



Finding Solutions to Troubled Loans Work Out with Care, but Don't Go It Alone



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You don't have to be a corporate giant to be searching for solutions to troubled debt these days. CPAs are working with clients at all ends of the spectrum on "workouts" to resolve complicated tax scenarios stemming from troubled loans. In this article I address several specific scenarios: debt on a personal residence, debt on an asset held for appreciation and debt on business-related property.

The key takeaway is caution. The instruction booklet that came with your treadmill urges you to exercise carefully. That's precisely the advice I offer to clients tackling loan workouts. It's easy to get hurt if you're not mindful of the pitfalls.

Home, Sweet Debt

Debt on one's personal residence has its own income tax rules and structure, distinct from other types of debt. The key issues are whether the

home is used by the taxpayer as a principal residence, and whether the debt forgiveness is due to a foreclosure or writing down of the debt as part of a negotiation or short sale. If either is the case, up to \$2 million in debt forgiveness can be excluded from income tax as long as it was debt incurred to acquire the home.

Let's do the math. Assume that an individual borrowed \$400,000 to purchase a home. She was unable to make the payments and the bank foreclosed on the property, estimating its value at \$250,000. From a tax perspective, the owner is deemed to have sold the house for \$250,000. The IRS deems this a personal loss, which is not deductible.

But that's not the end of the story. In this case, \$150,000 worth of debt has been forgiven. Forgiveness of debt is generally considered

ordinary income, but due to recently passed rules it may not be taxed under the right circumstances.

If the home has been refinanced several times it is still possible to have a taxable gain on the home even after all of the other exclusions have been applied.

Far from Home

Now consider a situation involving debt on a property that is not one's personal residence. The owner purchased a home for \$400,000 with borrowed funds and with the intent to "flip it," that is, to sell it at a profit in a reasonably short time period. But that didn't come to pass. The owner was caught somewhere between the real estate slowdown and the economic meltdown,

and the bank foreclosed on the property, determining its worth at \$250,000.

Here, the taxpayer is looking at a capital loss of \$150,000 and ordinary income of \$150,000. Current IRS rules limit the deduction to \$3,000 of that loss, unless there are other capital gains. This is different from the personal loss described above, which is not deductible but has special rules that apply. In this case the loss is on a sale of an asset purchased for investment. The taxpayer reports the \$150,000 loss on her return, can only carry \$3,000 of that loss to the front page, directly offsetting her taxable income and reports \$150,000 of COD (cancellation of debt) income taxed as ordinary income. This could create a significant tax liability from this “phantom income”. The taxpayers solvency can affect how this income is reported.

What about larger loans, for example those made by and for businesses? My colleagues and I have been actively involved in many troubled debt workouts in this category. They can be complicated and the tax implications need to be carefully considered.

Let’s consider the fictitious owner of a significant asset, for example

a mobile home park that has operated in the black for a number of years. For a variety of reasons the rent generated can no longer cover the owner’s operating expenses and debt. He wants out.

In a case like this the owner has the opportunity to (and often should) return to the lender to potentially work out an arrangement for some type of forbearance or modification on the loan. The right strategy would permit the mobile home park to survive the current difficulties and, theoretically, the borrower would be able to pay on the debt in the future.

An important distinction in business loans is between nonrecourse and recourse debt. A nonrecourse loan is one secured by a pledge of collateral, typically property, for which the borrower is not personally liable. In a default, the lender is limited to reclaiming the collateral. If the property value is insufficient to cover the loan, the lender absorbs the difference.

Proceed with Caution (and Assistance)

In their eagerness to save their homes and businesses, individuals can potentially misstep when attempting to fix troubled

loans. A trusted professional should always help structure and present the offer. That’s especially true with business loans when prospective financial statements and other documentation can help “sell” the lender on the future viability of the deal. The opportunities for negotiating a workout are diverse; handing the property back to the lender is not the only answer.

CPA Richard E. Goble is a Shareholder with Kerkering Barberio & Co., P.A. in Sarasota, FL. His areas of practice include Forensic Accounting and Litigation Support and Individual and Business Tax Consulting. He specializes in Real Estate Support Services and is recognized for his knowledge in the area of 1031 Exchanges. Mr. Goble joined Kerkering Barberio in 1978 and was admitted as a Shareholder in 1979. From 2000 through 2002, he served as Managing Shareholder.