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## TAX NEWS

### **Tax Planning Opportunities in Foreclosures May 1991 14 CEB Real Property Law Reporter**

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Last month's column reviewed the tax consequences of a foreclosure of partnership property. In this issue we focus on tax planning ideas to minimize the tax consequences of such a foreclosure.

Assume that Partnership X has as its only asset a commercial building with a tax basis of \$25 million and a fair market value of \$23 million. The building is security for a \$37 million nonrecourse loan and has been depreciated on the straight line method. The operation is in financial difficulty and the building is likely to be foreclosed within the next 12 months.

Partnership X has two equal partners, A and B. A and B each have a \$12.5 million tax basis in their partnership interest, and each has a 50 percent share of partnership liabilities. A is insolvent by \$10 million. B is solvent and has a net operating loss carryover of \$10 million.

#### **Foreclosure or Deed in Lieu**

If the lender forecloses on nonrecourse debt, then under *Commissioner v. Tufts* (1983) 461 US 300 the partnership will realize \$12 million of capital gain (excess of nonrecourse debt of \$37 million over tax basis of \$25 million), and each partner will recognize \$6 million of capital gain. B will be able to offset his \$6 million of capital gain with his net operating loss carryover. A, however, will owe tax on the \$6 million of capital gain even though she is insolvent.

## **Creating Cancellation of Indebtedness Income<sup>1</sup>**

If the \$12 million of capital gain could be converted to cancellation of indebtedness (COD) income, then, because A is insolvent, A could exclude the COD income. Is there any way to convert the capital gain to COD income? Perhaps.

Proposed Regulation §1.1274-1(c) provides that a material modification of a debt instrument is a taxable event, which can result in COD income. Under the proposed regulations it is relatively easy to accomplish a material modification of a debt instrument. For example, a 1 percent change in the interest rate or a change in the payment schedule may constitute a material modification. See Prop Reg §1.1274-7(a)(3), Examples (2) and (3). A material modification of a debt instrument is treated as if the original debt instrument (old debt) was exchanged for the modified debt instrument (new debt).

Internal Revenue Code §1274(b)(3)(A) provides that, in the case of nonrecourse debt, the principal amount of the new debt is the fair market value of the old debt instrument. Presumably the old nonrecourse debt is only as valuable as its collateral, and the principal amount of the new debt should therefore be \$23 million. Consequently, the partnership would be treated as having satisfied the old debt of \$37 million with a new debt of \$23 million, resulting in \$14 million of COD income. Because A is insolvent by \$10 million, she can exclude the \$7 million of COD income allocated to her. B, of course, can use his net operating loss carryover to offset his \$7 million of COD income. (See the last paragraph of this column for discussion of a possible IRS challenge.)

If the property is later foreclosed on, the partnership will recognize a capital loss of \$2 million (excess of tax basis of \$25 million over nonrecourse debt of \$23 million), and A and B will each be allocated \$1 million of capital loss.

## **Creating Capital Gain Income**

What if we change the facts so that B has a capital loss carryover of \$10 million instead of a net operating loss carryover of \$10 million? In that case, A is still delighted with the debt modification idea because she can exclude the COD income. B, however, prefers to let the foreclosure take place because he can offset the capital gain from a foreclosure with his capital loss carryover, but cannot use his capital loss carryover against COD income which will result if the debt is modified.

Is there any way to have the best of both worlds -- COD income for A and capital gain for B. Perhaps.

One possibility is for B, before the time the debt is modified, to contribute his partnership interest to a corporation he owns. Under IRC §357(c), B will recognize gain on the transfer to the extent that his share of partnership liabilities exceeds the basis of his partnership interest. Rev Rul 80-323, 1980-2 Cum Bull 124. Consequently, the transfer of the partnership interest to the

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<sup>1</sup> On May 7, 1991, as this issue was going to press, the IRS published Prop Reg §1.1274-4(g). This proposed regulation makes it more difficult to create COD income. In the July issue we will discuss the effect of this proposed regulation and possible ways to plan around it.

corporation should trigger capital gain to B of \$6 million (debt of \$18.5 million and tax basis of \$12.5 million) which he can offset with his capital loss carryforward. So far, so good.

If the debt is then modified, A will recognize COD income. COD income for A (which she can exclude because she is insolvent), and capital gain for B (which he can offset with his capital loss). Voila!

B, though, must consider the tax consequences for his corporation (which is now a partner in X) from the debt modification. When the debt is modified, the corporate partner will recognize \$7 million of COD income. Assuming the property is later foreclosed on and the partnership liquidated, the corporation will recognize a capital loss of \$7 million. Because the capital loss cannot be used to offset COD income, the corporation will owe tax on the \$7 million of COD income. Accordingly, B is likely to resist this plan unless (1) his corporation has few assets from which the tax can be collected, (2) his corporation has a large net operating loss carryover which is about to expire, (3) his corporation has a large capital gain which can be offset by the \$7 million capital loss, or (4) A provides consideration to B in order to get his cooperation.

Capital gain for B and COD income for A will not make the tax collector happy, and the IRS may challenge the above transactions, particularly if they take place just before foreclosure and without any apparent business purpose. Good tax planning is essential for success. In this situation, good tax planning will include such things as allowing significant time between the steps, using an existing corporation, and documenting a business purpose.