

PUBLICATION

Tax Consequences of Modification of Debt Instruments

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According to news reports, since peaking in early 2007, the value of the nation's commercial property has fallen an estimated 30 to 40 percent. According to the Real Estate Roundtable, approximately \$520 billion in commercial real estate debt matures in 2010, followed by \$550 billion in 2011.

In this time of economic uncertainty, holders of and obligors on debt instruments should be concerned about the tax consequences of modification of debt instruments. Most obligors are aware that there may be tax consequences. Few holders are aware. This article summarizes the tax consequences to each. The consequences may be radically different.

The modification of a debt instrument may have tax consequences to the lender independent of consequences to the borrower. In the second to last real estate recession, the regulatory agency that regulated thrifts (e.g., savings and loans) recommended that thrifts enter into exchange transactions with other thrifts to recognize tax losses which could be carried back to profitable years to generate tax refunds.

A typical transaction was for one thrift to bundle a group of mortgage loans and swap them for a similar pool of mortgage loans with a similar weighted average maturity and average yield. At that time, virtually all mortgage loans had depreciated in value. For tax law purposes, in order to recognize a loss for income tax purposes, it was and is necessary for there to be a "sale or exchange" in the context of Section 1001 of the Internal Revenue Code of 1986.

Most thrifts followed the regulatory advice and engaged in such transactions. The Service chose *Cottage Savings* to take to the U.S. Supreme Court. The Internal Revenue Service (IRS) took the position that all debt instruments with the same characteristics are fungible and that there was no "sale or exchange" and consequently there was no loss to be recognized.

The Supreme Court held that there had been a "sale or exchange" since there were different obligors and different collateral. This has come to be known as the "hair trigger" theory.

There are many instances where it is necessary to determine whether a substituted debt instrument is the same as an older obligation or is a new obligation. Following the *Cottage Savings* decision, the IRS undertook a regulations project addressing when there has been a "sale or exchange" of a debt instrument, resulting in a gain or loss.

The upshot of this project was a new regulation.

Treas. Reg. §1.1001-3 sets forth "bright lines" on the question of whether for tax purposes one obligation which has been modified is the same as the modified obligation.

In general, subject to many exceptions, there are two tests: (a) has there been a modification and, if so, (b) is the modification significant?

Modification defined:

In general, a modification means any alteration, including any deletion or addition, of a legal right or obligation of the issuer or holder, whether evidenced by express agreement (however evidenced), other than a change occurring by operation of the express terms of the debt instrument. A modification results in a sale or exchange only if it is "significant."

Exceptions:

Like most rules in tax law, there are many exceptions to the definition of modification, including alterations occurring by operation of the terms of the debt instrument. An example of this would be the change in an interest rate by virtue of being linked to an index, e.g., prime.

Exceptions to the exception include the following, all of which are classified as modifications, even though they occur by the express terms of the debt instrument:

A change in the obligor or whether the instrument is recourse or non-recourse.

A change to an instrument which transforms it into equity as opposed to debt.

An alteration resulting from the exercise of an option, unless the option is unilateral and the exercise of the option does not result in a deferral of, or a reduction in, any scheduled payment of interest or principal.

A failure to perform an agreement (e.g., an uncured default) for a period that exceeds two years.

As noted above, a change in an instrument is treated as a new instrument only if the change is "significant."

This determination is highly subjective. The regulations state that a modification is significant, "only if, based on all facts and circumstances, the legal rights or obligations that are altered and the degree to which they are altered are economically significant." The regulations do, however, give several bright lines:

Change in yield. This rule, which applies to debt instruments that provide for only fixed payments, provides that a change in yield is significant if the yield varies from the annual yield on the unmodified instrument by more than the greater of 25 basis points or 5 percent of the annual yield of the unmodified instrument.

Change in timing of payments. In general, subject to exceptions, a change in the timing of payments is significant.

Change in Obligor or Security. A substitution of a new obligor on a recourse debt instrument is generally a "significant" modification.

Change in Security or Credit Enhancement. A modification that releases, substitutes or otherwise alters the collateral on, or other form of credit enhancements for a recourse debt instrument generally results in a change in payment expectations that is significant.

Change in the nature of a debt instrument. A modification that changes the nature of the instrument from debt to equity is always significant. Similarly, a change in recourse nature is significant.

Changes in Covenants. The addition, deletion or alteration of customary accounting or financial covenants is not a significant modification.

In the current times, it is highly unlikely that any change will not result in a loss which can be recognized for tax purposes.

Borrower's Perspective

Initially, it is important to know whether the obligation is recourse or non-recourse. If property is conveyed to a lender in satisfaction of a debt, the amount and existence of cancellation of indebtedness income will depend on whether the obligation is recourse or non-recourse. If the obligation is recourse, the debtor has cancellation of indebtedness income equal to the excess of the amount of the debt over the value of the property. If the obligation is non-recourse, the excess of the debt over the basis of the property is gain and not cancellation of indebtedness income.

Most borrowers will need to be concerned with avoiding taxable income or gain if their debt instruments are modified.

The Code has long provided that cancellation of debt (COD) results in taxable income, subject to many exceptions.

The following are the principal exceptions:

The discharge occurs in a Title 11 Bankruptcy case. The discharge occurs when the taxpayer is insolvent.

The debt discharged is "qualified farm indebtedness." Qualified farm indebtedness is debt incurred directly in connection with the operation of a farm.

In the case of a taxpayer other than a C corporation, the indebtedness discharged is "qualified real property indebtedness." Qualified real property indebtedness is indebtedness incurred after 1992 that is:

indebtedness incurred or assumed to acquire, construct, reconstruct, or substantially improve real property used in a trade or business; or

indebtedness used to refinance qualified real property business debt incurred or assumed before that date.

The indebtedness discharged is "qualified principal residence indebtedness" discharged after 2006 and before 2013. The limit is \$2,000,000 (\$1,000,000 in the case of married persons filing separately). Also, the exclusion is available only if the discharge is related to a decline in the value of the residence or to the financial condition of the taxpayer.

Forgiveness of COD income does not come without a price. Various "tax attributes" are required to be reduced. These are, in the following order:

Net operating loss carryovers;

General business credits;

Minimum tax credits;

Capital loss carryovers;

Basis of property;

Passive activity loss and credit carryovers;

Foreign tax credit carryovers.

There are important general rules and qualifications:

In general, the acquisition of debt instruments by the debtor or a related person at a discount is treated as a discharge.

In the case of a partnership, the determination of whether the debtor is bankrupt or insolvent, and attribute reduction, is made at the partner level and not the partnership level. Income derived from discharge of partnership debt is not excludable at the partnership level, but is allocable to the partners.

If the particular item discharged would have resulted in a deduction, it is disregarded.

A purchase price reduction is generally not treated as income but reduces the cost basis of the property acquired.

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