


**BDPB TAX**

## Real Estate Debt Workouts in 2008

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## Circular 230

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## Agenda

- The Rules have Changed
- A Step by Step Analysis
  - *Will the Workout Result in COD Income?*
  - *What can the Debtor do if COD Income is Realized?*
  - *What if the Debt cannot be Worked Out?*
- Debt Workouts in 2008




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**What the Headlines are Saying...**

- Foreclosure activity up 184% from Q3 2007
- More Americans are facing foreclosure than any other time in recent memory
- 1 in every 186 FL households received a foreclosure filing notice in July
- CA and FL account for 9 out of the “Top 10 Metropolitan Foreclosure Rates”

*Source: July 2008 U.S. Foreclosure Market Report™ from RealtyTrac.*



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**The rules have changed**

- In response to the real estate crash of the early 1990s, several techniques were developed that allowed lenders and borrowers to deal with the economic issues involved in debt workouts without triggering adverse tax consequences to either party.
- These techniques included the following:
  - Loan extensions
  - Converting debt into an equity interest in the partnership that owned the property



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**The rules have changed**

- it can be anticipated that a number of loans will have to be “worked out” because the FMV of a property may be less than the debt that encumbers it
- cash flow from the property may be insufficient to satisfy the required payments of interest and principal on that debt.
- changes in the law during the past 12 years will make it more difficult to avoid adverse consequences.
- many of the “tried and true” workout techniques that were used in the 1990s will not work now.



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### The rules have changed

1990	2008
Workouts usually involved: -Single lender that made loan to a single borrower -Lender and borrower had a long-standing business relationship	Debt that currently encumbers real estate: -Sold to a securitization structure -The only relationship between holder and borrower is a loan servicer
The applicable law was designed for workouts where the lender and borrower knew each other and were working to resolve issues involving the property and the borrower's ability to pay	Securitized debt instrument's interests are held (in various branches) by investors around the world

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### Overview

➤ Common Fact Pattern in 2008:

Property FMV	800,000
Mortgage	(1,000,000)
<b>Net Equity</b>	<b>(200,000)</b>

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### Overview of the applicable law: Income Inclusion

*Section 61(a)(12) provides that gross income includes COD income*

➤ COD income triggering events:

- Debt Cancellation (Debt Forgiveness)
- Renegotiation of mortgage ("workout")
- Foreclosure or repossession
- Deed in lieu of foreclosure

*The Supreme Court's decision in Kirby Lumber Co, stated that cancellation of indebtedness results in ordinary income to the taxpayer*

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**A. Is a Debt being Forgiven or Reduced?**




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**Example**

➤ Renegotiation of Mortgage:

Property FMV	\$	800,000
Mortgage	\$	(1,000,000)
Workout Principal Reduction	\$	200,000
Net Equity	\$	-
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COD Income?	\$	200,000




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**1. Can the TP Deduct the Debt being Reduced?**

108(e) General rules for nonrecognition of COD

- Income not realized to extent of lost deductions:** No income shall be realized from the discharge of indebtedness to the extent that payment of the liability would have given rise to a deduction.
- Ex. Interest, business expenses




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**2. Can the TP Qualify for a Purchase Price Reduction?**

5. **Purchase-money debt reduction for solvent debtor treated as price reduction:**

- a) The debt of a purchaser of property to the seller of such property which arose out of the purchase of such property is reduced.
- b) Such reduction does not occur
  - in a title 11 case, or
  - When the purchaser is insolvent
- c) Such reduction would be treated as income to the purchaser from the discharge of indebtedness, then such reduction shall be treated as a purchase price adjustment.

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**B. Is a Debt being Exchanged for Equity?**

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**1. Is a Debt being repaid with Stock or Partnership Interest?**

- **Indebtedness satisfied by corporate stock or partnership interest:**
  - If a debtor corporation transfers stock, or a debtor partnership transfers a capital or profits interest in such partnership, to a creditor in satisfaction of its recourse or nonrecourse indebtedness, such corporation or partnership shall be treated as having satisfied the indebtedness with an amount of money equal to the fair market value of the stock of interest.
  - In the case of any partnership, any discharge of indebtedness income recognized under this paragraph shall be included in the distributive shares of taxpayers which were the partners in the partnership immediately before such discharge.

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**C. Has a Debt been Modified?**



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**Taxable Events:**  
**Adoption of new Regulations under Section 1001**

- The most important change in the law since the early 1990s is the adoption of new Regulations under Section 1001 - debt modification will be treated as an exchange of the original debt for a new debt instrument.
- The issue price of the new debt is determined under Sections 1273 and 1274.
- The new debt will be treated as having an issue price less than the face amount of the old debt if the interest rate on the new debt is less than the AFR.



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**Taxable Events:**  
**Adoption of new Regulations under Section 1001**

- Treasury and the IRS issued regulations involving a two-part test under which the alteration of the terms of the old debt will be deemed an exchange if there is a "significant modification" of the debt instrument.
  - Step 1: Determine whether the change constitutes a "modification"
  - Step 2: Determine whether the modification is "significant"



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### Step 1: Modifications

➤ “Modification” generally means any alteration of a legal right or obligation of the issuer or holder of a debt instrument. It may occur through an express agreement or the conduct of the parties.




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### Step 2: Significant Modifications

**The bright-line rules:**

1. Changes in yield
2. Changes in timing of payments
3. Change in Obligor
4. Addition or Deletion of Co-obligor
5. Change in Collateral
6. Change in Priority of Debt
7. Change from Debt to Equity
8. Change in Recourse Nature
9. Change in Covenants
10. Tax-Exempt Bonds




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### Solution

➤ Renegotiation of Mortgage:

Property FMV	\$	800,000
Mortgage	\$	(1,000,000)
Workout Principal Reduction	\$	200,000
Net Equity	\$	-
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COD Income (Form 1099-C)	\$	200,000




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**Section 108 – What can the Debtor do if COD Income is Realized?**




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**1. Is the Debtor in Chapter 11 Bankruptcy or Insolvent?**

108(a) Exclusions from gross income

➤ Section 108(a)(1) provides five circumstances in which COD income is excluded:

1. The discharge occurs in a Title 11 case
2. The discharge occurs when the taxpayer is insolvent
3. The indebtedness discharged is qualified farm indebtedness (QFI)
4. For TP's other than a C corporation, the indebtedness discharged is qualified real property business indebtedness (QRPBI)
5. Qualified principal residence indebtedness (QPRI) discharged before 2010




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**2. Does the Debtor have any Tax Attributes?**

108(b) Reduction of tax attributes

➤ TP pays a "price" for COD exclusion through the reduction of tax attributes, including basis. Under Section 108(b)(2), the following attributes are reduced in order:

- NOLs – from 2007 first, then carryovers
- General business credits
- Minimum tax credits
- Capital loss carryovers
- Basis of depreciable property of the taxpayer, pursuant to Section 1017
- Passive activity loss and credit carryovers
- Foreign tax credit carryovers

➤ Any excess is permanently excluded!




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### 3. Is the Debt Qualified Principal Residence Debt?

**Mortgage Forgiveness Debt Relief Act of 2007:**

- Provides for exclusion of up to \$2M on a principal residence (\$1M for married filing separate)
- Applies to debt reduced through restructuring or debt forgiven in foreclosure during 2007, 2008 or 2009
- Debt must have been used for principal residence (second homes, rental or business property do not qualify)
- TP will receive Form 1099-C from lender




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### Example – Principal Residence

- Primary residence is foreclosed or surrendered:

<b>FACTS:</b>		<b>TAX IMPLICATIONS:</b>	
Principal Res. FMV	800,000	Recourse Mortgage	1,000,000
Recourse Mortgage	1,000,000	Property FMV	(800,000)
		COD Income	200,000
		QPRI Exclusion	(200,000)
		Taxable Income	-




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### 4. Is the Debt Qualified Real Property Business Indebtedness (QRPBI)?

- QRPBI
  - Incurred for real property used in trade or business
  - It is secured by the property
- Qualified Acquisition Debt
  - Incurred to construct, reconstruct or improve property
  - Refinanced debt – must not exceed the original debt




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**QRPBI – Exclusion Limit**

- Cannot exceed:
  - AB of depreciable real property held immediately before cancellation
- Limited to the excess of:

Outstanding Debt
(-) FMV of Property
(-) Other Secured Debt
= Exclusion Amount

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**Reducing Basis of Property**

- Reduce in the following order (within each category in proportion to AB):
  - Real Property that secured debt
  - Personal Property that secured debt
  - Inventory & AR
  - Personal use property

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**Recapture of Basis Reductions**

- Applies to subsequent sale of reduced basis property
- Property must be sold at a gain
- Part of gain due to basis reduction is taxable as ordinary income

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**Section 108 overview:  
Exclusion from gross income**

➤ Because the forgiveness of a single debt theoretically could satisfy several of these exceptions, there is a set of ordering rules:

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    graph TD
      A[Title 11 exclusion] --> B[QPRI]
      B --> C[Insolvency exclusion]
      C --> D["(QFI)"]
      C --> E["(QRPBI)"]
  
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**C. Is the Property being Foreclosed on, or Deeded in Lieu of Foreclosure?**




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**Overview of the applicable law:  
Foreclosure/Deed in Lieu**

*Section 61(a)(12) provides that gross income includes COD income*

➤ Treated as sale of property to lender in satisfaction of debt  
 ➤ The calculation of COD income will depend on whether the debt is recourse or nonrecourse:

- Debt for which you are personally liable is recourse debt
- All other debt is nonrecourse debt

*The Supreme Court's decision in Kirby Lumber Co, stated that cancellation of indebtedness results in ordinary income to the taxpayer*




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## 1. Is the Debt on the Property Recourse Debt?

*Section 61(a)(12) provides that gross income includes COD income*

- If property is conveyed in satisfaction of a recourse debt:
  - TP may recognize taxable gain on sale
  - Proceeds amount = lesser of FMV of property or Debt Amount
  - May recognize COD if property FMV < Debt

*The Supreme Court's decision in Kirby Lumber Co, derived this provision which states that cancellation of indebtedness results in ordinary income to the taxpayer*




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## Example – Recourse Debt

- Property is foreclosed or surrendered to satisfy recourse debt:

<b>FACTS:</b>		<b>Recourse Mortgage</b>	1,000,000
Property AB	500,000	Property FMV	(800,000)
Property FMV	800,000	COD Income	200,000
Recourse Mortgage	1,000,000	Property FMV	800,000
		Property Adjusted Basis	(500,000)
		Gain on Sale	300,000




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## 2. Is the Debt on the Property Nonrecourse Debt?

- If property is conveyed in satisfaction of a nonrecourse debt:
  - Treated as a sale by the borrower to the lender
  - Proceeds = amount of nonrecourse debt
  - No COD income




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### Example – Nonrecourse Debt

➤ Property is foreclosed or surrendered to satisfy nonrecourse debt:

<u>FACTS:</u>		<u>TAX IMPLICATIONS:</u>	
Property AB	500,000	Nonrecourse Mortgage	1,000,000
Property FMV	800,000	Property AB	(500,000)
Nonrecourse Mortgage	1,000,000	Gain on Sale	500,000

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### Debt Workouts in the New Millennium: Partnerships

An equity-for-debt exchange involving a partnership did not give rise to COD income

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Any exchange of debt for a partnership interest results in COD income to the extent that the FMV of the partnership interest is less than the face amount of the instrument

The 2004 changes made tax planning more difficult for any partnership in which some of the partners hold both debt and equity interests. The partners might desire to increase the equity of the partnership by contributing some of the debt to equity.

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### Debt Workouts in the New Millennium: Partnerships

- Prior to the change in law, taxpayers could treat the contribution of debt to the equity of a partnership by a pre-existing partner as nontaxable
- Under section 108(e)(8), the partnership will now have COD income
- Even worse, even though the contributing partners will have taken an economic loss when they contribute debt to a partnership in exchange for a partnership interest, they will not be permitted to recognize that loss under Section 721.
- Thus, the contributing partner could have COD income at the same time that it realizes an unrecognized economic loss – the worst of all possible worlds.

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