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Federal Tax ADVISORY ■

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Borrowers Beware: Short Sales of Distressed Assets May Have Unfavorable Tax Consequences

The COVID-19 pandemic continues to significantly impact the financial health of taxpayers. Many businesses are unable to meet their outstanding debt obligations, have significantly devalued assets on their balance sheets securing those debt obligations, and are either in or potentially approaching a default under the obligations' terms. Where nonrecourse loans are "underwater," it may be both necessary and in the best interests of the parties to explore alternative arrangements, including debt restructurings and forced asset sales to the extent these options maximize a creditor's ultimate recovery.

In non-financial-products speak, a "short sale" involves: (1) a borrower selling its property to a third party for less than the outstanding debt; and (2) the creditor accepting the net sales proceeds in full discharge of its debt. While many considerations play a role in whether a creditor agrees to a short sale, debtors should also be cautious. A short sale of nonrecourse indebtedness can cause a borrower to suffer potentially unfavorable tax consequences.

For federal income tax purposes, the tax treatment of a short sale of nonrecourse debt hinges on whether it is treated as two separate transactions or as a single, integrated transaction. If respected as separate transactions, the sale to the third party will be governed by the rules under Section 1001 applicable to sales and exchanges of property, while the discharge of the borrower's nonrecourse debt will be governed by the rules under Section 108 addressing income arising from the cancellation of indebtedness (CODI). This two-step transaction approach will generally result in more favorable tax treatment for the financially distressed borrower that disposed of property for less than its tax basis and thereafter qualifies for the insolvency or another CODI exclusion under Section 108.

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However, if the short sale components are instead viewed as a single, integrated transaction, the short sale will be governed solely by the rules under Section 1001. Specifically, Treas. Reg. Section 1.1001-2(a)(1) provides that "the amount realized from a sale or other disposition of property includes the amount of liabilities from which the transferor is discharged as a result of the sale or disposition." Unlike the separate transaction approach, this single-transaction treatment could result in unfavorable taxable gain to a short-sale borrower.

Both the Fifth Circuit Court of Appeals and the U.S. Tax Court have addressed the federal income tax treatment of short sales. In *2925 Briarpark Ltd. v. Commissioner* (1997), the taxpayer owned a building subject to a nonrecourse mortgage that substantially exceeded the value of the building. After considering various alternatives, the creditor determined that its best course of action was to allow the taxpayer to sell the property for its fair market value, forgive any remaining debt it was owed, and release its lien on the property upon its receipt of the net sale proceeds. The taxpayer reported the short sale as two separate transactions. The taxpayer reported a loss on the sale of the property equal to the difference between the sale proceeds received and its basis in the property. Importantly, the taxpayer did not report any CODI for the forgiven mortgage debt due to an exclusion under Section 108. The IRS challenged the taxpayer's short-sale characterization, arguing that the short sale should be treated for tax purposes as a single, integrated transaction. The court agreed with the IRS's position. Based on the court's decision, the taxpayer was required to include the full amount of its outstanding nonrecourse debt as sales proceeds from the short sale of the property, resulting in a large capital gain to the taxpayer.

Similarly, in *Simonsen v. Commissioner* (2018), the taxpayers sold their home in a short sale in exchange for the discharge of the nonrecourse mortgage on the property. The taxpayers claimed that the short sale and consequent debt forgiveness were two separate transactions, so the taxpayers reported both a substantial deductible loss and an excludable CODI amount. The U.S. Tax Court, relying on the *Briarpark* decision, integrated the two separate short-sale components and ruled the amount realized on the taxpayers' sale included the discharged debt, and thus the taxpayers did not have any loss and could not utilize any of the CODI exclusions.

In each case, the court determined that the borrower's disposition of its property and the forgiveness of its debt were sufficiently intertwined to treat the short sale as a single transaction with any forgiven debt included as sales proceeds. In each case, the court reasoned that the creditor had adequate authority and influence over the entire transaction such that the short sale was the "functional equivalent of a foreclosure."

Determining whether a particular short sale could be characterized as the "functional equivalent of a foreclosure" is often complicated and requires a case-by-case analysis. It is crucial for borrowers to understand and appreciate the potentially unfavorable tax consequences of a short sale before pursuing this approach.

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