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Income tax risks require real property owners to tread carefully in structuring their mortgage loan workouts

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The COVID-19 pandemic has had an immediate and severe adverse impact on many owners of commercial rental properties. It's far beyond anything that has been experienced in prior economic downturns. Cash flow and net operating income from retail, restaurant, and hotel properties have, in a best case scenario, dropped precipitously and, in most instances, have become negative. Cash flow and net operating income generated by other categories of rental properties have also dropped significantly. The full impact of the pandemic on property values and lending practices on a long-term basis is impossible to accurately predict but it seems likely that, on a going-forward basis, property values will be depressed and lending requirements will become much more stringent than in the past.

Real estate industry participants have varied ownership structures and the particular structure will influence negotiations, workout structures, and forbearance decisions that will in turn dictate the tax results. The income tax implications arising at each step in this process need to be identified and quantified to avoid subjecting the ultimate owners of the property to significant income tax liabilities, none of which will be funded by the underlying property itself. Further, any discussion of income tax issues is always highly fact specific; a summary of general tax concepts and principles must be viewed in the context of the actual facts of the underlying situation. Keeping this caveat in mind, this discussion will use three typical fact patterns to flesh out the tax considerations. We assume an entity classified for income tax purposes as a "partnership." In today's world, this may often be a limited liability company (we will refer to either as the "***partnership***") that owns rental real estate property (the "***project***") encumbered by non-recourse debt in which a significant, and managing, owner is the developer or a promoter (the "***sponsor***") and the balance of the equity is held by investors who are not actively involved in the day-to-day operation of the project (the "***investors***").

Of course, there is always the possibility that some form of litigation will be instituted; either by the partnership or a creditor. The use and effect of litigation is not specifically addressed here but is always lurking in the background as a potential tool for, or threat against, the partnership that is trying to work its way through debt restructuring.

Initial steps — develop a reasonable cash flow projection after speaking to tenants and reviewing operative documents

A reasonable projection of cash flows over the next few months, and then on a short-term and longer-term basis, is critical to evaluating what course of action should be pursued. With that in mind, here are some important steps.

First, it is important to have ongoing discussions with existing tenants as to what the partnership can reasonably expect from them. Presumably, this process has already begun and will continue over the next few months. Obviously, you need reasonable and achievable commitments from tenants before you make any commitments to waive any material rights.

Next, the underlying loan documents and partnership agreement need to be reviewed to identify critical legal issues, including the following:

- What breaches of the loan covenants have occurred, or are likely to occur, and what are the lender's potential remedies as a result of these breaches?
- Whether the sponsor has any exposure to personal liability due to potential violations of "bad boy" clauses in the loan documents.
- What communications should be issued by the sponsor to the investors, initially and as things develop over time?
- Whether the partnership agreement allows capital calls or issuing new classes of equity if it is determined that these are reasonable responses to the changed circumstances faced by the property short of a deed in lieu of foreclosure.
- What is the sponsor's and investors' exposure to "recapture taxes" due to negative capital accounts in the event of foreclosure?
- If the underlying loan is renegotiated at a reduced amount, how will any cancellation of indebtedness be allocated between the sponsors and investors?

Needless to say, reasonable projections of cash flow and a technical reading of the operative documents are the starting point of the process. The parameters of what lenders are willing to do will evolve over time but it is unlikely that any lender is eager to take title to or assume responsibility for operating the project. Depending on the facts, potential negotiations with investors might be challenging, relatively easy, or somewhere in between. From the sponsor's and investors' perspective, income taxes triggered or deferred in this process are critical to any decision.

Immediate issues — loan forbearance

When evaluating the project's current obligations to creditors, three immediate issues need be addressed. ***First***, virtually all nonrecourse loans have "bad boy" provisions that could subject the sponsor of the project to varying degrees of personal liability. "Bad boy" provisions invariably include what would be obvious "bad" acts such as diverting funds, filing for bankruptcy, and the like. In addition, in many cases, these provisions also include innocent acts such as permitting liens to be filed against the property or other contractual defaults that might adversely affect the lender's security (e.g., the failure to timely pay real estate taxes, insurance premiums, or materialmen due to the absence of cash flow). Clearly, the sponsor needs to make sure that he is protected from personal liability for these items and, in an extreme case, avoid having some portion or all of the loan balance converted to a recourse liability. This can be important to investors who may be relying on nonrecourse debt to provide tax basis against which they have taken losses or received distributions. If any partner is charged with personal liability for some or all of the debt, this could trigger "recapture" of negative capital accounts for the investors, resulting in an immediate income tax liability.

Second, there is the issue of negotiating temporary forbearance as a short-term "fix" due to the inability to satisfy numerous loan covenants such as timely payment of principal and interest, satisfying coverage ratios, and the like. The IRS regulations can treat some forbearance arrangements as the substitution of a new debt obligation for the one currently in place, ***even though the original loan documents continue largely in their current form.*** If this happens, the deemed substitution of a "new" debt instrument for the "old" one might give rise to potential cancellation of indebtedness income ("***COD Income***"), original issue discount ("***OID***") issues, and, as described above, it might trigger recapture of "negative capital accounts" due to changes in the allocation of debt among the sponsor and investors. All of these issues are addressed in greater detail in the following section.

Fortunately, the IRS has provided "bright line" tests for determining whether the line between a mere loan modification and a more significant "material modification" has been crossed. Application of these tests is relatively easy. They can be briefly summarized as follows:

- The lender's waiver or modification of a financial or accounting covenant is generally not a material modification of the original loan.
- The lender's "temporary" agreement not to exercise its rights to accelerate the balance due and foreclose for two years (and sometimes longer) is not a material modification of the original loan.
- Agreements to defer payments otherwise due for less than 50% of the original loan term (or five years or less if the original term was more than 10 years) is not a material modification of the original loan.
- Relatively minor changes in yield that are under 25 basis points (or, for loans with a yield of more than 5%, 5% or less of the annual yield) are not material.
- Changes involving the obligor or a guarantor can be a material modification to a recourse loan.
- Changes involving the collateral can be a material modification to a nonrecourse loan.
- Changes in payment expectations from "reasonably expected to be repaid" to not, or vice versa, can be a material modification.

In brief, the terms and scope of any temporary forbearance agreement need to be evaluated, but it is unlikely that an arrangement clearly intended to be a "temporary fix" will be problematic from an income tax perspective.

Third, there is the issue of whether the partnership is entitled to continue to claim deductions for interest expense, real estate taxes, and the like, even if these items are not being paid currently. The same issue arises as to whether the partnership must report rental income that is accruing, but is not being paid. If the partnership determines its taxable income on the "cash basis," the answer is obvious: until rent is collected from tenants there is no income, and until an item of expense has been paid there is no deduction. However, most real estate partnerships are on an accrual basis for tax purposes. In that case, the date that the right to receive income arises or the date the obligation to pay an expense is fixed is the critical event. Based on this, most return preparers will likely plan to accrue rental income and deduct the obligation to pay an expense absent exigent circumstances, and the partnership should carefully evaluate whether the ultimate collection of rental income from certain tenants is so speculative that it need not be reported as income.

Long-term issues — debt renegotiation and refinancing

At this time, trying to determine the terms that the lending market will be willing to extend over the next year or two is, at best, highly speculative. One inescapable conclusion is that it is extremely unlikely a project which, until recently, could support a $10 million, $20 million, or $100 million loan a year or two ago, will support a comparable loan now or into the foreseeable future. This raises the question of what to do with debt-financed properties that are no longer worth what they used to be (or at least will not support the same amount of mortgage indebtedness as before due to more stringent lending standards).

Assuming that terms for temporary forbearance have been agreed to, the options for a long-term solution for many properties need to be evaluated.

The ***first*** option is trying to sell the property on terms that generate a recovery of capital and hopefully a cash profit for the sponsor and investors. The economic analysis and income tax consequences of this alternative are well known. A deciding factor may be whether the market for commercial real estate has become so depressed that the projected sales price will be inadequate to satisfy the outstanding debt, cover the anticipated income tax cost to the owners, or whether, hopefully, these conditions permit the return of the sponsor's and investors' initial investment and even afford a net cash profit. Depending on the terms of the partnership agreement, and potential alternatives for making use of the net sales proceeds, any tax gain from a sale might be deferred through (i) a like kind exchange in which property with greater "upside potential" is acquired to replace the current project, or (ii) an opportunity zone investment, which might both defer gain recognition until December 2026 and also eliminate all tax on a future disposition if made more than ten years later.

The ***second*** option is to simply permit the lender to foreclose and take title to the underlying property in satisfaction of the loan. The net effect of foreclosure will involve not only the loss of the original investment but, in all likelihood, "recapture taxes" since prior tax losses and prior distributions of cash flow and refinancing proceeds have presumably created "negative capital accounts," which will be triggered upon foreclosure. Thus, in most circumstances, foreclosure will subject the partners to an immediate tax bill with no net cash proceeds available to satisfy the resulting tax obligations. The tax cost of simply surrendering the project has to be determined in order to provide a measure of the viability of attempting to retain title through renegotiation of the current mortgage or refinancing. Note that charitable donations of troubled properties will ***not*** work to pass the tax liability associated with a negative capital account on to the tax-exempt owner and formal bankruptcy is generally contractually prohibited and, in the end, will not provide a viable solution to the current problems facing the project.

The ***third*** option would be to try to renegotiate the terms of the existing loan with the current lender (a "***workout***"). This process will typically involve one or more of the following: extending the maturity date for the loan, changing the interest rate, modifying loan covenants, negotiating a reduction of the loan balance, giving the lender some form of equity interest, raising additional capital and paying down the loan balance, and/or providing additional security such as personal guaranties. Since there will undoubtedly be a substantial change to the terms of the current loan package, this process will trigger all of the potential issues and concerns that were discussed in the preceding section, and presumably were avoided when the terms for temporary forbearance were negotiated. Effectively, the amendments to the current loan terms negotiated in a workout are likely to be sufficiently material that the renegotiated loan terms will be treated for income tax purposes as an entirely new loan. Again, there may be a significant risk that any materially modified loan will trigger recapture of “negative capital accounts,” which would mean an immediate tax bill for some or all of the owners. Careful negotiation can avoid that draconian result, but there may still be an immediate tax cost incurred.

Summarizing the potential tax consequences of a workout

Potential income tax consequences that will result from a workout can be briefly summarized as follows. Again, it must be emphasized that these rules can become exceedingly complex and the full income tax implications can only be determined based on a comprehensive evaluation of the facts in each situation.

Reduction of outstanding obligations

If outstanding accrued but unpaid interest is forgiven, taxable “cancellation of indebtedness income” (“***COD income***”) is technically triggered. Of course, since the underlying obligation to pay interest was either already deducted by an accrual basis partnership or would have been deductible if paid by a cash basis partnership, no material adverse income tax consequences should result, bearing in mind that the value of a deduction taken last year won’t make investors feel good about a corresponding income item this year. In contrast to interest expense, if there is a reduction of the principal obligation of either a recourse or nonrecourse obligation, COD income is triggered. At first glance, under a special rule that applies to real estate, it might be possible to avoid having to recognize income from this in exchange for reducing the depreciable tax basis of the property. However, it is important to check the kind of financing being reduced. The nonrecognition rule only applies to monies borrowed to purchase or refinance the initial loan that was used to purchase (or improve) the project. Refinancing proceeds that were distributed to the partners and reductions of the initial purchase money mortgage balance through debt service payments would be taxable at ordinary income tax rates to the partners. Insolvency of an individual partner will shield that partner from an income tax liability for COD income but it is unlikely that that exception will be available in most situations. To the extent there is not a reduction in the principal owed, then COD would only result if the debt is publicly traded, but taxpayers should be careful as to what is considered publicly traded for these purposes.

Recharacterization of the lender as a partner

When a loan modification is characterized for income tax purposes as a new loan, all of the underlying assumptions associated with the original loan are retested. Although extreme, it is possible, particularly with extremely distressed projects, that the lender’s mortgage loan might be treated, for income tax purposes, as being equivalent to equity. For example, the lender might receive an “equity kicker” that effectively makes it the de facto owner (or a partial owner) of the underlying property. A similar issue arises if (i) the loan is nonrecourse, and (ii) the agreed balance of the renegotiated loan clearly exceeds the current fair market value of the property securing that obligation (in which case the nominal partners hold what is the economic equivalent of an option that will be exercised, if and only if, the property appreciates in value). If either of these scenarios occurs, all of the current partners’ negative capital accounts would be triggered and each would be subjected to gain that would be equivalent to permitting the property to go into foreclosure.

Reallocation of debt supporting negative capital accounts

This can occur if, as a part of the workout, any personal guarantees or other credit support are provided by the sponsor, new equity is issued by the partnership, or some partners fail to satisfy their obligations due to a capital call. The net effect of any of these events might be to trigger a portion or all of some partners' negative capital accounts causing them to recognize income. It is often possible to avoid this result by structuring the underlying debt such that the nonrecourse portion is adequate to support existing negative capital account. However, whether this is achievable, in whole or part, requires a careful analysis of the terms of the workout and, in all likelihood, amendments to the partnership agreement.

Creation of an OID obligation

A long-term deferral of interest can create an obligation that has "original issue discount" ("***OID***") where the interest is deemed to be paid and earned on present value principles based on the actual yield to maturity as opposed to the stated terms for payment of interest and principal. For example, an instrument that permits the borrower to defer debt service payments of some period of time, instead of requiring annual interest payments, will have to be analyzed to determine the OID associated with it. The math that has to be done to determine the effect of this change can be complex but, in the current low-interest rate environment, aside from the risk of having some relatively nominal COD income (due to a deemed reduction of the principal balance owed), the existence of OID should entail relatively minimal income tax implications for the borrower.

Other potential income tax considerations

The previous sections summarize what should be the principal income tax considerations. Depending on the amounts at issue, and other facts, there are other potential tax issues such as the added tax cost associated with Section 1250 recapture, the taxation of net investment income, conversion of accrued but unpaid interest and real estate taxes into capital gain income, applying suspended passive losses and 2020 operating results to eliminate or reduce COD income, and the like, which might factor into the ultimate decision but are not discussed separately here.

The ***final*** option would involve securing an entirely new loan for the property. If that is possible, the tax analysis would be similar to the analysis that applied when the terms of the current loan are renegotiated.

Plainly, the tax consequences associated with rental real estate can be significantly affected by the economic turmoil associated with the COVID-19 pandemic. It is important to review any significant change in landlord-tenant, lender-debtor, or among the partners/members to avoid costly surprises.

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