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Today's distressed world: Tax traps and planning opportunities

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The current economic downturn has resulted in a widespread decline in leveraged property values, forcing property owners, lenders and borrowers to consider various "work-out" scenarios including discounted pay-offs of mortgages, loan modifications, deeds-in-lieu and foreclosures. Meanwhile, investors with available capital may be considering investing in distressed properties or loans. For lenders, borrowers and investors, tax consequences are critical as there are both surprising traps and potential planning opportunities.

Borrowers seeking to restructure distressed debt should carefully weigh various alternatives. Some workout techniques may trigger taxable income, often at ordinary income rather than favorable capital gain tax rates. In general, when a borrower's debt is written down, the borrower recognizes immediate taxable income at ordinary income rates. This is called cancellation of debt income, or COD, and cannot be offset by capital losses. Common examples include when a lender forgives a portion of a debt, accepts a discounted pay-off of a note, or where a borrower (or its affiliate) purchases its own debt at a discount. COD also occurs to the extent that a borrower issues its own equity to a lender in payment of a debt at a discount or, somewhat surprisingly, in certain situations, as a result of loan modification or forbearance agreements.

A borrower may be able to avoid unfavorable COD income in a loan modification if the loan principal remains unchanged, even though the modification may change terms such as interest rate, loan collateral, or the payment term. To avoid the COD, the debt must bear interest at rate at least equal to the federal minimum rate and must not be treated as publicly traded. It is also important to realize, however, that some lenders may prefer to restructure by writing down the principal amount of a debt in order to recognize tax losses on an underwater loan.

A borrower's consequences upon a foreclosure or deed-in-lieu of underlying property differ drastically depending on whether the debt is nonrecourse or recourse. Where, for example, a lender accepts a deed-in-lieu or forecloses on an office building encumbered by nonrecourse debt, the borrower generally recognizes capital gain. On the other hand, if the debt on the office building is recourse debt and the lender forgives any amount over the property's then fair market value, the forgiveness creates ordinary income.

Despite the lower capital gains rates that may apply in a foreclosure or deed-in-lieu scenario, a borrower still may prefer a restructuring technique that triggers COD if the borrower is able to exclude or defer being taxed on COD under one of many provisions under the tax rules. Most often, the price of exclusion or deferral is a reduction in the borrower's tax attributes, principally any net operating losses and the tax basis of borrower's property. Although these rules are more liberal for taxpayers in bankruptcy, the costs and delays of a bankruptcy proceeding need to be considered when evaluating the borrower's alternatives. Note that the partners or members of partnership or

LLC borrowers must, themselves, be bankrupt or insolvent to make use of either of these exceptions. A borrower (other than a C corporation) with depreciable real property may qualify to exclude COD under the so-called, "Qualified Real Property Business Indebtedness" exception. This exception, however, requires the borrower to reduce the basis in its depreciable property, which increases gain on a future sale of that property. Finally, under a recently added tax rule, borrowers may be able to defer COD from certain debt instruments until 2014, and then include it in income evenly over 5 years from 2014-2018, giving a borrower the benefit of the present value of the COD deferral without reducing the borrower's tax attributes.

From a lender's perspective, it may be easier to trigger tax losses by selling an underwater debt instrument to an investor looking to acquire distressed debt at attractive prices, rather than working out the debt with the borrower. However, investors in discounted debt should be aware that a subsequent restructuring of the discounted debt by modifying its terms, even without reducing the face amount, potentially triggers phantom income to the investor. Given that convincing the historic lender and borrower to restructure the debt before purchase often is not practical or possible, an investor should factor the economic impact of the phantom income into the pricing when acquiring the asset.

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