

REAL ESTATE ADVISOR
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CANCELLATION OF INDEBTEDNESS- NOT QUITE A “GIFT”

As the fallout from the financial tremors of 2008 continues, many leveraged real estate owners are engaging in transactions involving the cancellation of debt (COD). Although COD can be complicated enough with only the borrower and lender involved, Uncle Sam's demands for a take can make things even more taxing.

Basic COD rules

From a tax perspective, cancellation or forgiveness of debt isn't quite as much of a “gift” as it might first appear because it generally results in ordinary taxable income to the debtor. COD transactions can result from foreclosures, cash settlements, loan workouts, related-party acquisitions of debt or debt-for-equity swaps.

Let's look at an example: An investor owns an office building that cost \$10 million. The building, which is subject to \$8 million of recourse debt, has a current fair market value of \$6 million. If the lender agrees to a loan payoff of \$6 million instead of \$8 million, the debtor will have \$2 million of ordinary taxable income (in the absence of exceptions).

For partnerships, the \$2 million of COD income would be recognized and passed through to partners as taxable income.

Foreclosure or deed-in-lieu

A foreclosure or deed-in-lieu of foreclosure, where the borrower conveys all interest in a property to the lender to satisfy the loan, is treated for tax purposes as a sale of property to the lender.

If the debt involved is *nonrecourse* debt, the gain or loss on the sale will be the difference between the amount of debt and the seller's tax basis in the property. Such sales aren't considered COD and don't qualify for certain exclusions from taxation.

If the debt is *recourse* debt, the sales price for tax purposes is deemed to be the lower of the fair market value (FMV) of the property or the outstanding secured debt balance and the gain or loss will be equal to this sales price less the debtor's basis in the property. The debtor will have COD income to the extent that the outstanding debt balance exceeds the FMV of the property.

Debt modification

Significant modification to a debt instrument also may result in COD income to the debtor. For tax purposes, a significant modification occurs if the rights and obligations of the debt instrument have been altered in material ways.

Events that automatically trigger this rule include a material change in yield (more than the greater of 25 basis points or 5% of annual yield), material deferral of payments or principal reduction, which is treated as a reduction of yield for this purpose. Changing from recourse to nonrecourse debt, a change in debtors (generally only for recourse debt), or alterations in collateral or payment expectation also could trigger this rule.

Deterioration in the financial condition of the debtor doesn't qualify as a modification, nor does adding or modifying financial covenants or changes resulting from the exercise of unilateral options in debt agreements.

Related-party acquisition of debt

If a related party acquires debt from an unrelated party (that is, the debt purchaser is related to the debtor) at a discount, the debtor will generally have COD income. In such a transaction, the debtor is deemed to reissue the debt with an issue price equal to the purchase price paid by the related party. The difference between the new issue price and the face amount of the debt will be the original issue discount, which must be amortized as income to the investor and expense to the debtor.

Partnership debt for equity swaps

The exchange of debt on a property for corporate stock will result in COD income if the FMV of the stock is less than the amount of the debt. This result can be avoided if the lender cancels the debt in exchange for an equal amount of capital in the corporation and has sufficient basis in the debt.

The exchange of debt for an interest in a partnership also will result in COD. In this case, COD income is equal to the difference between the debt and the FMV of the partnership interest. Even if a substantial amount of debt remains in place, the admission of a creditor into the partnership may convert debt to "partner nonrecourse debt." Such debt will be allocated to the creditor/partner, resulting in a deemed distribution to the other partners.

There is a light at the end of the tunnel- Exceptions to COD income recognition

A few of the exceptions to the immediate recognition of COD income by real estate investors and other debtors include:

- Bankruptcy- COD realized in bankruptcy is excluded from income.
- Insolvency- COD realized by an insolvent debtor is excluded to the extent of insolvency. Keep in mind that you have to reduce tax attributes, including NOL's, as the quid pro quo for the exclusion due to bankruptcy or insolvency.
- Qualified real property business indebtedness (QRPBI)- For QRPBI incurred in connection with trade or business real estate, the debtor can elect to reduce the basis of depreciable real property instead of recognizing COD. This will reduce future depreciation deductions and the reduction will be recaptured as ordinary income under Sections 1245 and 1250 of the Internal Revenue Code. This exclusion applies only to the extent that the QRPBI does not exceed the excess of the outstanding principal of such debt over the fair market value of the property, reduced by any other QRPBI secured by the property. If there is insufficient depreciable basis in the property subject to COD, the debtor can use other depreciable real property owned directly or through partnerships. This exclusion does not apply to C corporations or to the extent that the taxpayer is insolvent or bankrupt.
- American Recovery and Reinvestment Act of 2009 (ARRA) Section 108(i)- COD realized in 2009 and 2010 may be deferred until 2014, at which time COD is recognized at the rate of 20% per annum for five years. In making this election, keep in mind that many states do not follow the federal rule for deferring COD income, including New Jersey, Connecticut, Massachusetts and Rhode Island and more states are expected to join the bandwagon.

The applicability of any exceptions to COD income recognition are determined at the partner level for partnerships and the corporate level for S corporations.

Work with a pro

Due to the technical nature of debt cancellation, there may be other rules and exceptions not addressed here. To help ensure that your next investment doesn't result in unexpected tax liability or land you in hot water with the IRS, please consult your financial advisor.

BEYOND THE NOI-BASED APPRAISAL

Sophisticated valuation methods can lead to smarter investments

One of the simplest and most common methods of establishing real estate value involves taking one year's net operating income (NOI) and dividing it by an appropriate capitalization rate to determine the

sales price or property value. But questions regarding the accuracy of NOI numbers can make this a less than reliable method of valuation.

Buyer beware

Unfortunately for unwitting buyers, the NOI that sellers provide isn't always reliable. Sellers often price their property based on 12 months of NOI. However, NOI may be skewed if sellers are operating properties in a "soon-to-be-sold" mode in the year before the sale.

For example, sellers may artificially inflate property income by billing in advance, billing based on inflated estimates and collecting lump sum payments. Classifying operating expenses as capital items and deferring needed maintenance is another favorite ploy. The end goal of such maneuvers is an artificially inflated NOI and an overvalued property.

Smart investors can uncover inflated values by not relying on numbers that can't be independently verified. A zero-based budget with numbers developed by the investor is a helpful tool. Additionally, it's wise to analyze values generated by more sophisticated valuation techniques, such as:

Net present value (NPV). While NOI-based appraisal methods capitalize a single year of earnings, the net present value (NPV) method of valuation looks at long-term cash flow projections. The NPV method is often used for rehab projects or properties under construction because it provides for annual cash flow fluctuations until the investment generates a more predictable income stream. At the end of the projection period — typically three to seven years — a terminal (or residual) value is calculated by capitalizing the expected cash flows in the final projection period.

The NPV method takes annual projected cash flows for a proposed investment property and then determines each year's present value by applying a discount rate. The discount rate used generally takes into account the opportunity cost, or the rate of return the investor can earn on another investment that's comparable in size, risk and duration. NPV of the expected cash flows equals the sum of the present values, including the present value of the terminal value. Thus, if the NPV at the investor's required discount rate were \$10 million, the investor would consider purchasing the property for \$10 million.

Knowledge is power

Successful investors understand that, if they don't do the homework necessary to determine the best price, they'll almost always overpay. As an investor, your goal is to be aware of the maximum price you can pay and still receive a rate of return commensurate with the associated risks.

It's up to you, the investor, to establish the most accurate value for the property you're considering. Using the sophisticated analytical tools described above and understanding the numbers generated are two of the most important steps you can take in this direction.

HELP ENSURE A SUCCESSFUL FUTURE FOR YOUR FIRM WITH A SUCCESSION PLAN

All too often business owners get so bogged down in the daily grind of running their business that planning for succession takes a back seat. Putting off planning for the inevitable can place your real estate at risk and significantly affect your financial future. One of the best things you can do now to help ensure a successful future for your company and your retirement is to develop a succession plan.

A well-thought-out succession plan will help you effectively transfer ownership and cash out, while at the same time structuring the succession to minimize the tax consequences. Let's review some of the decisions you'll need to make and the criteria to consider when setting up your succession plan.

Keeping it in the family

You'll first need to ask whether you plan to transfer the business to a family member or someone else inside the company, or sell it to an outsider. If your children are involved in the business or there's another logical successor — someone who could fill the seat behind your desk — you should start

grooming that person as early as possible. Depending on the amount of support and knowledge your prospective replacement needs, this may take several years.

Because business succession and estate planning are inextricably linked, make sure you consult legal and financial advisors to help you create the transfer plan and fund your retirement.

Setting the price

If none of your family members are qualified or want to assume the mantle, consider:

- Selling the firm to your employees through an employee stock ownership plan (ESOP),
- Setting up a management buyout, or
- Selling to an outside buyer.

Each of these options has its pros and cons. The first two options save you the time and expense involved in finding an outside buyer. On the other hand, if you can find the *right* outside buyer, you may be able to sell your business at a premium.

Next, determine the market value of your business. This may require the expertise of a professional who specializes in business valuations. Your valuation expert will assess your business' tangible and intangible assets and future revenue potential. Valuation professionals can help you decide whether it makes sense to sell your business intact or sell individual assets.

Off to market

When you're ready to put your business on the market, develop a list of possible buyers, such as your competitors and business associates. Once you've identified the target buyer, formulate a plan for marketing your business to these groups.

You can personally approach potential buyers with whom you have an established relationship — for example, partners, business associates and employees — but you probably should enlist the assistance of specialists such as business brokers and investment bankers to act as a go-between with other types of buyers. These advisors can guide you through the often lengthy and complicated sale process.

Consider the tax costs

Once you've chosen a successor, discuss how to structure the transaction in the most effective manner so that cash flow is maximized and you could sit back in comfort and enjoy the fruits of your labor. Make sure you meet with your CPA to discuss the tax consequences of the transfer or sale, which can have a major impact on the after tax cash flows available to you as you set sail into the sunset.

SPOTLIGHT ON MP&S

Thought Leadership

Revenue Recovery

MP&S Partner Susan H. Nadler, CPA, has authored an article in *Commercial Investment Real Estate* that provides property owners with guidance about uncovering hidden revenue opportunities and ensuring that property portfolios are yielding maximum returns in this difficult economy.

Anti-Money Laundering Measures and Tax Fraud

Instances of money laundering and tax fraud seem to rise during a downturn. This economic downturn is no exception and has led to a surge in white collar crime. However, pinning the rise to a single factor is difficult to justify, and unlikely to be correct – ultimately, there are a myriad of drivers. MP&S Director David Gannaway, MBA, CFE, CAMS, EA, provides his perspective in an article in *Financier Worldwide*.

2010 Federal Estate Tax Repeal and Haiti Relief Update

In the firm's latest Tax Alert, MP&S outlines rules of the 2010 Federal Estate and Generation-Skipping Transfer (GST) taxes repeal and what it means for estate planning. In addition, the firm discusses

President Obama's new measure that provides accelerated tax benefit for taxpayers making charitable cash contributions to the Haiti earthquake relief efforts.

People in the News

Valuation Specialist and Former MIT Professor Joins the Firm

Donald M. May, Ph.D., CPA, has joined the firm's Litigation and Corporate Financial Advisory Services Group. Dr. May brings global consulting and accounting experience in valuation, lost profits, opposing expert reports and deposition and trial preparation. He is also a former Assistant Professor of economics and accounting in the Sloan School of Management at the Massachusetts Institute of Technology.

MP&S Partner Elected to Transnational Auditors Committee

On January 1, William M. Stocker III, CPA, the Partner-in-Charge of the firm's Professional Practices Group, began serving a two-year term as a member of the Transnational Auditors Committee (TAC). In this global role, he represents the member firms of JHI, a leading worldwide association of independent accounting firms, business advisors and financial consultants. TAC is a committee of the International Federation of Accountants (IFAC).

ASK THE ADVISOR

What cost-effective steps can I take to turn my rental homes “green”?

Remodeling an older rental home to make it “green” is a wise alternative to building a new property. Because of the tremendous savings in lumber, that choice alone is one of the greenest ones a landlord can make. But there are other ways to green up an otherwise energy-*inefficient* house and increase the property's cash flow.

For starters

Begin by installing natural insulation in the walls, attic and roof. Natural insulation, which has fewer potentially allergenic chemical ingredients than synthetic insulation, is highly effective in reducing heat loss and carbon dioxide emissions while maintaining a low environmental impact.

Improving roof insulation can save as much as 13% each year on heating bills, according to architect and green building expert Eric Corey Freed, author of *Green Building & Remodeling for Dummies*. Installing a well-insulated and energy-efficient water heater and energy-efficient windows also can produce significant cost savings.

Low-flow shower heads and dual-flush toilets can substantially reduce a home's water usage. Installing energy-efficient appliances should also be a top priority.

Go solar

The average home solar heating system can pay for itself over time by saving landlords hundreds of dollars annually on their energy bills. A number of utility companies offer rebates on solar systems that can help defray the costs of installation. Some will even buy back excess energy that's generated by a solar system. Solar water heaters are another environmentally friendly investment that can help slash energy costs.

Another way to harness the sun and save on electricity costs is with sun tunnels. These mini skylights bring in natural light while minimizing energy loss.

Heating and cooling with less

Although an energy-efficient heating system is a must for any “green” house, it's only the beginning. According to Freed, installing a programmable thermostat can save another 5% to 15% on heating costs.

An attic or whole house fan can bring in much-needed cooler outside air at night. This increased air circulation, which protects against mold and mildew by reducing humidity in the attic, can save up to 30% on air-conditioning costs, according to Freed.

Make the most of tax breaks

Ask your tax advisor about how the Residential Energy Property Credit, established under the American Recovery and Reinvestment Act of 2009, can help save tax dollars when greening your rental homes. Depending on a taxpayer's adjusted gross income, this law provides a tax credit equal to 30% of the cost of all qualifying improvements, up to a maximum credit of \$1,500 for improvements placed in service in 2009 and 2010.

FOR FURTHER INFORMATION

If you have any questions, please contact **Harry Moehringer**, Partner-in-Charge of the **Real Estate Services Group** at 212.503.8904 or hmoehringer@markspaneth.com or any of the other partners in the MP&S Real Estate Services Group:

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