

GETTING OFF THE SHOALS MORTGAGE FORECLOSURES AND WORKOUTS

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I. FORECLOSURE BY ADVERTISEMENT

- A. To utilize, Mortgage must include a *power of sale*, which is standard in most mortgages.
- B. Lender publishes Notice of Sale once each week for at least 4 weeks.
- C. Auction sale conducted by County Sheriff. Mortgagee typically bids the amount of the debt. The highest bidder receives a Sheriff's Deed from which the Mortgagor can redeem.
- D. Redemption period is generally 6 months.
- E. Mortgagor remains in possession until expiration of redemption period unless Mortgagee has an Assignment of Rents.
- F. With an Assignment of Rents, Mortgagee may collect rents from tenants during the pendency of the foreclosure and redemption period after recording a notice of default and serving a copy of the notice and the assignment upon the tenants. However, if the Mortgagee collects rents but does not pay the bills of the property, tenants are likely to stop paying rent.
- G. Mortgagee may seek the appointment of a receiver to aid in the collection of rents by filing suit in state court. Generally best for the lender to have a receivership clause in the mortgage. The Mortgagee may concurrently foreclose by advertisement and maintain an action for the appointment of a receiver. However, if a receiver is appointed prior to the mortgage sale, it is necessary to obtain Court approval before proceeding to sale.

- H. If recourse exists under the Mortgage and there is a deficiency at the sale, the lender may sue the Mortgagor for a deficiency. If the Mortgagee was the successful bidder at the sale, as is most often the case, the Mortgagor may challenge the bid as inadequate. Contrast a judicial foreclosure where the deficiency is established at the confirmation of the sale. Therefore, it is unusual for the lender to use foreclosure by advertisement where a deficiency is sought.

II. JUDICIAL FORECLOSURE

- A. Commenced by filing of a lawsuit and recording of a lis pendens. The complaint may include a count for a deficiency judgment.
- B. Court may appoint a receiver during pendency.
- C. Claims of competing lien claimants may be adjudicated.
- D. The foreclosure sale may not take place until 6 months after filing of the suit. The Mortgagor often may be able to delay the process and obtain an Upset Price-the minimum amount which may be bid at the foreclosure sale.
- E. The principal advantage to the lender, in addition to the possibility of obtaining resolution of competing claims, is that in one suit it may obtain the appointment of a receiver and obtain a deficiency judgment.
- F. Redemption period is 6 months.

III. DEED IN LIEU OF FORECLOSURE

- A. Mortgagor and Mortgagee may agree to accept a deed in lieu of foreclosure and generally to release any and all claims against the Borrower and Guarantors.
- B. Even with a settlement, the lender may wish to proceed with a "friendly foreclosure" to be sure to wipe out competing or intervening lien claims.

- C. The lender may not want to take title to the mortgaged property due to environmental contamination or other reasons, and may attempt to find a purchaser during the period of receivership.

IV. TAX CONSEQUENCES OF FORECLOSURE OR DEED IN LIEU

A. Inclusion of Debt in Basis

- 1. Basic Rule. Loan Proceeds are not taxable so long as the borrower has an unconditional obligation to repay the debt. This is because the \$ received by the borrower is offset by an identical liability to repay the debt. If no such obligation exists, either in whole or in part, then income is realized to the extent that there is no obligation to repay.
- 2. Refinance Proceeds, even if greater than prior debt, are also not taxable. This is not tax avoidance but a deferral. That is, when the mortgaged property is sold, the amount realized for tax purposes is the cash or other property received plus the principal balance of the debt.

B. Recourse v Nonrecourse Debt

- 1. A nonrecourse loan typically provides in the Note that the lender's recourse is limited to the security for the loan, the sole remedy is foreclosure and no deficiency judgment may be obtained.
- 2. Most nonrecourse loans today have exceptions or *carve-outs* for various items, such as:
 - a. rents and profits after a default;
 - b. intentional misrepresentation and fraud;
 - c. environmental indemnity;

- d. security deposits and rents paid more than 30 days in advance;
- e. a myriad of other things such as unpaid property taxes, converted insurance proceeds, waste and the like.

In addition, many nonrecourse loans have springing liability where the borrower may be liable for the entire indebtedness in the event of a voluntary or collusive bankruptcy involving the borrower, a violation of the single purpose entity covenants of the loan, or a violation of the transfer restrictions.

C. Income from Cancellation or Discharge of Indebtedness (“COD Income”). The first question often is whether the transaction will result in COD income to the borrower.

1. In General, the amount of COD income may vary based on the type of debt cancelled and the transaction involved.
 - a. Both recourse and nonrecourse debt which is reduced or cancelled without forfeiture of the underlying security, results in COD income to the full amount of the cancelled debt.
 - b. Where there is a foreclosure of a recourse debt, if the market value of the encumbered property is greater than the taxpayer’s basis but less than the debt, the gain may be bifurcated. That is, sale or exchange treatment applies to the difference between the fair market value and the basis while COD income treatment applies to the difference between the full amount of the debt and the fair market value of the property.
 - c. Where there is a foreclosure of nonrecourse debt, the entire amount of the debt is treated as the amount realized and the transaction results in capital gain or loss under IRC Sections

61(a)(3) and 1001. There is no COD Income under Section 61(a)(12) and Section 108 does not apply.

- D. IRC Section 108 Exceptions to Recognition of COD Income. Section 108 contains a number of special rules of exclusion that taxpayers may use to avoid recognition of COD income they have realized.
1. Application of Exceptions. Certain of these are applied at the corporate level (where the debtor is a C or S corporation) while other rules apply to individual taxpayers. If the debtor is a tax partnership, as is often the case, the determination as to whether COD Income has been realized is made solely at the Partnership level. If any COD income has been realized, it is then allocated to the partners who, in turn, must ascertain whether the special rules of exclusion are available to them.
 2. Bankruptcy and Insolvency Exception. COD income is excluded from gross income if it occurs in a Bankruptcy Case or if the taxpayer is insolvent. If this exception is available, there will be a reduction in the tax attributes available to the taxpayer in an order specified by 108(b)(12), including elimination of net operating losses for current or carryover years, reduction of certain tax credits, reduction of basis in accordance with Section 1017 and various other attributes until the COD Income for that year is matched with any remaining income having no tax consequences. Alternatively, the insolvent taxpayer may elect to first reduce the basis of his other depreciable property.
 - a. An insolvent taxpayer may exclude COD income only if he is insolvent before and after the discharge. COD Income is recognized to the extent that a taxpayer is rendered solvent by the discharge. The determination of solvency can be complex in that it may or may not exclude contingent liabilities, exempt assets and the like.

- b. In the Partnership setting, the insolvency test is at the partner level. Thus the results may vary among partners depending on their level of insolvency. The calculation can also be complex where a partner wishes to take into account his share of partnership liabilities other than the cancelled debt.
- 3. Qualified Real Property Business Indebtedness. Under this provision, a taxpayer other than a C-Corporation, is allowed to adjust the basis of his business real property rather than to recognize COD Income. The amount which may be excluded is the excess of the principal amount of the debt immediately before discharge over the fair market value of the property. There are significant limitations to the use of this exception.
 - a. The debt must be incurred or assumed in connection with real property used in a trade or business and secured by a mortgage on that property.
 - b. If the debt was assumed or incurred after 1992, the proceeds must be used to acquire, construct, reconstruct or substantially improve the mortgaged property. Thus, if the taxpayer “overborrows” the debt will not be qualified (unless pre-1993 debt is being refinanced).
 - c. The amount that may be excluded is limited in 2 ways.
 - i. The fair market value limitation provides that the amount excluded from income may not exceed the excess of the principal amount before the discharge over the fair market value of the property before the discharge. Note that it may be difficult to establish fair market value of troubled property.

- ii. The Basis Limitation – the amount excluded cannot exceed the adjusted basis of depreciable real property held by the taxpayer immediately prior to the discharge, excluding any property acquired in contemplation of the discharge.
- d. The trade off for this exclusion is that the basis of depreciable real property held by the taxpayer at the beginning of the taxable year after the year in which the discharge occurs must be reduced.
- e. For Partnerships, the determination of whether the debt is qualified real property business debt is made at the Partnership level. However, the election to exclude the income is made at the partner level.
 - i. The basis reduction with respect to a partner's interest in the partnership is applied under Section 1017 rules so that the partnership interest is treated as depreciable real property to the extent of the partner's interest in depreciable real property held by the partnership. This must be coordinated with the partnership. The Section 752 deemed distribution is offset by a basis increase for the amount of the debt discharge income allocated to the partner.
- f. Ordinary Income from recapture will apply to the disposition of the property whose basis has been reduced as a result of electing this exclusion. Thus, 108(c) is inadvisable if the property will be disposed of in the near future since this can convert capital gain into ordinary income. The recapture is reduced over time if the taxpayer continues to hold the property.

4. Purchase Price Adjustment. Both under common law prior to its enactment and IRC Section 108(e)(5), no COD Income will be realized from a purchase price adjustment. In the typical case where the seller financed a sale through a land contract or purchase money mortgage, an agreement between the buyer and seller made post closing to reduce the debt may be a non-taxable purchase price adjustment.
 - a. The judicial exception probably does not apply unless the outstanding debt at the time of the reduction exceeds the fair market value of the property.
 - b. 108(e)(5) is not elective. Thus, debt reductions described therein are automatically treated as purchase price adjustments.
 - i. Does not apply in bankruptcy or where taxpayer is insolvent.
 - ii. Does not apply where the property is no longer owned by the original borrower or the debt is no longer held by the original seller. Must have direct agreement between buyer and seller.
 - iii. May only apply to debt reduction by third party lender where an infirmity relates back to the fraud of the seller in the original sale.
 - c. The price adjustment would require a similar basis adjustment.
 - d. For Partnerships, the IRS initially took the position that 108(e)(5) is applied at the Partnership level. As such, it would not apply to a partnership's purchase money debt if the partnership is insolvent or in bankruptcy. The fact that

one or more of the partners is solvent is not relevant. So it is possible to have the anomalous result that an insolvent partnership cannot take the price adjustment and must pass COD income down to its partners, who must recognize it unless they are insolvent. To cure this, the IRS has announced that it will allow an insolvent partnership to use 108(e)(5) so long as all partners consistently report the transaction as a purchase price reduction. *Rev. Proc. 92-92, 1992-2 C.B. 505.*

E. **Modification of Debt.** If the terms of a debt instrument are *materially modified*, for federal income tax purposes there is a deemed exchange of the old debt for a new (modified) debt instrument.

1. The lender will realize a gain or loss equal to the difference between the adjusted issue price of the new debt and its tax basis in the old debt. IRC Section 1274 involves application of the original issue discount ("OID") rules which are complex and beyond the scope of this presentation. The tests for material modification set forth in the Treasury Regulations are quite broad.
2. In the case of a modification of an installment obligation (e.g., land contract or purchase money mortgage note), the tests for material modification are more liberal. For example, for 453 purposes the following do not constitute a material modification: (i) change in interest rate; (ii) suspension of principal payments for a stated period of time; or (iii) substitution of obligor.
3. The borrower generally will have minimal adverse tax consequences arising from modifications of interest rate, moratorium on principal payments and other changes which do not reduce the principal balance so long as the new debt

instrument is not publicly traded and provides for an interest rate which is no less than the Applicable Federal Rate.

4. Other Creditor Tax Issues.

a. Accrual of Interest. In general, an accrual basis lender can cease accruing interest when a debtor becomes insolvent and any accrued but uncollected interest before the borrower becomes insolvent is deductible as a bad debt under Section 166. However, it is difficult to determine the date of insolvency and when the debt should be considered uncorrectable. It is the position of the IRS that the OID rules are not subject to the normal accrual rules. From the IRS' standpoint, they want to avoid the borrower from deducting accrued OID while the lender avoids taking it into income.

b. Upon receipt by the lender of the collateral in a foreclosure, the lender realizes gain or loss to the extent of the difference between the amount realized and its adjusted basis in the debt. In a foreclosure, the fair market value of the property is equal to the proceeds received from the sale or the bid price if the lender is the successful bidder. Previous debt write-offs or write downs reduce the lender's basis in the debt. Expenses paid from the proceeds such as back taxes are not deductible but increase the lender's adjusted basis in the property.

F. Payments in Satisfaction of Guarantees. Payments by guarantors, indemnitors and other secondary obligors are deductible as bad debts under IRC Section 166 and are deductible from ordinary income, if:

1. The guaranty was entered into in the taxpayer's trade or business or in a transaction for profit;

2. The taxpayer was legally obligated to make the payment;
3. The guaranty was made before the debt became worthless; and
4. The guarantor received reasonable consideration for the guaranty. "Reasonable consideration" includes guarantees made in accordance with normal business practice or for a valid business purpose except in a family context where actual cash consideration is required.

Guarantee payments unrelated to the guarantor's trade or business or which are not given in a transaction for profit are not deductible.

V. CONVERSION OF DEBT TO EQUITY. A creditor might consider contributing a portion of its debt to equity in the borrower. This will probably avoid recognition of COD income but will cause a Section 752(b) deemed distribution and may require a minimum gain chargeback.

VI. WORKOUT MECHANICS

A. Forbearance Agreements.

1. Lenders will generally require:
 - a. Waiver by borrower of redemption period;
 - b. Release by borrower and guarantor of any claims against Lender;
 - c. Reaffirmation of debt by borrower and guarantors;
 - d. Acknowledgement by borrower of lender's reservation of rights and remedies;
 - e. Budgets and audited financials;
 - f. Lockbox for rents;

- g. Payment of all fees and costs;
- h. Additional equity contributions by borrower.

2. Borrowers want:

- a. TIME;
- b. Moratorium on payments;
- c. Reduction in debt, interest rate or both.