

MATERIAL TAX CONSEQUENCES OF REAL ESTATE WORKOUTS

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Discussion Example:

The real estate is a Traverse City, Michigan shopping center (the “Project”). The Project’s annual net operating income has generally equaled its operating expenses, including interest, but recently the owner of the Project, Borrower LLC (“Borrower”), has lost a number of key tenants. The owners of Borrower, individuals A, B and C, each of whom own 1/3 membership interests, know that they will not be able to continue making debt service payments to the Project’s senior lender (the “Lender”). Borrower owes Lender \$10 million (the “Debt”), which is secured by the Project and it estimates that the current value of the Project is \$7.5 million. The original term of the Debt was fifteen (15) years. On account of annual depreciation deductions Borrower has a \$4 million tax basis in the Project and each of A, B and C have (\$2 million) negative capital accounts. A, B and C each have other real estate interests that are performing well. A has served as the Manager of Borrower and as such, has assumed the duties of filing its tax returns and paying any taxes owing.

This Outline identifies the material tax issues that typically arise, for each of Borrower and Lender, as they negotiate Borrower’s distressed financial situation.

I. Principal Reduction:

- A. **Backdrop:** Borrower believes that the Project will turn around and believes that if it can negotiate a reduction of the Debt to an amount equal to its \$7.5 million FMV, Borrower can cover the annual debt service to the Lender and ultimately protect its upside investment.

- B. **Tax Stakes:** If Lender agrees to this reduction, without taking back the Project, then Borrower will have cancellation of indebtedness income (“COD”) under Code § 61(a)(12) and Treas. Reg. § 1.61-12(a). The amount of COD will equal the reduction in liability, or \$2.5 million. If Lender is a corporation (or if not, provided the debt is other than a non-business debt), § 166(a)(2) permits a creditor to claim a deduction from ordinary income with respect to a partially worthless debt, but only if the creditor charges off such debt on its books during the tax year.

II. Recognition of COD:

A. **Generally:** The Code provides various statutory exclusions which apply to a taxpayer's recognition of COD income. Since these exclusions apply *only* to COD, as opposed to other sources of income (*i.e.* gain from sale), a critical planning aspect of any real estate workout is to structure the transition in a way to generate COD.

B. Deferral of COD:

1. Historically, prior to 1993, §108(a) permitted taxpayers to exclude COD only if they were either bankrupt or insolvent (but only to the degree of such insolvency). §108(a)(1)(A) and §108(a)(1)(B).

a. The bankruptcy exclusion applies to a taxpayer under the jurisdiction of a court in a case under title 11 and the discharge of indebtedness is granted by the court or pursuant to a plan approved by the court. §108(d)(2).

b. Insolvency is defined as the excess of liabilities over the fair market value of assets (*i.e.* a balance sheet analysis) and is determined based upon the taxpayer's assets and liabilities immediately before the discharge. §108(d)(3).

(1) Assets that are typically exempt for bankruptcy purposes (*e.g.* personal residence) are included in the calculation of a taxpayer's assets.
Roderick E. Carlson, 116 T.C. 87.

(2) Contingent liabilities and guaranties are also taken into account, but only if it is more probable than not that the taxpayer will be called upon to pay the amount claimed. *D.B. Merkel*, 192 F.3d. 844, *aff'g* 109 T.C. 22.

(3) When non-recourse debt is secured by property and the fair market value of the property is less than the debt, Rev. Rul. 92-53, 1992-2 C.B. 48 concludes that the debt in excess of the property's value may be treated as a liability, but only if such excess is discharged by a lender.

2. Operationally, §108(a) permits taxpayers to exclude COD in exchange for reducing certain tax attributes. Thus, the label of “COD exclusion” in § 108(a) is a misnomer. The cost for immediate recognition of COD is foregoing tax attributes that a taxpayer may benefit from in the future. Consequently, Section 108(a) practically functions merely as a deferral of COD. The length of this deferral will depend on which attributes a taxpayer forfeits.
3. In the context of real estate, where property is typically owned by partnerships and now LLCs, these provisions have traditionally been of limited use, since the tests for bankruptcy and insolvency are made at the partner level as opposed to the partnership level. §108(d)(6). In other words, while Borrower LLC might file for bankruptcy or claim that it is insolvent, the LLC’s recognition of COD may only be deferred if any of its members, A, B or C, can themselves demonstrate bankruptcy or insolvency. As suggested in the discussion example, this is not the case and consequently, neither A, B nor C will be able to defer the recognition of COD based upon the bankruptcy or insolvency exceptions of §108(a).
4. While LLCs and partnerships are almost always the preferred vehicle for real estate investments, with respect to the narrow issue of COD deferral, S corporations are clearly preferable. This is because the determination of bankruptcy and insolvency for S corporations is made at the corporate level. §108(d)(7)(A). This is a rare but significant advantage of S corporations over LLCs. Could Borrower LLC convert to an S corporation, thus allowing its members A, B and C to defer the \$2.5 million of COD? Not without significant gain recognition. While the contribution of assets to a corporation is generally tax free under § 351, an exception exists where encumbered assets are contributed. Code § 357(c) will cause a taxpayer to recognize gain upon capitalizing a corporation equal to the excess of liabilities assumed by the corporation over the tax basis of the contributed assets. In the case of Borrower LLC, this would result in the immediate recognition of \$6 million in gain on account of the members’ collective negative capital accounts. This gain would be recognized regardless of the form in which Borrower converts to a corporation (*e.g.* contribution of assets; liquidation of assets; contribution of membership interests; automatic conversion under state law).

5. Assuming that either A, B or C could qualify under the bankruptcy or insolvency exclusions, Code §108(b)(2) specifies the order of tax attribute reduction: NOLs, general business credits, alternative minimum tax credits, capital loss carryovers, taxpayers' basis in property, passive activity losses and credits and foreign tax credits.
 - a. Taxpayers' may elect to first apply the COD against the basis of depreciable property. §108(b)(5).
 - b. These reductions are made after the taxpayer computes his or her tax liability for the year of discharge and thus do not impact the taxpayer's tax liability for such year. §108(b)(4).
 - c. Attributes are reduced on a dollar for dollar basis, except with respect to credits, which are reduced 33.3¢ for every dollar of COD deferred. §108(b)(3).
6. If a taxpayer's COD exceeds his available tax attributes, then any excess COD is simply excluded. Thus, in this narrow case, §108(a) will function as a true exclusion of COD and not merely as deferral.
7. In response to the inability of solvent partners/members to obtain relief under §108, Congress adopted in 1993, the qualified real property business exception to COD recognition ("QRPBI"), set forth in §108(c).
 - a. Generally, the concept is that all partners/members may claim the exemption; there is no need for bankruptcy or insolvency. The cost of making such election, however, is a dollar for dollar reduction in the basis of depreciable property. Conceptually, the immediate tax hit of COD is thus deferred into the future by virtue of reduced depreciation deductions from the property secured by the discharged debt, as well as potential greater gain on a future disposition. Like the exclusions for bankruptcy and insolvency, the election is made at the partner level. §108(d)(6). Thus, depending on the particular circumstances of members in an LLC, each may decide to invoke different deferral opportunities under § 108 (e.g., bankruptcy, insolvency or QRPBI). For S corporations, the election for relief

under the QRPBI exclusion is made at the corporate level. §108(d)(7).

- b. QRPBI is defined as indebtedness which: (i) was incurred or assumed by the taxpayer in connection with real property used in the trade or business and is secured by such real property, (ii) was incurred or assumed before January 1, 1993, or was incurred or assumed after such date to acquire, construct, reconstruct, or substantially improve such property, and (iii) with respect to which the taxpayer makes an election. §108(c)(3). Recently, in PLR 200953005, the Service concluded that an LLC's indebtedness secured by its ownership in a disregarded entity owning real property, would satisfy the "secured by real property" requirement to qualify as QRPBI.
- c. Two principal exceptions exist with respect to the amount a taxpayer may claim under the QRPBI exclusion. The amount of the exclusion cannot exceed the lesser of: (i) the outstanding principal balance of the debt (immediately before the discharge) over the fair market value of property securing the debt or (ii) the aggregate adjusted basis of depreciable real property of the taxpayer. §108(c)(2).
 - (1) As applied to Borrower, the first limitation, which is calculated at the LLC level, would be computed as \$10,000,000 - \$7,500,000 or \$2.5 million.
 - (2) The second limitation is applied at the member level and with respect to A, B and C, in the aggregate, would equal \$4.0 million.
- d. Complex rules at Code §1017 describe the ordering and timing of basis reduction that must be made against depreciable property. Treas. Reg. §1.1017-1(c) indicates that the basis reduction must be made first to the property that has secured the debt which has been forgiven, and then to other depreciable property owned by the taxpayer.
- e. Basis reductions are made on the first day of the tax year which immediately follows the year of

discharge. Treas. Reg. §1.1017-1(a). Such reduction will be accelerated, however, if the property is disposed of prior to such time. Code § 1017(b)(3)(F)(iii).

- f. For purposes of making basis reductions, partners (who do not per se own the underlying real property of their partnerships), must treat their partnership interests as depreciable property, to the extent of their “proportionate share” of the partnership’s basis in such property, but only if the partnership consents to a corresponding reduction in the partnership’s inside basis of such depreciable property. Treas. Reg. §1.1017-1(g). Effectively, the mechanism is similar to that which occurs when a partner makes a § 754 election and a partnership adjusts such partner’s inside basis of partnership property under § 743.
- (1) The regulations provide that certain partners must formally request the consent of the partnership in order to undertake the basis adjustment.
 - (2) A taxpayer must request a partnership's consent to reduce inside basis if, at the time of the discharge, the taxpayer owns (directly or indirectly) a greater than 50 percent interest in the capital and profits of the partnership, or if reductions to the basis of the taxpayer's depreciable property (or depreciable real property) are being made with respect to the taxpayer's distributive share of COD income of the partnership. Treas. Reg. §1.1017-1(g)(2)(ii)(B).
 - (3) A partnership must consent to reduce its partners' shares of inside basis with respect to a discharged indebtedness if consent is requested with respect to that indebtedness by partners owning (directly or indirectly) an aggregate of more than 80 percent of the capital and profits interests of the partnership or five or fewer partners owning (directly or indirectly) an aggregate of more than 50 percent of the capital and profits interests of the partnership. Treas. Reg. §1.1017-1(g)(2)(ii)(C). Thus, if each of

A, B and C were to make a request for the consent of Borrower, since collectively they would own more than 80% of the capital and profits of Borrower, Borrower would have to consent.

- g. If a taxpayer elects QRPBI, the gain on a future sale of such property may in part be taxed as ordinary income; effectively to recapture what would have been COD income. § 1017(d)(2). The amount of ordinary recapture will bleed off annually, however, with it disappearing completely if the taxpayer holds the property for the duration of its depreciable life.

8. **New 5-Year Deferral:**

- a. Effective for tax years ending 2009 and 2010, Congress has enacted §108(i), which gives taxpayers the opportunity to defer COD income for a period of 60 months, commencing in 2014. Unlike traditional COD deferral mechanisms, there is no quid pro quo in terms of attribute reduction or basis reduction. Rather, this is simply deferral, with a specific time horizon.
- b. To qualify, an “applicable debt instrument” must be “reacquired” either for: (i) cash; (ii) in exchange for another debt instrument; (iii) for stock or a partnership interest; (iv) in exchange for a contribution to capital or (v) completely forgiven. §108(i)(4)(B). An outstanding issue with this new legislation is whether COD created in the event of a foreclosure is within the ambit of the new rule. Technically, the exchange of “property” for an applicable debt instrument does not fall within the reach of the statute. While the IRS has yet to issue clear guidance on this point, many practitioners feel that COD created upon a foreclosure would qualify.
- c. An “applicable debt instrument” is defined as any “debt instrument” issued by a corporation or any other person in “connection with the conduct of a trade or business.” Code § 108(i)(3)(A). While the activities of Borrower will amount to a trade or business, it is possible that a single asset LLC involving a triple net lease may not meet this “trade

or business” standard, since it may be treated as a mere investment activity. A debt instrument is broadly defined to include any bond, debenture, note, certificate or other contractual arrangement constituting indebtedness. Code § 108(i)(3)(B).

- d. Unlike the other elections under §108(a) or (c) which are made at the partner level, the 5-year deferral is made at the partnership level. §108(i)(5)(B)(iii). Further, if a partnership elects the 5-year deferral, none of its constituent members may take advantage of any of the other deferral mechanisms. §108(i)(5)(C). This introduces conflict among members who may have differing tax positions (*e.g.*, if one member wishes to use the QRPBI, or is insolvent). Recently issued Rev. Proc. 2009-37, however, does suggest a mechanism where partners may have some flexibility to obtain disparate treatment.
- e. The new 5-year deferral has a number of acceleration rules. These include immediate full COD recognition in the event of the sale of substantially all of the borrower’s assets (including liquidation or title 11 filing), ceasing to do business or similar circumstance. §108(i)(5)(D)(ii). In the case of pass thru entities, additional acceleration rules apply in the case of a partner’s death, redemption, or other sale or disposition of a membership interest. §108(i)(5)(D)(i). Note that the acceleration of COD on death effectively means that a partner will not be able to receive any basis step-up (assuming such death occurs after 2010).
- f. Section 108(i)(6) integrates the rules of debt discharge with those regarding deemed distributions associated with reductions of debt under § 752(b). Generally, when a partnership’s debt is reduced the amount of such reduction is treated as a deemed distribution of cash under § 752(b). If this deemed distribution exceeds a partner’s outside basis, gain will be triggered under § 731(a). Since recognized COD increases a partner’s outside basis, the deemed distribution of § 752(b) is often offset by an identical basis increase. [Note that where COD is allocated differently than the deemed distribution, this will not occur. *See* Rev. Rul. 92-97, 1992 – 2

C.B. 124]. Given the deferral afforded by § 108(i), a partner's outside basis is not immediately increased. Hence, if the deemed distribution rules under § 752(b) still operated, partners may recognize gain associated with the debt discharge under § 731(a). Section 108(i)(6) prevents this from occurring by deferring the deemed distribution under § 752(b), but only as necessary to prevent gain recognition under § 731(a). The cost, however, is that with respect to members with negative capital accounts, they may lose the benefit of taking future tax losses, since their outside tax basis may be reduced to zero.

- g. In the case of acquisitions of debt by related parties, §108(i)(2) eliminates the borrower's annual OID deductions [*See* §IV.G, *infra*] thus preventing an unintended benefit from the deferred COD income. Note that the related party who acquired the debt, however, must still pick up OID income. In many circumstances, this has the effect of simply shifting immediate COD recognition to the related party, in the form of OID recognized over the remaining life of the loan.
- h. The several deferral items associated with an election under §108(i) — those relating not only to COD, but also OID and § 752(b) delayed distributions, must annually be reported to both the IRS and partners in accordance with the rules set forth in Rev. Proc. 2009-37. These reporting requirements are detailed, complicated and in the case of partners who themselves are partnerships (who must report these items to their constituent owners), extremely burdensome.
- i. On balance, the QRPBI exception may be preferable, since its deferral horizon may be far greater than merely 5 years. As well, members with deep negative capital accounts, who rely on the basis step-up of §1014 on death, will also prefer the QRPBI exclusion.

III. Significant Modifications:

- A. **Backdrop:** Lender refuses Borrower's request to reduce the principal of the Debt. Rather, Lender agrees to extend the term of the Debt an additional five (5) years.
- B. **Tax Stakes:** Code § 108(e)(10) provides that COD may be recognized upon the *exchange* of a new debt instrument for an existing debt instrument. At issue is whether the modifications to the Debt will be treated as an exchange falling within § 108(e)(10). If so, Borrower may recognize COD even when there is *no express reduction* in principal granted by Lender.
1. Code § 108(e)(10)(A) provides that a debtor will be treated as having satisfied an existing indebtedness with an amount of money equal to the issue price of such new debt instrument. Issue price, for this purpose, is determined under the rules of §§ 1273 and 1274. Generally, if the debt is not publicly traded, § 1274 will govern and treat the issue price as the stated principal amount of the debt, but only where there is adequate stated interest (*i.e.* an interest rate at least equal to the AFR). If the debt is publicly traded then the FMV of the property will be its issue price.
 2. Taken together, these rules mean that if the new debt instrument has an issue price less than the principal amount of the existing indebtedness, the debtor will recognize COD equal to this difference. As well, if the creditor has a basis in the existing debt less than the issue price of the new indebtedness (*i.e.*, a purchase at a discount), such creditor will recognize gain.
- C. In 1996, the Treasury finalized regulations at Treas. Reg. § 1.1001-3 which provide rules on when debt instruments are deemed modified. These regulations were in response to the Supreme Court decision in Cottage Savings Association v. Commissioner, 499 U.S. 554 (1991). Under the Treas. Reg. at § 1.1001-3, any *significant modification* will be treated as resulting in a deemed exchange of a debt instrument. §1.1001-3(b).
1. A modification is broadly defined as any alteration in any legal right or obligation of the issuer or holder unless the modification occurs by operation of the original terms of the instrument. § 1.1001-3(c)
 2. Creditor agreements to defer collection after default, delay acceleration rights or defer demand for payment after

acceleration are not generally treated as modifications if the forbearance period is limited to two years (with extensions granted if the debtor is in a title 11 case or the parties are negotiating in good faith). Treas. Reg. § 1.1001-3(c)(4)(ii).

- D. Whether modifications are treated as *significant* depends on all of the facts and circumstances. Treas. Reg § 1.1001-3(e). Generally, modifications are considered collectively, so that a series of modifications may be significant when considered together although each modification, if considered alone, would not be significant. Treas. Reg § 1.1001-3(e)(1). Notwithstanding this collective approach, a number of bright line rules identifying “significant modifications” have been established at Treas. Reg § 1.1001-3(e), and these are summarized below:
1. a change in the yield to maturity of more than 25 basis points. Treas. Reg § 1.1001-3(e)(2) ;
 2. an extension of the final maturity of more than the lesser of five (5) years or fifty percent of the original term, Treas. Reg § 1.1001-3(e)(3);
 3. changes in the obligor of recourse (but not non-recourse) debt. Treas. Reg § 1.1001-3(e)(4)(i);
 4. the addition or material alteration of a guaranty or other form of credit enhancement. Treas. Reg § 1.1001-3(e)(4)(iv);
 5. a change in collateral securing non-recourse debt if a substantial portion of the collateral is released or replaced with other property (exclusive of collateral that is fungible). Treas. Reg § 1.1001-3(e)(4)(iv)(B);
 6. a change in the priority of a debt instrument relative to other debt of the issuer, if it results in a change in payment expectations. Treas. Reg § 1.1001-3(e)(4)(v); and
 7. a change from recourse to non-recourse or vice versa. Treas. Reg § 1.1001-3(e)(5)(ii).
- E. In the discussion example, since the Debt has been extended by five (5) years, which is more than the lesser of five years or fifty percent of the original term of 15 years, the Debt will be treated as significantly modified. Notably, many other common modifications would have also produced the same result, such as requiring a guarantee to be executed by A, B or C or increasing the interest rate.

- F. Oddly, the party most often adversely affected by the deemed exchange resulting from a significant modification is the lender.
1. If the debt retains an interest rate at least equal to the AFR (which is likely in a workout situation), then the issue price of the deemed new debt instrument will be its principal amount. In the absence of any principal reduction, no COD will be triggered since the new debt will be deemed satisfied for an amount of money equal to its face amount.
 2. In the case of a lender, however, if the lender's basis in the old debt instrument is less than its face amount, possibly due to an earlier discounted purchase from the original lender, then ironically, the lender will recognize gain on the deemed exchange. Since the lender is most likely the party that initiated and directed the particulars of the debt modification, this ranks high among the traps for the unwary.

IV. Sale of Debt:

- A. **Backdrop:** Lender has refused any principal reduction or modification of the Debt. Lender has indicated that it is willing to sell the Debt, however, either to the Borrower or a third party, for its FMV, or \$7.5 million.
- B. **Tax Stakes:** If the Lender sells off the Debt to a third party *unrelated* to Borrower, there will be no tax consequences to the Borrower. Alternatively, under § 108(e)(4), if the Debt is acquired by a person bearing a relationship to the debtor specified in § 267(b) or § 707(b)(1), from a person who does not bear such a relationship to the debtor, then Borrower will incur COD. From the lender's perspective, if the Debt is sold (regardless of to whom), the Lender will recognize a loss on its sale equal to the difference between its amount realized (\$7.5 million) and its existing tax basis (\$10 million).
- C. Relatedness is tested under §§ 707(b) and 267(b) and generally refers to a more than 50% affiliation. In this regard, a number of attribution rules apply as set forth in § 267(c). In addition, two entities treated as a single employer under § 414(b) or (c) will be treated as related for purposes of testing under § 108(e)(4). Thus, for example, if A's daughter were to acquire the Debt, while attribution rules would treat this as if A herself acquired the Debt, A's 33.33% interest would not eclipse the more than 50% relatedness standard.

1. In complicated LLC structures where members' interests shift, the determination of the 50% threshold is particularly complicated.
 2. In this regard, note that as of 2008, the partnership tax return Form 1065, now asks specific questions regarding the identity of more than 50% partners or members in an entity. *See* Schedule B, Q.3 and Q.4. Clearly, the IRS is now more interested in tracking related party transactions.
- D. Assuming the relatedness threshold is tripped, then §108(e)(4) will treat the debtor as having acquired the existing indebtedness with the issuance of a new debt instrument.
- E. Under Treas. Reg. §1.108-2(f)(1), the debtor will recognize COD equal to the excess of the adjusted issue price of the (old) debt instrument over the related party's adjusted basis in the acquired debt (generally, its cost).
- F. Any COD generated may be deferred under the available exemptions of §108, including those relating to bankruptcy and insolvency, QRPBI and the 5-year deferral.
- G. A significant and complicated wrinkle of any transaction involving the acquisition of debt by a related party is the creation of original issue discount ("OID"). Treasury Regulations at 1.108-2(g)(2) provide that any difference between the face amount of the old debt and the issue price of the deemed new debt (*i.e.* cost basis), is treated as OD.
1. Under applicable rules, this OID may be deducted by the borrower and picked up as income by the related party during the life of the loan.
 2. If the borrower and the acquirer are significantly (*i.e.*, near 100%) related, these items will generally offset one another. If the relatedness is closer to 50% however, then unexpected parties may be picking up phantom income. In many cases, assuming parties have elected to defer COD under one of the provisions of § 108, this phantom OID pickup becomes a key driver in a workout scenario. For this reason, taxpayers will often strive to have an unrelated, but friendly party acquire debt.
 - a. Note that if successful, any changes to the recently acquired debt (*e.g.*, decreasing the interest rate, extending the maturity, etc.) may trip the rules on

significant modifications, in which case the friendly party may paradoxically end up recognizing gain.

- b. Assuming the debt remains unmodified, any principal amounts received by the acquiring party in excess of its issue price, will be subject to the market discount rules of § 1276, and generally reported as ordinary income, but only when cash is received.
- H. Regulations at 1.108-2(c) also contemplate that an indirect acquisition might be subject to the related party rules and COD income. An indirect acquisition includes a transaction in which the holder of an outstanding indebtedness becomes related to the debtor, but only if the holder acquired the indebtedness in anticipation of becoming related to the debtor. This would occur, for example, if after A acquired the Debt from Lender, A transferred a portion of such Debt to B. Since A *together* with B would now exceed the more than 50% relatedness threshold, § 108(c)(4) may be triggered. Treas. Reg. §1.108-2(c)(2) provides that all relevant facts and circumstances will be considered to determine whether the intent test is satisfied. A presumption exists that if the holder acquired the indebtedness less than six months before the date the holder becomes related to the debtor, that such debt was acquired in anticipation of becoming related. Treas. Reg. §1.108-2(c)(3).

V. Admission of Lender to Partnership:

- A. **Backdrop:** The Lender has refused to reduce or modify the Debt for no consideration. The Lender has indicated, however, that it is willing to take an equity position in Borrower in exchange for reducing the face amount of the debt to \$7.5 million.
- B. **Tax Stakes:** Admitting a lender into a distressed partnership has historically been one way of addressing a borrower's financial distress. This transaction, however introduces numerous complexities and will often result in either COD recognition to a borrower's partners or taxable gain to such partners under § 731(a).
- C. Code §721 provides that no gain or loss will be recognized to a partnership or any of its partners where property is contributed in exchange for an interest in the partnership. Recently issued proposed regulations at §1.721-1(d)(1) confirm that § 721 applies to a contribution of the partnership's recourse or non-recourse indebtedness by a creditor in exchange for a capital or profits

interest in the partnership. The proposed regulation goes on to state, however, that § 721 will not apply if the indebtedness represents unpaid rent, royalties or interest on indebtedness (including accrued OID). Prop. Reg. § 1.721-1(d)(2). As a consequence, if the Lender contributes \$2.5 million of its debt for an interest in Borrower, the Lender will not have any gain or loss.

- D. The tax consequences to the Borrower, however, are not generally as favorable. Historically, some practitioners believed that a common law “debt for equity” exchange would not trigger any COD income. In 2004, however, Congress enacted § 108(e)(8), which now provides that a partnership that transfers a capital or profits interest to a creditor in satisfaction of a recourse or non-recourse liability, will be treated, for purposes of § 108, as having satisfied the liability with an amount of money equal to the *fair market value* of the transferred partnership interest.
1. Prop. Reg. § 1.108-8(b) provides that the fair market value of a partnership interest transferred by a debtor partnership to a creditor in satisfaction of the debt is the *liquidation value* of the debt-for-equity interest.
 2. Liquidation value is defined as the amount of cash that the creditor would receive with respect to the debt-for-equity interest if, immediately after the transfer, the partnership sold all of its assets (including goodwill, going concern value, and any other intangibles associated with the partnership’s operation) for cash equal to the fair market value of those assets and then liquidated, provided: (a) the partnership maintains the typical capital account maintenance rules of Treas. Reg. § 1.704-1(b)(2)(iv); (b) all parties treat the partnership interest as having such liquidation value; (c) the debt for equity exchange is arms length and (d) subsequent to the exchange, neither the partnership nor any related party redeems the debt for equity interest as part of a plan to avoid COD income by the partnership.
 3. Typically, in a distress situation, the liquidation fair market value of a debt-for-equity interest will be less than its face amount and consequently, under § 108(e)(8), it is likely that a partnership which admits in a creditor will recognize COD income. In the discussion example, assuming the value of Lender’s membership interest is \$100,000, Borrower would have \$2.4 million of COD. Members A, B and C, however, would be able to mitigate this income by electing under § 108(a), § 108(c) or § 108(i).

4. A further wrinkle on any debt for equity exchange is that the partnership's overall liabilities will decrease. Under rules at § 752(b), a decrease of partnership liabilities will be treated as a deemed distribution of cash. While this deemed distribution will often be offset by an equal amount of COD income, there are some circumstances where COD income will be allocated differently than discharged indebtedness. Rev. Rul. 92-97, 1992 – 2C.B. 124. In such a situation, a partner may recognize gain under § 731(a)(i).
5. Beyond this obvious wrinkle there is a related, but less noticeable effect upon a creditors admission to a partnership. Under applicable rules at Treas. Reg. § 1.752-2(c)(1), when a more than 10% partner becomes a lender, such partner is treated as economically at risk and hence all of the debt associated with such member (or related party) is allocated to such partner and away from members who historically received such an allocation. To the extent these other members had negative capital accounts, this loss of allocable debt will force them recapture their negative capital account balances, resulting in taxable gain under Code § 731(a)(1).
 - a. A similar rule will reallocate debt in the event a member guarantees non-recourse debt of a partnership. Treas. Reg. § 1.752-2(b)(3)(i);
 - b. Members will sometimes execute bottom dollar guarantees or agree to limited deficit restoration obligations in order to insure that they will have a minimum amount of debt allocable to them to prevent the recapture of their negative capital accounts.

VI. Property Transfer:

- A. **Backdrop:** Lender is not interested in any modifications to the Debt and has communicated that it simply wishes to acquire the Project in complete satisfaction of Borrower's obligation.
- B. **Tax Stakes:** Unlike the prior workout efforts, where Borrower has mostly been concerned about recognizing COD income (and possibly gain on the deemed distribution rules of § 752(b)), if a transfer of the Project occurs, then both Borrower and Lender must address the tax consequences of a property disposition, a situation far more complicated than just recognizing COD. Generally, the form of the property disposition, whether through

statutory foreclosure or deed in lieu of transaction, does not materially vary the tax consequences to the parties.

- C. **Federal Tax Consequences to Borrower:** The tax treatment to the borrower depends critically on whether the debt is recourse or non-recourse.

1. **Nonrecourse Debt:**

- a. When property is transferred in satisfaction of a non-recourse debt, the borrower will be treated as having sold the property for an amount equal to the face amount of the non-recourse liability. Gain (or loss) will be calculated as the difference between the face amount of the debt and the taxpayer's basis. The FMV of the property is not relevant. Treas. Reg. § 1001-2(c), Ex. 7, *Commissioner v. Tufts*, 461 U.S., 300 (1983). In the discussion example, this means that the Borrower will recognize gain of \$6 million (\$10 million Debt - \$4 million basis).
- b. Provided the Project has been held for at least one (1) year, the gain will generally be classified as a §1231 gain, which may be taxed at favorable capital gains rates (currently 15%, scheduled to increase to 20% on January 1, 2011).
- c. The key exception to this rule is that depreciation recapture is subject to a 25% rate. §1(h)(6)(A). Thus, in the discussion example, all \$6,000,000 would be treated as §1250 gain, taxable at the 25% rate.

2. **Recourse Debt:**

- a. If the Debt were recourse, then the tax treatment is materially different. Here, the FMV of the Project is very relevant. Borrower would recognize gain equal to the difference between the fair market value and the Project tax basis, or \$3,500,000, and this gain would be characterized as §1231 gain. Under the facts of the discussion, example, this gain would be treated as depreciation recapture at a 25% rate. The difference between the debt of \$10,000,000 and the fair market value of \$7,500,000, however, an amount equal to \$2.5 million, would be treated as COD. Treas. Reg.

§1.1001-2(c), Ex. 8 and Rev. Rul. 90-16, 1990 – 1 C. B. 12. COD is always taxed at ordinary income tax rates. Treas. Reg. §1.61-12(a).

- b. Typical carve-outs from traditional non-recourse financing for fraud, gross negligence and material covenant violations do not cause an otherwise non-recourse debt to become recourse.
- c. A single member LLC that obtains recourse financing, but with no guaranty by its owner, will likely be treated as having non-recourse financing, although this is not certain. *See* FSA 200135002.
- d. A multi-member LLC that obtains recourse financing, but with no member guaranties, is less clear. While no member will obviously have any personal liability, it is not clear under the Treasury Regulations at §1.1001-2(a), that this is the appropriate standard. Recent court decisions, however, do support that the debt in such a situation would be non-recourse, by looking to the members' absence of liability under the §752 standards. *Great Plains Classification Associates v. Commissioner*, 92 T.C.M. (CCH) 534 (2006).

3. **The Stakes:**

- a. The divergent tax treatment dependent on whether the debt is non-recourse or recourse is highly significant. First, since COD income is taxed at ordinary income rates (currently 35% and 39.6% as of January 1, 2011), for taxpayers in the highest marginal bracket, the difference between COD verses §1231 gain could be as high as 20%. Even with the §1250 rate of 25%, the difference could be 10%.
- b. The real interest in generating COD is of course the opportunity for deferral, under § 108(a), § 108(c) or § 108(i), as discussed above. While a taxpayer may ultimately have to recognize such deferred COD as ordinary income (either through attribute reduction or decreases to the basis of property), the chance to pay taxes in the future is often an irresistible attraction, especially considering the otherwise distressed character of a borrower's portfolio.

- c. Given the advantages of generating COD income on a foreclosure, debtors have sought to restructure their financing to maximize the deferral under § 108
- d. In *2925 Briarpark Ltd. v. Commissioner*, 163 F. 3d 313 (5th Cir 1999), taxpayer owned property with a value significantly below the amount of the non-recourse debt it secured. The lender agreed to release the underlying property from all liens if the debtor sold the property for a minimum gross sales price and assigned the net sales proceeds to the lender. The taxpayer asserted that this two-step transaction generated COD in an amount equal to the difference between its outstanding debt to the bank and the net sale proceeds transferred to the lender. One of taxpayer's partners was insolvent and sought deferral under § 108(a)(1)(A). [Note that merely claiming the QRPBI exclusion would not have produced any benefit, since under the rules at § 1017, the basis of the encumbered property would have to be reduced, thus generating additional gain (ordinary under § 1017(d)) on sale.] The 5th Circuit did not respect the two-step nature of the transaction and consequently treated the borrower as recognizing gain on sale, as opposed to any COD. Based upon this decision, any effort to first generate COD and then transfer property, must not be deemed connected or inter-dependent.

D. **MBT Consequences:**

- 1. **Backdrop:** Historically, state tax consequences have not been a material consideration in workout transactions. This has in part been due to the significance of the Federal issues as well as a general acceptance that whatever levy was imposed by the states, was merely “a cost of doing business.” Not so anymore. States and local municipalities are hungry for tax revenue and planning to mitigate state and local taxation is now a critical part of any workout transaction, especially one involving a transfer of property.
- 2. **Michigan Business Tax (“MBT”):**
 - a. The MBT is imposed upon all “persons” with substantial nexus to Michigan, including, specifically, flow-through entities such as LLCs, partnerships and S corporations. MCL § 208.1200,

and MCL § 108.1113(3). Thus, unlike the Federal treatment of LLCs, which taxes such entity's members, the MBT (like its predecessor the SBT) imposes an entity level tax.

- b. A taxpayer has nexus to Michigan and is subject to the MBT if it owns, rents, leases or maintains real property located in Michigan. *Michigan Dep't of Treasury Rev. Admin. Bulletin 2008-4 (10/21/08)*.
- c. The MBT, first effective on January 1, 2008, is a combination of an income tax and modified gross receipts tax. The business income tax generally mirrors the determination of Federal taxable income and is assessed at the rate of 4.95%. MCL § 208.1201(1). Gross receipts of a taxpayer are taxed at a rate of 0.8%. MCL § 208.1203(1). The definition of gross receipts is very broad and includes the amount realized on a foreclosure as well as a taxpayer's COD income. Some reductions are taken into account for "purchases from other firms" (e.g. inventory, depreciable property). MCL § 208.1113(6). Currently, a 21.99% surtax applies to both components of the MBT, thus causing the business income tax to be roughly 6% and the gross receipts tax roughly 1%. MCL § 208.1281(1). Since Michigan's SBT was generally equal to 1% of gross receipts, the MBT represents a substantial tax increase for real estate owners, especially in connection with a property disposition.
- d. In the discussion example, if the Debt is assumed as non-recourse, the MBT income tax liability would be roughly 6% of \$6,000,000 or \$360,000. MCL 208.1201(1) and MCL 208.1281(1). Additionally, 1% of the deemed sales price of \$10,000,000 or \$100,000 would be assessed, thus bringing the total tax liability to \$460,000. MCL 208.1203(1) and MCL 208.1281(1). If any of the consideration on sale were allocated to land, under MCL § 208.1111(1)(p), only the gain (and not the gross receipts) is taken into account for purposes of the gross receipts calculation.
- e. If the Debt in the discussion example were recourse, however, and \$2,500,000 of COD were generated, which A, B and C excluded under the QRPBI

exception at § 108(c), at issue is how the MBT would treat this deferral. Since the MBT is an entity level tax and the § 108(c) exclusion is elected at the member level, there is the possibility that the MBT will not recognize the members' election and a double tax could result. Michigan Treasury, however, has analyzed this issue in a favorable manner in FAQ B35, http://www.michigan.gov/documents/taxes/MBTFAQ_208917_7.pdf. In the FAQ, COD was triggered by a partnership when the principal of its debt was reduced as a result of a workout. Some of the partners elected the QRPBI exclusion under § 108(c). The FAQ recognizes that the partnership should *not* report COD in the year of the debt discharge, at least with respect to the amount of the COD deferred by the electing partners. Rather, the partnership will report amounts based on the partners' collective tax situation (*i.e.* decreased depreciation and additional gain on sale). While beneficial, this approach will produce challenging (if not nightmarish) record keeping, especially if less than all partners make the QRPBI election. Note that while the FAQ is specific to the QRPBI exception, presumably Michigan Treasury would apply the same reasoning if an election were made under the 5-year deferral rule of § 108(i) or in the event of a partner bankruptcy or insolvency under § 108(a).

3. **Potential Personal Liability:**

- a. With the increased rate of tax imposed by the MBT, a significant issue in any foreclosure is the prospect for personal liability. MCL §205.27a(5) imposes liability for MBT upon so-called responsible persons. Specifically, "any entity's officers, members, managers or partners who the department determines, based on either audit or investigation, have control or supervision of, or responsibility for, making the returns or payments is personally liable for the failure." While this provision (in similar form) has been part of the Michigan tax code for decades, it has largely gone unnoticed. It has now become a critical aspect of foreclosures since in many cases an entity has not reserved for MBT taxes that are triggered on such a transaction.

Michigan Treasury has made it clear in various seminars that in such circumstances they will go after the “responsible person.”

- b. Based upon the express language of MCL §205.27a(5), to the extent a person is a manager of an LLC, and as such would have control or supervision or responsibility for filing tax returns or making tax payments, this individual will be personally liable for such entity’s unpaid MBT liability.
- c. At issue is whether Michigan Treasury will look through a multi-tiered structure to identify responsible persons. In other words, if an LLC has a corporate manager and the president of such corporation, in such capacity, files tax returns for the LLC and makes tax payments will this president be treated as a “responsible person?” The legislative history on MCL §205.27a(5) suggests that Treasury may, indeed, adopt this approach. Historically, personal liability exposure under MCL §205.27a(5) was limited solely to officers of corporations. When the statute was amended in 2003, the Michigan House specifically noted that, “the statute did not extend to other business entities and therefore allowed the officers of certain other entities to escape responsibility for taxes owed to the state.” Michigan House Legislative Analysis Section, Second Analysis (7-10-03) to House Bills 4567-4569 as enrolled. As noted by the Michigan House, the legislation would extend MCL §205.27a(5) to “limited liability companies, limited liability partnerships, partnerships, and limited partnerships and, likewise, to their individual members, managers, and partners” and that the liability would be imposed on “those who the department determined after either an audit or an investigation have control or supervision of, or are charged with the responsibility for, making the returns or payments.” *Id.*
- d. Mitigation of personal liability may be achieved by eliminating an individual’s status as a responsible person, undertaking a §1031 exchange, selling membership interests (MBT FAQ B15 and M30 provide that the sale of ownership interests in a

corporation, partnership or LLC will generally not be subject to MBT) or reducing the MBT exposure by engaging in redemption transactions.

E. **Tax Consequences to Lender:**

1. Typically, where a lender has advanced the face amount of a debt, its tax basis for the loan equals such amount. Consequently, the subsequent receipt of principal payments, either in installments or in a lump sum on maturity, represents a non-taxable return of capital. Where the debt is settled at a discount, however, the lender's basis will not be fully recovered and it will recognize a loss.
2. If the lender acquires property in a foreclosure, for tax purposes, the transaction is bifurcated. As a creditor, the lender may claim a bad debt loss. As a purchaser, however, the lender may simultaneously have either gain or loss.
 - a. The lender's bid price is deemed to be the proceeds for purposes of the calculations. Thus, if the bid price is less than the amount of the debt, the portion of the debt remaining unsatisfied and uncollectible may be treated as a bad debt. Treas. Reg. §1.166-6(a)(1). Accrued but unpaid interest is included as part of the bad debt to the extent it previously has been reported as income. Treas. Reg. §1.166-6(a)(2). If the lender is a corporation, the bad debt is always considered a business bad debt that is fully deductible against ordinary income. If the lender is not a corporation, however, the bad debt will be deductible only as a short-term capital loss unless it can be shown that the debt is a business debt. § 166(d).
 - b. As a purchaser, the lender's recognition of gain or loss is measured by the difference between the amount of the bid price and the fair market value of the property. Treas. Reg. §1.166-6(b)(1). Thus, if the fair market value of the property is less than the bid price, the lender will have a loss and if it is more, the lender will have a gain. The fair market value of the property is presumed to be the bid price, in the absence of clear and convincing proof to the contrary. Treas. Reg. §1.166-6(b)(2).

VII. Abandonment:

- A. **Backdrop:** A, the manager of Borrower, who has now been advised about his likely personal liability for the Project's MBT tax on a foreclosure, wishes to withdraw from the LLC. He is prepared simply to walk away from the Project.
- B. **Tax Stakes:** Assuming a partner is able to withdrawal under an entity's governing agreement and state law, for tax purposes, the abandonment of a partnership interest is generally treated as the sale of a capital asset. As noted above, this sale treatment will not generate COD. Where partners have positive capital accounts (not the case with Member A), at issue is whether the loss on abandonment can be treated as an ordinary loss. Capital losses may only be used to offset capital gains and up to \$3,000 annually of ordinary income. Code § 1211(b). Consequently, recognizing a sizeable capital loss on the abandonment of a partnership interest is unlikely to provide significant tax benefits.
- C. In Rev. Rul. 93-80, 1993-2 C.B. 235, the Service announced its position regarding the tax treatment of partnership interest abandonments. This Ruling generally follows the holding in *Citron v. Commissioner*, 97 T.C. 200 (1991). According to the Service, whether the loss from abandonment is capital or ordinary depends on whether the loss results from the *sale or exchange* of an capital asset. The Rev. Rul. holds where a deemed distribution under §752(b) occurs in connection with such abandonment (due to the discharge of debt), §731(a)(1) will treat the transaction as a sale or exchange of a partnership interest, thus characterizing such loss as capital. Effectively, this means that any abandonment undertaken when a partner has indebtedness allocated to him will always be treated as a sale or exchange. The Ruling goes on to state that where there is no actual or deemed distribution in connection with such abandonment, the loss will be ordinary.
- D. In order for a taxpayer to achieve an effective abandonment, it must take all steps necessary under state law. This generally includes written notification indicating the taxpayer's voluntary withdrawal as well as its effective date. Such notice should refer to any statutory provisions or sections of an operating agreement permitting a voluntary withdrawal.

VIII. Guarantors:

- A. **Backdrop:** A has persuaded Lender to keep the Debt outstanding under its current terms and conditions, since A has gotten his college roommate, Z, to guaranty \$2.5 million of the Debt.

- B. **Tax Stakes:** The tax consequences to Z and to the Borrower depend on facts regarding relatedness and whether Z's guaranty is incidental to his trade or business.
- C. If Z is related to A, within the meaning of Treas. Reg. § 1.752-4(b) [generally, the usual § 267(b) and § 707(b) thresholds, but substituting 80% for 50%], then A will be treated as having guaranteed the Debt, with the result that the Debt will now become "recourse" to A under Treas. Reg. § 1.752-2(b)(3)(i). As a consequence, \$2.5 million of the Debt will be allocated expressly to A, with the balance allocable 1/3rd to each of A, B and C. Since B and C will now receive a Debt allocation of only \$1.67 million, which is less than their negative capital accounts of \$2.0 million, they will each recognize gain under § 731(a)(1) of \$333,000.
- D. If Z is not related to A, then there will be no reallocation of the Debt among Members A, B and C
- E. If Lender goes after Z to recover its deficiency of \$2.5 million following foreclosure of the Project, what are tax consequences to Z?
1. Generally, if a taxpayer has a loss arising from a guarantee obligation he receives the same treatment as if the loss had been from a loan he made directly. Treas. Reg. § 1.166-9.
 2. For Z to claim an ordinary loss, Z must establish that the guarantee was undertaken in connection with his "trade or business." Treas. Reg. § 1.166-9(a). This is often a high standard to reach.
 3. If Z can only demonstrate that the guaranty was undertaken with a profit motive, but not in connection with a trade or business, then Z will only be able to claim a short term capital loss. Treas. Reg. § 1.166-9(b). To prove a profit motive, a guarantor must demonstrate that "reasonable consideration" was received for entering into the guaranty agreement. Treas. Reg. § 1.166-9(e).
 4. If Z cannot demonstrate that the guaranty was minimally undertaken for a profit motive, he will not be able to claim any loss. Treas. Reg. § 1.166-9(d). The transaction will be treated as personal in nature.