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Tax cost to modification of nonrecourse debt

March 10, 2011 - Front Section

As the economy, and especially the real estate industry, continues to struggle, with conflicting opinions as to the timing of any significant turnaround, debt restructuring has become a niche industry for attorneys and bankers alike. Recent articles herein have provided a general overview of some of the intricate rules relating to the tax implications of restructuring debt obligations. This article highlights the somewhat surprising tax treatment of modifications to nonrecourse obligations. One very technical and interesting nuance to the tax consequences of debt modifications relates to the treatment of modifications of nonrecourse debt, that is, debt with respect to which the lender has recourse only against the secured property, the collateral, and not against any other assets of the borrower. Nonrecourse indebtedness is most popular with regard to loans relating to real estate acquisitions and developments.

Although a lender can only look to the mortgaged property, as opposed to the borrower's general assets, the Internal Revenue Service's position is that a reduction in the outstanding principal results in the realization of discharge of indebtedness income by the borrower. In other words, despite the fact that the borrower never had any economic accountability, the borrower realizes income upon discharge. The Service's position has been upheld in several court decisions.

Although a borrower may be surprised to realize income relating to modifications of nonrecourse debt, there are certain mitigating Tax Code provisions which may be available to the borrower, particularly with respect to the real estate industry. First, insolvent taxpayers may exclude discharge income in exchange for a reduction in various tax attributes, including net operating and passive losses and basis in the real property. Second, solvent real estate entities may exclude discharge income in exchange for basis reduction if the debt was incurred to acquire the real property.

Of course, these and other exceptions to the general realization rule are complex and should be carefully reviewed by any taxpayer renegotiating debt obligations.

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New England Real Estate Journal - 17 Accord Park Drive #207, Norwell MA 02061 - (781) 878-4540