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IRS Creates New Disregarded Entity Exclusion from Debt Cancellation Income

The IRS has announced a new safe harbor from the discharge of debt income rules.

Debt that is cancelled, discharged or forgiven is generally taxable as income, but there are exceptions. Under one exception, certain income from discharge of certain debt secured by real estate can be excluded from gross income. Under the new safe harbor, debt secured by ownership interests in an entity holding the real estate may be treated as if it were secured by the real estate itself. To qualify, the secured interest must be in a wholly-owned, tax-disregarded entity, such as a single member LLC.

Taxpayers utilizing “mezzanine” or other specialty financing techniques may find the new safe harbor helpful in addressing the tax ramifications of workouts and similar restructurings.

The new safe harbor applies to any taxpayer, other than a C corporation, satisfying the following requirements:

- the taxpayer/borrower or a wholly-owned disregarded entity of the borrower incurs indebtedness;
- the borrower directly or indirectly owns 100 percent of the ownership interest in a separate disregarded entity owning real property and the borrower is not the same entity as the property owner;
- the borrower pledges to the lender a first-priority security interest in the borrower's ownership in the property owner and any further encumbrance on the pledged ownership interest must be subordinate to the lender's security interest in the property owner;
- at least 90 percent of the fair market value of the total assets directly owned by the property owner must be real property used in a trade or business and any other assets held by the property owner must be incidental to the acquisition, ownership, and operation of the real property; and
- upon default and foreclosure on the indebtedness, the lender will replace the borrower as the sole member of the property owner.

Where the safe harbor requirements are met all other operative rules related to Code Sec. 108 apply, including the reduction of basis by the amount excluded from gross income.

On its face the safe harbor only applies to first tier disregarded entities. In fact, in more complex situations, there can be multiple tiers of entities involved which are designed to help protect lenders against unknown risks involved with the underlying real estate, such as environmental concerns. In these cases, the taxpayer is not precluded from arguing the applicability of the safe harbor's rationale to the arrangement. According to the Rev. Proc.:

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).

The guidance is effective for taxpayers who make an election under Code Sec. 108(c)(3) regarding discharged indebtedness on or after February 5, 2014. Revenue Procedure 2014-20, will be in Internal Revenue Bulletin 2014-09 on Feb. 24, 2014.

Should you have any questions about this or any other estate planning related issue, please contact [Jim Tramonte](#) or any member of our Tax Practice Group.

The opinions expressed in this bulletin are intended for general guidance only. They are not intended as recommendations for specific situations.

As always, readers should consult a qualified attorney for specific legal guidance. Should you need assistance from a Miller & Martin attorney, please call 1-800-275-7303.

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