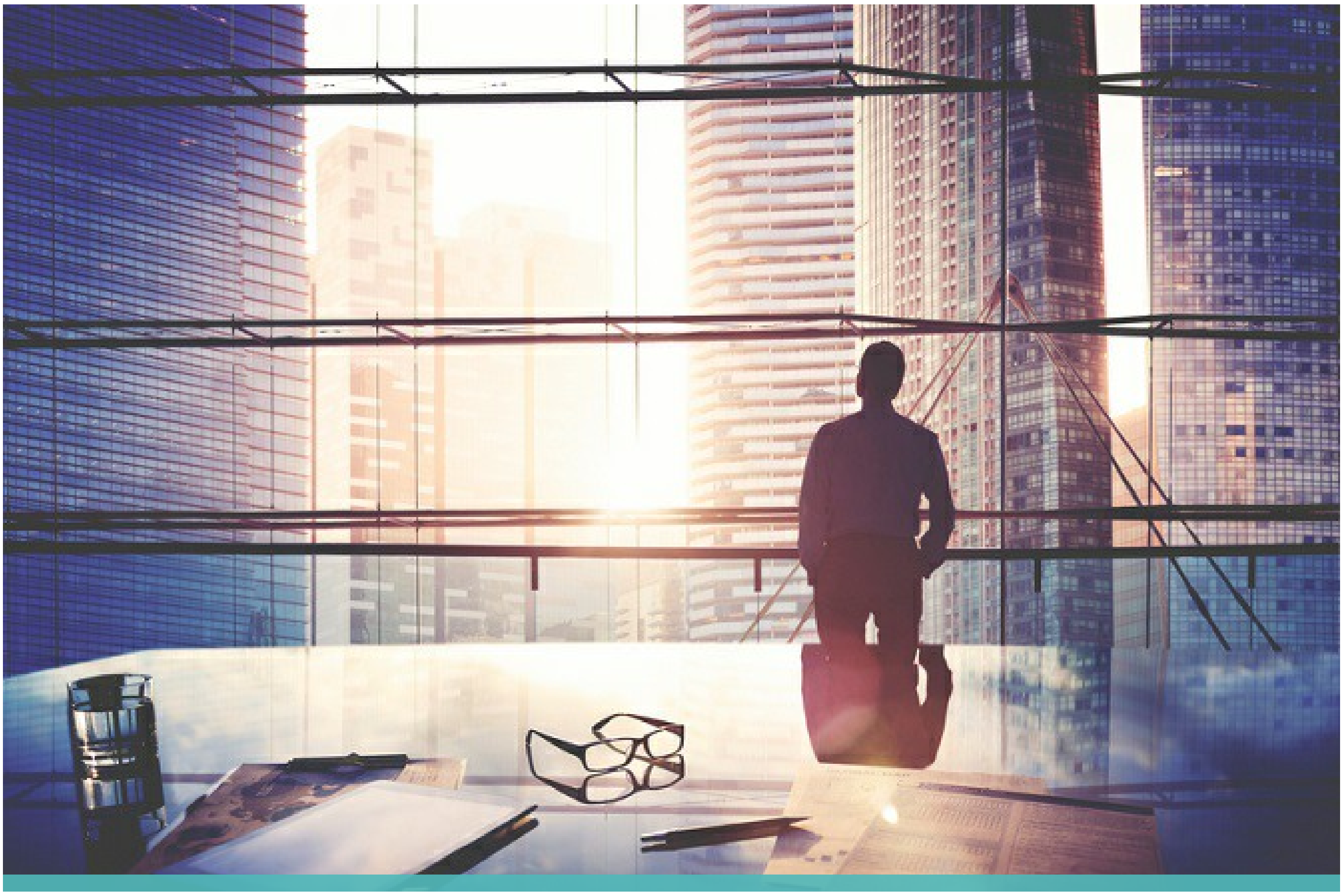
Cancellation of debt income and its impact on loan workouts



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Uncertain economic times and high leverage multiples on many loan transactions have combined to create distress in many commercial loans. Owners of financially distressed companies struggling to generate sufficient cash flow to service loan payments owed to secured lenders may find themselves being forced to consider bankruptcy and other types of financial restructurings and workouts. Owners, borrowers, and guarantors must consider tax implications when seeking debt relief, as many strategies may trigger cancelation of debt ("COD") income. COD income is generally referred to as phantom income because the debtor is deemed to have received it even though there is no actual receipt of the income. The general rule is straightforward – if a creditor cancels a debt, then the debtor recognizes taxable income under Section 61(a)(12) of the Internal Revenue Code ("IRC"). Determining the amount of COD income and any exceptions that may apply under applicable law are crucial to developing a sound workout strategy.

Below are some general rules:

1. A COD event occurs when a debt is discharged in bankruptcy or becomes unenforceable because the applicable statute of limitations has lapsed.
2. COD income arises only to the extent that the underlying debt is undisputed. A settlement of the disputed amount is treated as the debt cognizable for tax purposes.
3. If a taxpayer buys back its own debt from a third-party creditor for an amount that is less than the amount of the debt, then COD income is triggered for the balance of the loan amount (less the purchase price).
4. Generally, the acquisition of debt by a party that is related to the debtor triggers COD income to the debtor. IRC 108(e)(4). The test for relatedness requires a review of a number of factors. In general, the two entities will be treated as related if one owns more than 50 percent of the other, or if indirect common ownership of the two entities is greater than 50 percent. IRC 108(e)(4)(C). Family members are treated as related. IRC 108(e)(4)(B). COD income is triggered whether or not the debt is formally cancelled.

Exceptions

1. A debtor does not have COD income if a creditor forecloses on the collateral in satisfaction of a nonrecourse debt. Treas. Reg. § 1.1001-2. The transaction is treated as a sale.

2. Generally, common and preferred stock are not treated as debt. Accordingly, cancellation or modification of equity interests usually will not trigger COD income.

3. **Bankruptcy Exclusion**. IRC 108(a)(1)(A) provides that if a taxpayer's debts are discharged in bankruptcy, then the resulting COD income is fully excluded. This rule applies whether the discharge occurs under Chapter 7, 11, 12 or 13 of the Bankruptcy Code. The Debtor is required to undergo an "attributable reduction" analysis.

4. **Insolvency Exception**. If a debtor is insolvent, and if the debtor would otherwise realize COD income, then the debtor can exclude a portion of that income equal to the amount of the debtor's insolvency immediately before the discharge. IRC 108(a)(3).

5. **Attributable Reduction**. If a debtor excludes COD income under either the bankruptcy or insolvency exception, then the attributable reduction rules are triggered. IRC 108(b). These rules force the debtor to trade the current exclusion of income for future tax deductions. The debtor will be required to reduce tax attributes, in the following order:

   • Net operating loss carryovers;
   • Tax credit carryovers;
   • Capital loss carryovers;
   • Tax basis in assets;
   • Passive loss carryovers; and
   • Foreign tax credit carryovers.

   The debtor can elect to change the order of reductions and draw down on the tax basis first. IRC 108(b)(5). The attributable reduction occurs on the first day of the tax year following the year of discharge. IRC 108(b)(4)(A). As a result, the debtor can use various planning techniques available to minimize its gain on sales in the year of the debt discharge.

6. **Pass Through Entities**.

   LLCs and Partnerships. The bankruptcy and insolvency exceptions apply at the partner/member level, not at the limited liability company ("LLC") or partnership level. IRC 108(d)(6).

   Subchapter S Corporation Debt. The bankruptcy and insolvency exceptions apply at the entity level. IRC 108(d)(7). If an S corporation has debts that are discharged while in bankruptcy, then the COD income is excluded and does not pass through to shareholders. If the S corp qualifies for the insolvency exception, only the balance of the COD income not excluded by the corporation is passed through to the shareholders. Finally, the attributable reduction is applied at the S corporation level and does not travel down to shareholders.

7. **Qualified Real Property Business Indebtedness (QRPBI) Exception**. IRC 108(a)(1)(D). It does not require the debtor to be in bankruptcy or insolvent.

   Elements:

   • The debtor cannot be a regular C corporation. IRC 108(a)(1)(D).
   • The amount of the COD income that is excluded is generally equal to the balance of the debt less the fair market value of the real property underlying the debt. IRC 108(c)(2)(A).
   • The amount of the COD income excluded cannot exceed the total tax basis of all of the taxpayer's depreciable real property. IRC 108(c)(2)(B).
   • The exclusion triggers a basis reduction in the debtor's depreciable real property. IRC 108(c)(1)(A).

   To qualify the debt must be incurred or assumed in connection with – and secured by – real property used in the taxpayer's trade or business. IRC 108(c)(3). There is a broad interpretation of what real property is covered – including land, improvements, and even mineral rights.

   For partnerships and LLCs the determination of whether the debt is QRPBI is made at the entity level, but the basis limitation test and basis reduction occur at the partner/member level. IRC 108(d)(6). In contrast, in the case of an S corp, the determination of whether the debt is QRPBI is made at the entity level, as are the basis limitation and basis reduction. IRC 108(d)(7).

8. **Guarantor Liability**. Most cases hold that a taxpayer does not realize COD income if the taxpayer did not receive anything of value when the indebtedness was incurred. In *Landreth v. Commissioner*, 50 T.C. 803 (1968), the Tax Court found that a guarantor does not realize COD income when the underlying debt is paid. This is also true if the underlying obligation is not paid and the guarantor becomes liable for the indebtedness. *Landreth* at 813. TC Memo 1996-83.

   The IRS generally agrees that a guarantor (whether or not the primary obligor has defaulted and the guarantor has become liable for the indebtedness) does not realize COD income on release of a liability. IRC 108(e)(2). See also, IRS Memo 61.09-18. INFO 2002-0024.

Parties to workouts and financial restructurings of debt obligations should seek legal and accounting advice when developing their potential strategies. COD income and its impact on borrowers and owners of pass through entities must be considered in advance of implementing a workout plan that involves forgiveness of a debt obligation. A distressed borrower's financial problems rarely solve themselves. Early involvement of experienced restructuring and workout counsel is more likely to result in a successful outcome.

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