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TAX NEWS

The Tax Consequences of Foreclosure for a Partnership Borrower April 1991 14 CEB Real Property Law Reporter

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This is the first in a series of Tax News columns that will discuss various tax aspects of real estate loan workouts. In this issue, we examine the potentially complex tax consequences that can result to a partnership borrower from a foreclosure, based on the following hypothetical fact pattern:

A limited partnership has as its only asset a commercial building with a tax basis of \$25 million and a fair market value of \$28 million. The building is security for a nonpurchase-money loan that is in default and has a principal amount of \$32 million plus accrued but unpaid interest of \$5 million previously deducted by the partnership, which uses the accrual method of accounting for tax purposes. The loan is nonrecourse to the partnership, but guaranteed in full by the general partner. (We assume that the guaranty is enforceable against the general partner with no right of indemnity against the other partners.) The general partner has a 70 percent interest in partnership profits and losses. All deductions attributable to the loan were allocated to the general partner, which has a negative capital account of \$12 million. The general partner has a net operating loss carry-forward of \$3 million and \$2 million of suspended passive activity loss. The general partner has other depreciable property with a tax basis and fair market value of \$3 million and has no other assets or liabilities. The lender takes over the property through nonjudicial foreclosure. Neither the general partner nor the partnership transfers additional cash or other property to the lender in connection with the foreclosure. Thus, the general partner is solvent by \$3 million after the foreclosure.

General Tax Consequences

When a lender takes over property securing a loan through foreclosure or a deed in lieu, two possible types of income may result to the borrower: (1) gain (or loss) from sale or exchange of the property, and (2) cancellation of indebtedness (COD) income.

In the case of a nonrecourse loan, current law treats the entire excess of the loan balance (including unpaid interest, if previously deducted by the borrower) over the tax basis of the property as income from the sale or exchange of the property. See Reg §§1.1001-2(a)(1), 1.1001-2(b). See also *Tufts v Commissioner* (1983) 461 US 300, *Estate of Jerrold Delman* (1979) 73 TC 15, and IRC §7701(g). Accrued, but unpaid interest not yet deducted by a taxpayer using the cash method of accounting would not be included in the debt discharge amount. See IRC §108(e)(2). In the case of a recourse loan, the IRS takes the position that a transfer of property in satisfaction of the loan causes the borrower to realize gain (or loss) from sale of the property to the extent that the value of the property exceeds (or is less than) its tax basis. The excess of the loan balance over the value of the property is considered COD income. See Rev Rul 90-16, 1990-1 Cum Bull 12, and Reg §1.1001-2(a)(2). See also *Julian S. Danenberg* (1979) 73 TC 370.

This bifurcation of income maybe significant in several respects. COD income is ordinary income, while gain (or loss) from sale may be capital gain (or loss). This may affect the applicable tax rate (under current law, only for individuals) and the ability to use capital losses, which generally may be offset only against capital gains. Further, COD income may be excluded from income under IRC §108(a) if the borrower is in bankruptcy or to the extent the borrower is insolvent, whereas gain from sale is not excludable.)¹

The price for excluding COD income is generally a reduction (dollar-for-dollar for losses and 33 and 1/3 cents per dollar for credits) in the borrower's tax attributes, in the following order: net operating loss carryovers, general business credit carryovers, capital loss carryovers, asset basis, and foreign tax credit carryovers. The taxpayer can elect to apply the reduction to the basis of depreciable property first.

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Partnership Tax Consequences

The existence of a partnership borrower presents special problems. Generally, the amount and character of income is determined at the partnership level, and then is allocated to the partners. IRC §§703, 704. Thus, whether there is COD income is generally determined at the partnership level. However, the availability of IRC §108(a) exclusions is generally determined at the partner level, after the income has been allocated to the partners. See IRC §108(d)(6). Accordingly, the IRC §108(a) exclusions depend on the insolvency or bankruptcy of the partners, not the partnership. Further, it is the partner's tax attributes that are subject to reduction, not the partnership's.

¹ Readers should note that Rev Rul 90-16 is inconsistent with an earlier line of court decisions holding that an insolvent debtor does not recognize any income (including gain attributable to an excess of value over basis) on a transfer of property to a creditor in satisfaction of a debt, except to the extent that the transfer renders the debtor solvent. See *Dallas Transfer & Terminal Warehouse Co. v Commissioner* (5th Cir 1934) 70 F2d 95; *Main Props .. Inc.* (1944) 4 TC 364, acq 1945 Cum Bull 5, withdrawn as to this issue and nonacq substituted, 1987-2 Cum Bull 1. How these cases are affected by the later enactment of the Bankruptcy Tax Act of 1980 is unclear.

Tax Consequences In the Hypothetical

The existence of COD income in our hypothetical depends on whether the loan is a recourse loan. The loan is nonrecourse to the partnership, but guaranteed by the general partner. Although there appears to be no authority directly on point, the loan should be viewed as a recourse loan because the general partner bears the economic risk of loss with respect to the loan. See Temp Reg §1.752-1 T(a)(2).²

Presumably, the general partner would be allocated all \$12 million of income from the foreclosure. In order to eliminate its negative capital account of \$12 million. The income would consist of \$3 million of gain from sale (\$28 million value less \$25 million tax basis), which is fully taxable, and COD income of \$9 million (\$37 million debt less \$28 million value), of which only \$3 million would be taxable (and \$6 million excluded) because the general partner is solvent by only \$3 million after the discharge. (All the COD income would be excludable under IRC §108 if the general partner was in bankruptcy.)

Thus, the general partner would have total taxable income of \$6 million from the foreclosure. Before applying attribute reduction under IRC §108(b), the general partner would first calculate its taxable income for its tax year in which the foreclosure income from the partnership was included. See IRC §108(b)(4)(A). The general partner could reduce the \$6 million of taxable income by the \$3 million net operating loss carryover and by the \$2 million suspended passive activity loss, leaving taxable income of \$1 million for the year. The taxpayer's remaining tax attributes (i.e., the tax basis of \$3 million of its other depreciable assets) would be reduced to zero. Even though the IRC §108 exclusion (\$6 million) exceeds the attributes available for reduction (\$3 million), this does not produce additional taxable income.

If the loan had been nonrecourse, the tax result would be quite different. In that case, the entire \$12 million of income from the foreclosure would be treated as gain from the sale of the property, and not as COD income. If the \$12 million of gain was allocated to the general partner, he could offset it with his \$3 million net operating loss carryover and \$2 million passive loss. However, the remaining \$7 million would be fully taxable and could not be excluded under §108 because none of the income constitutes COD income.

² In some circumstances, a general partner's guaranty may not be enforceable under California law if the general partner is deemed to be guaranteeing its own debt. or is deemed to be an "alter ego" of the partnership, or if the guaranty is deemed to frustrate or circumvent the policies of the antideficiency laws. See California Mortgage and Deed of Trust Practice §8.18 (2d ed Cal CEB 1990); see also *The Enforceable Guarantee: Illusion or Reality?*, 8 Cal Real Prop J 1, 2 (Spring 1990). If the general partner's guaranty was unenforceable, the loan would presumably be treated as a nonrecourse loan.