

## IRS Provides Discharge of Indebtedness Safe Harbor for Debt Secured by Interest in Disregarded Entity Holding Real Property

In general, discharge of indebtedness income is excluded from the gross income of a taxpayer (other than a C corporation) if the indebtedness is qualified real property business indebtedness (QRPBI). To qualify as QRPBI, the indebtedness must (1) be incurred or assumed by the taxpayer in connection with real property used in a trade or business and secured by the real property (the Secured-By Requirement); (2) have been incurred or assumed before January 1, 1993, or, if incurred or assumed after that date, be indebtedness incurred or assumed to acquire, construct, reconstruct, or substantially improve real property used in a trade or business; and (3) be indebtedness the taxpayer elects to treat as QRPBI.

Revenue Procedure 2014-20 provides a safe harbor by which a taxpayer will have satisfied the Secured-By Requirement if:

- The taxpayer or a wholly owned entity that is disregarded for federal tax purposes (disregarded entity) of the taxpayer (Borrower) incurs indebtedness.
- Borrower directly or indirectly owns 100 percent of the ownership interest in a separate disregarded entity owning real property (Property Owner). Borrower is not the same entity as Property Owner.
- Borrower pledges to the lender a first priority security interest in Borrower's ownership interest in Property Owner. Any further encumbrance on the pledged ownership interest must be subordinate to the lender's security interest in Property Owner.
- At least 90 percent of the fair market value of the total assets (immediately before the discharge) directly owned by Property Owner must be real property used in a trade or business and any other assets

held by Property Owner must be incidental to Property Owner's acquisition, ownership, and operation of the real property.

- Upon default and foreclosure on the indebtedness, the lender will replace Borrower as the sole member of Property Owner.

If a taxpayer does not satisfy the requirements of the safe harbor, it may still argue that, based on facts and circumstances, its debt satisfies the Secured-By Requirement.

The safe harbor is available for taxpayers who elect to treat indebtedness as QRPBI on or after February 5, 2014.

If you have any questions, please contact [Alan J. Tarr](mailto:atarr@loeb.com) (at 212.407.4900 or [atarr@loeb.com](mailto:atarr@loeb.com)) or [Thomas N. Lawson](mailto:tlawson@loeb.com) (at 310.282.2289 or [tlawson@loeb.com](mailto:tlawson@loeb.com)).

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## Tax Group

MICHELLE W. ALBRECHT	MALBRECHT@LOEB.COM	212.407.4181
JOHN ARAO	JARAO@LOEB.COM	310.282.2231
MARLA ASPINWALL	MASPINWALL@LOEB.COM	310.282.2377
RYAN M. AUSTIN	RAUSTIN@LOEB.COM	310.282.2268
AMY BELL	ABELL@LOEB.COM	310.282.2170
LAURA B. BERGER	LBERGER@LOEB.COM	310.282.2274
LEAH M. BISHOP	LBISHOP@LOEB.COM	310.282.2353
SUSAN G. BLUMENTHAL	SBLUMENTHAL@LOEB.COM	202.618.5009
DEBORAH J. BROSS	DBROSS@LOEB.COM	310.282.2245
TARIN G. BROSS	TBROSS@LOEB.COM	310.282.2267
CHRISTOPHER W. CAMPBELL	CWCAMPBELL@LOEB.COM	310.282.2321
THERESA R. CLARDY	TCLARDY@LOEB.COM	310.282.2058
REGINA I. COVITT	RCOVITT@LOEB.COM	310.282.2344
TERENCE F. CUFF	TCUFF@LOEB.COM	310.282.2181
LINDA N. DEITCH	LDEITCH@LOEB.COM	310.282.2296
RACHEL R. DEMENY	RDEMENY@LOEB.COM	212.407.4135
PAUL N. FRIMMER	PFRIMMER@LOEB.COM	310.282.2383
ANDREW S. GARB	AGARB@LOEB.COM	310.282.2302
ELIOT P. GREEN	EGREEN@LOEB.COM	212.407.4908
RACHEL J. HARRIS	RHARRIS@LOEB.COM	310.282.2175
TANYA A. HARVEY	THARVEY@LOEB.COM	202.618.5024
DAVID M. HODGE	DHODGE@LOEB.COM	310.282.2224
KAREN L. KUSHKIN	KKUSHKIN@LOEB.COM	212.407.4984
THOMAS N. LAWSON	TLAWSON@LOEB.COM	310.282.2289
JEROME L. LEVINE	JLEVINE@LOEB.COM	212.407.4950

JANE E. LIPPMAN	JLIPPMAN@LOEB.COM	310.282.2397
JEFFREY M. LOEB	JLOEB@LOEB.COM	310.282.2266
MARY ANN MANCINI	MMANCINI@LOEB.COM	202.618.5006
ANNETTE MEYERSON	AMEYERSON@LOEB.COM	310.282.2156
DAVID C. NELSON	DNELSON@LOEB.COM	310.282.2346
LANNY A. OPPENHEIM	LOPPENHEIM@LOEB.COM	212.407.4115
RONALD C. PEARSON	RPEARSON@LOEB.COM	310.282.2230
ALYSE N. PELAVIN	APELAVIN@LOEB.COM	310.282.2298
JONATHAN J. RIKOON	JRIKOON@LOEB.COM	212.407.4844
STANFORD K. RUBIN	SRUBIN@LOEB.COM	310.282.2090
LAURIE S. RUCKEL	LRUCKEL@LOEB.COM	212.407.4836
CRISTINE M. SAPERS	CSAPERS@LOEB.COM	212.407.4262
JOHN F. SETTINERI	JSETTINERI@LOEB.COM	212.407.4851
ANDREW K. STEENBOCK	ASTEENBOCK@LOEB.COM	310.282.2242
REBECCA M. STERLING	RSTERLING@LOEB.COM	310.282.2301
MEGAN A. STOMBOCK	MSTOMBOCK@LOEB.COM	212.407.4226
ADAM F. STREISAND	ASTREISAND@LOEB.COM	310.282.2354
ALAN J. TARR	ATARR@LOEB.COM	212.407.4900
STUART P. TOBISMAN	STOBISMAN@LOEB.COM	310.282.2323
JESSICA C. VAIL	JVAIL@LOEB.COM	310.282.2132
NICHOLAS J. VAN BRUNT	NVANBRUNT@LOEB.COM	310.282.2109
GABRIELLE A. VIDAL	GVIDAL@LOEB.COM	310.282.2362
BRUCE J. WEXLER	BWEXLER@LOEB.COM	212.407.4081
DANIEL M. YARMISH	DYARMISH@LOEB.COM	212.407.4116