

33rd Annual Tax Symposium

WE GAVE THE BUILDING BACK TO THE BANK: A CASE STUDY ON FORGIVENESS OF INDEBTEDNESS

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I. FORGIVENESS OF DEBT

- A. In general, if your debt is canceled, forgiven, or discharged for less than the amount owed, the amount of the canceled debt is taxable. If taxable, you must report the canceled debt on your tax return for the year in which the cancellation occurred.
- B. If your debt is secured by property, and the creditor takes that property in full or partial satisfaction of your debt, you are treated as having sold that property to the creditor.
- C. The tax treatment of the deemed sale depends on whether you were personally liable for the debt (recourse debt) or not personally liable for the debt (nonrecourse debt).

II. TAX CONSEQUENCES OF RECOURSE VS. NONRECOURSE DEBT

- A. **Recourse Debt:** The amount realized on the deemed sale is the fair market value (FMV) of the property. The difference between FMV and the borrower's adjusted basis (usually cost) will be a gain or loss on the disposition of the property. The ordinary income from the cancellation of the debt is the amount by which the discharged debt exceeds the FMV of the property. The taxpayer includes this cancellation of debt in gross income unless an exception or exclusion.
- B. **Nonrecourse Debt:** The amount realized is the entire amount of the nonrecourse debt, minus the amount of cash and the FMV of any non-cash property transferred. You will not have ordinary income resulting from debt cancellation, but will have a gain or loss.

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III. THE FACT PATTERN

- A. Silicon Valley Bank Holdings LLC (the “LLC”) owns an office building (the “Property”) with basis of approximately \$3,875,000.
- B. The amount of the debt is approximately \$8,850,000 and the estimated fair market value of the Property is \$4,000,000.
- C. To make matters worse, the major Tenant in the Property has five years left under its lease, but has vacated the Property. The amount still owing under the lease is approximately \$8,500,000.

IV. THE TWISTS AND TURNS OF THE TAX CODE

- A. The simple case with nonrecourse debt. If the lender takes back the Property and no resolution is reached with the Tenant, the transaction is treated as if the Property is sold to the lender for the amount of the debt. Therefore, there is a long-term capital gain of \$4,975,000 (\$8,850,000 [hypothetical sales price]- \$3,875,000 [basis]). The does not include State Taxes or IRS Recapture.
- B. The plot thickens as we look at settling with the lender and the Tenant. Any money paid by the Tenant to settle the lease termination is ordinary income to the LLC. Assume that prior to the lender taking back the Property, the Tenant pays the client \$2,000,000. The client then buys down the debt and the gain is reduced to \$2,975,000. So, when the dust settles, the client has \$2,000,000 of ordinary income and \$2,975,000 of long-term gain. The maximum long-term capital gains rate is 20%. The maximum ordinary income tax rate is 37%. The trap is that the client could end up paying more tax, specifically, 17% (37% - 20%) on \$2,000,000 of ordinary income.
- C. Therefore, we may need to structure the settlement with the Tenant to arrange that we effectively assign the lease to the lender first. If the lender takes the Property and the Tenant pays the \$2,000,000 to the lender, then the LLC does not recognize ordinary income.

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- D. Maddin Hauser negotiates a lease termination payment with the Tenant in the amount of \$6,000,000.
1. If we are forced to treat the lease termination payment and the turning the Property over to the lender as two separate transactions, then we have \$6,000,000 of ordinary income from the Tenant. That money is used to pay down the debt down to \$2,850,000. This results as a Section 1231 loss of \$1,025,000.
 2. If we can treat this as one integrated transaction in connection with the settlement and turning the Property over to the lender, then we have \$4,975,000 of Section 1231 gain.
- E. A Section 1031 Exchange is another option.
1. A Section 1031 Exchange may be a solution to defer the (phantom) gain upon the disposition of the Property.
 2. With a nonrecourse loan, using a qualified intermediary may create a valid safe harbor in an exchange which involves no cash or other property.
 3. In a Deed in Lieu situation, the LLC (borrower) and the lender enter into an Agreement in Lieu of Foreclosure that includes a tax-deferred cooperation clause.
 4. Prior to the conveyance, the LLC assigns its rights under Agreement in Lieu of Foreclosure to a qualified intermediary, with notice given to the lender.
 5. The LLC has 180 days from the date of the Deed in Lieu to acquire the replacement property or properties with a value equal to or greater than the amount of the project gain.

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6. The big issue is at the time of acquiring the replacement property, the LLC must have all of the required funds at closing since there are no funds being held by the qualified intermediary.
7. Private Letter Ruling No. 2013-02009.