Income Tax Planning for Commercial Real Estate Debt Restructuring

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Many industry observers forecast a continued downturn in the commercial real estate market over the next few years. In particular, many industry analysts forecast distress in the commercial real estate market in 2011 as many short-term commercial loans come due—while property values continue to decrease. Therefore, many commercial real estate property owners may have to restructure or renegotiate the commercial mortgages related to their property. These property owners (and their legal counsel and tax advisers) should carefully plan for the income tax consequences related to such a debt restructuring. These tax consequences are influenced both by the type of debt (i.e., recourse, nonrecourse, or partially recourse) and by the property owner's tax attributes.

Introduction

The continuing credit crisis has negatively affected the market value of most industrial and commercial real estate. This statement is true for corporate owner/operators of industrial and commercial real estate. And, this statement is particularly true for developers of—and investors in—multi-family residential property, hotel and other hospitality property, and office rental property.

This discussion collectively refers to such commercial real estate developers, institutional and commercial real estate investors, and industrial real estate owner/operators as "property owners."

For many such property owners, the current fair market value of their industrial, commercial, or residential properties has decreased below the mortgage debt amount on these properties.

Many such properties owners (whether or not they are currently in bankruptcy protection) may have to renegotiate the terms of their commercial mortgage debt.

The objective of such a commercial mortgage renegotiation process is that the property owner:

1. will be able to retain ownership of the commercial real estate and
2. will presumably be able to service the restructured mortgage debt payments on a going-forward basis.

The downside of such a commercial debt restructuring is that the property owner may recognize cancellation of debt (COD) income for income tax purposes. Of course, without the debt restructuring, the property owner may face both foreclosure and phantom income from debt relief.

With both foreclosure and commercial debt restructuring common in the current credit environment, the property owner (and the owner's valuation and other financial advisers) should be generally aware of the COD income tax rules.

And, the property owner (and the owner's professional advisers) should carefully plan for the income tax effects of any commercial debt restructuring transactions.

COD Income Tax Implications of Commercial Mortgage Restructuring

The American Recovery and Reinvestment Act (ARRA) of 2009 added Internal Revenue Code

Section 108(i). Section 108(i) allows certain taxpayers who realized COD income in 2009 or 2010 to defer that income and to recognize it ratably over a five-year period, beginning in 2014.

For a property owner that deferred COD income under this tax provision, the other COD income exclusion provisions will not be available.

Therefore, the property owner (and the property owner's tax adviser) should carefully consider whether other COD income exclusion tax provisions provide a greater immediate benefit.

Section 108(i) defers the COD income recognition only for a limited period of time. Accordingly, the previous COD income exclusion provisions may be more beneficial for providing income tax benefits to the property owner.

For example, bankrupt or insolvent property owners may be able to escape the recognition of COD income entirely, depending on their specific circumstances. And, COD income from the renegotiation of qualified real property indebtedness may also be excluded, depending on the property owner's specific circumstances.

The COD income recognition rules vary depending on whether the commercial debt related to the real estate being foreclosed is subject to (1) recourse debt, (2) nonrecourse debt, or (3) partially recourse and partially nonrecourse financing.

COD Income Recognition Provisions Related to Recourse Debt

For income tax purposes, when the mortgage holder forecloses on real estate in satisfaction of a recourse debt, the foreclosure is considered to be a property sale. The property sale proceeds are treated as being equal to either:

1. the amount of the debt or
2. the fair market value of the real estate, whichever is less.

For income tax purposes, the difference between (1) the deemed property sale proceeds and (2) the property cost basis is equal to (3) the gain or loss on the property sale.

To the extent that the recourse debt exceeds the amount of the real estate fair market value, the property owner is deemed to have COD income. This means that, when the commercial real estate has recourse debt, the debt restructuring transaction is considered to be two transactions for income tax purposes:

1. a property sale transaction
2. a COD income transaction

Since a property foreclosure is treated as a sale or exchange of the commercial real estate, the character of any tax gain or loss is determined in accordance with the Section 1221 and Section 1231 requirements. As a result, the property owner may have held the commercial real estate:

1. as a capital asset under Section 1221 or
2. for use in the taxpayer's trade or business under Section 1231.

In that case, then any gain may be a capital gain or a Section 1231 gain.

In the case of Section 1231 real estate, the gain is also subject to the Section 1250 depreciation recapture rules.

Alternatively, if the commercial real estate was held by the property owner primarily for sale to customers in the ordinary course of business (under Section 1221(a)(1)), then the property owner would recognize ordinary income or loss from the deemed sale transaction.

To the extent that the recourse debt is greater than the real estate fair market value, then the deemed property sale proceeds are considered to be equal to that fair market value amount. For income tax purposes:

the recourse debt
– the deemed property sale proceeds
= the property owner's COD income.

The property owner should also plan for any gain or loss on the mortgage foreclosure in addition to the COD income. For income tax purposes:

the deemed property sale proceeds (i.e., the real estate fair market value)

– the property cost basis

= the gain or loss.

This gain or loss calculation is made just as if the commercial real estate was actually sold.

Depending on the character of the commercial real estate in the property owner's hands, the deemed sale transaction gain or loss may be (1) capital, (2) Section 1231, or (3) ordinary.

Let's assume that both the recourse debt and the cost basis are greater than the commercial real estate fair market value. In that case, the property owner will have both:

1. COD income (i.e., the debt minus real estate market value) and
2. a Section 1231, ordinary, or capital loss (i.e., the real estate market value minus the property basis).

This scenario is known as a bifurcation.

The income tax implications are more straightforward if the amount of the recourse debt is less than the commercial real estate fair market value. In this scenario, the deemed property sale proceeds are equal to the amount of the recourse debt. And, in this scenario, the property owner will not recognize COD income.

However, the property owner will have a gain or loss on the deemed property sale (which may be capital, ordinary, or Section 1231).

COD Income Recognition Provisions Related to Nonrecourse Debt

For income tax purposes, the mortgage holder's foreclosure in satisfaction of nonrecourse debt, including the foreclosure of qualified nonrecourse debt, is treated as a deemed property sale. For income tax purposes, the deemed sale transaction proceeds are considered to be equal to the amount of the nonrecourse debt.

In this scenario, the amount of the commercial real estate fair market value is irrelevant for income tax purposes. Also, in this scenario, there is no COD income recognized by the property owner.

The income tax implications are based on:

1. the amount of the nonrecourse debt and
2. the tax basis of the commercial real estate.

If the amount of the discharged debt is greater than the commercial real estate cost basis, then the property owner will recognize income (whether capital, ordinary, or Section 1231) on the debt foreclosure. However, the gain is not treated as COD income to the property owner.

As a result, none of the Section 108 COD income exclusion discussed below are available. This statement is true even if the property owner is bankrupt or insolvent.

The gain in this scenario is includible in the property owner's gross income for the year. This taxpayer-unfriendly result is the major difference between foreclosures involving (1) recourse debt and (2) nonrecourse debt.

Alternatively, if the nonrecourse debt is less than the real estate cost basis, then the property owner will have a capital, Section 1231, or ordinary loss—depending on the nature of the commercial real estate.

COD Income Recognition Provisions Related to Partial Recourse Debt

If the mortgage is a partial recourse debt (e.g., due to a partial guarantee by a partner or an LLC member), then the income tax consequences of the debt restructuring will vary. The income tax consequences will depend on how the deemed sale transaction proceeds are allocated to satisfy the partial recourse debt.

The deemed sale transaction proceeds allocation options are:

1. the sale proceeds are first allocated to the recourse portion of the debt,

2. the sale proceeds are first allocated to the nonrecourse portion of the debt, or
3. the sale proceeds are allocated pro rata between the two components of the debt.

Unfortunately, there is little professional guidance available regarding this sale proceeds allocation issue.

Section 108 COD Income Recognition Exclusions Available

Under Section 61(a)(12), gross income includes income related to the discharge of indebtedness. However, Section 108 provides the property owner with several exceptions to this COD income recognition rule. The Section 108 exceptions to the COD income rule are as follows:

1. The debt discharge occurs as part of a Title 11 bankruptcy proceeding.
2. The debt discharge occurs when the taxpayer is insolvent.
3. The forgiven debt is qualified farm indebtedness.
4. The forgiven debt is qualified real property indebtedness.

The property owner in bankruptcy can exclude all of the COD income from gross income. The insolvent property owner can exclude COD income to the extent of the taxpayer's amount of the insolvency.

However, it is important to consider what type of entity qualifies as the taxpayer for these purposes. That is, these various Section 108 COD income recognition exceptions are applied differently for partnerships and for corporations.

Any COD income that a property owner excludes from gross income is applied dollar for dollar to reduce the amount of the income tax attributes of the subject taxpayer.

Let's assume that the property owner reduces all of its income tax attributes to zero but some excluded COD income still remains. Then, the balance of the COD income goes away.

According to Section 108(b)(2), the property owner's income tax attributes are reduced in the following order:

1. net operating losses (NOL) for the tax year of the debt discharge and any NOL carryforwards to that tax year
2. general business tax credits under Section 38
3. the minimum tax credits under Section 53
4. capital loss carryovers for the tax year of the debt discharge and any capital loss carryovers to that tax year
5. income tax basis reduction
6. passive activity loss and credit carryovers under Section 469(b)
7. foreign tax credit carryovers under Section 27

With regard to the income tax base reduction, the property owner may make an election under Section 108(b)(5) to reduce the tax basis of depreciable property first—before reducing any other income tax attributes.

A property owner making this election should follow a separate set of ordering rules for the tax basis reduction under Section 1017. The amount of the tax basis reduction will not exceed the total adjusted tax basis of all of the taxpayer's depreciable property as of the beginning of the tax year following the year of the debt discharge.

In the case of a partnership property owner, (1) the COD income exclusion from gross income under Section 108(a), (2) the reduction of the income tax attributes under Section 108(b), and (3) the discharge of qualified real property indebtedness under Section 108(c) are all applied at the partner level.

The bankruptcy or the insolvency of the property owner partnership—rather than of the individual partner—is not directly relevant.

Each individual partner will make his or her own determination as to whether to exclude the COD income under Section 108. And, each individual partner will then make his or her own corresponding income tax attribute and/or tax basis reductions.

In the case of a corporation property owner, the provisions of Section 108 are applied at the corporation level. For purposes of the tax basis reduction rules, losses of an S corporation may be:

1. disallowed at the shareholder level (for either tax basis or at-risk investment reasons) and
2. carried forward.

Such disallowed losses are then treated as an NOL of the corporation for purposes of the income tax attribute reduction.

If the property owner is neither bankrupt nor insolvent, then the property owner may still be able to exclude COD income if the debt is qualified real

property indebtedness (QRPI). QRPI is debt that was incurred or assumed by the property owner in connection with real estate used in a trade or business.

The QRPI must be secured by such real estate and must be incurred or assumed before January 1, 1993. Or, if incurred or assumed on or after that date, the QRPI must be qualified acquisition indebtedness. See Section 108(c)(3).

Qualified acquisition indebtedness is debt incurred or assumed to acquire, construct, reconstruct, or substantially improve such real estate.

The amount of the COD income excluded under Section 108(c)(2)(A) cannot exceed the excess of (1) the restructured debt principal amount over (2) the commercial real estate fair market value.

Further, the amount of COD income excluded cannot exceed the property owner's aggregate adjusted tax basis of the depreciable property. The amount of excluded COD income is applied so as to reduce the property owner's tax basis in the commercial real estate.

Rental real estate qualifies for the qualified real property indebtedness exclusion. However, any debt secured by land held for investment purposes would not qualify for the COD income exclusion. This is because such land is not held for use in a trade or business.

In order to take advantage of predevelopment appreciation at capital gain tax rates, the property owner may classify the newly acquired land as held for investment before the property owner decides on its ultimate use.

A property owner should carefully consider classifying land in this manner against (1) the potential of a troubled debt restructuring and (2) the opportunity to use this COD income exception under such a scenario.

Debtor Taxpayer Planning for the Tax Attribute Reduction Implications

In addition to finding the greatest deferral alternative for the property owner, careful planning should involve an analysis of the property owner's tax attributes that may be lost due to the excluded COD income. The amount of any NOL and capital loss carryforwards are reduced as of the first day of the next tax year.

Therefore, the property owner that is facing this tax attribute reduction should attempt to accelerate any income or gains where possible—in order to make use of these tax attributes before they are lost.

If a property owner facing any tax attribute reduction has a significant NOL carryforward and partnership interests with negative capital accounts, then the property owner may consider triggering the gain on those negative capital accounts. In that way, the property owner could use the NOL before it is lost to the tax attribute reduction provisions.

For example, the property owner could:

1. form a wholly owned S corporation and
2. transfer the partnership(s) interest(s) to that S corporation.

Since the liabilities covering the negative capital would no longer flow through to the property owner, the transfer transaction would be considered a constructive distribution—resulting in gain recognition.

Summary and Conclusion

Most industry analysts forecast that the commercial real estate market will continue to deteriorate for the next few years. This forecast is applicable for all types of industrial, commercial, multi-family residential, and mixed use property types.

Therefore, the market value of more commercial real estate projects is expected to decrease below the corresponding project indebtedness. Accordingly, many commercial property owners are expected to renegotiate/restructure the terms of their commercial property mortgages.

Such commercial property owners—whether or not in bankruptcy—will have to plan for the income tax consequences of such a commercial mortgage renegotiation/restructuring.

There are several planning alternatives available for property owners to minimize the current recognition of COD income. Many of these planning alternatives may be more beneficial than the Section 108(i) election provided for in the 2009 ARRA tax legislation.

The careful planning prior to the commercial mortgage renegotiation should include an examination of:

1. the property owner's solvency situation and
2. the property owners tax attributes.

The objective of such an examination is to produce the most favorable possible COD income exclusion or deferral consequences.

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