REAL ESTATE DEBT RESTRUCTURING ("WORK-OUTS") AND FORECLOSURES: SELECTED TAX CONSEQUENCES

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Discussion Hypothetical

The Borrower, an LLC taxed as a partnership, has incurred debt to finance an income-producing property.

The Lender underwrote the debt on the basis that the anticipated net operating income (NOI) from the LLC’s improved real property could service principal and interest.

But, as a result of economic conditions beyond the Borrower’s control, NOI is insufficient to pay both operating expenses and debt service.

As a result, the debt must be restructured through a “work-out” or the property must be transferred to the Lender in full satisfaction of the debt by a “deed in lieu” or foreclosure.

Bankruptcy, another solution, is beyond the scope of this discussion.

A work-out is a modification of the essential terms of a debt in order to allow the loan to return to a “no default” status.

Typically, a work-out is achieved by the Lender and Borrower agreeing to either –

- A reduction in principal,
- A reduction in the nominal interest rate or
- A conversion of (mezzanine) debt to equity.

Reduction in Principal

Generally, any reduction of the principal amount of a debt creates cancellation of indebtedness (COD) income.

The theory is that if a lender has given a borrower money that the borrower does not have to pay back, the money is taxable as income to the borrower.

COD income is taxable as ordinary income because it does not involve the sale of a capital asset.

Thus a reduction in loan principal is, subject to numerous exceptions, an income-producing event.

But, in tax law, there are always exceptions.

Reductions in principal are almost always the result of economic distress. It seems odd, and to some unfair, to tax someone who has encountered that distress.

When tax theory meets political reality, exceptions are created and complexity and confusion follow.

<u>Reduction in Purchase Price</u>. The reduction in principal may be treated as a reduction in the purchase price of property.

- The debt must be purchase money indebtedness.
- The basis of the property must be reduced to reflect the reduced purchase price.
- The borrower must be solvent.
- The transaction must be between the original buyer and seller.

Insolvency. COD income does not arise if the debtor is insolvent at the time of principal reduction.

- A distressed SPE taxed as a separate entity should be considered insolvent if the value of its assets is insufficient to discharge its indebtedness and its NOI is insufficient to pay both operating expenses and debt service. For an SPE taxed as either a disregarded entity or a partnership, insolvency is tested at the owner level.
- The principal reduction cannot be greater than the amount by which the debtor is insolvent.
- The Borrower’s tax attributes (asset basis, net operating losses (NOLs), NOL carryovers, tax credits) are reduced by the amount of the debt reduction.

<u>Qualified Real Property Business Indebtedness</u>. A *solvent* borrower may *elect* to exclude COD income in limited circumstances.

- The real property must be used in a business and secure the debt.
- The debt must be "qualified acquisition indebtedness" (that is, limited to the debt incurred to acquire or construct real property) but may include refinanced debt (not exceeding original acquisition debt).
- Exclusion cannot exceed the property's adjusted tax basis and is limited to the amount that the property is "under water."
- Basis of property must be reduced by the excluded COD income.

Note

The reduction in “tax attributes” – basis, NOLs, NOL carryovers, tax credits – means that the exclusion of COD income is not a permanent tax savings.

Rather, the tax impact is deferred until the property is sold (with a lower basis) or until the taxpayer realizes income in the future that will not be offset by the “lost” NOL carryovers or tax credits.

A Trap for the Unwary

While the concept of a reduction in principal amount seems self-evident, in tax law it is not always easy to determine whether or when such a reduction has occurred.

Suppose, instead of reducing principal, the Lender and Borrower agree simply to reduce the interest rate to a level that the NOI is adequate to cover both operating expenses and debt service (interest only).

The parties' agreement is documented by an amended note and loan agreement.

A Trap for the Unwary

A “significant” modification of the interest rate on an indebtedness is, for tax purposes, the creation of a new debt instrument.

- An interest rate change greater than the greater of 25 basis points or 5% of pre-modification annual rate are deemed “significant.”

The “new” debt is then deemed exchanged for the “old” debt.

The “exchange” is taxable to the borrower if the value of the “new” debt is less than the value of the “old” note.

The value of the new debt is determined by the general tax rules for valuing debt, including, if applicable, the “original issue discount” (OID) rules that apply time value of money concepts to determine present value where the debt does not provide for “adequate stated interest” (that is, the “applicable federal rate”).

Conversion of Debt to Equity

Often real estate is financed with more than one level of debt.

Mezzanine debt may be advanced to the members of an LLC or partnership and invested by the owners in the property.

The debt is secured by a pledge of the members’ or partners’ ownership interests.

A work-out of mezzanine debt may entail a conversion of that debt to equity.

Conversion of Debt to Equity

Normally, the exchange of property (i.e., the mezzanine note) for a partnership interest is a nontaxable transaction.

But if the value of the debt exceeds the value of the partnership interest received in the exchange, income, including COD income, may result. This may occur in an SPE where the only asset has limited value.

To provide enough value to the interest transferred in exchange for the debt, the equity interest can be given preferences effectively absorbing all of the available value of the underlying property.

This is a poorly developed area of tax law; results may be unpredictable.

Deeds in Lieu or Foreclosure

There are times and circumstances that make a work-out impossible or impractical. Bankruptcy is rarely a solution for an SPE.

At those times and in those circumstances, the property will be transferred to the lender in satisfaction of the debt.

The tax consequences of a deed in lieu or foreclosure are affected by the value of the property, the asset being exchanged (SPE interests or the property itself), and the nature of the debt (recourse or nonrecourse).

The transfer will be deemed a taxable sale and capital gain is recognized on the difference between the face amount of the debt (if nonrecourse) and the property's tax basis or on the difference between the value of the property (if recourse) and the property's tax basis.

In general, that income is allocable to the members or partners who derived tax benefit from the inclusion of the non-recourse debt in the basis of their partnership interests, allowing the pass-through of partnership losses and/or the distribution of nontaxable cash.

If recourse debt, COD may apply in addition to any capital gain triggered.

Thus, careful tax planning may be essential if a deed in lieu or foreclosure is inevitable.

If COD exceptions are available for recourse debt, substantiating a value equal or near to the basis of the property will eliminate or minimize taxable gain.

If COD exceptions are not available, recognition of greater value (capital gain) and less COD income (ordinary income) is desirable, especially if the taxpayers have useable capital losses.

If the debt is non-recourse debt, the availability of capital losses should be considered to offset the capital gain on disposition.

If little or no capital losses are available, steps to enhance the taxpayers' bases in their partnership interests should be considered to limit minimum gain.

This can be accomplished by –

- tiered partnerships including disregarded entities (to protect assets of "good" partnerships from claims of "bad" ones)
- aggregating basis by additional capital contribution, "bottom guarantees" or additional borrowings.

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Section 61

Section 108

Section 1001

Treas. Reg. § 1.61-12

Treas. Reg. § 1.108-6, -7

Treas. Reg. § 1.1001-2, -3

Rev. Rul. 90-16, 1990-1 CB 12

Rev. Rul. 91-31, 1991-1 CB 19