



One Minute Memo[®]

Cancellation of Debt Income Realized by Pass-Through Entities: Some Basic Considerations

As a general rule, a debtor realizes taxable income upon the partial or total cancellation of its debt. Special rules may apply, however, when the debtor is a “pass-through” entity—e.g., a partnership, a limited liability company (LLC) that is treated as a partnership for United States federal income tax purposes or a subchapter S corporation. Cancellation of debt (COD) income realized by a pass-through entity generally passes through to the entity’s owners, with each owner being required to report its allocable share of such income on its own income tax return. Under the recently-enacted American Recovery and Reinvestment Tax Act of 2009, a pass-through entity that realizes COD income in 2009 or 2010 might be able to elect to defer recognition of such income (COD Deferral Election), in which case its owners would be required to recognize such income ratably over a five-year period beginning in 2014. Please see our March 20, 2009 One Minute Memo entitled *The American Recovery and Reinvestment Tax Act of 2009 (the “Act”) Allows Deferred Recognition of Cancellation of Debt (COD) Income—COD Income Arising from Foreclosures/Deeds-In-Lieu Transfers Should Be Eligible for Deferral*.

A debtor who realizes COD income on the partial or complete cancellation of its indebtedness and who does not make or is not eligible to make the COD Deferral Election with respect to such income may nonetheless be able to avoid COD income recognition by availing itself of the “bankruptcy” exclusion, the “insolvency” exclusion or the “qualified real property business indebtedness” (QRPBI) exclusion.¹ The bankruptcy and insolvency exclusions generally allow a debtor to avoid COD income recognition if at the time the debt is cancelled the debtor is either in bankruptcy or insolvent, and the QRPBI exclusion allows a non-C corporation debtor, subject to certain limitations, to avoid COD income recognition if the debt is QRPBI.² A debtor is considered “insolvent” if immediately before the debt is cancelled the amount of the debtor’s liabilities exceeds the fair market value of its assets. The amount of COD income that an insolvent debtor may exclude under the insolvency exclusion is limited to the amount of the insolvency.

As a tradeoff for excluding COD income under the bankruptcy and insolvency exclusions, a bankrupt or insolvent debtor must reduce certain of its tax attributes by the amount of COD income excluded. Alternatively, the debtor can elect to first apply the excluded COD income to reduce the basis of its depreciable property and then apply any remaining COD income to reduce the debtor’s tax attributes. Similarly, as a tradeoff for excluding COD income under the QRPBI exclusion, the debtor must reduce the basis of its depreciable real property by the amount of cancelled QRPBI.

¹ These exclusions, as well as the COD Deferral Election, do **not** apply to the extent that the income resulting from the debt cancellation constitutes “sale” gain. This could occur in the case where property is transferred—whether in a foreclosure, a deed in lieu of foreclosure or otherwise—in full or partial satisfaction of a debt. If property is transferred to satisfy a *recourse* debt of the debtor then: (a) the property is treated as having been sold by the debtor for its fair market value, with the debtor realizing gain or loss from the deemed sale equal to the difference between the property’s fair market value and its basis, and (b) the debtor is treated as having COD income to the extent that such debt exceeds the property’s fair market value. If, instead, property is transferred to satisfy a *non-recourse* debt, the property is treated as having been sold for the amount of the debt (regardless of the property’s fair market value), with the debtor realizing gain or loss (although not COD income) equal to the difference between the amount of the debt and the basis of the property.

² In general, QRPBI means 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 (including indebtedness resulting from the refinancing of such indebtedness, but only to the extent it does not exceed the amount of the indebtedness being refinanced), and (c) the taxpayer makes an election to have treated as QRPBI. For purposes of clause (b) above, “qualified acquisition indebtedness” means, with respect to any real property described in clause (a) above, indebtedness incurred or assumed to acquire, construct, reconstruct, or substantially improve such property.

Where the debtor is a pass-through entity, the applicability of the exclusions is subject to special rules. If the debtor is an S corporation, the exclusions are applied at the S corporation level and are available only if the S corporation is in bankruptcy or insolvent or if its debt is QRPBI. In the case of a partnership/LLC debtor, however, the exclusions are instead applied at the partner/member level. Generally, this means that even if the debtor partnership/LLC is bankrupt or insolvent or if its debt is QRPBI, the partnership/LLC's COD income will pass through to its partners/members and only those partners/members that are bankrupt or insolvent or elect to reduce the basis of depreciable property in the case of QRPBI can take advantage of the exclusions and avoid recognizing COD income. If a partner/member elects to reduce the basis of depreciable property before reducing other tax attributes or elects to exclude COD income with respect to QRPBI, the partner/member must treat its partnership/LLC interest as depreciable property subject to basis reduction to the extent of the partner/member's proportionate share of the entity's basis in depreciable property (or depreciable real property, as the case may be), but only if the partnership/LLC makes a corresponding adjustment to the basis of its depreciable property (or depreciable real property).

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