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

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Basic Scenario:

Blackacre, investment property held for a few years. Value has tanked and now it's underwater.

<u>Original Debt = $20 million</u>

- Current Outstanding = $18 million
- Cost Basis = $25 million
- FMV = $10 million
- Maturity Date? Soon or Overdue
- Interest Rate

Options for Approaching a Workout

- Modify Debt
- Transfer Property

Tax Consequences

1. Cancellation of Debt income is ordinary income unless there is an exclusion.

2. If you give up the property it is a sale - character of gain or loss depends on whether it is an investment or a dealer property.

<u>Possible exclusions for Cancellation of Debt (§108)</u>

1. Bankruptcy | *(these two are*
2. Insolvency | *not elective)*
3. Qualified Real Property Business Debt
4. Qualified Farm Debt
5. Qualified Principal Residence Debt

Tax Attributes Reductions (the price of §108 Exclusions)

Reduction in:

1. NOLs
2. Depreciation
3. Basis

1. Modifications

- Change of obligor
- Principal reduction
- Change from recourse to non-recourse (or vice versa)
- Change in timing of payments (maturity date?)
- Change in interest rate
- Change in collateral
- Conversion to equity
- Change/release of guarantor

2. Transfer the Property

- Short sale
- Deed in lieu
- Foreclosure

3. Transfer of Note

- Friendly Investor
- Watch out for having related party acquire debt

4. Maintain Status Quo

- Keep on keeping on; or
- Stop making payments (may risk this being a deemed modification)

Tax Consequences of a Modification

Could be deemed an exchange of the old Note for a new Note - cancellation of indebtedness income to extent "fair market value" of new Note is less than the face value of the old Note.

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What is the "Fair Market Value" of the New Debt?

- May be face value (so unless you change principal amount due, probably okay).
- But, if "publicly traded", then its trade value - probably less than face value.

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Vicki's First Scenario

The first scenario involves potential modifications to this loan:

A. The lender is willing to agree to a principal reduction from \$18M to \$12M at this time, but will require an increase in the interest rate and that 100% of the net cash flow from the property will be paid to Bank Incorporated until the debt is satisfied.

B. Alternatively, the personal guarantees will be cancelled.

A. Tax Consequences to Modification of Loan to Reduce Principal Amount From $18M to $12M (Borrower keeps real property)

Debt Balance	$18 Million
New Debt Balance	$12 Million
COD Income	$6 Million

COD Income is taxable – unless one of the exclusions apply

B. Tax Consequences to Release of Guarantees

- If "New Debt" is not publicly traded:

Old Debt Balance	$18 Million
"New Debt" Face	$18 Million
COD Income	0

- If "New Debt" is publicly traded:

Old Debt Balance	$18 Million
"New Debt" Value	$12 Million
COD Income	$6 Million

Exclusions may be available for COD

<u>Tax Consequences of a Transfer of the Property</u>

- Depends on Whether the Debt is Non-Recourse or Recourse Debt

Non-Recourse Debt

- All sale/exchange treatment—full amount of debt is deemed "purchase price" for calculation of gain/loss
- Character of gain or loss depends on why you held property—dealer or investor

Recourse Debt

Bifurcated-character issues:

1. Sale/exchange to extent of FMV of property (could be capital).

   Character of gain or loss depends on whether you are investor or dealer.

2. Excess of debt over FMV of property – COD income (ordinary income).

Vicki's Second Scenario

- It is possible that Bob and Steve simply give up. They have no more resources and their guarantees are worthless.
- They agree to convey the property to the bank by deed in lieu of foreclosure or cooperate with a so-called "friendly foreclosure".

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A. <u>Tax Consequences to Transfer of Property to Bank for Foreclosure or by Deed in Lieu of Foreclosure*</u>

- 2 Aspects: 1) Sale and 2) Debt Cancellation
  - Step 1 - Sale of Property

FMV	$10 Million
Basis	<u>$25 Million</u>
Loss	$15 Million

Key Issue – Character of Loss

*Note: This debt was guaranteed, so it is recourse debt.

B. Tax Consequences to Transfer of Property to Bank for Foreclosure or by Deed in Lieu of Foreclosure

- Step 2 - Debt Cancellation

Total Debt	$18 Million
Debt “Paid” in Sale	$10 Million
Balance of Debt	$8 Million

$15 Million Loss and $8 Million COD.

Vicki's Third Scenario

Another option might be a discounted payoff. Bob and Steve have convinced the Bank that given the reduction in value of the property, they will put no more money into it and that their guarantees are worthless. Bob and Steve know they can find or raise the $10,000,000 that the property is worth and offer that to the Bank as a discounted payoff. Perhaps their access to other funds comes from a rich parent, a related party, or from a vulture fund, which is an unrelated third party, who buys the debt for the discounted payoff ($10,000,000) to Bank Incorporated. The Bank accepts.

Consequences of a Transfer of the Note

- Unrelated Party Buys Note from Bank
- Related Party Buys Note from Bank

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If related party acquires the debt, treated as if taxpayer himself acquires the taxpayer's debt - COD to extent of difference between debt and purchase price.

Tax Consequences if Unrelated Party Buys Note from Bank for $10 Million

None?

Key Point – The debt would likely be modified after its acquisition.

Tax Consequences if Related Party Buys Note from Bank for $10 Million

- Treated as if Borrower (not the Related Party) acquired the Note for $10 Million and as if the debt is reduced to $10 Million.

Debt Amount	$18 Million
Purchase Amount	$10 Million
COD Income	$8 Million

Recap – Important Points

- Any modification of debt raises risk of adverse tax consequences.
- Using a related party to buy your debt may <u>not</u> help (and may hurt).
- Conveying the property (to Bank or others) has two consequences:
  - “Sale” itself may trigger gain or loss
  - Debt cancellation is COD income
- Character of income and loss on sale is important (loss on sale may not offset COD income).
- Exclusions of COD income may be available to avoid taxation - have a cost later (tax attributes reduction).

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Questions?