# A Taxing Workout?

## Fit investors can take steps to avoid penalties when restructuring troubled assets.

by Gregory R. Wilson, JD, LLM

The slumping global economy and stagnant credit markets have taken a toll on nearly all commercial real estate properties. Many assets are struggling to generate sufficient income to meet financing obligations in the current market. As a result, many real estate owners are being forced to consider bankruptcy, foreclosure, and other types of workout plans. However, property owners should proceed with caution when seeking debt relief, as many strategies can result in the realization of taxable income.

While tax debt relief provisions are fraught with many legal exceptions and nuances, an understanding of some general concepts can be helpful. However, to accurately determine the specific tax consequences of certain actions, property owners should consult with qualified tax and legal advisers before pursuing debt relief.

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### Out-of-Shape Investors

In the previous bountiful economy, many commercial real estate investors succumbed to very unhealthy habits. In the provided chart, "Working Out a Workout Plan," a financially unfit investor is exploring various alternatives with his lenders to restructure his assets and liabilities. The question he must carefully consider is: What are the tax consequences of restructuring?

**COD Income and Section 1001 Gain.** Taxpayers generally realize income if the debt they owe is partially or entirely forgiven or canceled. Often this is true whether the debt is recourse or nonrecourse, and the resulting income commonly is referred to as cancellation of debt, or COD, income.

If a property is transferred to satisfy its debt, the transfer may result in COD income and/or Internal Revenue Code Section 1001 gain/loss, depending on if the debt is recourse or nonrecourse. Taxpayers normally realize Section 1001 gain if they transfer property and the amount realized exceeds their basis in the property. In a foreclosure or deed-in-lieu transaction, generally the amount realized is the amount of the debt on the property, as if the taxpayer sold the property for the amount of the debt.

If the debt is nonrecourse in a short sale, foreclosure, or deed-in-lieu, the taxpayer realizes Section 1001 gain/loss to the extent the property debt exceeds or is less than the taxpayer's basis. Section 1001 gain may be taxed as a capital gain if the asset trans-

**Working Out a Workout Plan**

*The first table illustrates an investor's commercial real estate asset profile. The second table provides an overview of the investor's workout plan.*

| ASSET | MARKET VALUE | DEBT | BASIS |
|---|---|---|---|
| Rental apartments 100% owned by investor through a single-member LLC | $15,000,000 | $20,000,000; recourse | $10,000,000 |
| LLC 50% owned by investor; sole asset is development land | $10,000,000 | $18,000,000; nonrecourse, LLC's mortgage on property | $30,000,000; LLC's basis in land |
| LLC 25% owned by investor; sole asset is office building | $50,000,000 | $50,000,000; nonrecourse, LLC's debt on building | $40,000,000; LLC's basis in building |

| ASSET | WORKOUT PLAN | RESULTING COD INCOME REALIZED | RESULTING SECTION 1001 GAIN REALIZED |
|---|---|---|---|
| Apartment LLC | Lender agrees to take property from investor in full satisfaction of debt | $5,000,000 | $5,000,000 |
| Land LLC | Lender agrees to reduce balance of loan to $10,000,000 | $8,000,000; amount realized by LLC and passed through to members | $0 |
| Office LLC | Company related to investor purchases LLC's debt for $30,000,000 | $20,000,000; amount realized by LLC and passed through to members | $0 |

ferred was capital in nature in the hands of the transferor. Commercial real estate is usually a capital asset if it is not held as inventory or by a dealer.

If the debt is recourse, both COD income and Section 1001 gain/loss can be realized on the transfer. The Section 1001 gain/loss equals the current market value of the property transferred (treated as the amount realized on the transfer) less the property owner's basis. Any additional amount of canceled debt is COD income.

## Creating a Workout Plan

Some workouts generate COD income, others generate Section 1001 gain, and some generate both. There are several exceptions available to avoid recognizing COD income and Section 1001 gain. In the "Working Out a Workout Plan" chart, whether the investor must recognize COD income and/or Section 1001 gain depends on the application of at least one of these exceptions.

**Insolvency Exception.** A taxpayer can exclude COD income to the extent that the taxpayer is insolvent. Insolvency is determined immediately before the debt discharge and equals the excess of the taxpayer's liabilities over the current market value of the taxpayer's assets. Nonrecourse loans — to the extent they exceed the value of the asset securing the debt — generally are not included as liabilities. This is not the case when the liability, or the excess, is being discharged and excluded under the insolvency exception. If assets are exempt from liabilities, they may cause an insolvent taxpayer to be solvent to the extent of the exempt assets' value.

In the case of most partnerships and limited liability companies, the insolvency test is applied at the partner/member level. Thus, it is irrelevant if the partnership/LLC itself is insolvent. For the COD income to be excluded, the partner/member must be insolvent when the debt is canceled. In the case of a C-corporation or S-corporation, the insolvency test is applied at the corporate level rather than the shareholder level.

In the example, the investor can exclude COD income generated by the proposed workouts to the extent he is insolvent. If his only assets and liabilities are the three properties listed in the example, the investor's net worth is negative $5 million. Thus, he can exclude up to $5 million of COD income generated by proposed workouts. However, the remainder of the COD income could not be excluded using the insolvency exception. Additionally, the $5 million of Section 1001 gain generated by the deed-in-lieu apartment transaction cannot be excluded using the insolvency exception.

Therefore, the investor might want to consider giving the LLC land property back to the lender in a deed-in-lieu transaction instead of the proposed principal reduction. A deed-in-lieu on the development land might generate a $12 million capital loss, $6 million of which would flow to the investor and could be used to offset the $5 million of capital gain generated by the apartment asset workout.

**Qualified Real Property Business Indebtedness.** Canceled debt that qualifies as real property business indebtedness is another exception to COD income. Generally, this exclusion applies at the entity level. However, this exception often is not helpful due to several requirements that can be difficult to satisfy.

First, this exclusion applies only if the entity is not insolvent and the discharge does not occur in Title 11 bankruptcy. Most entities obtaining debt relief are insolvent. Second, the relevant debt must have been used to buy or improve real property used in a trade or business. Commercial real estate is often considered to be used in a trade or business. Third, two calculations must be applied that limit the amount of excludable COD income under this exception. While these calculations are complex and not covered in the scope of this article, they often render this COD income exception useless.

In the example, the investor's LLC office building might qualify for this exception if all the requirements are met to avoid recognizing the $20 million COD income realized when the related party purchases the loan at a discount. However, not all LLC members may be in the same position and/or want the LLC to use the qualified real property business indebtedness exception if it is available. For instance, some may be insolvent. In the example, this could cause the investor — if he is both a member and manager of the LLC — to have a potential conflict between his personal preference as a member and his duties as a manager.

**Stimulus Bill Deferral.** The American Recovery and Reinvestment Act of 2009 added Section 108(i) to the Internal Revenue Code, which allows taxpayers to defer tax on COD income realized in 2009 and 2010 for four or five years and recognize it ratably over the subsequent five years if certain requirements are met. For example, a partnership/LLC may use this provision only if the canceled/reduced debt was incurred as part of its trade or business. This deferral is very valuable but still only applies to COD income (not Section 1001 gain) and only defers (not excludes) the tax due on COD income.

If other COD income exclusions are not available to the investor in the example, he probably can elect to utilize this provision to defer the tax due on COD income realized on his office building LLC. However, the debt taken on by the investor's land LLC probably is not related to a trade or business if the land was purchased as an investment and the LLC is not acting as a dealer. Thus, it is unlikely that Section 108(i) could be used for the COD income generated by the land LLC's workout.

**Bankruptcy.** COD income also is generally excluded if the debt reduction occurs in a Title 11 bankruptcy case. In a partnership or LLC, however, the partners/members must file for bankruptcy to qualify for this COD income exception. Thus, if the partnership/LLC files bankruptcy and its debt is canceled, the bankruptcy does not prevent the COD income from being taxable to the partners/members.

**Guarantees and Contingent Liabilities.** A guarantor typically does not realize COD income if a debt he guaranteed is discharged. Additionally, the cancelation of contingent and some legitimately disputed debt generally does not cause COD income. Thus, if a guarantee is removed and such guarantee was still contingent (the primary borrower has yet to default on the loan triggering the guarantee), removal of the guarantee should not cause the guarantor to realize COD income.

**Equity Called Debt.** No COD income is realized if the canceled debt actually was equity. For example, if members of an LLC made a member loan to the entity at the time it was under water and could not obtain bank financing and no payments were made on the loan, the loan could be classified as equity. No COD income results if equity is canceled or redeemed for a nominal amount.

**Purchase Price Adjustment.** If seller carry-back financing debt is reduced, generally it is treated as a purchase price adjustment and the basis in the property acquired is reduced. COD income in these situations may be excluded. However, this exception to COD income recognition is not applicable if the taxpayer is insolvent or in bankruptcy at the time of the reduction.

**Debt Modifications.** Debt modifications that result in principal reduction clearly produce COD income as debt has been partially canceled. If other terms are altered, a significant modification can result that is treated as if new debt was issued in exchange for the old debt. A significant modification of debt can result in COD income, even if the principal is not reduced. Thus, all debt modifications in a workout context must be analyzed to determine if COD income will result.

If debt is not publically traded, the debt's interest rate often can be reduced to the minimum Applicable Federal Rate in effect at the time of the modification and no significant COD income will result. Currently, the minimum AFR rate for a note of up to nine years is just over 2 percent. Thus, in the example, as an alternative workout, the investor could keep his apartments and negotiate to change the loan to a nine-year term with interest-only payments at the rate of 2.25 percent. This might enable him to avoid any COD income and the Section 1001 gain that was caused when he transferred the property to the lender.

### Additional Tax Planning Tips

Many COD income exclusions require that certain tax attributes or a taxpayer's basis in certain property be reduced to the extent COD income is excluded. For example, if a corporation excludes COD income because it is insolvent, it is required to reduce its net operating loss carryover and other tax assets to the extent of the exclusion. As a result, the excluded COD income may later, indirectly, be recognized or essentially be converted into Section 1001 gain. Additionally, some of the COD income exclusions require elections to be made by the taxpayer, and some require certain forms to be filed reporting the transaction that caused the COD income.

Investors can utilize many possible planning techniques to minimize the tax consequences of real estate workouts, including, in some cases, converting nonrecourse debt to recourse, reducing debt through a foreclosure instead of a loan modification to convert COD income to a Section 1001 loss, timing the workouts of multiple holdings, and planning transactions to shift more income to capital gain versus COD income or vice versa. In addition, given the extremely low — and below market — minimum current AFR rate, pursuing a loan modification with a lender to a nine-year loan at just over 2 percent interest instead of a principal reduction can result in the same economics to both parties with a much better tax result to the borrower.

Taxpayers should consult with their tax professionals before proceeding with real estate workouts to determine what can be done to reduce the resulting tax bill. ■

## Finding a Joint Venture Partner

These collaborations can breathe life into troubled properties.

Despite the doom and gloom in today's news, companies and individuals with cash are willing to invest in high-value properties that currently are underperforming. By using a joint venture partner to commit additional capital to a property, owners can pay down financing to a functional level or make necessary capital improvements. While sometimes risky, if well executed these arrangements also may attract high-quality tenants while raising a property's value.

### Vet Your Partner

The most important consideration when working with a JV partner is to do your homework. Though cash is king in the current market, don't let funding blur the details. It is imperative to completely understand a deal's economics and effects.

Many of today's JV partners are looking for protection and greater upside. Some are trying to structure deals that are similar to loans. Be wary of a JV partner that seeks a 15 percent priority return on contributed capital plus the return of its capital first, which essentially is a 15 percent nonrecourse mortgage. The numbers can be startling. With $10 million of contributed capital and a 15 percent preferred return, the required preferred return would be $1.5 million annually, which ignores the compounding of the preferred return.

In addition to hammering out the economic relationship, both JV partners must agree on who controls the property and share a synergistic outlook on the property's exit strategy. For instance, if one party considers the property to be a long-term hold, the other should not be looking to flip the property quickly.

### Tax Considerations

Property owners must address many tax concerns when adding a partner, and the place to do that is in the JV agreement. With careful planning, owners can minimize the tax ramifications of restructuring.

When negotiating a JV agreement, taxpayers must consider issues such as income allocations, Internal Revenue Code 704(c) depreciation allocation methods, and lock-out periods on the property's sale and debt repayment. JV agreements should be drafted carefully to avoid situations that cause phantom income allocations, which are income allocations without cash. This can be accomplished by carefully modeling the allocations or adding tax distribution clauses.

The most advantageous IRC 704(c) method also should be determined. The original property owner must be aware that depreciation deductions may be stripped and sent to the JV partner. With proactive tax planning, the burden of the stripped deductions can be reduced.

Lastly, negotiating lock-out periods where the property can't be sold or the debt can't be paid down can lead to many tax benefits. These include holding off gain recognition upon sale to a more tax advantageous period and avoiding the recapture of large negative capital accounts as a result of a decrease in the debt that supports them.

As with all property-related decisions, owners should seek the advice of tax and legal specialists before embarking on JV partnerships.

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