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Look Before You Leap: Tax Considerations of Surrendering Property

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Property owners dealing with mortgage payments for properties that have lost market value may feel as if they are trapped in a burning building on a dead-end street. No wonder they contemplate whether to jump from the building to reach safer ground.

Under what circumstances does it pay to surrender property, that is, give up the interest in the property and permit the secured creditor to repossess it and sell it? Whether or not the sale price covers the debt, there are specific tax considerations involved in surrendering property, including the nature of the loan.

Definitions of Non-recourse and Recourse Loans

With a **nonrecourse loan**, the borrower has pledged collateral for repayment, separating any personal liability in the event of a default. The lender may seize and sell only the collateral, and no other property or asset. In the case of a **recourse loan**, the borrower has given an agreement to the lender to repay the debt. In the event of a default, the lender can seize and sell the asset, and, furthermore, has the right to the borrower's unpledged assets and properties.

Default of a Nonrecourse Loan

Because the lender of a non-recourse loan is likely to seize the property that secured the loan and sell it, it may make sense to surrender the property. This arrangement is usually treated as a sale to the lender for the amount of debt.

As for the tax consequences, any capital gain or loss will be calculated as the difference between the amount of outstanding debt and the adjusted tax basis of the property. For example, the outstanding debt is \$2 million and the current tax basis is \$1.5 million. The borrower has seemingly gained \$500,000, which is taxable. Any discharge or forgiveness of the nonrecourse debt, however, does not result in taxable cancellation of debt income (CODI); that is because the lender cannot legally pursue any other assets of the borrower.

Default of a Recourse Loan

The default of a recourse loan is quite serious, because other assets of the property owner/borrower, whether an individual or a corporation, are liable for the remaining debt and might be seized by the lender. In this case, the surrender of property and the amount of the taxable gain or loss are calculated the same way; however, they are treated differently. The capital gain is calculated as the difference between the fair market value (FMV) of the property and the tax basis of the property. Returning to the example, if the FMV was \$1.7 million, the taxable gain would be the difference of \$1.7 million – \$1.5 million or \$200,000.

In calculating the CODI, or the amount of the debt minus the FMV of the property, note that after the surrender of the property, the \$300,000 CODI realized in this example (\$2 million – \$1.7 million) is taxable as ordinary income.

Under the following conditions, commercial taxpayers may exclude CODI after surrendering property, according to the Internal Revenue Code:

Bankruptcy: When a taxpayer's debts have been discharged in a Title 11 bankruptcy proceeding, CODI is generally excludable as income.

Insolvency: In the event of insolvency before the debt is discharged, the CODI is excluded, as calculated by subtracting the FMV of the taxpayer's total assets from the total liabilities before the discharge.

Qualified real property business indebtedness: A taxpayer may choose to lower the basis of depreciable property, instead of recognizing CODI, when the debt was incurred in connection with trade or business real estate. Accordingly, this will reduce future depreciation deductions and the reduction will be treated as ordinary income.

When CODI is excluded from taxable income as per one of these exceptions, the individual must also reduce any tax attributes, namely tax losses or credits that result from the CODI adjustments, as per the amount excluded. Perhaps the property owner will reduce the tax basis of other depreciable property before reducing any tax credits, net operating losses or carryovers. When all these tax attributes are reduced to zero, any remaining CODI is excluded permanently.

These Exceptions are Not Available for Pass-Through Entities

The first two exceptions of bankruptcy and insolvency are only available to the members of a limited liability company (LLC) and not the LLC itself.

Moreover, reduction of the tax attributes when CODI is excluded from taxable income refers to the individual members of the LLC, and not to the tax attributes of the LLC.

The Decision to Surrender

For the property owner, faced with a large debt and limited financial resources, making the decision to surrender property is a serious course of action with tax consequences for the current fiscal year and beyond. Your CPA or financial adviser will provide the guidance you need to evaluate and calculate the tax implications of surrendering property.

Should you have any questions about this topic, please contact me at 212.840.3456 or marc.wieder@anchin.com