Tax Consequences of Mortgage Discharge

In the current real estate climate of decreased property values and excess inventories, many rental property owners are facing reduced cash flows due to vacancies. At the same time, the fair market value of their property may be close to or even less than the amount owed on the mortgage ("upside down"). Thus, CPAs are commonly asked about the tax consequences if owners are no longer able to service debt on their property and lose it to the lender or substantially modify their debt.

These individuals may also be interested in taking advantage of provisions of the American Recovery and Reinvestment Act of 2009 (ARRA) that allow them to defer recognition until 2014 of income from cancellation of indebtedness occurring in 2009 or 2010 and then recognize it ratably over a five-year period starting that year.

One typical situation involves an individual who owns a membership interest in a limited liability company (LLC) that is treated as a partnership for tax purposes, which in turn holds title to real property. Let's assume the LLC also has a second, equal owner, with both owners having equal capital accounts and sharing profits and losses equally. The LLC is the legal titleholder of an office building with a mortgage of $21.5 million and a tax basis of $16.5 million. The property was refinanced two years ago when times were good, which allowed the members to each receive $1.5 million in distributions. The property is currently estimated to be worth $17 million. This individual has heard that if the property is given back to the lender, the discharged debt will be ordinary income. He wants to confirm the tax consequences. How will a foreclosure, bankruptcy or debt restructuring affect this individual?

<u>FORECLOSURE</u>**. In a foreclosure, the tax treatment depends on whether the debt secured by the property is nonrecourse or recourse. A debt is nonrecourse if the lender's only recourse upon the borrower's default on the debt is against the property securing the debt. A debt is recourse if the lender can look beyond the collateral pledged for the loan and hold the borrower - for a pass-through entity, its owners - personally accountable for the unpaid balance.**

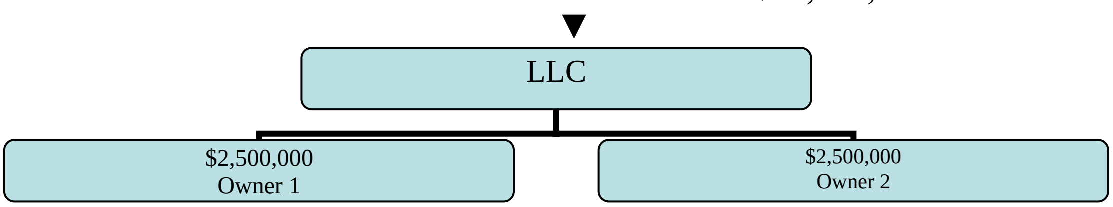
A foreclosure by a nonrecourse note holder is treated as a sale by the owner to the creditor for the greater of the fair market value of the property or the outstanding balance of the debt. The owner recognizes gain or loss equal to the difference between the tax basis of the property transferred to the creditor and the amount realized (The greater of the fair market value of the property or the debt discharged), and no cancellation of debt (COD) income is recognized under Internal Revenue Code of 1986, as amended (IRC) Section 61(a)(12) (see IRC 7701(g) and

Treas. Reg. 1.1001-2(b) and (c), Example 7; see also Commissioner v. Tufts, 461 U.S. 300 (1983), and Estate of Jerrold Delman, 73 TC 15 (1979)). Accrued interest not yet deducted by the borrower will be disregarded if the debtor uses the cash method of accounting (IRC 108(e) (2)).

In the above example, if the debt is nonrecourse, foreclosure would result in a deemed sale to the creditor for $21.5 million and taxable gain (recapture and capital gain treatment under normal rules) of $5 million (21.5 million minus $16.5 million). Since the LLC is a flow-through entity, each member would recognize one-half of that amount, or $2.5 million, as illustrated in Exhibit 1.

Exhibit 1 Nonrecouse Foreclosure: Gain

Debt Discharged	**$21,500,000**
Less Tax Basis	**$16,500,000**
Gain	**$ 5,000,000**



The $3 million previously distributed from the refinance transaction was not a taxable event but increased both the potential deemed sale price and the potential gain in the event of a foreclosure by increasing the amount of the debt without increasing the LLC's basis in the property. In other words, the sale price would have been $18.6 million but was effectively increased to $21.5 million after the additional borrowing, while the basis remained effectively unchanged because the loan proceeds were distributed to the owners instead of being used for property improvements.

If the mortgage on the property was with recourse, foreclosure can result in a combination of capital gain or loss and ordinary income. The tax law treats such a foreclosure as if the property were sold to the creditor for its fair market value (FMV), which is presumed to be the sale price at the foreclosure sale, absent clear and convincing proof to the contrary, resulting in capital gain or loss equal to the difference between the FMV and the tax basis (see Frazier v. Commissioner, 111 TC 243 (1998)). If the indebtedness exceeds the FMV of the property, the difference would be COD income, which is taxed as ordinary income to the extent forgiven by the lender (section 61(a)(12); Treas.Reg. 1.61-12 and 1.1001-2(a)(2); Revenue Ruling 90-16, 1990-1 CB 12; see also Julian S. Danenberg v. commissioner, 73 TC 370 (1979)). In this example, assuming recourse debt of $21.5 million is discharged by

the lender, the LLC would have a capital gain of $500,000 and COD income of $4.5 million ($21.5 million less $17 million), with each member recognizing one-half of those amounts, or $250,000 of capital gain and $2.25 million of COD income (see Exhibit 2).

Two exceptions to taxation of COD income are relevant to this client and involve foreclosure by a recourse note holder. First, COD income is taxed only to the extent the taxpayer is solvent (determined immediately before the discharge Section 108(a)(1)(B)). Second, COD income is not taxable in bankruptcy (discussed below). Insolvent taxpayers, however, must reduce tax attributes and reduce their basis of property (Section 108(b)). In addition, these exceptions are not available at the entity level; they are available only to each member to the extent the member qualifies, so the availability of these exclusions depends on the insolvency or bankruptcy of the members, not the LLC. Further, it is the member's tax attributes that are subject to reduction, not the attributes of the LLC. In fact, while these considerations of foreclosure are illustrated here for members of a two-member LLC, they apply equally to an individual.

<u>BANKRUPTCY</u>. A bankruptcy filing at the LLC level will stop or slow down a foreclosure and might allow the LLC to restructure its debts. However, the commencement of the bankruptcy case will not create a new taxable entity, and the LLC's tax incidence will continue to flow through to its members (Sections 1398(b)(2) and 1399). The tax incidence flowing through the LLC to the members is determined on the last day of the LLC's tax year (Section 706(a)).

A bankruptcy filing by the member will not trigger a partnership termination under Section 708(b)(1)(B). See Gulley v. Commissioner, TC Memo 2000-190 (2000). However, when an individual member files under Chapter 7 or 11 of the Bankruptcy Code, a new taxable entity is created, and that member's legal and equitable interests in property, including the membership interest in an LLC, become part of the bankruptcy estate under section 1398(d)(1). The member and the bankruptcy estate will then file separate returns. The new bankruptcy estate will succeed to the debtor member's post-petition interest in the member's assets, including income, gain, loss and deductions owned by the member (but not passive losses) (section 1398(g)). A new taxable entity is not created in a Chapter 13 filing.

The member should consider whether to elect under section 1398(d)(2) to close the member's taxable year on the day preceding the commencement date of the bankruptcy estate. If the Section 1398(d)(2) election is made, the member will have two short taxable years, the first beginning on the first day of the taxable year and ending on the day preceding the commencement date, and the second beginning on the commencement date and ending on the last day of the taxable year. If the election is made, the member's tax liability for the first short taxable year will be a

prepetition liability that is a charge against the bankruptcy estate, thought is is not dischargeable. If the election is not made, no portion of the member's tax liability for the year of the bankruptcy filing can be charged against the bankruptcy estate.

If foreclosure occurs at the LLC level during a member's Chapter 7 (liquidation) bankruptcy, the income resulting from the deemed sale is income of the bankruptcy estate, and the tax liability is an administrative expense of the estate. Again, a debtor in bankruptcy need not report COD income but must reduce tax attributes and reduce income tax basis. A trustee is concerned with getting the most he or she can for unsecured creditors and often will abandon an asset with a building gain if the asset is a burden to the state. In this case, the asset that would be abandoned is the LLC membership interest, not the real property, since the bankruptcy occurred at the member level.

In a Chapter 11 or 13 bankruptcy, the tax must be paid out of the assets of the estate. However, if a Chapter 11 or 13 case is converted to Chapter 7, the income tax is an administrative expense and is discharged. If, immediately before a foreclosure, the client filed for protection under either Chapter 7 or 11, the resulting income and tax will be attributed to the bankruptcy estate, and the client will escape taxation, a desired result. It is critical, however, that the property be foreclosed on and then taken completely out of the LLC's name before the bankruptcy discharge of the member occurs. If the asset is abandoned by the trustee prior to foreclosure, the client member would get the property back with the liability intact. If the property is foreclosed on after the abandonment, the tax liability would belong to the members. If a member's bankruptcy estate holds the membership interest at the end of the year, the distributive share of the LLC's income and loss for the entire year is allocated to the bankrupt estate. See Katz v. Commissioner, 116 TC 5 (2001); Gulley v. Commissioner, TC Memo 2000-190 (2000).

Bankruptcy, accordingly, is an option this client might consider, since taxable gain and COD income may be avoided. Nevertheless, bankruptcy is an extreme solution that involves adverse consequences that may offset any tax benefits that are realized. Therefore, when considering bankruptcy, advisers must also consider the client's overall financial situation and current and future needs.

<u>DEBT RESTRUCTURING OR DEBT BUYBACK</u>. The individual might also find that the lender has significant pressure to reduce its exposure to real estate and is willing to restructure the debt to provide more favorable terms, including a reduction in the principal balance of the debt. Alternatively, the lender may allow the individual and other member of the LLC to purchase the mortgage directly or indirectly trough an entity created by an under control of the individual and partner for less than the outstanding loan balance. Any such resulting, restructuring will carry a tax cost, however, by triggering recognition of COD income by the LLC, which, as discussed above, is ordinary income (Treas. Reg. 1.61-12(c)(2)(ii)).

COD income includes any discharge of debt in exchange for cash, new debt or significantly modified debt, or for an interest in a partnership, LLC or corporation with a value less than the outstanding face amount of the debt (Treas. Reg. 1.1001-3). COD income can arise from a reduction in nonrecourse liability without a surrender of the collateral (Revenue Ruling 91-31, 1991-1CB 19). In addition, COD income includes certain indirect acquisitions of debt through a party related to the buyer. Therefore, unless there were material changes in the beneficial ownership structure, it would be difficult to create entities to get around the tax problem. Indeed, the definition of "related party" is very broad and includes entities under the common control of the owners of an LLC (Section 108(e)(4)). Any significant modification of existing debt or replacement of a new debt for an old debt is deemed a discharge of debt for an amount equal to the issue price of the new debt, determined in accordance with original issue discount and imputed principal rules of sections 1273 and 1274 (section 108(e)(10)).

In the case of this individual, assume that both members together or through a new LLC purchase the $21.5 million mortgage from the lender for $19 million. The existing LLC would have COD income of $2.5 million, resulting in COD income to each member of $1.25 million. It would not matter whether the mortgage was recourse or nonrecourse to the members (see Exhibit 3).

ARRA DEFERAL AND SPREADING OF COD INCOME.

The ARRA, known as the Stimulus Act, codified the new IRC 108(i), providing an attractive option for taxpayers with taxable COD income. It allows them to elect to defer COD income recognized because of a "reacquisition" of an "applicable debt instrument" that occurs in 2009 or 2010. Taxpayers making the election will recognize the deferred income ratably over a five-year period beginning in 2014.

In the example above, if the Section 108(i) election for deferral and spreading of COD income were made, the LLC would recognize $500,000 of COD income $250,000 to each member) each year from 2014 to 2018 (see Exhibit 4).

The deferral is accelerated and income taken into account in the tax year in which the taxpayer (1) dies, (2) liquidates or sells substantially all of its assets (in bankruptcy cases deferred items are taken into income as of the day before the petition is filed), (3) ceases to do business, or (4) is in a similar circumstance to any of the above (Section 108(i)(5)(d)(i)).

The election to defer COD income must be made on the tax return of the debtor for the year in which the reacquisition occurs. The election is made on an instrument-by-instrument basis and is irrevocable once made. For pass-through entities such as the LLC in this case, it must be made at the entity level.

To make the election under Section 108(i), the COD income must arise in connection with a "reacquisition" of an "applicable debt instrument." A reacquisition occurs when a debtor (or related party) obligated under an applicable debt instrument (a debt instrument issued by a C corporation or by any other taxpayer in connection with the conduct of a trade or business) acquires the

instrument. It includes a deemed reacquisition resulting from a significant modification of the debt, an acquisition of debt for cash, and exchange of the debt instrument for another debt instrument, the exchange of the debt for corporate stock or a partnership interest, the contribution of the debt to capital, or the complete forgiveness of the debt by the holder.

A debt instrument is a bond, debenture, note, certificate or any other instrument or contractual agreement constituting indebtedness under Section 1275(a)(1). Any such reacquisition that gives rise to COD income may also decrease the allocable share of LLC liabilities of the LLC's members, which is generally treated as a nontaxable distribution but is taxable tot eh extent the deemed distribution exceeds the member's bases in their respective LLC interests. Any gain on such a deemed distribution will likewise be deferred until the remaining COD income recognized.

Before restructuring any LLC or partnership debt, the adviser should carefully review Sections 731 and 752 and the potential tax consequences tot eh members of an LLC of changes in entity-level liabilities that could be triggered by the debt restructuring, including possible conversion of partnership nonrecourse liabilities into recourse liabilities. Moreover, the election effectively waives the application of the COD income recognition exceptions mentioned above that would apply to owners of pass-through entities. Accordingly, each instance should be analyzed to determine whether the election would benefit or hurt the owners by preventing them from taking advantage of otherwise available exceptions to COD income recognition.

LESSENING THE ADVERSITY OF "UPSIDE DOWN" MORTGAGES

CPA's can provide their clients who are investors in pass-through entities and face "upside down" mortgages and reduced or negative cash flows with alternatives that can lessen, delay or eliminate adverse tax consequences. Nevertheless, since various forms of bankruptcy may be part of this tax planning. CPAs should work closely with a bankruptcy attorney when mapping out a plan that fits the facts and circumstances of each client. This is not any easy decision nor should any of the above moves be made without significant discussions with as many advisors as possible, to include a bankruptcy attorney.