

Clarifying Standards for Trade Or Business Real Estate Debt

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In this article, Johnson and Harmon argue that real estate lessors, developers, and dealers who realize cancellation of debt income attributable to acquisition debt for real property should be able to avail themselves of the exclusion for the discharge of qualified real property business indebtedness. Accordingly, they urge the IRS to clarify the definition of real property used in a trade or business for purposes of section 108(a)(1)(D).

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Section 108(a)(1)(D)¹ allows most taxpayers to exclude the discharge of qualified real property business indebtedness (QRPBI) from gross income. However, there is little guidance on how “real property used in a trade or business” is defined for purposes of that exclusion. Specifically, it is unclear whether the definition would include real property held for the production of rental income, development, or for sale to customers in the ordinary course of business. While those types of real property would not be included in the definition of real property used in a trade or business as defined in section 1231, legislative history and limited case law suggest that the definition under section 108(c) is broader.

¹The exclusion is technically in section 108(a)(1)(D), but this article refers to it as the section 108(c) exclusion because that subsection contains the definitional and operational terms.

We believe that real estate lessors, developers, and dealers who realize cancellation of debt (COD) income attributable to acquisition debt for real property held for the production of rental income, development, or sale to customers in the ordinary course of business should be able to avail themselves of the section 108(c) exclusion. However, because the definition of real property used in a trade or business is unclear, those taxpayers lack certainty regarding when the section 108(c) exclusion applies. Accordingly, the IRS should provide guidance in the form of a revenue ruling to clarify the definition.

A. Background

In *United States v. Kirby Lumber Co.*,² the Supreme Court established the principle that the gain or savings realized by a debtor upon the reduction or cancellation of its outstanding indebtedness for less than the amount due may be income for federal tax purposes. This article defines that income as COD income.³ The code provides that taxable income includes income from whatever source derived, including COD income.⁴ Accordingly, a taxpayer must include COD income in gross income unless the taxpayer meets an exclusion or exception.

Section 108 identifies five major exceptions to COD income: debtors in bankruptcy,⁵ insolvent debtors not in bankruptcy,⁶ real property business debt,⁷ solvent farm debtors,⁸ and qualified principal residence debt.⁹ Each of these exceptions allows a qualifying taxpayer to exclude some or all COD income from gross income. However, section 108 generally requires a corresponding reduction in a taxpayer’s losses, tax basis, and other tax attributes to the extent available, which effectively defers the recognition of income instead of eliminating it completely.

²284 U.S. 1 (1931).

³Not all reductions or cancellation of indebtedness are COD income excludible from gross income under section 108. Reductions in debt can be a medium of payment for compensation, goods, and other items, reg. section 1.61-12, but this article ignores the other possible characterizations.

⁴Section 61(a)(12).

⁵Section 108(a)(1)(A).

⁶Section 108(a)(1)(B).

⁷Section 108(a)(1)(D).

⁸Section 108(a)(1)(C).

⁹Section 108(a)(1)(E).

B. QRPBI

The Revenue Reconciliation Act of 1993 added qualified real property business indebtedness to the list of exclusions from gross income for COD income. This exclusion is available to all taxpayers except C corporations and is elective rather than mandatory. A chief advantage of the QRPBI exclusion is that it does not require the debtor to be in bankruptcy or insolvency.

If the taxpayer qualifies for this exclusion, the COD income is excluded from gross income and is applied instead to reduce the basis of depreciable real property held by the taxpayer at the beginning of the tax year following the year in which the discharge occurs.¹⁰ Unlike the rule when basis is reduced in bankruptcy or insolvency, real property held primarily for sale to customers in the ordinary course of business cannot be treated as depreciable property for the purpose of QRPBI.¹¹

A taxpayer must reduce the adjusted basis of the qualifying real property to the extent of the discharged QRPBI before reducing the adjusted bases of other depreciable real property.¹² In other words, if the qualifying real property is not depreciable real property for purposes of QRPBI, the bases of other depreciable real property must be reduced.

A partner in a partnership may choose to reduce the portion of the partner's basis in a partnership interest attributable to the partnership's depreciable real property and make a corresponding reduction in the partner's share of the partnership's basis in the real property.

The amount of QRPBI that can be excluded from gross income is limited to the excess of the outstanding principal amount of all QRPBI secured by the real property over the fair market value of the real property immediately before the discharge.¹³ Excludable QRPBI is limited to the taxpayer's basis in the property¹⁴ and is limited overall to the taxpayer's aggregate adjusted bases of all depreciable real properties.¹⁵

To qualify for the QRPBI exclusion, the debt must be "qualified real property business indebtedness." This means that the indebtedness¹⁶:

1. was incurred or assumed before January 1, 1993, or if incurred or assumed on or after that date, is qualified acquisition indebtedness;

2. 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; and

3. for which the taxpayer makes an election to exclude the income.

1. Qualified acquisition indebtedness. "Qualified acquisition indebtedness," as used above, means indebtedness incurred or assumed to acquire, construct, reconstruct, or substantially improve the property.¹⁷ Refinancing indebtedness also qualifies, but only to the extent that it does not exceed the amount of indebtedness being refinanced (the principal balance of the debt paid off by the refinance loan).¹⁸ To the extent that the proceeds from the refinance loan are used to substantially improve the property, that portion will qualify. However, if the proceeds from the refinance loan are not used to substantially improve the property, that portion will not be eligible for the QRPBI exclusion.

In the case of partnerships and limited liability companies classified as partnerships, the determination of whether debt is QRPBI is made at the entity level, but the basis limitation test and basis reduction occur at the partner level.¹⁹ In contrast, in the case of an S corporation, the determination of whether debt is QRPBI is made at the entity level, as are the basis limitation and basis reduction.²⁰

2. Real property used in a trade or business. As stated above, to qualify as QRPBI, the discharged debt must be incurred or assumed in connection with — and secured by — real property used in the taxpayer's trade or business.²¹ Neither section 108 nor its legislative history defines real property or what constitutes use in a trade or business. Accordingly, taxpayers holding real property for the production of rental income, for development, or for sale to customers in the ordinary course of a trade or business lack certainty regarding whether COD income they recognize can qualify as QRPBI and the section 108(c) exclusion.

The phrase "real property used in a trade or business" appears in several other sections of the

¹⁰Section 108(c)(1); section 1017(b)(3); reg. section 1.108-6.

¹¹Section 1017(b)(3)(F).

¹²Reg. section 1.1017-1(c)(1).

¹³Section 108(c)(2)(A).

¹⁴Section 108(c)(1)(A).

¹⁵Section 108(c)(2)(B).

¹⁶Section 108(c)(3).

¹⁷Section 108(c)(4).

¹⁸See section 108(c)(3) ("qualified business indebtedness . . . shall not include qualified farm indebtedness. Indebtedness under subparagraph (B) shall include indebtedness resulting from the refinancing of indebtedness under subparagraph (B) (or this sentence), but only to the extent it does not exceed the amount of the indebtedness being refinanced").

¹⁹Section 108(d)(6).

²⁰Section 108(d)(7).

²¹Section 108(c)(3).

code and Treasury regulations. Those sections provide guidance, but it is not clear whether those definitions should apply for purposes of the section 108(c) exclusion.

Section 172(d)(4) provides that the nonbusiness deductions of noncorporate taxpayers that are allowable but not attributable to a taxpayer's trade or business are allowed to the extent of gross income not derived from the trade or business. Under section 172(d)(4)(A), gains or losses from the sale of real property used in a trade or business are treated as attributable to a trade or business. Thus, real property held for sale by a dealer to customers in the ordinary course of business should be deemed to be real property used in a trade or business for purposes of section 172(d)(4). By extension, applying this definition to QRPBI, real property held for sale by a dealer should be considered real property used in the dealer's trade or business for purposes of section 108(c).

Also, reg. section 1.1017-1(a), which provides ordering rules for reducing the basis of property under section 108(b)(2)(E), describes the first category of property as "real property used in a trade or business or held for investment, other than real property described in section 1221(1), that secured the discharged debt immediately before the discharge."²² The wording of this rule, as well as similar language in reg. section 1.1017-1(a)(3), suggests that real property held for sale to customers in the ordinary course of business would, absent the specific exclusions, be considered property used in a trade or business for purposes of section 108(c).

Section 1231(b)(1) defines the term "property used in a trade or business" to include depreciable real property held for more than one year, as well as other real property used in a trade or business held for more than one year and not held primarily for sale to customers in the ordinary course of a trade or business.²³ If section 108(c) uses this definition, debt on real property held for the production of rental income, for development, or for sale to customers in the ordinary course of business would not qualify for the QRPBI exclusion.

Because section 1231 excludes dealer real property, the argument could be made that if not for this specific statutory exclusion, dealer real property would normally be property used in a trade or business. Section 108(c) does not contain a similar exclusion.

Case law under section 1231 indicates that real property acquired for development is treated as used in a trade or business even if the development

plans are later abandoned. In *Carter-Colton Cigar Co. v. Commissioner*,²⁴ a taxpayer corporation bought land for the purpose of building a new headquarters and a warehouse building. The taxpayer procured plans and specs but then abandoned the project, holding the land for a number of years before selling it at a loss. The court held that the taxpayer was entitled to an ordinary loss under the predecessor to section 1231 because the property was used in a trade or business, even though the development plans were abandoned. The court stated that "used in the trade or business" means "devoted" to the trade or business and includes all such property.²⁵

Even though the language of section 108(c) is similar to the language of section 1231(b), the legislative purposes of the sections are not the same. The House Budget Committee stated the following in proposing QRPBI:

The committee understands that real property has declined in value in some areas of the nation, in some cases to such a degree that the property can no longer support the debt with which it is encumbered. The committee believes that where an individual has discharge of indebtedness that results from a decline in value of business real property securing that indebtedness, it is appropriate to provide for deferral, rather than current inclusion, of the resulting income. Generally, that deferral should not extend beyond the period that the taxpayer owns the property.²⁶

This legislative history shows that section 108 was intended to have a broader definition than the narrow one used in section 1231. It also explains that the reason for the provision's enactment was to grant a deferral to taxpayers who have COD income resulting from a decline in the value of business real property securing the discharged debt.

Section 108(c) does not contain any limitation on the definition of real property used in a trade or business. The only limitation to the definition of QRPBI is that it does not include qualified farm indebtedness.²⁷ The section's other limitations pertain to the amount that can be excluded from gross income. Similarly, the legislative history of section 108 does not indicate that there are any limitations on the type of business real property that can qualify, except that it must be real property used in a trade or business.

²²Reg. section 1.1017-1(a)(1).

²³Section 1231(b)(1).

²⁴9 T.C. 219 (1947), *acq.*, 1947-2 C.B. 1.

²⁵*Id.* at 221.

²⁶H.R. Rep. No. 103-111, at 622-623 (1992).

²⁷Section 108(c)(3).

The legislative history clearly indicates that the purpose of the exclusion's enactment was to help those affected by the depressed real estate market, including real estate lessors, developers, and dealers. Accordingly, the definition of real property used in a trade or business should be liberally construed to include property held for the production of rental income, for development, and for the sale to customers in the ordinary course of business. No legislative policy would be served by narrowing the definition as in section 1231(b)(1).

Property that is held solely for the production of rental income but that is not treated as used in the taxpayer's trade or business would presumably not qualify for the QRPBI exclusion under section 108(c). However, unless the IRS provides further guidance, it is difficult to determine whether property held solely for the production of rent could qualify for the QRPBI exclusion.²⁸

Historically, the courts have held that the rental of even a single property may constitute a trade or business under various provisions of the code.²⁹ However, the ownership and rental of property does not always constitute a trade or business.³⁰ This ultimately comes down to a question of fact whether the scope of a taxpayer's rental property activities, conducted either personally or through agents, are so extensive as to rise to the stature of a business.³¹

In a 1983 technical advice memorandum,³² the IRS announced its position that the mere rental of real property does not constitute a trade or business under section 1231. Both sections 1231 and 108(c)

refer to property used in a trade or business.³³ As a result, taxpayers may be concerned about whether the IRS will allow the QRPBI exclusion for real property held for the production of rental income.

In the memorandum, the IRS relied mostly on *Curphey v. Commissioner*.³⁴ In that case, the taxpayer was a dermatologist employed by a hospital who owned and managed six rental properties. He sought to deduct expenses incurred for a room in his residence used as an office for his rental business. The Tax Court ruled that the question whether a taxpayer's ownership and rental of real property constitutes a trade or business depends on the facts and circumstances of the case.³⁵

After issuing the 1983 technical advice memorandum, the IRS held in a series of 14 identical letter rulings that a multi-tenant office building held by a limited partnership for rental to tenants qualified as a trade or business under section 108(c).³⁶ Similarly, the IRS ruled that a multi-unit residential building held by a general partnership for rental to tenants qualified as a trade or business under section 108(c).³⁷ Also, two court cases ruled that the holding of a single rental property consisted of two activities — a rental activity and an investment activity — and the rental activity was not engaged in for profit (that is, it was not a business).³⁸ However, in both of those cases, the taxpayers did not rent the properties to the general public, and the rentals were seasonal and of short duration.³⁹ In another case, the IRS argued that the taxpayer's holding of a

²⁸Reg. section 1.1221-1(b).

²⁹See, e.g., *Hazard v. Commissioner*, 7 T.C. 372 (1946), acq., 1946-2 C.B. 3; *Post v. Commissioner*, 26 T.C. 1055 (1956), acq., 1958-2 C.B. 7; *Gilford v. Commissioner*, 201 F.2d 735 (2d Cir. 1953); *Schwarcz v. Commissioner*, 24 T.C. 733 (1955), acq., 1956-1 C.B. 5; *Elek v. Commissioner*, 30 T.C. 731 (1958), acq., 1958-2 C.B. 5; *Fegan v. Commissioner*, 71 T.C. 791 (1979), aff'd, No. 79-1890 (10th Cir. 1981); and *Pinchot v. Commissioner*, 113 F.2d 718 (2d Cir. 1940).

³⁰See *Neill v. Commissioner*, 46 B.T.A. 197 (1942) (nonresident alien was not in the trade or business of renting a single building, the rent for which was collected by her attorney); Rev. Rul. 73-522, 1973-2 C.B. 226 (nonresident alien was not in the trade or business of renting real estate using net leases).

³¹*Bauer v. United States*, 168 F. Supp. 539, 541 (Ct. Cl. 1958) (undivided interest in stock of corporation that owned an apartment building was not a business); *Schwarcz v. Commissioner*, 24 T.C. 733 (1955) (taxpayer's management of two apartment buildings in Budapest, Hungary qualified as a business). See also *Higgins v. Commissioner*, 312 U.S. 212 (1941) (management of the taxpayer's own investment portfolio was not a business).

³²TAM 8350008.

³³Section 108(c)(3)(A) uses the word "a," whereas section 1231 uses the word "the." However, the verbiage difference does not appear to the authors to have any significance in this context.

³⁴73 T.C. 766 (1980).

³⁵*Id.* at 774-775.

³⁶See LTR 9426006 through LTR 9426019.

³⁷LTR 9840026 (June 30, 1998).

³⁸*Vandeyacht v. Commissioner*, T.C. Memo. 1994-148 (the rental of a taxpayer's waterfront condominium and house in Sarasota, Florida, which were held for rental and investment purposes, was not an activity engaged in for profit, even though the properties were held for appreciation); *Rivera v. Commissioner*, T.C. Summ. Op. 2004-81 (the ski-season rental of a taxpayer's property in Truckee, California, which was held for rental and investment purposes, was not an activity engaged in for profit, even though the property was held for appreciation).

³⁹In *Vandeyacht*, T.C. Memo. 1994-148, the taxpayers rented only to friends or their adult children. In *Rivera*, T.C. Summ. Op. 2004-81, the taxpayers rented only to acquaintances and co-workers. The seasonal nature of the rentals and the fact that the taxpayers didn't rent to the general public probably resulted in the court's bifurcation of the activities into rental and investment activities.

single rental property consisted of two activities, but the court rejected this argument because the property was rented continuously at fair rental value.⁴⁰

The issue of whether a particular taxpayer's rental real property constitutes a trade or business under section 108(c) has not been litigated. As demonstrated by letter rulings issued after 1983, the IRS has backed away from its position that the mere renting of real property does not constitute a trade or business for purposes of section 108(c).⁴¹ Subsequent court cases have held that the trade or business question is a facts and circumstances issue.⁴² This allows different courts to reach different outcomes, which provides little guidance to taxpayers.

C. Clarifying the Standards

The IRS should clarify the definition of the term "real property used in a trade or business" by issuing a revenue ruling. A revenue ruling represents the IRS's interpretation of the code.⁴³ They are published to provide guidance in the disposition of cases and to assist taxpayers with compliance.⁴⁴ Taxpayers can rely on revenue rulings to determine the tax treatment of their transactions.⁴⁵

As shown above, section 108 does not define real property used in a trade or business. While the term is used in other sections of the code, including section 1231, it should be defined more broadly for

the QRPBI exclusion to include real property held for the production of rental income, for development, and for sale to customers in the ordinary course of business.

This clarification would not affect the type or amount of taxes owed. Under section 1231, if real property is used in a trade or business, the income or loss would be ordinary instead of capital. In contrast, under section 108(c), if real property is used in a trade or business (that is, it qualifies as QRPBI), the COD income is excluded from gross income, but there is a corresponding reduction in the tax basis of the taxpayer's depreciable real property. If the qualifying real property is held for sale to customers in the ordinary course of business, which is specifically not depreciable property under section 1017(b)(3)(F), the bases of the taxpayer's other depreciable real property is reduced. This ultimately results in a deferral of the recognition of the income, but it is not a change in the type of income.

D. Conclusion

A real estate lessor, developer, or dealer that realizes COD income attributable to acquisition debt for real property should be able to use the QRPBI exclusion of section 108(c) to exclude the income. However, it is unclear whether COD income can qualify for that exclusion. The code states that QRPBI must be real property used in a trade or business.⁴⁶ However, the term is not defined, and there is no precedent stating whether the definitions found in section 1231 or other provisions of the code should apply. In contrast, several authorities suggest that the definition for purposes of the QRPBI exclusion of section 108(c) is broader than the definition for purposes of section 1231. To resolve the ambiguity, the IRS should publish a revenue ruling to clarify that the definition includes real property held for the production of rental income, for development, and for the sale to customers in the ordinary course of business.

⁴⁰*Mayes v. United States*, No. 84-5157 (W.D. Mo. 1986) (The taxpayer's house in Hilton Head Island, South Carolina, was held for rental and investment purposes, the rental of which was only a functional part of holding the property for appreciation and future sale. The court considered both undertakings as a single activity for purposes of deciding whether the activity was engaged in for profit.)

⁴¹See LTR 8713072; LTR 9426008; and LTR 9840026 (finding that rental of even a single property may constitute a trade or business under various provisions).

⁴²*Cozzi v. Commissioner*, 88 T.C. 435, 445 (1987); LTR 201228023; *Grier v. United States*, 120 F. Supp. 395 (D. Conn. 1954), *aff'd*, 218 F.2d 603 (2d Cir. 1955).

⁴³Rev. Proc. 89-14, 1989-1 C.B. 814, section 3.01.

⁴⁴Rev. Proc. 89-14, section 56, section 7.01(4).

⁴⁵Rev. Proc. 89-14, section 7.02(5).

⁴⁶Section 108(c)(3)(A).