Proskauer

Distressed Real Estate Workouts, Trades and Loan Purchases: Tax Consequences Matter

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The COVID-19 pandemic has been wreaking havoc on the economy generally, and with respect to many asset classes of real estate, specifically, and the general consensus now is this unfortunate situation will not abate for some time in the future. Not surprisingly, with businesses closed, employees furloughed, and revenue streams severely challenged, many owners of real estate and their tenants are simply not making rent and debt service payments. When that happens, the value of the real estate is reset, leaving the equity and possibly some of the debt impaired. When fighting for survival it might seem like tax considerations are an afterthought, but they should not be—the tax consequences of the actions that can arise from this loss in value, including modifications of real estate loans, foreclosures, debt-for-equity exchanges, purchases of distressed debt or real estate, and the like, can be significant and may often be major drivers of the ultimate decisions taken by the various stakeholders.

I. Trying to Save the Investment: Forbearances, Modifications, Amendments

So, as an owner of real property starts experiencing distress as a result of rent defaults or, in the case of hotels, almost non-existent occupancy, both the owner and the lenders (senior, mezzanine, and all the rest) will start feeling the pinch. What types of things can happen?

As one very straightforward possibility, an owner might just stop paying interest due on the debt. With respect to current-cash-pay interest, the lender may make a case that it should not recognize any income on the interest—it didn't receive it, after all! While this may present a decent case under applicable federal tax law (at least if the lender can conclude, at the very least, that there is a reasonable doubt as to whether the interest will ever be collected), the IRS takes a different position with respect to original issue discount ("OID"). In particular, the IRS insists that the lender continue to accrue OID at its usual rate, even if the owner is threatening to never pay, and even if the owner is in a bankruptcy proceeding which would limit its ability to pay even if payment becomes due—although note that this is just the IRS's position, courts have yet to approve of this conclusion (nor have they rejected it, either, to be fair).

The owner and lenders could discuss modifications or forbearances with respect to the loans. The consequences of such modifications or forbearances depend on many factors, including the size of the tranche of the loan in question, whether the loans are "publicly traded," the nature of the modifications, and other factors.

If the modifications are "significant," then, for federal tax purposes, the owner is treated as paying off the "old," unmodified loan for a new loan (one issued with the modified terms). Under such an exchange, the lender may recognize gain or loss. How much gain or loss? Well, if the total outstanding amount of the tranche of loan in question is $100 million or less, the gain or loss might be zero—at least, if the face amount of the loan didn't change as part of the modification, there is no OID on the original loan, and the lender hasn't written off the loan for federal tax purposes in whole or in part already. This is because the "value" of the loan can often in such circumstances be treated as equal to the face amount of the loan, for federal tax purposes.

But if the total amount outstanding on the loan is greater than $100 million and the loan is “publicly traded” (as defined in the relevant tax regulations, which, it should be noted, uses a very broad definition of “publicly traded”—it may be enough if one or more brokers are willing to provide an indicative quote to purchase or sell the debt), the “new” loan must be valued at fair market value. For a distressed loan, that probably means the loan will have a value that will be less than its face amount—which means the lender might recognize a tax loss (based on the difference between the value of the loan and the lender’s tax basis)[1] and the borrower might recognize cancellation of debt income (“CODI”)—basically, income from having the loan treated as “forgiven” in the amount of the difference between the face amount of the loan and the fair market value of the loan.

Other consequences could arise from such an exchange. The “new” loan will have a deemed issue price equal to its fair market value on the date of the modification, but the face amount might be significantly higher. As such, the “new” loan could have significant OID, triggering substantial additional interest inclusion to the lenders. And, the loan may have so much OID that special tax rules applicable to high-yield high-OID notes could trigger, which can force the borrower to defer (or even completely lose) interest deductions on a portion of the interest paid or accrued on the note.

It’s not all bad, perhaps. For borrowers that are insolvent[2] or in bankruptcy, the CODI could be partially or entirely excluded from income, although *first*, the borrower must reduce tax attributes (like losses or the tax basis in depreciable assets) in the amount of the excluded CODI, and *second*, for a borrower that is a flowthrough for federal tax purposes (like most limited partnerships or limited liability companies), the availability of the exclusion is determined at the *owners*’ level, not the flowthrough’s level—in other words, the exclusion is available to an owner only if the owner itself is either insolvent or in a bankruptcy proceeding (and thus it doesn’t matter if the LLC is itself insolvent or in a bankruptcy proceeding). And, for non-corporate borrowers that (1) used the loan proceeds to acquire, construct, reconstruct, or substantially improve real property, where (2) the real property is security for the loan, and (3) where the real property is used in a trade or business, any CODI resulting from modification of the loan for which the real property is security may also be excluded (subject to limitations).

So, when is a modification or amendment of a loan enough to trigger a “significant modification”? There is no binary answer to this, although there are some safe harbors and guidelines in the tax regulations. A lender’s decision merely to forbear on enforcement is usually not a significant modification for two years (or for as long as good faith negotiations continue, or during the course of the borrower’s bankruptcy proceeding, if it is in one). Modification of the yield on the instrument will be a significant modification if large enough (and “large enough” is not that large—basically, a change in yield greater than the greater of (1) 25 basis points or (2) 5% of the yield of the unmodified loan is generally enough to trigger a significant modification). Extension of time to make interest or principal payments may not be a significant modification if the delay is not too long—the safe harbor is that extensions that are less than the lesser of (1) 5 years or (2) 50% of the original term of the instrument will generally not be a significant modification. There are other safe harbors, and if an amendment or a modification does not fall within a safe harbor, the test becomes a much more nuanced one and is based on all facts and circumstances.

II. Giving Up On the Investment: Foreclosures, Debt-for-Equity Exchanges, and the Like

Now let’s assume attempts to save the investment fail: the property value is just too depressed, its prospects are just too bleak, and/or the owner’s cash flow is simply insufficient for the mortgagees and other lenders to be comfortable with leaving the loans outstanding, even with forbearances and forgiveness. What happens now?

The lenders could foreclose on the real property, or otherwise take ownership of the real property, whether directly (in other words, title in the real property itself could be transferred) or indirectly through acquiring the equity of the entity owning the real property. The tax consequences can differ substantially depending on multiple factors regarding the structure of ownership of the real property, the specifics of the loan, the specifics of the structure, and related matters.

A. “Recourse” Loans versus “Nonrecourse” Loans

One of the key questions is whether the loan in question is a “recourse” loan or a “nonrecourse” loan. For federal tax purposes, these terms have certain special meaning. Generally, a “recourse” loan is one where the creditor can recover from any assets of the borrower, not just the property securing the loan; a “nonrecourse” loan is the opposite, where the lender generally can only recover against the property secured by the loan.

Of course, as is often the case under the federal tax laws, it’s not necessarily that straightforward. If the borrower is a flowthrough entity (like an LLC), is wholly owned by another person, and hasn’t elected under the tax laws to be treated as a corporation, then *even if* the loan to the borrower is fully recourse to all assets of the borrower, it may be treated as a nonrecourse loan. Even if dealing with a borrower that isn’t a flowthrough entity wholly owned by another person, a loan purportedly fully recourse to such borrower might be treated as nonrecourse if the borrower is barred from acquiring any assets after the issuance of the loan. To add more complexity, a flowthrough entity with a single owner could be treated as having made a recourse loan if the owner of the entity guarantees the loan!

Conversely, a fully recourse loan to, for instance, a corporation where the lender has full security over and can recover against any and all after-acquired property can be treated as a recourse loan even if, as a practical matter, the owner of the corporation will never acquire any assets other than the initial property (because the owner wants to treat the entity as a special-purpose vehicle, perhaps existing only to hold a single piece of real property). The lesson is that the rules for determining “recourse” versus “nonrecourse” status of loans for federal tax purposes are rife with a mixture of unusual rules, sometimes excessively formal, sometimes not formal at all, and it is hard to make conclusions without digging into the details with an experienced tax advisor. As a practical matter, many (perhaps most) real estate loans will be treated as “nonrecourse” loans for federal tax purposes.

B. Tax Consequences of the Foreclosure on the Property

The consequences of a direct foreclosure on the real property securing the loan depends now on the “recourse” or “nonrecourse” status of the loan. If the loan is “nonrecourse,” then on foreclosure the borrower is treated as selling the real property to the lender for the amount of the nonrecourse loan forgiven in the transaction (plus any other consideration paid by the lender). The borrower will recognize gain or loss (generally capital, although potentially subject to partial recapture of depreciation deductions at a tax rate higher than the usual capital gain rate for noncorporate borrowers) in an amount equal to the difference between the amount of the loan forgiven (plus extra consideration, if any) and the borrower’s tax basis in the real property—the lender will now own the real property with a tax basis equal to the amount of the loan it gave up to acquire the property (plus extra consideration, if any).

This treatment (as a sale of a capital asset) can cause problems for a borrower. As discussed above, a borrower can often exclude income that accrues due to forgiveness of debt (CODI) if the borrower meets certain conditions (such as insolvency). This income exclusion does *not* apply to ordinary or capital gain recognized on a sale of property. Thus, if the borrower is facing significant gains because the size of the nonrecourse loan exceeds the borrower’s tax basis in the property (which could easily be true if the property has been substantially depreciated), the borrower could be facing a large tax bill! Conversely, though, if the borrower wasn’t going to be able to exclude any CODI (because the borrower isn’t in bankruptcy or insolvent) and the borrower is sensitive to the tax rate differences between ordinary and capital gain (because, for instance, the borrower is an individual, or a flowthrough which is ultimately owned primarily by individuals), the borrower may be thrilled with the tax treatment—the foreclosure generates (generally) capital gain, while CODI is taxed at ordinary income rates.

If the loan is “recourse,” however, the tax treatment is different. On foreclosure, the borrower is treated as selling the property to the lender for an amount equal to the current fair market value of the property, *not* the amount of the loan being forgiven. To the extent the fair market value of the property is less than the amount forgiven on the loan, the difference is treated as CODI to the borrower. Like the discussion of “nonrecourse” loans above, the borrower may be happy or angry with this treatment: if the borrower is entitled to exclude CODI for some reason, it will be happy to have the excludable CODI instead of having extra capital gain. If the borrower prefers capital gain rates and can’t exclude CODI, though, it will be facing extra income tax on the subject-to-ordinary-income-rates CODI that it recognizes on the foreclosure.

Can one effectively elect to transform a “recourse” loan to a “nonrecourse” loan? For instance, let’s say that a foreclosure on a nonrecourse loan is imminent, but the borrower is insolvent and the only asset it holds is real property pledged for the nonrecourse loan. Could the borrower and lender agree to modify the nonrecourse loan to make it a recourse, say, by the borrower agreeing to make all of its assets available for recovery? That is an empty promise, of course, as the borrower has no other assets to help the lender in any event. Not surprisingly, that wouldn’t work: the courts would likely agree that this attempted modification was meaningless (and thus the parties were stuck with nonrecourse loan treatment). Other modifications made in anticipation of foreclosure would also likely be closely scrutinized.

C. Acquisition of the Equity of the Owner of the Real Property

An alternative structure could be undertaken by some lenders (perhaps predominantly mezzanine lenders) acquiring the real property securing their loans: the lender could take the equity of the entity owning the real property. What happens? It depends on many factors, one significant one being what type of entity the borrower is.

If the borrower is a single member LLC (and didn’t elect to be treated as a corporation for tax purposes), then taking 100% of the equity is equivalent, for federal tax purposes, as directly acquiring the property. The tax consequences are generally the same as those discussed above.

So, let’s say the borrower is either a multi-member flowthrough entity or a corporation, and the lender takes equity in the borrower in exchange for some or all of its loan. First, it should be noted that the lender will generally not recognize any gain or loss in this transaction, and any basis the lender had in the exchanged debt will generally carry over into the equity received by the lender.

Second, the borrower itself (or, if the borrower is a flowthrough entity, the borrower’s owners as determined immediately before the exchange) will recognize CODI generally in an amount equal to the difference between the fair market value of the borrower’s equity and the amount of the loan forgiven. To the extent the borrower is a corporation, the lender (being the new owner) will now be the person most sensitive to the tax consequences of the exchange, and so the lender might want to be certain that exclusions from CODI exist.

Third, if the borrower is a corporation and has valuable tax assets (like losses that can carry forward and shelter future income) which do not get eliminated by any CODI recognized in the debt-for-equity exchange, the change in ownership of the borrower could trigger limitations on the ability to use these tax attributes. The limitations can be massive and material, especially if the debt-for-equity exchange occurs outside of bankruptcy. Because special tax rules apply for corporations being restructured in a bankruptcy proceeding, to the extent tax assets have material value, a bankruptcy proceeding should be considered with respect to a planned debt-for-equity exchange.

Fourth, the owners of the borrower itself may prefer this structure if they are facing, for instance, significant capital gain on a deemed foreclosure (because the debt is nonrecourse, as discussed above). Frequently, debt-for-equity exchanges or other equity-acquisition structures can be executed in a way to allow the owners to defer any such built-in gain. Often the owners will need to maintain some stub equity in the borrower in order to make this work, and, depending on other factors, such a structure may not be possible.

III. Taking the Opportunity to Acquire New Investments: Acquiring Distressed Real Property or Distressed Real Property Loans

Whenever assets reprice, opportunity can be presented to opportunistic investors with available capital. These investors looking to play offense will be seeking to acquire real property at its new, lower price, or to buy debt secured by real estate from distressed lenders.

A. Direct Purchases of Distressed Real Property

What happens if a third party buyer shows up to buy distressed real property? If the real property is sold subject to the debt, or if the buyer agrees to assume the debt, the seller is treated as if it sold the real property for an amount equal to any proceeds received *plus* the amount of the debt treated as transferred to the buyer. Thus, to the extent the proceeds plus the amount of the debt exceed the seller's tax basis in the property, seller will recognize gain. If the total amount of the proceeds plus debt greatly exceeds seller's tax basis, it is even possible for the total tax imposed on the gain recognized by the seller to exceed the proceeds the seller receives!

If the property is sold without having the debt treated as assumed by the buyer (and, instead, the proceeds received by seller are used to repay the seller's debt, to the extent possible), then the treatment of any shortfall in the debt repayments depends on whether the loan is treated as recourse or nonrecourse. If recourse, then the shortfall is CODI and potentially excludable; if nonrecourse, the shortfall is rated as sale proceeds that either increase gain or decrease loss on the sale—thus potentially giving seller a larger tax bill on the capital gain (see above in the discussion regarding foreclosures for an analysis of similar tax issues).

B. Purchasing Distressed Real Property Debt

What faces an investor who buys distressed real property debt? If the investor is buying the debt at (presumably) a significant discount—this will trigger the (appropriately named) “market discount” rules under the Internal Revenue Code. The investor will step in the shoes of the seller with respect to any OID that accrues on the debt, and doesn’t have to accrue *more* OID year-to-year just because it bought at a discount. But, the market discount in the note must be recognized if the investor later sells or exchanges the debt (or forecloses on the underlying real estate): basically, the amount of the discount that would have been accrued as if it were extra OID on the date of the later sale, exchange, or foreclosure must be recognized as ordinary income, although the investor can elect to recognize the market discount accruals on a current basis. There are ancillary issues as well in connection with market discount—for instance, if the buyer of a note at a discount used debt to finance the acquisition, the interest deductions on the debt will be suspended (at least to the extent the deductions exceed the amount of income earned on the note purchased with the proceeds of the debt) until the market discount is recognized.

The investor who purchased distressed real property debt at a discount must be very sensitive to modifications or amendments to the debt. As discussed above (at I.), if there is a “significant modification” of the purchased debt, and the face amount of the debt is $100 million or less (or more than $100 million but not “publicly traded” as determined under the tax regulations), generally the debt is treated as exchanged for new debt with a fair market value deemed to be the face amount. This means the investor of the discount debt could recognize immediate gain! As an example: an investor purchases an $80 million tranche of real estate debt for $20 million, and then shortly thereafter agrees to amend the debt in a way so as to trigger a “significant modification.” The investor could face an immediate $60 million dollar tax gain—the difference between the face amount of $80 million and the investor’s purchase price/tax basis of $20 million!

C. Miscellaneous Issues

There are some other tax issues to keep in mind when analyzing potential acquisitions or sales of distressed real property or real property debt. For instance, if a buyer of debt at a discount is related to the borrower (generally, and very roughly speaking, a buyer and a borrower are related if there is more than 50% joint ownership, directly or indirectly), then the borrower must itself recognize CODI in the amount of the discount to the buyer. Worse, a buyer of debt which intends to become related to the borrower (say, by acquiring the debt with the plan to exchange the debt for all of the equity of the borrower) is treated as related for these purposes—and an intent to become related is presumed if the buyer becomes related to the borrower within six months of purchasing the debt.

Similarly, a buyer that has special limitations—such as a fund with foreign investors—must be particularly sensitive as to how they plan to acquire any real property or real property debt. For instance, directly holding U.S. real property will cause issues in such a circumstance: the investor will want to hold the real property in a blocker entity (likely a U.S. corporation). The exit from the investment must be structured correctly: the blocker may very well be a so-called “United States real property holding company” and thus selling the blocker itself could cause tax to be recognized to tax-sensitive investors. Frequently, recognition of U.S. tax can be limited by careful exit strategies, such as having the blocker sell the real property first and then liquidating—note that this does not avoid corporate-level tax on the sale of the property, but it does potentially shelter any investor from having to recognize U.S. tax directly and thus the investor shouldn’t be forced, due to the transaction, to file any U.S. tax return.

IV. Transfer Taxes

The above discussion has focused on federal income tax issues, but state issues should not be forgotten when dealing with distressed real property. Just to touch on one potentially relevant state tax issue: states that impose real estate transfer taxes do not necessarily create exceptions to the transfer tax just because, for instance, the transfer of the real estate occurs due to foreclosure. Some states and localities can impose material transfer taxes on transfers of real estate—New York State imposes a tax of 0.4% on the consideration plus an additional 0.25% on the consideration for certain sales of property over a certain value (generally $2 million or $3 million, depending on the character of the property) in large cities, and New York City imposes an additional 2.625% on the total consideration (at the highest rates, putting aside “mansion” taxes and the like).

Some jurisdictions may have transfer taxes that can be mitigated through, for instance, transferring the equity of the entity instead. Not all jurisdictions allow this: New York State and New York City, for example, impose real estate transfer taxes even on the transfer of equity interests, if a “controlling interest” in an entity that owns real estate is transferred, as do many other jurisdiction, such as Los Angeles County in California, and Florida. One way to minimize transfer taxes is to make use of a bankruptcy proceeding. The federal bankruptcy provisions provide protection against certain transfer taxes imposed if the transfer is pursuant to a plan of bankruptcy—but note that this means that the transfer of real property must be part of the plan of bankruptcy itself, it is not enough just for the transfer to be approved by the bankruptcy judge if the transfer is not part of the plan.

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The above discussion only touches on many of the most relevant tax issues facing borrowers, owners, lenders, investors, and others facing distressed real property investments. Tax can be forgotten when one is watching one’s formerly valuable real estate crash in value, or one is deciding whether to seize real property to try to recover as much of one’s loan as one can, but the consequences of ignoring the tax rules can be severe. The value that careful tax advice and tax planning can create in distressed real property scenarios is real, and can mean the difference between financial disaster and financial recovery.

[1] In some cases the lender will not be allowed to recognize the loss. For instance, if the borrower is a corporation for tax purposes, and the loan had an original term of longer than 10 years, then even if there is a deemed exchange for tax purposes the lender may still have a loss disallowed. Instead, the tax basis in the "old" debt would be rolled over into the "new" debt, and the lender would only recognize a loss at a later date, if ever.

[2] A taxpayer is insolvent if its liabilities exceed the value of its assets immediately before the discharge of debt, as determined under federal tax law principles, although with one added complication for nonreourse loans where the amount owed under the loan exceeds the value of the property securing the loan—in such a circumstance, the "excess" nonrecourse liability is included in the insolvency calculation only to the extent the excess nonrecourse liability is forgiven as part of the transaction in question. Note that the exclusion for CODI under the insolvency exception only applies to the extent the taxpayer is insolvent—in other words, the CODI excluded from income is limited to the amount by which the taxpayer's liabilities exceed its asset value, and any additional CODI must be recognized. Further note that for a single-member flowthrough entity (called a "disregarded entity" under federal tax law), the test is calculated at the level of the sole owner of the entity, not just at the entity level—thus, the owner of the entity must be insolvent in order for the exception to apply.

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