

Alert I – January 27, 2009

## Tax Planning in a Foreclosure

With the country officially in a recession and the lack of available refinancing options continuing, more and more businesses are faced with the realities of foreclosure. While foreclosure often allows a business to wipe the debt slate clean with respect to the foreclosed property, it can also create unintended tax consequences as well as tax planning opportunities.

### Recourse v. Non-Recourse Debt

A foreclosure sale to a third party, or a grant of a deed in lieu of foreclosure that extinguishes the debt, is treated as a taxable sale or exchange. The tax consequences, however, depend on whether the mortgagor is personally liable for the underlying indebtedness.

For a corporation or an individual, it is relatively simple to distinguish between recourse and non-recourse debt. If the corporation or individual is personally liable on the debt, it is recourse debt. If only the property secures the debt, it is non-recourse debt. For a partnership or limited liability company taxed as a partnership, however, the recourse nature of the debt is determined at the partner level. For example, regardless of whether the partnership is personally liable on the loan, if the individual partners are limited partners (which, for these purposes, include all members of an LLC) and there is no economic risk of loss to them personally, the loan is considered non-recourse debt. If, however, a partner is a general partner, or if a limited partner or LLC member guarantees indebtedness (whether or not the loan is characterized as recourse or non-recourse debt to the partnership), the loan is considered recourse debt to that partner or LLC member.

### Recourse Debt

A foreclosure sale or conveyance of a deed in lieu of foreclosure by a mortgagor who is personally liable creates the possibility of both capital gain or loss as well as discharge of indebtedness ("DOI") income. In a foreclosure of property securing a recourse debt, the fair market value ("FMV") of the property determines the amount realized. Absent evidence indicating otherwise, the foreclosure sale price is presumed to be the FMV of the property. To the extent the FMV is greater than the debtor's adjusted basis in the property, the gain recognized is treated as a capital gain. Similarly, to the extent the property's FMV is less than the debtor's adjusted basis in the property, the loss recognized is treated as a capital loss.

The debtor may also recognize discharge of indebtedness income to the extent the outstanding debt discharged exceeds the FMV of the property. Generally, DOI income is treated as ordinary income. The taxpayer, however, may be able to make a qualified real property indebtedness election and reduce its basis in depreciable property, thus postponing the income recognition event. Further, a recourse debtor may deduct as an ordinary and necessary business expense any unpaid interest and real property taxes to the extent the foreclosure sale proceeds are used to discharge these payments. The value of this deduction, however, may be reduced if the debtor has insufficient ordinary income. In that case, the debtor must use the deduction to offset capital gains income rather than ordinary income.

### Non-Recourse Debt

A foreclosure sale or conveyance by a deed in lieu of foreclosure of property that secures a non-recourse debt creates the possibility of capital gain or loss. Absent evidence indicating otherwise, the foreclosure sale price is presumed to be the FMV of the property. FMV, however, is irrelevant in determining the amount realized where the indebtedness is non-recourse debt. Rather, the outstanding principal debt obligation determines the amount realized upon discharge of a non-recourse debt. The FMV, however, does determine whether a cash-basis taxpayer may deduct accrued interest and unpaid taxes as an ordinary and necessary business expense. For example, accrued interest can be deducted to the extent that FMV exceeds the outstanding principal balance of the indebtedness. Generally, a mortgagee will not bid more than the outstanding loan obligation. Therefore, if the taxpayer believes that the FMV exceeds its outstanding obligation, it may consider obtaining an independent appraisal to justify the FMV. The taxpayer may deduct accrued interest and unpaid property taxes to the extent the appraised FMV exceeds the outstanding principal obligation, regardless of the foreclosure sale price.

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## Conclusion

Each foreclosure is unique, and the possibility for creative tax planning to lessen the financial impact should be considered. Prior to a taxpayer's entering into a foreclosure arrangement, therefore, it is important for the taxpayer to consult with a tax professional to ensure that it has achieved the most beneficial tax treatment available, given the circumstances.

## Recourse Loan with Full Discharge

	Outstanding Principal Obligation	Accrued Interest/Taxes	Fair Market Value <sup>1</sup>	Adjusted Basis	Amount Realized <sup>2</sup>	Capital Gain/(Loss)	Discharge of Indebtedness Income <sup>3</sup>	Deductibility of Accrued Interest/Taxes <sup>4</sup>
<b>Example #1</b> Capital Gain & DOI Income Recognized	\$12,000	\$100	\$10,000	\$7,000	\$10,000	\$3,000	\$2,000	\$100
<b>Example #2</b> Capital Gain but no DOI Income Recognized	\$10,000	\$100	\$12,000	\$8,000	\$12,000	\$4,000	\$0	\$100
<b>Example #3</b> Capital Loss and DOI Income Recognized	\$7,000	\$100	\$6,000	\$10,000	\$6,000	(\$4,000)	\$1,000	\$100
<b>Example #4</b> Capital Loss but no DOI Income Recognized	\$7,000	\$100	\$8,000	\$10,000	\$8,000	(\$2,000)	\$0	\$100

<sup>1</sup>Assuming the foreclosure sale price is the FMV of the property.

<sup>2</sup>In each case, the amount realized equals the FMV of the property.

<sup>3</sup>DOI income equals the outstanding principal amount in excess of the amount realized.

<sup>4</sup>Assuming that a portion of the foreclosure sales proceeds were used to pay accrued interest and taxes.

## Non-Recourse Loan with Full Discharge for Cash Basis Taxpayer

	Outstanding Principal Debt	Accrued Interest	Fair Market Value <sup>5</sup>	Adjusted Basis	Amount Realized <sup>6</sup>	Capital Gain/(Loss)	Discharge of Indebtedness Income	Deductibility of Accrued Interest
<b>Example #1</b> No Accrued Interest Deducted	\$12,000	\$100	\$12,000	\$10,000	\$12,000	\$2,000	\$0	\$0
<b>Example #2</b> All Accrued Interest Deducted	\$10,000	\$100	\$11,000	\$5,000	\$10,000	\$5,000	\$0	\$100
<b>Example #3</b> Part of Accrued Interest Deducted	\$10,000	\$100	\$10,050	\$5,000	\$10,000	\$5,000	\$0	\$50

<sup>5</sup>Assuming the foreclosure sale price is the FMV of the property.

<sup>6</sup>In each case, the amount realized equals the outstanding principal amount of the indebtedness.