Income Tax Implications of Industrial and Commercial Property Mortgage Debt Restructuring

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Many commercial and industrial real estate owners have experienced a decrease in the market value of their owned real estate. Many real estate industry analysts expect that this downward trend in commercial real estate market values will continue for the next year or two. In many cases, the market value of the commercial real estate is (or will be) less than the associated commercial mortgage. Also in many cases, the property owners will renegotiate or restructure the terms of these commercial mortgages. In such instances, the commercial and industrial property owners should carefully consider the federal income tax implications associated with the restructuring of such mortgage debt.

Introduction

The 2008 credit crisis and the subsequent recession have 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 will collectively refer to 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 of these properties.

Many such property owners (whether they are currently in bankruptcy or not) will have to renegotiate the terms of their mortgage debt. The objective of such a mortgage renegotiation is that the property owner (1) is able to retain ownership of the commercial real estate and (2) is able to, presumably, service the restructured debt payments.

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

With both foreclosure and commercial debt restructuring common in this current economic environment, the property owner (and the valuation and other financial advisers) should be aware of the COD income tax rules and should carefully plan for the income tax effects of these commercial debt restructuring transactions.

The Income Tax Implications of the Restructuring COD Income

The American Recovery and Reinvestment Act added Internal Revenue Code Section 108(i). Section 108(i) allows certain taxpayers who realize COD income in 2009 or 2010 to (1) defer that COD income and (2) recognize the COD income ratably over a five-year period, beginning in 2014.

For a property owner that defers COD income under this new tax provision, the other COD income exclusion provisions will not be available. Therefore, the property owner should carefully consider whether these already existing tax provisions may provide a greater immediate benefit to the taxpayer.

The new Section 108(i) defers the COD income recognition only for a limited period of time. That is why the previous COD income exclusion provisions may be more beneficial 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. The

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 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 (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 real estate has recourse debt, the debt restructuring transaction is considered to be two transactions for income tax purposes: (1) a property sale transaction and (2) a COD income transaction.

Since a property foreclosure is treated as a sale or exchange of the 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, if the taxpayer property owner held the real estate (1) as a capital asset under Section 1221 or (2) for use in the taxpayer's trade or business under Section 1231, 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 real estate was held by the taxpayer property owner primarily for sale to customers in the ordinary course of business (i.e., 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, the deemed property sale proceeds are considered to be equal to that real estate market value amount. For income tax purposes, (1) the recourse debt minus (2) the deemed property sale proceeds is equal to (3) 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, (1) the deemed property sale proceeds (i.e., the real estate fair market value) minus (2) the property cost basis is equal to (3) the gain or loss. This gain or loss calculation is made just as if the real estate was actually sold.

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

Let's assume that both the recourse debt and the property cost basis are greater than the real estate fair market value. In that case, the property owner will have both (1) COD income (i.e., the debt minus real estate value) and (2) a Section 1231, ordinary, or capital loss (i.e., the real estate 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 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 does not recognize any 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 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 taxpayer property owner.

As a result, none of the Section 108 COD income exclusion provisions discussed below are available. This 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 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 as follows:

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.
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.

The 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 taxpayer property owner with several exceptions to this COD income recognition rule if:

- the debt discharge occurs as part of a Title 11 bankruptcy proceeding,
- the debt discharge occurs when the taxpayer is insolvent,
- the forgiven debt is qualified farm indebtedness, or
- 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 partnership property owner—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 provi-

sions of Section 108 are applied at the corporation level. For purposes of the tax basis reduction rules, any losses of an S corporation that were disallowed at the shareholder level (for either tax basis or at-risk investment reasons) and are carried forward 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, the taxpayer 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 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 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.

Property Owner 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 taxpayer 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 real estate industry analysts believe that the commercial real estate market will continue to deteriorate in 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, during the next year or two, many commercial property owners are expected to renegotiate/restructure the terms of their commercial property mortgages.

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

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

The careful tax planning prior to the commercial mortgage renegotiation should include an examination of the property owner's solvency situation and tax attributes, so as to produce the most favorable possible COD income exclusion or deferral consequences.

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