



## **NOTE FROM THE REAL ESTATE RESTRUCTURING GROUP**

### **ACQUISITION OF DISTRESSED MORTGAGE DEBT: SIGNIFICANT INCOME TAX CONSIDERATIONS**

As is the case with any investment, the purchaser of non-performing (“distressed”) mortgage debt must understand the income tax ramifications of acquiring and realizing upon the mortgage debt (whether by sale, foreclosure, deed in lieu or payment) in order to fully evaluate its investment decision. The tax consequences associated with the ownership and disposition of distressed mortgage debt are complex and often counterintuitive. Given the deterioration of real estate values and the accompanying growth in non-performing mortgage debt sale and acquisition transactions, an understanding of these tax consequences has become critical to more investors.

Highlighted below are some of the most significant Federal income tax considerations that the purchaser of non-performing mortgage debt needs to be aware of in order to maximize the after-tax returns of its investment and avoid unexpected tax liabilities. (Although potentially significant, the impact of state and local income taxes is beyond the scope of this Note.)

#### **Market Discount Rules**

Debt acquired at a discount is subject to rules known as the “market discount rules.” In general, the amount of the discount (i.e., the amount by which the outstanding principal balance and accrued interest exceeds the purchase price) is accrued ratably over the then remaining term of the mortgage, with such accrued amount being recognized as ordinary income (rather than capital gains) when principal payments are subsequently made or upon the sale or other disposition of the mortgage debt (e.g., foreclosure or deed-in-lieu). For example, if the purchaser acquires a \$10 million mortgage debt with three years remaining until maturity for a purchase price of \$7 million, and one year later sells the indebtedness for \$10 million, the purchaser will recognize \$1 million in ordinary income (the accrued market discount portion of the gain) and \$2 million as a capital gain.

Where a default has already occurred and the mortgage debt has been accelerated prior to the purchaser’s acquisition of the mortgage debt, it has been argued that the market discount rules do not apply. Accordingly, the purchaser may be able to support a position that the entire gain from the transaction is capital gain (with no portion of the gain being treated as “market discount” ordinary income). The strength of this position in any given purchase transaction will depend on the particular facts and circumstances.

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## **Loan Modifications**

Following the purchase of non-performing mortgage debt at a discount, the subsequent “significant modification” of the debt may give rise to phantom income tax liability. A significant modification occurs if the legal rights and obligations of the parties to a debt instrument are altered to a degree that is “economically significant.” For tax purposes, such a significant modification is deemed to be an exchange of the “old” mortgage debt for a “new” mortgage debt with the modified loan terms. In general, this exchange will create a taxable gain to the extent that the face amount of the modified mortgage exceeds the purchaser’s tax basis in the mortgage debt (and will create a taxable loss to the extent that the face amount of the modified mortgage is less than the tax basis in the mortgage debt). For example, if the purchaser acquired a mortgage debt of \$25 million for a purchase price of \$18 million (i.e., a \$7 million discount), and thereafter enters into modifications of the mortgage loan provisions (such as reducing the interest rate, deferring interest or principal payments, extending the maturity date, substitution of collateral, etc.) which are considered “economically significant,” the Purchaser will be deemed to have exchanged the old mortgage debt for a new mortgage debt on the modified terms. In this illustration, the Purchaser will be required to recognize a gain in the amount of \$7 million (i.e., the excess of the face amount of the new mortgage debt of \$25 million over the purchaser’s tax basis in the old mortgage debt of \$18 million). It should be noted that if the modification included a \$5 million reduction of the principal amount of the mortgage debt (i.e., the mortgage debt amended to have a face amount of \$20 million), then such gain would be in the amount of \$2 million. The foregoing gain may be a short-term or long-term capital gain, depending upon the holding period since the acquisition of the mortgage debt, and, as discussed above, may even be partially ordinary income to extent of the “market discount”.

The result discussed above may be avoided if the debt modifications are completed prior to the time the debt is purchased, if possible. In addition, this tax liability may be deferred and mitigated as a result of the installment sale method of reporting gains (although this method has limitations) and/or a number of other methods, the use of which will depend on the particular facts and circumstances.

## **Foreclosure/Deed in Lieu**

As is the case with a significant modification, the subsequent acquisition of the underlying real estate by the purchaser of mortgage debt, upon the foreclosure of the mortgage or deed in lieu of foreclosure, may give rise to considerable phantom income tax liability. In general, in a foreclosure, or a deed-in-lieu of foreclosure, the purchaser of the mortgage debt recognizes taxable income to the extent that the fair market value of the real property received exceeds the tax basis in the mortgage debt (and the purchaser will recognize a taxable loss to the extent the value of the property received is less than the tax basis in the mortgage debt). For example, if the purchaser acquired the mortgage debt for a purchase price of \$10 million, and shortly thereafter acquires ownership of the underlying real estate (either through a foreclosure or deed-in-lieu transaction) when the real estate has a fair market value of \$12 million, the purchaser will recognize a \$2 million gain. Such gain may be a short-term or long-term capital gain, depending upon the holding period since the acquisition of the mortgage debt, and, as discussed above, may even be partially ordinary income to extent of the “market discount”.

The holder of the mortgage debt has the burden of proof with respect to the determination of the actual fair market value of the real property as of the date it acquires title to the real property, and an independent appraisal may be required to substantiate such valuation.

These are just a few of the tax considerations that come into play in connection with the acquisition of non-performing mortgage debt, and, depending upon the nature of the transaction, many exceptions to

these rules may be applicable. In addition, depending upon the nature of the transaction, there are several other areas of taxation that should be considered in order to maximize the after-tax returns of the investment and to avoid unexpected tax liabilities, including the impact of state and local tax regulations. Accordingly, consultation with a tax lawyer and/or other tax advisor is always strongly recommended before entering any transaction to acquire non-performing mortgage debt.

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This Note was prepared by Eric S. Schoenfeld, a partner in the Real Estate Practice Group, and Michele Gibbs, a partner in Tannenbaum Helpert's Tax Law Practice Group.

The Real Estate Restructuring Group is comprised of attorneys from several of Tannenbaum Helpert's practice areas, and provides a cohesive, multi-disciplinary, legal team, with a targeted focus on providing strategic advice and effective solutions to the diverse and complex issues which must be addressed in connection with the acquisition, restructuring and disposition of distressed real estate assets. If you have any questions regarding this Note or the Real Estate Restructuring Group, please contact Eric S. Schoenfeld (212.508.6713 or [schoenfeld@thshlaw.com](mailto:schoenfeld@thshlaw.com)) or any of our firm's partners. You may also visit our firm's website: [www.thshlaw.com](http://www.thshlaw.com).

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