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Federal Tax Issues Arising in Connection With Real Estate Distressed Debt Workouts

Kelley Drye Client Advisory

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The COVID-19 pandemic is having a profound impact upon commercial real estate. This Client Advisory discusses selected federal tax issues arising in connection with real estate distressed debt workouts. The issues arise in connection with:

- Foreclosures and deeds-in-lieu of foreclosure;
- Debt-for-debt exchanges; and
- Modifications of a debt instrument.

There are two scenarios addressed below: Under one scenario, the borrower retains the real estate, and its debt is restructured. Under the second scenario, the borrower transfers the real estate in connection with the debt restructuring.

Subject to the exceptions discussed below, a borrower generally realizes cancellation of indebtedness ("COD") income if and to the extent that it discharges its debt obligation for an amount that is less than the principal amount of the debt.

"Recourse" vs. "Nonrecourse" Debt

If a borrower transfers property to a lender in satisfaction of debt, the computation of COD income will depend upon whether the debt is considered "recourse" or "nonrecourse" for tax purposes. If the debt is considered "recourse" debt, then the borrower would generally realize COD income if and to the extent that the principal amount of the discharged debt exceeds the fair market value of the underlying property. If the debt is considered "nonrecourse," then the borrower would generally realize taxable gain from the sale of the underlying property, measured by the excess of (i) the principal amount of the "nonrecourse" debt over (ii) the borrower's adjusted tax basis in the transferred property. In many cases, classification of debt as "recourse" or "nonrecourse" for federal tax purposes will be uncertain.

In certain cases, a borrower will be incentivized to structure a distressed debt workout to generate taxable gain, rather than COD income, because taxable gain could be taxable at preferential capital gains rates (*i.e.,* 23.8%, in the case of an individual), while COD income would be taxable at ordinary income rates (*i.e.,* 40.8%, in the case of an individual). In other cases, a borrower will be incentivized

to structure a distressed debt workout to generate COD income, rather than taxable gain from the sale of the underlying property, because, as discussed below, COD income can sometimes be excluded from gross income.

A borrower may attempt to convert a "recourse" debt to a "nonrecourse" debt, or vice versa, to minimize tax liability, but it is uncertain whether a tax-motivated change in the tax status of debt would be respected by the IRS or the courts.

COD Income Exceptions

Bankruptcy and Insolvency Exceptions

COD income can be excluded from gross income if (i) the debt discharge occurs in a Title 11 case or (ii) the taxpayer is insolvent (but only to the extent that the taxpayer is insolvent).

If the borrower is an entity classified as a partnership for federal tax purposes, the bankruptcy and insolvency exceptions apply at the partner, rather than the partnership, level. Accordingly, if a partner is solvent and not subject to a Title 11 case, these exceptions would not apply, even if the partnership is insolvent or subject to a Title 11 case.

If the borrower is a C or S corporation, the bankruptcy and insolvency exceptions apply at the corporate, rather than the shareholder, level.

A taxpayer is insolvent to the extent that the principal amount of its liabilities exceeds the fair market value of its assets. In certain cases, it will be uncertain how to treat contingent liabilities in measuring insolvency. If the principal amount of a "nonrecourse" liability exceeds the fair market value of assets securing the liability, special rules apply in measuring insolvency.

Reduction of Tax Attributes

A taxpayer that excludes COD income from gross income pursuant to the bankruptcy or insolvency exceptions is required to reduce its tax attributes by the amount of the excluded income in the following order: (i) NOLs, (ii) general business credits, (iii) minimum tax credits, (iv) capital loss carryovers, (v) tax basis in property, (vi) passive activity loss and credit carryovers, and (vii) foreign tax credit carryovers.

"Qualified Real Property Business Indebtedness"

In the case of a taxpayer other than a C corporation, COD income can be excluded from gross income if the debt discharged is so-called "qualified real property business indebtedness."

"Qualified real property business indebtedness" is defined as indebtedness which (i) was incurred or assumed by the taxpayer in connection with real property used in a trade or business and is secured

by such property, (ii) was incurred or assumed to acquire, construct, reconstruct, or substantially improve such property, and (iii) with respect to which the taxpayer makes an election.

COD excluded from gross income under this exception cannot exceed the excess, if any, of (i) the outstanding principal of the "qualified real property business indebtedness" immediately before the discharge over (ii) the net fair market value of the real property immediately before the discharge.

Under a second limitation, the amount of COD excluded from gross income with respect to "qualified real property business indebtedness" cannot exceed the aggregate adjusted bases of depreciable real property held by the borrower immediately before the debt discharge.

Purchase Money Debt Reduction

If the debt of a purchaser of property to the seller of such property that arose from the purchase of such property is reduced, then the debt reduction will be treated as a nontaxable purchase price adjustment, which would not give rise to COD. This COD exclusion is not available, however, if the debtor is bankrupt or insolvent.

Acquisition of Debt by a Third Party

In certain cases, a borrower may attempt to avoid COD by having a "friendly" third party acquire its debt at a discount.

If the purchaser is "related" to the borrower (under Sections 267(b) and 707(b)(1) of the Internal Revenue Code), the acquisition of the discounted debt would trigger COD to the borrower. If a purchaser acquires the discounted debt in anticipation of becoming "related" to the borrower, the purchase could also trigger COD. If a purchaser becomes "related" to the borrower within six months after purchase of the discounted debt, the purchase will trigger COD. If a purchaser becomes "related" to the borrower more than six months after purchase of the discounted debt, COD will also be triggered under certain circumstances.

Debt-for-Debt Exchanges and "Publicly Traded" Debt

If (i) a borrower issues new debt in exchange for preexisting debt, (ii) the stated principal amount of the issue that includes the new debt exceeds $100 million, and (iii) the new debt is deemed "publicly traded" debt under broad Treasury regulations described below, then the borrower would realize COD income in an amount equal to the excess of (x) the principal amount of the original debt over (y) the fair market value of the new debt. Thus, assume that a borrower has debt outstanding with a principal amount of $120 million, and it issues new debt with a principal amount of $120 million and a fair market value of $70 million (reflecting its deteriorated financial condition) in exchange for its preexisting $120 million of debt. The borrower would realize $50 million of COD income ($120

million less $70 million), notwithstanding the fact that the principal amount of the borrower's debt did not change in connection with the debt-for-debt exchange

Under applicable Treasury regulations, debt is treated as "publicly traded" debt if it is traded on an "established market" during the 31-day period ending 15 days after the issue date. An "established market" does not have to be a formal market. It is sufficient if there is one or more "firm quotes" or "indicative quotes" for such debt. An "indicative quote" is considered to exist when a "price quote" is available from at least one broker, dealer, or pricing service (including a price provided only to certain customers or subscribers). Pricing services such as Bloomberg provide "indicative quotes" for many debt issues, even if there is no actual trading.

If the stated principal amount of debt exceeds $100 million, it will often be difficult for a tax advisor to conclude that the debt is not "publicly traded," because to reach this conclusion, the tax advisor would have to determine that no securities sales or pricing services are providing "firm quotes" or "indicative quotes" with respect to the debt.

If the new debt is not considered "publicly traded" debt or the outstanding stated principal amount of the issue that includes the new debt does not exceed $100 million, the debt-for-debt exchange would not give rise to COD income, provided that the principal amount of the new debt is not less than the principal amount of the preexisting debt and the interest rate on the new debt is at least equal to the "applicable federal rate" ("AFR").

Original Issue Discount ("OID")

OID is generally equal to the excess of a debt instrument's stated redemption price at maturity over its issue price.

In a debt-for-debt exchange, if the new debt is treated as "publicly traded" debt and the stated principal amount of the issue that includes the new debt exceeds $100 million, the exchange could give rise to OID, in an amount equal to the excess of (i) the stated principal amount of the new debt over (ii) the fair market value of the new debt.

The lender must include OID in gross income as it accrues over the term of the new debt using the "constant yield method," and prior to receipt of cash payments.

"Applicable High-Yield Debt Obligation" ("AHYDO")

If the borrower is a corporation or a partnership with one or more corporate partners, its interest expense deduction with respect to the OID could be significantly limited or disallowed pursuant to the so-called AHYDO rules. An AHYDO is generally defined as a debt instrument which (i) has a term in excess of five years, (ii) has a yield-to-maturity exceeding the applicable AFR plus five percentage points, and (iii) generally defers the payment of more than one year of interest at any time after the end of the first accrual following the fifth anniversary of issuance. In the case of a

corporate issuer, OID with respect to an AHYDO is deductible only when paid and is disallowed entirely if the yield-to-maturity with respect to the AHYDO exceeds the AFR plus six percentage points.

Inability to Rely on the "Doubtful Collectability Exception" with Respect to an OID Obligation

Under a so-called "doubtful collectability exception," an accrual basis taxpayer is not required to accrue interest with respect to a debt instrument issued by a financially distressed borrower if the income is of "doubtful collectability" or it is reasonably certain that it will not be collected. The IRS has ruled, however, that the "doubtful collectability exception" does not apply to an OID obligation

Thus, if a debt-for-debt exchange results in an OID obligation, a lender may be required to accrue interest even if the income is of "doubtful collectability" or it is reasonably certain that it will not be collected. (Note that the IRS's position is potentially subject to attack.)

"Significant Modification" of Debt and Deemed Reissuance of Debt

Under applicable Treasury regulations, a so-called "significant modification" of a debt instrument results in a deemed exchange of the original debt instrument for a new modified debt instrument.

A "significant modification" occurs if there is a change in the yield of a debt instrument by more than the greater of (i) 25 basis points, or (ii) five percent of the annual yield of the original debt instrument.

A modification that changes the timing of payments is also deemed a "significant modification" if it results in the "material" deferral of payments. Deferral of one or more payments is not deemed "material" if the deferred payments are unconditionally payable not later than at the end of an applicable safe harbor period. The safe harbor begins on the original due date that is deferred and extends for a period equal to the lesser of five years or 50% of the original term of the debt instrument.

There are many other situations in which a modification of a debt instrument would be classified as a "significant modification," thus resulting in a deemed issuance of a new debt instrument in exchange for the original debt instrument.

A "significant modification" of a "publicly traded" debt instrument with a stated principal amount in excess of $100 million could give rise to COD and OID, in an amount equal to the excess of (i) the principal amount of the debt instrument over (ii) the fair market value of the debt instrument as of the date it is "significantly modified," even if the principal amount of the debt instrument has not changed.