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Pitfalls and Planning for the Tax Consequences of Loan Workouts and Debt Restructuring

Potential adverse tax consequences should be considered whenever there is any form of restructuring or modification involving a debt. Modifications which can give rise to tax consequences include the obvious, such as reduction in principal amount, as well as some less obvious, such as changing the nature of the debt from recourse to non-recourse, changing the interest rate, substituting collateral, or changing payment dates. Any significant modification of the debt is considered to be an exchange of the debt for "new" debt for federal income tax purposes, and therefore every modification of a debt should be analyzed. A significant modification of debt will give rise to cancellation of indebtedness income to the extent of the excess of the "fair market value" of the debt (a complex determination) after modification over the face value of the debt before modification.

In addition to modifications of debt, adverse tax consequences arise where property encumbered by a debt is transferred (and some of the debt is cancelled), whether through a short sale, foreclosure, or deed in lieu of foreclosure. Here, the resulting tax consequences depend on whether the debt is recourse or non-recourse. Where the debt is non-recourse, the entire amount of the outstanding debt cancelled is considered to be the sales price, and all gain or loss resulting therefrom is gain or loss from the sale or exchange of the property. The character of the gain or loss will depend on whether the real property was held for investment (capital gain or loss) or for inventory or other trade or business purposes (potential ordinary gain or loss).

Where the debt is recourse, the exchange of the property gives rise to a bifurcated analysis. The debtor will have gain or loss from the sale or exchange of the property based upon a deemed sale price only to the extent of the fair market value of the property, with any debt forgiven in excess of the fair market value of the property giving rise to cancellation of debt income. Because cancellation of debt income is ordinary, while the character of the gain or loss depends on the character of the property held, there is a potential that there will be a mismatch of ordinary income and a capital loss.

If a transaction relating to debt modification (or foreclosure of a recourse debt) gives rise to cancellation of debt income, there are a number of exclusions available which should be considered (to avoid the recognition of such cancellation of debt income). Note that these exclusions are only available for income from cancellation of debt, the exclusions are <u>not</u> available for gain resulting from foreclosure of a non-recourse debt.

If the cancellation of the debt arises in bankruptcy, then the income is excluded entirely. If the cancellation of debt arises when the taxpayer is insolvent, then the income is excluded to the extent of the taxpayer's insolvency (which is measured immediately before the discharge). Where the debtor is a partnership, it is important to remember that the bankruptcy and insolvency exclusions are tested at the partner level. That is, the partnership's bankruptcy or insolvency is irrelevant, and each partner must examine his own assets and liabilities to determine whether such exclusion is available to him.

There are also exclusions available for cancelled debt which is qualified real property business indebtedness, qualified farm indebtedness, or qualified principal residence indebtedness. All exclusions for cancellation of indebtedness come with a cost, in the form of a reduction in tax attributes (net operating losses, credits, depreciable basis, etc.) Consideration should be made of this "cost" when electing to utilize any of the exclusions available.

It is important to note that there are pitfalls to avoid relating to bad debt. For instance, having a "related" party (such as a family member, or an entity more than half of which is owned by the debtor or family members) acquire the debt is not a solution, as this will be treated as if the debtor himself acquired the debt for the purchase price, giving rise to immediate cancellation of indebtedness income.

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