Originally published in the:
New York Law Journal ***August 23, 2023***

The Importance of Character: Tax Court Addresses Cancellation of Nonrecourse Debt

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The characterization of debt as recourse (where the borrower is personally liable for repayment of the loan) or nonrecourse (where the lender's sole recourse is to its security) can have important income tax consequences. When nonrecourse debt is forgiven in connection with a sale of property, the amount of the debt is included in the taxpayer's amount realized and is usually taxed as capital gain. In contrast, if recourse debt is forgiven for any reason (or if nonrecourse debt is forgiven other than in connection with a sale of property), then the amount of debt forgiven is treated as cancellation-of-indebtedness (COD) income, which is taxed at ordinary income rates. However, COD income can be excluded under a number of exceptions contained in the Code, which do not apply to gain from the sale of property.

This distinction between COD income and gain on the sale of property was at issue in a recent Tax Court case, *Parker v. Commissioner*, T.C. Memo 2023-104. In that case, an S corporation owned by the taxpayer had acquired land in California in 2007 for the purpose of commercial development. The purchase had been funded by both mortgage loans and mezzanine loans incurred by various LLCs that were wholly owned by the S corporation. Both the mortgage loans and mezzanine loans were personally guaranteed by the taxpayer.

In 2012, the S corporation sold its interests in the property-owning LLCs for a nominal price. The buyers assumed the mortgage loans, which had a balance of about $40 million, and agreed to take over the taxpayer's personal guarantees of those loans. In addition, at the time of the sale, the holder of the mezzanine loans agreed to cancel those loans, which had a balance of about $13 million. The relevant documents stated that the cancellation of the mezzanine loans was made in connection with the sale.

On its tax return for the year of the sale, the S corporation had initially shown the entire $53M of debt as its amount realized from the sale of the property, which, after subtracting its tax basis and other deductions, resulted in about $2.7 million of gain. However, the S corporation subsequently amended its return to exclude the amount realized attributable to the mezzanine loans, on the grounds that this constituted COD income rather than gain from the sale of property. An exception to the COD rules generally permits a taxpayer to exclude COD income to the extent it is insolvent (although the taxpayer must reduce its basis or other tax attributes by the amount of the excluded income). Because the S corporation claimed this insolvency exception, it excluded all of the COD income and showed no tax as being due.

The IRS disagreed with the treatment on the S corporation's amended return, and the Tax Court sided with the IRS. The court held that the mezzanine loans constituted nonrecourse debt, even though they were personally guaranteed by the S corporation's shareholder, because the separate existence of the S corporation from its shareholder should be respected. The court also found that the cancellation of the mezzanine loans was clearly effected as part of the same transaction as the sale, since all documents were executed on the same date and the cancellation documents referenced the sale. The Tax Court therefore held that the income from the cancellation of the mezzanine loans constituted an additional amount realized from the sale of the property rather than COD income.

One interesting point raised in this case is that an S corporation's debt will be respected as nonrecourse notwithstanding a personal guarantee by the S corporation's shareholder. If, instead, a partner had personally guaranteed the nonrecourse debt of a partnership, the court might have reached a different result.

In addition, this case is an important reminder of the difference between COD income and gain from the sale of property and the resulting tax consequences. Which one is preferable will depend on a taxpayer's individual circumstances. In the case, the taxpayer preferred to recognize COD income, since the S corporation could exclude the income under the insolvency exception.

However, in other situations, COD income may be undesirable. When property is owned through a partnership instead of an S corporation, the insolvency exception is not available unless the partners themselves are insolvent, which is often not the case. Treatment as gain from the sale of property allows the taxpayer to offset its tax basis against the gain, and the gain is usually taxed at capital gains rates, which are benefits that are not available in the case of COD income.

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