2005

Disposing of Overleveraged Real Estate: Thinking Outside the Box

Blake D. Rubin
**Disposing of Overleveraged Real Estate: Thinking Outside the Box**

Blake D. Rubin
Arnold & Porter LLP
555 Twelfth Street, N.W.
Washington, D.C. 20004
blake_rubin@aporter.com

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**The Property**

<table>
<thead>
<tr>
<th>VALUE</th>
<th>$100</th>
</tr>
</thead>
<tbody>
<tr>
<td>BASIS</td>
<td>$40</td>
</tr>
<tr>
<td>NONRECOUSE DEBT (10 YRS.)</td>
<td>$99</td>
</tr>
<tr>
<td>REMAINING DEPRECIABLE LIFE</td>
<td>10 YEARS</td>
</tr>
<tr>
<td>NEW DEPRECIABLE LIFE</td>
<td>39 YEARS</td>
</tr>
</tbody>
</table>

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**Outright Sale**

<table>
<thead>
<tr>
<th>AMOUNT REALIZED:</th>
</tr>
</thead>
<tbody>
<tr>
<td>CASH PROCEEDS</td>
</tr>
<tr>
<td>DEBT</td>
</tr>
<tr>
<td>TOTAL</td>
</tr>
<tr>
<td>ADJUSTED BASIS</td>
</tr>
<tr>
<td>GAIN</td>
</tr>
<tr>
<td>TAX RATE</td>
</tr>
<tr>
<td>TAX LIABILITY</td>
</tr>
<tr>
<td>AFTER-TAX PROCEEDS</td>
</tr>
</tbody>
</table>
Installment Sale Subject to First Mortgage

- BUYER TAKES PROPERTY SUBJECT TO $99 FIRST MORTGAGE, AND GIVES SELLER $1 NOTE PAYABLE, $.10 PER YEAR FOR 10 YEARS.

Installment Sale Subject to First Mortgage

SELLING PRICE $100
GROSS PROFIT $ 60
CONTRACT PRICE $ 60
GROSS PROFIT RATIO 60/60
PAYMENT IN YEAR 1:
DEBT $ 59.00
CASH $.10
TOTAL $ 59.10

Installment Sale Subject to First Mortgage

PAYMENT IN YEAR 1 $59.10
GROSS PROFIT RATIO x 1.00
GAIN IN YEAR 1 $59.10
GAIN IN YEARS 2-10 $ .90
Installment Sale
Wraparound Mortgage

BUYER GIVES SELLER $100
"WRAPAROUND" MORTGAGE;
SELLER AGREES TO PAY $99
FIRST MORTGAGE

Installment Sale
Wraparound Mortgage

SELLING PRICE $100
GROSS PROFIT $ 60
CONTRACT PRICE $100
GROSS PROFIT RATIO 60/100
PAYMENT IN YEAR 1:
DEBT $ 0
CASH 10.00
TOTAL $ 10.00

Installment Sale
Wraparound Mortgage

PAYMENT IN YEAR 1 $10.00
GROSS PROFIT RATIO x .60
GAIN IN YEAR 1 $ 6.00
GAIN IN YEARS 2-10 $54.00
Pre-Foreclosure
Like-Kind Exchange

A $10 CASH

B $10 CASH

Prop. B Value $120

Liab. $100

Q.I.

1. Partnership holds Prop. B with low basis; Q.I. recognizes no gain on foreclosure.

2. Is there an "exchange" when Prop. A has no equity value?

Bank

Partnership Admission
With Book-Up

Old Partners

New Partners

1%

99%

1%

$1

Partnership

Partnership Admission
With Book-Up

<table>
<thead>
<tr>
<th>TAX</th>
<th>BOOK</th>
</tr>
</thead>
<tbody>
<tr>
<td>Prop. 40 Cash 1</td>
<td>Prop. 100 Debt</td>
</tr>
<tr>
<td>1 New (60) Old</td>
<td>1 New</td>
</tr>
<tr>
<td>0 Old</td>
<td>100 Debt</td>
</tr>
</tbody>
</table>

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Sec. 704(c) Consequences: Traditional Method

- NEW PARTNERS RECEIVE $4/YEAR DEPRECIATION FOR 10 YEARS
- OLD PARTNERS RECOGNIZE $5.54 CAPITAL GAIN IN YEAR 1, $5.94/YEAR CAPITAL GAIN IN YEARS 1-10 UNDER SECS. 752(b) AND 731

Sec. 704(c) Consequences: Curative Method

- NEW PARTNERS RECEIVE $9.90/YEAR DEPRECIATION FOR 10 YEARS
- OLD PARTNERS RECOGNIZE $5.90/YEAR ORDINARY INCOME IN YEARS 1-10

Sec. 704(c) Consequences: Traditional Method

- SEC. 734(b) ADJUSTMENT REDUCES SEC. 704(c) GAIN
- "CYCLOTRON" PROBLEM? REDUCTION IN SEC. 704(c) GAIN REDUCES SECOND TIER SEC. 752 ALLOCATION, TRIGGERING ADDITIONAL GAIN, WHICH TRIGGERS ADDITIONAL 734(b) ADJUSTMENT, ETC., ETC., ETC.
Sec. 704(c) Consequences: Remedial Method

- NEW PARTNERS RECEIVE $5.48/YEAR DEPRECIATION IN YEARS 1-10; $1.52/YEAR IN YEARS 11-39
- OLD PARTNERS RECOGNIZE $1.48/YEAR ORDINARY INCOME IN YEARS 1-10, $1.52/YEAR ORDINARY INCOME IN YEARS 11-39

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Partnership Admission With No Book-Up

- CAPITAL SHIFT ISSUE?
- SEC. 704(c) PRINCIPLES INAPPLICABLE
- NEW PARTNERS RECEIVE $3.96/YEAR DEPRECIATION FOR 10 YEARS
- OLD PARTNERS DEFER GAIN UNTIL MINIMUM GAIN CHARGEBACK EVENT

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Summary:
Where Do You Want To Go Today?

<table>
<thead>
<tr>
<th>Install.</th>
<th>Wrap</th>
<th>Pshp-</th>
<th>Pshp-</th>
<th>Pshp-</th>
<th>Pshp-</th>
</tr>
</thead>
<tbody>
<tr>
<td>Sale</td>
<td>Note</td>
<td>Trad'</td>
<td>Curat.</td>
<td>Remed.</td>
<td>Book-Up</td>
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<tr>
<td>Gain in 59.10</td>
<td>6</td>
<td>5.54</td>
<td>5.90</td>
<td>1.48</td>
<td>0</td>
</tr>
<tr>
<td>KG</td>
<td>KG</td>
<td>KG</td>
<td>Ol</td>
<td>Ol</td>
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<tr>
<td>Deprec. in Years 2.56</td>
<td>2.56</td>
<td>4</td>
<td>9.90</td>
<td>5.48</td>
<td>3.96</td>
</tr>
<tr>
<td>1-10</td>
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<td></td>
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## Summary:

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<tr>
<td>Goal in Year 1</td>
<td>KG</td>
<td>KG</td>
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Gain in Year 1: 59.10
Deprec. in Years: 2.56
Summary:
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<th>Pshp.-</th>
<th>Pshp.-</th>
<th>Pshp-No</th>
<th>Book-Up</th>
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Gain in Year 1

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<th>KG</th>
<th>KG</th>
<th>OI</th>
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Deprec. in Years 1-10

| 2.56 | 2.56 | 4   | 9.90  | 5.48  | 3.96   |

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