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When Purchasing Loans, Look Beyond Dollars and Cents

By Scott O'Sullivan, CPA

It's the kind of scenario managing members and/or CFOs of investment entities may dread: Just when you thought you'd highlighted a solid investment opportunity for investors, the calls start coming in – and they're not sounding good.

You're in the business of buying loans (potentially in distress) from banks that want them off their balance sheet, and for a time, you've successfully identified loans that could yield a favorable return on investment; any payments from the original borrower, north of your entity's loan purchase, have been a win.

Somewhere along the way, though, you've gone from holding an intangible, which lacked the physical nexus in a state, to actually owning the property: It's no longer simply about gains and income. Instead, your entity and partners are now being taxed by certain states for trade, business, and/or rental income.

That means your investors, who thought they'd signed up for a simple investment not tied to the ownership of any physical property, are suddenly getting K-1 forms for states they've never even visited, and they're starting to ask you, "Why do I need to file a tax return in such-and-such state, when I don't even live there?"

Having to get a souped-up tax program or hire a sophisticated tax accountant is the least of your investors' worries.

Next thing you know, the investment's income and distributable net cash are being impacted by additional professional fees (legal and accounting). Additionally, the investors' ROI are further reduced by tax return compliance costs, including nonresident tax withholding requirements, which now accompany the state – or states – where each property or operation tied to your investment is located.

But here's the good news: It doesn't have to be that way. There is a solution, and it rests on conducting the right due diligence, and asking the right questions, all up front.

Look Beyond 'Dollars and Cents'

The first step has to begin by looking beyond business as usual.

Far too often, when evaluating the potential ROI of a loan purchased at face or at a discount, it's tempting to simply focus on the dollars and cents of such a transaction, or, to home in on whether the loan is in default, and what its tax treatment would be.

There is a lot more to consider, though. In fact, a lot of interesting federal, state/local, and foreign tax issues start piling up early on. Consider just a few: If you're now the lender, and the borrower is now making payments to you, do you have income? Is the loan that you purchased technically in default?

The questions get even more complicated upon receipt of the collateral, which triggers a taxable event that many investors are ill-prepared for.

Truth is, no investor goes into a publicly traded partnership understanding the state/local and additional tax filing and compliance costs, to name just a few. That explains why, as just one of many examples, someone who owns 1/10th of 1 percent of a publicly traded oil-and-gas partnership may later be shocked to find they have to file in 15 different states for what they thought was a straightforward investment.

If it's an international investment, matters get even more complicated. Who is responsible for filing any foreign tax returns? Do you have foreign issues? Do you have bank accounts in other jurisdictions?

Wherever the asset is located, if the borrower fails to make adequate payments, and investors take back the property, you're looking at a taxable event for which taxes can be significant and cost-prohibitive if tax compliance, and accompanying filing requirements, are not properly implemented.

The asset's location isn't the only issue, either. So is the value of the underlying collateral, upon satisfaction of the loan, which will determine if you have a gain or loss. If it's the latter, and a state has a net operating loss carryover provision, you can file – and establish – an NOL, which can then be applied toward future profit. Conversely, if a state has no such provision, there's no tax impact if investors don't file to substantiate an NOL.

Start Your Due Diligence Early

Questions like these can be overwhelming, but they're manageable if you do your due diligence early – on day one.

The first question you should be asking is, "What's the end game"?

If there's a high probability of ultimately holding the property that secures the loan, you'll want to understand, in turn, the state's filing and withholding requirements at the outset, and – just as critically – inform investors in your partnership that they may eventually have to file tax returns in several different states.

Eventual ownership will trigger other questions, too. To list just a few: Do you have foreign investors, and where are they located? Is there a tax treaty with the foreign jurisdiction? What types of income are you passing on to investors (fixed and determinable type income or effectively connected US trade or business income) that may or may not be subject to U.S. tax withholdings on behalf of foreigners?

Delving into these questions early on makes all the difference. Your investors won't only avoid scrambling to do their tax returns on or about the due date; they, and you, will also have a better idea of the economics of a deal, and how to minimize overall compliance costs along the way.

Most importantly, you'll have peace of mind knowing your investors won't be calling you, blindsided, after having signed on the dotted line.

About Scott O'Sullivan, CPA

Scott is a tax partner at Margolin, Winer & Evens LLP. He serves in the Real Estate Practice Group, where he is heavily involved in tax planning and deal structuring, including 1031 exchanges, cost segregation studies, energy and sustainability related incentives, rehabilitation tax credits, and other transactions on behalf of prominent real estate developers and investors, property managers, nursing home owners and operators and other diverse businesses.

Scott's achievements were recognized by Long Island Business News which identified him as one of the Top Five to Watch in Commercial Real Estate. He was also named one of Real Estate Weekly's "Rising Stars."

Scott holds a Bachelor of Science in Accountancy from Villanova University and a Master of Science in Taxation from Hofstra University. Additionally, he has successfully completed various real estate finance and investment courses at New York University's School of Continuing & Professional Studies' Real Estate Institute. He is a member of the American Institute of Certified Public Accountants (AICPA), Long Island Real Estate Group (LIREG), CoreNet Global, and the Our Lady of Miraculous Medal Pastoral Council. Scott can be reached at ***sosullivan@mwellp.com.***

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