

# Significant Modification of Debt: Understanding a Tax Nuance

March 27, 2023



*As seen in [Commercial Observer](#)*

The [real estate industry](#) is currently facing unprecedented challenges as the period of reduced interest rates and low inflation has come to an end and economic uncertainty continues to prevail, impacting all types of financing transactions. Most recently, the failures of Silicon Valley Bank and Signature Bank have put the real estate industry on high alert, as owners and lenders prepare for the aftermath.

In a distressed real estate market, owners and lenders may consider debt restructuring and renegotiating their loan terms to manage their cashflow. However, taxpayers are often surprised to learn that modifying the terms of their debt could have substantial tax ramifications. It is important for owners and lenders to [consider all their tax options](#) before developing a strategy to minimize their compounding debt. In this article, we will review various tax implications for debt modifications and foreclosures.

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# Debt modifications

Debt restructuring can take many forms. For example, the lender can agree to modify the terms of the indebtedness by reducing the principal amount and/or deferring the unpaid interest payments, and thereby allowing the borrower to keep the property subject to the restructured debt.

For income tax purposes, one should consider whether a modification of an existing debt constitutes a “significant modification.” The taxpayers who negotiate changes in the terms of debt instruments must be aware of the potential consequences of seemingly immaterial modifications. If a “significant modification” occurs, the existing debt is deemed to be exchanged for a new debt instrument and the old debt is treated as having been retired for an amount equal to the issue price of the new debt. This is called, a debt-for-debt exchange. Conversely, if the old debt is not changed in a material way, there is no true exchange, and any tax consequences are limited. As a result of a significant modification to a debt instrument, a taxpayer will generally recognize the cancellation of indebtedness (COD) income to the extent that the adjusted issue price of the old debt exceeds the issue price of the new debt. If the issue price of the modified debt instrument is equal to the adjusted issue price of the original debt instrument, the deemed exchange should be tax neutral.

COD income is not all bad. For borrowers that are insolvent, the COD income could be partially or entirely excluded from income. When the borrower is a pass-through entity, COD income realized by the pass-through entity passes through to the entity’s owners. The availability of the exclusion is determined at the owners’ level, not the entity level. The owner itself must be insolvent and it doesn’t matter if the entity is insolvent.

If the income from the discharge of indebtedness cannot be excluded because the taxpayer is solvent, then the income may be excluded if the debt constitutes qualified real property business debt.

For non-corporate borrowers that used the loan proceeds to acquire, construct, reconstruct, or substantially improve real property which is secured by the loan, and the real property is used in a trade or business, any COD income resulting from a

modification of the loan may be excluded (subject to limitations). If the income from the discharge of indebtedness is excluded under the qualified real property indebtedness provision, the taxpayer must reduce the basis of the depreciable real property that was subject to the mortgage.

This exclusion doesn't apply to gains recognized from the sale or other disposition of the property, such as a transfer in foreclosure.

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## **Tax Consequences in Lieu of Foreclosure**

If the borrower is unable to achieve a satisfactory work-out of its debt obligation with the lender, the borrower can simply surrender the property to the lender. The tax consequences in the event of a foreclosure or surrendering the collateral to the creditor will depend on the [nature of the debt](#) (nonrecourse or recourse).

### **Nonrecourse debt**

If a borrower surrenders property subject to a nonrecourse debt to the creditor in satisfaction of the debt, the borrower is treated as having transferred the property in exchange for an amount realized equal to the outstanding balance of the debt. The borrower will recognize the gain measured by the difference between the amount of the loan forgiven and the borrower's tax basis in the real property, and that gain is generally subject to recapture of depreciation. In this instance, the borrower doesn't recognize COD income.

For example, ABC Realty LLC owns a building with a mortgage of \$2,000 and basis of \$500. If ABC Realty defaults on the loan and surrenders the building to the lender in satisfaction of debt, it will recognize \$1,500 of phantom gain. The fair market value of the building is not relevant in this case.

In some situations, the recognition of the gain by a debtor will be preferable to receiving COD income, given that the modification gain may qualify for favorable capital gains rates while COD income is ordinary in character. However, if the debtor can qualify for an exclusion of the COD income, the sale treatment may

produce a less favorable result. When the property is conveyed in exchange for the satisfaction of nonrecourse debt, no COD income is generated and none of the COD income exclusions are available. As a result, an insolvent debtor cannot use the insolvency exception and exclude the gain recognition of capital gain when the debt is nonrecourse.

## **Recourse debt**

In the case of a foreclosure involving recourse debt, the analysis is more complicated and the consequences to the borrowers might be unpleasant unless they have planned properly.

If the creditor agrees to discharge a debtor from responsibility for a recourse liability in exchange for the transfer of property, the debtor will be treated as if it sold the property in exchange for an amount equal to the fair market value (FMV) of such property. To the extent that the amount of the debt cancelled exceeds the value of the property transferred, the debtor will have COD income that, if not otherwise excludable, will be taxable at ordinary income rates. The debtor will also have a phantom gain to the extent that the FMV of the building secured by the recourse debt exceeds the adjusted basis of that property. Phantom gains from the sale or other disposition of real estate are not considered income from the discharge of indebtedness and do not qualify for the exclusion discussed above. This portion will be treated as a sale or exchange transaction.

For example, ABC Realty LLC owns a building with a mortgage of \$2,000, FMV of \$1,000, and basis of \$500. If ABC Realty gives the lender a deed-in-lieu of foreclosure and the balance of the mortgage is cancelled, it will have COD income of \$1,000 and a phantom gain of \$500.

COD income is a good result if the debtor can qualify for exclusion, such as when the debt is discharged in a bankruptcy case or when the debtor is insolvent. From a tax perspective, having excludable COD income is much better than capital gains. Conversely, debtors who are solvent and can't exclude COD income may desire the debt to be classified as nonrecourse, so they can benefit from the lower capital gains tax rate.

Debt restructuring can produce phantom taxable gains even though no cash proceeds are received. Real estate owners must be aware of the tax ramifications of debt modification and be prepared to set aside cash for taxes owed arising from these transactions. For this reason, it is important for businesses to partner with their tax and accounting advisor early on to develop a tax strategy to minimize tax ramifications.

For more information on the tax nuances of debt modifications and foreclosures, please contact [Alek Dziedzic](#) or your Anchin Relationship Partner.

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