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Proper Planning for Debt Workouts

By Richard M. Goldstein and Patrick W. Hancock

The severe economic downturn in residential and commercial real estate, coupled with high loan-to-value ratios at origination, has left a substantial number of real estate owners with zero or "negative" equity in their property. Commercial and residential rental real estate assets are struggling to generate sufficient income to meet financing obligations in the current market. Many property owners face loan defaults, bank workouts, or imminent foreclosure.

To add insult to injury, owners of distressed property may realize gross income and incur tax liability from a real estate debt workout with a lender. Fortunately, certain provisions under the Internal Revenue Code, including new legislation, exempt certain debt relief income from taxation or permit deferral of such income.

Generally, a lender's discharge of a debt results in gross income to the debtor equal to the amount of the cancelled debt. Likewise, a negotiated reduction of a debt, or a modification of a debt instrument that results in a reduction of the debtor's indebtedness, produces cancellation of indebtedness income to the extent of the debt's write down. In addition, a partnership that transfers a capital or profits interest therein to a creditor in satisfaction of all or a portion of a partnership debt recognizes cancellation of indebtedness income as if the debt had been satisfied with cash equal to the fair market value of the partnership interest.

Also, a conveyance of encumbered property from debtor to lender in satisfaction of the debt is treated as a sale or exchange for tax purposes, regardless of whether the transfer is by deed in lieu of foreclosure or by foreclosure. Property encumbered by nonrecourse debt is treated as sold for the full amount of the debt and the taxable gain is the difference between the debt and the taxpayer's basis. When recourse debt is discharged by foreclosure, the debtor has gain or loss equal to the difference in fair market value and its basis, and also recognizes cancellation of indebtedness income to the extent the debt exceeds the fair market value of the foreclosed property.

Assuming that a taxpayer has cancellation of indebtedness income, there are several provisions of the IRC available to eliminate or defer the income tax liability. For example, if a taxpayer is insolvent when the discharge of debt occurs there is no cancellation of indebtedness income.

Also, if the debt was incurred or assumed in connection with the acquisition, construction, reconstruction or improvement of real property used in a trade or business and secured by that real property, a taxpayer may elect to exclude income attributable to discharge of the debt from gross income. The income excluded reduces the basis of the property. The amount excludable under this provision may not be more than the excess of the outstanding principal amount of such debt (immediately before the discharge) over the fair market value (immediately before discharge) of the business real property that is security for the debt.

Finally, recent legislation was enacted permitting taxpayers to elect to defer taxation on cancellation of indebtedness income from the reacquisition of an applicable debt instrument this year or in 2010 until 2014 and include such income ratably over five years (i.e., 20% of 2009 cancellation of indebtedness income that qualifies for deferral is included in taxable income in 2014 and each of the four years thereafter).

For purposes of this new deferral-of-income rule, "applicable debt instrument" means any debt instrument that was issued by a C corporation or any other person, including a partnership, in connection with the conduct of a trade or business by such person. A "reacquisition" includes an acquisition in exchange for an interest in a partnership and the forgiveness of all or a portion of a debt instrument.

Although the pitfalls of cancellation of indebtedness income can present onerous obstacles for underwater property owners, proper planning for debt workouts, including use of the insolvency exemption and the acquisition indebtedness exemption to eliminate income taxation, as well as the recently enacted deferral legislation, can go a long way toward substantially reducing a debtor's current income tax burden.

The views expressed here are those of the author and not of ALM's Real Estate Group or its publications.

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