Cancellation of indebtedness exclusion clarified - by John Varella

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When a real property development goes bust, the developer often must negotiate with its lenders to cancel some or all of the indebtedness incurred to develop the property. Any reduction in the indebtedness may result in cancellation of debt income (COD Income) to the developer. However, there are several exclusions that could apply to prevent recognition of the COD Income. One of the most commonly used exclusions is for "qualified real property business indebtedness" (QRPBI).

QRPBI is indebtedness which (i) is incurred or assumed by the developer in connection with real property used in a trade or business and is secured by that real property, (ii) was incurred or assumed before January 1, 1993, or, if incurred or assumed on or after that date, to acquire, construct, reconstruct, or substantially improve the real property, and (iii) which the developer elects to exclude from gross income. The exclusion is limited to the excess of the outstanding principal amount of the QRPBI immediately prior to the cancellation over the fair market value of the real property. In addition, the exclusion may not exceed the aggregate adjusted basis of depreciable real property held by the developer immediately prior to the cancellation.

Practitioners have sought clarity as to the definition of "trade or business" for purpose of the QRPBI exclusion. While the Internal Revenue Code and its regulations use the term "trade or business" in hundreds of places, there was a lack of guidance as to whether (i) developing and holding that developed real property out primarily for sale to customers was a "trade or business", and (ii) developing and holding that developed real property for lease in a leasing business was a "trade or business."

Recently, the Internal Revenue Service issued a revenue ruling that answers these questions directly. In the ruling, the IRS concludes that, for purposes of the QRPBI exclusion, property that is developed and held out primarily for sale to customers is NOT a trade or business for which the QRPBI exclusion is available. On the other hand, property that is developed and held for lease in a leasing business is part of a trade or business for which the QRPBI can apply if elected.

This is an important clarification for leasing developers, but a trap for the unwary for a developer looking primarily to sell developed real property. Developer beware.

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