

# Real Property Law Section NEWSLETTER State Bar of Georgia

A Publication for Real Property Lawyers

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**REAL PROPERTY  
LAW SECTION**

## COMMENTS FROM THE CHAIR

*A. Michelle (Shelli) Willis  
Troutman Sanders LLP*

What a year this has been. Though economic conditions cannot be compared to the tragedy of 9/11, September is now a month marked with the memory of both the fall of the economy and the fall of the Twin Towers. I had hoped that by the time I assumed the role of Chair from the able guidance of Susan Elliott, we would be well on our way to better times. Instead, we've now all put on our walking shoes and are preparing for the long, slow climb to recovery.

At our annual planning retreat a few weeks ago, the Executive Committee discussed the year ahead, and the ways in which we serve our membership and how we could do even more. We strive to provide relevant and effective communication and content to our membership, through our newsletters, e-blasts, the list serve, seminars and our web site. The list serve, in particular, continues to be popular with our membership as a great forum for advice and debate. Please be mindful of the need to keep the content focused on the practice of law- exercise good decorum and the "Golden Rule" in your posts.

The following are some of our goals and plans for this Bar year:

- In response to the many comments on the list serve and as a morale booster, the Section is sponsoring a party in connection with the Mid-Year meeting of the State Bar in Atlanta on January 8th. An Educational program will precede the event. We are also planning a "Lunch and Learn" at the State Bar in Savannah, and will be jointly hosting a reception with the Georgia Society of CPAs again this year. More details will follow on all events.
- We are hopeful that our membership will remain involved in the Bar during this economic downturn. To that end, we lowered the annual dues last year, sponsored a Bar lunch and learn for out of work attorneys, and are offering scholarships to some of our seminars this year for unemployed real estate attorneys. We are also planning to hold new attorney seminars to provide basic tools for those wishing to join the practice of real estate law.

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## NEW REGULATIONS FACILITATE REAL PROPERTY MORTGAGE MODIFICATIONS

*Nedom A. Haley*

*Baker, Donelson, Bearman, Caldwell & Berkowitz, PC*

On September 16, 2009, the U.S. Treasury took steps to assist in the modification of various loans held by Real Estate Mortgage Investment Conduits ("REMICs"), which have been recognized by the Internal Revenue Code since the Tax Reform Act of 1986. REMICs are designed to invest in a static pool of mortgages which are principally secured by real estate and are not intended to dispose of mortgages before maturity.

### Background

Operationally, REMICs acquire mortgages on a given day, referred to as the "start up" date. REMICs have a limited amount of time to become fully invested. The major issuers are the Federal Home Loan Mortgage Corporation (Freddie Mac) and the Federal National Mortgage Association (Fannie Mae) as well as privately operated mortgage conduits owned by mortgage bankers, mortgage insurance companies and savings institutions. REMICs are not subject to federal income taxes. Rather, the income of a REMIC flows through to its owners.

Consistent with the stated purpose of REMICs holding a static pool of mortgages, the Internal Revenue Code imposes a 100% excise tax on "prohibited transactions." Among the class of prohibited transactions are "dispositions" of mortgages, other than by payment at maturity and a mortgage no longer "being principally secured by real property." The term "disposition" includes many transactions other than an outright sale or exchange for

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- We continue to work to link real estate attorneys with pro bono opportunities, and this year we are excited that we will be partnering with a liaison for the Military to provide legal assistance to JAG attorneys, Veterans and the Military and their families.
- We continue to support and respond to legislation that is germane to the practice of real estate law in Georgia.

The following members completed their terms of service on the Executive Committee this year:

Edward Hudson, Columbus, past Chair  
 Leon Adams, Atlanta  
 Tim Bailey, Marietta  
 Machel Redmond, Atlanta  
 Janney Sanders, Toccoa

The following new members were elected to the Executive Committee:

John Cripe, Jefferson  
 Sue Ellen Henderson, Atlanta  
 Brad Hutchins, Atlanta  
 Gayle Camp Keener, Woodstock

Please let these individuals know that you appreciate their time and commitment to the Section.

I invite you to take the opportunity, as we all retrench and reevaluate, to become more active in our Section. We have a number of Section Sub-committees that lend themselves to broader membership, such as the Legislative Committee, the Pro Bono Committee and the RESPA/Residential Committee. Positions on the Executive Committee usually become available at the end of each Bar year in May. We are always looking for individuals interested in serving, and service on Section Sub-committees is a great introduction. In serving, I'm confident you will find, as I did, that the opportunities to meet and work with your fellow Section members from all over the State and all walks of practice provide immeasurable returns for your contributions.

We welcome ideas and volunteers. Please contact me or any member of the Executive Committee if you are interested in serving or have ideas for seminars, articles, legislation, socials or otherwise.



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another mortgage. As a general rule, for a loan to be considered "principally secured by real property," the value of the real property must be at least 80% of the face value of the loan. This test is applied on the front end when the loan is acquired by the REMIC and again if there is a significant modification of the loan.

There is a vast body of law on the subject of when the modification of a debt instrument is a disposition. In the usual context, if the modification rises to the level of a disposition, the holder is treated as having sold the debt instrument for the value of what the holder has after the transaction.

The present rules on whether a modification of a debt instrument constitutes a disposition have their origin in a 1991 decision of the United States Supreme Court in the case of Cottage Savings Association v. Commissioner. In the years under consideration by that decision, it was the usual practice of thrift institutions to hold the mortgages they originate. At that time, most thrifts had loans on their books which were made at relatively low interest rates, and which were worth less than their face amounts. The thrifts desired to dispose of such loans and thereby generate losses which could offset income and thus result in tax refunds due to carrying the losses back to early years.

The Federal Home Loan Bank Board, which then regulated thrifts, published a directive to the effect that if a thrift exchanged a portfolio of loans for a substantially identical portfolio, the thrift, while being able to take a tax loss, would not be required to take a loss for purposes of thrift accounting. The Internal Revenue Service took the position that the loans were fungible and denied the loss.

The Supreme Court held in the Cottage Savings case that the loss was allowable because the borrowers and the collateral were different. The holding of the case, which became known as the "hair trigger" test, generated considerable confusion, particularly in the context of whether the modification of a debt instrument constitutes a disposition of the debt instrument and thus a taxable event resulting in the recognition of gain or loss.

The Internal Revenue Service published regulations in 1996 to provide guidance on whether the modification of a debt instrument results in a deemed disposition of the instrument. In general, those regulations state that a modification results in a disposition only if there is a significant modification.

The Internal Revenue Service also published regulations concerning whether the modification of a debt instrument held by a REMIC constitutes a disposition of the debt instrument for purposes of applying the 100% excise tax. The existing regulations state that a modification of a debt instrument results in the disposition of the debt instrument only if the modification of the debt instrument would be considered a disposition under the

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*COMMITTEE MEMBERS OF THE REAL PROPERTY LAW SECTION, State Bar of Georgia, gathered for a quick photo shoot while taking a break from their Saturday meeting at the Section's annual Fall Retreat. Families joined the Committee members for the rest of the retreat weekend, which was held at Reynolds Plantation, Lake Oconee, GA.*

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Cottage Savings regulations. In addition the following types of modification would not result in a disposition for purposes of the excise tax:

- (a) Changes occasioned by a default or a foreseeable default;
- (b) Assumption of the obligation by another person;
- (c) Waiver of a due on sale or due on encumbrance clause;
- (d) Conversion of an interest rate pursuant to a convertible mortgage.

From the beginning of the present financial crisis, REMICs have been hesitant to agree to modify debt instruments for fear of incurring a 100% excise tax on the value of the debt instrument modified.

Given that many loans will need to be reworked in the near future and will not fit under the safe harbors mentioned above, various industry groups have been asking Treasury to set forth some additional safe harbors.

### September 16 Regulations

On September 16, 2009, Treasury published final regulations expanding the types of modifications that will not result in a deemed disposition or disqualification of the mortgage for purposes of the 100% excise tax. The following modifications, even if they would result in a deemed sale of the debt instrument for purposes of recognizing gain or loss, will not cause the imposition of the excise tax:

- (a) A release of a lien on real property will not disqualify the mortgage so long as the loan is principally secured by other real property;
- (b) A change from recourse to nonrecourse or vice versa so long as the obligation continues to be principally secured by real property; and
- (c) The addition or deletion of credit enhancement, so long as the obligation continues to be principally secured by real property.

The final regulations continue the fundamental rule of REMIC qualification that an obligation is principally secured by real property if the value of the real property is at least 80% of the face amount of the loan. Fortunately, there is no need for an independent appraisal as the regulations provide that the "principally secured" requirement is satisfied if the holder reasonably believes that the modified mortgage satisfies the 80% test at the time of the modification.

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## NEW PROJECT COORDINATOR FOR THE PRO BONO MATCHMAKER PROJECT

The Pro Bono Matchmaker Project (PBMP) has a new project coordinator! Missy Robinson of Nations & Robinson, LLC has agreed to take on this valuable role.

The PBMP was created in December 2005 to increase pro bono participation by real property attorneys. Currently, over 120 attorneys have volunteered to be a part of PBMP. The PBMP is in contact with several qualifying organizations that need real property

legal services. Attorneys simply volunteer to join a pool of attorneys available to handle such projects. Once we learn of a project, we simply send an e-mail solely to the volunteer attorney pool with a project description. Once volunteer(s) respond to the e-mail agreeing to provide assistance, we put the organization and volunteer(s) in contact with each other to coordinate handling of the project. By agreeing to be included in the volunteer attorney pool, you are only agreeing to receive e-mails about possible pro bono projects. You are not obligated in any way to take on any projects.

Recently, we matched an attorney with the Georgia Legal Services Program in Carroll County who has a client who has had mold issues in her Hickory Falls apartment since August. The client has moved out and has not paid October rent after the landlord acknowledged the mold, but refused to turn over any air quality tests and claimed that the mold was due to the client's failure to run the air conditioner properly and keep adequate lighting.

If you are interested in joining our pool of volunteers or are aware of any pro bono needs with which our group of volunteers may be able to assist, please email Missy Robinson at [missy@nationsandrobinson.com](mailto:missy@nationsandrobinson.com).

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## UNDERSTANDING THE PROTECTING TENANTS IN FORECLOSURE ACT OF 2009

*Monica K. Gilroy, Esquire  
Dickenson Gilroy LLC*

Homeowners as well as tenants often experience confusion in understanding what they should do and what their rights are when facing foreclosure. In Georgia, a tenant's rights are immensely protected under the Landlord Tenant Act, codified at O.C. G. A. 44-7-1 to 44-7-103. In a property that is being foreclosed, however, tenants more often than not end up with the short end of the stick. In many cases the tenant continues paying the rent while the landlord defaults on the mortgage payments for that property. Eventually, the lender starts the foreclosure process (a tenant often is first aware of a problem when they receive mail, addressed to "occupant" from the foreclosure law firm or lender). Once the foreclosure sale has occurred, in Georgia, the eviction process (the dispossession process) can be initiated swiftly by the lender, such that in most counties a tenant, who has lost their rental situation due to foreclosure, may be unceremoniously told a writ of possession will be issued against them and that they only have seven days to vacate before the eviction occurs. Previously, the only remedy for the tenant was to pursue the landlord for a breach of the rental contract (however, this is the same landlord who just was foreclosed upon for a lack of payment of the mortgage) or hope that the evicting lender will offer "cash for keys" (funds to permit the tenant to move out in an agreed upon fashion and timeframe).

In order to prevent these types of actions and to protect tenants living in a property that is being foreclosed, the federal government passed the "Protecting Tenants at Foreclosure Act of 2009" which

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became effective on May 20, 2009. This new law protects tenants from immediate eviction by persons or entities that become owners of residential property through the foreclosure process, and extends additional protections for tenants with U.S. Department of Housing and Urban Development Section 8 vouchers. The law expires on December 31, 2012.

The basic purpose of the Protecting Tenants at Foreclosure Act is to ensure that tenants facing eviction from a foreclosed property have adequate time to find alternative housing. To that end, the law establishes a minimum time period that a tenant can remain in a foreclosed property before eviction. The law does not affect any state or local law that provides longer time periods or other additional protections for tenants.

Under the law, the immediate successor in interest at foreclosure (most likely the lender who has taken back the property at foreclosure, but possible a third party purchaser), must: (a) provide bona fide tenants with 90 days notice prior to eviction; and, (b) allow bona fide tenants with leases to occupy property until the end of the lease term, except the lease can be terminated on 90 days notice if the unit is sold to a purchaser who will occupy the property. A lease or tenancy is bona fide if the tenant is not the mortgagor or the parent, spouse, or child of the mortgagor, the lease or tenancy is the result of an arms-length transaction, and the lease or tenancy requires rent that is not substantially lower than fair market rent or is reduced or subsidized due to a Federal, State or local subsidy. The law does not cover tenants facing eviction in a non-foreclosed property, tenants with a fraudulent lease, tenants who enter in lease agreements after a foreclosure sale, or homeowners in foreclosure.

If there is a year-lease contract between the landlord and the tenant, and the property is foreclosed after May 20, 2009, the bank must recognize that lease. Tenants in this situation have the right to stay in the property until the end of that year-lease, however, the lease must have been in existence before the Notice of Foreclosure is sent by the foreclosing law firm. In addition, a true tenancy must exist for this to apply. Otherwise, the occupants have only 90 days to vacate the property. A real or true tenancy refers to a legitimate lease/rental situation. Often times, in response to this new law, desperate owners are creating "false leases" between themselves and a non borrower spouse or family member in an effort to retain possession of the property. If the lender views the lease or rental contact as not being in good faith, no requirement to honor the lease applies. This is very subjective on the part of the lender and will require the lender to actually obtain, read and analyze a copy of the lease. This is a very foreign task to many lenders, and poses just one of the many challenges this new law brings.

Under Georgia law, the lender is now the Landlord. Therefore, the lender is responsible for the habitability of the property, the quiet enjoyment of the tenant of the property and for the upkeep and maintenance of the property. Moreover, many properties are facing fines from municipalities or cities for the lack of upkeep of the property by the borrower who has just defaulted. Finally, lenders are now faced with mounting monthly HOA or condo association dues and must quickly inform such organizations of their new "ownership" of the property so as to quickly bring any

non compliant aspects of the property up to par.

If a tenant does not have a month-to-month lease, nor are they operating under a "good faith" lease, they are entitled to only 90 days before the bank can take steps to evict them. Most lenders in Georgia are erring on the side of caution and providing at least 90 days to all tenants left behind in a foreclosure rather than taking an aggressive posture within the dispossession court. Before the actual foreclosure sale, the current landlord of the property is entitled to collect rent because he still owns the property. After the foreclosure sale, however, the person who purchases the property or the lender will inherit the lease entitling them to collect rent. Additionally, regardless of there being a lease or not, if the former landlord was responsible for the utilities, the lender, post foreclosure, must continue to provide utility service. It is violation of Georgia law to force a tenant out of the property by turning off the utilities, as that is considered constructive eviction.

The law has created a situation where lender landlords are not serving tenants with an eviction notice until after 90 days have passed unless some other legal remedy for invoking the landlord tenant act (a hold over tenant, etc) is occurring. Lenders are most certainly not in the business of managing properties; therefore, they will frequently offer money for tenants to relocate under cash for keys scenario. Lenders are also struggling with security deposits turned over to them by prior property management companies, as well as how to address routine maintenance. It will be some time before the act is fully tested and its application understood by lenders. Also, the Federal Reserve Board is monitoring national lenders around the country to ensure compliance with the law, placing extra burden on the lender to become compliant. National Investors, such as Fannie Mae and Freddie Mac, are in the process of promulgating guidelines in terms of the act which may prove helpful for implementation and analysis of whether a lease is "true" and "arms length. The law in its entirety is attached to the end of this article.

**Public Law 111-22, Effective Date May 20, 2009**

**TITLE VII--PROTECTING TENANTS AT FORECLOSURE ACT**

**SEC. 701. SHORT TITLE.**

This title may be cited as the 'Protecting Tenants at Foreclosure Act of 2009'.

**SEC. 702. EFFECT OF FORECLOSURE ON PREEXISTING TENANCY.**

- (a) In General- In the case of any foreclosure on a federally-related mortgage loan or on any dwelling or residential real property after the date of enactment of this title, any immediate successor in interest in such property pursuant to the foreclosure shall assume such interest subject to--
- (1) the provision, by such successor in interest of a notice to vacate to any bona fide tenant at least 90 days before the effective date of such notice; and
  - (2) the rights of any bona fide tenant, as of the date of such notice of foreclosure--
    - (A) under any bona fide lease entered into before the notice of foreclosure to occupy the premises until the end of the remaining term of the lease, except that a successor in

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interest may terminate a lease effective on the date of sale of the unit to a purchaser who will occupy the unit as a primary residence, subject to the receipt by the tenant of the 90 day notice under paragraph (1); or

(B) without a lease or with a lease terminable at will under State law, subject to the receipt by the tenant of the 90 day notice under subsection (1), except that nothing under this section shall affect the requirements for termination of any Federal- or State-subsidized tenancy or of any State or local law that provides longer time periods or other additional protections for tenants.

(b) Bona Fide Lease or Tenancy- For purposes of this section, a lease or tenancy shall be considered bona fide only if--

- (1) the mortgagor or the child, spouse, or parent of the mortgagor under the contract is not the tenant;
- (2) the lease or tenancy was the result of an arms-length transaction; and
- (3) the lease or tenancy requires the receipt of rent that is not substantially less than fair market rent for the property or the unit's rent is reduced or subsidized due to a Federal, State, or local subsidy.

(c) Definition- For purposes of this section, the term 'federally-related mortgage loan' has the same meaning as in section 3 of the Real Estate Settlement Procedures Act of 1974 (12 U.S.C. 2602).

#### **SEC. 703. EFFECT OF FORECLOSURE ON SECTION 8 TENANCIES.**

Section 8(o)(7) of the United States Housing Act of 1937 (42 U.S.C. 1437f(o)(7)) is amended--

- (1) by inserting before the semicolon in subparagraph (C) the following: 'and in the case of an owner who is an immediate successor in interest pursuant to foreclosure during the term of the lease vacating the property prior to sale shall not constitute other good cause, except that the owner may terminate the tenancy effective on the date of transfer of the unit to the owner if the owner--
  - (i) will occupy the unit as a primary residence; and
  - (ii) has provided the tenant a notice to vacate at least 90 days before the effective date of such notice.'; and
- (2) by inserting at the end of subparagraph (F) the following: 'In the case of any foreclosure on any federally-related mortgage loan (as that term is defined in section 3 of the Real Estate Settlement Procedures Act of 1974 (12 U.S.C. 2602)) or on any residential real property in which a recipient of assistance under this subsection resides, the immediate successor in interest in such property pursuant to the foreclosure shall assume such interest subject to the lease between the prior owner and the tenant and to the housing assistance payments contract between the prior owner and the public housing agency for the occupied unit, except that this provision and the provisions related to foreclosure in subparagraph (C) shall not affect any State or local law that provides longer time periods or other additional protections for tenants.'

#### **SEC. 704. SUNSET.**

This title, and any amendments made by this title are repealed, and the requirements under this title shall terminate, on December 31, 2012.

## **SPOTLIGHT ON RPLS MEMBER**

*JOHN CRIFE*

Elected to a three year term at the Real Property Institute in May of 2009, John Crife has already proven to be an excellent addition to the RPLS Executive Committee. A 1969 graduate of Purdue University, John left Indiana to pursue his law degree at Emory Law School and graduated in 1973. While in law school, John clerked with McCurdy & Candler, becoming a litigation associate with the firm under George Carley until Justice Carley assumed the bench in 1979. John's career path diverted to the real estate department at the McCurdy firm and remained active in their real estate division until joining Safeco Title Insurance Company as Division Counsel in 1982. In 1986 John returned to private practice, remaining today as a sole practitioner, (although he enjoyed a brief a tenure with Louise Wells at Morris, Manning and Martin).

John has had the opportunity to live all over the world from England and South Africa to Italy, Brazil and Mexico. Married to his wife, Denise, since 2002, John and Denise, both Atlanta residents, decided to move to Jefferson in 2003. They relocated to a beautiful 20 acre spread which the couple had acquired earlier. John and Denise enjoy their time in Jefferson with Denise's son and their two young grandsons.

While the idea of moving to Jefferson was to adopt a less crowded, slower pace of life, John finds himself in Atlanta traffic often enough to remind him of why he moved. His current practice has evolved from residential closings and commercial title examinations to a great deal of title examination and analysis of timber tracts. Examining and analyzing timber titles is the study of title history – often times the timber title begins with tracts acquired in the late 1800's or early 1900's for timber and the land has remained as timberland ever since. This area of practice provides John with the opportunity to visit rural courthouses and to pour over old dust covered records with legal descriptions which are vague to the extreme (think-"Farmer John's barn to the old oak tree"...). "Happily for me," shares John, "these titles are puzzles I like to solve. Most often, the primary hurdle is confirming that the vague description from 1915 is the same property that the timber company now claims to own and I describe the area with the aid of GPS, satellite photos and other modern technology. I have thoroughly enjoyed the work and hope to continue it as long as I can lift a thirty pound deed book."

John's wisdom and breadth of experience will greatly benefit all members of the Section. He can be reached at his office in Jefferson at: 404-909-0174 or [jpcrife@windstream.net](mailto:jpcrife@windstream.net).

## **TAX CONSEQUENCES OF MODIFICATION OF DEBT INSTRUMENTS**

*Nedom A. Haley*

*Baker, Donelson, Bearman, Caldwell & Berkowitz, PC*

In this time of economic uncertainty, holders of and obligees on debt instruments should be concerned about the tax consequences of modification of debt instruments. Most obligors are aware that

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there may be tax consequences; few holders are aware. This article summarizes the tax consequences to each, which may be radically different.

### **Holder's perspective**

The modification of a debt instrument may have tax consequences to the lender independent of consequences to the holder. In most circumstances, the consequences are the same, regardless of whether the debt instrument is the product of a sale of assets or the borrowing of money.

In the second to last real estate recession, the regulatory agency that regulated thrifts (e.g., savings and loans) recommended that thrifts enter into exchange transactions with other thrifts to recognize tax losses, which could be carried back to profitable years to generate tax refunds.<sup>1</sup>

A typical transaction was for one thrift to bundle a group of mortgage loans and swap them for a similar pool of mortgage loans with a similar weighted average maturity and average yield. In this era, virtually all mortgage loans had depreciated in value. For tax law purposes, in order to recognize a loss for income tax purposes, it was and is necessary for there to be a "sale or exchange" in the context of Section 1001 of the Internal Revenue Code of 1986.

Most thrifts followed the regulatory advice and engaged in such transactions. The Service chose one case to take to the U.S. Supreme Court.<sup>2</sup>

The Service took the position that all debt instruments with the same characteristics are fungible and that there was no "sale or exchange" and consequently, there was no loss to be recognized.

The Supreme Court held that there had been a "sale or exchange" since there were different obligors and different collateral. This has come to be known as the "hair trigger" theory.

There are many instances where it is necessary to determine whether a substituted debt instrument is the same as an older obligation or is a new obligation. For example, in the case of debt obligations, the interest on which is intended to be exempt from federal income taxation under section 103 of the Code, the time such obligation is issued can be materially determinative. For purposes of section 103 and many other provisions of the Code, the Service undertook a regulations project addressing when there has been a "sale or exchange" of a debt instrument, resulting in a gain or loss or a reissuance.

The upshot of this project was T.D. 8675, adopted on June 26, 1996, which brought Treas. Reg. §1.1001-3 into the Code of Federal Regulations.

Treas. Reg. §1.1001-3 sets forth "bright lines" on the question of whether for tax purposes, one obligation which has been modified is the same as the modified obligation.

In general, subject to many exceptions, there are two tests: to-wit (a) has there been a modification and, if so, (b) is the modification significant?

### **Modification defined**

In general, a modification means any alteration, including any deletion or addition, of a legal right or obligation of the issuer or

holder, whether evidenced by express agreement (however evidenced), other than a change occurring by operation of the express terms of the debt instrument.<sup>3</sup> As discussed below, a modification results in a sale or exchange only if it is "significant."

### **Exceptions**

Like most rules in tax law, there are many exceptions to the definition of modification, including alterations occurring by operation of the terms of the debt instrument. An example of this would be the change in an interest rate by virtue of being linked to an index, e.g., prime.

Exceptions to the exception include the following, all of which are classified as modifications, even though they occur by the express terms of the debt instrument:

- (a) A change in the obligor or in whether the instrument is recourse or non-recourse.
- (b) A change to an instrument which transforms it into equity as opposed to debt.
- (c) An alteration resulting from the exercise of an option, unless the option is unilateral and the exercise of the option does not result in a deferral of, or a reduction in, any scheduled payment of interest or principal.
- (d) A failure to perform an agreement (e.g., an uncured default) for a period that exceeds two years.

A failure of a party to exercise an option is not a modification (e.g., a "put" right which is not exercised.)

The time of a modification is generally the time the parties enter into an agreement, even if not effective immediately.<sup>4</sup>

As noted above, a change in an instrument is treated as a new instrument only if the change is "significant."

This determination is highly subjective. The regulations state that a modification is significant, "only if, based on all facts and circumstances, the legal rights or obligations that are altered and the degree to which they are altered are economically significant." The regulations do, however, give several bright lines, to-wit<sup>5</sup>:

- (a) Change in yield. This rule, which applies to debt instruments that provide for only fixed payments, provides that a change in yield is significant if the yield varies from the annual yield on the unmodified instrument by more than the greater of 25 basis points or 5% of the annual yield of the unmodified instrument.
- (b) Change in timing of payments. In general a change in the timing of payments is significant. An exception to this rule (resulting in a change that is not significant) is if the length of the delay is the lesser of 5 years or one-half the original term of the instrument.
- (c) Change in Obligor or Security. A substitution of a new obligor on a recourse debt instrument is generally a "significant" modification. Exceptions include substitutions occurring by virtue of a corporate reorganization or the filing of a bankruptcy petition. The substitution of a new obligor on a nonrecourse debt instrument is a significant modification. The addition or deletion of a co-obligor is a significant modification if it results in a change in payment expectations.

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- (d) **Change in Security or Credit Enhancement.** A modification that releases, substitutes or otherwise alters the collateral on, or other form of credit enhancements for a recourse debt instrument results in a change in payment expectations is significant. For example, the substitution of a letter of credit from a Baa rated bank for the letter of credit of a AA rated bank results in a change in payment expectations. Any such change for a nonrecourse debt instrument is significant regardless of whether there is a change in payment expectations.
- (e) **Change in the nature of a debt instrument.** A modification that changes the nature of the instrument from debt to equity is always significant. Similarly, a change in recourse nature is significant. A change in the priority of a debt instrument is significant if it results in a change in payment expectations.
- (f) **Changes in Covenants.** The addition, deletion or alteration of customary accounting or financial covenants is not a significant modification.
- (g) **Tax Exempt Bonds.** There are special rules for tax exempt bonds. The entity which actually issues the bonds is the obligor and not any conduit issuer.

In the times in which we live, it is highly unlikely that any change will not result in a loss recognized for tax purposes.

The following examples illustrate the provisions of the Cottage Savings regulations.

**Example 1.** Creditor A holds a note secured by real estate, which it exchanges for a note having identical terms and similar security. This is always a sale or exchange and a taxable event.

**Example 2.** An obligation provides for the interest rate to be re-set every 49 days through an auction by remarketing agent. The re-set occurs by operation of the terms of the obligation and is not a modification.

**Example 3.** The original terms of a bond provide that the interest rate is 9%. The terms also provide that, if the obligor files a registration statement covering the bond with the Securities and Exchange Commission, the interest rate will decrease to 8%. If the obligor files an effective registration statement, the decrease in the interest rate occurs by operation of the bond and thus is not a modification.

**Example 4.** Under the terms of an obligation issued by a corporation, an acquirer of substantially all of the assets of the corporation may assume the obligation. Substantially all of the assets of the corporation are acquired by a new party. Even though the substitution occurs by operation of the original bond, since the obligor has changed, it is a significant modification and a taxable event.

**Example 5.** The holder of a residential mortgage decreases the interest rate in order to induce the homeowner to not refinance with another lender. This unilateral action is a modification. If the annual yield changes by more than 25 basis points, or 5% of the annual yield, the modification is significant and there is a sale or exchange.

**Example 6.** The original terms of a mortgage provide for a variable interest rate, re-set annually based on an objective index. Under the terms of the original mortgage, the mortgagor has the option to convert to a fixed rate, as determined based on the value of another index, upon the payment of a fee equal to a percentage of the principal amount. Since the required consideration to exercise the option is a specified amount fixed on the issue date, the option is unilateral and the exercise is not a modification. If the terms of conversion are determined after the issue date, the conversion is a modification and is significant.

**Example 7.** A corporation issues a 10-year note to a bank in exchange for cash. Under the terms of the note, the corporation may defer all or part of the interest. For deferred payments, interest will compound at a rate 150 basis points greater than the stated rate. The exercise of the option results in a right of the corporation to defer scheduled payments and is not classified as a unilateral option. The alteration is a significant modification.

**Example 8.** The original terms of a note provide that the issuer may extend the maturity, with the consent of the holder. Since any extension requires the consent of two parties, the extension does not occur by the exercise of a unilateral option and is a modification. If the deferral is for more than the lesser of 50% of the original term or five years, the modification is significant and results in a taxable event.

**Example 9.** Under the terms of a note, if the obligor fails to make a scheduled payment, the full principal amount is due and payable immediately. The holder temporarily waives the right to accelerate the maturity for one year. This is not a modification. If the default continues indefinitely, at some point there is a taxable event.

#### *Borrower's perspective*

Initially, it is important to know whether the obligation is recourse or non-recourse. If property is conveyed to a lender in satisfaction of a debt, the amount and existence of cancellation of indebtedness income will depend on whether the obligation is recourse or non-recourse. If the obligation is recourse, the debtor has cancellation of indebtedness income equal to the excess of the amount of the debt over the value of the property. If the obligation is non-recourse, the excess of the debt over the basis of the property is gain and not cancellation of indebtedness income.

As noted above, since many debt instruments created in the past are now worth less than their face value, many lenders will recognize a deductible loss when the instrument is modified. In the times in which we live, many borrowers will need to be concerned with avoiding taxable income or gain if their debt instruments are modified.

The Code has long provided that cancellation of debt ("COD") results in taxable income, subject to many exceptions.

The principal exceptions are contained in section 108(a)(1) of the Code which lists the following circumstances when COD is excluded, to-wit<sup>6</sup>:

- (a) The discharge occurs in a Title 11 case. For this exception to apply, the taxpayer must be under the jurisdiction of the bankruptcy court and the discharge must be granted by the court or must be under a plan approved by the court.
- (b) The discharge occurs when the taxpayer is insolvent. The determination of insolvency is based on the amount of lia-

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bilities and the value of the assets immediately before the discharge. The amount that can be excluded under this exclusion is limited to the excess of the liabilities over the value of the assets. The excess of non-recourse debt over the value of property securing it is not taken into account in testing for insolvency. Assets exempt from levy (e.g. a rollover IRA) are taken into account.

- (c) The debt discharged is “qualified farm indebtedness.” Qualified farm indebtedness is debt incurred directly in connection with the operation of a farm. Half or more of the aggregate gross receipts for the three years immediately preceding the year of the discharge must be attributed to the trade or business of farming. Proceeds from the sale of inventory, livestock, and farm equipment count, but rents and credits under local incentives do not. The taxpayer must be actively and regularly engaged in farming. The amount excluded may not exceed the sum of:
- (i) the sum of net operating losses or carryovers and net capital losses and carryovers;
  - (ii) the dollar amounts of general business credit carryovers, foreign tax credit carryovers, minimum tax credit and passive activity; plus
  - (iii) the total adjusted bases of property used or held for use in a trade or business or for the production of income held by the taxpayer at the beginning of the tax year following the tax year in which the discharge occurs.
- (d) In the case of a taxpayer other than a C corporation, the indebtedness discharged is “qualified real property indebtedness.” Unlike other exclusions, this exclusion is elective. Qualified real property indebtedness is indebtedness incurred after 1992 that is:
- (i) indebtedness incurred or assumed to acquire, construct, reconstruct, or substantially improve real property used in a trade or business; or
  - (ii) indebtedness used to refinance qualified real property business debt incurred or assumed before that date.

The excludable amount cannot exceed the excess of the outstanding principal amount immediately before the discharge, over the net fair market value of the property immediately before the discharge.

In addition, the amount excluded may not exceed the total adjusted basis of all depreciable real property held by the taxpayer immediately before the discharge, reduced by the sum of any depreciation for any tax year in which the taxpayer excluded COD from gross income pursuant to the exclusion for such reduction and reductions to the adjusted bases of depreciable real property required for the same tax year.

As noted above, the exclusion is elective. In the case of a partnership, the election is made at the level of the partner. In the case of an S corporation, the election is made by the corporation.

- (e) The indebtedness discharged is “qualified principal residence indebtedness” which is discharged after 2006 and before 2013. The exclusion applies only to a principal residence. The limit is \$2,000,000 (\$1,000,000 in the case of married persons

filing separately). Also, the exclusion is available only if the discharge is related to a decline in the value of the residence or to the financial condition of the taxpayer.

This article does not discuss the provision for discharge of student loan indebtedness in exchange for certain public service occupations, IRC §108(f), or to indebtedness discharged to the estates of victims of terrorism, as these exceptions have limited application.

Forgiveness of COD income does not come without a price. Various “tax attributes” are required to be reduced.<sup>7</sup> These are, in the following order:

- (i) Net operating loss carryovers;
- (ii) General business credits;
- (iii) Minimum tax credits;
- (iv) Capital loss carryovers;
- (v) Basis of depreciable property.
- (vi) Passive activity loss and credit carryovers.
- (vii) Foreign tax credit carryovers.

There are important general rules and qualifications, to-wit:

- (A) In general, the acquisition of debt instruments by the debtor or a related person at a discount is treated as a discharge.<sup>8</sup>
- (B) In the case of a partnership, the determination of whether the debtor is bankrupt or insolvent, and attribute reduction, is made at the partner level and not the partnership level. Income derived from discharge of partnership debt is not excludable at the partnership level, but is allocable to the partners.
- (C) If the particular item discharged would have resulted in a deduction, it is disregarded.
- (D) A purchase price reduction is generally not treated as income but reduces the cost basis of the property acquired.

All of the foregoing rules and guidelines are subject to numerous exceptions and qualifications.<sup>9</sup>

In many debt workouts, the creditor ends up with an ownership stake in the debtor.

In the case of a corporation that issues shares of stock in satisfaction of debt, COD income is recognized in an amount equal to the excess of the principal amount of debt discharged over the value of the stock issued.<sup>10</sup> The Internal Revenue Service takes the position that when convertible preferred stock is converted into common stock, the corporation recognizes COD income if the value of the common stock issued is less than the adjusted issue price of the preferred stock.<sup>11</sup>

As noted above, COD income of a partnership is allocated to each partner. As in the case of corporations, if a lender accepts in satisfaction of indebtedness an interest in capital or profits, the partnership will recognize COD income to the extent that the debt discharged exceeds the value of the interest transferred to the lender, which amount will then be apportioned to the partners.

The IRS has proposed (Prop. Treas. Reg. §1.108-8(b)(2)) that the value of the partnership interest taken into account is the liquidation value. In the case of an interest in profits only, this would likely be zero.

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The Code was recently amended to permit certain taxpayers to spread recognition of cancellation of indebtedness income over five years for certain types of business debts reacquired between January 1, 2009 and December 31, 2010. Such income would be included ratably over a five-year period, with recognition beginning in the fifth or fourth taxable year after reacquisition of the debt (fifth year for debt acquired in 2009, fourth year for debt reacquired in 2010). The new provision applies to the reacquisition of a "debt instrument," which means a bond, debenture, note, certificate, or any other instrument or contractual arrangement constituting indebtedness within the meaning of IRC §1275(a)(1). The provision applies to a debtor's or related party's reacquisition of debt by cash purchases, debt-for-debt exchanges, stock-for-debt exchanges, contributions of the debt to an entity's capital, as well as complete forgiveness of a debt by its holder. In the case of a debt-for-debt exchange covered by this new provision, any deduction for original issue discount is deferred to the same taxable periods described above.

The following examples illustrate the principles of this section.

**Example 1.** Taxpayer owns a building subject to a non-recourse loan in the amount of \$1,000, its original cost. At a time when the value has dropped to \$800, the lender agrees to decrease the amount of loan principal to \$825, forgiving \$175. Taxpayer has other assets worth \$100 and owes a recourse liability of \$50.

Assets:		Liabilities:	
Building	\$800	Recourse debt	\$50
Other assets	100	Non-recourse debt to extent	
Total	\$900	of Value of building	800
		Excess debt discharged	175
		Total	\$1,025

Taxpayer must include only \$50 of the forgiven \$175, as he is insolvent to the extent of \$125 of the \$175 forgiven debt.

**Example 2.** The facts are the same as in Example 1, except that there is no reduction in the principal amount of the mortgage and the holder of the recourse debt agrees to accept \$40 of taxpayer's other assets in satisfaction of the \$50 recourse debt.

Assets:		Liabilities:	
Building	\$800	Recourse debt	\$50
Other assets	100	Non-recourse debt to extent	
Total	\$900	of Value of building	800
		Total	\$850

Excess non-recourse debt is not taken into account in determining whether or the extent taxpayer is insolvent. Taxpayer is solvent immediately before he discharge and must include the entire \$10 of forgiven debt in income.

**Example 3.** Taxpayer conveys property worth \$800 to lender in satisfaction of \$1,000 recourse debt. Taxpayer has COD income of \$200. If the debt was non-recourse, the taxpayer would have gain or loss measured by the difference between the basis of the property and the amount of the debt.

**Example 4.** Taxpayer owes \$10,000,000 and cannot pay. The parties reduce the principal to \$7,000,000. If the debt remains classified as debt, the taxpayer has \$3,000,000 of COD income. If the characteristics of the instrument more closely resemble equity, the entire \$10,000,000 is COD income.

**Example 5.** Taxpayer owes bank \$10,000,000. Taxpayer's immediate family acquires the note for \$7,000,000. Taxpayer has \$3,000,000 COD income which, unless one of the exceptions from inclusion applies, may be deferred if the transaction occurs before 2011.

## UPCOMING CALENDAR DATES REAL PROPERTY LAW SECTION

— 2009 —

November 12<sup>th</sup>, 2009  
Fall Commercial Real Estate  
Law Seminar  
Georgia State Bar Headquarters

November 12<sup>th</sup>, 2009  
RPLS monthly meeting  
(Capital City Club)

November 19<sup>th</sup>, 2009  
Joint Reception of RPLS and Georgia  
Society of CPA's, Real Estate Section  
RiRa Restaurant

December 15<sup>th</sup>, 2009  
RPLS monthly meeting  
(Troutman Sanders)

— 2010 —

JANUARY 19<sup>th</sup>, 2010  
RPLS Monthly Meeting  
( Troutman Sanders )

February 12<sup>th</sup>, 2010  
Spring Residential Practice Seminar  
Georgia Public Television Headquarters  
(February 18<sup>th</sup> Replay)

February 16<sup>th</sup>, 2010  
RPLS monthly meeting  
(Troutman Sanders)

March 16<sup>th</sup>, 2010  
RPLS monthly meeting  
(Troutman Sanders)

April 1<sup>st</sup>, 2010  
Foreclosure Seminar  
Georgia State Bar Headquarters

April 20<sup>th</sup>, 2010  
RPLS monthly meeting  
(Troutman Sanders)

May 6<sup>th</sup> - 8<sup>th</sup>, 2010  
Real Property Law Institute  
(Sandestin Hilton)

<sup>1</sup> At that time, it was common for institutions which originated residential mortgage loans to hold them until maturity.

<sup>2</sup> *Cottage Savings Bank*, 499 U.S. 554 (1991).

<sup>3</sup> Treas. Reg. §1.1001-3(b).

<sup>4</sup> Treas. Reg. §1.1001-3(b)(6).

<sup>5</sup> Treas. Reg. 1.1001-3(e).

<sup>6</sup> IRC §108(a)(1).

<sup>7</sup> IRC § 108(b)(1).

<sup>8</sup> IRC § 108(e)(4).

<sup>9</sup> IRC §108(e)(8).

<sup>10</sup> IRC §108(e)(8).

<sup>11</sup> TAM 200606037.

## **REAL PROPERTY LAW SECTION**

**2217 Donato Dr**

**Belleair Beach, FL 33786**

### **ANNUAL TITLE STANDARDS SEMINAR**

October 1st, 2009, the Real Property Section of the State Bar, in partnership with ICLE Georgia sponsored the annual Title Standards Seminar. Attendance remained strong, over 100 attendees, despite the economic impact on the real estate bar. Although this year's seminar continued in the tradition of covering the fundamentals of title issues, there was special emphasis placed on issues arising from the downturn in the real estate market; namely foreclosure, bankruptcy and lien issues.

Tim Minors of Old Republic and Pamela Lapham of First American shared their underwriting experience in covering the basics of title and Christine Mast of Hawkins Et Parnell LLP returned to provide her annual update on lawyer liability issues. In addition to inviting members to suggest topics for next year's seminar, the Title Standards Subcommittee of the Section also invites members to provide input on changes to existing title standards and additional standards. Please forward any suggestions to Subcommittee Chair Jeff Schneider at [jeffschneider@wncwlaw.com](mailto:jeffschneider@wncwlaw.com).

### **JOINT KICK-OFF EVENT**

You are invited to a meeting of the Georgia Society of CPAs Real Estate Section. This is an informative and networking opportunity which is intended to give you a better understanding of what this community can do for you. This is your opportunity to participate in discussing our issues and opportunities as we move forward together.

Date: Thursday, November 19, 2009 • Time: 5:30 – 7:30 pm • Location: RiRa Restaurant

#### **About the Real Estate Section:**

The Real Estate Section was founded in 2002 and has become one of the GSCPAs' most active sections. This section is dedicated to improving the skills and broadening the expertise of accountants who practice or work in this industry and provides numerous opportunities for networking, learning, and interaction, including the annual Real Estate Conference, Real Estate Roundtable Series, and the Discussion Group program.

We hope that you will join us. Your participation is important to our success! Please register by November 16, 2009 to confirm your attendance. If you have any questions, please email Jeff Wells at [jeff.wells@gscpa.org](mailto:jeff.wells@gscpa.org).

Click here to register: <http://www.gscpa.org/Public/Catalog/CourseDetails.aspx?courseID=0911920>