



# Real Estate Report

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## Cancellation of Debt Income

by: Tom Cox, Tax Supervisor

Cancellation of debt income (CODI) is becoming more prevalent as a result of the continuing economic slump. All types of real estate investors, from the large commercial investor to the small rental property owner and even the mere owner of a principal residence, are subject to the tax laws regarding CODI. CODI can arise from a straightforward forgiveness of debt, a foreclosure, a short sale or from a significant modification in loan terms.

Although CODI is taxable income in general, there are a few opportunities to minimize the tax effect of CODI, and in some cases, eliminate it completely.

### *Recourse vs. Non-recourse Debt*

The first step in analyzing any potential CODI situation is to determine the type of debt. If the lender has the right to obtain a judgment against the borrower for any deficiency, that type of loan is considered recourse debt. If the debtor can walk away from the debt without any further consequences, then the debt is considered non-recourse debt.

Non-recourse debt does not give rise to CODI since the debt is considered fully satisfied upon the return of the secured property. The borrower, in the case of non-recourse debt, reports the foreclosure as a sale which may be a gain or a loss depending on the tax basis of the property.

The recourse debt situation is treated differently. The borrower has a reportable sale of the property and may have a taxable gain depending on the tax basis. The

borrower may also have CODI, which is the amount of debt that exceeds the fair market value of the real estate. This portion may be excluded from income as discussed below.

### *Triggering CODI*

CODI occurs when a debt is discharged in whole or in part or there is a significant modification in the loan terms. The first scenario is simple; the lender forgives a portion of the loan resulting in the borrower having CODI. The second scenario isn't so transparent.

Under the tax regulations, a modification generally means any change (deletion in whole or in part or addition) of any legal right or obligation of either party. The alteration may be effected by express agreement (oral or written), by operation of the parties or by any other means. This definition of a modification is extremely broad and is easily triggered. The fact that the modification must be "significant" somewhat mitigates this sensitive trigger.

There are three exceptions to the definition of a modification:

1. If the modification of the terms comes about by the mere operation of the agreement. For example, the agreement may allow for rate resetting or have embedded options
2. Borrower's failure to perform
3. A party's failure to exercise an option

Although the IRS guidance on the above exceptions isn't crystal clear, it can be inferred that any change in the original

terms of the loan or any non-performance with respect to the original terms of the loan will be considered a modification.

### *What is a significant modification?*

The general rule is that if the rights and/or the obligations are changed to a degree that is considered economically significant. All modifications (other than the bright line rules below) are considered collectively and may result in the determination of "significant" while each change considered separately may not be significant.

There are ten bright line tests in the tax regulations:

1. Changes in yield of the debt by more than the greater of 25 basis points or 5% of the annual yield of the unmodified instrument
2. Changes in the payment schedule that result in a material deferral either in due date or amount due prior to maturity
3. Change in obligor with a few exceptions such as an acquisition or asset purchase of the original borrower
4. Addition or deletion of an obligor
5. Changes in security or credit enhancement
6. Changes in the priority of the debt
7. Conversion of debt to equity
8. Change in debt type, recourse to non-recourse
9. Alteration of covenants
10. Special rules for tax exempt bonds

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## Renovation or Demolition?

By: Jim Kohles, Audit Stockholder

My apartment building is 20 years old and in need of an upgrade, what happens if I just demolish it and start over?

You should be careful about planning a complete demolition of a commercial building. The remaining undepreciated basis of the existing structure and the cost of the demo must be capitalized to land costs per IRS regulations. This is not a good result for tax planning

purposes as these amounts do not get depreciated going forward. A better tax plan might be to consider a major renovation in which some part of the original building is retained. How much of the existing structure must be retained to avoid the land cost result is a matter of some judgment so you should consult with an attorney or accountant that is experienced in this area if you decide to do something like this.



## Our landlord paid for improvements to our retail operation. Are there any tax consequences to us?

By: Walt Tchirkine, Tax Stockholder

It depends on whether you "own" those improvements under the lease. If so, the amount paid by the landlord is income to you and the improvements are depreciated over their useful life (generally 15 years). However, IRC Section 110 allows you to exclude from gross income any amount used for qualifying construction of leasehold improvements. The lease must not exceed 15 years and the amounts excluded must be expended for qualifying long

term real property in the year received or within 8 1/2 months after year end. A reimbursement received for amounts expended in an earlier year can also be excluded provided no depreciation deductions were claimed. Qualifying leasehold improvements expended in excess of landlord allowances may qualify for the 50% bonus depreciation and 15 year depreciation recovery period provided required conditions are met.

### *Cancelation of Debt Income continued from page 1*

As with most of the tax code, there are exceptions to most general rules, even to these bright line tests.

The determination of significance is made by first applying the bright line tests. If the modification or modifications are not covered by the bright line tests, the general rule is applied.

Any discharge of debt or significant modification is termed as a "reacquisition" of the debt instrument by the debtor.



## Ask the CPA

By: Brad Gai, Audit Stockholder

**Q:** What is Zillow and is it accurate?

**A:** Many readers are familiar with Zillow.com. You can search for property and find an "estimate" of value, known as a Zestimate. There is a persuasive credibility when a dollar value is listed on the screen. The Zillow web site provides an explanation of the Zestimate and how they determine the values. The web site warns the reader that the Zestimate is not an appraisal. The web site provides a table showing how the Zestimate relates to actual sales prices for properties that have sold. The Zestimate is within 5% of the sale price 23.5% of the time. The percentage improves to 42.2% if the accuracy measure is 10%. Most of the Zestimates (57.8%) were off more than 10%. Enjoy the Zillow web site but understand its limitations. Read the information at Zillow FAQs under the Advice tab on the home page.



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475 14th St., Suite 1200, Oakland, California 94612  
(510) 893-6908 / FAX: (510) 834-1522 / 1-800-RINA CPA

3200 Douglas Blvd., Suite 100, Roseville, California 95661  
(916) 771-3000 / FAX: (916) 771-3252 / 1-800-570-0272

1220 Oakland Blvd., Suite 300, Walnut Creek, California 94596  
(925) 210-2180 / FAX: (925) 210-2199

100 Montgomery St., Suite 2075, San Francisco, California 94104  
(415) 777-4488 / FAX: (415) 777-0680

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