33rd Annual

Tax Symposium

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

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FORGIVENESS OF DEBT

RECOURSE VS. NONRECOURSE DEBT

A. **Recourse Debt:**
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.

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 you transfer.

You will not have ordinary income resulting from debt cancellation, but will have a gain or loss.

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.

THE TWISTS AND TURNS OF THE TAX CODE

A. Lender takes the Property: long-term capital gain of $4,975,000 ($8,850,000 [hypothetical sales price]- $3,875,000 [basis]). This does not include State Taxes or IRS Recapture.

B. The Tenant settles and pays the client $2,000,000. The client then buys down the debt and the gain is reduced to $2,975,000.

   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.

THE TWISTS AND TURNS OF THE TAX CODE

C. Assign the lease to the lender if they take the Property and the Tenant pays the lender so that the client does not recognize ordinary income.

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 over the Property 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. Other Options – 1031 Exchange

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THANK YOU

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