance of the gain (if any) is taxed as capital gain.

III. CONDEMNATION

An involuntary conversion is the loss of property by, among other things, the actual or threatened seizure and condemnation by the government without the taxpayer’s consent through the power of eminent domain. Depending on the amount received and the adjusted basis of the asset, a gain or loss may result.

A. Deferring Gain

When business or income-producing property is partially or wholly taken by an involuntary conversion and the taxpayer receives a money settlement, a gain may be realized. An election can be made to defer the gain if the funds received are reinvested, within a prescribed period, in either (1) property similar or related in service or use, or (2) like-kind property. The amount of the realized gain to be recognized or deferred, as the case may be, depends on the cost of the replacement property. Treas. Reg. § 1.1033(a)-2(c)(l).

A taxpayer may defer gain that results from a threat or imminence of condemnation, rather than actual condemnation, if the taxpayer has reasonable cause to believe the property will be seized or condemned and this fact has been conveyed to the taxpayer directly by the condemning authority. Rev. Rul. 63-221, 1963-2 C.B. 332. In addition, it is not necessary that the taxpayer sell the property to the condemning authority. The taxpayer can sell the property to be condemned to a third party and still be allowed to defer the gain under Section 1033. Rev. Rul. 81-180, 1981-2 C.B. 161. In such a case, the taxpayer must have received a notice directly from the condemning authority of its intention to proceed with a condemnation and that the taxpayer's property will be condemned if the property is not sold to the third party. The owner cannot learn about the threat from news reports or other second-hand information. Rev. Rul. 58-557, 1958-2 C.B. 402. If an individual purchases property that has been threatened with condemnation, the buyer may also defer any gain resulting from a subsequent sale of the same property to the government when it is actually condemned. Rev. Rul. 81-181, 1981-2 C.B. 162.

B. Qualifying Replacement Property

To defer a gain resulting from an involuntary conversion, the replacement property must be (1) similar to or related in service or use to the involuntarily converted property, or (2) like-kind. Sections 1033(a) and (g); Treas. Reg. § 1.1033(a)-l. What is qualified replacement property depends on the type of property condemned, the nature of the involuntary conversion, and its use (owner using it in a trade or business, or owner holding the property as investment).

In the case of real property held for investment or used in a trade or business, gain may be deferred by purchasing "like-kind" property, rather than property that is similar or related in service or use. Under the Section 1031 like-kind rules, improved real property can be replaced with unimproved real property or unimproved real property can be replaced with improved real property. It should be noted that Treas. Reg. § 1.1033(a)-2(c)(9) states, however, that there is no investment in similar property devoted to similar use if the proceeds (1) from the condemnation of unimproved real estate are invested in improved real estate, or (2) are used to reduce debt previously incurred in the purchase of a leasehold. Therefore, it is important to understand which standard applies to the property being condemned.

C. Period for Acquisition of Replacement Property

A three-year replacement period (as opposed to the typical two-year replacement period) is allowed for condemned real property held for investment or used in a trade or business. Section 1033(g)(4). The replacement period begins at the end of the tax year in which a gain is

realized, not the date the threat of an actual condemnation occurs. It is not necessarily the same tax year the involuntary conversion occurred because the condemnation proceeds may be received and the gain realized in the next tax year. If a taxpayer shows reasonable cause, an extension of the replacement period may be granted if the request is made before the period expires. Treas. Reg. § 1.1033(a)-2(c)(3). For real property under the threat or imminence of condemnation, qualified replacement property can be acquired anytime from the date of the threat or imminence of condemnation until three years after the end of the tax year in which the gain is realized.

D. Gain Deferral and Basis of Replacement Property

The realized gain is condemnation proceeds received (after any expenses such as attorney's or appraisal fees to settle the claim) that exceed the adjusted basis of the property. Interest received is ordinary income and not part of the amount realized in determining the gain on the involuntary conversion.

The deferred gain is the difference between the realized gain and the recognized gain. The recognized gain is the lesser of (1) the realized gain, or (2) the money received in excess of the cost of the replacement property. Section 1033(a)(2)(A). To defer the entire gain, the replacement property must cost at least as much as the amount received for the involuntarily converted property. The basis of the new property will be its cost less the deferred gain. The holding period of the involuntarily converted property tacks on to the holding period of the replacement property. Section 1223(1)(A). Any recognized gain is subject to depreciation recapture.

If a taxpayer fails to replace the property within the allowable period or purchases property for less than the amount realized on the conversion of the involuntarily converted property, the recognized gain must be reported on an amended return for the year in which the gain was realized. Treas. Reg. § 1.1033(a)-2(c)(2).

E. Use of Condemnation Proceeds

In contrast to Section 1031, it is not necessary that all of the cash proceeds received from a condemnation be invested in the replacement property in order to defer the gain. Gain is recognized, assuming all of the other requirements of Section 1033 are met, only to the extent the cost of the replacement property does not equal or exceed the cash or nonqualifying property received in the condemnation. Treas. Reg. § 1.1033(a)-2(c)(1). Thus, a taxpayer may purchase part or all of the replacement property with debt and keep the cash proceeds without recognizing any gain.

IV. TAX-FREE EXCHANGES OF REAL ESTATE UNDER SECTION 1031

A. General

1. Section 1031(a)(1) states that "No gain or loss shall be recognized on the exchange of property held for productive use in a trade or business or for investment if such

property is exchanged solely for property of like kind which is to be held either for productive use in a trade or business or for investment.”

2. An exchange qualifying under Section 1031 is technically not, as it is often called, a “tax-free” exchange, it is a “deferred” exchange as the basis of the property received is reduced for the gain not recognized.

3. As the statute states, there must be an “exchange.” A sale followed by an immediate investment in like-kind property does not fall within the scope of Section 1031. The taxpayer must *not* receive directly or indirectly the proceeds from the disposition of the property.

4. An exchange can involve *multiple* parties, often referred to as a “three-corner” exchange. For example, X wants to transfer his property to Y in a Section 1031 exchange but Y does not own any property that X desires. Y can acquire property from Z who owns the property that X desires and arrange for it to be transferred to X.

5. A multi-party exchange does not have to be *simultaneous*. Section 1031(a)(3) contains rules for *deferred* exchanges, sometimes referred to as “Starker exchanges” after a 1979 Ninth Circuit case that permitted a nonsimultaneous exchange.

6. Section 1031 is *not* elective. Where an exchange meets the requirements of Section 1031, nonrecognition will be afforded, even if the taxpayer desires that the transfer be taxable, or produce a loss. Thus to have a taxable transaction, an attempt must be made to fall outside Section 1031.

7. Gain is *recognized* to the extent that net cash and other nonqualified property, known as “boot,” is received. However, the amount of the gain recognized is limited to the gain *realized*.

8. No *loss* can be recognized in a qualifying exchange. Section 1031(c).

9. In limited circumstances, an exchange can be with a related party. However, any gain recognized may be ordinary income under Section 1239. Also, special rules exist under Section 1031(f) for exchanges with *related parties*. These rules generally require that the unrecognized gain be recognized when either of the related parties disposes of the exchanged property within two years. Section 1031(f)(2) states that this rule will not apply to the following situations:

- a. After the earlier of the death of the taxpayer or the related person.
- b. To a disposition resulting from a compulsory or involuntary conversion.
- c. In other circumstances if it is established that neither the original exchange nor the subsequent disposition had as one of its principal purposes the avoidance of tax.

Exchanges must be reported on Form 8824, Like-Kind Exchanges. This form reports the computation of both the *realized* gain and the *recognized* gain.

B. Property Qualifying For Section 1031 Treatment

1. Specific Properties Not Qualifying Under Section 1031

- a. Stock in trade or other property held primarily for sale ((a)(2)(A)).
- b. Stocks, bonds, or notes ((a)(2)(B)).
- c. Other securities or evidences of indebtedness or interest ((a)(2)(C)).
- d. Interests in a partnership ((a)(2)(D)).
- e. Certificates of trust or beneficial interests ((a)(2)(E)).
- f. Choses in action [a personal right not reduced into possession, but recoverable by a suit at law or other right of action] ((a)(2)(F)).
- g. Real property located in the U.S. exchanged for real property located outside the U.S. ((h)).

2. Purpose for Holding

- a. Section 1031(a)(1) states that no gain or loss is recognized if property held for productive use in a trade or business or for investment is exchanged solely for property of a like kind to be held either for productive use in a trade or business or for investment. Property held for productive use can be exchanged for property held for investment. For example, land held for investment can be exchanged for an office building held for rental.
- b. The property received in the exchange must also be held for investment or for use in the taxpayer's trade or business. It is not clear how long such property must be held. The phrase "to be held for" in Section 1031(a) implies *a continuity of ownership*. A subsequent disposition of the property received may be evidence that the property was not acquired for investment or use in the taxpayer's business.

3. "Like-Kind"

- a. The term "like-kind" as used in Section 1031(a) has reference to the "nature or character of the property and not to its grade or quality." One kind or class of property may not be exchanged for property of a different kind or class. Treas. Reg. § 1.1031(a)-1(b).

- b. The fact that real estate is improved or unimproved is not material, for that fact relates only to the grade or quality of the property and not to its kind or class. Treas. Reg. § 1.1031 (a)-1 (b).

C. Boot Given And Received

1. Money and other nonqualified property *received* in an exchange is called “boot.” Other property includes specifically excluded property (e.g. stock) and property that is not like-kind (e.g. land for farm equipment).

2. The *giving* of boot along with qualified property does not cause the transaction to fall outside Section 1031. For example, one can exchange land and farm equipment for land and it will qualify for Section 1031 treatment.

3. Liabilities of the taxpayer assumed by the person receiving the taxpayer’s property and liabilities attached to the property transferred (e.g., nonrecourse debt) are treated as boot received by the taxpayer in the exchange. Treas Reg. § 1.1031(b)-1(c) and § 1.1031(d)-2.

4. The regulations specifically permit the *netting* of liabilities “given” and “received.” Treas. Reg. § 1.1031(b)-1(c). Thus if a taxpayer transfers property subject to a liability of \$1,000,000 and receives property in the exchange subject to a liability of \$800,000, he has received boot of \$200,000. (The other party to the exchange has given boot of \$200,000).

D. Basis In Property Received

1. The tax basis of property received in an exchange qualifying under Section 1031 is the tax basis of the property surrendered increased by any additional consideration given, decreased by the amount of any money received, and increased by any gain or decreased by any loss recognized on the exchange. Section 1031(d).

2. When *multiple* qualifying properties are received, the aggregate tax basis of the properties received is allocated proportionately to each property received in the exchange in accordance with its fair market value. Treas. Reg. § 1031(j)-1(c).

E. Multi-Party Exchanges

1. An exchange implies a transfer of properties between *two* parties. However, this is often not practical as the person who desires the property of the taxpayer often does not have property that the taxpayer wants in an exchange. Therefore, the other party will be required to acquire property to be transferred to the taxpayer. Thus, a multi-party exchange is created.

2. Multi-party exchanges are known as “three-party” exchanges or “four-party exchanges.” A typical three-party exchange involves three parties: A, the taxpayer desiring to exchange property for new property; B, a would-be purchaser of A’s property; and C, who owns property that A wants but who only wants to sell and not exchange the property.

F. Deferred Exchanges

1. Background

The concept of a deferred or non-simultaneous exchange was recognized in *Starker v. United States*, 602 F.2d 1341 (9th Cir. 1979). Because of the administrative problems caused by the lapse of time allowed in the *Starker* decision, Congress enacted Section 1031(a)(3) to restrict the time in which a deferred exchange may be accomplished. The regulations provide that a “deferred exchange” is an exchange in which, “pursuant to an agreement” the taxpayer transfers and receives qualifying property. Treas. Reg. § 1.1031(k)-1(a). With respect to the property to be received in the transaction, the taxpayer must meet the identification and receipt requirements. *Id.* Furthermore, the transaction must constitute an exchange of properties, as opposed to a transfer of property for money. *Id.*

2. Identification and Receipt Requirements

a. Section 1031(a)(3)

Section 1031(a)(3) provides that property received by the taxpayer shall not be treated as like-kind unless (a) the property is identified on or before midnight of the 45th day after the date on which the taxpayer transferred the property relinquished in the exchange, and (b) the taxpayer receives the replacement property prior to the earlier of (i) midnight of the 180th day after the date on which the taxpayer transferred the property relinquished in the exchange, or (ii) the due date (including extensions) for the taxpayer-transferor’s return for the year in which the transfer of the property relinquished in the exchange occurs. In determining when to begin the counting of the 45 and 180 day periods, the regulations provide that you start with the day following the date the relinquished property is transferred. Treas. Reg. § 1.1031(k)-1(b)(3) (Example).

b. Regulations

With respect to the identification period and exchange period, the regulations provide that if the taxpayer transfers more than one piece of property as part of the same deferred exchange and the relinquished properties are transferred on different dates, the identification period and exchange period are determined by reference to the earliest date on which any of the properties are transferred. Treas. Reg. § 1.1031(k)-1(b)(2).

The proposed regulations provided that, for purposes of determining when the identification period or exchange period ends, Section 7503 (relating to the time for performance of acts where the last day for performance falls on a Saturday, Sunday, or legal holiday) will *not* apply. *Id.*

i. Identification of Replacement Property. In the case of any deferred exchange, any replacement property received by the taxpayer before the end of the identification period will in “all events” be treated as identified before the end of the identification period. Treas. Reg. § 1.1031(k)-1(c). In all other cases, replacement property is identified *only* if it is designated as replacement property in a written document signed by the taxpayer and either hand delivered, mailed, telecopied, or otherwise *sent* before the end of the identification period to (i) a person involved in the exchange other than the taxpayer or a “disqualified person” (as defined below), or (ii) the person obligated to transfer the replacement property to the taxpayer (regardless of whether that person is a disqualified person). *Id.* A written exchange document, identifying the replacement property, signed by all the parties to the exchange before the end of the identification period, will be treated as satisfying the identification requirement. *Id.*

ii. Description of Replacement Property. Replacement property is identified only if it is “unambiguously described in the written document or agreement.” Treas. Reg. § 1.1031(k)-1(c)(3). Real property is generally unambiguously described if its legal description or street address is provided. *Id.* Personal property generally is unambiguously described by particular type of property. *Id.*

iii. Alternative and Multiple Properties. The regulations provide that a taxpayer may identify more than one property as replacement property. Treas. Reg. § 1.1031(k)-1(c)(4). Regardless of the number of properties relinquished as part of the “same” deferred exchange, the *maximum* number of replacement properties that may be identified is (i) three properties without regard to fair market value, or (ii) any number of properties as long as the aggregate fair market value of the properties identified at the end of the identification period does not exceed 200 percent of the aggregate fair market value of all relinquished properties, determined on the date that the relinquished properties were transferred by the taxpayer. *Id.* In a case where, at the end of the identification period, the taxpayer has identified more replacement properties than permitted, none of the replacement properties are treated as having been identified. *Id.* However, this rule will not apply and the identification requirements will be deemed satisfied with respect to (i) replacement property received before the end of the identification period, and (ii) replacement property identified before the end of the identification period and received before the end of the exchange period, but only if the taxpayer receives before the end of the exchange period identified replacement property

constituting at least 95 percent of the aggregate fair market value of all identified replacement properties. *Id.* For this rule, fair market value of identified replacement property is determined as of the earlier of the date the property is received by the taxpayer or the last day of the exchange period. *Id.*

3. Receipt of Money or Other Property/Constructive Receipt and Agency

The regulations contain four safe harbors for deferred exchanges. [Note: The “qualified intermediary” safe harbor also applies to simultaneous exchanges.] Transactions which fall within the safe harbors generally will avoid an argument by the IRS that the taxpayer was in actual or constructive receipt of any funds used to acquire replacement property.

a. Qualified Intermediaries. The third and most often utilized safe harbor provides that deferred exchanges may be facilitated by the use of a qualified intermediary if the taxpayer’s rights to receive money or other property are limited as provided in the regulations (see subparagraph (e) below). Treas. Reg. § 1.1031(k)-1(g)(4). A transaction structured under this provision of the regulations qualifies regardless of the fact that the intermediary is or may be the taxpayer’s agent. A “qualified intermediary” is any person who (i) is not the taxpayer or a disqualified person (as discussed below), and (ii) enters into a written agreement with the taxpayer for the exchange of properties pursuant to which such person acquires the relinquished property from the taxpayer, acquires the replacement property, and transfers the replacement property to the taxpayer. *Id.*

The regulations provide guidance with respect to what must be done by the intermediary in order for it to be considered to have acquired and transferred the relinquished and replacement properties. The regulations provide that: (i) an intermediary acquires and transfers property if the intermediary acquires and transfers legal title to that property; (ii) an intermediary acquires and transfers the relinquished property if the intermediary (either on its own behalf or as the agent of any party to the transaction) enters into an agreement with a person other than the taxpayer for the transfer of the relinquished property to that person and, pursuant to that agreement, the relinquished property is so transferred; and (iii) an intermediary acquires and transfers replacement property if the intermediary (either on its own behalf or as the agent of any party to the transaction) enters into an agreement with the owner of the replacement for the transfer of that property and, pursuant to that agreement, replacement property is so transferred. Treas. Reg. § 1.1031(k)-(g)(4)(iv). Items (ii) and (iii) allow the relinquished and replacement properties to be directly deeded by the current owners without the intermediary coming into title. For purposes of determining whether the intermediary has entered into a written agreement, the regulations provide that the intermediary is treated as to entering into an agreement if the rights of a

party to the agreement are assigned to the intermediary, and all parties to that agreement are notified in writing of the assignment by the date of the relevant transfer of property. In addition, rights under state law to terminate or dismiss the intermediary are disregarded for purposes of determining whether the taxpayer has the immediate ability or unrestricted right to receive, pledge, borrow or otherwise obtain the benefits of the cash or cash equivalent.

b. Additional Limitations for Qualified Intermediaries, and Interest and Growth Factors. The taxpayer's rights will be considered as limited under the regulations if the taxpayer does not have the right to receive money or other property until (i) in the case where taxpayer does not identify replacement property before the end of the identification period, after the end of the identification period, (ii) in the case where the taxpayer has identified replacement property, after the taxpayer has received all of the identified replacement property which the taxpayer is entitled, (iii) in the case where taxpayer identifies replacement property, after the later of the identification period and the occurrence of a substantial contingency that (I) relates to the deferred exchange, (II) is provided for in writing, and (III) is beyond the control of the taxpayer or any disqualified person, or (iv) otherwise, after the end of the exchange period. Treas. Reg. § 1.1031(k)-1(g)(6).

4. Reverse Deferred Exchange

a. Reverse Exchanges

In a reverse exchange, the taxpayer desires to acquire the replacement property before the taxpayer transfers the relinquished property. Typically, this occurs when the seller of the replacement property requires that the sales transaction close before the taxpayer can close on the relinquished property, and in many cases, the taxpayer has not yet found a buyer for the relinquished property. Not surprisingly, the IRS has been quite selective in the fact patterns of the court cases which have addressed the issue of reverse exchanges. In a number of cases, taxpayers have been unsuccessful in treating the acquisition of replacement property followed by the sale of the relinquished property as an exchange, with the typical reason given by the courts for the failure to meet the exchange standard was the lack of interdependence" between the purchase and sale transactions. See, e.g., *Bezdjian v. Commissioner*, 845 F.2d 217 (9th Cir. 1988); *Lincoln v. Commissioner*, TC Memo 1998-421. Despite the apparent lack of judicial support of the taxpayers in these cases, it appears that the cases do offer a guide for a transaction which, if properly structured, could achieve exchange treatment. See also *DeCleene v. Commissioner*, 115 T.C. 457 (2000) (transaction failed to qualify as exchange where taxpayer "parked" property and accommodator had no

economic risk of loss). The *DeCleene* case was distinguished in *Bartell v. Commissioner*, 147 T.C. 140 (2016), *nonacq.* 2017-33 IRB (accommodator, used at the outset, treated as the owner of the replacement property despite not having the benefits and burdens of ownership). See also PLR 200329021 and PLR 200251008 (IRS rules favorably on build-to-suit transactions involving related parties under certain reverse exchange/lease arrangements).

i. Revenue Procedure 2000-37 - “Safe Harbor”. The IRS has issued a revenue procedure which provides a safe harbor for reverse exchange transactions. Rev. Proc. 2000-37, 2002-2 C.B. 308. The revenue procedure states that the IRS will not challenge the qualification of property as either relinquished property or replacement property, or the treatment of an “exchange accommodation titleholder” (“EAT”) as the beneficial owner of either form of property, if the property is held pursuant to a “qualified exchange accommodation agreement” (“QEAA”).

Rev. Proc. 2000-37 was modified by Rev. Proc. 2004-51, 2004-2 C.B. 294. A limitation was added to Section 4.05 of Rev. Proc. 2000-37 which provides that the revenue procedure does not apply to replacement property held in a QEAA if the property was owned by the taxpayer within 180 days of the date the property is transferred to the EAT. This modification is effective for transfers after July 19, 2004.

G. Tenancy In Common Interests As Replacement Property-Syndicated Properties And Compliance With Rev. Proc. 2002-22

The IRS issued Rev. Proc. 2002-22, 2002-1 C.B. 733, to specify the conditions under which it would consider a request for a ruling that a tenancy in common interest in real property is eligible for tax-free exchange under Section 1031. A tenant in common owns a fractional interest in land with a right to possess the whole of the property, and has rights to a proportionate share of rents from the property, but is not equivalent to a partnership for federal tax purposes. A tenancy in common, the IRS stated, is conceptually distinct from a partnership, because a tenancy in common is mere co-ownership of property, whereas a partnership involves a “join[ing] together [of] capital or services with the intent of conducting a business enterprise and of sharing the profits and losses from the venture.” The recognition of this distinction is key to obtaining tax deferral under Section 1031 for an exchange of tenancy in common interests, because an exchange of partnership interests is not eligible for the provisions of Section 1031. Section 1031(a)(2)(D).

The IRS set forth fifteen conditions that generally must be satisfied for a favorable ruling, but stated that it may nonetheless consider ruling in cases where not all conditions are met, but “the facts and circumstances clearly establish that such a ruling is appropriate.”

H. Related Party Exchanges

Section 1031(f) restricts exchanges between related persons. In general, if a taxpayer directly or indirectly exchanges property with a related person [as defined in Sections 267(b) and 707(b)(1)], the taxpayer and the related party must hold the respective properties received in the exchange for a period of two years in order for the original exchange to qualify for non-recognition treatment. Section 1031(g) provides that the two-year period for holding the property will be suspended for any period during which the holder's risk of loss is substantially diminished by the holding of a put with respect to such property, the holding of another person of a right to acquire such property, or a short sale or any other transaction. Exceptions to the two-year rule include disposition due to death, involuntary conversion of the property (i.e., Section 1033) or where it is established to the satisfaction of the Secretary that neither the exchange nor the disposition had as one of its principal purposes the avoidance of tax. The legislative history provides that the non-tax avoidance standard will apply, but not be limited to, transactions involving the exchange of undivided interests in different properties so that the taxpayer ends up owning the entire interest or a larger undivided interest in the property, dispositions involving nonrecognition transactions, and transactions which do not involve basis shifting techniques.

In *Teruya Bros., Ltd. v. Commissioner*, 124 T.C. 45 (2005), *aff'd* 580 F.3d 1038 (9th Cir. 2009), the Tax Court held that imposing a qualified intermediary in a related party exchange was done to circumvent the related party restrictions of Section 1031(f). *See also* Rev. Rul. 2002-83, 2002 C.B. 927 (IRS ruled that a taxpayer who transferred relinquished property to a qualified intermediary in exchange for replacement property acquired from a related party will not be entitled to exchange treatment if the related party received cash or other non-like kind property for the replacement property. The ruling applies the language of the legislative history enacting the related party rules in reaching its conclusion.) On the other hand, the IRS ruled in PLR 200440002 that when both of the related parties end up with suitable replacement property, neither party is "cashing out" and Section 1031(f) will not deny nonrecognition treatment.

In PLR 200541037, the IRS ruled that the related party rules did not apply to an exchange of timber property between the taxpayer and a corporation "related" to the taxpayer. The harvesting and sale of the timber, by the corporation, within two years after the exchange was not considered a sale of real estate for purposes of the related party rules.

In PLR 201408019, the IRS ruled a transaction qualified for exchange treatment when a party related to the taxpayer entered into a general lease with an accommodator, the accommodator constructed improvements on the property and transferred the property subject to the ground lease and the improvements to the taxpayer.

V. INSTALLMENT SALES

A. In General

If the sale of real estate qualifies as an installment sale, the installment method of accounting permits a taxpayer to defer recognition of gain or the gross profit until the taxpayer

actually receives the money. Thus, under the installment method, gain on sale is spread over the period during which the installment payments are received, rather than being taxed in the year of sale.

1. Basic Rules

An installment sale is a disposition of property in which one or more payments are to be received after the close of the taxable year in which the disposition occurs. Section 453(b)(1). In order to qualify as an installment sale, at least one payment must be received in a taxable year after the year of sale, but there is no requirement that there be more than one payment.

The installment method permits gain from eligible installment sales to be reported as the taxpayer receives installment payments. Each payment received is treated in part as (i) a nontaxable recovery of a portion of the seller's basis in the property; (ii) a taxable realization of a portion of the seller's gain; and (iii) interest. Thus, the taxpayer is taxed only on the part of the payment that represents gain on the sale and interest income. The amount of each payment that must be reported as gain is determined by multiplying the total amount of payments received during the year by the gross profit percentage. The gross profit percentage is the ratio of the gross profit (i.e., selling price less adjusted basis) to the total contract price. Treas. Reg. § 15A.453-1(b)(2)(i).

If a disposition qualifies as an installment sale, the installment method is automatically applied unless the taxpayer "elects out." Section 453(d)(1). An election not to use the installment method must be made not later than the due date for filing the taxpayer's return (including extensions) for the year in which the sale occurs. Section 453(d)(2). The installment method can only be used to report gains and not losses. A loss is only deductible in the year of the sale. Rev. Rul. 70-430, 1970-2 C.B. 51.

2. Restrictions on Use of Installment Method

There are a number of statutory restrictions that limit the use of the installment method with regard to real estate. The following transactions and types of gain are ineligible for installment method reporting: dispositions by dealers (Section 453(b)(2)(A)); gain on sales of depreciable property to related persons (Section 453(g)); and the portion of any gain attributable to depreciation recapture (Section 453(i)). If property on which depreciation has been claimed is sold in an installment sale, the seller must report all "recapture income" in the year of sale, and installment method reporting applies only to the gain in excess of the recapture income. *Id.*

In certain cases, interest is charged on the amount of deferred tax liability the taxpayer is claiming under the installment method. Section 453A(a). The interest charge imposed by Section 453A(a)(1) applies to any nondealer installment obligation in excess of \$150,000 which arose during the taxable year and remains outstanding at the close of the taxable year if the face amount of all such obligations that arose from sales during the year and remain outstanding as of the close of such taxable year exceeds \$5,000,000. Section 453A(b). If interest is required to be paid with respect to an obligation that arises during any year, interest

must be paid for any subsequent taxable year at the close of which any part of that obligation remains outstanding. For partnerships and other pass-through entities, the \$5,000,000 threshold is applied, and the interest charge is computed, at the partner or shareholder level rather than at the entity level.

VI. PASSIVE LOSS RULES

The passive activity loss rules arise in situations where losses are generated from operating a trade or business, or when property is sold by a “dealer” (discussed in Section II above). A determination of whether an activity is considered passive or nonpassive affects the ability of the taxpayer to utilize a loss related to that activity to reduce other taxable income generated by the taxpayer. For example, losses generated from a passive real estate activity cannot be used to offset nonpassive income such as wages. Section 469. Rather, the loss from the passive real estate activity is suspended and carried forward and applied against the taxpayer’s other passive income. Section 469(b); Treas. Reg. § 1.469-1(f)(4). Suspended losses may be utilized in their entirety when the taxpayer disposes of the property to an unrelated party. Section 469(g).

The presumption that owning real estate is a passive activity can be overcome if the property owner establishes that the real estate activity constitutes a trade or business (other than rental property) and that the owner “materially participates” in that trade or business. Section 469(c). The material participation rules are complex and require a detail reading of the Treasury Regulations. Real estate used as rental property is presumed to be passive regardless of whether the taxpayer materially participates. Treas. Reg. § 1.469-1T(e)(3)(ii) provides various criteria which describes those activities which are not considered to be a rental activity.

VII. DEBT FORGIVENESS

A. General

Section 61(a)(12) provides that gross income includes “income from discharge of indebtedness.” Debt cancellation can be voluntary (e.g., deed in lieu) or involuntary (e.g., foreclosure). Furthermore, the character of the income (ordinary income versus capital gain), if any, will depend upon the nature of the debt that is discharged. Finally, even in an instance where a taxpayer recognizes income from the cancellation of indebtedness, all or a portion of such income may be excluded from the taxpayer’s income under the circumstances provided in Section 108 (discussed below).

B. Forbearance

A lender’s agreement to forbearance (i.e., an agreement not to exercise lender’s legal remedies in connection with a debt payment default in exchange for an agreement to a revised payment schedule or plan) may not be taxable if the modified terms of the agreement do not rise to the level of a material modification under Section 1001 and related Treasury Regulations. For such agreements to be non-taxable, there should be no written or oral agreement to materially modify the underlying terms of the debt (for example, a change to the interest rate or the

principal amount owed), and the forbearance should last for no more than two years after default on the original loan plus any additional period of time negotiated in good faith between the parties. Treas. Reg. § 1.1001-3(c)(4)(ii).

C. Modification/Foreclosure

1. Conveyance to Lender in Satisfaction of Debt. The tax impact of conveying property to a lender in satisfaction of a debt (e.g. in foreclosure) varies depending upon whether the property is secured by recourse or non-recourse debt.

a. Recourse. Where debt is recourse, the foreclosure or other conveyance is broken into two parts. The transaction first involves a taxable disposition where the amount realized is the fair market value of the property and the gain or loss is based on the difference between such amount and the adjusted basis of the property. Next, if the outstanding debt exceeds the fair market value of the property, then either the borrower will remain indebted for such excess or, if the debt is forgiven, the borrower will have cancellation of indebtedness income equal to the excess of the debt forgiven over the fair market value of the property. Section 61(a)(12); Treas. Reg. § 1.1001-2(a)(2).

i. For example, John owns commercial building A which has a FMV of \$5,000,000, outstanding recourse debt of \$7,000,000, and adjusted basis of \$6,000,000. The building is foreclosed, and all outstanding debt is forgiven. John will recognize \$2,000,000 in cancellation of debt income (\$7,000,000-\$5,000,000) which is characterized as ordinary taxable income plus a \$1,000,000 capital loss (\$6,000,000-\$5,000,000).

b. Nonrecourse. Where the debt is nonrecourse, a transfer of the property in satisfaction of the debt does not result in cancellation of indebtedness income. For purposes of computing capital gain or loss, however, the amount realized includes the amount of liabilities the borrower is relieved from in the transfer. *Commissioner v. Tufts*, 461 U.S. 300 (1983); Treas. Reg. § 1.1001-2(a)(1). In effect, the amount realized in the foreclosure of a nonrecourse debt will be the greater of the sales price or the amount of the nonrecourse debt and the borrower will have taxable gain/loss to the extent the amount realized differs from the borrower's adjusted basis.

i. For example, assume the same facts as the example above, except that John's loan on the building is nonrecourse. When the property is forfeited, there will not be any cancellation of debt income to John. However, John will recognize \$1,000,000 in capital gain on the transaction (\$7,000,000-\$6,000,000). This may seem like an equivalent tax consequence to that in the first example

since a \$1,000,000 taxable gain is similar to the net of a \$2,000,000 income item plus a \$1,000,000 loss, but the difference in tax characterization between ordinary income and capital gain can result in a substantial tax benefit for debtors with non-recourse loans.

D. Debt Modification

The treatment of debt modification for debt instruments is generally found in Treas. Reg. § 1.1001-3. These regulations are quite detailed and should be reviewed in connection with any proposed debt modification to determine the application of the regulations to the particular facts of the modification. The following provides an overview of the modification rules.

1. Deemed Exchange. Treasury regulations deem a “significant modification” in a debt instrument an exchange in which the original debt instrument is exchanged for a modified instrument with the new terms. Treas. Reg. § 1.1001-3(b). Such a transaction is taxable to each party. Treas. Reg. § 1.1001-1(a).

2. Effect From the Borrower’s Perspective. In general, significant modifications to loans that result in the debtor owing less to the lender will trigger cancellation of indebtedness (COD) income (discussed below). For example, formal agreements for reductions in the principal amount owed, interest rate changes, changes from recourse to non-recourse debt and maturity date extensions will generally trigger COD income. However, not all forms of restructured debt lead to this result.

3. Effect From the Lender’s Perspective. A lender will recognize taxable gain or loss to the extent their basis in the old instrument differs from their basis in the new instrument. For original lenders, there is not a significant likelihood of the recognition of gain in a troubled economy where the value of the new instrument is likely to be less than the lender’s basis in the old instrument. By contrast, holders who acquired a debt instrument in the market may have a basis that could trigger gain in the deemed exchange.

4. “Significant Modification”. To be considered a deemed exchange, a change in outstanding indebtedness must be both a “modification” and “significant.”

a. In general, any alteration of a legal right or obligation of an issuer or holder of a debt instrument will constitute a modification (with the exception of certain alterations that occur by operation of the debt instrument). Treas. Reg. § 1.1001-3(c).

b. Determining whether a modification is “significant” requires more significant analysis. The general rule is that a modification is significant if, based on all the facts and circumstances, the legal rights or obligations that are altered and the degree to which they are altered are economically significant. Treas. Reg. § 1.1001-3(e)(1). For certain modifications (and many of the most common modifications), this general rule gives way to

specific rules used to determine significance. A highlight of these rules follows:

i. Change in Yield. A change in yield is a significant modification if the yield (computed as provided in the regulations) varies from the yield of the unmodified instrument by the greater of 25 basis points or 5% of the annual yield of the unmodified instrument. Treas. Reg. § 1.1001-3(e)(2). A change in yield may be the result of one or more of the following:

- A reduction of principal
- A reduction of the interest rate
- A change in timing of payments

ii. Changes in Timing of Payments: A change in the timing of payments is a significant modification if it results in the material deferral of scheduled payments. Treas. Reg. § 1.1001-3(e)(3)(i).

Safe-harbor – The deferral of one or more scheduled payments is not a significant modification if all payments are unconditionally due within the safe-harbor period. The safe-harbor period begins to run on the first date a scheduled payment is deferred and extends for the lesser of 5 years or 50% of the original term of the debt obligation (without regard to any optional extensions under the instrument). Treas. Reg. § 1.1001-3(e)(3)(ii).

iii. Changes in Obligor or Security:

- (a) A change in an obligor on a recourse debt instrument is a significant modification subject to certain exceptions. Treas. Reg. § 1.1001-3(e)(4)(i).
- (b) A change in obligor on a nonrecourse debt instrument is not a significant modification. Treas. Reg. § 1.1001-3(e)(4)(ii).
- (c) An addition or deletion of co-obligor is a significant modification if it results in a change in payment expectations. Treas. Reg. § 1.1001-3(e)(4)(iii).
- (d) A modification that alters the collateral, guarantees or other credit enhancements of a recourse debt instrument is a significant modification if it results in a change in payment expectations. Treas. Reg. § 1.1001-3(e)(4)(iv)(A).

- (e) A modification that alters the collateral, guarantees or other credit enhancements of a nonrecourse debt instrument is a significant modification subject to certain exceptions. Treas. Reg. § 1.1001-3(e)(4)(iv)(B).
- (f) A modification that alters the priority of a debt instrument is a significant modification if it results in a change in payment expectations. Treas. Reg. § 1.1001-3(e)(4)(v).
- (g) A “change in payment expectations” occurs if, as a result of the transaction there is either a substantial enhancement of the obligor’s capacity to meet the payment obligations under a debt instrument and that capacity was primarily speculative prior to the modifications and is adequate after the modifications; or a substantial impairment of the obligor’s capacity to meet the payment obligations under a debt instrument and that capacity was adequate prior to the modifications and is primarily speculative after the modifications. The “obligor’s capacity” includes any source of payment, including collateral, guarantees, or other credit enhancement.

iv. Changes in the Nature of a Debt Instrument.

- (a) Modification of a debt instrument that results in the debt instrument being classified as something other than debt for federal tax purposes (i.e. equity) is a significant modification. For purposes of this section, deterioration of the financial condition of the issuer between issuance and modification is not taken into account, unless there is a substitution of a new obligor or the addition or deletion of a co-obligor. Treas. Reg. § 1.1001-3(e)(5)(i).
- (b) A change in the nature of a debt instrument from recourse to non-recourse is a significant modification subject to certain exceptions. Treas. Reg. § 1.1001-3(e)(5)(ii).
- (c) A change in the nature of a debt instrument from nonrecourse to recourse is a significant modification. Treas. Reg. § 1.1001-3(e)(5)(ii).

E. Exclusion of Cancellation of Indebtedness (COD) Income

The tax rules pertaining to COD income are complex and frequently amended, with numerous exceptions to the general rule. Generally, indebtedness cancelled by the lender in whole or in part, is recognized as taxable income to the extent of the debt relief. Such COD income is taxed at ordinary income tax rates unless an exclusion from income applies. Section 61(a)(12). COD income in certain circumstances can be excluded from the taxpayer's income.

1. Section 108(a): Exclusions from COD Income. The following are the primary exclusions from COD income related to commercial property.

a. Bankruptcy. Debts (including mortgage debt) discharged through bankruptcy are not included in taxable income. Section 108(a)(1)(A).

b. Insolvency. Taxpayers who are legally insolvent at the time that debt is cancelled may be eligible to exclude the COD income from their tax returns to the extent they are insolvent. Sections 108(a)(1)(B) and 108(a)(3).

c. Certain Farm Indebtedness. Cancelled COD income related directly to the operation of a farm can generally be excluded from taxable income so long as the taxpayer earned more than half of its taxable income from farming in each of the three years prior to the cancellation and the loan is owed to a qualified lender. Section 108(a)(1)(C).

d. Qualified Real Property Business Indebtedness. In the case of a taxpayer other than a C corporation, the COD income resulting from the discharge of qualified real property business indebtedness can be excluded from taxable income. Section 108(a)(1)(D). Qualified real property business indebtedness means indebtedness that (i) was incurred or assumed by the taxpayer in connection with real property used in a trade or business and is secured by such real property, (ii) was incurred or assumed before January 1, 1993, or if incurred or assumed on or after such date, was incurred or assumed to acquire, construct, reconstruct, or substantially improve such property, and (iii) with respect to which such taxpayer makes an election to have Section 108(c)(3) apply. Sections 108(c)(3) & (4). The excluded amount of COD income reduces the taxpayer's basis in the property. Section 108(c)(1). There also exist a couple of restrictions pertaining to the use of this exclusion. The COD income exclusion cannot exceed the excess of the outstanding principal amount of such indebtedness (immediately before the discharge), over the fair market value of the real property, reduced by the outstanding principal amount of any other qualified real property business indebtedness secured by such property (as of such time). Section 108(c)(2)(A). Also, the COD income exclusion cannot exceed the aggregate adjusted bases of depreciable real property

(determined after making several possible reductions) held by the taxpayer immediately before the discharge (other than depreciable real property acquired in contemplation of such discharge). Section 108(c)(2)(B).

e. Special Rule Pertaining to Seller Financing. Section 108(e)(5) provides special rules for modifying indebtedness in situations involving seller financing. If the principal amount of seller-financed debt is reduced outside of bankruptcy or insolvency, such reduction is treated as a purchase price reduction. Treas. Reg. § 108(e)(5).

2. Reduction in Taxpayer Attributes. The exclusions to COD income related to bankruptcy, insolvency and farm indebtedness must be applied to reduce up to seven other taxpayer tax attributes. Section 108(b). The reduction of attributes are made in the following order:

a. Any net operating loss or carryover for the taxable year of discharge. Section 108(b)(2)(A).

b. Amounts used to determine the allowable general business credit in the year of discharge. Section 108(b)(2)(B).

c. Amount of minimum tax credit available in year after discharge. Section 108(b)(2)(C).

d. Any net capital loss or carryover for the taxable year of discharge. Section 108(b)(2)(D).

e. Reduction of the basis of the taxpayer's property in accordance with Section 1017. Section 108(b)(2)(E). A taxpayer can elect to reduce this attribute first to the extent of the adjusted bases of the depreciable property held by the taxpayer as of the beginning of the taxable year following the taxable year of discharge. Section 108(b)(5).

f. Passive activity loss or credit carryover for the taxable year of discharge. Section 108(b)(2)(F).

g. Amounts used to determine the allowable foreign tax credit in the year of discharge. Section 108(b)(2)(G).