

Part III

Administrative, Procedural, and Miscellaneous

26 CFR 601.105: Examination of returns and claims for refund, credit or abatement; determination of correct tax liability.

Rev. Proc. 2014-20

SECTION 1. PURPOSE

This revenue procedure provides a safe harbor under which the Internal Revenue Service (the “Service”) will treat indebtedness that is secured by 100 percent of the ownership interest in a disregarded entity holding real property as indebtedness that is secured by real property for purposes of § 108(c)(3)(A) of the Internal Revenue Code.

SECTION 2. BACKGROUND

.01 Often borrowers incur debt in connection with real property used in a trade or business. If the debt is later discharged, the income from the discharge of indebtedness may be excluded from gross income if certain requirements are met. In some cases, the real property is held by the borrower in an entity that is wholly owned by the borrower, and is, for federal tax purposes, disregarded as an entity separate from its

owner. In these cases, the debt may be secured by the borrower's ownership interest in the disregarded entity holding the real property.

.02 Section 61(a)(12) provides that gross income includes income from the discharge of indebtedness.

.03 Section 108(a)(1)(D) excludes income from the discharge of indebtedness from gross income if, in the case of a taxpayer other than a C corporation, the indebtedness discharged is qualified real property business indebtedness ("QRPBI").

.04 To qualify as QRPBI, § 108(c)(3) requires that the indebtedness must be incurred or assumed by the taxpayer in connection with real property used in a trade or business and be secured by such real property. The taxpayer must make an election to treat the indebtedness as QRPBI. QRPBI does not include qualified farm indebtedness. Section 108(c)(3)(B) provides that QRPBI must be indebtedness that was incurred or assumed before January 1, 1993, or if the indebtedness was incurred or assumed on or after January 1, 1993, it must be qualified acquisition indebtedness. Section 108(c)(3) also provides that indebtedness under § 108(c)(3)(B) includes indebtedness resulting from the refinancing of indebtedness under § 108(c)(3)(B), but only to the extent it does not exceed the amount of indebtedness being refinanced.

.05 Section 108(c)(4) defines qualified acquisition indebtedness as indebtedness incurred or assumed to acquire, construct, reconstruct, or substantially improve real property used in a trade or business.

.06 Section 108(c)(2)(A) limits the amount that may be excluded from gross income with respect to a discharge of QRPBI to the excess of (i) the outstanding principal amount of the QRPBI immediately before the discharge, over (ii) the fair market value of the real property reduced by the outstanding principal amount of any other QRPBI secured by the property at the time of discharge.

.07 Section 108(c)(1) provides that the basis of depreciable real property of a taxpayer shall be reduced by the amount excluded from gross income under § 108(a)(1)(D).

.08 Neither the statute nor the legislative history contains any explanation of or definition for the term “secured by such real property” used in § 108(c)(3)(A). Mortgages are commonly used by lenders to secure an interest in real estate. The legislative history does not suggest, however, that mortgages are the exclusive form of security for § 108(c)(3)(A). See H.R. Rep. No. 103-111 (1993), 1993-3 C.B. 167, 622-625. The fact that the statutory language does not limit the § 108 security interest to a mortgage indicates an intent to include a broader range of security interests.

.09 Section 301.7701-3(b)(1)(ii) of the Procedure and Administration Regulations provides that certain entities (including limited liability companies) with a single member that do not elect to be treated as corporations are disregarded as entities separate from their owners for federal tax purposes (“disregarded entity”).

.10 In other contexts, the Service has, where certain conditions are satisfied, treated debt as secured by real property when the debt is secured by the sole membership

interest in a disregarded entity that holds the real property. See Rev. Proc. 2003-65, 2003-2 C.B. 336.

SECTION 3. SCOPE

.01 This revenue procedure applies to the discharge of indebtedness of any taxpayer, other than a C corporation, provided the requirements of section 3.03 of this revenue procedure are satisfied.

.02 This revenue procedure provides a safe harbor under which the Service will treat debt as “secured by” real property for purposes of § 108(c)(3)(A).

.03 The requirements of this section 3.03 of this revenue procedure are satisfied if:

(1) The taxpayer or a wholly owned disregarded entity of the taxpayer (“Borrower”) incurs indebtedness.

(2) Borrower directly or indirectly owns 100% of the ownership interest in a separate disregarded entity owning real property (“Property Owner”). Borrower is not the same entity as Property Owner.

(3) Borrower pledges to the lender a first priority security interest in Borrower’s ownership interest in Property Owner. Any further encumbrance on the pledged ownership interest must be subordinate to the lender’s security interest in Property Owner.

(4) At least 90 percent of the fair market value of the total assets (immediately before the discharge) directly owned by Property Owner must be real property used in a

trade or business and any other assets held by Property Owner must be incidental to Property Owner's acquisition, ownership, and operation of the real property.

(5) Upon default and foreclosure on the indebtedness, the lender will replace Borrower as the sole member of Property Owner.

.04 If a taxpayer does not meet the requirements of this safe harbor, it is not precluded from arguing, based on facts and circumstances, that its debt satisfies the "secured by" requirement of § 108(c)(3)(A).

SECTION 4. PROCEDURE

Indebtedness that satisfies the requirements of section 3.03 of this revenue procedure will be treated as indebtedness secured by real property for purposes of § 108(c)(3)(A). Provided the indebtedness meets the other requirements of § 108(c)(3), such indebtedness will be QRPBI and, accordingly, any income from the discharge of such indebtedness will be excluded from the taxpayer's gross income pursuant to §108(a)(1)(D) subject to the limitations provided in § 108(c). Further, as provided in § 108(c)(1), the basis of depreciable real property of the taxpayer will be reduced by the amount excluded from gross income.

SECTION 5. EFFECTIVE DATE

This revenue procedure is effective for taxpayers who make an election under § 108(c)(3) regarding discharged indebtedness on or after February 5, 2014.

DRAFTING INFORMATION

The principal author of this revenue procedure is Seoyeon Sharon Park of the Office of Associate Chief Counsel (Income Tax and Accounting). For further information regarding this revenue procedure, contact Ms. Park at (202) 317-7006 (not a toll-free call).