



FARELLA BRAUN + MARTEL LLP

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## **TAX ASPECTS OF DEBT MODIFICATION AND FORECLOSURE**

Using Tax Savings to Make Better Distressed Debt Deals

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# Overview

- Tax Issues Are Certain, at the Death or Rebirth of a Real Estate Project with Secured Debt
- Tax Consequences of Foreclosure or Debt Restructuring are not always Intuitive and Can Sometimes have Horrific Results
- Often, Careful Planning Can Reduce these Potentially Expensive Tax Consequences, and May Create Opportunities

# Goals

- Understand the Treatment of Recourse vs. Non-Recourse Debt
- Understand Potential Tax Issues in Foreclosure and Debt Restructuring
- Learn Various Planning Techniques to Reduce Tax Problems
- Be Able to Recognize Tax Issues to Structure Better Distressed Debt Deals

# Agenda

- Basics Tax Treatment, Foreclosure and Debt Restructuring—Recourse or Not?
- Key Tax Traps for Borrowers, Guarantors, Debt Buyers
- Tax Planning at Foreclosure
- Tax Planning and Debt Modification
- Using Tax Savvy to Make Better Workout and Distressed Debt Deals

# Key Concept: “Recourse” Debt

- Tax Treatment Turns on Whether Debt Is “Recourse” or “Non-Recourse”
- Example of Recourse Debt: Owner Guaranties the Debt
- Whether Debt Is “Recourse” Is Not Always Certain
- Can Be “Recourse” to Some Owner-Guarantors but Not Others

# Three Common Tax Traps

- Deemed Sale at Foreclosure: Capital Gain or Loss
- Discharge of Indebtedness Income for Recourse Debt: Ordinary Income
- Taxable Exchange on Significant “Modification” of Debt: (Buyer of Debt at Discount Modifies Debt, Gets Huge Tax Hit)

# Key Concepts at Foreclosure

- Basis: Owner's Cost, Less Depreciation
- Fair Market Value: Of Asset at Time of Foreclosure
- Debt: Amount of Debt Satisfied by Transfer of Asset at Foreclosure
- Recourse vs. Non-Recourse Debt: Treatment Is Different

# Non-Recourse Foreclosure

- Deemed Sale of the Asset for the Amount of the Debt
- Capital Gain if the Debt Exceeds the Basis in the Asset
- Capital Loss if the Debt Is Less than the Basis in the Asset (Limited Usefulness: Capital Loss Cannot Be Used to Offset Substantial Ordinary Income)



# Recourse Debt Foreclosure

- Deemed Sale for the Fair Market Value (“FMV”) of the Asset
- If FMV is Greater than the Basis, Capital Gain
- If Debt Exceeds FMV, and Debt Is Satisfied by the Foreclosure, Discharge of Indebtedness Income of the Difference Between FMV and Debt

# Recourse Foreclosure Examples

- Debt \$50 MM; Fair Market Value \$40 MM; Basis \$30 MM: \$10 MM capital gain, \$10 MM CODI (ouch) (asset held for awhile)
- Debt \$60 MM; Fair Market Value \$40 MM; Basis \$50 MM: \$10 MM capital loss, \$20 MM CODI (ouch) (new development project – inventory?)

# Debt Modification Concepts

- Substantial Modification Is an “Exchange”
- Recourse Debt Modification Can Trigger Discharge of Indebtedness Income
- Internal Revenue Code Section 108 Excludes Some Kinds of Discharge of Indebtedness Income
- An Exchange Can Trigger Tax Consequences for the Holder of the Debt, Especially if Bought at a Discount

# CODI Exceptions

- Taxpayer in Bankruptcy—No Income
- Taxpayer Insolvent—No Income
- New 108(i) Rules Defer Income from Debt Discharge in 2009 and 2010
- Qualified Real Property Based Indebtedness  
108(c), 108(a)(1)(D)

# Foreclosure Tax Planning

- Goal: Reduce Capital Gain
- Convert Non-Recourse Debt to Recourse, If Taxpayers Can Exclude CODI
- Pre-Foreclosure Workout to Reduce Face Amount of Debt
- Extension/Forbearance
- Purchase of Debt by “Unrelated” Entity
- Combination of Above

# Tax Obligations--Scary

- Many Tax Obligations Are Difficult or Impossible to Discharge in Bankruptcy
- Federal Taxes Can Be Collected from Assets Exempt from Levy by Other Creditors—IRAs, 401(k)s, Property Exempt Under State Law
- Capital Losses Cannot Offset Ordinary Income
- Phantom Income—No Cash to Pay Tax

# Minimizing CODI

- Take Tax Hit While Insolvent/In Bankruptcy
- Transfer Ownership to Insolvent Taxpayers
- S Corporations
- Defer CODI

# Using Tax to Make Better Deals

- Lenders: Understand Borrower/Owner Tax Motivations: They May Advance New Money for Tax Deferral
- Debt Buyers: Restructure the Debt Before Purchase, Not After
- Owners: Avoid Capital Gains and CODI Through Careful Tax Planning



# Past Webinars

- Buying Hotels (and Other Commercial Real Estate) Out of Bankruptcy (Date: 03/17/10)
- Guaranties of Debt in Default: What to Do Now (for Guarantors and Their Creditors) (Date: 03/31/10)
- Working Out Problem Hotel Loans (Date: 04/14/10)

*To listen to the above webinars, please go to [www.fbm.com](http://www.fbm.com), click on Media, click on Speaking Engagements and search by the webinar date.*

# Upcoming Webinars

## **Insurance in Bankruptcy: Preserving and Maximizing Insurance Assets of a Bankrupt Entity**

June 2, 2010

10:00 a.m.-11:00 a.m. (Pacific Time)

# Panelists

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