Real Estate Loans in Foreclosure

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As certain areas of commercial real estate remain in stagnation and many balloon payments on real estate loans are coming due, these real estate borrowers may have difficulty refinancing existing debt. Therefore, lenders will need to rework the terms of the existing debt but in some circumstances the lenders may foreclose (or take a deed in lieu of foreclosure) on the mortgaged property. In connection with a foreclosure, borrowers should take care to understand the tax consequences of the foreclosure because failure to do so can lead to significantly worse tax outcomes.

One of the primary factors to be considered in connection with the tax treatment of a loan foreclosure is whether the debt is recourse to the borrower or not. If the funds were borrowed on a recourse basis, and then the property is foreclosed upon, the debt is deemed repaid in an amount equal to the fair market value of the property and with the excess unpaid debt amount treated as cancellation of debt income (the timing of this cancellation of debt income is described below). However, if the debt is non-recourse to the borrower, then the property is deemed to be exchanged for the face amount of the debt.

It is generally better from a tax perspective for the borrower involved in a foreclosure to owe non-recourse debt rather than recourse debt. However, the tax determination of whether debt is recourse or non-recourse may be different than the corporate characterization of such debt. For instance, recourse debt of a single asset LLC may be treated as non-recourse debt from a tax perspective. Debt that would otherwise be treated as non-recourse may be treated as recourse debt if there are guarantors for the payment of the loan. Any guarantee in connection with a loan should be analyzed to determine whether it causes an otherwise non-recourse loan to be treated as recourse for tax purposes.

In addition, there are circumstances under which cancellation of debt may be preferable for certain borrowers if they qualify for cancellation of debt income exceptions. In such circumstances, the borrowers would be well served to realize cancellation of debt income rather than capital gain.

As you can see, the tax complications in connection with real estate foreclosure are complex from some of the topics touched upon in this article. Be sure to consult your tax advisor prior to agreeing to foreclosure terms to make sure your interests are properly served in the workout.

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