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Making the best of challenging situations

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Top of mind in the real estate industry: The current economic situation. With credit markets still frozen, many property owners are faced with mortgages coming due, underperforming properties, or both! To compound the issue, the ability to refinance or sell the property is daunting. While the outlook may appear to be grim, it is not hopeless. There are options, and with proper business and tax planning, a positive outcome can be a reality.

If your property is facing one of the issues above, there are options. These options include renegotiating the loan with your current lender, finding a joint venture partner, or even allowing the bank to foreclose on the property.

Renegotiate Loans

Your current lender may be willing to renegotiating the terms of your loan. More than ever, banks are willing to renegotiate loans to allow properties to stabilize during these tough economic times.

If you choose to renegotiate your loan, consider that the bank most likely will require a guarantee from a key owner or group of owners. Additionally, the bank may have requirements resulting in higher professional fees, including bank, legal and accountant fees.

The biggest tax issue is cancellation of debt (COD) income. COD income most commonly occurs when the principal balance of the loan is reduced. COD income is a two-fold issue. First, the income is taxed at ordinary income rates rather than capital gain rates. Second, there is no cash to cover the tax liability generated by the COD income. Luckily, there are ways to lessen the tax impact by spreading the income recognition over a number of years.

Other tax issues to watch for are material modification of the debt and original issue discounts issues. These are complex tax areas that have many hidden pitfalls that can easily be avoided by involving your tax adviser in the early stages of the renegotiation process.

Find a Joint Venture Partner

Another option to breathe life into a troubled property is to find a joint venture partner to infuse capital.

The most important piece of business advice, when working with a joint venture partner, is to do your homework. Don't let funding blind you to the details of the deal. It is imperative to completely understand the economics of the deal and its effects. Joint venture partners are looking for more protection and greater upside by trying to structure the deals more similar to loans. A joint venture partner that is looking for a 15% priority return on contributed capital plus the return of their capital first is offering no more than a 15% nonrecourse mortgage. Would you accept these terms from a bank?

Other business issues that need to be considered include a solid understanding of who has control of the property and if both parties have a synergistic outlook on the life span of the property.

There many tax aspects that must be addressed when adding a joint venture partner, but with careful tax planning, you can minimize the tax effects of restructuring.

All issues must be addressed while negotiating the joint venture agreement, including income allocations, IRC 704(c) depreciation allocation methods, lock up periods on the sale of the property, and pay down of the debt.

Joint venture agreements should be thoroughly drafted and reviewed by both a lawyer and tax professional.

Allow the Bank to Foreclose

In many situations, foreclosure is a last resort scenario with troubled real estate ventures, and it is becoming increasingly more difficult to accomplish in these troubled times. Banks do not want troubled properties on their books.

When deciding to allow the bank to foreclose, consider the effect of any guarantees and the relationships with investors and the bank. Remember, if there are guarantees on the debt, the guarantor will need to come up with the cash. A foreclosure can also put a big strain on investor relationships. Foreclosure will result in the recognition of gain to the investors with no cash to pay the corresponding tax. An investor may be able to live with losing the capital they invested but having to then pay additional tax could irreversibly damage the relationship.

When a property is foreclosed on, it is generally treated for tax purposes as a sale of property for the debt as long as the debt is nonrecourse. The gain from foreclosure is a capital gain, but is subject to certain depreciation recapture rules that can result in a higher tax rate. Unlike the deferral periods allowed for COD income, there is no such deferral mechanism available for foreclosures.

Now, more than ever, it is important to remember that there are options even in the toughest of situations. Owners of troubled or underperforming properties can make the best of these challenging situations with proper business and tax planning.

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