

Tax Tips

Recourse vs Nonrecourse Indebtedness in a Debt Workout:

Does the Difference Matter?

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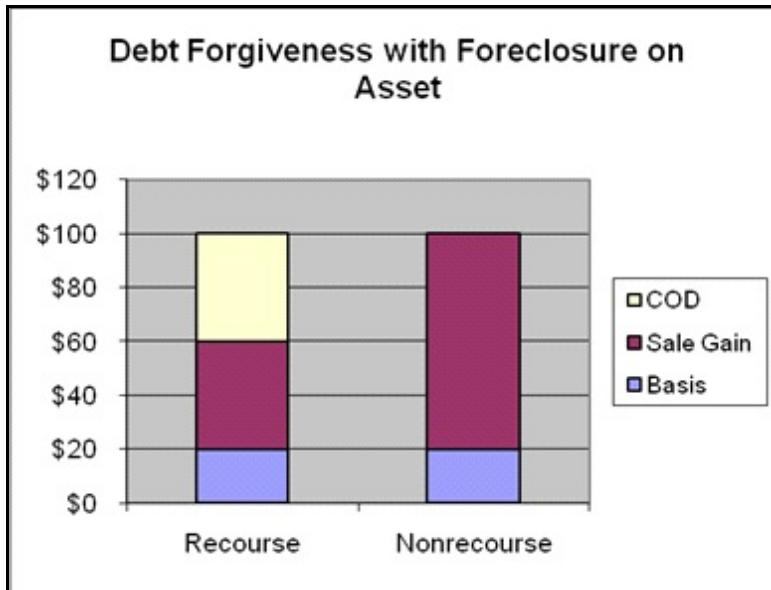
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A consequence of today's difficult market conditions, with asset prices declining below principal balances of debt obligations, is that a client may have to go through the difficult process of working out their debts with their lender. If your client manages to work out a settlement with the lender, the reality will soon set in that his or her hard work will result in an unexpected tax liability. The amount subject to tax will depend upon whether the debt is recourse or nonrecourse, and how the debt workout is structured. While the tax analysis of a debt workout are too complicated to summarize here, the following is intended to help you identify the key issues that can impact your client's tax liabilities when dealing with recourse versus nonrecourse debt.

For purposes of this analysis, we will assume the following facts: Lender has agreed to satisfy a debt for less than its full amount. The outstanding principal balance of the debt is \$100x, the fair market value of the asset subject to the debt is \$60x (the property is underwater by \$40x) and the taxpayer's basis in the asset is \$20x. Lender is willing to forgive \$40x of the principal balance of the indebtedness.

1. Recourse vs Nonrecourse Debt With a Foreclosure.

What happens if Lender forecloses upon the property in satisfaction of the indebtedness? The tax consequences to Taxpayer depend on the characterization of the debt as either recourse or nonrecourse.



If the debt is recourse, then the tax consequences are bifurcated between cancellation of indebtedness (“COD”) income, which is potentially taxable under Internal Revenue Code (“IRC”) section 108, and sale or exchange gain, which may be taxable under IRC section 1001.¹ With recourse debt, Taxpayer is treated as having “sold” the property to Lender for the property’s current fair market value. The amount of the debt in excess of the property’s fair market value is characterized as COD income. In contrast, if the debt is nonrecourse, then the debtor is treated as having sold the property for the outstanding balance of the debt (not just its fair market value).²

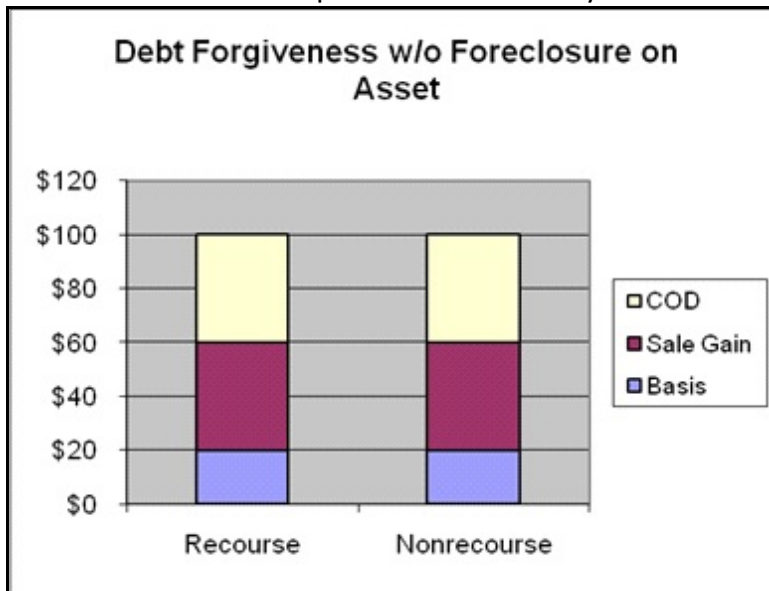
Why is the distinction important? In addition to determining what constitutes COD income, section 108 provides exclusions that permit Taxpayer to exclude COD income if he or she meets certain qualifications (e.g., if Taxpayer is insolvent). If the debt is nonrecourse, then none of the gain is treated as COD income and thus prevents the debtor from receiving relief from one of the section 108 exclusions. If Taxpayer is insolvent in the above example, then Taxpayer will be taxed on \$40x of the gain if the debt is recourse, as opposed to \$80x if the debt is nonrecourse.

2. Recourse vs Nonrecourse Without a Foreclosure.

¹Treas. Reg. §§1.1001-2(a); -2(c) Ex. 8.

²IRC §7701(g); Treas. Reg. §1.1001-2(c) Ex. 7.

If Taxpayer is permitted to keep the property, then the tax consequences are more straightforward. Whether the debt is recourse or nonrecourse, Taxpayer recognizes COD income in an amount equal to the amount by which the debt is modified (i.e., \$40x).³

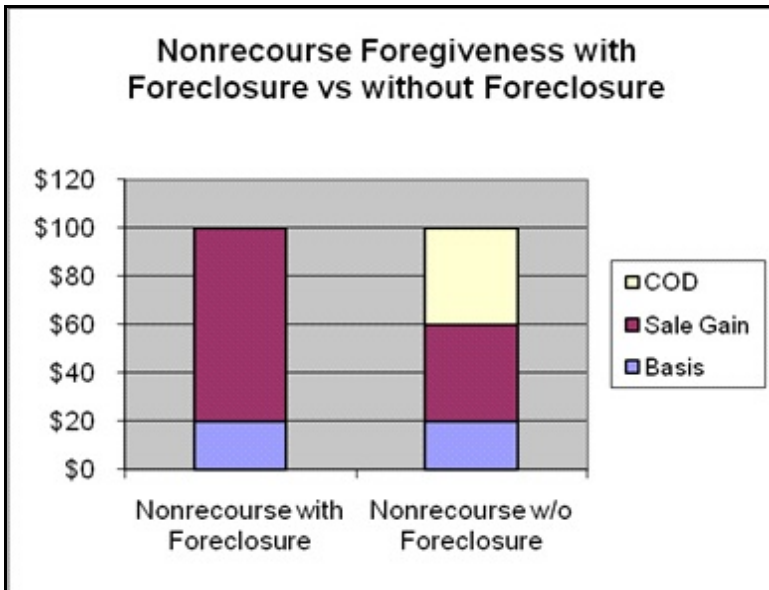


If Taxpayer subsequently sells the property in a transaction unrelated to the debt modification worked out with Lender, then Taxpayer recognizes sales gain (\$40x) taxable under section 1001.

3. The Impact of Foreclosures on Nonrecourse Debt.

As can be seen by the two charts above, not only is there an important distinction between recourse and nonrecourse debt in a workout scenario, but also whether or not the property is liquidated.

³Revenue Ruling 91-34; 1991-1 C.B. 19; *Gershowitz v. Commissioner*, 88 T.C. 984 (1987).



If the debt is nonrecourse, can Taxpayer ensure COD income treatment for a portion of the gain by merely selling the property to a third party and applying the proceeds to the debt? Probably not because the IRS may apply the step transaction to the structure if it becomes apparent that a condition to the modification of the debt was that the debtor sell the property and use the proceeds to pay-off the debt (a de-facto foreclosure). If the IRS is successful making this argument, then all of the gain is section 1001 sales gain and the debtor loses the opportunity to exclude any income under section 108.

We hope that this was a helpful exercise in identifying issues your client will face in a debt workout. If you have any questions or comments, please feel free to contact either Davis Smith at (334)409-2219 or Robert Gilpin at (334)409-2236.