

**New Tax Incentives for Discharge of Real Property Indebtedness
Under Economic Stimulus Bill**

March 23, 2009

A new tax election contained in the recently enacted American Recovery and Reinvestment Act of 2009 (the stimulus bill) can benefit certain owners of commercial real estate who repurchase, exchange, or modify their existing real property indebtedness during 2009 and 2010. If a “workout” with a lender results in cancellation-of-debt (COD) income, the owner will now have the choice to either (1) defer such income until 2014 or (2) apply the provisions of the preamendment law to the income.

Apart from this change, the law permits property owners to exclude COD income resulting from workouts under certain circumstances. The price for this exclusion is the reduction of tax attributes that would normally provide a benefit in future years. For example, if an insolvent company discharged \$5 million of debt in 2008 for a discounted price of \$4 million, that company would be able to exclude the \$1 million in COD income for that tax year but would also have to reduce its tax attributes (e.g., reduce its net operating loss carryforward or basis in the property).

Not every property owner in a position to negotiate a workout is entitled to exclude COD income. For those property owners, COD income (which is noncash income) is currently taxable, which often limits the benefits of a workout. The stimulus bill encourages debt restructuring by allowing property owners to elect to defer any resulting COD income until 2014, recognizing 20% of the COD income in 2014 and in each of the four subsequent years.

Property owners with an opportunity to enter into a workout should examine their circumstances to determine if the new alternative of deferring COD income would be more beneficial than the traditional approach of excluding COD income and reducing tax attributes.

For all property owners, the election to defer COD income is irrevocable, and must be made on the tax return for the applicable debt instrument in the taxable year in which the repurchase, exchange, or modification occurs.

Note that if the property owner is a partnership, the election to defer COD income is made at the partnership level. This is a departure from prior law, which applied the exclusion and tax attribute reduction at the partner level.

For property owners who can use the new provision (particularly those who did not qualify under the prior exclusion and reduction approach), the benefit of the new law is two-fold: first, it allows highly leveraged owners whose properties are otherwise performing to renegotiate debt at lower interest rates and/or reduced principal, resulting in reduced amortization payments and increased liquidity in the short term; and second, it finances the resulting tax payment interest-free until 2014.

This new legislation should put owners restructuring their debt in a better position to weather the existing economic downturn, provided their lenders are willing to consider these transactions. We welcome the opportunity to discuss these rules in more detail.

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