

Debt modification tips for the currently turbulent real estate market

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The real estate sector is encountering exceptional difficulties in this era of high interest rates and high—though seemingly abating—Inflation. In a distressed real estate market, owners and lenders may consider loan term renegotiations to maximize their cash flow.

While potentially valuable, these modifications may bring unexpected tax consequences.

Real estate owners may modify their debt to better manage their cash flow by using various strategies, including:

- Extending the loan's maturity date;
- Changing the interest rate;
- Exercising conversion features; or
- Changing fixed payment of principal to contingent amounts.

When the original debt's issue price is higher than the new debt's issue price, the taxpayer usually recognizes Cancellation of Indebtedness (COD) income. In other words, they may realize a substantial taxable gain even though they have not received any cash proceeds.

That said, there are provisions that allow taxpayers to exclude or defer COD income.

Bankruptcy and insolvency

In bankruptcy, taxpayers do not have to include forgiven debt as income. However, taxpayers that are insolvent, but are not bankrupt, can only exclude COD income up to the amount by which their debts are greater than the value of their assets.

Both the bankruptcy exception and the insolvency exception apply at the partner

level.

Reduction of tax attributes

Being able to exclude COD income in the event of bankruptcy or insolvency comes at the cost of lowering certain tax benefits, generally in the following order:

1. Net operating losses;
2. General business credits;
3. Minimum tax credits;
4. Capital loss carryovers;
5. Basis of the taxpayer's property;
6. Passive activity loss and credit and carryovers; and
7. Foreign tax credit carryovers.

A taxpayer who wishes to retain net operating losses and other carryovers can elect to reduce basis in depreciable property (or in realty held as inventory).

Qualified Real Property Business Indebtedness (QRPBI)

Subject to limitations, taxpayers who are neither bankrupt nor insolvent may have the option to exclude COD income from the discharge of QRPBI. (Note, this election is not available to C corporations).

QRPBI is defined as debt that is:

- incurred or assumed by the taxpayer in connection with real property used in a trade or business and is secured by such real property; and
- was incurred or assumed before Jan. 1, 1993, or was incurred or assumed after such date to acquire, construct, reconstruct or substantially improve such property.

As with the bankruptcy and insolvency exceptions, the QRPBI exclusion applies at the partner, rather than the partnership, level.

To exclude income from the discharge of QRPBI, the taxpayer must make a valid election. The amount of excluded income reduces the basis of the taxpayer's depreciable real property, which is not limited to the property that was secured by

the debt.

The fact that the debt must be secured by real property can create challenges when dealing with LLCs. In large acquisitions, it is typical to see multiple tranches of debt, with varying maturities, interest rates and degrees of risk. Under an IRS safe harbor rule, debt backed by full ownership in a disregarded entity satisfies the “secured by” requirement under certain conditions, but it appears that the safe harbor allows for only one level of debt to be secured by a disregarded entity interest.

Limitations on excludable income

Taxpayers have two limits on how much forgiven debt income they can exclude for tax purposes. Generally, the amount of income excluded cannot exceed the lesser of:

- The excess of the outstanding debt principal (immediately before the discharge) over the fair market value of the real property securing the debt (reduced by the principal amount of any other qualified real property business debt secured by the property).
- The aggregate adjusted bases of all depreciable real property held by the taxpayer determined as of the first day of the tax year following the discharge (or, if earlier, the property’s disposal date)—the overall limitation.

When refinancing, relief is available if the new loan amount doesn’t exceed the amount of the original business property debt. If a partnership borrows against real property and distributes all the additional proceeds to its partners, the additional borrowing can’t be treated as QRPBI.

Debt modifications involving real estate in a distressed market can offer tax relief. They can also incur unforeseen payments. Consult an accountant specializing in real estate on how best to utilize debt modifications for tax savings.

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