SWAN + GARDINER

CERTIFIED PUBLIC ACCOUNTANTS

TAX TREATMENT OF ABANDONED / FORECLOSED LAND HELD IN LLCS

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Many of our real estate clients have called and emailed us for assistance and information about general guidelines for the tax treatment of cancellation of debt with non-recourse and recourse debt. Swan and Gardiner is committed to helping our clients understand important matters affecting their businesses and we have prepared the following to provide additional information and help clarify these issues.

When raw land held for investment in an LLC is abandoned or foreclosed on, this may create a taxable event for the members of the LLC. To determine the taxability of the transaction, we first need to look at the type of loan on the property.

Is the loan *recourse* or *non-recourse* debt?

Non-Recourse

A *non-recourse* loan is one that is secured *only* by the property. If the borrower (LLC) defaults on the loan, the lender can seize the property and borrower (LLC) will not be liable for any deficiency. When a property that is encumbered by a non-recourse loan is abandoned or foreclosed, the property is treated as if it was sold. The sales price is the amount of the loan on the property. A capital gain or loss (long term or short term depending on the holding period) will result. **There is no cancellation of debt income with non-recourse loans**.

Recourse

A recourse loan is one in which the lender has the ability to fall back on a guarantor of the loan if the borrower (LLC) fails to pay. When a property that is encumbered by a recourse loan is abandoned or foreclosed, there are two parts to the transaction. First, the property is treated as if it was sold. The sales price is the fair market value (FMV) of the property. In this case, the note amount is not necessarily the value of the property. Depending on the FMV a capital gain or loss will result. The capital gain / loss will be allocated based on ownership among all of the members of the LLC. In the second part of the transaction, there is a comparison made between the FMV of the property and the amount of the loan. If the loan is higher then the FMV of the property, **cancellation of debt (COD) income will occur.** The COD income will be allocated to the members who hold the ultimate economic risk of loss on the loan (ie the personal guarantor of the loan). <u>COD income is treated as a flow through item on the K-1 and the ultimate taxability of the COD income is determined on the individual tax return</u>.

Not all Cancellation Of Debt (COD) income must be included as gross income on an individual tax return.
The exceptions are as follows:

- *Bankruptcy*
- *Insolvency –when total liabilities exceed FMV of assets (see worksheet)*
- *Qualified farm indebtedness*
- *Qualified real property business indebtedness*

Call us with the following to discuss your specific situation.
(702) 869-9700

- **Loan documents**
  Non-recourse or recourse loan
  Guarantor of loan
- **If recourse, documentation of FMV of property**
  (appraisal or comparables)
- **COD checklist, documentation of values**

This example is meant to illustrate the difference between recourse and non-recourse debt.

FMV $500,000
Note $750,000
Cost $600,000

<u>Non-recourse debt</u>
Gain on sale $150,000
($750,000 -$600,000)

<u>Recourse debt</u>
Loss on sale $100,000
($500,000 - $600,000)

COD income $250,000
($750,000- $500,000)

Visit swanandgardiner.com for a <u>FREE</u> Insolvency Worksheet to help you determine your taxable COD income!