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Legal Alert

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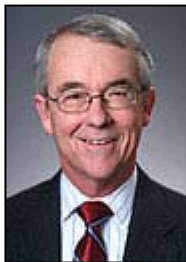

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Debt Workouts and the Borrower's Tax Considerations

Borrowers and lenders in the real estate industry have good reason to feel uneasy lately. The declining value of real property collateral and the failure of some of America's most stalwart financial institutions have brought into focus loan products on the balance sheets of surviving banks and lenders. The unprecedented volatility of the market and weakening economy have borrowers struggling to fund current debt obligations and lenders seeking to salvage their return on investment.

A debt workout may provide relief for both borrowers and lenders. Although debt workouts typically arise in the rush to avoid foreclosure or bankruptcy, even performing loans are susceptible to a workout. Until recently, securitization was a reliable mechanism for removing real estate loans from a lender's books. There also was an active market of third party purchasers of debt. Those exit strategies are no longer viable.

Whether a borrower is financially viable or in a financial freefall, a debt workout should not be entered into without considering the tax consequences. Without careful tax planning, a workout may result in the borrower being indebted to the Internal Revenue Service rather than a financial institution.

Both lenders and borrowers wish to complete workouts quickly. If the borrower and lender simply agree to reduce the debt, or the borrower refinances and pays off the debt at a discount, the borrower potentially will have ordinary income to the extent of the reduction or discount. However, if a friendly third party acquires the debt from the lender at a discount, provided that the friendly party is not too closely related to the borrower, the borrower will not have cancellation of debt income. The friendly party must be careful or the modification of the acquired debt could result in the friendly party recognizing taxable income equal to the discount.

When the borrower is a partnership or limited liability company taxable as a partnership, new partners or members may be admitted, existing partners or members may make non-pro rata additional capital contributions, or an interest in the partnership or LLC may be issued to the lender. These events also can result in cancellation of debt income unless carefully structured.

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In some cases cancellation of debt income can be excluded from tax. The most common exclusion is when the borrower is insolvent or in bankruptcy. Under certain circumstances, a borrower can elect to exclude cancellation of debt income arising from real property debt. When these exceptions apply, the borrower must reduce certain tax attributes, such as net operating losses or the tax basis of depreciable property by the amount of the exclusion.

Business exigencies may require outstanding debt to be restructured or modified, but a borrower should be aware that such transactions may have substantial tax consequences, both under federal and California law. All members of the Allen Matkins tax department are familiar with the tax consequences of debt workouts and any one of them can be contacted to discuss how to plan or structure such transactions.

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