REPORT #817

TAX SECTION

New York State Bar Association

Report on Certain Issues Under Code Section 108(c)

January 10, 1995

Table of Contents

TAX SECTION
New York State Bar Association

January 10, 1995

Hon. Leslie B. Samuels
Assistant Secretary (Tax Policy)
Department of the Treasury
1500 Pennsylvania Avenue, N.W.
Washington, D.C. 20220

Hon. Margaret M. Richardson
Commissioner
Internal Revenue Service
1111 Constitution Avenue, N.W.
Washington, D.C. 20224

Re: Issues under Section 108(c)

Dear Secretary Samuels and Commissioner Richardson:

Enclosed is a Report by the New York State Bar Association Tax Section commenting on issues arising under Section 108(c) of the Code. That provision, added by the Omnibus Budget Reconciliation Act of 1993, allows a taxpayer's income otherwise arising from the cancellation of “qualified real property business indebtedness” to be deferred through the reduction in the basis of depreciable real property owned by the taxpayer.

The Report makes a number of suggestions for regulations under Section 108(c), including the following:

1. Construction-period interest should generally be eligible for the benefits of Section 108(c) if cancelled. While the statute

can be read to exclude other interest accrued after 1992, consideration should be given to treating such interest as eligible for Section 108(c) on policy grounds as well as on the basis of precedents in other contexts.

2. A partner in a partnership that owns depreciable real property as well as other property should have its tax basis in the partnership allocated between the real property and the other property in proportion to the partnership's relative bases in the two categories of property.

3. A partner in a partnership using the remedial method of allocation should take that method into account in determining the partner's share of the partnership's basis in depreciable real property.

4. When qualified indebtedness of a partnership is cancelled but the partnership does not reduce the basis of its real property that secured the debt, each partner of the partnership should be permitted to apply Section 108(c) by reducing the basis of other depreciable property owned by the partner.

5. Property should be presumed not to be acquired in contemplation of debt cancellation (and thus should eligible for basis reduction) if acquired more than a specified period (such as one or at most two years) before the cancellation. Property not eligible for the presumption should be ineligible for basis reduction only if acquired with a principal purpose to take advantage of Section 108(c).

Please let me know if we can be of further help in the development of regulations under Section 108(c).

Very truly yours,

Michael L. Schler
Chair, Tax Section

Tax Report # 817

NEW YORK STATE BAR ASSOCIATION

TAX SECTION

COMMITTEE ON BANKRUPTCY[1]

Report on Certain Issues Under Code Section 108(c)

January 10, 1995

This Report comments on a number of key issues under Section 108(c)[2], relating to cancellation of qualified real property business indebtedness, as enacted by the Omnibus Budget Reconciliation Act of 1993 (the “1993 Act”). Specifically, the Report focuses on three areas: (i) the treatment of the discharge of accrued interest, (ii) issues relating to the treatment of certain partnership interests as depreciable real property and (iii) standards for determining when real property is considered acquired in contemplation of a discharge for purposes of applying the aggregate real property basis limitation of Section 108(c)(2)(B).

1. Discharge of Accrued Interest

Section 108(a)(1)(D) provides that in the case of a taxpayer other than a C corporation, gross income does not include cancellation of indebtedness (“COD”) amounts from the discharge of qualified real property business indebtedness

[1] The principal authors of this report were Joel Scharfstein and Elliot Pisem, who are the co-chairs of the Committee on Bankruptcy, and Elia Fischer. Helpful comments were provided by Stephen B. Land, Carolyn Joy Lee, Richard L. Reinhold and Michael L. Schler.

[2] Unless otherwise indicated, all Section references herein are to the Internal Revenue Code of 1986 (the “Code”), as amended to date.

(“QRPBI”). Section 108(c)(3) defines QRPBI as indebtedness that (i) was incurred or assumed in connection with real property used in a trade or business, (ii) is secured by that real property, (iii) was either incurred prior to 1993 or constitutes “qualified acquisition indebtedness,” and (iv) with respect to which the taxpayer elects to have Section 108(c) apply. Under Section 108(c)(2)(A), the amount of discharged QRPBI that is excludable income is limited to the excess of (i) the “outstanding principal amount” of the indebtedness discharged, over (ii) the fair market value of the real property securing the debt (reduced by the “outstanding principal amount” of any other QRPBI secured by the property) (the “principal limitation”). Interest that accrues after December 31,1992 with respect to QRPBI will be QRPBI only if such interest is “qualified acquisition indebtedness” (“QAI”). Under Section 108(c)(4), indebtedness with respect to a property is QAI only if it was “incurred or assumed to acquire, construct, reconstruct or substantially improve such property.”

The statute does not address with any clarity the treatment of accrued interest. This raises a number of questions that should be addressed in regulations, including:

- whether interest that accrues on post-1993 QRPBI is itself QRPBI;
- whether interest that accrues after 1992 on pre-1993 debt can qualify as QRPBI;
- whether interest accruals increase the “principal limitation” in Section 108(c)(2)(A)(i); and

- what ordering rules should be applied if distinctions are drawn between the cancellation of accrued interest and the cancellation of the "principal" amount owed.[3]

As a threshold matter, it should be noted that in most instances the parties will not care for non-tax purposes whether the indebtedness that is canceled is labeled "principal" or "accrued interest." For any indebtedness on which interest compounds there is no business distinction between canceling accrued interest and canceling principal.

In considering whether interest incurred or assumed after 1992 can be classified as QAI under Section 108(c)(4), there is a range of possible approaches. The statute defines qualified acquisition indebtedness as interest "incurred or assumed to acquire, construct, reconstruct or substantially improve [real] property." On one extreme, it could be said that interest is never incurred to acquire or construct property, since interest is a cost of the use of funds, not a cost of the property for which the funds are used.

We do not believe this view is correct. We believe it is entirely consistent with both the language of the Code and the logic of Section 108(c) to treat indebtedness attributable to capitalized interest as being within the scope of Section 108(c).

[3] For example, if A owns property with a fair market value of 100 that is encumbered by 120 of debt, of which 10 is post-1992 accrued interest, under the principal limitation, 10 of debt would be eligible for exclusion under Section 108(c). However, if the creditor were to discharge 10 of accrued interest, Section 108(c) would apply only if the accrued interest is included in QRPBI. Query whether debtors should be eligible to determine whether amounts discharged are interest or principal or whether a specific ordering rule should apply. Note also that different tax consequences may result to creditors depending on whether the discharged debt is interest or principal.

Thus, we believe QAI should include construction period interest that accrues on QAI and is allocated under Section 263A(f) to the production of property and required to be capitalized and added to the basis of property.[4] One might expand this concept to also treat as QAI construction period interest on debt other than QAI, which interest is capitalized under Section 263A(f) under the avoided cost method.

Outside of the construction period, there is the question whether interest accruing on QAI can be considered QAI. The statute could be read to exclude such interest and the legislative history of Section 108(c) provides no direct guidance. We note, however, that regulations promulgated in other contexts have treated interest on debt incurred to acquire or construct property as a cost of acquisition or construction, such that accrued interest would be considered an indebtedness incurred to acquire or construct property.[5]

---

[4] Interest on QAI that is capitalized under Section 266 and added to the basis of the asset acquired with the QAI should also be treated as QAI.

[5] Instances where the Service has previously classified interest accruals as being of the same character as the underlying debt include the following: (i) In the context of the tax credit for qualified rehabilitation expenditures ("QREs"), Section 47(c)(2)(B) provides that QREs do not include "the cost of acquiring any building or interest therein." Regulation Section 1.48-12(c)(9) defines cost of acquisition to include "any interest incurred on indebtedness the proceeds of which are attributable to the acquisition of a building." (ii) Qualified residence interest under Section 163(h) is defined as including interest "incurred in acquiring, constructing or substantially improving any qualified residence. . . ." Section 163(h)(3)(B)(i). Regulation §1.163-1lT(b) provides that "interest that accrues on indebtedness that is incurred to acquire, construct, or substantially improve a residence of the taxpayer is also treated, until it is paid, as indebtedness incurred to acquire, construct, or substantially improve a residence." Thus, compound interest accruing on qualified residence indebtedness is treated as itself constituting qualified residence interest, (iii) In the general interest tracing provisions, interest accruals are characterized by reference to the use of the proceeds of the underlying debt. Reg. §1.163-8T(c)(2)(ii)(B).

In addition, we note that if interest accruing on QAI is not itself generally QAI, then the ability of a borrower to use Section 108(c) will become eroded over the life of the loan, particularly if an ordering rule prescribes that accrued interest is always treated as canceled first, before principal. Such erosion may impede real estate debt restructurings.[6]

Interest accruals on pre-1993 indebtedness will qualify as QRPBI if either (i) the pre-1993 indebtedness is itself QAI and the interest accruals are treated as QAI under the criteria discussed above, or (ii) the interest is incurred or assumed before January 1, 1993. Pre-1993 interest accruals on pre-1993 debt should clearly qualify as QRPBI as indebtedness incurred before January 1, 1993. However, it is not clear whether post-1993 interest accruals with respect to pre-1993 indebtedness should be treated as incurred or assumed before January 1, 1993 for this purpose.[7]

Arguably, interest is not “incurred” until it economically accrues. However, even where interest has not yet economically accrued, a borrower assumes the contractual obligation to pay future interest when the loan is entered into (assuming the loan is not prepaid). The best example of this is

---

[6] While debtors may have received deductions for accruals of interest, the availability of such deductions has heretofore not affected the availability of Section 108 relief. Moreover, a debtor’s deductions for the accrued interest may well have been absorbed in prior years, making any income recognition with respect to accrued interest a significant current cost.

[7] We note the regulations under Section 163(h)(3)(D), which “grandfathered” and treated as residence indebtedness “any indebtedness which was incurred on or before October 13, 1987.” In describing the treatment of interest accruals under the same version of this rule in the 1986 amendments, Reg. §1.163-10T(m)(2)(ii) essentially provides that taxpayers do not have to allocate interest expense between the “old” debt and the “new” accrued interest provided interest is paid at least quarterly.

with zero coupon debt, under which the full face amount of the debt becomes an obligation of the taxpayer when the debt is issued (absent prepayment), even though the interest will economically accrue in future periods. This may provide a basis for treating post-1992 interest on pre-1993 debt as incurred prior to 1993 and thus covered by Section 108(c). In addition, the question of whether interest accruals on pre-1993 debt should be treated as being within the scope of Section 108(c) has parallels to the question, discussed above, as to whether interest on QAI is itself QAI. If interest on QAI is generally considered QAI (i.e., it was "incurred" to acquire or construct property), then similar reasoning and statutory construction suggest that interest on "grandfathered" debt should itself be grandfathered (i.e., it was "incurred" before 1993). As in the case of post-1993 debt, if interest accruals on pre-1993 debt are outside the scope of Section 108(c), the benefits of that Section will become eroded over time. This erosion of relief for grandfathered debt may be particularly inappropriate where the terms of a pre-1993 indebtedness specifically contemplated the accrual of interest that would not be paid on a current basis.

As with the treatment of accrued interest under the QRPBI definition, the "principal" limitation of Section 108(c)(2)(A)(i) gives rise to additional, although different, interpretative issues. The statute might literally be read to exclude all accrued interest from the "principal" limitation. However, such a literal reading would not make sense if we are correct that the only purpose of the limitation was to prevent a taxpayer from using Section 108(c) to the extent the debt cancellation would create equity in the property. The existence of equity does not depend on whether the liability is principal or accrued interest. Moreover, the literal interpretation of the statute would (with no logical reason) distinguish between taxpayers whose indebtedness provides for interest accruals and taxpayers who borrow additional amounts to pay interest currently, and between taxpayers who refinanced a grandfathered debt before 1993 and those who came into 1993 with debt that comprised both interest accruals and “principal” amount. The literal interpretation would also arbitrarily treat the issuer of a middle-aged zero-coupon indebtedness as having a principal amount of either the original issue price or the face amount ultimately payable, neither of which makes sense in the context of the “principal” limitation.

Again, at a minimum we believe that the “principal” limitation should be interpreted to coordinate with basis inclusions. Thus accrued interest that is capitalized into the basis of an asset should be treated as principal for purposes of the limitation.

Consideration should also be given to interpreting “principal” for Section 108(c) purposes to mean all amounts owed that, immediately before the discharge, are equivalent to principal in the sense that interest on such amounts would accrue and compound in the future. This would tie the definition of “principal” to a significant aspect of the business arrangement of the parties.[8] Such a test seems preferable as a policy matter to a test that depends on the labels assigned and the formal steps taken by the parties.

2. Reduction of Basis in Partnership Property

2.1. General

[8] Such a definition also would be consistent with Allan v. Commissioner. 856 F.2d 1169 (8th Cir. 1988).

Section 108(c)(1)(A) provides that the amount of discharged QRPBI excluded from gross income under Section 108(a)(1)(D) is to be applied to reduce the basis of depreciable real property of the taxpayer. Under Section 1017(b)(3)(C), an interest of a partner in a partnership is treated as depreciable property "to the extent of the partner's proportionate interest in the depreciable property held by the partnership," but only if there is a corresponding reduction in the partnership's basis in depreciable property with respect to such partner.[9] Under Section 1017(b)(3)(F), for purposes of applying Section 1017(b)(3)(C) to basis reductions under Section 108(c), depreciable property includes only depreciable real property.

2.2. Corresponding Basis Reduction

Section 1017(b)(3)(C) provides that a partnership interest of a partner in a partnership is treated as depreciable real property only to the extent that there is a "corresponding reduction" in the basis of the partnership's depreciable real property with respect to such partner. A consequence of this limitation is that a partner's basis in a partnership interest is presumably only eligible to be treated as depreciable real property to the extent of the lesser of (i) the basis of such partnership interest and (ii) such interest's share of the partnership's underlying basis in depreciable real property. We recommend that the regulations explicitly provide for this

[9] See H. R. Rep. No. 111, 103d Cong., 1st Sess. 624 (1992) which states the application of this provision to QRPBI.

limitation.[10]

> Example 1: AB is an equal partnership whose sole asset is depreciable real property with a basis of $200,000. A has a basis of $150,000 for his partnership interest.

In this example, A’s partnership interest could be treated as depreciable real property only to the extent of $100,000 of his basis (i.e., A’s share of the partnership’s basis in the real property).

> Example 2: The same facts as Example 1, except that A has a basis of only $40,000 for his partnership interest.

In this example, A’s depreciable real property basis resulting from his ownership of the partnership interest is limited to $40,000.[11] If A were to reduce his basis to zero, AB would also reduce its basis for the real property by $40,000, i.e., to $160,000.

2.3. Extent - Multiple Partnership Assets

A partnership interest is considered depreciable property only “to the extent” of a partner’s proportionate interest in the partnership’s depreciable real property. Where a partnership owns both depreciable real property as well as other assets, the statutory language allows only a portion of a

---

10 It would be inappropriate for the regulations to take the alternative position that where the basis of a partnership interest exceeds such interest’s share of underlying depreciable real property basis, the fall amount of the partnership interest basis could be treated as depreciable property and the corresponding basis reduction requirement met, as long as the partnership reduced the interest’s share of underlying depreciable real property basis to zero. Such a position would not result in a reduction of future depreciation deductions corresponding to the excluded COD income.

11 The statutory scheme does not ignore the existence of the partnership; rather, it treats the partnership interest as depreciable property, thus limiting A's basis in depreciable property to the basis of his partnership interest.

partner's basis in his partnership interest, i.e., that portion which represents such partner's proportionate interest in depreciable real property held by the partnership, to be treated as depreciable property.[12] While the application of the "to the extent" limitation is clear in cases where the basis and fair market values of the partnership's properties are the same, its application in the more typical case, where a partnership holds properties whose tax bases and fair market values differ, is less clear. We believe that the most appropriate approach to applying the "to the extent" limitation would be based on the relative bases of the partnerships properties,[13] and recommend that the regulations adopt this approach.[14]

> Example 3: AB is an equal partnership which owns a building with a fair market value of $200,000 and a tax basis of $100,000 and land with a fair market value and tax basis of $200,000. A has a $150,000 basis for his partnership interest.

In this example, depreciable real property represents 33xh% of the aggregate adjusted tax basis of AB's property and 50% of the fair market value of AB's property. Under the

---

[12] The "to the extent" limitation fully overlaps with the requirement that there be a corresponding basis reduction in the partnership's depreciable real property in cases where a partnership only owns depreciable real property. However, it has separate significance where a partnership has both depreciable real property and other property. For example, if AB is an equal partnership which owns depreciable real property with a basis and fair market value of 400, and other property with a basis and fair market value of 200, and A has a 200 basis for his partnership interest, it seems inappropriate to allow A to treat the entire 200 of his partnership interest basis as depreciable property, which would be the result if only the corresponding basis reduction limitation were relied on.

[13] An alternative approach would be to apply the limitation based on the relative fair market values of the partnership's properties. However, we believe the basis approach provides a more appropriate correlation in most cases between inside and outside basis as well as providing clear administrative advantages.

[14] The proper application of the "to the extent" limitation is an issue that has existed under Section 1017(b)(3)(C) since it was included in the Code in 1980 (as are many of the other issues concerning the application of Section 1017(b)(3)(C)).

recommended approach $50,000 ($33^{1/3}$%) of A's basis in his interest in the AB partnership would be considered depreciable real property.[15]

Since most real estate partnerships will have some cash, receivables and personal property, we recommend that the Treasury consider providing a de minimis rule under which an allocation between depreciable real property and other property (other than land) will not be required. The de minimis rule should be available notwithstanding the fact that land may represent a significant partnership asset.[16]

2.4. Basis Reduction With Respect to a Partner

Section 1017(b)(3)(C) requires that any reduction in the basis of a partner's interest in the partnership be mirrored by a corresponding reduction in the partnership's basis in depreciable real property with "respect to such partner." Presumably, the statute's intent is that the basis reductions affect, to the extent possible, only the partner claiming the partnership interest basis reduction and no other partner. Thus, any reduction in depreciation will reduce only the claiming partner's share of partnership deductions, and the additional gain (or diminished loss) recognized by the partnership upon selling the

15 If a fair market value allocation approach were used, $75,000 of A's basis in his interest would be treated as depreciable.

16 Since most real estate partnerships also own an interest in land, availability of the de minimis rule as applied to a partnership's other assets should generally be determined without regard to land, even if land constitutes a significant partnership asset, perhaps subject to some overall limitation on the proportion of total assets (e.g., 25%) which are land. If the other assets were de minimis, they would be aggregated with the depreciable real property, and the allocation required by the "to the extent" limitation would only be applied to segregate out the partnership interest basis attributable to the land.

property as a result of the basis reduction will be allocated only to such partner.

The reduction scheme should in general parallel the approach currently adopted under the Section 743 regulations.[17] The approach of those regulations[18] would then be applied as though the partner claiming the basis reduction had purchased his interest, at the time of the basis reduction, for an amount equal to his post-reduction basis in his partnership interest.[19]

---

[17] Cf. S. Rep. No. 96-1035, 2d Sess. (1980) (Bankruptcy Tax Act of 1980), at footnote 28: "[A] partner may reduce basis in his interest in the partnership only if the partnership makes a corresponding reduction in the basis of the partnership property with respect to such partner (in a manner similar to that which would be required if the partnership had made an election under section 754 to adjust basis in the case of a transfer of a partnership interest)."

[18] Section 743 and the regulations thereunder provides for adjustments to the basis of partnership property in the case of a sale or exchange of a partnership interest to reflect the difference between a transferee's basis for his partnership interest over his share of the adjusted basis of all partnership property. The adjustment is a special basis adjustment that affects the basis of the partnership with respect to the transferee partner only. Reg. § 1.743-l(b). If the partnership holds both depreciable real property and other property, these rules would have to be applied, for purposes of Section 1017(b)(3)(C), separately with respect to the depreciable real estate portion.

[19] Reg. § 1.743-l(b) provides that "a partner's share of the adjusted basis of partnership property is equal to the sum of his interest as a partner in partnership capital and surplus, plus his share of liabilities." In some cases, this can result in a basis reduction with respect to one partner affecting other partners. For example, if A contributes a property with a fair market value and basis of 1000 to a partnership and B contributes 0, but B is allocated 50% of all depreciation deductions with respect to the property (and has a negative capital account make-up), it would appear that under the Section 743 regulations, A could claim a full basis reduction of 1000, thereby eliminating all of the partnership's depreciation deductions, including those allocable to B. Reg. § 1.743-l(b)(l). Query whether this method of determining a partner's share of underlying partnership basis is appropriate in this context or whether the method should be keyed to a partner's share of depreciation deductions with respect to a property. Note that Treasury officials have suggested that the Section 743 approach of looking to share of capital may be applied in this context as well. Comments of David Weisbach, attorney-adviser, Department of the Treasury, Minutes of January 28, 1994 Meeting of Real Estate Taxation Committee of the A.B.A. Section of Taxation, at p. 6.

> Example 4: AB is an equal partnership whose sole property is depreciable real property with a basis and fair market value of $500,000. A has a basis of $250,000 in his partnership interest. A has $250,000 of C.O.D. income and elects to reduce the basis of his partnership interest by that amount, with a corresponding adjustment to the partnership's basis in its property.

A's basis adjustment should affect only A and not B. A should be treated as though he had a zero basis in his share of the property. Accordingly, A will not be entitled to any depreciation deduction with respect to the property, and his share of gain or loss with respect to the property will be determined by reference to his zero basis share of property basis. B's depreciation and gain or loss will continue to be based on his $250,000 share of property basis.

2.5. Interaction of Section l017(b)(3)(c) with Section 704(c)

Section 704(c) and the regulations thereunder provide that a partnership must allocate income, gain, loss, depreciation and amortization with respect to property contributed by a partner to take into account the variation between the adjusted tax basis of the property and its fair market value at the time of contribution. In general terms, the effect of Section 704(c) and the Section 704(c) regulations is to allocate the benefits of the basis of contributed property first to the noncontributing partners to the extent of their proportionate shares (economic interest as determined under the partnership agreement) of the fair market value of such property at the time of contribution, with the contributing partner getting only whatever benefits remain. Accordingly, in the case of a contribution of appreciated property to a partnership, the contributing partner will generally be allocated less than his proportionate share of tax depreciation with respect to the property, and if the property is subsequently sold, will be specially allocated any remaining built-in taxable gain. The regulations should confirm that Section 704(c) principles apply in determining what portion of a partnership’s basis in depreciable real property is “with respect to a partner.”

> Example 5: AB is an equal partnership. A contributes property with a $600,000 tax basis and $1 million fair market value, and B contributes $1 million in cash.

Under Section 704(c), B would be entitled to depreciations deductions with respect to $500,000 of AB’s basis in the property, and A would be entitled to depreciation deductions with respect to only $100,000 of AB’s basis in the property; accordingly, A should only be able to reduce his partnership basis by $100,000.

The Section 704(c) regulations provide two methods, the traditional method and traditional method with curative allocations, and the temporary regulations provide a third method, the remedial method, for allocating tax items under Section 704(c) which are generally considered reasonable. The remedial and curative methods are intended to address issues raised under the traditional method as a result of the application of the so-called ceiling rule.[20]

> Example 6: Same facts as Example 5, except that A contributes property with a $400,000 tax basis and $1 million fair market value. AB purchases nondepreciable property with the $1 million cash.

Under the traditional method, B’s share of the property’s book basis is $500,000, but based on the “ceiling

[20] Under the ceiling rule, the amount of any tax item with respect to Section 704(c) property that can be allocated to any partner cannot exceed the total amount of such item that is available to the partnership. Reg. § 1.704-3(b)(l).

rule," B would only be entitled to depreciation deductions with respect to AB's $400,000 tax basis in the property. Therefore, if AB is using the traditional method, B should only be allowed to reduce his partnership basis by $400,000, while A should not be entitled to any partnership basis reduction.

Under the remedial method, a partnership can make reasonable "remedial" allocations, by creating an income item and an offsetting deduction item, to eliminate ceiling rule disparities between tax allocations and book allocations to the noncontributing partners.[21] In this case, although AB's property basis is only $400,000, additional tax depreciation would be created, and B would be allocated tax depreciation based on his $500,000 book basis in the property; a corresponding income item would be created and allocated to A. Since the effect of the remedial method is to provide B, for both depreciation and profit and loss purposes, with a tax basis with respect to the property which is effectively $500,000, B should be allowed to reduce his outside partnership basis by $500,000.[22]

Under the curative allocation method, if a partnership has built-in gain property, in order to substitute for deduction items unavailable to a noncontributing partner as a result of the ceiling rule, the partnership may either allocate additional deduction items to the noncontributing partner, or allocate corresponding amounts of income to the contributing partner.[23] The proper course with respect to curative allocations is less clear,

[21] Temp. Reg. § i.704-3T(d)(l).

[22] After the basis reduction, A would continue to include the offsetting income item in taxable income as though the partnership's basis in the property had not been reduced.

[23] Reg. § 1.704-3(c).

in part because they do not provide the exact equivalent basis to the noncontributing partner.[24]

2.6. Partnership Selectivity and Basis Reduction Ordering

Section 1017(b)(3)(C) provides that an interest of a partner in a partnership is treated as depreciable property "only if there is a corresponding reduction in the partnership's basis in depreciable property with respect to such partner." When QRPBI of a partnership is reduced, failure of the partnership to make the corresponding basis reduction precludes the interests in that partnership from being treated as depreciable real property. This can lead to apparently anomalous results with respect to the application of the basis reduction ordering rules of Section 1017 to the partners of the partnership.

Section 1017(a)(2) provides that, if an amount excluded from gross income under Section 108(a) is applied to reduce basis under Section 108(b)(2)(D) (relating to basis reduction by bankrupt and insolvent taxpayers generally),[25] 108(b)(5) (relating to the election by bankrupt and insolvent debtors to reduce the basis of depreciable property), or 108(c)(1) (relating to basis reduction in the case of the discharge of qualified real property business indebtedness), the amount applied to reduce basis shall be applied in reduction of the basis of property held

[24] For example, a full curative allocation of depreciation could not be made in cases where there are not sufficient deduction items of the proper type in a given year. In addition, curative allocations of ceiling- rule limited depreciation can be effected by allocating additional income items to the contributing partner rather than additional deduction items to the noncontributing partner, which poses the question of how to effect the equivalent of the required basis reduction.

[25] The 1993 Act redesignated subparagraph (D) of Section 108(b)(2) as subparagraph (E). In an apparent oversight, a conforming change to Section 1017(a)(2) was not made.

by the taxpayer at the beginning of the taxable year following the year of the discharge. Section 1017(b)(1) provides that the particular properties the bases of which are to be reduced shall be "determined under regulations prescribed by the Secretary."

The legislative history of the Bankruptcy Tax Act of 1980 states that, in the case of basis reduction by a bankrupt or insolvent taxpayer, "[i]t is anticipated that the order of reduction prescribed in such regulations will generally accord with present [i.e., as in effect in 1980] . . . Treas. Regs. §§ 1.1016-7 and 1.1016-8."[26] In the case of nonbankruptcy debtors who were, prior to the Tax Reform Act of 1986, permitted to reduce basis in depreciable real or personal property, the legislative history states, "[i]t is anticipated that the order of reduction among depreciable assets of the taxpayer will generally accord with present (i.e., as in effect in 1980] . . . Treas. Regs. §§ 1.1017-1 and 1.1017-2. "[27]

The legislative history of the QRPBI provisions of the 1993 Act provides no explicit guidance regarding the order of reduction among depreciable real property of the taxpayer; however, in view of the fact that the reduction is made under the same statutory provision as applied from 1980 through 1986 to solvent taxpayers generally, it appears that the 1980 legislative history's reference to the pre-1980 Section 1017 regulations should provide the starting point for determining how the reduction is to be made.

Reg. §§ 1.1016-7 and 1.1017-2 both provide that, in the case of a discharge of indebtedness incurred to purchase specific

---

[26] S. Rep. No. 1035, 96th Cong., 2d Sess. 14 (1980).

[27] Id, at 15.

property, whether or not a lien was placed against such property to secure payment of the indebtedness, the basis of the property purchased is reduced before the basis of other property.[28] If basis in such property is inadequate, basis is then reduced in other property against which there is a lien securing the payment of the indebtedness discharged. If basis both in the property purchased with the debt discharged and in other property securing payment of that debt is inadequate, basis is then reduced in other property; generally, if the approach of the Section 1017 regulations were to be followed in the case of the discharge of QRPBI, it appears that the remaining basis reduction would be allocated among the taxpayer's other depreciable real properties proportionately to their adjusted bases.

Since QRPBI must, by definition, be secured by real property (Section 108(c)(3)(A)), its discharge would be expected to invoke one of the priority basis reduction rules of the pre-1980 regulations.[29] Those rules would be disadvantageous to a taxpayer in a case in which the remaining useful life (or

[28] Reg. § 1.1016-7(a)(l) contains a limitation, not found in Reg. § 1.1017-l(a)(l)i to the effect that basis in the property cannot be reduced below the property's fair market value. Although the Bankruptcy Tax Act eliminated the underlying asset-by-asset fair market value limitation applicable to bankrupt taxpayers under prior law, see id., at 9, and, under Section 1017 (b)(2), substituted an aggregate basis limitation applicable to both bankruptcy and insolvent taxpayers, it is unclear whether, for ordering purposes and after basis in the specific property purchased has been reduced to fair market value, basis of a bankrupt or insolvent taxpayer in some other property should be reduced before basis in the specific property purchased with the debt discharged is further reduced below fair market value. (A similar question arises under the other provisions of Reg. § 1.1016-7 that also have fair market value limitations.)

[29] Generally, the basis of depreciable real property securing the debt would be reduced before any other basis. However, if indebtedness was incurred to purchase depreciable real property other than that which secures it, the basis of the purchased property would be reduced before the basis of the property securing the debt; the basis of depreciable real property securing the debt would then be reduced before the basis of any other depreciable real property.

recovery period) of the property securing the debt discharged is shorter than the remaining useful life (or recovery period) of the taxpayer's other depreciable real property.[30] In the case of QRPBI incurred directly by the taxpayer, such disadvantageous results could be avoided only by obtaining a closing agreement under Reg. § 1.1016-8 or 1.1017-2 and could not simply be eliminated at the taxpayer's election.

When QRPBI of a partnership incurred with respect to depreciable real property is reduced,[31] the requirement that the partnership make the "corresponding reduction" to the basis of its depreciable real property apparently results in the basis reduction ordering rules taking on a much more elective character. Particular partnerships, including those which may have realized income from the discharge of QRPBI, may decline to make the "corresponding reduction" described in the statute. So long as the taxpayer has sufficient <u>other</u> depreciable real property (held directly or through partnerships which <u>do</u> make the "corresponding reduction"), however, the current inclusion of income can be avoided without the need to reduce basis in depreciable real property securing the indebtedness discharged.

This result may in fact be anomalous, but it is supported by the language of the statute and legislative history. Although the Code does not expressly refer to the treatment of partnership interests (individually or in the aggregate) as an "election," there is nothing in the Code to compel a partnership

---

30 The rules would be similarly disadvantageous if the property securing the debt was to be sold relatively soon after the discharge.

31 QRPBI may at times be incurred with respect to nondepreciable real property used in trade or business (<u>e.g.</u>, land held by a "dealer"). If such indebtedness is discharged, it is entirely appropriate that the basis reduction be applied to other, depreciable real property of the taxpayer.

to make a "corresponding reduction." Moreover, the legislative history of the Bankruptcy Tax Act, in describing these provisions, uses the expression "if the partnership agrees to make a corresponding reduction."[32] Under these circumstances, we are of the view that the Service should not attempt to mandate a reduction in basis of property held through partnerships, except possibly in those situations in which property is transferred to a partnership for the specific purpose of avoiding the priority basis reduction rules.

3. Property Acquired in Contemplation - Basis Limitation

The amount of income from the discharge of indebtedness that may be excluded from gross income by a noncorporate taxpayer in the case of the discharge of QRPBI may not exceed the aggregate adjusted bases of depreciable real property held by the taxpayer immediately before the discharge. In determining the aggregate adjusted bases of the taxpayer's depreciable real property, depreciable real property acquired "in contemplation of the discharge" is not taken into account.[33] Neither the Code nor the legislative history of the 1993 Act provides guidance regarding when an acquisition of real property will be considered to have been acquired "in contemplation" of a discharge of QRPBI.

We recommend that the regulations provide a presumption pursuant to which property would not be considered to have been acquired in contemplation of discharge of indebtedness if such property is acquired more than a specified period before the transaction giving rise to the Section 108(c) discharge. For this purpose, the time of the discharge transaction should be measured

---

32 S. Rep. No. 1035, 96th Cong., 2d Sess. 22 (1980) (emphasis added).

33 Section 108(c)(2)(B).

from the date the creditor (or the entity through which the taxpayer is allocated income from the discharged indebtedness) becomes legally bound to discharge the indebtedness.[34] We believe that a period of one or at most two years would be appropriate. In most cases prior to the beginning of such a period, the taxpayer's "contemplation" of the discharge that ultimately occurs can be no more than a mere hope that the transaction will ultimately occur; in such a case, the likelihood that the taxpayer would be motivated to a significant degree in making the acquisition by the possibility of increasing the limitation on the amount that may be excluded from gross income is small.

In the case of an acquisition of depreciable real property to which the presumption does not apply, such real property should be excluded in computing the asset basis limitation only if a principal purpose of the acquisition was to take advantage of the exclusion. All relevant facts and circumstances should be considered in determining whether the acquisition had such a principal purpose, including the significance of the property acquired (on a fair market value basis) in proportion to the taxpayer's other holdings of depreciable real property. The mere fact that the taxpayer was aware of the tax benefits to be achieved by the acquisition of depreciable real property should not be determinative,[35] nor should the fact that the taxpayer may have accelerated an

---

[34] In the case of income realized under Section 108(e)(4), the relevant date would ordinarily be determined by reference to the date on which the creditor agreed to transfer the indebtedness to a person "related" to the debtor. In the case of an "indirect acquisition" under Reg. § 1.108-2(c), the relevant date would be determined by reference to the date on which the holder agreed to the transaction by means of which it would become related to the debtor.

[35] Cf. D'Arcy-MacManus & Masius. Inc. v. Commissioner, 63 T.C. 440, 451 (1975) ("consideration of the tax aspects of a transaction does not mandatorily require application of section 269 ... and such consideration is only prudent business planning").

acquisition motivated by adequate non-tax reasons and that would otherwise have been made for those reasons.