

**CANCELLATION OF DEBT
INCOME AND OTHER STRATEGIC
CONSIDERATIONS RELATED TO
BANKRUPTCY AND WORKOUT OF
TROUBLED LOANS**

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This Presentation is Meant to be an Overview of Issues to Consider in the Workout of Troubled Real Estate Loans and not a Dissertation on Tax Law

Judge Learned Hand once noted:

In my own case the words of such an act as the Income Tax, for example, merely dance before my eyes in a meaningless procession: cross-reference to cross-reference, exception upon exception--couched in abstract terms that offer no handle to seize hold of--leave in my mind only a confused sense of some vitally important, but successfully concealed purport, which it is my duty to extract, but which is within my power, if at all, only after the most inordinate expenditure of time.³

Ann M. Tabor, Gitlitz v. Commissioner: Windfall for Shareholders of an Insolvent S Corporation, 46 S.D.L. Rev. 648 (2001) (Footnote: Learned Hand, *The Spirit of Liberty: Papers and Addresses of Learned Hand* 213 (Irving Dillard ed., 2d ed., 1953))

INITIAL FACTORS TO CONSIDER

Tax Payer

- Individual or married couple (age, etc.)
- C-Corporation
- S-Corporation
- Partnership
- LLC

Property

- Nature of the property (residence or commercial)
- Principal residence
- Rental Property
- Age
- Tax attributes
- Mortgage Debt
- Current fair market value

TAXES THAT NEED TO BE CONSIDERED

- Ordinary income or loss
- Capital gain or loss
- Cancellation of debt income (also ordinary income)

NATURE OF THE DEBT

- Is the taxpayer the borrower or a guarantor?
- How many lenders are involved?
- Who are the lenders?
 - Initial bank, government body, such as the SBA or Fannie or Freddie, successor to failed bank

MAKE UP OF TAX PAYER

- Sophistication and expertise
- Publicly held company
- Unity of the ownership group
- With regard to individual tax payers, sophistication, emotional well being and strength of the relationship

CAUSE OF DEFAULT

- Loan matured
- Market downturn which causes default of loan covenants
- Major life event (death, loss of job, divorce, dissolution of company, etc.)
- Possibility or probability that current situation can be fixed

METHODS OF PAYING OFF LOAN

- Refinance
- Fair market sale or sale as going concern
- Auction sale
- Deed in lieu of foreclosure
- Contested foreclosure
- Consent foreclosure

CANCELLATION OF DEBT TAX FACTORS TO CONSIDER

FACT PATTERN NUMBER 1

- Mortgage Default
- Principal residence
- Tax Payer is young married couple (35 – 40)
- Purchase price \$450,000.00
- Current fair market value \$300,000.00
- Mortgage debt \$400,000.00 – balloon payment on loan comes due on maturity.
- Cause of default – balloon payment on loan comes due on maturity

FACT PATTERN NUMBER 2

- Mortgage default
- Tax payer is husband and wife that own a rental property
- Fair market value \$500,000.00
- Purchased in 1995 – tax basis on the property \$250,000.00
- Current debt \$750,000.00. Market conditions change, so the current rental climate changes, so that is a result of vacancy and available
- Both parties are makers of the loan

FACT PATTERN NUMBER 3

- Husband and wife own a residence in Lake Forest
- Current fair market value \$1,250,000.00
- Debt \$1,750,000.00. First mortgage \$1,500,000.00, second mortgage \$250,000.00.
- Tax basis on the property \$500,000.00
- IRA and exempt assets of \$750,000.00

FACT PATTERN NUMBER 4

- Tax payer is a Partnership or Limited Liability Company entity that owns an office building
- Fair market value \$5,500,000.00
- Debt on the property \$7,500,000.00
- Tax basis on the property is about \$5,000,000.00
- Change ownership to S-Corporations

Bill & Ted Partnership (BTP)

- \$3,000,000 building purchased by BTP, funded entirely by Big Bank, recourse funding, interest only
 - Building depreciated by \$1,200,000 and basis to BTP is \$1,800,000
 - FMV building now \$1,000,000, loan balance \$3,000,000
- A. If BTP pays Big Bank \$1,000,000 to satisfy loan, the \$2,000,000 COD income to BTP

Bill & Ted Partnership (BTP)

B. If Big Bank forecloses on building, bifurcate:

- Consider sold for portion of recourse debt being equal to property's FMV:
- FMV - \$1,000,000
- Basis - \$1,800,000
- \$(800,000) Section 1231 loss
- Difference between loan balance and sale price (FMV) = COD income of \$2,000,000

C. If Big Bank forecloses on building, and loan was non-recourse:

- \$3,000,000 amount realized from relief of debt
- (1,800,000) property's basis
- \$1,200,000 Section 1231 gain