

FINDING THE UPSIDE IN THE DOWNTURN:

Uncovering the Tax Opportunities for Distressed Real Properties



Executive Brief

- *The current economy has exposed both residential and commercial property owners to significant financial stresses, in particular Cancellation of Debt Income.*
- *The options for distressed properties usually involve a modification of the original debt obligation, often resulting in CODI.*
- *CODI can be handled in various ways to minimize its income tax consequences.*

WHAT DO WE REALLY MEAN BY “DISTRESSED?”

There's no doubt that the ownership of real property carries varying levels of stress. The loss of a major tenant results not only in a significant decline in revenues, but the lost income stream can test the resources and resourcefulness of the most astute property owner.

At some point, the options available to the property owner may be limited to those dealing with the lender. A substantial modification of the loan may become necessary in order to survive. Reducing the amount of the loan will result in Cancellation of Debt Income (CODI), an undesirable outcome. The failure to strike a deal with a lender may result in the disposition of the property by deed in lieu of foreclosure, foreclosure or forced sale.

In these last instances, a reduction of the obligations of the property owner may result in CODI.

BASICS OF CANCELLATION OF DEBT INCOME: *Pain Behind the Gain*

CODI arises from the discharge of a debt or an obligation that is not otherwise excluded from income. The main problem associated with CODI is that it generates taxable income without funds to pay any tax arising from its creation. Generally, the funds were utilized to acquire the property or the property had appreciated to the point that the owners were able to refinance and withdraw cash for other purposes. The equity that previously existed had since evaporated due to the market's subsequent crash, while the cash basis equity used for the acquisition or distribution no longer exists. Taxable income is created since liabilities have been relieved, but there is generally no cash from either a loan modification or from a disposition of the property.

The Origins of Cancellation of Debt Income

The courts long ago began to construct the concepts that resulted in the recognition of income when taxpayers realize relief from liabilities. The Supreme Court of the United States issued its landmark

opinion in 1931.¹ The Court formulated the doctrine that “the cancellation of indebtedness reflects a ‘freeing of assets’ and, therefore, ordinary income arises where there is a reduction to liabilities without a corresponding reduction in assets.” Congress followed by codifying recognition of these principles in the definition of gross income for tax purposes.²

Another aspect of the issue ruled on by the Supreme Court was the issue of recourse vs. non-recourse debt. Non-recourse debt is secured by the property only, with no recourse to borrower or borrower’s other assets. In a ruling that did not actually involve a foreclosure, the Supreme Court laid a framework involving sales of property subject to non-recourse debt.³ However, the language of the opinion was broad enough that the principle is applied in foreclosure sales.

“Generally, lenders are reluctant to be engaged until there has been an actual default on the loan.”

OPTIONS FOR PROPERTIES IN DISTRESS

When property owners are constrained from increasing rents to restore the viability of a property, they are compelled to find ways to deal with the lender. Generally, lenders are reluctant to be engaged until there has been an actual default on the loan. Once the property owner has defaulted however, negotiations can begin.

In general, all of the options in dealing with the lender amount to some form of modification of the original obligation to allow the property to reduce its cash outflow to a sustainable level. Whatever form the modification takes, it will generally result in a reduction of the debt amount which leads to CODI. The most common options are a workout arrangement with respect to the loan or a disposition of the property that will satisfy the obligation, such as a short sale, a foreclosure, a deed in lieu (of foreclosure), or abandonment.

Other than a sale or sale for the amount of the debt, CODI arises from any transaction where the debt is reduced. The actual forgiveness of the obligation occurs when it becomes evident that the debt will never be repaid.⁴

“CODI arises from any transaction where the debt is reduced.”

A reduction of debt through a workout will always result in CODI. This is the case regardless of whether the obligation is recourse or non-recourse.

A sale of property subject to a recourse debt will create CODI to the extent that the amount of the obligation exceeds the fair market value of the property. A sale of property, foreclosure, or deed in lieu of foreclosure involving non-recourse debt will not result in CODI.⁵

A short sale is essentially a hybrid transaction involving a reduction of the debt and a sale of the property. Since the transaction has two parts, the principle stated in the Tufts case does not apply.

Workouts: Property Retention

A workout is any transaction that involves a modification of the original loan. A modification occurs whenever any legal right or obligation of the issuer or holder of the loan is altered in any way, either in whole or part, regardless of whether the alteration is evidenced by an express agreement, conduct of the parties, or otherwise. A “significant modification” occurs when the legal rights or obligations are altered and the degrees to which they are altered are economically significant. To the extent that the terms of the original loan are “significantly modified,” the debt before the modification is deemed to have been exchanged for the modified debt. As such, the deemed exchange can result in detrimental tax consequences such as CODI to the issuer or phantom gain or loss to a holder will if there are differences between the issue price of the modified debt and the adjusted issue price of the debt before modification.⁶ Workouts which are considered significant modifications include, but are not limited to, the following:

- A change in yield if the change exceeds 25 basis points (0.25%) or 5% of the unmodified instrument’s original yield, whichever is greater,
- A modification in the due date of any payments if the modification results in material deferral of any scheduled payments. Material deferral results only if payments can be made after the expiration of the safe-harbor period. The safe-harbor period begins on the original due date of the first scheduled payment that is deferred and extends for a period equal to the lesser of five years or 50% of the original term of the instrument,
- Changes in the obligor with exceptions such as an acquisition or asset purchase of the original borrower,
- The addition or deletion of a co-obligor, if as a result of the addition or deletion, that results in change in payment expectation,
- Change in security or credit-enhancement,
- Changes in the priority of the instrument,
- Conversions of debt to equity,
- Change in the nature of the debt, such as recourse to non-recourse.

A workout offers several advantages, both tax and economic. First, a workout allows property owners to retain their property. The owner may also avoid CODI and gain/loss if the modifications avoid reduction of the debt or changes so significant that they meet the exchange benchmark. Particularly for individuals, specifically homeowners, workouts may permit them to comply with the revised terms, thus maintaining their credit rating. Cancellation of unpaid interest will not result in CODI for cash-basis taxpayers since no deduction has been taken for the interest. However, any discharge of lender's attorney/collection/trustee fees will result in CODI.

Sales, Foreclosures & Deeds in Lieu of Foreclosure: Property Disposition

A sale, foreclosure, or deed in lieu of foreclosure, results in a termination of the obligation, but with a loss of the property. Generally, CODI can be avoided with any of these transactions as long as the debt secured by the property is non-recourse. In a foreclosure sale or a transfer of a deed in lieu of foreclosure, the property, if encumbered by non-recourse debt, is deemed sold for the amount of the debt only and no other consideration. As such, there is no CODI since the debt is considered fully satisfied upon the return of the property. However, if the property is encumbered by recourse debt, CODI will be the amount of debt that exceeds the fair market value of the property.

Mortgage loans on a taxpayer's principal residence are generally non-recourse, but the taxpayer should be aware that refinancing, where the borrower has received cash, will change the character of the debt to recourse. Commercial financing may be non-recourse, but property owners should check their loan documents to confirm the character of the debt.

Example: Building owner A has a property with an original basis of \$10,000,000 and an adjusted basis after depreciation of \$9,000,000. The property is secured by a non-recourse, interest-only \$7,500,000 loan used to acquire the property. The owner has defaulted on the loan and has been unable to arrive at an agreement with the lender so the lender foreclosed on the property in a non-judicial foreclosure. At the time of the foreclosure, the fair market value of the building was \$6,000,000. Based on the loan documents, the loan was non-recourse. The owner recognizes a loss on the sale of \$1,500,000 and no CODI (proceeds of \$7,500,000 less adjusted basis of \$9,000,000). The fair market value of the property is irrelevant.

“...the taxpayer should be aware that refinancing, where the borrower has received cash, will change the character of the debt...”

Analysis: Had the loan been a recourse obligation, the difference between the outstanding loan and the fair market value of the property would have created CODI of \$1,500,000 and the proceeds would have been the fair value of the property resulting in a loss of \$3,000,000. While the economic consequences

are the same, the tax result would have been different. As long as the property was subject to depreciation, both the CODI and the loss are ordinary. For some taxpayers, the character of the gain/loss may be capital in nature.

Short Sales: Hybrid Transactions

A short sale is a sale of the property to a third party for its fair market value with lender approval. Unlike a sale or foreclosure sale, a short sale will generate CODI. The lender's approval is required in these arrangements since the lender will be shorted on the payoff of the loan, agreeing to take the net proceeds in satisfaction of the debt.

While not entirely clear, the transaction is deemed to be bifurcated into a reduction of the obligation to its fair market value and then a sale of the property if the obligation was recourse. The result will produce ordinary income from the realization of CODI and a gain or loss on the sale of the property. It is possible that a short sale produce very negative results; on one hand CODI, and on the other, a capital or non-deductible loss.

Example: Assume a taxpayer purchased a residence in 2006 for \$800,000 subject to an interest-only first recourse mortgage of \$640,000. In 2009, when the economy forced the taxpayer into a situation where he/she had to arrange with the lender for a short sale, the home was worth \$550,000. The home was sold for the fair market value of \$550,000 with the approval of the lender. The lender received the net proceeds of the sale (consideration less expenses of the sale), which amounted to \$530,000. The homeowner realized CODI of \$110,000 as a result of the short sale. The sale transaction results in a loss of \$270,000 (consideration of \$550,000 less basis of \$800,000 less expenses of the sale of \$20,000). Since a residence is a personal asset, the loss would be nondeductible.

Analysis: In the case of the short sale of property encumbered by non-recourse debt, the debt cancellation is included in the sales proceeds, similar to a foreclosure.⁷ Therefore, the taxpayer would realize a loss on sale of \$160,000 and no CODI would be realized.

While short sales are less common with commercial or investment property, the result of the foregoing example is an economic loss, but the tax result mirrors that loss. In the case of property encumbered by recourse debt, the short sale still results in CODI, but the loss on the property will be deductible. The problem with investment property is that the loss may have to be treated as a capital loss, which cannot be used to offset ordinary income like CODI.

Abandonment: Exiting the Scene

Another strategy for exiting a distressed property is abandonment. Abandonment, similar to foreclosure, is treated as a disposition and is generally recognized as a loss under IRC §165. The use of abandonment as an exit strategy, however, is not without risk. It is up to the taxpayer to prove abandonment has actually occurred and the cases are not all taxpayer-favorable. There is also the risk that an abandonment involving the release of liabilities may still be treated as a gain. If considering this alternative, the property owner should consult with its legal and tax advisor.

TAKING ACTION: *What To Do With It Now That You've Got It*

When income is realized as a result of a loan modification, there are ways that taxpayers can often find to soften the blow. When CODI arises, taxpayers can generally manage CODI in three ways:

- Use it,
- Exclude/defer it, and/or
- Create a firewall to block it.

The solution to reduce the impact of CODI in a particular case may involve one or more of the above approaches to reduce the impact of CODI. The approach that is most effective will depend on the financial state of the property owner as well as the owner's tax status.

Option #1: Using CODI Currently

Once CODI has been realized, it is included in the gross income of the taxpayer unless otherwise excluded under IRC §108. If realized and recognized in income, the character of CODI is ordinary. If CODI arises from a Passive Activity, current or suspended passive losses may offset the income recognized. This would be the case for most property owners who own rental property since rental activity is a Passive Activity. If the property owner still has CODI after the utilization of passive losses, Net Operating Losses may be utilized to offset regular tax. Alternative Tax Net Operating Losses (AMT NOL's) are limited to 90% of the Alternative Minimum Minimum Taxable Income. Any excess income (net of the exclusion, if any) will be subject to the Alternative Minimum Tax. Since CODI is ordinary in character, it cannot be offset by Capital Loss Carryforwards.

"The main means of excluding CODI is provided by IRC §108."

Option #2: Certain Exclusions Apply

The main means of excluding CODI is provided by IRC §108. When CODI arises, if there are no means of currently offsetting the income, a taxpayer may exclude CODI under §108 to prevent current recognition of the income or take advantage of some of the exclusions that are available to the taxpayer.

Bankruptcy and Insolvency Exclusions

Bankruptcy Title 11 cases have the broadest ability to exclude CODI, followed by insolvency cases. Under the Code, cases in bankruptcy have priority over all other instances. Insolvency takes precedence over exclusions for solvent taxpayers. In the case of an insolvent taxpayer, the amount excluded from taxable income is limited to the taxpayer's insolvency (the excess of liabilities over the fair market value of assets).

“Insolvency takes precedence over exclusions for solvent taxpayers.”

When bankrupt or insolvent taxpayers exclude CODI from income under §108, they are required to reduce their tax attributes in the following order:

- 1] Net Operating Losses. The first reduction is applied against any net operating loss for the taxable year of the discharge, and any net operating loss carryover to such taxable year.
- 2] General Business Credit. If the NOLs are not sufficient to absorb the CODI, it is applied next against any general business credit carryover to or from the taxable year of the discharge of an amount for purposes of determining the amount allowable as a credit under IRC §38 (relating to general business credit).
- 3] Minimum tax credit. The amount of the minimum tax credit available under IRC §53(b) as of the beginning of the taxable year immediately following the taxable year of the discharge.
- 4] Capital loss carryovers. Any net capital loss for the taxable year of the discharge, and any capital loss carryover to such taxable year under IRC §1212.
- 5] Basis reduction. The basis of the property of the taxpayer. How the reductions are determined are controlled by IRC §1017.
- 6] Passive activity loss and credit carryovers. Any passive activity loss or credit carryover of the taxpayer under IRC §469(b) from the taxable year of the discharge.
- 7] Foreign tax credit carryovers. Any carryover to or from the taxable year of the discharge for purposes of determining the amount of the credit allowable under IRC §27.

The reduction amount for each of the listed attributes is dollar-for-dollar except for the General Business Credit, Minimum Tax Credit, and the Foreign Tax Credit carryovers. In these cases, the reduction amount is 33 1/3 cents for each dollar of exclusion.

While the waterfall of attribute reductions strictly follows the order above, taxpayers may also elect to first reduce the basis of depreciable property using the rules in IRC §1017. The reduction is limited to the amount of adjusted basis of the taxpayer’s depreciable assets as of the first day of the tax year following the year of the discharge. Any amount used to reduce property basis will not apply to the reduction of other tax attributes.

Example: An insolvent property owner arranges a loan modification to reduce the balance owed on a property by \$1,000,000. The owner has a \$500,000 Net Operating Loss, no minimum tax credit available, other depreciable business property with an adjusted basis of \$5,000,000, suspended passive activity losses of \$400,000, and no foreign tax credit carryovers. At the time of discharge, the property owners’ liabilities exceed the fair market value of his assets by \$625,000. Therefore, the tax attributes of the property owner should be as follows:

Amount of Discharged Indebtedness:	\$625,000
Less: Reduction in NOL:	(\$500,000)
Less: Reduction in Basis of Other Property:	(\$125,000)
Remaining Discharged Indebtedness:	<u>(\$ 0)</u>

Analysis: There is also the matter of the \$375,000 of CODI that cannot be excluded under the insolvency exception. This amount of CODI can be excluded in conjunction with the other exclusions available to a solvent taxpayer.

Discharge of Qualified Real Property Business Indebtedness

The Qualified Real Property Business Indebtedness (QRPBI) exclusion is probably the one tool most likely to be used by owners of commercial property seeking to manage CODI from a discharge of indebtedness. It is less onerous than the process of going through bankruptcy proceedings and may be used in conjunction with the insolvency exclusion. To the extent insolvency is eliminated by a discharge, a taxpayer can use the excess if the debt qualifies as QRPBI. If the taxpayer elects to utilize the QRPBI exclusion, the CODI excluded shall be applied to reduce the basis of depreciable property held by the taxpayer. However, there are strict limitations to which property owners must adhere, both in qualifying and in applying the basis reductions available under IRC §1017. The QRPBI exclusion is not available to C Corporations.

“The QRPBI exclusion is probably the one tool most likely to be used by owners of commercial property seeking to manage CODI from a discharge of indebtedness.”

QRPBI is debt incurred or assumed in connection with real property used in a trade or business and secured by such real property. The taxpayer elects to have the exclusion apply.⁸ Debt incurred after 1993 qualifies for this exclusion only if considered qualified acquisition indebtedness (i.e. debt incurred in order to acquire, construct, reconstruct, or substantially improve property). QRPBI does not include indebtedness except to the extent of the qualified acquisition debt that has been refinanced.

The Code also imposes dollar limitations on the amount of QRPBI. The amount of QRPBI is limited to the amount of debt (before the discharge) which exceeds the fair market value of the real property secured by the debt before the discharge. The amount excluded may not then exceed the total adjusted basis of the depreciable property of the taxpayer to be reduced. Furthermore, the reduction in basis is treated as depreciation so that on disposition of the property, the amount reduced will be recaptured as ordinary income.⁹

Example: A property owner has lost a major tenant that occupied half the office space of a building and can no longer fund the losses. The property has an adjusted basis of \$2,500,000, of which \$500,000 represents the basis of the land. The fair market value of the property is \$2,750,000. The property has a first mortgage with a remaining balance of \$2,000,000 and a second mortgage from a refinance of \$1,000,000. As a result of the revenue decline, the property owner reached an agreement with the lender to reduce the balance of the second mortgage to \$500,000, which will result in Cancellation of Debt Income. There is sufficient depreciable basis to exclude the full amount of the discharge; however, the property owner will be able to exclude only \$250,000 of the discharge from income since the amount of the debt before discharge in excess of the fair market value of the property is \$250,000. The balance of the discharge will be recognized as income unless the property owner is insolvent to the extent of the remainder or a greater amount.

Analysis: Since the QRPBI exclusion is elective, effective tax planning must consider whether there are sufficient tax attributes to exclude the discharge. If the property owner was insolvent and had Net Operating Loss Carry forwards or Passive Activity Loss Carry forwards that were not sufficient to exclude the full amount of the discharge, the QRPBI exclusion could work in conjunction with the insolvency exceptions to defer the full amount of the discharge.

INDEBTEDNESS

Discharge of Principal Residence Indebtedness

A provision of the Code was enacted to assist homeowners deal with the impact of the credit crunch. Under these revised rules, a homeowner is allowed to exclude up to \$2,000,000 of qualified acquisition indebtedness. It does not apply to any amount of refinanced debt over the amortized balance of the

mortgage used to acquire the property (or construct or improve). If the refinanced debt is forgiven, then the amount of refinanced debt above the qualifying amount will have to be recognized as income or excluded using another one of the exemptions provided by §108. The owner applies the exclusion by reducing the basis of the principal residence in the year the debt is discharged, but only up to the basis of the property. While originally applicable only to discharges that took place before January 1, 2010, Congress has extended the provision to apply to discharges that occur prior to January 1, 2013.

A homeowner's exclusion of debt as principal residence applies before the insolvency exception unless the homeowner elects the reverse application.

Example:¹⁰ In 2003, an individual taxpayer bought a main home for \$315,000. The taxpayer took out a \$300,000 mortgage loan to buy the home and made a down payment of \$15,000. The loan was secured by the home. In 2004, the taxpayer took out a second mortgage loan in the amount of \$50,000 that he used to add as a garage to his home.

In 2004, when the outstanding principal on the first and second mortgage loans was \$325,000, the taxpayer refinanced the two loans into one loan in the amount of \$400,000. The fair market value of the home at the time of the refinancing was \$430,000. The taxpayer used the additional \$75,000 in debt proceeds (\$400,000 new mortgage loan minus \$325,000 outstanding principal balance of the taxpayer's first and second mortgage loans immediately before the refinancing) to pay off personal credit cards to pay college tuition for his daughter.

After the refinancing, the taxpayer's qualified residence indebtedness is \$325,000 because the debt resulting from the refinancing is qualified principal residence indebtedness only to the extent that it is not more than the old mortgage principal just before the refinancing.

Discharge of Qualified Farm Indebtedness

Under §108, there is also an exclusion for Qualified Farm Indebtedness (QFI). Unlike the QRPBI exclusion, the exclusion for discharge of Qualified Farm Indebtedness is applied through attribute reduction. The insolvency exclusion takes precedence over the exclusion for QFI such that a taxpayer who has exhausted the insolvency exclusion can then utilize the exclusion for discharge of QFI.

The Code imposes three requirements to be eligible for the discharge of QFI:

- The discharge of the qualifying indebtedness must be made by a qualified person, regularly engaged in the business of lending and not related to the debtor.¹¹

"A homeowner's exclusion of debt as principal residence applies before the insolvency exception unless the homeowner elects the reverse application."

- The debt must have been incurred directly in connection to the business of farming,
- Fifty percent or more of the taxpayer’s gross receipts must have been attributable to the business of farming for the three tax years prior to the year of the discharge.¹²

If these qualifications are met, then the taxpayer can exclude Qualified Farm Indebtedness to the extent of the taxpayer’s tax attributes plus the adjusted basis of qualifying business property. One interesting aspect of what constitutes qualified property is that there is no requirement that it be used in farming, but may be for any trade or business or for the production of income. This particular exception may be particularly helpful to vineyard owners who may also be able to reduce the basis of business property from wineries as well as the vineyard. In applying the exclusion, the reduction must first be applied to the taxpayer’s tax attributes, in the order prescribed by §108(b), and then to qualifying property. While qualifying property includes property other than for farming, the ordering rules will still tend to reduce farming property ahead of other trade or business property.

“One interesting aspect of what constitutes qualified property is that there is no requirement that it be used in farming, but may be any trade or business or for the production of income.”

Discharge of Seller-Financed Indebtedness

A special rule exists under §108 to exclude the discharge of Seller Financing as a purchase price reduction of the property securing the debt. This exception applies only to solvent taxpayers and applies only if the amount of the reduction would otherwise be treated as income from the discharge of debt.¹³ Unlike other exceptions under §108, the exception for the reduction in purchase price is mandatory rather than elective.

This exception had judicial basis before Congress made it statutory in the Bankruptcy Tax Act of 1980. In some of the decided cases, the debt did not have to be purchase money debt, but could be third party debt that was part of the transaction to acquire the property. The terms included in the Code, however, clearly apply only to seller-financed debt. In that same regard, the Committee Reports also eliminate situations where: 1) the seller has assigned the debt and is no longer the mortgagor, 2) the original debtor transferred the property, or 3) the debt is reduced as a result of circumstances other than direct agreement between the buyer and the seller.

Recent Legislation: Deferring Business Indebtedness

Congress added §108(i) to the Code under the American Recovery and Reinvestment Act of 2009 as a response to the economic crisis. This provision, which allowed for the deferral of CODI realized in connection with a “reacquisition” of an “applicable debt instrument” after December 31, 2008 and before

January 1, 2011, has since expired. While it is uncertain whether this type of deferral will be made available for years 2011 and beyond, a description of the provision follows.

An “applicable debt instrument” is any debt instrument issued by a C corporation or by any other person in connection with the conduct of a trade or business by that person.¹⁴ “Reacquisition” generally means any acquisition of an applicable debt instrument by the debtor, or a person related to the debtor. The term “acquisition” includes: 1) a purchase of a debt instrument for cash, 2) the exchange of the debt instrument for another debt instrument, 3) the exchange of the debt instrument for corporate stock or a partnership interest, 4) the contribution of the debt instrument of capital of a corporation or partnership, and 5) the complete forgiveness of the indebtedness by the holder of the debt instrument.¹⁵

If an election has been made, then CODI is included ratably over a five tax-year period beginning with (1) the fifth tax year following the year in which the reacquisition occurs during the 2009 tax year or (2) the fourth tax year following the tax year in which the reacquisition occurs during the 2010 tax year.

Special Considerations for Partnerships and S Corporations

The comments and observations above have all made reference to the taxpayer. The primary reason for this approach to examining the exclusions of §108 is that a partnership realizes the CODI from the debt discharge, but the taxability of CODI is determined by the partner.¹⁶ Since much of U.S. commercial real estate is held in partnership form, this one particular section is the basis for much of the planning that must be done as a result of the realization of CODI. The insolvency of the partnership or LLC is irrelevant to the partners. The partnership or LLC must also account for the allocation of the CODI, taking into account the partnership allocation rules under the §704(b) regulations and any pre-contribution gain on property contributed to the partnership. It is the competing interests of the individual partners that creates the challenge.

While the exclusions under §108 are taken into account by the partners in a partnership, the §108 exclusions apply at the corporate level in an S Corporation. Exclusion resulting from bankruptcy, insolvency, Qualified Real Property Business Indebtedness and Qualified Farm Indebtedness are all applied at the corporate rather than the shareholder level. Similarly, an election under new §108(i) must be made at the corporate level.

Option #3: Creating Firewalls

A firewall is used as a means of blocking the advance of disaster. In the context of debt discharge, the disaster is CODI that is taxable to the property owner or partner who receives an allocation of CODI

because exclusions are not available or are not sufficient to offset the income created. If a taxpayer faces the prospect of such a circumstance, the planning changes focus from using or deferring to avoiding CODI. The structural changes to an existing entity listed below may avoid CODI or the realization of taxable income from CODI.

Admitting a New Partner

The admission of a new partner to a partnership or LLC with a significant cash contribution may be difficult to accomplish, but the additional cash may be sufficient to get the partnership through the crisis and forestall the default that would precede a workout or sale of the property. Admitting a new partner is a non-taxable event, but there are additional tax considerations that may have an effect on the partnership allocations. In order to acquire a new partner, the property must still retain sufficient value to attract an additional investor. The bottom line remains the avoidance of CODI.

Admitting Lender as Partner

The admission of the lender as a partner or shareholder in exchange for an interest in the entity is an exchange generally treated as a non-taxable transaction; however, the stock for debt exchange still carries a risk that CODI may be generated. Under the Code, if the fair market value of the stock or partnership interest is less than the amount of debt being discharged, the excess is CODI.

Pass-Through Entity

A third possible alternative is to incorporate a pass-through entity to elect corporate status in order to absorb the impact of a discharge. Since the taxation of CODI is realized by a person paying taxes, it may be possible to insert a taxpaying entity between the property and a taxpayer who may not have the ability to absorb the CODI created. This option should be based on a solid business purpose in order for the conversion to a corporation to not be treated as a tax avoidance transaction.

White Knights to the Rescue

The 'White Knight' option to avoiding a debt discharge can be used, if available. It involves transferring the debt to a "friendly party," who may then be able to purchase the loan from the lender and assist in restructuring the loan payments. The ability to purchase the loan at a discount allows the subsequent note holder more flexibility in negotiating new terms. One consideration in restructuring with a subsequent purchaser is that a note modification may be regarded as an exchange creating taxable gain. Care should be exercised if a related third party is involved (see your legal or tax advisor).

CONCLUSION

The effects of debt discharge are complex and, as noted above, the solutions are varied and complex as well. Sifting through the many opportunities, there is likely an option that will help most taxpayers avoid the trap of taxable income realized from discharge of debt with no funds to pay the tax. Given its complexity, it is a process that should involve the taxpayer's CPA or attorney.

1] U.S. v. Kirby Lumber (1931) 284 U.S. 1.

2] I.R.C. §61(a)(12).

3] Tufts v. Comm'r (1983) 471 U.S. 300.

Justice Blackmun: "When a taxpayer sells or disposes of property encumbered by a nonrecourse obligation, the Commissioner properly requires him to include among the assets realized the outstanding amount of the obligation. The fair market value of the property is irrelevant to this calculation."

4] U.S. v. Kirby Lumber (1931) 284 U.S. 1, 76 L. Ed. 131, 52 S. Ct. 4.

5] Ruling 91-31, 1991-1 CB 19, Instances where the sale involves a negotiated reduction of debt, however, may still create CODI.

6] Treasury Regulation §1.1001-3, **Modifications of Debt Instruments**. Under a complex set of rules, a determined significant modification results in an exchange of notes that may result in gain or loss on the exchange as determined under Reg. §1.1001-1(a).

7] Briarpark v. Commissioner (1999)163 F. 3d 313.

8] I.R.C. §108(c)(5).

9] I.R.C. §1017(d)(2).

10] I.R.S. Publication 4681.

11] I.R.C. §108(g)(1).

12] I.R.C. §108(g)(2).

13] I.R.C. §108(e)(5).

14] I.R.C. §108(l)(3).

15] I.R.C. §108(l)(4).

16] I.R.C. §108(d)(6).

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