Office of Chief Counsel
Internal Revenue Service
Memorandum

Number: **201623009**
Release Date: 6/3/2016

CC:ITA:B05:JBLovelace
POSTF-139972-15

UILC: 108.01-04

date: March 02, 2016

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subject: Limitation on the Exclusion for Discharges of Qualified Real Property Business Indebtedness

This Chief Counsel Advice responds to your request for assistance. This advice may not be used or cited as precedent.

LEGEND

Taxpayer =
Property A =
Property B =
Debt C =
Debt D =
$a =
$b =
$c =
$d =
$e =
$f =

$g =

ISSUES

You have asked whether, in determining the net fair market value of real property under the qualified real property business indebtedness (QRPBI) exclusion of section 108(a)(1)(D), the exclusion limitation formula in section 108(c)(2) and § 1.108-6(a) takes into account all real property held by a taxpayer with respect to which there is some QRPBI and all debts that are QRPBI with respect to any item of real property held by the taxpayer.

The Taxpayer and the field disagree over the proper interpretation of the "net fair market value" formula in the QRPBI exclusion limitation of section 108(c)(2)(A). The Taxpayer takes the position that the starting point for this calculation, described in the Code as "the fair market value of the real property described in paragraph (3)(A)", is the fair market value of the single item of real property for which the discharged debt is QRPBI. The field interprets this clause to refer to the fair market value of all items of real property held by the Taxpayer with respect to which any debt is QRPBI and not just the single item of property for which the discharged debt is QRPBI.

The Taxpayer and the field agree that the net fair market value formula in the QRPBI exclusion limitation requires the fair market value be reduced by the total of all other debts that are QRPBI with respect to any item of real property held by the Taxpayer.

CONCLUSIONS

The formula for the QRPBI exclusion limitation in section 108(c)(2) and § 1.108-6(a) begins with the total fair market value of the single item of real property to which the discharged debt is QRPBI and then reduces that total by the sum of all other debts that are secured by, and QRPBI with respect to, that item of real property.

The alternative view advanced by the Taxpayer that the net fair market value is the fair market value of the single item of real property to which the discharged debt is QRPBI, reduced by the amount of other debt secured by such property but that is QRPBI with respect to any item of real property held by the taxpayer is in error.

The field's interpretation, which aggregates all of the real property with respect to which some debt is QRPBI to determine the fair market value and then subtracts the aggregate of all QRPBI from that amount to obtain the net fair market value is also in error.

FACTS

The Taxpayer owns two items of real property used in a trade or business, Property A and Property B. At the time of the of the debt forgiveness at issue, Property A had a fair market value of $a and was security on Debt C with a principal amount of $b. At the same time, Property B had a fair market value of $c and was security on Debt D with a principal amount of $d. Debt D was also secured by Property A, and Debt C was secured by Property B. The proceeds from Debt C were used to improve Property A and were not used for Property B. The proceeds from Debt D were used to construct or improve Property B and not used for Property A.

Debt C was reduced to $e, reflecting a discharge amount of $f. In its calculation of the maximum exclusion amount under section 108(c)(2), the Taxpayer has reduced the fair market value of Property A by Debt D without also adding the value of Property B to Property A. On this basis, the Taxpayer has excluded the entire amount of Debt C that was discharged. Neither Debt C nor Debt D were incurred or assumed before January 1, 1993.

LAW

Section 108(a)(1)(D) provides that gross income does not include discharged amounts if “the indebtedness discharged is qualified real property business indebtedness.”

Section 108(c)(3) defines “qualified real property business indebtedness” to mean:

> indebtedness which—
>
> (A) 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,
>
> (B) was incurred or assumed before January 1, 1993, or, if incurred or assumed on or after such date, is qualified acquisition indebtedness, and
>
> (C) with respect to which such taxpayer makes an election to have this paragraph apply.

“Qualified acquisition indebtedness” is defined in section 108(c)(4), which provides:

> For purposes of paragraph (3)(B), the term “qualified acquisition indebtedness” means, with respect to any real property described in paragraph (3)(A), indebtedness incurred or assumed to acquire, construct, reconstruct, or substantially improve such property.

Section 108(c)(2)(A) limits the amount excluded under section 108(a)(1)(D). It provides:

> The amount excluded under subparagraph (D) of subsection (a)(1) with respect to any qualified real property business indebtedness shall not exceed the excess (if any) of –
>
> (i) the outstanding principal amount of such indebtedness (immediately before the discharge), over

> (ii) the fair market value of the real property described in paragraph (3)(A) (as of such time), reduced by the outstanding principal amount of any other qualified real property business indebtedness secured by such property (as of such time).

Treas. Reg. § 1.108-6(a) provides, in part:

> With respect to any qualified real property business indebtedness that is discharged, the amount excluded from gross income under section 108(a)(1)(D) (concerning discharges of qualified real property business indebtedness) shall not exceed the excess, if any, of the outstanding principal amount of that indebtedness immediately before the discharge over the net fair market value of the qualifying real property, as defined in § 1.1017-1(c)(1), immediately before the discharge. For purposes of this section, net fair market value means the fair market value of the qualifying real property (notwithstanding section 7701(g)), reduced by the outstanding principal amount of any qualified real property business indebtedness (other than the discharged indebtedness) that is secured by such property immediately before and after the discharge.

Treas. Reg. § 1.1017-1(c)(1) provides, in part:

> Furthermore, for basis reductions under section 108(c), a taxpayer must reduce the adjusted basis of the qualifying real property to the extent of the discharged qualifying real property business indebtedness before reducing the adjusted bases of other depreciable real property. The term qualifying real property means real property with respect to which the indebtedness is qualified real property business indebtedness within the meaning of section 108(c)(3).

ANALYSIS

To understand the QRPBI exclusion limitation, it is necessary to look at each element of it in the context of the entire QRPBI exclusion limitation provision.

The QRPBI exclusion limitation in section 108(c)(2)(A) consists of four different elements, divided up as follows:

(1) The amount excluded under subparagraph (D) of subsection (a)(1) with respect to any qualified real property business indebtedness shall not exceed the excess (if any) of—

(2) (i) the outstanding principal amount of such indebtedness (immediately before the discharge), over

(3) (ii) the fair market value of the real property described in paragraph (3)(A) (as of such time),

(4) reduced by the outstanding principal amount of any other qualified real property business indebtedness secured by such property (as of such time).

(1) The amount excluded under subparagraph (D) of subsection (a)(1) with respect to any qualified real property business indebtedness shall not exceed the excess (if any) of—

The first element is the introductory language that provides, "The amount excluded under subparagraph (D) of subsection (a)(1) with respect to any qualified real property business indebtedness shall not exceed the excess (if any) of--". For debt amounts to be excluded, they must first be discharged. Thus, this introductory phrase refers to the amount of the discharged debt that is QRPBI with respect to a single item of real property.

(2) (i) the outstanding principal amount of such indebtedness (immediately before the discharge), over

The second element of the QRPBI exclusion limitation provides, "(i) the outstanding principal amount of such indebtedness (immediately before the discharge), over". The amount referred to in this element is the principal amount of the debt referred to in the introductory language, i.e. the discharged debt that is QRPBI with respect to a single item of real property. Accordingly, the same real property referenced in the first element is implicitly referenced in the second element.

(3) (ii) the fair market value of the real property described in paragraph (3)(A) (as of such time),

The third element of the QRPBI exclusion limitation provides, "(ii) the fair market value of the real property described in paragraph (3)(A) (as of such time)". "Paragraph (3)(A)" is the first requirement of three in the definition of "qualified real property business indebtedness" in section 108(c)(3) (i.e. section 108(c)(3)(A)). This requirement is that debt be incurred or assumed by the taxpayer "in connection with real property used in a trade or business."

There are two permissible interpretations of the "real property described in paragraph (3)(A)." Under the first interpretation, "the real property described in paragraph (3)(A)" refers to all real property held by a taxpayer for which there is some debt that is QRPBI. When a taxpayer has two items of real property, each with its own associated QRPBI, the fair market value of both properties would, under this interpretation, be taken into account in determining the QRPBI exclusion limitation.

Under the second interpretation, "the real property described in paragraph (3)(A)" refers to the single item of real property with respect to which the discharged debt referenced in the first two elements is QRPBI. When a taxpayer has two items of real property, each with its own associated QRPBI, the fair market value of only the item of real property with respect to which the discharged debt is QRPBI would be taken into account in determining the QRPBI exclusion limitation.

The proposed adjustment aggregates the values of the Taxpayer's real property, and thus relies on the first interpretation. The Taxpayer's position takes into account only the value of the single item of real property with respect to which the discharged debt is QRPBI, and thus relies on the second interpretation.

The Taxpayer's interpretation of the third element is the better of the two. On its face, "the property described in paragraph (3)(A)" refers to a single item of property, literally "the property." Were Congress to have intended "the property" to refer to more than one property, it would have made more sense to use the term "any property" or, even more clearly, "all properties." An unmodified singular term used in combination with the article "the" usually refers to a single item rather than all items of that type.

This interpretive principle is at work in the immediately following fourth element, where the Code draws in more than one debt through use of the qualifying word "any" before "other qualifying real property business indebtedness secured by such property." While "any" as used in the fourth element is arguably unnecessary, its use makes it quite clear that the fair market value of the real property is to be reduced more than one debt. The absence of a similar qualifier in front of the word "property" in the third element suggests that "the property" refers to the single item of real property for which the discharged debt is QRPBI.

More support for this can be found in section 108(c)(2)(B), which imposes a second, overall limitation on the amount that may be excluded under the QRPBI discharge exclusion. Section 108(c)(2)(B) provides:

> The amount excluded under subparagraph (D) of subsection (a)(1) shall not exceed the aggregate adjusted bases of depreciable real property (determined after any reductions under subsections (b) and (g)) held by the taxpayer immediately before the discharge (other than depreciable real property acquired in contemplation of such discharge).

Here, the singular term "depreciable real property" does refer to more than one item of depreciable real property, but this is made clear by the use of the terms "aggregate" and "bases" which draw together the bases of all depreciable real property held by a taxpayer to establish the overall limitation. Thus, elsewhere in this provision where the Code refers to more than one item of real property by using the singular "property," the language contains a modifier to make it clear that the Code is referring to more than one item of real property. Where the Code does not do this, the better interpretation is that Congress intended "property" to refer to one and only one item of real property.

The regulations also support the interpretation under which "the real property described in paragraph (3)(A)" is the real property to which the discharged debt is QRPBI. Treas. Reg. § 1.108-6(a) provides, in part:

> With respect to any qualified real property business indebtedness that is discharged, the amount excluded from gross income under section 108(a)(1)(D) (concerning discharges of qualified real property business indebtedness) shall not exceed the excess, if any, of the outstanding principal amount of that indebtedness immediately before the discharge over the net fair market value of the qualifying real property, as defined in § 1.1017-1(c)(1), immediately before the discharge. For purposes of this section, net fair market value means the fair market value of the qualifying real property (notwithstanding section 7701(g)), reduced by the outstanding principal amount of any qualified real property business indebtedness (other than the discharged indebtedness) that is secured by such property immediately before and after the discharge.

In these regulations, "the real property described in paragraph (3)(A)" is referred to as "the qualifying real property, as defined in § 1.1017-1(c)(1)." Treas. Reg. § 1.1017-1(c)(1) provides, in part:

> Furthermore, for basis reductions under section 108(c), a taxpayer must reduce the adjusted basis of the qualifying real property to the extent of the discharged qualifying real property business indebtedness before reducing the adjusted bases of other depreciable real property. The term qualifying real property means real property with respect to which the indebtedness is qualified real property business indebtedness within the meaning of section 108(c)(3).

Accordingly, the "the real property described in paragraph (3)(A)" is the "real property with respect to which the indebtedness is qualified real property business indebtedness within the meaning of section 108(c)(3)." "The indebtedness" here refers to the indebtedness described in the immediately preceding sentence, i.e. the discharged indebtedness. The qualifying real property then is the item of real property for which the discharged debt is QRPBI and does not include any other items of real property with respect to which debts other than the discharged debt are QRPBI.

(4) reduced by the outstanding principal amount of any other qualified real property business indebtedness secured by such property (as of such time).

The fourth and last element of the QRPBI exclusion limitation provides, "reduced by the outstanding principal amount of any other qualified real property business indebtedness secured by such property (as of such time)." "Such property" at the end of the clause refers to the same item of real property as the third element, which, as previously discussed, is the single item of real property with respect to which the discharged debt is QRPBI.

The other important piece of the fourth element is the phrase, "any other qualified real property business indebtedness." Both the Taxpayer and the field interpret this phrase to refer to any debt that qualifies as QRPBI with respect to any item of real property held by a taxpayer, whether or not that item of real property is the item of real property referred to directly or indirectly in the first three elements and “such property” of the fourth element.

There is, however, a second, better interpretation of this clause. “[A]ny other qualified real property business indebtedness” could refer to all debts other than the discharged debt that are QRPBI with respect to the same item of real property referred to in the first three elements and “such property” of the fourth element. The term “qualified real property business indebtedness” used here in the fourth element is a term that is defined, in part, by the same paragraph (3)(A) that is used to describe the real property with respect to which the discharged debt is QRPBI. If, as is most likely, the language “real property described in paragraph (3)(A)” in the third element refers only to the item of real property to which the discharged debt is QRPBI, the only consistent reading of the fourth element’s use of the term “qualified real property business indebtedness” – a term whose definition incorporates paragraph (3)(A) -- is that it refers only to debts that are QRPBI with respect to the same item of real property of the third element.

As described above, the proceeds of Debt C were used to improve Property A and were not used for Property B. Consequently, Debt C is qualified acquisition indebtedness (within the meaning of section 108(c)(4)) only for Property A and not Property B. Thus, Debt C is QRPBI only with respect to Property A. Similarly, the proceeds of Debt D were used to construct or improve Property B and were not used for Property A. Debt D is qualified acquisition indebtedness only for Property B, and thus is QRPBI only with respect to Property B and not Property A.

The only QRPBI with respect to Property A is Debt C. Because Debt C is the debt discharged, the fair market value of Property A is not reduced by any amount under the formula for the net fair market value in § 1.108-6(a). Under the QRPBI exclusion limitation, the Taxpayer may exclude no more than the amount by which the principal amount of Debt C ($b) exceeds the net fair market value of Property A ($a). Consequently, the Taxpayer may exclude $g of the amount of Debt C that was discharged ($f).

<u>CASE DEVELOPMENT, HAZARDS AND OTHER CONSIDERATIONS</u>

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