Distressed real estate - distressed debt - by Sandy Klein

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Uncertainty and concerns about the New York commercial real estate market abound. Office vacancy rates are at close-to if not at all-time highs. The pandemic-induced work-from-home mode has become the new reality and interest rates have seen a steep surge to levels not seen in many years. Each of these situations alone is a challenge but together they feed into each other causing the "perfect storm".

Needless to say market values of properties have dropped quite significantly. In 2022 a group of academics from NYU and Columbia estimated that New York office buildings had lost 39% of their long-term value and then in early 2023, after working with updated data, they said the decline was 44%.

This then directly leads to the crushing pressure on debt service - commercial real estate, especially in New York City, is at the point of facing the harsh facts that properties are financially distressed. Massive loan maturities are looming and debt modification is the first option to consider.

DEBT MODIFICATION

Debt modification includes a number of components: reduction of principle, extensions of due dates (maturities), change in the interest rate (rate change, modify the payment, modify the unpaid interest to accrue and/or a "kicker" payment), changes to other specific features of the debt, and changes between recourse and non-recourse debt.

Cancellation of Debt: Of those just mentioned let's discuss the consequences of a debt modification – specifically Cancellation of Debt (COD). While COD may resolve cash flow and insolvency issues; it could result in recognizing income to the extent that principal is reduced. When a lender agrees to reduce the remaining outstanding principal – the debt reduction (COD) might result in income to the debtor/borrower. As an example let's say a $25 million loan is modified to new debt of $15 million. The debt reduction of $10 million is deemed COD.

Analysis: The COD income may be excluded in certain circumstances. This would include bankruptcy or insolvency (looked at the ultimate taxpayer level), Qualified Real Property Business Indebtedness (QRPBI) and purchase price adjustments.

For debt to qualify as QRPBI it must meet certain criteria: the debt was incurred in connection with real property used in a trade or business, the debt is secured by the underlying property, only individuals qualify and lastly the indebtedness was incurred/assumed to acquire, construct or substantially improve the property. Having met these criteria it will be deemed QRPBI.

In such case the taxpayer can elect to not recognize the COD income and alternatively reduce the basis in the underlying property as well as other properties. There may be depreciation recapture upon disposition of the property.

OTHER CONSIDERATIONS

1031 Exchange: With underwater property another option is doing a like-kind (section 1031) exchange as to avoid any gain and tax. As an example lets say the current fair market value of the property is $35 million, the outstanding debt is $50 million and your basis in the property is $10 million. The new property investment must be $50 million however the most debt you can secure is $35 million; so cash of $15 million will be required to acquire the new property and the new basis will be $10 million.

New Money – New Investor: Finding a new/additional partner in today's market may be an option. While real estate continues to distress and lending has dramatically dropped there are investors (with cash) looking to invest and take advantage of the market value downturn. A new partner may (1) wish to convert equity to debt or (2) acquires the debt from the existing lender and at the same time contribute capital to the partnership or (3) contribute capital to the partnership and restructure the borrowers capital structure.

The new money partner, the lender (original and new) and the original partners all have their own wants and needs. The new partner and also the lender (old and/or new) want and are seeking certain returns while protecting their share of the underlying asset. The original partners need to maintain control of the property including cash flow decisions and control of the exit strategy and it's timing. As borrowers, the old and new partners are mindful of their basis in the property now and into the future, future deductions, restrictions on disposition and of course current and future tax consequences.

Short Sale: Selling in this market is one of the last things to consider. Owners/landlords are hanging-on with existing debt and funding the debt-service while hoping for a turn-around. If that and the above situations are not available, then the owner/landlord may look to do a short sale (sale price is below the outstanding debt). For example the owner/landlord may owe $25 million on a property now valued at $18 million. A buyer may be found at the depressed value, the sales proceeds ($18 million) reduce the debt and the original owner/landlord then walks away from the financial drain. The lender plays a crucial role in the process as the lender must agree to the sale and must accept (or reject) the buyer's offer. The owner/landlord is responsible for selling the property however the lender is responsible for negotiations.

The real estate market today is distressed and experiencing significant challenges as it stares at a newly established work-from-home philosophy resulting in severely depressed occupancy rates/loss of tenants, high interest rates, debt service challenges and looming debt maturities. What we discussed above are some of the approaches being utilized in today's market. Each has its own merits and provides a solution best suited to the owner/landlord/borrower. As each are considered it is recommended to consult with your financial and tax advisors as part of the due diligence process.

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