

Phantom Income Problems for Note Purchasers

Over the past few months we have seen a significant increase in note purchase transactions. In representing note purchasers, much of the discussion previously focused on the various issues that would arise if the borrower filed for bankruptcy. However, seasoned note purchasers are now turning their focus to the hidden tax costs involved in a note purchase and taking measures to adopt affirmative steps to mitigate these costs.

Original Issue Discount

In general terms, the purchase of a note at a price that is less than the amount owed under the note will create several potential tax problems. First, under the so-called "original issue discount" rules, if the note is acquired at a discount, there are circumstances in which the note purchaser will be required to recognize taxable income each year in an amount equal to the amount of the discount divided by the number of years remaining on the note. As a result, in the absence of affirmative tax planning, a note purchaser, whose ultimate goal is to take title to the real property securing the note, might have to recognize interest income during the foreclosure process, notwithstanding that no payments are being made.

Bid Price Issue

In addition to the original issue discount problem, note purchasers also face potential for phantom income when they take ownership of the real property securing the note. The Treasury Regulations promulgated under Code Section 166 provide that the amount bid in the foreclosure sale is presumed to be the fair market value of the property. These Treasury Regulations provide that "clear and convincing" proof is required to rebut this presumption. Thus, in the absence of affirmative tax planning, a note purchaser who bids the amount owed under the note in the foreclosure could be required to recognize short-term capital gain at the time it obtains title to the property in an amount equal to the amount by which the bid price exceeds the amount paid by the note purchaser to acquire the note.

Tax Planning to Avoid Phantom Income

As is the case with many tax issues, the tax costs arising from the original discount issue and the bid price issue can be significantly reduced, if not eliminated, through pro-active planning at the time of the note purchase. In fact, some of the strategies that can be adopted to address these tax issues can also be used to increase the negotiating leverage against the borrower.

For example, some note purchasers have unilaterally written down the principal amount owed as a way to reduce the amount of phantom income that would arise under the original issue discount rules. This write-down will create cancellation of indebtedness income for the borrower. Done in a serial manner, the continued creation of cancellation of indebtedness income while the foreclosure process plays out could force the borrower's hand to cooperate with the foreclosure process.

Another example is the use of an LLC roll-up strategy. In the LLC roll-up strategy, the borrower typically contributes the real property securing the note to a newly formed LLC. The new LLC will be structured such that both note purchaser and the borrower will own interests in the LLC, with the note purchaser owning "preferred units", and the borrower owning "common units". In this structure, the note is written down by the note purchaser and restructured so it can be currently funded by the cash-flow from the property. In most circumstances, the LLC roll-up strategy will help the note purchaser mitigate the tax costs associated with the original issue discount issues (since the note purchase discount amount will diminish due to the write down of the note), and will eliminate the tax costs arising under the bid price issues (because the need to foreclose is eliminated). The use of this strategy can also help the borrower defer the tax costs that it would face in a foreclosure, since there is no deemed sale of the property for tax purposes.

There are several other strategies that can be adopted to minimize the phantom tax costs in a note purchase. However, none of these can be adopted after the note purchaser forecloses on the real property securing the note. Therefore, in addition to the bankruptcy, real estate, financing and other considerations traditionally examined by purchasers in note purchase transactions, it is critical that note purchasers also evaluate the phantom income risks early on in the process and endeavor to adopt structures that will minimize same.

The tax attorneys within Freeborn & Peters' Real Estate and Land Use Practice Group are well-versed in this area and have been involved in numerous negotiations concerning phantom income issues. We encourage you to reach out to us with any questions you may have in connection with this complex topic.

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