# Why Office Borrowers Should Think Twice Before Handing the Keys to Their Lender(s)

We've all read the headlines - real estate owners (big and small) are handing (or considering handing) lenders the "keys" to office buildings. With remote working models in flux and tenants gravitating towards amenitized Class A buildings, office building owners may find few options for older properties with weaker tenant rosters and large capital needs. As a result, a solution may be to stop servicing the debt and transfer title to the lender.

For many borrowers, the financial prospects for a property may be so bleak that a decision to hand back keys on non-recourse debt squarely falls into the "no-brainer" category. However, borrowers would be wise to consider additional factors before taking this step.

### Taxes Taxes Taxes!

The tax consequences of surrendering a property often are a primary consideration regardless of a property's economic prospects.

### Phantom Gain

From a tax perspective, transferring title to the lender (whether voluntarily, in foreclosure or through a "deed-in-lieu" of foreclosure) is considered a sale of the property. The owner is treated as receiving sale proceeds equal to the outstanding debt. As a result, the building owner could have taxable gain equal to the excess of the amount of such debt over the adjusted tax basis in the building, typically taxed at the capital gains tax rate.

For older buildings that have generated substantial depreciation deductions over the years, this could result in a phantom gain (i.e., taxable gain with no cash proceeds). Even recently acquired buildings may have a low tax basis if they were acquired in a like-kind exchange of a building held for many years. This can also be the case where owners have levered up the property as the property has appreciated or where depreciation has been accelerated.

It should be noted that the above tax consequences relate to nonrecourse debt (meaning the lender does not have the legal right to look to other assets of the building owner or a guarantor to satisfy it).

By contrast, if property securing recourse debt is surrendered to the lender, the transfer is treated as two separate transactions for tax purposes. As a result, both phantom gain and "cancellation of debt" ("COD") income would be recognized. Phantom gain would be realized to the extent that the fair market value of the property exceeds the debtor's adjusted tax basis. COD income would be realized to the extent that the principal amount of the debt exceeds the FMV of the property. For example, if a debtor transfers an asset with a fair market value of $10 million in discharge of $15 million of recourse debt, and the debtor's tax basis in the asset is $7 million, the debtor will realize $5 million of COD income ($15 million of recourse debt less property with a fair market value of $10 million), and $3 million of phantom gain ($10 million of recourse debt less $7 million adjusted tax basis in the property).

## Phantom Gain Solutions

Unlike the cancellation of debt rules, discussed below, there are very few ways to defer a phantom gain.

One possibility is doing a "like-kind exchange" into a new property. However, doing a like-kind exchange of property that generates no cash at closing presents its own challenges, such as finding sufficient capital to buy the new replacement property and structuring the ownership with potentially new investors (in addition to satisfying all other requirements of these transactions such as hiring a "qualified intermediary"). Another possible strategy would be to hand back the keys in a year in which the owner has losses from other properties that may be used to offset the resulting phantom gain.

## Cancellation of Debt

A borrower might also consider options for reducing or restructuring the debt as an alternative to handing back the keys, but these strategies have their own set of tax considerations that must be analyzed before pursuing such a workout.

If a lender agrees to reduce the outstanding principal balance of a loan (e.g., through a loan modification or discounted payoff) the borrower will have to recognize COD income in an amount equal to the debt that has been forgiven. COD income resulting from forgiveness of debt occurs whether the debt is recourse or nonrecourse. Unlike gain resulting from surrendering the property to the lender, COD income is taxed at the higher ordinary income tax rate.

## COD Solutions

Federal tax law affords several ways to defer recognition of COD income. For example, if the debt was used to acquire or improve the building and the debt currently exceeds the fair market value of the building, the owner may elect to defer the COD income equal to that excess amount, but at a price. In exchange for deferring the COD income, the owner is required to reduce the taxable basis in the building (and, if necessary, of other buildings owned by borrower). This results in lower depreciation deductions in the future than would otherwise be available to shelter taxable income as well as potentially increased taxable gains in the event the building is sold in the future.

U.S. tax law offers insolvent or bankrupt borrowers additional options for reducing COD income. In such situations, the borrower is entitled to exclude COD income to the extent the borrower is insolvent, or the debt is discharged in bankruptcy. However, the borrower must reduce certain tax "attributes" such as net operating losses and the adjusted tax basis of the building and other depreciable assets. As discussed above, this does not eliminate COD income but defers it through reduced deductions and potentially increased gains in the future.

Notably, complex rules apply to deferral of COD income when property is owned through a partnership (such as a limited partnership or limited liability company). Because partnerships are "pass-through" entities for tax purposes, the respective partners – rather than the partnership itself – must be insolvent or receive the discharge in bankruptcy to take advantage of the insolvency and bankruptcy exceptions to recognizing COD income. Therefore, while a partnership may be insolvent because the debt exceeds the fair market value of the building, if a partner is not itself insolvent then the insolvency exception is unavailable. Further, a partnership may have one partner that is insolvent and may take advantage of the insolvency exception while other partners are not insolvent and will not be able to benefit and must recognize their share of the COD income. This can create some interesting conversations/negotiations amongst partners when structuring a debt workout.

Once the tax consequences of a give-back or debt reduction are clear, the economic benefits of handing back the keys may be less compelling.

## When The Tax Tail is Not Wagging the Dog

A borrower should consider the entire after-tax economic picture when evaluating a workout or resolution of debt on a challenged office property. If the property's future value is uncertain and/or where tax consequences preclude a straight-up surrender or debt reduction, borrowers will want to consider a variety of options with their lenders. In addition to the now familiar "amend and extend" these include, for example:

— Reducing current interest payable and accruing the balance which might involve restructuring the debt into a performing "A" note and a subordinated "B" where interest accrues;

— Providing additional collateral or limited guarantees;

— Raising additional equity, preferred equity or mezzanine debt to pay off the existing loan and refinance it under prevailing (i.e., more stringent) underwriting terms; or

— Repositioning/redeveloping the property into a different use which will require analysis of prevailing market conditions and access to development capital.

Of course, any loan payoff raises the specter of possible prepayment premia and defeasance costs that also must be considered/negotiated if the loan has not matured or otherwise been outstanding for required periods of time.

## Don't Waste a Good Crisis

Armed with a better understanding of the tax implications, borrowers may want to consider options to maintain control of their properties. Negative tax consequences can be a powerful motivation to contributing capital and restructuring rather than bailing.

Lenders are often willing to work with borrowers that are part of the solution, not part of the problem. Developing a plan and presenting it to your lender – that includes "giving something to get something" – can result in continued ownership and avoidance of negative tax consequences.

Real estate investing favors those with patience and capital.

*The above discussion is illustrative and is not intended to cover all aspects of tax rules as they would apply to an almost infinite number of business scenarios nor to the myriad options available to stakeholders involved in restructuring troubled real estate debt. Every property and borrower is unique, which offers both borrowers and lenders the potential for finding multiple paths to creatively resolve current challenges and thus preserve future opportunities.*

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