Debt cancellations and modifications - by Sandy Klein

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Introduction:

The “R” word (recession) is back in vogue. The current economic climate marked by rising interest rates, bank failures and consequential stricter lending standards, is putting a damper on economic activity. Economic downturns have a direct correlation with debt servicing. This article takes a bird’s-eye view of the tax implications of troubled debt in the real estate sector. The tax consequences of debt cancellations or modifications depend on whether the debt is recourse (borrower personally liable) or non-recourse (secured only by property). This article references only non-recourse debt.

When mortgaged property is owned by a partnership or LLC taxed as a partnership, the potential passthrough tax consequences of entity-level transactions to members of the LLC or partnership require evaluation. Changes in entity-level liabilities can have a significant tax effect. For example, a reduction in a partner’s share of entity-level liabilities may result in a constructive distribution of cash producing currently taxable income to owners.

Debt Cancellations, Foreclosures, Repossessions and Abandonments

There are a variety of ways to discharge debt. The facts and circumstances of the transactions determine if the realized income is compensation, gain on the disposition of property, rent, dividends or cancellation of debt income (COD). Typically, when a lender forecloses on or repossesses property, or the debtor abandons the property, or the lender agrees to the sale of the property for less than the debt (short sale), the transaction is treated as a sale. It is as if the debtor sold the property for the cash equivalent of the debt and then applied the cash to the

payment of the debt. This results in a debtor's gain or loss equal to the difference between the amount of the cancelled debt and the basis of the asset transferred. Generally, there is no COD as the repossession of the mortgaged property satisfies the debt but there are exceptions.

Debt Modification, Restructurings, Forbearance and Deferment

A modification means any alteration, in whole or part, of a legal right or obligation of the issuer or holder of the debt instrument, including deletion or addition. Not all actions constitute a modification. Significant modifications of which there are four specific categories – changes in yield, material change in timing of payments, change in the obligor or security, changes in the nature of the instrument - produce taxable exchange. The Reg. Sec. 1.1001-3 provides details and examples of each category. The debtor is deemed for tax purposes to exchange old for a new debt. Discharge of indebtedness income can be avoided through workout deals designed so that the issue price of the new debt is not less than the principal amount of the old debt. One simple stratagem is to provide for adequate stated interest.

Two most common types of debt modifications are forbearance and deferment. In a typical deferment, the suspension applies to both principal and interest with no penalty. For instance, suspension of all payments for six months and extend the loan for six months. Forbearance suspends some payments during a set term, but interest continues to accrue during the forbearance period. The interest may be capitalized (added to the loan) and the suspended debt payments become due as a lump sum at the end of the forbearance period or added to the end of the original loan period.

Discharge-of-Indebtedness Income for Qualified Real Property Business Indebtedness

For noncorporate borrowers, if the negotiated mortgage reduction meets the requirements for being "qualified real property business indebtedness," specified discharge of indebtedness resulting from modification may be excluded subject to basis reduction. For property owned by a partnership, determination of whether property is qualified real property business indebtedness is made at the partnership level.

An election is made on a timely filed federal income tax return for the taxable year in which the taxpayer has discharge of indebtedness income that is excluded from gross income under I.R.C. §108(a) by filing a completed Form 982, Reduction of Tax Attributes Due to Discharge of Indebtedness.

Two limitations apply to the exclusion of income: (1) the exclusion cannot exceed the excess of the outstanding principal amount of the debt over the net fair market of the property, and (2) cannot exceed the aggregate adjusted basis of all depreciable real property.

As a condition of the election, the taxpayer must reduce the basis of depreciable real property of the taxpayer (I.R.C. §1017(b)(3)). With respect to partnerships, the benefit of the exclusion passes through to the partner thus reducing the partner's share of the basis in the depreciable real property, not so in the case of S Corporation.

Please consult your tax advisor as to how the above may impact your particular circumstances.

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