

Unraveling the Mystery of Cancellation of Indebtedness Income

What Borrowers Need to Know of the Potential Tax Costs of Loan Workouts and Foreclosures

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ABOUT THIS WHITE PAPER:

Owners of commercial real estate have faced significant challenges over the past several years. For many owners, the receipt of a notice of foreclosure will cause the owner to focus on the possible loss of his or her entire investment in the property. However, in many cases, these owners quickly discover that the more pressing issue in a foreclosure situation is how the owner will fund the tax costs that will arise if the property is lost to foreclosure.

The Borrower's Tax Consequences in a Foreclosure

The mechanics of foreclosure are specific to the laws of the State in which the property is located. In general, in a foreclosure, the court will order the issuance of a sheriff's deed to the owner of the underlying loan. For Federal income tax purposes, this transfer of title is treated as if the borrower sold the real estate that secured the loan to the recipient of the sheriff's deed.

If the selling price deemed to have been paid in the foreclosure is less than the borrower's adjusted tax basis in the property, the borrower will recognize a taxable loss on the foreclosure. In contrast, if the selling price deemed to have been paid in the foreclosure exceeds the borrower's adjusted tax basis, the borrower will recognize a taxable gain in connection with the foreclosure. In a foreclosure, the amount that the property is deemed to have been sold will depend upon whether the loan is treated as "recourse" debt for purposes of Section 1001 of the Internal Revenue Code of 1986, as amended (the "Code") or as "non-recourse debt."

i. Determining the Selling Price in the Foreclosure - Non-Recourse Loans

If the creditor's remedies are limited to specified collateral under the loan documents, the loan should be treated as non-recourse debt for purposes of Code Section 1001. The existence of "bad boy" carve-out guarantees that typically accompany a CMBS loan should not cause a loan to become a recourse loan for purpose of Code Section 1001. On the other hand, a loan that is secured by a mortgage on the sole asset of a limited liability company will likely not be treated as non-recourse debt for purposes of Code Section 1001 if some or all of the members of the limited liability company have provided a personal guarantee of loan. In a foreclosure, if the loan is treated as non-recourse debt for purposes of Code Section 1001, the borrower will be treated as having sold the underlying real estate for an amount equal to the greater of (x) the unpaid principal balance of the loan or (y) the real estate's fair market value.

ii. Determining Whether Taxable Gain Arises in the Sale

Calculating the amount of taxable gain or loss that will arise in the foreclosure is based upon whether the price at which the property is deemed to have been sold exceeds the borrower's adjusted tax basis in the property. The first step in making this determination is to confirm whether the borrower acquired the property using like-kind exchange proceeds or not.



If the acquisition of the property was not part of a prior like-kind exchange, the adjusted tax basis of the property will equal the acquisition cost of the property less depreciation deductions claimed to date. In the case of a borrower who acquired the property using like-kind exchange proceeds, the calculation of the borrower's adjusted tax basis in the property is more complex.

If property that is deemed sold in a foreclosure was acquired as part of a prior like-kind exchange, the borrower's tax basis in the property is not based upon the borrower's cost incurred to acquire the property. Instead, the taxpayer will have a "carryover" tax basis, which is measured with reference to the sum of (a) the taxpayer's tax basis in the property relinquished in the like-kind exchange, plus (b) any gain recognized by the taxpayer on the like-kind exchange, plus (c) the positive difference between the loan on the replacement property at the time of its acquisition and the loan on the relinquished property at the time of the prior exchange. For purposes of determining the amount of gain or loss that will arise in the foreclosure, the adjusted tax basis will be the "carryover" tax basis reduced by depreciation deductions claimed to date.

Example

Tax Costs Arising from the Foreclosure - Non-Recourse Debt

The Acme Opportunity Fund, LLC (the "Fund") acquired a suburban office building for \$20 million. The Fund formed a single member LLC ("Propco") to hold the title to the property and to act as the borrower under the \$16 million acquisition loan. The Fund raised the remaining purchase price from investors who were issued membership interests in the Fund in exchange for their cash contributions. (No like-kind exchange proceeds were involved in the acquisition).

In 2009, several tenants elected not to renew their leases and the Fund was unable to fund current payments required under the mortgage loan. In 2011, the lender foreclosed on the mortgage and issued a sheriff's deed to the property. At the time of the foreclosure, the fair market value of the property was \$10 million and the principal balance remaining on the mortgage loan was \$12 million. Because of depreciation deductions claimed by the Fund (and that were allocated to the investors), the tax basis of the property was reduced to \$11.4 million. If the mortgage loan is treated as non-recourse debt for purposes of Code Section 1001, Propco will be treated as selling the property for an amount equal to \$12 million, the amount of unpaid principal owed under the loan.

Under these facts, the taxable gain arising from the foreclosure is \$600,000 (\$12 million - \$11.4 million). If the loan was treated as non-recourse debt for purposes of Code Section 1001, no cancellation of indebtedness income arises from the foreclosure.



iii. Determining the Applicable Tax Rate

If the foreclosure results in taxable gain, the tax rate that applies to this gain will be based upon whether the amount of this gain exceeds the accumulated depreciation deductions claimed by the borrower. If the amount of taxable gain is equal to or less than the accumulated depreciation deductions, all of the gain will be subject to federal income tax at the applicable depreciation recapture rates, which currently range from 25% to 35%. If the taxable gain arising from the foreclosure exceeds the accumulated depreciation deductions claimed by the borrower, this excess is subject to federal income tax at the capital gain rate, which is generally imposed at a flat 15% rate. (The remaining portion of the gain will be subject to federal income tax at the applicable depreciation recapture rates referenced above.)

Based upon the facts of the example above, because the \$600,000 of taxable gain arising from the foreclosure is less than the amount of accumulated depreciation, this taxable gain will be subject to tax at the rates that apply to depreciation recapture (35% on recapture of depreciation on personal property and 25% on the recapture of depreciation on real property).

If, for purposes of this example, all of the prior depreciation deductions claimed by the Fund were from the depreciation of real property, the investors would face the following tax costs in connection with the foreclosure:

Taxable Gain **\$600,000** X Effective Tax Rate **25%** = Total Tax Cost **\$150,000**

iv. The Borrower's Tax Consequences of Foreclosure – Recourse Loans

If the loan is treated as recourse debt for purposes of Code Section 1001, the tax consequences arising from foreclosure are somewhat different than those previously described. Specifically, if the loan is treated as recourse debt for purposes of Code Section 1001, the borrower will be treated as having sold the underlying real estate for an amount equal to the real estate's fair market value. In addition, if the fair market value of the real estate is less than the amount owed under the loan, this shortfall will cause the borrower to recognize cancellation of indebtedness income, which is subject to federal income tax at ordinary rates. Thus, unlike in the case of a foreclosure involving non-recourse debt, in a foreclosure involving recourse debt, there are two potential transactions for federal income tax purposes: (a) a deemed sale of the property for its then fair market value and (b) the forgiveness of any remaining amount of principal that remains unpaid after the foreclosure. *See example on page 4.*



Example

Tax Costs Arising from the Foreclosure – Recourse Debt

Using the facts from the prior example, if the mortgage loan is treated as recourse debt for purposes of Code Section 1001, Propco will be treated as selling the property for an amount equal to \$10 million, which is the fair market value of the property. As a result, no taxable gain would arise from the foreclosure. Instead, there would be a taxable loss of \$1.4 million (\$10 million - \$11.4 million). However, if the loan was treated as recourse debt for purposes of Code Section 1001, the Fund would also recognize cancellation of indebtedness income to the extent that the fair market value of the property (\$10 million) is less than the unpaid principal amount of the debt (\$12 million). This \$2 million of cancellation of indebtedness income would be subject to federal income tax at ordinary rates, which have a top marginal rate of 35%.

In some cases, this \$1.4 million taxable loss on the foreclosure can be used to offset the cancellation of indebtedness income recognized in the foreclosure under the tax rules that apply to so-called Section 1231 Property. If, in this example, the \$1.4 million of taxable loss arising from the foreclosure is available to offset the \$2 million of cancellation of indebtedness income, the investors' tax costs would be as follows:

Summary of Tax Costs - Recourse Debt:

CODI \$2,000,000 – Taxable Loss \$1,400,000 = Net Taxable Income \$600,000
X Effective Tax Rate 35% = Total Tax Cost from CODI \$210,000

The Borrower's Tax Consequences of Loan Workouts

If the borrower undertakes a loan workout instead of a foreclosure, no sale will be deemed to have occurred in most cases. However, in a loan workout, cancellation of indebtedness income will arise if the "issue price" of the modified debt is less than the unpaid principal amount of the loan prior to the modification. In the case of an outright reduction of the amount owed under the loan, the creation of cancellation of indebtedness income is obvious. However, in more complex loan modifications, such as the implementation of the so-called A/B note structure, a more technical tax analysis must be undertaken.

In a typical A/B note structure, the lender will modify the existing loan by bifurcating the loan into an "A Loan," which typically sets forth a principal amount owed that is less than the unpaid principal owed under the existing loan, and a "B Loan," which generally calls for the repayment of the remaining amount owed under the existing loan under terms that are somewhat non-traditional for a loan (e.g., payment equal to 50% of the amounts distributed from the sale of the property after the A Loan is repaid). In this type of loan modification, the tax consequence could depend upon whether the B Loan is treated as a loan for tax purposes or if it is to be re-cast as a partnership interest.



A detailed analysis of whether cancellation of indebtedness income will arise in a debt modification is beyond the scope of this discussion. However, in an A/B note structure, determining the issue price of the modified loan might not be as simple as adding up the amount of the two loans. Specifically, if the B Loan is recast as a partnership interest for tax purposes, it could be disregarded for purposes of determining issue price. If this occurred, cancellation of indebtedness income could arise.

For CMBS loans, the lender and the special servicer will be very sensitive to this issue because it is relevant to the tax status of the trust that owns the loans. However, in the workout of other loans, review of this “partnership” issues should be considered in the process of negotiating the terms of the B Note. If the B Note is not properly structured, the borrower will face some risk that the IRS will find that cancellation of indebtedness income arose in the transaction.

Tax Planning Opportunities

The amount of taxable income and gain that can arise in a foreclosure will depend upon a number of factors. As a result, borrowers cannot ignore these potential tax costs in deciding between pursuing a loan workout or simply allowing the foreclosure process to move toward its completion. However, borrowers should also consider the various tax planning opportunities that they may have to defer these tax costs.

i. Deed-in-Lieu Like-Kind Exchanges

In some cases, the gain arising from the sale of the property that is deemed to occur in a foreclosure can be deferred if instead of proceeding through the foreclosure process, the borrower and lender enter into a “deed-in-lieu of foreclosure” and the borrower structures the transfer of title to the lender (or its designee) as a tax-free like-kind exchange under Code Section 1031. To properly adopt this deferral technique, the borrower must engage a qualified intermediary prior to the date that the deed-in-lieu of foreclosure is signed. In addition, the deed-in-lieu of foreclosure agreement between the lender and the borrower must include specific provisions with respect to the like-kind exchange. However, if the deed-in-lieu like-kind exchange is properly structured, the borrower can defer the gain that would have arisen from the foreclosure until the property acquired in this like-kind exchange is subsequently sold.

ii. Avoiding CODI under the QRPBI Election

If the foreclosure or loan modification results in cancellation of indebtedness income, there are several tax planning opportunities that are available under Code Section 108. For example, Code Section 108(a)(1) provides that if the cancellation of indebtedness income arises when the taxpayer is insolvent or under the jurisdiction of the bankruptcy court, the cancellation of indebtedness income is not taxable. However, this “bankruptcy and insolvency” exception applies at the individual level and not the entity level if the borrower is a multi-member limited liability company or limited partnership. As a result, avoiding cancellation of indebtedness income under



the bankruptcy or insolvency exception set forth in Code Section 108 might not be available where the underlying property is owned by a multi-member limited liability company.

Another tax planning opportunity for cancellation of indebtedness income under Code Section 108 is the “qualified real property business indebtedness election” (the “QRPBI Election”). If the taxpayer is eligible to make this election, the taxpayer has the opportunity to reduce his or her tax basis in his depreciable real property instead of recognizing the cancellation of indebtedness income as taxable income. There are collateral consequences of making the QRPBI Election that could cause a portion of the gain arising from the subsequent sale of the property to be subject to federal income tax at ordinary rates. As a result, evaluating whether the QRPBI Election is a good tax planning tool will depend upon the facts and circumstance of each case.

iii. Recapitalizing the Borrower Entity

Another deferral technique that can be adopted as part of a loan modification is to restructure the ownership of the entity that owns the underlying real estate. In the case of a multi-member limited liability company both the taxable gain arising from the foreclosure and the cancellation of indebtedness income from the loan workout can be deferred until the subsequent sale of the property. In general, under this deferral structure, the parties restructure the existing membership interests of the limited liability company to grant “preferred units” to the parties that are infusing additional capital into the transaction or to the note holder in exchange for a reduction in the amount owed. (This structure cannot be used to issue preferred units to the noteholder if the noteholder is the original lender.)

Under the borrower recapitalization structure, the original borrowers could be required to make a QRPBI Election with respect to the tax basis of the existing property. In addition, special tax- oriented provisions will have to be included in the amended and restated limited liability company agreement in order to preserve the borrower’s tax-free treatment. However, if properly structured, use of the borrower recapitalization structure can also be used to help the borrower avoid any tax costs in connection with the loan workout.

Conclusion

Borrowers facing the threat of foreclosure should not ignore the tax cost they could face if the foreclosure occurs. As previously noted, even if taxable gain or cancellation of indebtedness income arise, there are proactive steps the borrower can take to reduce or deter these tax costs. As a result, borrowers facing the threat of foreclosure should consult with a tax counsel prior to deciding whether to undertake a loan modification or to simply let the foreclosure process move to completion.



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