Nonrecourse debt

Non-recourse debt or a **non-recourse loan** is a secured loan (debt) that is secured by a pledge of collateral, typically real property, but for which the borrower is not personally liable. If the borrower defaults, the lender/issuer can seize the collateral, but the lender's recovery is limited to the collateral. Thus, non-recourse debt is typically limited to 50% or 60% loan-to-value ratios,[1] so that the property itself provides "overcollateralization" of the loan.

The incentives for the parties are at an intermediate position between those of a full recourse secured loan and a totally unsecured loan. While the borrower is in first loss position, the lender also assumes significant risk, so the lender must underwrite the loan with much more care than in a full recourse loan. This typically requires that the lender have significant domain expertise and financial modeling expertise.

Nonrecourse debt is used for residential mortgage loans in the United States,[2][3] although most of Europe enforces mortgage debt forgiveness after eviction.[4]

Common uses

Non-recourse debt is typically used to finance commercial real estate, shipping or other similar projects with high capital expenditures, long loan periods, and uncertain revenue streams. It is also commonly used for stock loans and other securities-collateralized lending structures. Since most commercial real estate is owned in a partnership structure (or similar tax pass-through), non-recourse borrowing gives the real estate owner the tax benefits of a tax-pass-through partnership structure (that is, loss pass-through and no double taxation), and simultaneously limits personal liability to the value of the investment.

In some states, "antideficiency statutes" provide that mortgages secured by personal residences are non-recourse against the borrower.[5]

A non-recourse debt of $30 billion was issued to JPMorgan Chase by the Federal Reserve in order to purchase Bear Stearns on March 16, 2008. The non-recourse loan was issued with Bear Stearns's less liquid assets as collateral, meaning that the Federal Reserve will absorb the loss should the value of those assets be below their collateralized value.

Self-directed IRA investors who choose to purchase investment real estate are able to leverage their purchase with a non-recourse loan. Because of the IRS regulations, it would be deemed a violation of the qualified retirement account status to personally guarantee any loan on real estate owned by a self-directed IRA.

Non recourse lawsuit funding

There is another type of **non recourse funding** available, often used to provide cash to plaintiffs involved in a contingency based lawsuit. The money is a cash advance on the anticipated

settlement amount, and is based on a percentage of that amount. This money is true non recourse funding, in that if the case is lost, you owe the lawsuit funding company nothing. They are actually investing in the lawsuit. For this reason, they require case documentation from the plaintiffs attorney, which is kept in complete confidence. The funders will review the case files an if they feel the case is worthwhile, they will invest in it.

This money is not cheap in comparison to a home equity loan, or even a credit card cash advance. This is because lenders prey on plaintiffs who cannot afford to lose their cases, so they give away a large percentage of any potential recovery in order to guarantee a small, immediate reward. People who incur this type of debt often wind up worse off in the long run had they simply waited out a settlement.

Characterization[edit]

Non-recourse debt is usually carried on a debtor company's balance sheet as a liability, and the collateral is carried as an asset.

Tax consequences of disposition of property encumbered by non-recourse debt

For U.S. Federal income tax purposes, the interaction among the concepts of (1) the "amount realized" upon a disposition, (2) the amount of non-recourse debt, and (3) the amount of adjusted basis in the property is fairly complex. The tax consequences of a disposition depend on whether the taxpayer acquired the property with the non-recourse debt already attached, or whether the taxpayer took out the non-recourse debt after acquisition of the property, and the relative relationships between fair market value (FMV) and purchase price and disposition price.

Basic concept: Computing gain or loss on a disposition

Upon a sale or other disposition of property under U.S. income tax law, a taxable gain generally results where the amount realized upon the sale or other disposition of property exceeds the amount of the taxpayer's adjusted basis in that property.

Generally, the amount realized is the amount of cash and other consideration received by the taxpayer. The amount of any loan forgiven or discharged is generally part of that consideration.[6]

The adjusted basis is the sum of the following:

- the amount of the original cost incurred by the taxpayer when the property was acquired, including the amount of any non-recourse debt assumed by the owner/taxpayer as part of the acquisition (also known as "original basis"),
- plus the costs of improvements (if any) made by the taxpayer to the property,
- less the amount of depreciation (or similar) deductions allowed (or allowable) to the taxpayer on that property.

If the amount realized exceeds the amount of adjusted basis, the taxpayer has realized a gain at the time of disposition. If the adjusted basis exceeds the amount realized, a loss has been incurred.[7] The federal income tax effect of non-recourse debt may be explained by first considering the tax effect of a disposition involving recourse debt (that is, a debt in which the property provides first security coverage, and the borrower/taxpayer is personally liable for any deficiency that may remain after the lender forecloses against the property), and then contrasting against similar facts involving non-recourse debt, as follows:

Disposition of property subject to a recourse debt

Example:

1. The unpaid principal of the recourse debt is $100,000;
2. The fair market value of the property is $80,000;
3. The taxpayer's adjusted basis in the property is $45,000.

Assuming that the creditor forecloses on the property and that the $20,000 excess of the debt over the property's fair market value ($100,000 less $80,000) is contractually discharged (for didactic symmetry with the non-recourse example, let's assume, contrary to the commercial point of a recourse loan, that the debt is outright forgiven by the creditor, with no actual payment), the taxpayer would realize the $20,000 amount as income from the discharge of indebtedness. That $20,000 of forgiveness would be taxable to the taxpayer as ordinary income even though the taxpayer received no cash at the time of the discharge.[8] The $35,000 excess of the fair market value over the adjusted basis ($80,000 less $45,000) would be treated as a taxable capital gain on the "sale or other disposition" of the property – again, even though the taxpayer received no cash at the time of the foreclosure.

Disposition of property subject to a non-recourse debt

Assuming the same facts except that the debt is non-recourse, the result would be quite different. The taxpayer would realize zero taxable ordinary income from the discharge of debt. Instead, the entire $55,000 difference between the unpaid principal of the debt and the taxpayer's adjusted basis ($100,000 less $45,000) would be treated as a taxable capital gain on the "sale or other disposition" of the property—again, even though no cash is received by the taxpayer at the time of foreclosure.[9]

At the sale, foreclosure or other disposition, non-recourse debt incurred as part of the financing of the acquisition, and money extracted from an investment by mortgaging out, are treated the same: both are taxable realization only at the time of the property's disposition,[10] even if, at time of disposition, the property is worth less than the amount of the mortgage. Non-recourse debt that is in place at the time of acquisition of the property is included in basis, *Crane v. Commissioner*,[11] subsequent borrowing is not. *Woodsam Associates, Inc. v. Commissioner*.[12] Subsequent borrowing proceeds reinvested in a depreciable property thereby avoid *Woodsam* and take advantage of *Crane*.

United States

According to the National Consumer Law Center (NCLC), at least 10 states can be generally classified as non-recourse for residential mortgages:[13]

- Alaska
- Arizona
- California
- Hawaii
- Minnesota
- Montana
- North Dakota
- Oklahoma
- Oregon
- Washington

Recent legislation also makes Nevada non-recourse in most cases for residential purchasers for mortgages obtained on or after October 1, 2009.[13]

Footnotes

1. "U.S. new and existing home sales move in opposite directions in April". Reed Construction Data. May 24, 2011. Retrieved 15 November 2013.
2. Congressional Budget Office (2010). *Fannie Mae, Freddie Mac, and the Federal Role in the Secondary Mortgage Market*. p. 49.
3. United Nations (2009). *Forest Products Annual Market Review 2008-2009*. United Nations Publications. p. 42. ISBN 978-92-1-117007-8.
4. Hogan, Cawlainn (14 November 2011). "Spanish property bubble fallout continues with evictions, debt and fear of homelessness". The Irish Times. "Unlike most European countries, Spanish law does not enforce mortgage debt forgiveness after eviction."
5. Ghent, Andra C. and Kudlyak, Marianna, Recourse and Residential Mortgage Default: Theory and Evidence from U.S. States (July 10, 2009). Federal Reserve Bank of Richmond Working Paper No. 09-10. Available at SSRN: http://ssrn.com/abstract=1432437. The authors classify eleven states (Alaska, Arizona, California, Iowa, Minnesota, Montana, North Carolina, North Dakota, Oregon, Washington, and Wisconsin) as non-recourse. The authors also discuss the reasoning for this classification on a state-by-state basis. In several of the non-recourse states some form of recourse is available but impractical due to lengthy and expensive judicial proceedings, jury trials, and extended redemption periods.
6. Determination of amount and recognition of gain or loss. Taxalmanac.com.
7. [1] . Justia. Justia.com
8. Unless the $20,000 qualifies as being excludable under 26 U.S.C. § 108.
9. *Commissioner v. Tufts*, 461 U.S. 300 (1983); *Crane v. Commissioner of Internal Revenue*, 331 U.S. 1 (1947).
10. *Estate of Levine v. Commissioner*, 72 T.C. 780, 792 (1979), *aff'd*, 634 F.2d 12 (1980) (a "non-recourse mortgage debt is a debt of the property owner since he is, in reality, a quasi-obligor on the debt, notwithstanding the fact that the debt is owed by the property."); *Woodsam Associates, Inc. v. Commissioner*, 16 T.C. 649 (1951), *aff'd*, 198 F.2d 357 (2d Cir. 1952) (the excess of the amount of the debt over the adjusted basis of the property is gain, and will be treated as capital gain, subject to the rules on depreciation recapture).
11. *Crane v. Commissioner of Internal Revenue*, 331 U.S. 1 (1947).

12. *Woodsam Associates, Inc. v. Commissioner*, 16 T.C. 649 (1951), *aff'd*, 198 F.2d 357 (2d Cir. 1952).
13. "COMPARISON OF STATE LAWS ON MORTGAGE DEFICIENCIES AND REDEMPTION PERIODS". Connecticut Office of Legislative Research. 29 July 2010. Retrieved 24 August 2013.

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