Partnerships Lose Tax Exclusion On Canceled Debt

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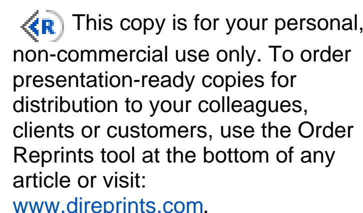

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For some real-estate investors, the "workout" just got a lot harder.

A little-noticed but significant provision in the tax bill signed into law by President Bush in October makes it more difficult for certain real-estate investors to renegotiate the terms of loans on their properties in the event those properties decline in value, a process known as a debt workout.

Under the provision, investors in partnerships will no longer be able to automatically exclude canceled-debt income from their personal taxable income under what is known as an equity-for-debt exception.

EXCEPTIONS TO THE RULE

Investors in partnerships can qualify for exclusions from paying income tax on canceled debt income to the extent that the mortgage debt isn't reduced below the fair-market value of the property. That is among the criteria that must be met to qualify for an exclusion. Here's an example.

- **Partnership P acquired** property for $15 million in 1990, financed in part with mortgage debt of $10 million.
- **The mortgage debt has** since been paid down to $9 million.
- **The value of the property has** fallen to $7.5 million.
- **The partnership negotiates** with the lender for a debt reduction to $7.5 million from $9 million in exchange for the lender receiving a 50% equity interest in the partnership.
- **Under the new law**, the $1.5 million of so-called cancellation of indebtedness, or COD, income is taxable at the partnership level, but individual partners may qualify to defer their shares of the income.
- **An individual partner who owns** a 20% interest in the partnership is allocated $300,000 of the partnership's COD income (20% of $1.5 million).
- **Because the mortgage debt isn't reduced** below the $7.5 million property value, the individual may be entitled to defer his entire $300,000 share of COD income. The individual makes the election for the deduction by filing IRS form 982 with his or her personal income-tax return.

Source: Robert Schachat, Ernst & Young LLP's national tax department

In the past, if a partnership obtained a loan to purchase a property and the property later declined in value, the partnership could try to renegotiate the terms of the loan to reflect the reduced value in a debt workout. In many workouts, the lender agrees to reduce the loan amount and, in turn, receives an equity interest in the partnership in order to participate in any future increase in value.

The restructuring would result in the cancellation of some portion of the debt. And under the equity-for-debt exception, investors wouldn't have to pay income tax on their share of the debt canceled in exchange for giving the lender an equity interest in the partnership.

The new act changes that. Investors in partnerships will have to pay income taxes at ordinary income-tax rates on their share of canceled debt -- though there are exceptions based on a host of requirements. Investors in partnerships that renegotiate debt to reflect the lower value of their property will no longer be able to claim an exclusion, even though they may actually have less income from the property because the value has declined. (In the 1993 tax bill, Congress repealed the equity-for-debt exception for corporations.)

Fred Witt, national director of Deloitte Tax LLP's national real-estate tax services, in Phoenix, cites this example to show the difference: If the value of a building has declined from $100,000 to $60,000 and the partnership goes to the lender to renegotiate the loan from $100,000 to $60,000, then the partners would have to pay tax on the $40,000 at the ordinary tax rate of about 40%. "That's $16,000 in additional out-of-pocket-money you would have to find to pay the tax," he says.

Robert D. Schachat, director of the real-estate group in the national tax department of Ernst & Young

LLP in Washington, D.C., describes this as "hitting investors when they're already down because it removes one major level of protection from income tax at a time when the taxpayer is perhaps least able to pay it."

Situations under which a property's value can decline and prompt debt renegotiation can include a tenant going bankrupt, a tenant's lease expiring and the owner's having difficulty finding a replacement tenant quickly, or an industry or area experiencing a downturn. So this could affect any real-estate investor who is part of a partnership or limited liability company, whether it includes two members or hundreds. (The new law applies to all partnerships and liability companies, not just real-estate entities.)

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But Mr. Witt points out there is some hope. There are ways investors can qualify for an exclusion from paying income tax on the canceled debt, but there are many technical requirements and steps to qualification. One requirement, he says, is that the debt must be secured by the real estate. Another is that the mortgage debt isn't reduced below the property value.

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