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Working With Your Commercial Real Estate Lender

Thanks to COVID-19, the commercial real estate industry is struggling. If your clients have invested in CRE, now's the time to help them ensure they're taking care of their assets, whether that means working out the terms of debt repayment with their lender or possibly handling a foreclosure. In his first article for AccountingWEB, CPA James Philbin, a partner at Marcum LLP, explains what you need to know.

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The COVID-19 pandemic continues to place significant pressure on the commercial real estate industry. Without an adequate stream of rental revenue, many CRE owners are not able to make full and/or timely debt service payments, which have led to increasing numbers of delinquencies and defaults on mortgage loans. With debt impairment looming and a decrease in real estate value likely, owners should consider workout opportunities with their lenders. Owners also need to consider the tax planning consequences of potential outcomes for resolving the debt impairment, including loan modification and possible real estate foreclosure.

Loan Workouts – Forbearance and Modification Agreements with Lenders

Lenders may be willing to provide short-term forbearance or a permanent loan modification to property owner borrowers as an alternative to foreclosing on the

property. Legal costs and time lag are reasons the lender may consider foreclosure as a last-resort measure. Traditional lenders, including banks and insurance companies, do not generally have the resources to operate commercial real estate. Additionally, the lender and owner may have a longstanding relationship and other existing engagements within the owner's portfolio.

Forbearance agreements offer short-term relief to borrowers, as the lender agrees not to take enforcement action with respect to certain defaults for a specified time. In the agreement, the borrower should acknowledge all existing and potential defaults in order to avoid early termination of the agreement as a result of a nondisclosed triggering event. The borrower's disclosures are important, from the lender's perspective, to limit the borrower's ability to contest the existence of those defaults if the lender elects to exercise remedies after the termination of the forbearance period. Forbearance agreements may provide for financial relief, including interest-only payments during the forbearance period, or allowing the borrower to use escrow reserves to fund operating deficits. The agreement will likely require an update of the borrower's representations and warranties and a release of any claims against the lender prior to the date of the forbearance.

Borrowers and lenders may enter into permanent loan modifications either in lieu of or after executing a forbearance agreement. Modifying the loan is practical from the lender's standpoint if the net present value of the stream of the adjusted loan payments post-modification exceed "Modification" means any alteration, including any deletion or addition, in whole or in part, of a legal right or obligation of the lender or borrower, whether the alteration is evidenced by an express agreement (oral or written), conduct of the parties or otherwise. A modification can occur from amending the existing loan or through exchanging one debt instrument for another.

Modifications that a lender may concede to include an extension of the loan maturity date, waivers or deferrals of interest payments and changes to financial covenants (debt service coverage ratio or debt yield tests). Borrowers will be required to pay a fee to the lender for the loan modification and will likely have to provide the lender with additional concessions and loan support, including provisions for additional security (additional equity contribution to reduce debt, expanded guaranties, letters of credit or cash collateral). The borrower may also be subject to greater lender oversight of cash management and discretionary spending and distributions. There may be additional reporting obligations.

The income tax consequences of loan modifications or forbearances depend on several factors, including the significance of the modifications, the size of the debt and whether the debt is publicly traded. If the modifications are "significant," then, for federal tax purposes, the borrower is treated as having paid off the original loan with

the modified loan. Under such an exchange, the lender may recognize taxable gain or loss. The borrower may recognize cancellation of debt income (CODI) for the reduction of the loan amount.

Insolvent borrowers or those in bankruptcy can exclude some or all CODI from taxable income. The CODI amount must be applied to reduce the borrower's tax attributes (such as NOL carryforwards or the tax basis of depreciable assets) to the extent of the excluded CODI. Additionally, non-corporate borrowers may elect to exclude CODI derived from the discharge of qualified real property business indebtedness. The borrower is required to reduce the basis of depreciable real property to the extent that CODI is excluded from income.

Modification or amendment is significant based upon facts and circumstances, which could include any of the following changes:

- Loan yield - a change in yield greater than the greater of 25 basis points or 5 percent of the yield of the unmodified loan
- Timing of payments – an extension of 5 years or 50 percent of the original term of the loan
- Change in obligor or security - substitution of a new obligor on a recourse loan
- The nature of a debt instrument - modification of the loan such that it is no longer considered debt for federal income tax purposes
- Changes to accounting or financial covenants – tied to a borrower payment that would change the loan yield

Foreclosures

Some sectors of commercial real estate have been hit especially hard by the pandemic, including retail malls and hospitality. Valuations have fallen and an owner's cash flow forecast for the property may not be sufficient for the lender to offer forbearance or modification to keep the loans outstanding. The lenders could foreclose on the real property and take title to the real estate. The foreclosure can be cast in any one of several forms. The status of the debt as recourse or nonrecourse affects whether tax issues related to cancelled debt apply.

In a strict foreclosure, a court of law orders the property to be conveyed to the lender in full satisfaction of the debt. There is no sale of the property, and the conveyance of the property to the lender is deemed payment of the mortgage.

Gain or loss to the owner in a foreclosure in which the lender takes title is computed in the same manner as if the property had been sold to a third party. The owner's gain or loss is measured by the difference between the deemed sales price, which, in the

case of a nonrecourse obligation, includes the amount of the mortgage obligation extinguished, and the basis in the property. If a recourse debt is extinguished, the deemed sales price is limited to the value of the property. Debt cancelled in excess of the foreclosure value is treated as cancellation of indebtedness income.

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