

Current Trends in Real Estate Debt Workouts

David Friedline

October 28, 2025



David Friedline

Partner
Deloitte Tax LLP
Phone +1.212.492.3983
dfriedline@deloitte.com

Agenda

Introduction	2 mins
Cancellation of Debt Income	10 mins
Deed in Lieu of Foreclosure and Short Sale	7 mins
Partnership Debt-for-Equity and Transactions with Partners	5 mins
CODI Continued – Exclusions, Allocations, and Deemed Distributions	2 mins
Debt Modifications	25 mins
Course Length	50 mins

Cancellation of Debt Income

Cancellation of Debt Income

In General

- Cancellation of debt income (“CODI”) is includable in gross income under §61(a)(11)
 - Borrowed funds are excluded from gross income because of offsetting obligation to repay, *Centennial Savings Banks*
 - Repurchase of debt at a discount results in CODI because there is an “**accession to wealth**,” *Kirby Lumber*
- In general, CODI is realized when an issuer satisfies a debt instrument with consideration less than its “adjusted issue price”
- Treatment of discharged debt in connection with transfer of property (Reg. §1.1001-2)
 - General rule – **full amount of discharged debt is included in amount realized** (FMV irrelevant, Reg. §1.1001-2(c), Example 7)
 - Recourse exception: Amount realized from discharge of recourse debt is limited to FMV of property transferred; CODI realized to extent **recourse debt exceeds FMV** of property (aka “bifurcated approach”, Reg. §1.1001-2(c), Example 8)
- Absent a transfer of property, discharge of debt results in CODI whether or not the debt is recourse (Rev. Rul. 91-31)

Cancellation of Debt Income

In General (cont'd)

- Other events that may give rise to CODI:
 - Satisfaction in exchange for issuance of new debt, including a “**significant modification**” under Reg. §1.1001-3 (§108(e)(10))
 - Satisfaction of **partnership debt** in exchange for the issuance of equity in the debtor partnership; see §108(e)(8)(B)
 - For corporate debtors,
 - See §108(e)(6) for “contribution” of debt by a shareholder and §108(e)(8)(A) equity issued for debt of a creditor
 - **A person “related to” an issuer acquires a debt** instrument of the issuer at a discount from a person who is not related to the issuer; see §108(e)(4) and Reg. §1.108-2(b)
 - Relatedness is tested under §§267(b) and 707(b)(1)
 - In certain circumstances, the rule applies if holder becomes related to the issuer

Cancellation of Debt Income

In General (cont'd)

- What's not CODI?
 - §108(e)(2): payment of liability gives rise to deduction
 - §108(e)(5): purchase price adjustment
 - *Landreth v. Comm'r*: release of guarantee or contingent liability
 - *Zarin v. Comm'r*: contested amounts
 - *Pittsburgh Milk v. Comm'r*: rebates



Cancellation of Debt Income

Recourse vs. Nonrecourse

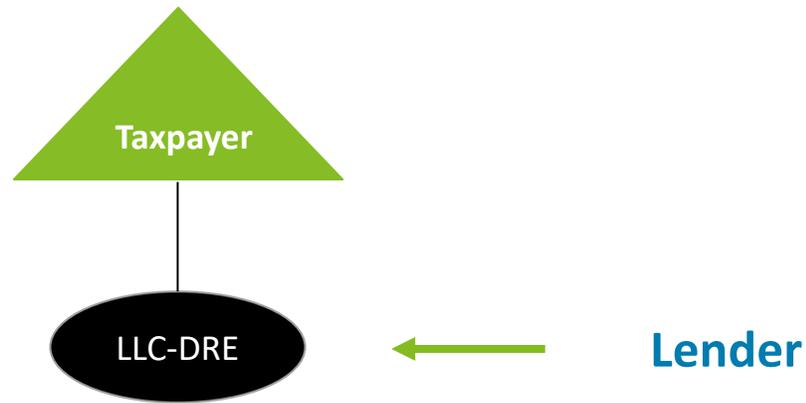
**When is a debt
recourse or
nonrecourse for
purposes of the
CODI rules?**

- Is it the same as for purposes of §752?
 - *Great Plains Gasification Associates v. Comm.*, T.C. Memo. 2006-275
 - CCA 201525010
- Or do you review the terms of the loan agreement?
 - Can the creditor reach all of the borrower's assets?
 - If a debt is nonrecourse, the loan agreement will say so
- What about disregarded entities?

Cancellation of Debt Income

Recourse vs. Nonrecourse

- Does it matter that the obligor is a disregarded entity (“DRE”)?



In PLR 201644018, the IRS took the view that debt owed by a DRE was nonrecourse debt for purposes of the CODI rules. Therefore, the taxpayer had debt relief in the form of amount realized rather than CODI

- Compare PLR 202337007, IRS took a state-law approach for purposes of determining whether a check-the-box election with respect to an obligor caused a “modification” under Reg. §1.1001-3(c)

Deed in Lieu of Foreclosure and Short Sale



Deed in Lieu of Foreclosure

Background State Law Terms

- “Title,” which is the legal right to own real property, is transferred via a deed
- “Deed” is the legal agreement that transfers ownership in real estate from seller to buyer
- Loan agreement sets forth the terms of the loan, including the agreement to pledge the collateral (aka a “promissory note”)
- **Mortgage Contract**
 - Two party security agreement between the lender (“mortgagee”) and the borrower (“mortgagor”)
 - A mortgage is a contract that creates a lien
 - The lender records the mortgage contract which creates the lien
 - Lender has a lien over the property
 - The lien is a right in the property that allows the lender to force a sale
 - In the event of default, the lender sues for foreclosure (“judicial”)
- **Deed of Trust**
 - Three party security agreement between the lender (“beneficiary”), borrower (“trustor”), and a trustee
 - Borrower transfers title to the trustee in exchange for a loan from the lender
 - The trustee holds legal title to the property until the loan is repaid
 - Trustee has the power to sell in the case of default
 - Foreclosure is non-judicial
 - A court is not involved (less expensive)
 - The trustee is in charge of the foreclosure sale

Deed in Lieu of Foreclosure

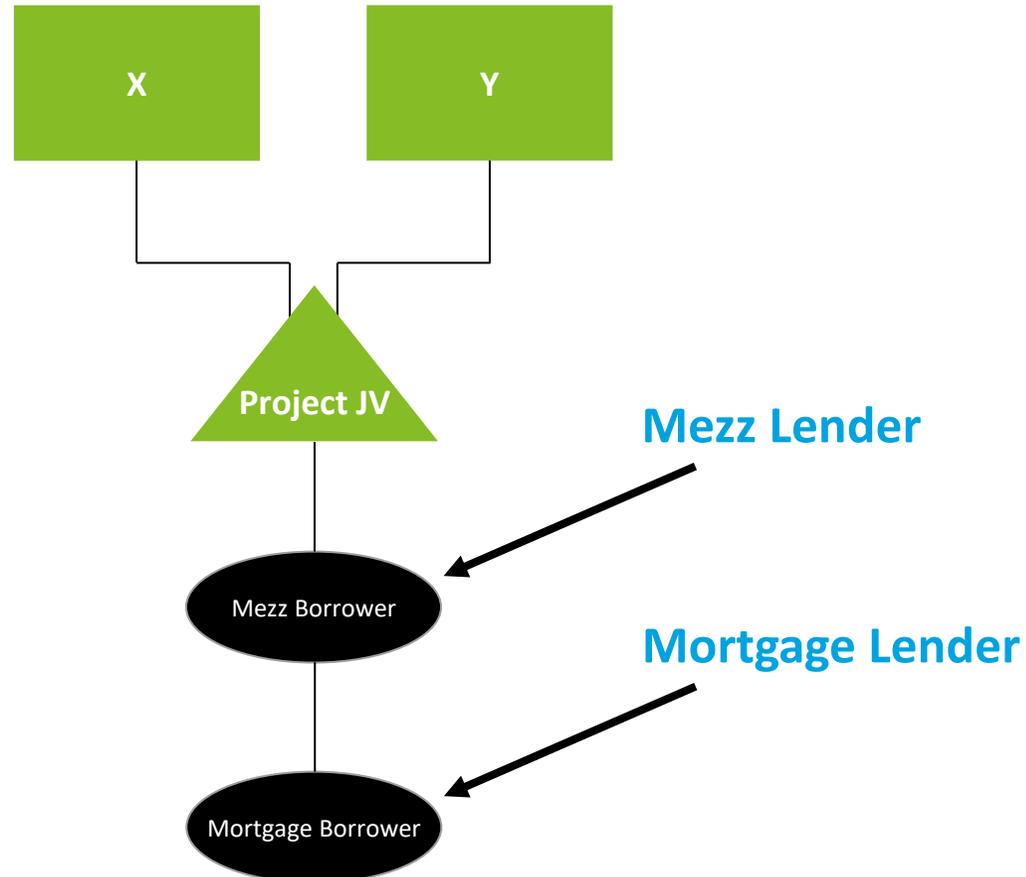
Common Borrower Structure

- **Mezz Lender**

- Security is in the interests of the mortgage borrower
 - Mezz lender can engage in “strict foreclosure” in the event of default
 - The interests in personal property are conveyed to the lender in default (aka “UCC foreclosure”)

- **Mortgage Lender**

- Security is in the real estate (i.e., a lien)
 - Mortgage lender can foreclose on the real estate and force a sale in the event of default
 - Alternatively, the borrower can transfer the deed to the lender in lieu of a foreclosure (“deed in-lieu”)



Deed in Lieu of Foreclosure

Borrower

- Assume B borrowed \$100 to buy a building for \$100
- Assume that—
 - The fair market value (FMV) of the property is now \$70
 - The adjusted basis (AB) is now \$80 (reflecting \$20 of depreciation)
- B cannot pay the mortgage and transfers the property to the lender



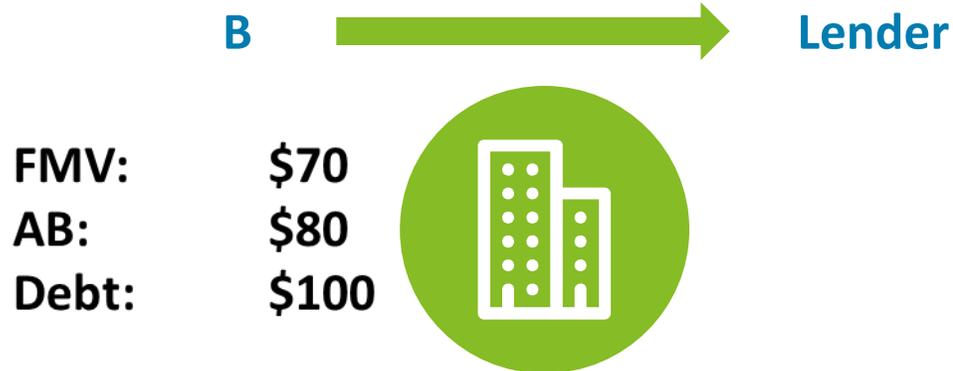
FMV:	\$70
AB:	\$80
Debt:	\$100

Deed in Lieu of Foreclosure

Borrower – Recourse Debt

Recourse debt

Sale of the property at FMV + CODI for shortfall



- B's transfer of the property represents a \$70 payment on the loan
- B realizes gain or loss on the property based on FMV
- \$10 loss = \$70 amount realized and \$80 AB
- If the loan is cancelled, B has \$30 of CODI

Deed in Lieu of Foreclosure

Borrower – Nonrecourse Debt

Nonrecourse debt

Amount realized = debt relief; no CODI



- The amount realized = liability relief
- B is treated as selling the property to lender for \$100
- Gain on the property = \$100 amount realized - \$80 AB = \$20 gain

Deed in Lieu of Foreclosure

Borrower – Recourse vs. Nonrecourse

Recourse	Nonrecourse
Property sold at FMV	Property sold for amount of debt
Shortfall = CODI	N/A
\$10 loss on property	\$20 gain on property
\$30 CODI	\$0 CODI
<i>See Reg. §1.1001-2(c), Example 8</i> <i>See also Rev. Rul. 90-16</i>	<i>See Reg. §1.1001-2(c), Example 7</i>

* Query whether the *Tufts* result in Reg. §1.1001-2(c) may be reconciled with Rev. Rul. 91-31?

- Example 7 concludes the transferor does not realize CODI despite the deficiency because the transferor is not personally liable, yet
- Rev. Rul. 91-31 holds reduction of nonrecourse debt results in CODI

Short Sale

Borrower

- Can a short sale be taxed the same as a deed in lieu of foreclosure?
- With a short sale, the property is transferred to a third-party buyer, not the lender



Short Sale

Borrower (cont'd)

- Compare *Gershkowitz v. Comm'r*, 88 T.C. 984 (1987)
 - Short sale of property encumbered by nonrecourse debt
 - Cancellation of debt without transfer of property resulted in COD income
- With *2925 Briarpark, Ltd. v. Comm'r*, 163 F.3d 313 (5th Cir. 1999)
 - Three-party transaction involving borrower selling the property to a buyer for \$11 million, with the lender agreeing to accept \$11 million and release the lien on nonrecourse debt
 - Buyer did not assume the debt
 - Treated as the functional equivalent of a deed in lieu of foreclosure
- Form can matter
 - The transfer of collateral was only 3 months after the discharge of debt in *Gershkowitz*



Partnership Debt-for-Equity and Transactions with Partners

Partnership Debt-for-Equity

Section 108(e)(8)

- Under §108(e)(8)(B), a debtor partnership that transfers a capital or profits interest to a creditor in satisfaction of indebtedness owed by the partnership is treated as satisfying the indebtedness for an amount of money equal to the fair market value of the interest transferred to the creditor
 - Applies to both recourse and nonrecourse indebtedness
 - All facts and circumstances are considered in determining the FMV of the partnership interest; *see* Reg. §1.108-8(b)(1) (safe harbor, if met, liquidation value equals deemed sale at FMV)
- Any CODI recognized by the partnership must be allocated to the taxpayers who were partners in the partnership **immediately before** the discharge

Partnership Debt-for-Equity

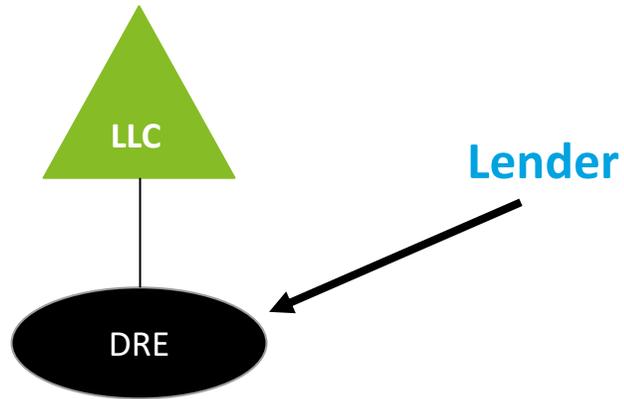
General Nonrecognition Treatment of Exchange

- Section 721 generally applies to a contribution of a partnership's indebtedness by a creditor to the debtor partnership in exchange for an interest in the partnership; *see* Reg. §1.721-1(d)(1)
 - Section 721 does *not* apply, however, to the transfer of a partnership interest to a creditor in satisfaction of a partnership's indebtedness **for unpaid rent, royalties, or interest on indebtedness** (including accrued OID) that accrued on or after the beginning of the creditor's holding period for the indebtedness; *see* Reg. §1.721-1(d)(2)
 - Even if the debtor partnership transfers a partnership interest to a creditor in a debt-for-equity exchange for unpaid rent, royalties, or interest (including accrued OID), the **debtor partnership does not recognize gain or loss** on the transfer; *see* Reg. §1.721-1(d)(2)
- Partners may recognize gain under §731(a) as a result of a deemed distribution of money under §752(b)

Partnership Debt-for-Equity

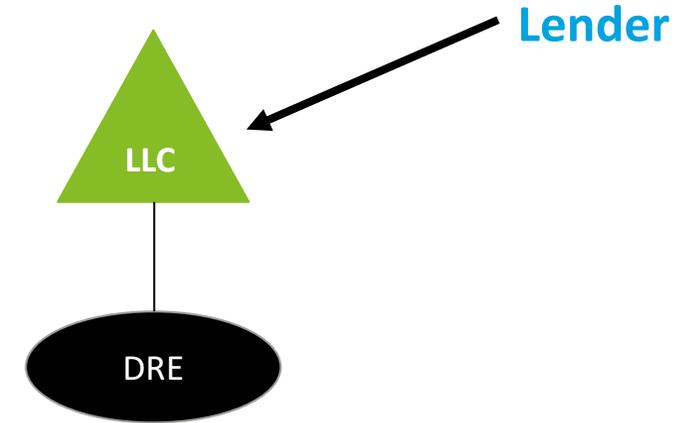
Foreclosure Effect vs. Contribution

Rev. Rul. 99-5, Situation 1



- Lender takes partial equity in DRE in exchange for debt
- Partnership has a deemed proportionate sale of DRE's asset to Lender (*i.e.*, deemed foreclosure) under Rev. Rul. 99-5, Situation 1
- Section 108(e)(8) does not apply; no CODI if debt is nonrecourse

Contribution to Partnership



- Lender takes equity in LLC in exchange for debt
- Partnership could have CODI under §108(e)(8)

CODI Continued – Exclusions, Allocations, and Deemed Distributions

CODI Exclusions

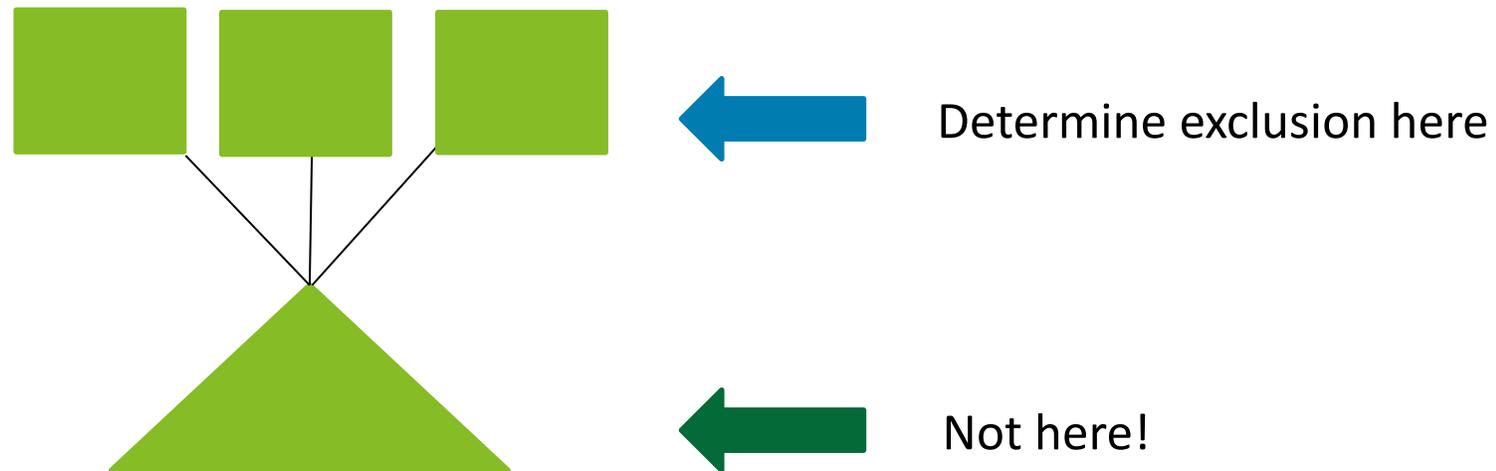
In General

- Section 108(a)(1) provides potential exclusions for CODI from gross income
 - Bankruptcy
 - Insolvency
 - Qualified farm indebtedness
 - Qualified real property business indebtedness (“QRPBI”), or
 - Certain qualified principal residence indebtedness
- Taxpayers “pay for” excluded CODI with attribute reduction - §108(b):
 - NOLs, general business credits, minimum tax credits, capital loss carryovers, basis of taxpayer’s property, passive activity loss and credit carryovers, and foreign tax credit carryovers
 - Favorable “black hole” CODI situation: where taxpayer has insufficient attributes for full dollar-for-dollar reduction

CODI Exclusions

Insolvency and Bankruptcy

- The insolvency and bankruptcy exclusions are applied at the partner level; see §108(d)(6)
- Therefore, the insolvency or bankruptcy of the partnership are not directly relevant to applying these exclusions



CODI Exclusions

QRPBI

- Section 108(a)(1)(D)
 - Excludes CODI from discharge of QRPBI
 - FMV limitation: Excluded amount is limited to the excess of (1) pre-discharge debt principal over (2) the FMV of real property securing the QRPBI (net of all QRPBI) (*see* §108(c)(2)(A))
 - Basis limitation: Excluded amount limited to taxpayer's aggregate pre-discharge basis in depreciable real property (*see* §108(b)(2)(B))
 - Note: Exclusion does not apply to C corporations

CODI Exclusions

QRPBI (cont'd)

- QRPBI is
 - Secured by real property used in a trade or business
 - Incurred or assumed to acquire, construct, repair, or substantially improve the real property
- Applied at the partner level
- Excluded CODI is applied to reduce basis of taxpayer's **depreciable** real property (see §§108(c)(1) and 1017)
 - Depreciable real property includes an interest in a partnership to the extent of the partner's share of the partnership's depreciable real property

CODI Allocation by Partnership

General Rules

- CODI is income of the partnership that is allocated to the partners subject to the rules of §704
 - The legislative history to the 1980 Bankruptcy Tax Act assumes that CODI will be allocated among partners in the same way that the discharged liability was shared by the partners under §752
 - Rev. Rul. 92-97 recognizes that, in some cases, CODI may be allocated in a manner other than how the liability is shared
 - Must consider partnership minimum gain (Reg. §1.704-2)
- When partners' interests vary, CODI generally must be allocated among the partners in proportion to their interests in the partnership item at the time of day on which the CODI occurred (*see* Reg. §1.706-4(e)(2)(vi))

CODI – Partnership Deemed Distributions

Deemed Distributions of Money under §752(b)

- A decrease in partner's share of partnership liabilities causes a deemed distribution of money under §752(b)
- Distribution of money in excess of a partner's basis in its partnership interest results in the partner recognizing gain under §731(a)
- Partner increases basis in its partnership interest for allocable share of CODI even if CODI is excluded (S. Rep. No. 96-1035 (1980))
- Drawing rule
 - Advances or draws of money or property against a partner's distributive share of income are treated as current distributions made on the last day of the partnership's taxable year with respect to the distributee
 - Deemed distributions under §752(b) are treated as advances/draws to the extent of the partner's distributive share of income for the partnership taxable year (see Rev. Ruls. 92-97 and 94-4)

Debt Modification



Debt Modification

In General

- CODI can arise from satisfaction of a debt for the issuance of a new debt instrument, including a deemed exchange of debt caused by a “**significant modification**” under Reg. §1.1001-3 (§108(e)(10))
 - **Bright line tests** for significant modification
 - Outcome can depend on debt’s **recourse/nonrecourse** status
 - PLR 202337007 (state law approach to modification determination)
 - Deemed exchange of the debt (unmodified for modified)
 - Often no CODI arises from a modification if the debt is not reduced; but confirm debt is not “**publicly traded**” (Reg. §1.1273-2(f)) and modified rate is not less than **AFR**
 - **Example**, \$1,000 debt with 5% interest rate is modified by reducing the interest rate to 0% for an additional 5 years
 - Assume AFR is 4.04%
 - Adjusted issue price of unmodified debt is \$1,000
 - Issue price of modified debt is \$820
 - CODI is \$180, §108(e)(10)
 - $PV = FV / (1+r)^n$ or $\$1,000 / (1+0.0404)^5$

Debt Modification

Retest Requirement

- Modified debt must be retested for status as debt for tax purposes, Reg. §1.1001-3(e)(5)
 - **Factors:** *Estate of Mixon v. United States*, 464 F.2d 394 (5th Cir. 1972); Notice 94-47
 - Certain factors very problematic if debt is distressed
 - Relaxed by Reg. §1.1001-3(f)(7)
 - **Ignore deterioration of financial condition**
 - Change in obligor exception
 - For reference, see modification rules applicable to changes in obligor, Reg. §1.1001-3(e)(4)(i)-(iii)
 - Tax fiction, see, e.g., GLAM 2011-003 (check the box liquidation of insolvent corporation)
 - State law determines entitlements, *Aquilino v. U.S.*, 363 U.S. 509, 513 (1960), cited in PLR 202337007 (obligor converted from LLC-DRE to corporation, no change in obligor)
 - Appropriate to read “change in obligor” as change in collateral with respect to nonrecourse debt



Debt Modification

Retest Requirement

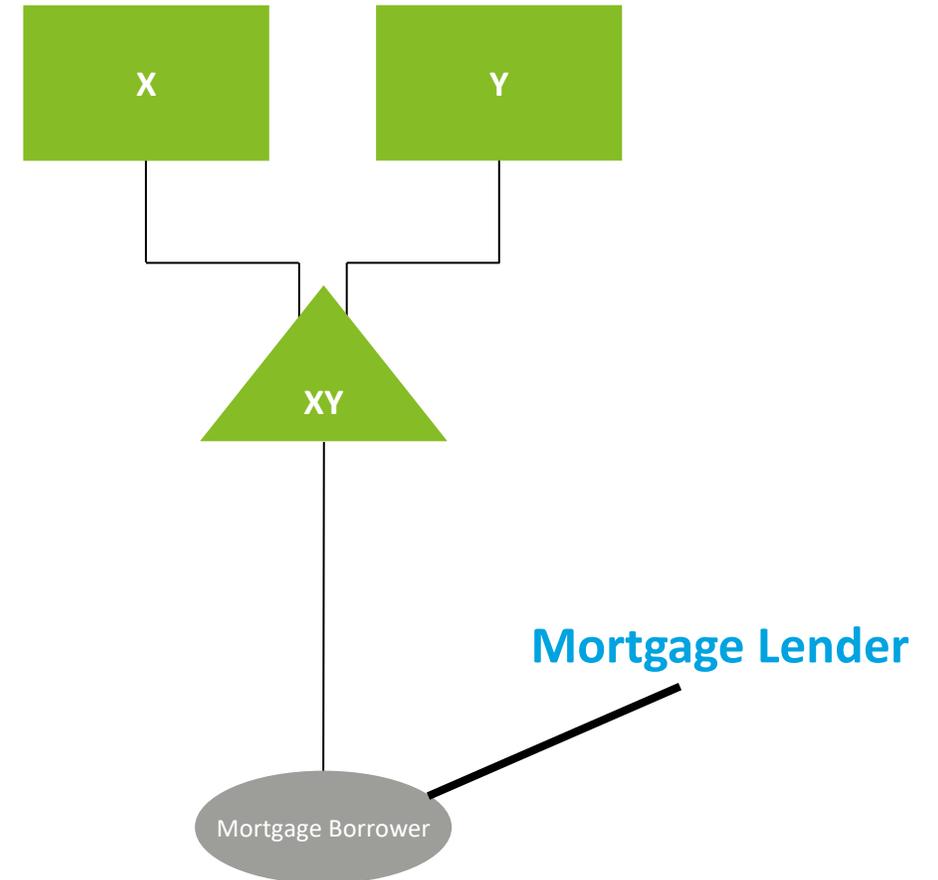
- Modified debt must be retested for status as debt for tax purposes, Reg. §1.1001-3(e)(5)
 - Relaxed by Reg. §1.1001-3(f)(7)
 - Adjust common law factors
 - Type of factors that may be ignored, i.e., those that examine the ability to service the debt in a corporation
 - Thin cap, lack of reasonable expectation of repayment or security
 - Whether a third party would lend under the modified terms
 - The fact that the debtor requires an infusion of cash
 - Types of factors that may not be ignored
 - Removal of a maturity date
 - “Equity”
 - Any **new debt** must be tested under usual common-law factors
 - Important, for example, if modified debt is subordinated to new debt

Debt Modification

Bifurcated Debt

- **Example I**

- Assume office property has declined in value to \$55 from its \$100 purchase
 - Property held by DRE-LLC, adjusted basis \$70
 - Mortgage is \$60 plus accrued and unpaid interest of \$30 (nonrecourse debt)
 - Additional capital of \$20 required for capex to convert office to residential
 - Tax issue: avoid out of pocket costs for tax on CODI



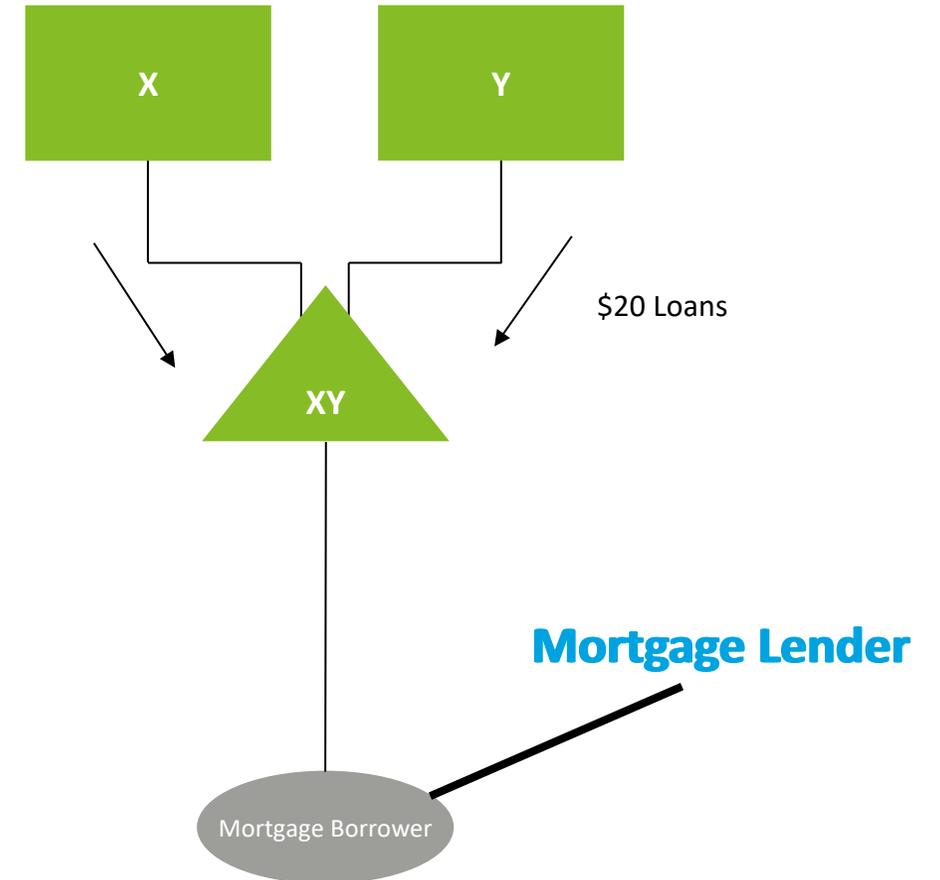
Debt Modification

Bifurcated Debt

- **Example I**

- Proposed Modification:

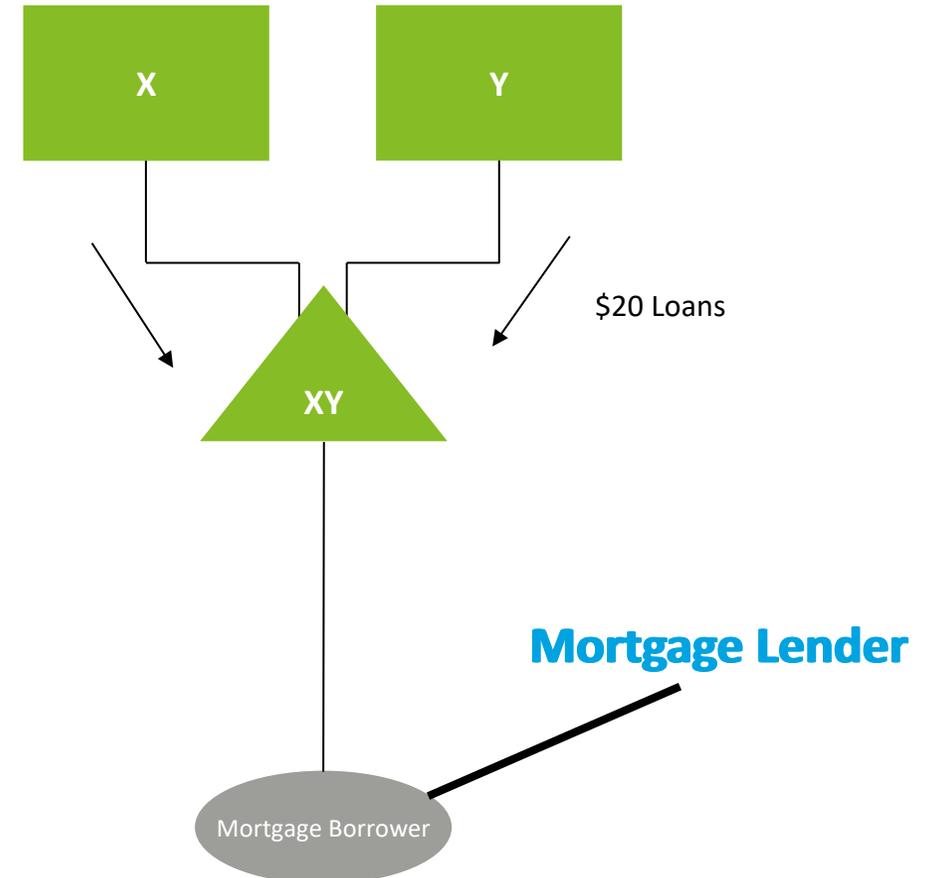
- Bifurcate mortgage into an A note of \$50 with a 5-year maturity and at the same interest rate as the original mortgage and a B note of \$40 that has no interest rate, 5-year maturity and is subordinated to the \$20 of additional capital
 - \$20 new money in the form of a 5-year 10% loan from X & Y to XY
 - Parties agree to a waterfall on sale or refinancing:
 - Repay principal and accrued and unpaid interest on A note
 - Repay the new money loan and accrued and unpaid interest
 - Repayment principal on B note
 - Residual distribution to X & Y
 - Projections demonstrate a current pay of the A note's interest plus interest on the new money loan and upon sale in 5 years a full repayment of the A & B notes, and repayment of the new money loan, plus residual net cash flow to the X & Y



Debt Modification

Bifurcated Debt

- **Example I**
 - Debt modification and CODI analysis
 - The bifurcation is a “modification” of the original mortgage
 - The modification is a “significant modification” because of the extended terms of both notes and the change in interest rate of the B note; resulting in a deemed exchange of the debt

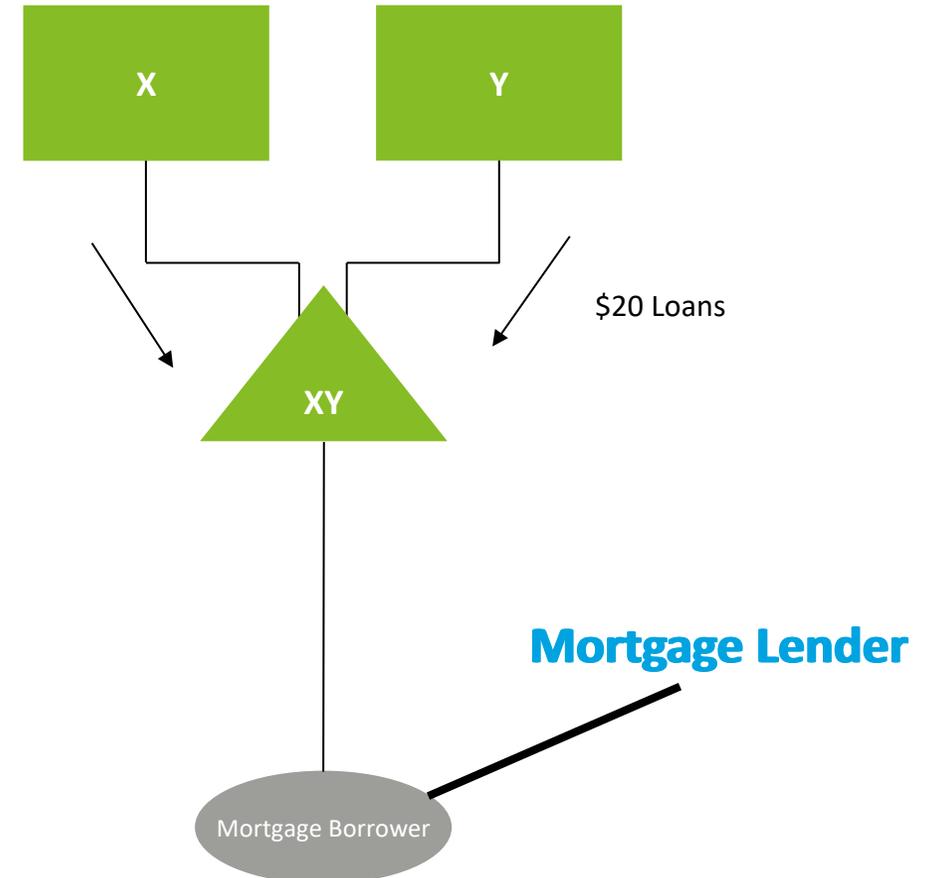


Debt Modification

Bifurcated Debt

- **Example I**

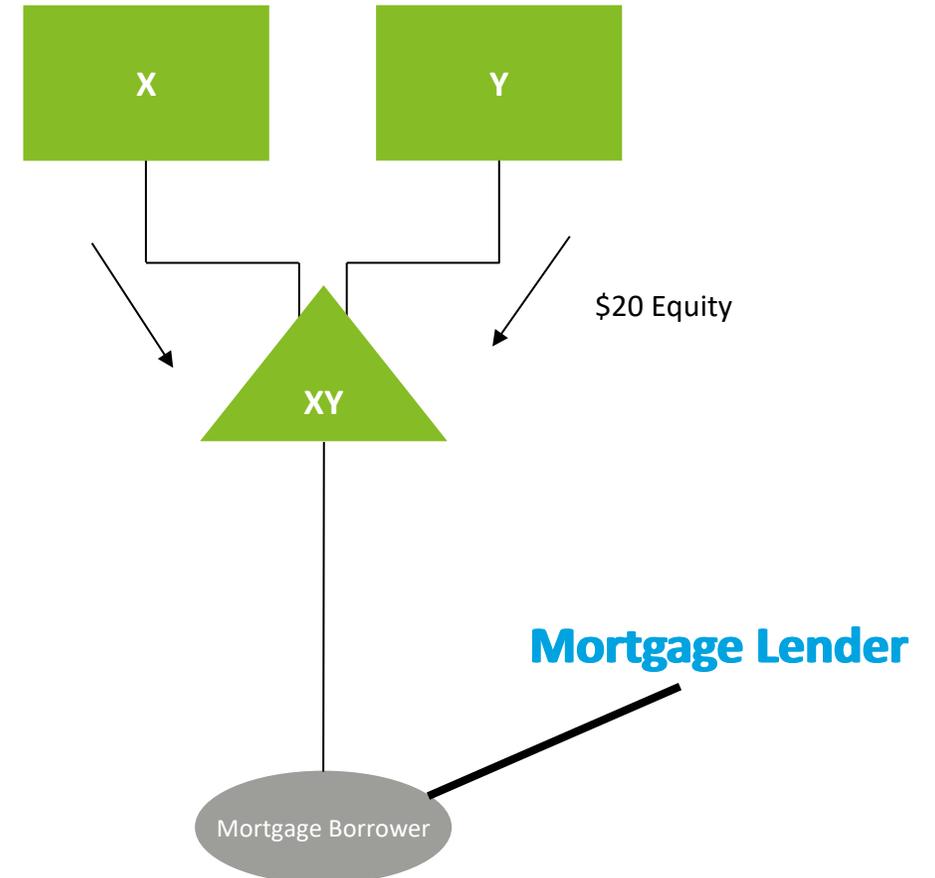
- Debt modification and CODI analysis (cont'd)
 - Retest: no change in obligor; ignore deterioration in financial condition
 - Other factors to consider
 - Form of debt, maturity date, and unconditional obligation to repay
 - Extended maturity by 5 years not sufficient to affect debt status
 - Zero interest rate?
 - Parties can agree to a zero rate on a debt instrument
 - See *Kena, Inc. v. Comm’r*, 44 B.T.A. 217, 221 (1941); §§7872, 1274, 483
 - Subordination?
 - Arguably the factor only matters if there’s distress
 - If the factor must be taken into account,
 - Bullock v. Comm’r*, 26 T.C. 276 (1956) (subsequent subordination)
 - X & Y’s \$20 loan also must be analyzed for debt status
 - Projections would seem to support a reasonable expectation of repayment
 - \$55 of value plus \$20 of new money
 - >>> B note likely debt for tax purposes
 - CODI to extent the adjusted issue price of the A & B notes is less than \$90



Debt Modification

Bifurcated Debt

- **Example II – same as Example I except new money is a contribution to capital by X & Y**
 - Debt modification and CODI analysis
 - Retest:
 - Subordination to equity?
 - Hallmark of debt is it's not subordinate to equity
 - Arguably the factor only matters if there's distress, which is to be ignored
 - If the factor must be taken into account,
 - Creditor is just trying to maximize recovery of its loan
 - B note was not contributed to capital, and form of debt remained, maturity date, and unconditional obligation to repay;
 - Was the lender made a member of the LLC? (demonstrates intention by parties as debt)

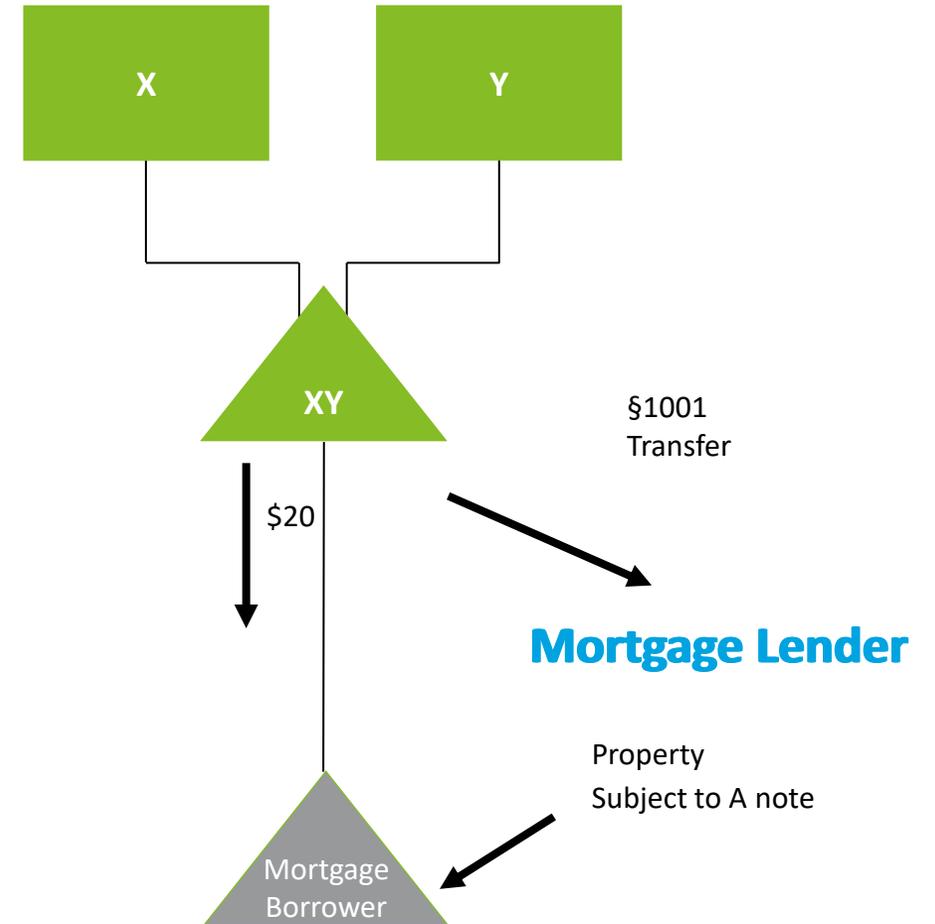


Debt Modification

Bifurcated Debt

- **Example II**

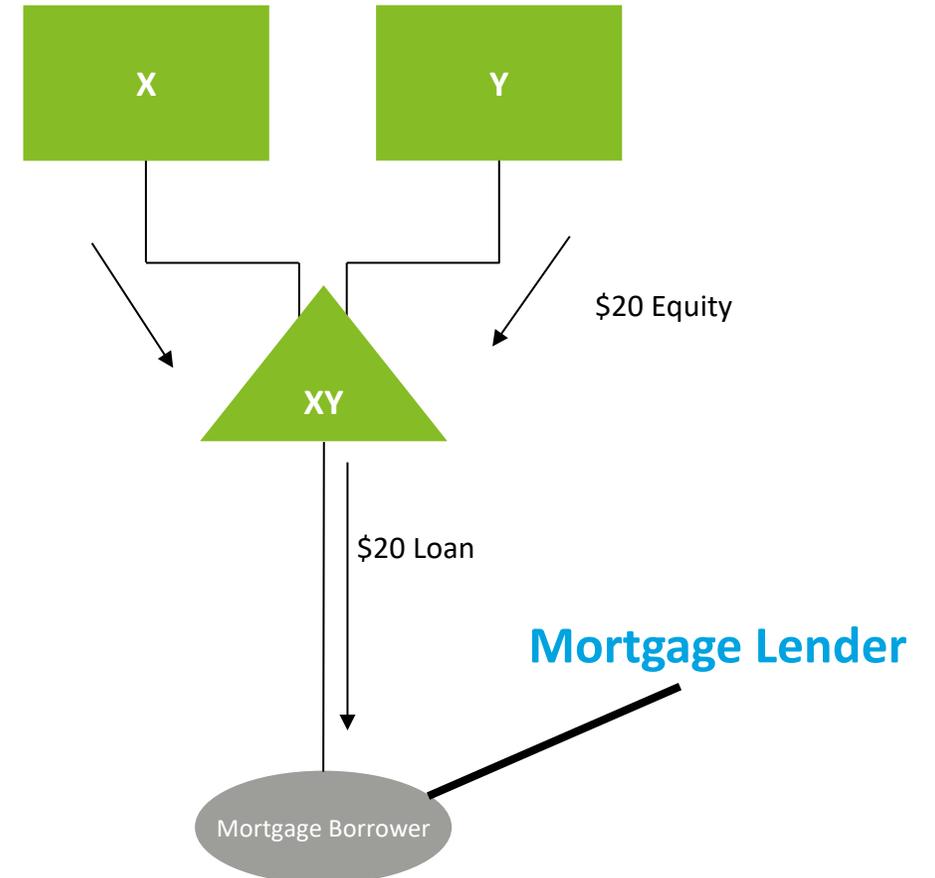
- Debt modification and CODI analysis
 - If B note is not debt for tax purposes, CODI analysis
 - B note is legal debt of Mortgage Borrower
 - Rev. Rul. 99-5, Sit. 1, Reg. §1.1001-2
 - No CODI for discharge of B note under Reg. §1.1001-2
 - Adjusted basis of property \$70
 - Unmodified debt \$90
 - Gain \$20 to Project JV
 - Followed by deemed contributions of \$20 and \$55 value property subject to \$50 A Note



Debt Modification

Bifurcated Debt

- **Example III – XY lends X & Y’s contribution to the Mortgage Borrower?**
 - Waterfall at Mortgage Borrower (DRE-LLC)
 - Subordination of B note expressly to another debt
 - Retest:
 - Loan from Project JV disregarded for tax purposes
 - Is B note subordinated to equity of JV?
 - PLR 201644018
 - Does state-law have primacy?
 - B note is subordinated to state-law debt of Mortgage Borrower
 - PLR 202337007



Debt Modification

Bifurcated Debt

- **Example IV – same facts as Example I, except that the projections aren't quite as rosy!**
 - Subordination to other debt
 - Reg. §1.1001-3(f)(7) – should it matter?
 - Could impact whether the new debt is debt for tax purposes
 - Subordination to equity
 - More gain, less loss (or more CODI depending on the structure)
 - B note may not be substantial enough to be regarded as an ownership interest in the LLC, i.e., no deemed new partnership



Conclusion





This presentation contains general information only and Deloitte is not, by means of this presentation, rendering accounting, business, financial, investment, legal, tax, or other professional advice or services. This presentation is not a substitute for such professional advice or services, nor should it be used as a basis for any decision or action that may affect your business. Before making any decision or taking any action that may affect your business, you should consult a qualified professional advisor.

Deloitte shall not be responsible for any loss sustained by any person who relies on this presentation.

This document is for internal distribution and use only among personnel of Deloitte Tax LLP. Deloitte Tax LLP shall not be responsible for any loss whatsoever sustained by any person who relies on this document.

As used in this document, "Deloitte" means Deloitte Tax LLP, a subsidiary of Deloitte LLP. Please see www.deloitte.com/about for a detailed description of our legal structure. Certain services may not be available to attest clients under the rules and regulations of public accounting.