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Persons seeking debt relief must comprehend tax consequences

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As the current economic downturn continues, commercial real estate investments certainly are not immune to failure. Commercial real estate investors may find that, due to vacancies, declining rents or otherwise, real estate is not only not producing positive cash flow, but cannot satisfy mortgage obligations on a current basis. Investors that turn to mortgage holders seeking relief must be wary of the tax consequences of any restructuring, as consequences can vary depending on the negotiated settlement terms as well as the type of entity holding title to the property.

One possibility is the discharge of a portion of the indebtedness encumbering a property. The discharge of such indebtedness generally constitutes taxable income to a taxpayer, but there are a myriad of exceptions and intricacies. One such exception relates to the insolvent taxpayer. The so-called insolvency exception provides that, subject to certain constraints, an insolvent taxpayer will not recognize current income upon discharge (alternatively, basis reduction applies). These days, it is quite common for commercial real estate to be held by a limited liability company, which, if it has more than one member, is generally treated as a partnership for income tax purposes. The oddity here is that the Internal Revenue Code provides that the exclusion for discharge of indebtedness income is applied at the partner level, as opposed to the partnership level. In other words, although the discharge income is partnership income, the exclusion provided by the Internal Revenue Code varies from partner to partner. As a result, the discharge of indebtedness could have quite different consequences from one partner to the next. If a partner is insolvent, his share of the discharge income will not be recognized, however, if a partner is not insolvent, the exclusion from income will not apply whether or not the partnership itself is insolvent or bankrupt.

Persons charged with negotiating debt relief with lenders must be certain to fully comprehend the many technical tax consequences of any debt restructuring.

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