



## TAX ADVISOR

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### 2008 TAX IMPACT OF DEBT RESTRUCTURING

Over the past six to 12 months, the economic engine of the real estate industry has sputtered and gasped. The recent events in the financial sector has caused a general seizing up of credit for strong and weak borrowers alike. The sound of running footsteps outside your door are your clients coming to you to find out how they will be able to restructure their debts. It is imperative that real estate developers, businesses and their advisors have a firm grasp of the tax impact of debt restructuring.

**What are the three types of debt?** The debt can be either: (1) qualified farm indebtedness; (2) personal residence indebtedness; or (3) qualified real property business indebtedness.

**Debt and Taxes.** If the debtor is discharged from the obligation to repay the loan, then the debtor is taxable on the amount of the loan discharged or forgiven. A debtor can exclude from income the amount of discharged debt where the debtor is either bankrupt or insolvent.

**Is the relevant debt Recourse or Non-recourse?** For planning purposes, the most important question to ask in the determination of Federal Income Tax consequences of the income from a debt discharge ("**COD Income**") is whether the relevant debt is recourse or non-recourse. Here are few pointers:

1. The key determining factor is the amount of proceeds that will be deemed realized by the debtor as a result of the disposition. The answer depends upon several factors, the most important of which are:
  - Whether the debt which encumbers the property constitutes recourse or non-recourse debt
  - The current fair market value of the property
2. If the debtor surrenders the property for a reduction or cancellation of the liability, then the amount of COD Income that the debtor must include depends on several factors, including whether the debt is recourse or non-recourse.
3. Generally, if the creditor reduces the amount of debt without receiving the property securing the debt, the debtor will have COD Income equal to the amount the debt was reduced.
4. A debtor's property transfer to a creditor as a form of debt satisfaction (whether voluntary, e.g., a deed-in-lieu, or involuntary, e.g., foreclosure) has the same economic result as a discharge of indebtedness.
5. A property transfer to satisfy or discharge a debt must be treated as two transactions:
  - A "discharge" of indebtedness (with the income eligible for exclusion under Section 108) for the amount of excess debt above the "sale amount"
  - A "sale or exchange" of property governed by Section 1001 for the difference between the tax basis and the amount the property is sold for
6. In the unwinding of debt there are numerous factors and limitations facing the debtor and lender alike. Other solutions involve disposing of overleveraged properties to 3rd party buyers and minimizing taxable gain through installment sales, partnership formation and Section 1031 exchanges.

**How can costly mistakes on the unwinding of debt be avoided?** Engage the services of an experienced, Board Certified Tax Attorney who:

1. Provides high quality and innovative tax services, which are comparable to or better than the largest law firms.
2. Increases your clients' satisfaction in the quality of your work and the success of their transactions.
3. Creates new opportunities for legal services for your clients with expanded service options, including a review of the legal work for identifying the tax consequences of the transaction.

Rely on Stephen L. Robison, Esq., to assist you in providing high quality and innovative tax services. Steve Robison is one of only 19 attorneys in Ohio who has been certified by the Ohio Bar Association in Federal Tax Law since 2002.



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TAX AND BUSINESS

Board Certified  
in Federal Taxation Law  
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Selected as  
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Providing tax and business  
Advice to professional  
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- Income Tax Planning
- Tax Audits & Appeals
- Partnership Agreements
- Corporate Tax Planning
- S Corporation Planning
- LLCs
- Like Kind Exchanges

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