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Workouts, Cancellation of Indebtedness and IRS Reporting Requirements: What Borrowers and Special Servicers Need to Know

Workouts, Cancellation of Indebtedness and IRS Reporting Requirements: What Borrowers and Special Servicers Need to Know

Thomas J. Biafore

Background: Borrowers and special servicers seldom appreciate the tax consequences of a workout or foreclosure. These consequences can upset a negotiated workout or friendly foreclosure at the eleventh hour when the borrower realizes it may have a substantial tax liability to the IRS even though the borrower's liability to the lender has been resolved. IRS reporting requirements, together with the applicable provisions of the relevant pooling and servicing agreement ("PSA"), require servicers[1] to report to borrowers and the IRS transactions that generate cancellation of indebtedness ("COD") or gain on sale income. This article examines the tax consequences of typical settlements of defaulted loans.[2]

Reporting Requirements: Under the Internal Revenue Code of 1986 (the "Code"), an entity that lends money in connection with its trade or business and in full or partial satisfaction of a loan takes title to collateral property or discharges at least $600 of indebtedness during the calendar year is required to file an information return, commonly known as a Form 1099. A Form 1099-A–Acquisition or Abandonment of Secured Property, must be filed where, in full or partial satisfaction of the debt, the lender acquires an interest in the property that secures the borrower's obligations under the terms of a defaulted loan. The lender reports on the Form 1099-A the principal balance of the loan outstanding and, in some cases, the fair market value ("FMV") of the collateral acquired. As discussed below and despite the name on the Form 1099-A ("Acquisition on Abandonment of Secured Property"), a lender is required to file a Form 1099-A in many cases when the lender does not ever take title to the collateral property (*e.g.,* in connection with a short sale). A lender files a different form, Form 1099-C–Cancellation of Debt, when all or a portion of a debt the borrower owes is forgiven. When the lender accepts

[1] For purposes of this article, we have referred generally to the special servicer's reporting obligation, but under many PSAs the master servicer retains all 1099 reporting obligations.

[2] In 2015, CREFC released its 1099 Tax Reporting Best Practices guide, which references a number of the issues discussed in this article.

a discounted payoff of a defaulted loan, the borrower experiences a discharge of indebtedness that requires the special servicer to file a Form 1099-C. The amount reported is the amount of debt canceled or forgiven.

Basic Settlements: After a special servicer determines that a transaction results in a settlement or discharge of the loan, the special servicer must determine whether the transaction resulted in income for the borrower.

Special servicers typically face four common resolutions when dealing with a nonrecourse loan:

> ***Loan Sales:*** The lender may elect to sell the loan to a third party as a final resolution strategy for the loan. *See* Mark Palmer, "CMBS Defaulted Loan Sales Update — No Reps, No Warranties, No Recourse" in this Guide for a discussion on the mechanics applicable to a REMIC's sale of a defaulted loan. Though the REMIC had disposed of the loan, the obligations of the borrower continue and there is no settlement of the loan or COD income at the time the REMIC sells the loan. As a result, the special servicer would not issue either a Form 1099-A or -C.
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> ***Assumptions:*** The borrower may transfer the collateral to a third-party buyer that assumes the defaulted loan (either in accordance with the loan's original terms or as a result of a negotiated modification to alter those terms once the buyer assumes the loan). Though there has been a sale of the underlying collateral and the buyer/assumptor under the terms of the loan is the new obligor, the noteholder/REMIC continues to hold the loan. In this transaction, as to the buyer/assumptor there is no settlement of the loan or COD income and the special servicer would file neither a Form 1099-A nor -C at the time of the assumption (irrespective of whether the loan was written down for the benefit of the buyer at the time of the assumption). The original borrower may have gain or loss on the sale of the collateral that can be reported by the dispersing title or escrow company on a Form 1099-S or, to the extent that a portion of the loan was forgiven to accommodate the buyer/assumptor's purchase of the collateral, the special servicer can issue

the original borrower a Form 1099-A. See the discussion below in this article related to the tax consequences to a borrower in a short sale or receiver sale of the collateral property.

Foreclosures/Deeds in Lieu: The borrower may transfer the collateral to the lender by deed in lieu of foreclosure or as part of a formal foreclosure. Here, if the debt is nonrecourse, the debt will be canceled by the foreclosure, but the borrower realizes no COD income, irrespective of the value of the collateral at the time of foreclosure. With nonrecourse lending, the borrower is obligated to repay the loan according to the loan's terms or by transferring the collateral to the lender (or its designee) in satisfaction of the debt. When the collateral is transferred to the lender as part of a foreclosure or deed in lieu of foreclosure or the lender elects to allow the property to be sold to a competing bidder on the courthouse steps during a foreclosure proceeding, the loan has been satisfied in accordance with the loan's terms and no COD income results. The foreclosure is treated as if the borrower sold the collateral to a third party for the full amount of the debt (even if greater than the property's value) and used proceeds from this "sale" to pay the lender the full amount of the nonrecourse debt. In a foreclosure or deed in lieu of foreclosure of a nonrecourse loan, the special servicer files a Form 1099-A with the borrower and the IRS. Similarly, should the lender elect to let the property go to a competing bidder on the courthouse steps at foreclosure in satisfaction of the borrower's nonrecourse debt, the special servicer should file a Form 1099-A despite the fact that the lender technically never takes title to the collateral property.[3]

[3] A foreclosure or deed in lieu of the property securing a nonrecourse loan is is reported by the defaulting borrower for all tax purposes as a sale (1099-A) transaction. As a result, forward thinking borrowers may request that the special servicer participate in a 1031 like-kind exchange transaction in connection with this "sale." Unlike in the typical sale, where the buyer tenders cash proceeds to the seller and the 1031 like-kind exchange requirements are more established, in a foreclosure or deed in lieu, there are no proceeds passing from the "buyer" (lender) to the seller (defaulting borrower) as a result of this "sale" (just the deemed proceeds in the amount of the nonrecourse debt). In this setting, therefore, the mechanics necessary to complete a 1031 like-kind exchange are less clear cut. Special servicers that are considering accommodating a borrower's request for a 1031 like-kind exchange transaction in connection with a foreclosure or deed in lieu should coordinate with the borrower and its accountants to make certain that the special servicer understands the mechanics and requirements that the borrower is requesting to complete its 1031 like-kind exchange.

> ***DPOs:*** The borrower may agree in a discounted payoff (or "DPO") to pay the lender cash or property other than the collateral and, in return, the debt is canceled and the lien on the collateral is released. The DPO generates COD income that the borrower must recognize unless an exception applies. For DPOs, the special servicer files a Form 1099-C with the borrower and the IRS.

PSA Requirements: The special servicer must comply with the PSA when reporting income from the settlement of a loan. A typical PSA provision relating to this requirement reads as follows:

> "The Special Servicer shall report to the Internal Revenue Service and the related Mortgagor, in the manner required by applicable law, the information required to be reported regarding any Mortgage Property which is abandoned or foreclosed, information returns with respect to the receipt of mortgage interests received in a trade or business and the information returns relating to cancellation of indebtedness income with respect to any Mortgage Property required by Sections 6050J, 6050H and 6050P, respectively, of the Code. Such reports shall be in form and substance sufficient to meet the reporting requirements imposed by Sections 6050J, 6050H, and 6050P of the Code. The Special Servicer shall deliver a copy of any such report upon request to the Trustee."

As we have seen, the form required by applicable law, either a Form 1099-A or 1099-C, will differ depending on the circumstances of the settlement of the defaulted loan.[4]

The instructions for Form 1099-C provide that, until the IRS issues further guidance, no penalty will apply as a result of the special servicer's failure

4 The instructions for Form 1099-A are basic and provide no guidance for anything other than the simplest foreclosure situations. For example, the instructions provide no direction on how and if the special servicer should file a Form 1099-A at the time that part, but not all, of the collateral is acquired by the REMIC, as would be the case where the borrower's obligation under the terms of a defaulted loan was secured by several properties located in several jurisdictions. While it is not stated in the instructions for the Form 1099-A, a special servicer should file a Form 1099-A in each year that part of the collateral is acquired by the REMIC and should allocate and report (based on bid price, fair market value or other) a portion of the outstanding indebtedness to the property acquired.

to file Form 1099-C for a canceled debt held by a REMIC. While the IRS may not levy a penalty against a REMIC for failing to file a Form 1099-C, special servicers must file these information returns for proper PSA compliance.

When to Report? If a borrower retains a right of redemption after a foreclosure sale under state law, the Form 1099-A reporting requirement does not arise until this redemption right expires.[5] If the borrower wants to realize a gain or loss from the foreclosure prior to the expiration of the right of redemption, the borrower may waive this right. In contrast, a borrower realizes a discharge of indebtedness in the year when the debt is legally forgiven or becomes unenforceable (for example, as a result of the statute of limitations).[6]

Borrower Concerns: Depending on its particular tax position, a borrower may have a strong preference as to whether a workout results in COD income (1099-C) or gain on sale (1099-A). As a result, borrowers may attempt to recharacterize the nature of a workout to accomplish their tax goals. In general, gain on sale income cannot be excluded from the borrower's income but may be taxed at reduced (capital gain) rates. COD income is taxed at the borrower's regular tax rate but may, depending on the circumstances, be excluded from the borrower's income. Borrowers must understand that the economics of a workout will control the borrower's tax consequences, not the form of the transaction or the label that the borrower and the special servicer put on the transaction. For example:

> ***Short Sales:*** As we have seen, when nonrecourse debt is canceled incident to a short sale of the collateral to a third party, the borrower

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[5] Compare the requirements for applying for an extension of the three-year grace period for foreclosure property described in Tom Biafore, "Foreclosure Property Extensions — When, What and Where to File" in this Guide.

[6] With basic defaulted loan resolutions (*e.g.,* foreclosure, deed-in-lieu, etc.) the timing of the special servicer's 1099 filing obligation is not at issue. Not so, however, with some of the more exotic loan restructurings that became commonplace during the last economic downturn. *See* Steve Edwards, "Is There Hope for A/B Notes?" for a detailed discussion of the A/B note structure and the special servicer's 1099 reporting obligations. With A/B notes and similar structures — where part of the borrower's obligation is converted to a contingent obligation that may not be repaid (depending on the outcome of future events) — the special servicer would typically issue the original borrower a 1099 at the time of the restructuring. As a result, in such a structure the borrower may experience a cancellation of part of its obligation when the loan is restructured, not when the future events that determine when and to what extent the borrower will make payment on the contingent B Note unfold.

has gain on sale (1099-A) rather than COD (1099-C) income, despite the fact that the lender does not ever take title to the collateral property before the property passes to the purchaser. In the leading case on the issue, known as *Briarpark,* a borrower owned property that was subject to a $25 million nonrecourse debt. The borrower's tax basis in the property was $11 million, meaning that the borrower would have had taxable gain on sale of $14 million (the difference between the amount of the debt and the borrower's tax basis in the collateral) if the lender foreclosed the collateral (as the borrower would be treated as having sold the property to a third party for $25 million, the amount of nonrecourse debt encumbering the collateral). This gain could not be excluded from the borrower's gross income. The borrower sold the property to a third party in a short sale and paid the proceeds to the lender in full satisfaction of the debt. The borrower took the position that the short sale generated COD income that could be excluded from the borrower's income (based on the borrower's circumstances and an applicable exception in the Code for COD income). As support for this position, the borrower argued that the short sale was separate from the debt cancellation because the sale involved a purchaser other than the borrower and the loan was not assumed by the purchaser.

The *Briarpark* court disagreed with the borrower and held that there was only one transaction and the lender's cancellation of the debt in exchange for the sales proceeds from the short sale was evidence that the transaction was like a foreclosure with the borrower realizing gain on sale (1099-A) rather than COD income (1099-C). The court did not rule out the possibility of a borrower having COD income where a prior write-down of the nonrecourse debt occurs and the collateral is subsequently transferred to a third party. The court did, however, indicate that a borrower seeking COD income in these types of transactions must establish that a lender's prior write-down of the debt was separate from the subsequent disposition of the collateral in the short sale.[7]

[7] Some commentators have incorrectly suggested that Treas. Reg. § 1.1274-5(b)(1) supports the notion that, if the buyer of the collateral property in a short sale transaction assumes even $1 of the original borrower's debt,

Query whether the borrower in the *Briarpark* case could have obtained the desired COD income had the borrower negotiated a DPO with the lender based on the anticipated proceeds that the short sale buyer was willing to pay, with the intention that the borrower would immediately sell the property to the short sale buyer immediately after the DPO. Provided the two transactions (the DPO between the original borrower and the lender and subsequent sale of the collateral by the original borrower to the short sale buyer following the DPO) are not dependent on each other (that is, that the DPO is final whether or not the borrower is successful in selling the property to the short sale buyer) the borrower should be able to take the position that the transaction generated COD income for the borrower.

Write-down of Debt Prior to Sale: A borrower seeking COD income rather than gain on sale income may offer some form of consideration to the lender to induce the lender to write down the debt prior to (but in anticipation of) a foreclosure or deed in lieu of foreclosure. In this situation, too, the economics of the transaction will control: the write-down of the debt in anticipation of the borrower's transfer of the collateral to the lender in complete satisfaction of the debt will be disregarded and the borrower should recognize gain on sale from the transaction despite the fact that the lender technically wrote down the debt prior to the foreclosure.

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the original borrower can treat any income realized on the write down of the debt from its face amount in the hands of the original borrower to $1 in the hands of the buyer as COD income (1099-C) rather than gain on sale income (1099-A). Treas. Reg. § 1.1274-5(b)(1) provides generally that, if a debt instrument is modified (reduced) in connection with a sale, the modification is treated as a separate transaction that is deemed to take place before the sale of the property and is only between the original borrower and the lender. Treas. Reg. § 1.1274-5(b)(1) should be read as nothing more than a regulatory acknowledgement of the general tax principle that the buyer of property subject to assumed debt does not experience the tax consequences of the modification to the assumed debt done solely to facilitate the sale of the property to the buyer. Rather, the tax consequences of the write down of the debt remain with the seller/original borrower. To suggest that Treas. Reg. § 1.1274-5(b)(1) can be used by a defaulting borrower to convert gain on sale (1099-A) to COD income (1099-C) in what is in effect the original borrower's surrender of the collateral property to the lender's designee in satisfaction of the original borrower's debt is an overly broad reading of the Regulation that is inconsistent with general tax principles and not supported by the decisional law that has considered the issue. The obvious question to proponents of this use of Treas. Reg. § 1.1274-5(b) (1) is, how can a transaction that is merely deemed to take place between the original borrower and the lender in anticipation of the loan assumption create COD income (1099-C) for the original borrower when an actual writedown of the loan between the original borrower and lender in anticipation of (and prior to) transfer of the collateral property and assumption of the loan creates gain on sale income (1099A) for the original borrower?

Conversion of Debt to Recourse: A borrower may ask the lender to convert the loan to recourse debt before foreclosure, even though both the lender and the borrower know that the lender has no intention to pursue the deficiency created by this new "recourse" obligation. In a foreclosure of a recourse debt, the defaulting borrower has gain on sale income (1099-A) equal to the difference between the fair market value of the collateral and the borrower's tax basis in the collateral and COD income (1099-C) equal to the deficiency to the extent forgiven. The conversion of the loan from nonrecourse to recourse will not be respected for tax purposes and the taxpayer will have gain on sale for the entire difference between the borrower's basis and the amount of the debt. Remember, no borrower would agree to have a defaulted nonrecourse loan convert to a recourse obligation before foreclosure absent a preexisting agreement from the lender not to pursue the borrower on the deficiency.

DPOs by Loan Sale: Another common borrower request involves an effort to convert a negotiated DPO (which would generate COD income for the borrower) to a loan sale to a party friendly with the borrower. Unlike a DPO, a loan sale in these circumstances would, if respected as a true sale, generate no taxable consequences to the borrower, as the full amount of the loan remains outstanding after the sale. These sales are often arranged by the borrower at the eleventh hour after a DPO has been thoroughly negotiated but the borrower finally realizes that it faces a large tax bill related to COD income if the DPO goes forward. In this case too, the economics of the transaction should control and the special servicer should examine this "sale" very carefully before agreeing to issue the borrower something other than a Form 1099-C in connection with the transaction. Aside from the fact that the special servicer can only sell a loan pursuant to the express terms of the PSA, the fact that the transaction was initially structured and negotiated as a DPO and the fact that the sales price received was not a price established on the open market as a fair value for the loan, but rather represented the previously negotiated DPO amount, should be warning signs to the special servicer.

Transfer to Lender's Designee/Receiver Sales: A REMIC cannot provide financing to the purchaser of REO property on which the REMIC has foreclosed. As a result, a popular transaction in a distressed environment has been to use a receiver to market and sell the collateral property subject to the existing nonrecourse debt but with the modified terms (including a principal write down).

Despite the form of the transaction (*i.e.,* a direct transfer from the current borrower to the buyer where the REMIC never accepts title of the collateral property) the transaction will be treated, for tax purposes, like a short sale in which the borrower transferred the collateral property to the REMIC (generating gain on sale for the original borrower equal to the difference between the amount realized from the transaction (generally the unpaid principal balance of the loan) and the borrower's basis in the property) and the REMIC subsequently transferred the collateral property to the buyer subject to the terms of the modified debt.

It has been suggested in the context of a receivership transfer and loan assumption that, because the original loan will be modified and reduced as to the buyer of the property and because the collateral property was never transferred directly to the lender in satisfaction of the original borrower's debt, the receivership transfer must somehow create COD income for either the original borrower or the assuming borrower depending on when the assumed loan is written down. This suggestion is incorrect. Rather than creating COD income, the tax consequences of the receivership sale are controlled by the economics of the sale and the transaction is classified as a transfer by the original borrower to the REMIC/lender's designee (the short sale buyer) in satisfaction of the original borrower's obligation (creating gain on sale income (1099-A) for the original borrower) and an assumption of the loan on modified terms by the buyer with no tax consequences for the buyer at that time. No COD income is realized as a result of the receiver sale and loan assumption.[8]

Basis and Amount Realized: The borrower's tax consequences of a workout are affected by the borrower's tax basis in the collateral, the "amount realized" by the borrower in connection the workout, and the structure of the workout.

As noted above, a foreclosure or deed in lieu of foreclosure related to a nonrecourse loan is classified for tax purposes as if the borrower sold the collateral to a third party. This transaction creates gain on sale income for the borrower equal to the difference between the "amount realized" on the transaction and the borrower's tax basis in the collateral. For these purposes, the "amount realized" includes the amount of the nonrecourse debt to which the collateral is subject at the time of the foreclosure. Similarly, the borrower's tax basis in the collateral includes the amount of the acquisition indebtedness (including the nonrecourse debt) to which the collateral is subject.

Consider the following example: A borrower has a basis of $10 in the collateral, consisting of $2 of cash equity contributed by the borrower to acquire the collateral and $8 of nonrecourse debt that encumbers the collateral. If the lender forgives $2 of the nonrecourse debt in connection with a workout of the loan in year 1, the borrower has $2 of COD income at that time (which may be excluded from the borrower's income in certain circumstances). If the borrower then sells the collateral in year 2 for $9, the borrower has a $1 loss on the sale transaction ($9 realized on the transaction less borrower's $10 basis in collateral). Combining this $1 loss on the sales transaction with the $2 of prior gain related to the COD income from year 1, the borrower has realized a net gain of $1. These tax results are consistent with the economics of the transaction — the borrower contributed $2 of cash to acquire the collateral and received $3 on the sale of the collateral, based on $9 realized on the sale less $6 used to pay off the outstanding debt at the time of the sale (as the debt was written down by $2 (from $8 to $6) as part of the workout) for a net plus of $1.

[8] See footnote above regarding the proper application of Treas. Reg. § 1.1274-5(b)(1) in the context of a receiver sale.

If, instead, the lender forecloses on the collateral in year 2, the borrower has a \$4 loss on the sale (1099-A) equal to the difference between the \$6 amount realized on the foreclosure (the amount of the nonrecourse debt to which the property is subject at the time of foreclosure) and the borrower's tax basis in the collateral of \$10 (\$2 of cash contributed to purchase the property plus \$8 of acquisition indebtedness). Taking this \$4 loss on the foreclosure transaction with the \$2 of COD income that the borrower realized when the lender wrote down the loan by \$2 in year 1, the foreclosure generates a net \$2 loss for the borrower. These tax results are consistent with the economics of the foreclosure, as the borrower contributed \$2 of cash to acquire the collateral and the borrower has lost this entire \$2 investment as a result of the foreclosure.

Guarantor Reporting: A guarantor of a loan is not a debtor or borrower for purposes Form 1099-A and -C reporting. A special servicer will not, therefore, issue a Form 1099 to a guarantor when a loan is settled against the borrower even if the special servicer establishes a deficiency but elects to abandon any effort to recover that deficiency from the guarantor. Aside from the fact that the Form 1099 Instructions are clear that a Form 1099 should not be issued to a guarantor, as a fundamental tax matter a guarantor realizes no income when a special servicer abandons any attempt to recover any of the deficiency from a guarantor. As a general matter, a taxpayer does not realize income from the forgiveness of an obligation the payment of which would have entitled the taxpayer to an offsetting deduction in the first instance. In the case of a guarantor making a payment on a borrower's deficiency claim, the guarantor would be entitled to a bad debt or other deduction for the amount paid in satisfaction of the borrower's deficiency, because the borrower is without any assets and otherwise insolvent at the time the guarantor makes this payment. Under these facts, the special servicer's abandonment of the effort to pursue the guarantor for the deficiency does not result in any COD income to the guarantor as a matter of fundamental tax principles.

Conclusion and Summary: The tax consequences of workouts and foreclosures are complicated and sometimes counterintuitive. A foreclosure or deed in lieu of foreclosure that satisfies a nonrecourse loan (whereby the borrower returns the collateral to the lender) is treated, for tax purposes, as if the borrower sold the collateral in a transaction for the full amount of the debt. The borrower has gain on sale income equal to (i) the amount of debt to which the collateral was subject, minus (ii) the borrower's tax basis in that collateral. The fair market value of the collateral is irrelevant in computing the tax gain. The borrower cannot exclude this gain on sale from its income, and the special servicer must report the transaction to the IRS and the borrower on a Form 1099-A.

A DPO or other settlement of a nonrecourse loan in which the borrower retains ownership of the collateral and all or some portion of the related debt is forgiven generates COD income for the borrower equal to the excess of the existing debt over the amount the borrower pays to settle that debt. COD income may be excluded from the borrower's income depending on the borrower's solvency, whether the borrower is in bankruptcy, and other circumstances specific to the borrower. The special servicer must report a transaction that generates COD income to the IRS and the borrower on a Form 1099-C, without regard to whether an exclusion applies.

Special servicers must understand these basic concepts if they are to negotiate effectively with borrowers and maximize recovery on defaulted loans.

For more information, contact:

Thomas J. Biafore
Kilpatrick Townsend & Stockton LLP
1100 Peachtree Street
Suite 2800
Atlanta, GA 30309-4528
t 404 8156250
f 404 5413129
TBiafore@KilpatrickTownsend.com