Cancellation of debt income

Dealing with CODI from distressed properties **Interviewed by Arthur G. Sharp**

Cancellation of debt income (CODI) from distressed properties is becoming more prevalent in today's economy. The term CODI sounds discouraging; however, there are a few opportunities to minimize the current tax impact as a result of debt forgiveness or debt restructuring.

As Jackie Matsumura of Burr Pilger Mayer explains, "There are several ways to deal with the inability to make loan repayments, including short sales, workouts, foreclosure, abandonment, to name a few." But, she adds, "There are different tax and nontax implications for each of them, and dealing with distressed properties is definitely not something that owners want to do alone."

She recommends property owners seek the advice of a tax professional before making any decisions.

Smart Business discussed the tax implications of CODI with Matsumura to learn more about them and the importance of seeking tax advice early.

Jackie Matsumura
Partner
Tax Practice
Burr Pilger Mayer

Is cancellation of debt income always taxable?

No, not always. CODI is generally taxable, but there is a provision in the tax law which allows the exclusion of CODI from taxable income. The provision applies to individuals and businesses, and to name some exceptions for real property owners — let's call them 'taxpayers' — who file Chapter 11, who are insolvent, or who have qualified real property indebtedness or qualified principal residence indebtedness qualify for the exclusion. In addition, there are specific tax consequences as a result of the exclusion; for example, net operating losses are reduced by the exclusion amount, tax credits are reduced, and/or the tax basis in property is reduced.

Also, the determination of whether CODI is taxable depends on the type of taxpayer, meaning whether the taxpayer is an individual, corporation or a pass-through entity. In a partnership situation, the determination is not made at the partnership level, but at the partner level. As a result, one partner's allocated CODI income may be treated differently from another partner's because one may be insolvent but the other may not, or one may file Chapter 11 but the other may not.

How can tax professionals help parties involved in buying and selling distressed properties get through the CODI maze?

Tax professionals can help taxpayers deal with distressed properties on the front end. Factors that affect tax results include what type of property is held, whether it is a principal residence, investment property or real estate used in a business; how the properly is held, say, by an individual, corporation or a partnership; what type of loan is involved, whether it's recourse or nonrecourse; or if the taxpayer has other businesses or has other unrelated tax issues to consider. Their tax advisers can assist in projecting out the tax implications of restructuring debt, when combined with other aspects of the taxpayer's tax situation or recommend the ideal timing of certain events to minimize taxes. Also, careful planning is necessary because the character of income may differ between CODI and loss from disposition of property (ordinary income versus capital loss).

Are laws regulating disposition of distressed properties and CODI changing?

Yes. For example, Congress recently enacted the Mortgage Forgiveness Debt Relief Act of 2007, which allows homeowners to exclude up to $2 million of debt that is forgiven through Dec. 31, 2009. One thing to note, however, is that the amount is not really tax-free, because the basis of that property is reduced by whatever is excluded from income; so it's really a deferral of tax.

Is it in lenders' and owners' best interests to cancel debt tied to distressed properties?

That depends. It is generally a business decision as to what the pros and cons of cancelled debt are from both the lenders' and taxpayers' perspectives. Taxpayers try restructuring the debt with lenders so that they can keep their property and protect their credit ratings. And, lenders do not necessarily want to foreclose on distressed property, sell it and get whatever they can for it. That could be more costly than trying to work out a deal with the taxpayers. Each lender works with the taxpayer differently. Some are willing to explore other options and others are not, so the taxpayer may not be able to control that decision.

Does anyone benefit from forgiving taxpayers' debt on distressed properties?

A reduction in the amount of debt may benefit both the taxpayer and the lender. One scenario is where the lender works with the taxpayer to reduce the balance of the debt, but in exchange, receives a partial interest in the ownership of the property or the entity that owns the property. This way, the taxpayer is able to keep the property and the debt repayment is more manageable, and the lender would share in the future profits generated from the property.

Since there are multiple scenarios with different tax consequences, it is highly recommended that taxpayers seek counsel very early in the process. <<

JACKIE MATSUMURA is a partner in the Tax Practice at Burr Pilger Mayer. Reach her at jmatsumura@bpmllp.com or (925) 296-1035.