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Your Loss, Your Gain: Structuring to Avoid Tax Gains in Commercial Foreclosures

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In this article, the authors discuss a transaction in which a joint venture entity owns an office building through a single-purpose entity and the joint venture's partners persuade the lender to forebear from foreclosing on the building.

Distress in the commercial real estate market has led to many property owners "handing over the keys" to their lenders, some willingly and others unwillingly. Some owners have been surprised by significant income tax bills that can arise from a foreclosure or deed-in-lieu of a foreclosure (deed-in-lieu) even when no cash is received by the owner. This gain arises when the amount of nonrecourse debt securing a commercial building exceeds the owner's tax basis in the building, after taking into account depreciation deductions that have been claimed over the years.

In certain situations, however, an owner may be able to delay or avoid the realization of tax gains by working with its lender to create a win-win arrangement whereby the lender takes control of the distressed building and obtains owner cooperation without a foreclosure or other transfer that would trigger tax gain for the owner.

Consider a situation where a joint venture entity (JV) owns an office building through a single-purpose entity (SPE). The existing partners of JV (the Partners) may be able to persuade a lender to forebear from foreclosing on the building in exchange for the Partners both (A) ceding control of the property to the lender by admitting the lender as a minority partner and giving the lender management control of JV, and (B) agreeing to use their deep expertise and connections to repurpose and lease up the building so as to maximize the value of the lender's collateral.

BACKGROUND

JV owns (through SPE) an office building that was refinanced when market valuations of office buildings were much higher than now, such that the outstanding principal balance of the new mortgage loan far exceeds the current fair market value of the building, which is expected to be largely vacant after a major lease expires. The lender wants to foreclose to reposition or sell the building, but under-

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stands that the Partners are better positioned to secure a new major lease for the building than any other party. The Partners for their part know that a foreclosure would generate significant tax gain because the amount of the nonrecourse debt greatly exceeds the adjusted tax basis of the building.

The Partners propose a solution to the lender: the Partners would cede management of JV (but not equity ownership) and fully co-operate in the re-leasing of the building and the lender would agree not to foreclose on the building. The lender agrees that SPE can remain in place but insists that JV be replaced with a new joint venture (New JV) and that the lender becomes a significant economic partner in New JV, arguing that the economic ownership is necessary to ensure the lender's control would be maintained and that it would not be removed as manager.

The lender's proposal may be unacceptable to the Partners because if lender obtains a significant equity stake in JV, the lender's debt would have to be specially allocated (under the Section 752 regulations) to the lender, causing a substantial taxable deemed distribution to the Partners under I.R.C. § 731(a)(1). The deemed distribution would result in "phantom" taxable gain to the Partners.

SOLUTION

The compromise solution that preserves the Partner's tax position while also satisfying the lender's economic and control goals involves two primary components.

First, a new joint venture (New JV) is formed as a state law limited liability company wholly owned by JV. JV then contributes the membership interests in SPE to New JV, causing SPE to become 100% owned by New JV, which in turn is 100% owned by JV. This transaction is disregarded for federal income tax purposes because SPE and New JV are disregarded entities of JV.

Second, the lender is admitted to New JV as a member with managerial control rights and JV is liquidated. The lender's interest in New JV is limited to 9% of all items of income, gain, loss, deduction and credit, which qualifies for the so-called "De Minimis Exception" in Reg. § 1.172-2(d). The De Minimis Exception provides that in the case of "Qualified Nonrecourse Financing" (financing made by a person regularly in the business of lending money, such as a bank, and which meets certain other tests), the debt will not be reallocated to the lender as long as the lender's partnership interest is never more than 10% of all items of income, gain, loss, deduction and credit.

BRINGING IT ALL TOGETHER

For federal income tax purposes, following the liquidation of JV (which owned 91% of New JV), New JV (which is owned 91% by the Partners and 9% by the lender) is deemed to be a "continuation" of JV and inherits its tax attributes.[1] From the standpoint of the Internal Revenue Service, New JV is the same as old JV for federal income tax purposes, despite New JV being a different entity for state law corporate purposes.

By virtue of the De Minimis Exception, the admittance of an entity related to the lender as a partner in New JV does not cause the debt to become recourse or to be reallocated to the lender, and the legacy Partners (now partners in New JV) maintain their tax position and avoid a taxable event.

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The lender benefits from the transaction and the Partners may repurpose the building on behalf of New JV.

NOTES:

[1]See Reg. Section 1.708-1(c)(1) and Rev. Rul. 66-264.

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