Tax Issues for U.S. Real Estate Investors in Distressed Markets

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The author discusses the significant, complex, and often very surprising or counterintuitive tax consequences associated with transactions taking place in distressed real estate and capital markets.

> *"Adversity will not define us…But our response to it might."*
>
> – Mike Tomlin, Head Coach of the 2008 World Champion Pittsburgh Steelers

Investors in U.S. real estate markets are currently experiencing unprecedented adversity. The subprime mortgage debacle, the collapse, or near collapse, of many of the world's most storied financial institutions, the freezing of capital markets, massive governmental bailouts, and horrifying daily declines in public stock markets, and other events have been well publicized, but they do not even begin to describe

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the economic difficulties being faced by investors across the globe. Although there is some debate about whether or to what extent the economic recession may recede during 2009, many analysts and observers are bracing for more, not less, turbulence in the U.S. commercial real estate markets in the upcoming year.[1]

This economic environment, and the multitude of interrelated causes and effects, have caused the market values of many U.S. real estate investments to decline precipitously, in some cases significantly below the amounts of debt financing currently secured by such properties. This seems to have occurred nearly across the board, with almost no particular sectors having been spared.[2] As a result, many property owners and investors now find themselves struggling with reduced cash flows from their assets and increased difficulties in meeting current debt service obligations. Many also have maturities coming due on loans, with little current ability to refinance or sell their projects in today's markets for sufficient proceeds. The current "buzzwords of the day" include the following: "de-leveraging," "debt workout," "re-structuring," "forbearance," "extension of maturity," "forgiveness of debt," and "foreclosure."[3]

At the same time, however, the current state of the market also is creating the possibility for some potentially incredible investment opportunities for certain investors. According to at least one report, more than 25 percent of all capital raised during 2008 by private equity real estate funds was earmarked for buying up distressed debt and similar distressed assets at steep discounts.[4] Yet another report puts the percentage at more than 33 percent during the early part of 2009.[5] This is true both for current borrowers who are beginning to take advantage of opportunities to repurchase their own outstanding debt at a discount as well as third party debt funds or other opportunistic investors who are purchasing debt of unrelated borrowers, often with an eye toward ultimately acquiring equity ownership of the underlying real estate.

The types of transactions that occur in this type of environment run the gamut from (1) debt write-downs or other negotiated work-outs, (2) foreclosures, to (3) purchases of discounted debt in the secondary market by distressed debt funds and other investors. The U.S. federal income tax consequences associated with these types of transactions are significant, complex, and sometimes very surprising or even counterintuitive. In today's economic environment, an investor's ability to smartly and efficiently manage these consequences can often define the difference between an investor with a failed project and one that can not only weather the storm but also sometimes identify opportunities in adversity.

DEBT WRITE-DOWNS AND OTHER WORK OUTS

Short of instituting foreclosure proceedings, a distressed property owner and its lenders will usually explore some type of negotiated work out in order to provide temporary debt relief to the borrower. The most direct form of this is a negotiated reduction in the principal amount of the debt. In some cases, a lender may simply be willing to write-down — or "forgive" — a portion of the outstanding principal owing under the debt, while other transactions may involve more complex, multiparty recapitalizations of the borrower. For example, many owners of over-leveraged properties are engaging in work out transactions that involve, in one form or another, the raising of new equity capital in order to fund pay-downs of existing debt, sometimes at a discount to the face amount of the debt. In each case, the goal is to provide the borrower with reduced debt service and to avoid having to institute costly foreclosure, bankruptcy, or other dissolution proceedings.

Forgiveness of Principal

In any case in which a lender agrees to a principal reduction in a loan, the principal tax issue for the borrower is the recognition of what is known as "cancellation of debt" ("COD") income. Under the tax law, a taxpayer is not subject to income taxation on the amount of money borrowed under a loan because the receipt of those funds is offset by a legally binding obligation to repay the loan.[6] However, if at some point in the future the taxpayer is able to discharge the debt for less than the borrowed amount, the justification for excluding such amounts from taxation disappears. Thus, the tax law generally provides that where a debt is being forgiven or reduced, the borrower recognizes COD income in the year of discharge and is subject to taxation on such amounts at ordinary income rates.[7] This is generally true both in the case or recourse debt as well as (at least in the absence of any transfer or sale of the underlying property) nonrecourse debt.[8]

For a distressed borrower who is seeking debt relief, the requirement that it recognize and pay tax at ordinary income rates on this COD income can sometimes, in and of itself, defeat the purposes of the work out. The U.S. Congress, recognizing that it may be a most inopportune time to impose significant tax liabilities upon distressed debtors, has added numerous exceptions and special rules to the tax code, many of which permit borrowers to exclude COD income from taxation or, at a minimum, to defer the taxation of such amounts into future years. Unfortunately, however, most of these exceptions and special rules have been grafted onto the tax code over a period of years (often in response to the "crisis of the day"), creating a patchwork of numerous and very complex rules. Some of the exceptions that apply most frequently to typical commercial real estate transactions include the following:[9]

Insolvency/Bankruptcy Exclusions

The tax code has long provided that a borrower can avoid reporting and paying current taxes on COD income if the discharge of debt occurs in a "Title 11 case" or if it occurs when the borrower is insolvent.[10] The trade off here is that the borrower has to, instead, reduce certain tax attributes (such as net operating losses, tax credits, tax basis of assets, and so forth) by the amount of COD income that is excluded under either the "Title 11" or the "insolvency" rule.[11]

A Title 11 case is defined as a case under Title 11 of the United States Code (relating to bankruptcy), but only if the borrower is under the jurisdiction of the court in such case, and the discharge of debt is granted by the court or is pursuant to a plan approved by the court.[12] Thus, in order to utilize the Title 11 exclusion, bankrupt borrowers are well advised to ensure that debt discharges are approved by the bankruptcy court, either through specific court orders and/or as part of the approval of the overall plan of reorganization.

Even outside of a formal bankruptcy proceeding, however, a borrower can still be eligible to exclude COD income from taxable income to the extent the borrower is considered to be "insolvent" as of the time immediately prior to the discharge.[13] For this purpose, a borrower will be considered to be insolvent to the extent that the aggregate amount of the borrower's liabilities as of such time exceeds the aggregate fair market value of the borrower's assets, also measured as of such time.[14] The maximum amount of COD income that may be excluded from taxation under the insolvency exception is limited to the amount by which the borrower is, in fact, insolvent.[15] Thus, an analysis of the value of the borrower's assets and liabilities is required in order to determine the extent and applicability of the insolvency exception in any particular case. In doing this type of analysis, the Internal Revenue Service ("IRS") takes the position that outstanding nonrecourse obligations of the debtor are taken into account as "liabilities" only to the extent they are either being currently discharged or to the extent they do not exceed the value of the property securing such debt.[16]

The ability of commercial real estate funds and other similar entities to utilize the foregoing exceptions to avoid current taxation of COD income is significantly limited by Section 108(d)(6) of the tax code. This provision requires that, in the case of entities taxed as partnerships,[17] the insolvency and/or Title 11 tests must be analyzed at the partner level.[18] In other words, even though the partnership itself, may be bankrupt or insolvent, it is the status of each partner that determines the applicability of these exceptions.

> ***Example One:*** Assume that a private real estate partnership has two investors, each of whom is a high net worth individual with a personal net worth (assets in excess of debts) in excess of $20 million. The partnership owns an office building with a current fair market value ("FMV") of $15 million, subject to a nonrecourse bank loan of $20 million. Thus, the partnership is "insolvent," even though the

individual investors in the partnership are not.

In this example, if the bank were to agree to forgive $5 million of the debt, the resulting $5 million of COD income would need to be allocated by the partnership to its partners. Since neither of the partners, themselves, is in bankruptcy nor is insolvent as of the time of this discharge, neither of them would be permitted to exclude the COD income under the Title 11 or insolvency exceptions. If, however, one of these partners was insolvent as of the time of the discharge, then, to that extent, that partner would exclude his or her share of the COD income.

Qualified Real Property Business Debt

In the early 1990s, during one of the prior U.S. real estate recessions, a massive wave of real estate loan work outs and write-downs rippled through the U.S. economy. During this time, there were many private real estate partnerships or other similar projects that, themselves, were "underwater," though the partners in such ventures perhaps were not. As described above, the Title 11 and/or insolvency exceptions to COD income were not applicable to these situations. The U.S. Congress believed that it was appropriate to provide relief to solvent investors (other than C corporations) in certain types of "underwater" real estate projects who would otherwise have been subject to current taxation from COD income as a result of a loan write-downs.[19] As a result, the tax code since 1993 also has permitted solvent taxpayers (other than C corporations) owning "underwater" real estate to make an affirmative election to exclude COD income from current taxation if the discharged debt is "qualified real property business debt."[20]

Once again, though, a trade off is mandated here. If a taxpayer elects to exclude COD income from current taxation under this provision, then the taxpayer is required to reduce his or her or its tax basis in any of the taxpayer's depreciable real estate by an equal amount (starting first with any depreciable real estate securing the discharged debt).[21] Thus, the exclusion here may ultimately amount to a deferral, rather than a permanent exclusion, since the reduced tax basis in the property may ultimately result in more taxable gain (or less depreciation deductions and/or less taxable loss) being recognized by the taxpayer in any subsequent taxable disposition of the property.

For this purpose, the term "qualified real property business debt" means indebtedness that meets each of the following requirements:

- The debt was incurred or assumed by the taxpayer in connection with real property used in a trade or business and is secured by such real property[22]
- The debt was incurred or assumed prior to January 1, 1993 or, if incurred or assumed on or after such date, the debt was incurred to refinance such debt, or was incurred or assumed to acquire, construct, reconstruct, or substantially improve such property
- The taxpayer makes an election to treat such debt (or portion) as qualified real property indebtedness[23]

However, the ability to exclude COD income from taxation under this provision is subject to important limitations. First, the amount of the exclusion is limited to the amount by which the outstanding principal amount of the debt (determined prior to discharge) exceeds the FMV of the real property securing the debt (*i.e.*, the property must be underwater).[24] In addition, the amount of the exclusion also cannot exceed the amount of electing taxpayer's tax basis in all depreciable real property held by the taxpayer as of the time immediately prior to the discharge.[25]

With respect to COD income that is recognized by entities taxed as partnerships, the determination of whether the discharged debt meets the requirements described above for qualified real property business debt is made at the partnership level by reference to the partnership's activities (*e.g.*, the debt must have been incurred or assumed by the partnership in connection with a trade or business, must be secured by the partnership's real property, and so forth).[26] In addition, the limitations that require that the amount of the debt exceed the FMV of the underlying real property also is analyzed at the partnership level. However, the election to apply the exclusion is made on a partner by partner basis.[27]

Thus, for a partnership that recognizes COD income with respect to qualified real property business debt, such COD income must be allocated among all of the partners in the partnership and some, all, or none of such partners may or may not be eligible to make the election to exclude their respective shares of the COD income from taxation under this provision. For a REIT that utilizes an UP-REIT operating structure, for example, the REIT itself, likely is ineligible to make the election (since it is a C corporation for tax purposes), though the other non-corporate partners of the operating partnership may be eligible.

Purchase Price Adjustments

Another exception to the general rule of taxability of COD income is the so-called "purchase price reduction" exception. This exception also is somewhat limited because it generally only applies to seller-carryback debt (*i.e.*, debt issued to the seller of the property as consideration for the property).

The purchase price reduction exception was judicially created and typically was used when a debt was reduced in settlement of a dispute arising out of the purchase of the property.[28] Some courts further expanded the exception to cover a reduction of the purchase note in a situation where the value of the property decreased from the date of purchase and the seller accepts a reduction of the purchase money note.[29] The later expansion of the purchase price reduction exception was not universally accepted by all courts, and taxpayers and the IRS continue to dispute the issue.

The judicially created purchase price reduction exception has been largely superseded by the enactment of Section 108(e)(5) in 1980. Section 108(e)(5) was enacted as part of the tax code in 1980 in order "to eliminate disagreements between the [IRS] and the debtor" regarding the application of the purchase price reduction exception.[30] In particular, Section 108(e)(5) provides that a reduction of a "purchase money note" (*i.e.*, a note issued by the original buyer to the original seller of property) will be treated as a purchase price adjustment provided that such reduction would have otherwise been treated as COD income to the borrower (*i.e.*, the borrower is "solvent" and does not otherwise qualify for any other COD income exceptions or exclusions). Once again, there is a trade off: A taxpayer who excludes COD income from taxable income under the purchase price reduction rule is required to reduce his or her tax basis in the related property by the excluded amount.[31]

Section 108(e)(5) will not apply to any reduction of debt that is not held by the original seller of the underlying property. Although some older case law stands for the proposition that a "common law" purchase price exception to COD income might still exist,[32] the IRS' position is that these cases have been "discredited" by subsequent judicial developments. In the IRS' view, the common law purchase price reduction exception will apply in third party lender cases only "to the extent that the debt reduction by the third party lender is based on an infirmity that clearly relates back to the original sale (*e.g.*, the seller's inducement of a higher purchase price by misrepresentation of a material fact or by fraud)."[33]

Modification of Debt Terms

One of the most surprising, and sometimes counterintuitive, aspects of tax law in this area is that a loan modification can give rise to COD income (as well as other significant tax consequences) even in the absence of any formal reduction of the principal or other amounts owing under the loan. For example, a lender and distressed borrower may agree to a debt modification under which the principal amount remains owing, albeit under modified terms (*e.g.*, extended maturity date, modified interest accruals, adding or removing additional security, and so forth). The borrower, from his or her point of view, is still obligated to repay the full amount of the modified debt. Nonetheless, under certain circumstances, if these modifications are deemed to be "significant," various tax consequences could arise, including the potential recognition of COD income to the borrower.

A "significant" modification of a debt instrument is treated for tax purposes the same as if the borrower has issued a "new" debt instrument to the lender in full satisfaction of the "old" debt instrument.[34] Thus, just like the cases (mentioned above) where a borrower repays existing debt for cash, if the existing debt is satisfied for less than the amount owing, the borrower will recognize COD income. In connection with significant debt modifications, this determination is made by (generally speaking) comparing the amounts owing under the existing debt to the "issue price" of the modified debt.[35] If the issue price of the modified debt is less than the amounts owing under the existing debt, then the borrower is treated for tax purposes as if he/she had repaid the existing debt for less than the amount owing, thereby giving rise to COD income.

> ***Example Two:*** Assume that a borrower is obligated under an existing debt instrument to pay \$10 million to a lender. Assume also that the borrower and the lender enter into a significant modification of the debt, albeit one under which the \$10 million remains owing under the modified debt terms. Assume also that the "issue price" of the modified debt is determined to be \$10 million.
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> Under this scenario, the borrower is treated for tax purposes as if he/she has issued a new debt instrument (in the form of the modified debt) to the lender in full payment and satisfaction of the existing \$10 million debt. The amount the borrower is deemed to have paid to the lender is equal to the issue price of the "new" debt, which, in this example, is \$10 million. Since the debtor has paid the debt in full, none of it is deemed cancelled and, thus, there is no COD income in this example.

> ***Example Three:*** Assume the same facts as in the preceding example, except that the "issue price" of the new debt is determined to be only \$8 million. Under these circumstances, the borrower is deemed to have repaid the \$10 million existing debt via an \$8 million payment to the lender, thereby resulting in \$2 million of COD income. If the borrower qualifies for any of the available exclusions to COD income (including those described above), he/she may utilize those to exclude this amount from taxable income. Otherwise, the borrower in this example would recognize \$2 million of COD income as a result of the debt modification even though the \$10 million is still owing under the modified debt!

Clearly, the determination of the "issue price" of the modified debt instrument is a critical element to any debt modification transaction. This determination is a fairly complex undertaking, with different rules applying depending upon (among other things) whether or not the debt is publicly traded.[36]

Non-Publicly Traded Debt Obligations

In cases where neither the original debt nor the modified debt is traded on an established securities market,[37] the issue price determinations are generally governed by Section 1274 of the tax code.[38] The calculation of issue price under Section 1274 depends on the exact terms of the debt instrument and sometimes can be very complex. However, as a general rule of thumb, the issue price of the modified debt instrument under Section 1274 will be equal to the stated principal amount of the modified debt, so long as the modified debt bears interest at a rate which is at least equal to the "applicable Federal rate," (or "AFR") as in effect at the time of the modification.[39]

In today's economic environment, the current AFRs have been hovering at or near all time lows.[40] Thus, *as a general rule*, there normally would be no COD income to the borrower in cases involving significant modifications of private debt, so long as (1) the modified debt provides for adequate interest (*i.e.*, at least equal to AFRs in effect at the time of the modification, and (2) the modification does not reduce any of the amounts owing under the existing debt (including accrued but unpaid interest on the existing debt).[41]

However, one category of private debt modifications that can give rise to significant amounts of COD income to the borrower (even with interest rates exceeding the AFR) are those that involve "contingent" debt instruments. For instance, it is not unusual for a lender in this environment to provide debt relief to a borrower by agreeing to reduce the fixed interest amounts owing on a debt and/or perhaps also portions of the outstanding principal. However, instead of forgiving or writing off such amounts entirely, the parties may provided that such amounts are instead payable only upon achievement of certain financial thresholds. In other words, a fixed debt instrument has been modified into a "contingent" debt instrument, either in whole or in part.

These types of "fixed to contingent" debt modifications are problematic for the borrower from a tax point of view because the contingent amounts are effectively ignored in calculating the issue price of the modified debt.[42] This can result in COD income to the borrower equal to the contingent amounts.

> ***Example Four:*** Assume that a real estate investor owns an office building that is encumbered by a $20 million debt. The loan is not in default, but the investor is struggling to stay current with monthly debt service payments. In order to provide needed debt relief to the borrower, the lender agrees to reduce the "fixed" amount of the debt to $15 million. But instead of writing off the $5 million excess, the parties agree that such amounts (including interest thereon) shall be payable only in the event certain financial thresholds are achieved (such as, for example, upon sale of the property for a certain minimal sales price, etc.).
>
> Under this scenario, the "issue price" of the modified debt would be $15 million because the $5 million contingent amount is assigned a value of zero for purposes of the issue price determination. Thus, the borrower would have $5 million COD income even though the $5 million has not been formally discharged and, in fact, may ultimately need to be repaid by the borrower.[43] This COD income could be excluded from taxable income by the borrower if any of the exclusions (including those described above) are satisfied. Otherwise, the borrower would have $5 million of ordinary taxable income as a result of this modification.

Publicly Traded Debt Obligations

As stated above, a significant modification of a debt instrument is treated for tax purposes as if the debtor satisfied the original debt instrument in full through the payment of an amount equal to the "issue price" of the modified debt. As also stated above, the "issue price" of a non-publicly traded debt is basically equal to the stated principal amount, provided that the modified debt maintains a rate of interest at least equal to the AFR. However, in the event that the existing and/or modified debt is "publicly traded"[44] then the "issue price" is determined by reference to the public trading price.[45] In most cases, it is logical to expect that the value of a distressed debt would have declined to an amount less than face amount as of the time of a restructuring. In the case of non-publicly traded debt, this decline in value is generally not relevant to the COD income analysis. In the case of publicly traded debt, this decline in value is very relevant and, in fact, usually will trigger COD income to the borrower:

> ***Example Five:*** Assume that a publicly traded REIT utilizes an UPREIT operating structure and that its operating partnership (the "OP") has issued publicly traded bonds that have an issue price of \$20 million. Assume also that sometime after issuance, the bonds are "significantly" modified at a time when the bonds are trading on an established securities market at 80 cents on the dollar. Under this scenario, the OP would have COD income equal to 20 cents on the dollar. Subject to the possible qualification for the various exceptions or exclusions discussed above, this COD income would be allocated and taxable to the partners in the OP.[46]

Based on the above example, any issuer of publicly traded debt should proceed carefully before entering into any agreement to modify any of the terms of such debt. The issuer should first consider whether the proposed modifications would be considered significant, because, if so, the result will likely be the triggering of COD income, which would then require an analysis of whether or to what extent any exceptions or exclusions can be utilized.

What Is a Significant Modification?

Prior to the early 1990s, the tax law was not at all clear as to which types of modifications would be considered significant enough to be treated for tax purposes as an exchange of the old debt for a new debt. This determination was instead made on a case by case basis with no uniform rules.[47] This all changed in the early 1990s with a fairly high profile decision by the U.S. Supreme Court,[48] followed shortly thereafter when the IRS issued regulations that were ultimately finalized in 1996.[49]

Very generally speaking, these regulations state that a modification of a debt instrument will be significant only if, based on all the facts and circumstances, the legal rights or obligations that are altered and the degree to which they are altered are economically significant.[50] The regulations then set forth certain specific types of modifications that are deemed significant for this purpose, including the following:

- A change in the yield of a debt instrument will be a significant modification if the annual yield of the modified debt differs from that of the unmodified debt by more than the greater of 25 basis points or five percent of the annual yield of the unmodified debt.[51]
- A change in the timing of any payments (*e.g.,* deferred maturities) due under the debt will be treated as significant if it results in a "material" deferral of scheduled payments.[52] What is "material" in any given case will depend on the overall facts and circumstances, though a safe harbor is provided under a deferral of not more than the lesser of five years or 50 percent of the original term of the debt instrument.
- A change of obligor under a non-recourse obligation is generally not considered to be significant (which makes sense, given the lack of "personal" obligation from a non-recourse obligation), whereas a change of obligor is generally considered to be significant (though there are exceptions for common types of business reorganizations and other similar transactions).[53]
- For non-recourse obligations, any modification that releases, substitutes, adds, or otherwise alters a substantial amount of the collateral, guarantee, or other form of credit enhancement is generally considered to be significant, whereas a change in security or credit

enhancement on a recourse obligation is generally considered to be significant only if there is a resulting change in payment expectations.[54]

It also should be noted that, as a general rule, alterations to the debt that occur as per the terms of the original debt instrument (such as conversion options, periodic re-setting of the interest rates based on a schedule or index, and so forth) are not even considered to be "modifications." Thus, these changes typically will not give rise to taxable exchanges, except in cases where the change results in a new obligor of a recourse obligation or alters the recourse/non-recourse nature of the instrument.[55]

Conversions to Equity

At times, a borrower and lender will enter into an agreement to exchange some or all of the outstanding debt for equity-ownership interests in the borrower (stock, in the case of a corporate borrower, or partnership/membership interests, in the case of a partnership/limited liability corporation ("LLC") borrower). These types of "debt to equity" swaps also can give rise to COD income under certain circumstances.

Specifically, Section 108(e)(8) of the tax code provides that for purposes of determining COD income, a corporate or partnership/LLC debtor that satisfies some or all of an outstanding debt (whether recourse or non-recourse) through the issuance of stock or partnership/membership interests, the debtor is treated as having satisfied that debt with an amount of money equal to the FMV of such stock or partnership/membership interest. Thus, if the FMV of such stock or partnership/LLC interests is less than the amount of the discharged debt, then to such extent the borrower will generally recognize COD income (subject to the normal exceptions and exclusions described above). The IRS recently issued proposed regulations that, in the case of a partnership/LLC, would value the partnership/membership interests for this purpose based on the liquidation value of the borrowing entity.[56]

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FORECLOSURES

In the event that the borrower and the lender are unable to come to terms on an acceptable write down or other modification of a distressed real estate loan, and in the absence of formal bankruptcy proceedings, the parties may have no alternative to transferring the underlying collateral to the lender in partial or full satisfaction of the debt, either voluntarily or involuntarily as part of state law foreclosure proceedings. In fact, for so called conduit loans that have been financed through the commercial mortgage-backed securities ("CMBS") markets, the lender's ability to agree to modifications or write downs may be significantly constrained by the tax laws, at least prior to actual default or a "reasonably foreseeable" default.[57]

In general, the transfer of property by a borrower to a lender in satisfaction of debt (whether voluntary or involuntary) is treated for tax purposes as a sale of the property upon which taxable gain or loss must be recognized by the borrower.[58] In calculating the amount of the owner's taxable gains or losses in these transactions, however, the tax law has different sets of rules that apply depending upon whether or not the debt is recourse or non-recourse.

Non-Recourse Debt

In the case of a non-recourse debt, the property owner's taxable gain or loss is measured by reference to the full amount of the debt being discharged, as compared to the owner's tax basis in the property as of that time.

Example Six: Assume that a taxpayer owns an office building that is encumbered by bank debt as follows:

Adjusted Tax Basis:	$20 million
FMV:	$10 million
Non-Recourse Debt:	$15 million

If this owner were to transfer the building to the lender in full satisfaction of the non-recourse debt, the owner would recognize a taxable loss (likely a capital loss) equal to $5 million, calculated as the difference between the owner's "amount realized" on the sale of $15 million (the full amount of the discharged debt) and the owner's tax basis of $20 million.

Example Seven: Assume that in Example Six, the taxpayer's basis in the property is only $5 million instead of $20 million.

Adjusted Tax Basis:	$5 million
FMV:	$10 million
Non-Recourse Debt:	$15 million

In this situation, the transfer of the property to the lender in full satisfaction of the debt would result in a taxable gain for the owner equal to $10 million, calculated as the excess of the owner's "amount realized" on the sale (again, equal to the full amount of the discharged debt of $15 million) minus the owner's tax basis of $5 million. Assuming that the property is not "dealer" property in the owner's hands, this gain would generally qualify as capital gains for tax purposes, subject to recapture for prior deprecation deductions taken by the owner on the property.

As the above examples demonstrate, in a foreclosure of a property in full satisfaction of a non-recourse debt, the FMV of the property is actually irrelevant to the owner's income tax consequences, and the owner never recognizes COD income. The owner is simply viewed as "selling" the property to the lender for an amount equal to the discharged non-recourse debt. If the discharged non-recourse debt is less than the owner's tax basis in the property, the owner will recognize a taxable loss from the transaction. Conversely, if the discharged non-recourse debt amount is higher than the owner's tax basis in the property, the owner will recognize taxable gains from the transaction.

Recourse Debt

By contrast, in the case of a transfer of a property in full satisfaction of a recourse debt obligation, the transfer is treated for tax purposes as two different transactions. First, to the extent the amount of the debt being discharged exceeds the current FMV of the property, such excess is treated as COD income to the property owner.[59] Second, the property owner also recognizes gain or loss from the sale of the property, this time measured by reference to the current FMV of the property as compared to the owner's tax basis in the property.[60] These different tax rules can lead to dramatically different tax consequences and, in some cases, planning opportunities and/or traps for the unwary.

Example Eight: Assume the same facts established in Example Six, except that the debt is a recourse obligation:

Adjusted Tax Basis:	$20 million
FMV:	$10 million
Recourse Debt:	$15 million

Upon a transfer of this property to the lender in satisfaction of the recourse debt, the tax consequences to the owner would be very different than was the case with the non-recourse loan. The transaction is treated as two separate transactions. First, since the value of the property is less than the amount of the discharged debt (*i.e.*, the property is underwater), the owner is treated as recognizing $5 million of COD income ($15 million minus $10 million). Second, the owner recognizes a $10 million capital loss on the sale of the property, measured by the difference between the property's FMV ($10 million) and the owner's tax basis in the property ($20 million). Only the portion of the debt discharge equal to the property's FMV is treated as being received by the property owner from the sale of the property.

When compared to the non-recourse debt situation, the property owner in Example Eight has the same "net" taxable income ($10 million capital loss and $5 million COD income), as did the property owner in example six ($5 million capital loss). The difficulty for the owner in Example Eight, however, is that since the tax code generally does not permit ordinary income to be offset with capital losses. The owner could have a "mismatch" that would require him/her to pay tax on the $5 million COD income without the ability to utilize the offsetting $10 million capital loss.[61] Thus, under certain circumstances, a taxpayer with a recourse obligation could be in a far worse tax position than one with a non-recourse obligation with all else being equal.

On the other hand, there are some circumstances in which the recourse obligor could be in a much *better* tax position than a comparable property owner with non-recourse debt. Consider the following example:

> ***Example Nine***: Assume the same facts established in Example Seven, except that the debt is recourse rather than non-recourse:

Adjusted Tax Basis:	$5 million
FMV:	$10 million
Recourse Debt:	$15 million

> Upon a transfer of this property to the lender in satisfaction of the debt, the transaction would be treated as two separate transactions. First, since the value of the property is less than the amount of the discharged debt (*i.e.*, the property is underwater), the owner is treated as recognizing $5 million of COD income ($15 million minus $10 million). Second, the owner recognizes a $5 million capital gain (subject to depreciation recapture) on the sale of the property measured by the difference between the property's FMV ($10 million) and the owner's tax basis in the property ($5 million).

Once again, as compared to the non-recourse debt example with the same numbers, the property owner in Example Nine has the same net taxable income ($5 million COD income and $5 million capital gain), as did the property owner in Example Seven ($10 million capital gain). Once again, however, the recourse nature of the loan in Example Nine creates income of a different type and character. On the one hand, it might be said that the property owner with the recourse obligation is once again worse off because half of his or her taxable income is ordinary income (*i.e.* COD income), whereas the non-recourse obligor recognizes the full $10 million of gain as potentially preferable capital gains.

On the other hand, if the recourse obligation in Example Nine were to qualify for one of the exceptions to COD income (summarized above), then the property owner in that example might be permitted to exclude the $5 million COD income and the recognize only $5 million of capital gains. For example, the recourse borrower might be insolvent or in bankruptcy at the time of the foreclosure/discharge, thus potentially qualifying for one of those exceptions. By contrast, the non-recourse obligor in Example Six would be required to recognize twice the amount of capital gains ($10 million) with none of such amounts being eligible for exclusions since it is not COD income.

Defining Key Terms

If the discussion in the preceding paragraphs elucidates anything, it is that there are significant differences in tax treatment arising from these types of transactions depending upon whether the debt is recourse or non-recourse. Given the importance of this distinction to the tax consequences, it is somewhat surprising that the tax law does not have a very clear definition of when a debt will be treated as one or the other for this purpose.

The most commonly understood definition of a loan that is non-recourse in nature is one in which the borrower has no personal liability for the loan per se, and the lender's sole recourse is to certain specified assets of the borrower that secure the loan.[62] However, these concepts can quickly become more complex in situations involving loans to LLCs.

Although some commentators have argued that a loan to an LLC should generally be considered non-recourse to the partners of that LLC for purposes of analyzing COD income issues, the better argument probably is that the nonrecourse/recourse analysis should be undertaken at the LLC level. In other words, a recourse obligation for this purpose would be one whereby the creditor generally may proceed against any of the LLC's assets to satisfy the debt.[63]

An interesting recent case on this issue was *Great Plains Gasification Associates v. Commissioner*, 92 T.C.M. (CCH) 534 (1996). In this case, a creditor made a loan to an LLC and generally had access to all of the LLC's assets to satisfy the loan (thus, indicating that the loan should be viewed as being recourse in nature), although the covenants of the loan agreement prohibited the LLC from acquiring any assets other than the underlying project for which the loan proceeds were intended. In other words, the LLC borrower was a "single purpose entity." Although the tax court's decision in this case is not exactly a model of clarity, this decision seems to stand for the proposition that this loan, although it otherwise would be treated as being recourse for this purpose, is more properly viewed as being effectively non-recourse, given the covenants.

Another interesting recent case in this area is *Briarpark v. Commissioner*, 163 F.2d 313 (5th Cir. 1999). In this case, a lender agreed to discharge/write-off a portion of an undersecured non-recourse loan, conditioned on the borrower's sale of the real estate to a third party borrower (with the net proceeds from the sale being used to repay the remaining portion of the debt). Because the write-off of the debt and the sale of the property were so closely related and tied together, the tax court in this case held that they constituted a "single transaction" to the effect that the write-down of the loan was considered to be additional sale proceeds to the borrower rather than COD income.

PURCHASES OF DEBT AT A DISCOUNT (INCLUDING SECONDARY MARKET TRANSACTIONS)

The distressed capital and real estate markets are creating some opportunities for debtors or investors to purchase debt from the lender at discounts to face amount. For example, many publicly traded REITs have recently announced debt repurchase programs pursuant to which they are buying back their outstanding publicly traded notes at a discount to par.[64] Many private real estate funds also are being presented with opportunities to repurchase their debt from lenders (particularly those who are holding the notes as non-securitized portfolio loans) at a discount to face. Moreover, many opportunity funds and other investors are launching large scale distressed debt funds with a focus on acquiring real estate mortgages or other debt at a discount, often with an eye toward obtaining ownership of the underlying real estate through foreclosure or work out proceedings.

Each of these types of secondary market or buy-back transactions has significant tax consequences, some of which can be quite unexpected and counterintuitive. These consequences will vary depending upon whether the purchaser of the debt is the borrower, a related party to the borrower, or an investor who is otherwise completely unrelated to the borrower.

Debtor Repurchases Its Own Debt

If a debtor directly repurchases its debt from the lender at a discount, the debtor generally is required to recognize and pay taxes on the discount as COD income.[65] This is generally true whether it is a REIT that repurchases its publicly traded bonds in the market at a discount to par, or whether it is a repurchase by a real estate fund, REIT, or other borrower of privately held debt at a discount to face. This also is generally true regardless of whether the discounted debt is recourse or non-recourse in nature.[66] The rationale here is the same as described above, where a creditor agrees to simply reduce the outstanding amount of debt as part of a negotiated work out. That is, the borrower is not taxable on the borrowed funds because the receipt of those funds is offset by a legally binding obligation to repay.[67] Thus, if the borrower is able at some point in the future to discharge that obligation without repaying the funds, the tax law generally requires tax to be paid (at ordinary income rates) on the discharged amounts.

"Traditional" COD Income Exceptions/Exclusions

As indicated above, the tax law provides several possible exceptions to the general rule, any one of which, if applicable, may relieve the borrower from having to pay current taxes on otherwise taxable COD income. Although there are numerous possible exceptions in the tax law, the most frequently utilized exceptions in commercial real estate transactions are the bankruptcy or insolvency exceptions, the qualified real property business debt exception, and/or the purchase price reduction exception.

> ***Example 10:*** Assume that a real estate investment partnership (or an operating partnership of a REIT) owes a lender $20 million of principal on a loan that is secured by the partnership's commercial real estate assets. If the partnership were to repurchase the note evidencing the $20 million debt for $15 million in cash, the partnership would recognize $5 million of COD income. This $5 million of COD income may be taxable to some, all, or none of the partners, depending on the particular facts and circumstances.
>
> If the debt being discharged happens to be carry-back debt issued by the partnership to (and still held by) the original seller of the property, then the discharge would be non-taxable to all partners in the partnership, with the trade-off being that the partnership needs to reduce its tax basis in the property by an amount equal to the discharge. If the debt is not carry-back debt, then the $5 million COD income needs to be allocated among the partners as dictated by the partnership agreement.

In Example 10, if any one of the partners is bankrupt or insolvent at the time of the discharge, then the partners may exclude their respective shares of COD income from taxable income on their own individual tax returns, with the trade-off that they each have to reduce tax attributes such as net operating losses ("NOLs"), credits, basis, and so forth. Or, for solvent partners, if the discharged debt was secured by real estate used in a trade or business and whose value is less than the debt secured by such property (*i.e.*, the property is underwater), each such partner may, subject to certain limitations, elect to exclude the COD income under the "qualified real property business" exception (again, with the trade-off of having to reduce their tax basis relating to such property).

Recent Tax Law Development

In addition to the traditional exceptions to COD income described above, additional special rules were added to the tax code in February 2009 as part of the American Recovery and Reinvestment Act of 2009 ("ARRA"). These new special rules apply only during 2009 and 2010 and are designed to provide temporary tax relief to struggling operating businesses (including REITs) by facilitating their ability to restructure their debt without incurring large tax liabilities from COD income.

ARRA adds new Section 108(i) to the tax code and permits taxpayers to elect to defer the payment of taxes on COD income recognized as a result of re-acquisitions of "applicable debt instruments" occurring during 2009 or 2010.[68] Under this new election, the taxpayer, instead of paying tax on the COD income entirely in the year of the discharge, is permitted to pay tax on the COD income ratably over a five year period beginning in 2011 and extending through 2016. For this purpose, an applicable debt instrument is a debt instrument issued by a C corporation or any other person (including partnerships) in connection with the conduct of a trade or business by such person.[69] The term "reacquisition" is defined very broadly and includes all of the following:

- An acquisition of the debt instrument for cash
- The exchange of the debt instrument for another debt instrument (including an exchange resulting from a modification of the debt instrument)
- The exchange of the debt instrument for corporate stock or a partnership interest
- The contribution of the debt instrument to capital
- The complete forgiveness of the indebtedness by the holder of the debt instrument[70]

- The requirement that the debt be issued "in connection with a trade or business probably means that these new rules do not apply to debt incurred, for example, by a partnership in connection with the acquisition or refinancing of raw land or triple net leased real estate, each of which is likely treated as not rising to the level of a trade or business. In the case of a partnership (including an LLC taxed as a partnership), the election under this new provision is made by the partnership and, once made, is irrevocable."[71]

  Example 11: Assume the same facts established in Example 10, whereby an operating partnership of a publicly traded REIT has $20 million of bank debt outstanding that is secured by certain of the partnership's real estate assets. During 2009, the partnership pays the lender $15 million to re-acquire from the lender the $20 million note evidencing this debt.

  The partnership has $5 million of COD income from this transaction. However, if the partnership makes an election under the new Section 108(i), then the partnership (and its partners) is not required to recognize and pay tax on this $5 million during 2009. Instead, the partnership recognizes and allocates to its partners an amount of COD income equal to $1 million per year ($5 million total divided by five) in each of the five tax years from 2014 through 2018, inclusive.

  Example 12: Assume the same exact facts established in Example 11, except that the partnership repurchases the debt in 2010 instead of 2009. The results here are exactly the same. The partnership recognizes and allocates to its partners an amount of COD income equal to $1 million per year ($5 million total divided by five) in each of the five tax years from 2014 through 2018, inclusive.

In each of the examples above, although all of the deferred COD income will eventually be recognized and taxed, the taxpayer benefits from the time value of money. The taxes relating to that income is deferred a significant number of years without an interest charge.[72] Still, taxpayers should carefully evaluate their own circumstances before making this type of deferral election, as it may not always be a preferable course of action. For example, in the year of discharge, the taxpayer might otherwise qualify for an existing exclusion (such as the "qualified real property business" exception, or one of the other exceptions described above.[73] Or the taxpayer might have other losses or tax attributes available in the year of discharge that will absorb the COD income, and such losses or tax attributes might be expiring or otherwise unavailable in five to 10 years.

Related Party Purchases Debt

As previously indicated, if a debtor repurchases its debt from the lender at a discount, the debtor normally is required to recognize and pay tax on the discount as COD income. Faced with this reality, some debtors began structuring transactions whereby a related entity (such as a controlled subsidiary entity or a commonly controlled affiliate), rather than the debtor, would purchase the debt from the lender at a discount. Since the debt was still outstanding and owing (albeit now owing to a related creditor), these parties took the position that no COD income was triggered. Prior to 1980, courts had held that although the purchasing entity was closely related to and commonly controlled with the debtor, it was nonetheless a separate legal entity and the transaction was generally respected as not giving rise to COD income.[74]

The U.S. Congress, believing this to be an inappropriate result, amended the law in 1980 by adding a new Section 108(e)(4) to the tax code. Section 108(e)(4) of the tax code now provides that for purposes of calculating COD income to a debtor, the purchase of a debt by a party related to the debtor is treated for tax purposes the same as if the debtor itself had effectuated the purchase.[75] For this purpose, two partnerships are treated as being "related" to each other if the same persons own more than 50 percent of the capital or profits interests in each partnership.[76] Similarly, a corporation and another legal entity (including another corporation or another partnership) are related to each other if they are commonly controlled by persons holding more than 50 percent ownership in each entity.[77] Attribution rules also are provided that would attribute direct or indirect ownership to person from family members and legal entities.[78]

These related party rules (and the case law in existence prior to the enactment of Section 108(e)(4)) also suggest that under the right circumstances, if a purchaser of a debt instrument at a discount is not related to the debtor under these rules, then no COD income should be triggered.

Unrelated Party Purchases (Distressed Debt Funds)

As indicated above, the distressed capital and real estate markets are creating opportunities for the purchase of discount debt not only for borrowers and their related entities, but also for third party investors. In the case of investors pursuing the acquisition of third party distressed debt obligations, many of these investments are being pursued with an eye towards ultimately acquiring equity ownership of the underlying real estate.

The tax consequences faced by these types of "distressed debt funds" are far more complex, and in many respects, more surprising and counterintuitive than those described above for equity real estate investors. In fact, a complete description of these tax consequences is far beyond the scope of this article. Nonetheless, there are perhaps a handful of very surprising tax results that any distressed debt fund must confront and which are worth at least mentioning at this point. These relate to the following (a) certain "phantom" tax liabilities that are imposed upon distressed debt funds upon modification of a distressed debt obligation, (b) the application of the so called "market discount" rules to distressed debt investments, and (c) additional phantom tax liabilities that are triggered for distressed debt funds both in connection with interest accruals on the debt and foreclosure transactions.

Phantom Tax Gains Upon Modifications of Distressed Debt

Perhaps the most surprising and counterintuitive aspect of the tax rules in this area are those that appear to apply in the case of a purchaser of a discounted debt instrument who then enters into a modification agreement with the borrower. As indicated above, a significant modification of a debt instrument is treated for tax purposes as the issuance by the debtor of a brand new debt instrument in full payment or satisfaction of the original debt instrument.[79] From the creditor's point of view, this results in a "sale or exchange" of the original note for the new note.[80] This is generally a taxable transaction for the creditor upon which gain or loss is recognized, with the amount of this gain or loss being measured by the difference between the creditor's "amount realized" on the sale and the creditor's tax basis in the note prior to modification.[81]

For this purpose, the creditor's "amount realized" will be equal to the issue price of the modified debt.[82] As alluded to above, in the case of non-publicly traded debt instruments, the debt's fair market value is generally irrelevant to the determination of issue price. Instead, the issue price of the modified debt instrument (assuming the interest rate is at least equal to the AFR) would be determined solely by reference to the stated principal amount of the note.[83]

The problem here is that a purchaser of distressed debt in the secondary market will certainly have purchased that debt at a significant discount to face, thus resulting in a tax basis that will likely be far less than the stated principal amount of the note. In other words, a significant modification of a non-publicly traded debt instrument following a purchase by an investor at a discount can trigger a significant amount of phantom tax gains for the investor.

> ***Example 13:*** Assume that a distressed debt fund (the "Fund") purchases a non-publicly traded debt instrument in the secondary market for $5 million. The face amount of the debt instrument is $10 million. Shortly after the investment, the Fund negotiates with the borrower and agrees to various modifications to the debt which amount to a significant modification. As part of these modifications, the principal amount of the debt is reduced from $10 million to $8 million. The modified debt continues to provide for interest in excess of the AFR.
>
> The significant modification of the debt is treated as a taxable sale by the Fund of the original debt (tax basis $5 million) for "sale" pro-

ceeds equal to the stated principal amount of the modified debt ($8 million). Thus, the Fund has a short term taxable gain equal to $3 million!

Clearly, the taxable gain in Example 13 has no basis in economic reality. Nonetheless, this appears to be the result under the tax code and regulations, subject to the following possible exceptions.

For non-publicly traded debt, this result can sometimes be avoided by executing the modifications prior to the time the debt is purchased by the investor. This is not always practicable, however, and in cases where the amendments cannot be executed prior to the purchase of the debt, the investor may be eligible to utilize the "installment method" of tax reporting to defer the reporting of the deemed tax gains until principal payments are made on the modified debt.[84] However, if the face amount of the modified debt (together with any other "installment" notes held by the investor and arising in the same taxable year) is greater than $5 million, then the investor is required to make interest payments to the IRS which, in effect, will eliminate the economic benefit of the tax deferral.[85] In the case of a partnership (or other entity taxed as a partnership), this $5 million limit is applied on a partner by partner basis, thereby perhaps providing some flexibility (albeit very limited) for real estate funds to utilize the installment method under the appropriate circumstances.

Example 14: Assume that in Example 13, above, the Fund, which is taxed as a partnership, is owned by two partners, each of whom owns 50 percent of the Fund. Each of these partners would be ascribed only $4 million of the modified note for these purposes.[86]

There is yet another possible exception to the phantom tax gains arising as a result of a modification of discount debt that applies in the case of corporate debtors. If the debt instrument that is being modified has been issued by an entity which is taxed as a corporation, then, to the extent the debt instrument qualifies as a "security," the deemed exchange might, either in whole or in part, qualify as a tax free exchange of corporate securities as per the corporate reorganization rules of the tax code.[87]

However, as indicated, this exception is limited solely to corporate debt instruments. For example, it probably would not apply in the case of a REIT that utilizes an UP-REIT operating structure and whose debt is issued by the "operating partnership." Although the REIT would qualify as a "corporation" for this purpose, the issuer of the debt is a "partnership."

Uncertain Application of Market Discount Tax Rules to Distressed Debt

Another very complex area of the tax law that often leads to surprising and counterintuitive results for distressed debt funds are the so called "market discount" rules. These rules were added to the tax code in 1984. There are at least two aspects of these market discount rules that are worth mentioning here. First, where these rules apply, they can require a distressed debt fund to pay tax upon collecting amounts from distressed debt investments at ordinary income (rather than capital gains) rates, and on an accelerated basis. Second, there are peculiarities to the application of theses tax rules in the case of "deep discount" and/or defaulted debt obligations. These aspects require a bit of understanding of the history and background of the market discount rules.

Generally speaking, any time a bond or other debt instrument has declined in value after its original issuance (other than by reason of repayment of principal), a subsequent purchaser who buys the bond from the original holder in the secondary market will be treated for tax purposes as holding a "market discount bond," with the "market discount" being the excess of the bond's face amount over the purchase price paid by such purchaser in the secondary market. Prior to the enactment of the market discount rules in 1984, a holder of a market discount bond was generally permitted to recognize the gain attributable to market discount as capital gain.[88] Where principal payments on these obligations were to be received in multiple installments over time, the case law generally required the holder to report the market discount on the bond as taxable income on a pro rata basis as and when principal payments were made on the bond.[89] For example, if 10 percent of the stated principal on the bond were to be repaid, the holder would be required to recognize and report

10 percent of the market discount as taxable income as of that time.

The pre-1984 case law on market discount also included several decided cases that carved out an exception to the general principle that market discount be recognized on a proportional basis as and when principal payments were made on the bonds. This exception applied to bonds that were purchased in the secondary market at a deep discount due to financial distress of the issuers.[90] In these cases, the likelihood of repayment of the bonds in full was deemed to be speculative or uncertain and, therefore, taxpayers were only required to recognize and report market discount as taxable income only when (or if) aggregate principal payments on the bonds exceeded the investor's purchase price.[91] In other words, for speculative bonds, the case law created an exception to the pro rata recognition of market discount, and permitted taxpayers to recover basis first, then recognize and report market discount only after they had recovered their purchase price in full. While this exception only addressed the timing of reporting market discount on installment obligations, it supports the notion that the normal market discount rules may not apply when dealing with speculative and distressed debt, the repayment in full of which is uncertain.

As indicated, Congress stepped into the fray in 1984 and amended the tax treatment of market discount bonds. As a result, the tax code now provides that, as a general rule, any gain from the disposition (including retirement) of a "market discount bond" shall be treated as ordinary income to the extent of any "accrued market discount" on the bond.[92] A market discount bond is defined, not surprisingly, as any bond that has "market discount," with the term "market discount," in turn, being defined generally as the excess of the bond's stated redemption price (which basically means all amounts payable by the issuer of the bond other than qualified stated interest) over the bondholder's basis in the bond (which generally would be the bondholder's purchase price for the bond).[93]

> ***Example 15:*** Assume that a distressed debt fund (the "Fund") purchases a non-traded debt instrument from the original lender for $5 million. The debt has an outstanding principal amount of $10m and

is secured by an office building. The project is in significant distress and the note is in default.

The Fund's tax basis in the note would be $5 million. This amount is certainly less than the "stated redemption price" or "face amount" of the bonds ($10 million). Thus, it seems clear that the note would have "market discount" and therefore would be considered to be a "market discount bond" for these purposes.

While it seems relatively clear that the $10 million note in Example 15 above, would be considered as a market discount bond for these purposes, what is less clear is the manner in which the market discount rules would be applied to this note, if at all. In other words, just because the note may meet the definition for market discount bond does not necessarily mean that all of the market discount on this note needs to be recognized as ordinary income by the Fund.

In fact, the tax code specifically provides that it is only the portion of the total market discount that is "accrued" as of the time of the pay off date that is required to be treated as ordinary income. The tax code then goes on to provide fairly detailed rules as to the manner in which the accrued market discount is to be calculated.[94] It is the manner in which this accrual is determined which, in the case of a defaulted and distressed note (such as the one described in Example 15), makes it somewhat uncertain as to whether or not the market discount rules were intended to apply at all to these types of instruments.

In particular, Section 1276(b)(1) of the tax provides, in pertinent part, that the portion of the total market discount on a bond which will be deemed to be accrued as of any given point in time is a percentage of the total market discount on that bond, with the percentage being determined by dividing the number of days which the taxpayer held the bond as of such time by the total number of days *after* the date the taxpayer acquired the bond and up to (and including) the date of maturity. This is perhaps most easily illustrated by use of a simplified example:

Example 16: Assume that in Example 15, above, the purchase of the note by the Fund occurs at a time when there are 720 days (*i.e.*, approximately two years) remaining until maturity. If the note is then sold by the Fund to another purchaser 360 days later for $10 million, then (assuming the market discount rules are applicable) approximately $2.5 million of the total $5 million market discount would be treated as "accrued" as of such time, and, thus, would be reported as ordinary income (*i.e.*, 360/720 total days x $5 million).[95] If instead the note is held until maturity and then retired for $10 million, then (again assuming the market discount rules are applicable) the entire $5m of market discount would be treated as "accrued" and taxed as ordinary income as of such time (*i.e.*, 720/720 x $30). In other words, the accrued market discount is calculated on a linear basis, based upon the number of days elapsed *after* the date of purchase up until the maturity date.[96]

Thus, on their face, these rules do not appear susceptible to application in cases where the note was in default and thus is already immediately due and payable at the time of its acquisition. In other words, the acquisition of the note in this case comes *after* the "maturity" date on this type of note.[97] In these types of cases, it would appear as if the numerator of the fraction prescribed by the statutory formula described above would be *zero* since there in fact are *zero* days "after the date the taxpayer acquired the bond and up to (and including) the date of maturity." This, of course, is an impossibility because one cannot divide any number by zero. Thus, a literal interpretation of the statutory language would seem to give rise to an argument that the market discounts rules were not intended to be applied, and thus, should not apply to recharacterize a distressed debt fund's gain from defaulted notes as ordinary income.

This argument is also arguably supported by certain excerpts from the legislative history to the market discount rules themselves.[98] For example, the conference report accompanying the enactment of these rules contains a statement whereby Congress indicated its expectation that the IRS will promulgate regulations that will "clarify" that the market discount tax rules are not applicable to a bond "that was demand debt when issued."[99] The Joint Committee on Taxation's explanation of the tax act that contains these rules states that the reason for exempting such "demand" obligations from the market discount rules is that "[d] emand debt is insusceptible to treatment under the rules for computing accrued market discount (which rules are applied by reference to a maturity date)."[100] Although this legislative history refers to an exemption for obligations that are demand debt "when issued," the same rationale should apply in the case of a past due bond that was not demand debt when issued but that becomes a demand debt upon default since the same "insusceptibility" to applying the market discount rules is equally present in both cases.[101]

The legislative history's exemption of demand debt from the application of the market discount rules is curious for an additional reason. One would presume that market discount would very rarely (if ever) arise in situations involving demand debt except in cases involving default and/or other financial distress of the issuer. In other words, in cases where the value of an outstanding demand obligation has decreased due to a general increase in the prevailing interest rates, the holder of the demand obligation would presumably never sell that obligation to a third party at a discount from face; he would simply demand that it be repaid in full by the issuer. Thus, it would seem that market discount would only arise in connection with demand obligations only in those cases where the issuer *cannot* pay the obligation in full; *i.e.*, situations where the issuer is in default and/or in distress. Therefore, it can be argued that Congress *must have* been referring to default and/or distress situations when it was addressing demand obligations since that is the only situation where market discount would arise with respect to such obligations.

In short, investors in these types of distressed, and perhaps defaulted, obligations may have arguments, based on the older case law described above, that some or all of their gains from these types of investments should be taxable as capital gains rather than ordinary income.[102] The strength of this position in any given transaction will depend on the exact facts and circumstances surrounding the investment.

Other Phantom Tax Issues for Distressed Debt Funds

There are a number of other potential phantom tax issues faced by distressed debt funds, including those relating to interest accruals on the debt instruments as well as certain taxable gains or losses that arise in foreclosure transactions.

Interest Accruals. In regards to the accrual of interest income on debt instruments, the tax code contains a number of very complex rules which governing the timing and amount of interest income which is to be recognized by the debt holder for tax purposes. Very generally speaking, for "current pay" debt instruments (*i.e.* those that unconditionally obligate the borrower to make "qualified stated interest" payments at least annually at a fixed rate) and which were not issued at a discount to par, the creditor must include the interest income in taxable income each year according to its method of accounting. As a general rule, for these types of current pay and non-discount obligations, a cash method creditor would take accrued interest into income as payments are made and an accrual method creditor would take interest into income as it accrues.[103] Notwithstanding the foregoing, however, there is a body of case law that stands for the proposition that, with respect to a debt that is in default on current interest payments, an accrual method creditor need not continue to include the defaulted interest in taxable income as it accrues, so long as the facts establish that there is no longer any reasonable expectation that such defaulted interest will ever, in fact be, paid.[104]

It should be noted, however, that the application of the aforementioned case law has been very controversial in the case of interest accruals that are subject to the "original issue discount" or "OID" rules of the tax code. Very generally speaking, for debt instruments that either provide for interest payments that are not payable unconditionally on at least an annual basis (*e.g.*, notes that provide for interest to accrue until maturity, etc.) and/or that have been issued at a discount to par, the tax code contains a complex set of rules that, in effect, will require the creditor to include the "deferred" interest and/or the discount principal amount in taxable income as interest over the term of the debt as it accrues prior to actual payment.[105] The IRS' position here is that where these OID rules require the current inclusion of the accrued amount in taxable income, such taxability is mandated even in the event that the debtor is in dire straights and is thus unlikely to ultimately pay such amounts.[106]

Foreclosures/Deeds in Lieu. Lastly, another area of potential phantom taxable income for distressed debt funds is in connection with foreclosures or other similar transactions (including deeds in lieu) whereby the creditor takes ownership of the underlying collateral in satisfaction of the debt. Although there is a significant amount of complexity and uncertainty regarding the exact character and/or timing of these amounts, the general rules are: (1) the creditor will recognize taxable gains to the extent that the FMV of the property received exceeds the creditor's tax basis in the debt, and (2) the creditor will recognize a taxable loss to the extent the value of the property received is less than the creditor's tax basis in the debt.[107] In any event, the creditor will take the property with a tax basis equal to the FMV of the property as of that time.

SUMMARY

The tax consequences associated with transactions taking place in distressed real estate and capital markets are significant, complex, and often very surprising or counterintuitive. Transactions such as debt write-downs, work outs, recapitalizations, foreclosures, and distressed/discount debt or asset acquisitions are likely to become more, not less, common in the coming year. An investor's ability to smartly and efficiently manage the tax consequences associated with these types of transactions can literally define the difference between a failed deal and one that either allows the investor to weather the storm, or, better yet, take advantage of some of the opportunities that these markets sometimes create.

NOTES

[1] *See e.g. Fed Official Calls Commercial Real Estate the Big Problem for 2009*, Real Estate Investment Smart Brief, February 24, 2009, http://

www.smartbrief.com/news/nareit/storyDetails.jsp; *Commercial Real Estate Investing is Stalled Despite Long Term Investor Optimism*; GlobeNewswire, September 18, 2008, http://www.globenewswire.com/newsroom/news.htm.

[2] *See e.g.*, Urban Land Institute and PricewaterhouseCoopers LLP, *Emerging Trends in Real Estate 2009,* October 2008.

[3] These "buzzwords of the day" stand in stark contrast to those of only one or two years ago: "capital gains," "tax deferral," "like-kind exchange," "installment sale," "leveraging-up" and "pulling out equity."

[4] *See* Kenney, "*Private Equity Gearing Up to Buy Distressed Assets, Report Finds*," REIT.com, http://www.reit.com/Portals/0/WebPreqin.pdf (February 25, 2009).

[5] Reuters, *"More Private Equity Eyeing Distressed Property: Report"* http://www.reuters.com/article/euDealsNews (February 24, 2009).

[6] *See e.g.*, *Milenbach v. Commissioner*, 318 F.3d 924 (9th Cir. 2003). *See also*, *Noguchi v. Commissioner*, 992 F.2d 226 (9th Cir. 1993).

[7] *See* IRC § 61(a)(12).

[8] *See e.g.*, Rev. Rul. 91-31, 1991-1 C.B. 19; *Gershkowitz v. Commissioner*, 88 T.C. 984 (1987); *cf. Fulton Gold Corp. v. Commissioner*, 31 B.T.A. 519 (1934). *See also*, *Commissioner v. Tufts*, 461 U.S. 300 (1983).

[9] In addition to those summarized above, some additional exceptions to COD income taxation that are less frequently utilized in connection with most commercial real estate transactions include the following: the exception for so-called "contingent" or "disputed" debt, the exception for cancellations involving "qualified farm indebtedness" (IRC § 108(a)(1)(C)), and discharges of certain types of student loans (IRC § 108(f)). As part of the Mortgage Forgiveness Debt Relief Act of 2007, Congress also recently added another new exception that permits certain homeowners to avoid or defer recognition of COD income in connection with certain types of write-downs of mortgages on principal residences. *See* IRC § 108(h).

[10] IRC § 108(a)(1)(A) (Title 11 cases) & (B) (borrower is insolvent). In the case of a discharge that occurs both while the borrower is bankrupt and insolvent, the exception under Section 108(a)(1)(A) takes precedence and applies in lieu of the insolvency rule under Section 108(a)(1)(B).

[11] *See* IRC § 108(b).

[12] IRC § 108(d)(2).

[13] IRC § 108(a)(1)(B).

[14] IRC § 108(d)(3).

[15] IRC § 108(a)(3).
[16] Rev. Rul. 92-53, 1992-2 C.B. 48 (stating that such "excess nonrecourse debt" should not be treated as a "liability" in determining insolvency of the debtor for these purposes). *Cf.* Lipton, "*IRS Adopts Inconsistent Positions on Nonrecourse Debt in Loan Workouts*," 77 J. Tax'n 196 (Oct. 1992) (criticizing the IRS' position in this regard).
[17] This would include not only entities formed as limited or general partnerships, but also those formed as limited liability companies (in each case, to the extent they have not elected under the "check-the-box" rules to be classified as corporations for tax purposes).
[18] IRC § 108(d)(6).
[19] HR Rep. No. 111, 103d Cong., 1st Sess. 622 (1993).
[20] IRC § 108(a)(1)(D).
[21] IRC § 108(c)(1).
[22] Thus, unsecured debt would not qualify. Also, many types of "mezz" debt (that is sometimes secured by the partnership interests in the partnership, but not by the partnership's real estate) also would not qualify unless secured by the real estate.
[23] IRC § 108(c)(3).
[24] IRC § 108(c)(2)(A).
[25] IRC § 108(c)(2)(B).
[26] *See e.g.*, PLR 9426006 (3/25/94).
[27] H.R. Rep. No. 111, 103rd Cong., 1st Sess., at 622-25 (1993).
[28] *See e.g.*, *Commissioner v. Sherman*, 43-1 USTC ¶ 9367 (6th Cir. 1943) (reduction of purchase money note as a result of settlement of claims for misrepresentation held not to constitute income to the borrower).
[29] *See e.g.*, *Helvering v. A.L. Killian Co.*, 1942-2 USTC ¶ 9487 (8th Cir. 1942).
[30] *See* S. Rep. No. 1035, 95th Cong., 2d Sess. 16-17, reprinted in 1980-2 C.B. 620.
[31] *See e.g.*, *Freedom Newspapers, Inc. v. Commissioner*, 36 T.C.M. 1755 (1977).
[32] *See e.g.*, *Allen v. Courts*, 127 F.2d 127 (5th Cir. 1942); *Hirsch v. Commissioner*, 115 F.2d 656 (7th Cir. 1940).
[33] Rev. Rul. 92-99, 1999-2 C.B. 35.
[34] IRC § 108(e)(10); Treas. Reg. § 1.1001-3.
[35] IRC § 108(e)(10)(A).

[36] IRC §§ 108(e)(10)(B); 1273; 1274.
[37] For this purpose, a debt instrument is generally considered to be "publicly traded" if at any time during the 60-day period ending 30 days after the modification it is (1) listed on a qualifying national securities exchange, a qualifying interdealer quotation system, or a qualifying foreign securities exchange, (2) the debt appears on a system of general circulation that provides a reasonable basis to determine FMV, or (3) price quotations are readily available from dealers, brokers, or traders. *See* Treas. Reg. § 1.1273-2(f).
[38] IRC §§ 1273(b); 1274.
[39] IRC § 1274(a)(1). The AFR is a minimum rate of interest that is published by the IRS on a monthly basis. *See* Rev. Rul. 2009-8, 2009-10 I.R.B. (setting forth AFRs that are applicable to modifications occurring during the month of March, 2009). Special rules different than those described above apply in certain cases involving debt instruments arising in connection with the sale of a farm, sale of a principal residence, or sales for less than $250,000. *See* IRC § 1274(c)(3).
[40] *See* Rev. Rul. 2009-8, *supra* (setting the AFRs for March, 2009 at 0.72 percent per annum for instruments having a term of three years or less, 1.94 percent for instruments having a term which is more than three years and nine years or less, and 3.52 percent for long-term instruments having a term of more than nine years, all assuming annual compounding conventions).
[41] In the event that the modified debt instrument does provide for interest at rates which are *less than* the AFR, then the result would be that a portion of stated principal of the modified debt will not be included in the "issue price" (such portion instead being treated as interest in an amount sufficient to give the modified instrument an overall rate at least equal to the AFR). This would result in an issue price that, to such extent, would then be less than the amounts owing under the existing debt, thus creating COD Income. *See* IRC § 1274(a)(2) & (b).
[42] *See* Treas. Reg. § 1.1275-4(c).
[43] If in fact the $5m has to be repaid by the borrower to the lender, the tax regulations provide for certain adjustments to be made at that time. *See* Treas. Reg. § 1.1274-4(c). These adjustments require the parties to present value the amount of the contingent payment back to the date of the original modification. The tax treatment to the borrower of this PV amount is not entirely certain, though it seems that such amounts should be treated as

"redemption premium" associated with the "redemption" of the original debt at the time of the modification (such amounts generally being deductible). The excess of the contingent payment over the PV amount would generally be treated as additional interest expense to the borrower. *Id*.

[44] See footnote #37, above, for the definition of "publicly traded" in this context.

[45] *See* IRC § 1273(b)(3); Treas. Reg. § 1.1273-2(b)(1).

[46] Importantly, the tax code provides that any COD income that is taxable to a real estate investment trust ("REIT") is ignored for purposes of determining whether the REIT meets the 95 percent and 75 percent "good" income tests for qualification as a REIT. *See* IRC § 108(e)(9); *see also* IRC § 857(e)(2)(D) (COD income recognized by a REIT is treated as "excess noncash income" for purposes of the REIT annual dividend requirements).

[47] *See e.g.,* Rev. Rul. 73-160, 1973-1 C.B. 365; *Western Missouri Power Co. v. Commissioner*, 18 T.C. 105 (1952) (10 year extension of maturity was not a taxable exchange of notes); *Field v. Commissioner*, 41 B.T.A. 183 (1940) (finding taxable exchange of notes upon change of interest rate).

[48] *See Cottage Savings Ass'n. v. Commissioner*, 499 U.S. 554 (1991).

[49] Treas. Reg. 1.1001-3.

[50] Treas. Reg. § 1.1001-3(e)(1).

[51] Treas. Reg. § 1.1001-3(e)(2)(ii).

[52] Treas. Reg. § 1.1001-3(e)(3).

[53] Treas. Reg. § 1.1001-3(e)(4)

[54] Treas. Reg. § 1.1001-3(e)(5).

[55] Treas. Reg. § 1.1001-3(c)(1)(ii).

[56] Prop. Treas. Reg. § 1.108-8 (October 31, 2008).

[57] *See* IRC § 860G(a)(3) and (4) (definition of "qualified mortgages" and "qualified replacement mortgages" including three-month and two-year rules for securitized debt held by real estate mortgage investment conduits ("REMICs"); Treas. Reg. § 1.860G-2(b) (certain "significant modifications" of REMIC obligations treated as newly issued obligations, resulting in non-qualified asset status and "prohibited transactions," also containing permitted exceptions to the foregoing, including modifications occasioned by default or reasonably foreseeable default and certain assumptions of obligations in a sale transaction). *See also,* Prop. Treas. Reg. § 1.860G-2(b)(3) (which, if enacted in their current form, would liberalize the ability to modify mortgages held by a REMIC). *See also,* Rev. Proc. 2008-28, 2008-

23 IRB 1 (if a modification relates to certain residential mortgage loans, the IRS will not challenge a securitization vehicle's qualification as a REMIC or argue that the modification is a prohibited transaction).

[58] *See e.g.*, *Frazier v. Commissioner*, 111 T.C. 243 (1998); *Gehl v. Commissioner*, 102 T.C. 784 (1994), *aff'd without published opinion*, 50 F.3d 12 (8th Cir. 1995); *Estate of Delman v. Commissioner*, 73 T.C. 15 (1979).

[59] *See Aizawa v. Commissioner*, 99 T.C. 197 (1992); *see also* Treas. Reg. § 1.1001-2(c), Ex. 8.

[60] *Id*.

[61] IRC § 1211(a) & (b) (corporate taxpayers only permitted to deduct capital losses against capital gains, and individual taxpayers only permitted to deduct up to $3,000 of capital losses in any taxable year against ordinary income, with excess only being deductible against capital gains).

[62] *See e.g.*, Sheppard, "Walk Away: Forgiveness of Nonrecourse Debt and Other Problems," 92 *Tax Notes Today* 34-5 (February 14, 1992).

[63] *See e.g.*, Sowell, "Debt Workouts: The Partnership and the Partners," 848 PLI *Tax Strategies for Corporate Acquisitions, Dispositions, Spin-Offs, Joint Ventures, Financings, Reorganizations, & Restructurings* 195 (Oct – Dec. 2008).

[64] CapLease (NYSE: LSE), Inland Real Estate Corp. (NYSE: IRC), and Gramercy Capital (NYSE: GKK) are just a few examples of REITs that have recently announced debt repurchase programs.

[65] *See* IRC § 61(a)(12).

[66] *See e.g.*, Rev. Rul. 91-31, *supra*; *Gershkowitz*, *supra; cf. Fulton Gold*, *supra*.

[67] *See e.g., Milenbach*, *supra.*

[68] IRC § 108(i).

[69] IRC § 108(i)(3).

[70] IRC § 108(i)(4).

[71] IRC § 108(i)(5)(D)(ii).

[72] It should be noted that the new law contains additional rules that accelerate the deferred tax on this COD income in cases of death, insolvency or similar events with respect to the taxpayer, as well as redemptions of partnership interests in the case of partners holding interests in partnerships making the election under Section 108(i). *See* IRC § 108(i)(5)(D).

[73] Importantly, on this point, the new provision also provides that if the

taxpayer elects to defer the recognition of COD income under Section 108(i) with respect to any particular debt instrument, then the other exclusions (such as the Title 11, insolvency, purchase price reduction, qualified real estate business debt, etc.) do not apply with respect to that debt instrument for the year of the election or any other subsequent year. *See* IRC § 108(i)(5)(C).

[74] *See e.g.*, *Peter Pan Seafoods, Inc. v. United States*, 417 F.2d 670 (9th Cir. 1969); *Forrester v. Commissioner*, 4 T.C. 907 (1945).

[75] IRC § 108(e)(4).

[76] IRC § 707(b)(1)(B). The term "partnership" also includes LLCs, which are taxed as partnerships.

[77] IRC § 267(b).

[78] *See* IRC § 267(c).

[79] *See* Treas. Reg. § 1.1001-3.

[80] *See* Treas. Reg. §§ 1.1001-1(g)(1) and -3(a).

[81] IRC § 1001(a).

[82] *See* Treas. Reg. §§ 1.1001-1(g)(1).

[83] IRC § 1274.

[84] *See* IRC § 453. An important limitation here is that the investor would not be eligible to utilize this deferral method if the investor is considered to be a "dealer" in these types of debt instruments. *See* IRC § 453(b)(2).

[85] IRC § 453A.

[86] Notice 88-81, 1988-2 C.B. 387.

[87] IRC §§ 354; 368(a)(1)(E).

[88] This was true at least in those cases where Section 1271 of the tax code (or its predecessor provision) applied. The predecessor to Section 1271 of the Code was originally codified as Section 117(f) of the Revenue Act of 1934, and originally provided that the retirement of an obligation issued by a corporation or government with interest coupons or in registered form was to be treated as a "sales or exchange" and, therefore, was eligible for capital gains treatment. The requirement that the corporate or government obligation have interest coupons or be in registered form was removed in 1954. This provision was modified again as part of DEFRA in 1984 when it was moved to Section 1271. DEFRA also expanded the scope of Section 1271 by amending it to provided that gain on retirement of all debt instruments except those issued by "natural persons" were to be eligible for capital gains treatment. Finally, in 1997, the exception for "natural persons"

was removed.

[89] *See e.g., Potter v. Commissioner*, 44 T.C. 872 (1965); *Darby Investment Corp. v. Commissioner*, 37 T.C. 839 (1962); *Vancoh Realty Co v. Commissioner*, 33 B.T.A. 918 (1936).

[90] *See, e.g., Lifton v. Commissioner*, 36 T.C. 909 (1961), *aff'd*, 317 F.2d 234 (4th Cir. 1963); *Underhill v. Commissioner*, 45 T.C. 489 (1966).

[91] *Lifton*, *supra*; *Underhill*, *supra*.

[92] IRC § 1276(a)(1).

[93] IRC § 1278(a)(1) & (2).

[94] *See* I.R.C. § 1276(b).

[95] Alternatively, if instead of selling the note for $10 million, the Fund were to collect $5 million in principal payments from the borrower in partial repayment of the note, the market discount rules require such $5 million payment to be treated as taxable ordinary income to the extent of the $2.5 million accrued market discount as of such time. *See* IRC § 1276(a)(3). Thus, the market discount rules tax these ordinary income amounts on a very accelerated ("first dollar") basis.

[96] *See* I.R.C. § 1276(b)(1). The Code provides that in lieu of this "ratable" method of calculating the amount of "accrued" market discount on a bond, a taxpayer may elect an alternative method based on a "constant interest rate" method. *See* I.R.C. § 1276(b)(2). In addition, the taxpayer is permitted to elect to include the market discount in income as it accrues, as opposed to when such discount is actually recognized upon disposition. *See* I.R.C. § 1278(b). It is assumed that no such elections have been filed with respect to the bonds.

[97] *See e.g*, *Mutual of Omaha Insurance Co. v. U.S.,* 317 F. Supp. 2d (D.C. Neb. 2004) (indicating that for these purposes the term "maturity" means not only the stated maturity, but also any prior date in the event of an accelerated maturity date of the note).

[98] The fact that the literal application of the statute in the case of past-due bonds creates an uncertainty or ambiguity would provide a court of law justification for looking beyond the face of the statute to the legislative history in order to interpret these statutory provisions. *See Toibb v. Radloff*, 501 U.S. 157, 162 (1991) (holding that if the language of a statute is ambiguous, it is appropriate to look to a statute's legislative history).

[99] *See* H. Rep. No. 98-861, 98th Cong., 2d Sess., at 806 (1984). The fact that the legislative history states that the future regulations will "clarify" that

this is the case is an indicator that such regulations are not required in order to implement such an exemption. In other words, demand debt is already exempt from the market discount rules and Congress has indicated its desire that the IRS "clarify" this with future regulations.

[100] *See* Staff of Joint Comm. on Tax'n, 98th Cong., 2d Sess., General Explanation of the Deficit Reduction Act of 1984, at 95 (1984). *See also* Keyes, *Federal Tax'n of Financial Instruments & Transactions*, at ¶ 8.02, which states, "The rationale for this exclusion is that under the market discount rules, market discount is amortized over a fixed period ending on the maturity date. Since a demand obligation has no maturity date, there is no fixed period of time over which market discount can be amortized, and the rules thus cannot be applied effectively."

[101] *See also,* Garlock, *Federal Income Taxation of Debt Instruments*, Ch. 11 (5th Edit.) (Aspen Publishers, 2007 Supp.) (making a similar argument); Levin, *The Purchase of a Mortgage Loan at a Discount (and the New Proposed Regulations)*, J. Real Est. Tax'n 376 (Summer, 1993) (also making a similar argument). *See also, Joint Committee on Taxation's Description of the President's FY 2000 Revenue Proposals* (JCS-1-99, February 22, 1999) (which also indicates that "deeply" discounted obligations perhaps were not intended by Congress to be covered by the market discount rules).

[102] Under current law, long-term capital gains for individual taxpayers are generally taxed at maximum federal rates of 15%, as compared to 35% applicable to short-term capital gains and ordinary income. IRC § 1.

[103] *See generally,* Treas. Reg. § 1.446-2.

[104] *See e.g.*, *Jones Lumber Co. v. Commissioner*, 404 F.2d 764 (6th Cir. 1968); *Corn Exchange Bank v. United States*, 37 F.2d 34 (2d Cir. 1930).

[105] IRC §§ 1272-1276.

[106] T.A.M. 9538007 (9/22/95).

[107] *See e.g.*, IRC § 1271; Treas. Reg. § 1.166-6; *Bingham v. Commissioner*, 105 F.2d 971 (2d Cir. 1939); *Commissioner v. Spreckels*, 120 F.2d 517 (9th Cir. 1941); Rev. Rul. 74-621, 1974-2 C.B. 405; Rev. Rul. 68-523, 1968-2 C.B. 82.