

Cancellation of Debt: Taxable Income Impact

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As the real estate market continues to work toward recovery, many real estate owners are engaging in transactions involving the cancellation of debt (COD). Although COD can be complicated enough with only the borrower and lender involved, Uncle Sam's demands for a take can make things even more taxing.

Basic COD rules

From a tax perspective, cancellation or forgiveness of debt isn't quite as much of a "gift" as it might first appear, because it results in ordinary taxable income to the debtor. COD transactions can result from foreclosures, cash settlements, loan workouts, related-party acquisitions of debt or debt-for-equity swaps.

Let's look at an example: An investor owns an office building that cost \$10 million. The building, which is subject to \$8 million of secured debt, has a current fair market value of \$6 million. If the lender agrees to a loan payoff of \$6 million instead of \$8 million, the debtor will have \$2 million of ordinary taxable income (in the absence of exceptions). For partnerships, the \$2 million of COD income would be recognized on the last day of the partnership's taxable year and passed through to partners as taxable income.

Foreclosure or deed-in-lieu

A foreclosure or deed-in-lieu of foreclosure, where the borrower conveys all interest in a property to the lender to satisfy the loan, is treated for tax purposes as a sale of property to the lender. If the debt involved is nonrecourse debt, the gain or loss on the sale will be the difference between the amount of debt and the seller's basis in the property. Such sales aren't, however, considered COD and don't qualify for certain exclusions from taxation. If the debt is recourse debt, the sales price for tax purposes will be the lower of the fair market value (FMV) of the property or the outstanding secured debt balance, and the gain or loss will be determined using this sales price less the debtor's basis in the property. The debtor will then have COD income to the extent that the outstanding debt balance exceeds the FMV of the property.

Debt modification

Significant modification to the debt also may result in COD income for the debtor. For tax purposes, a significant modification occurs if the rights and obligations of the debt instrument have been altered in material ways. Events that automatically trigger this rule include a material change in yield (more than the greater of 25 basis points or 5% of annual yield), material deferral of payments, or principal reduction, which is treated as a reduction of yield for this purpose. Changing from recourse to nonrecourse debt, a change in

debtors, or alterations in collateral or payment expectation also could trigger this rule. Deterioration in the financial condition of the debtor doesn't qualify as a modification, nor does adding or modifying financial covenants or changes resulting from the exercise of unilateral options in debt agreements.

Related-party acquisition of debt

If a related party acquires debt from an unrelated party (that is, the debt purchaser is related to the debtor) at a discount, the debtor will generally have COD income. In such a transaction, the debtor is deemed to reissue the debt with an issue price equal to the purchase price paid by the related party. The difference between the new issue price and the face amount of the debt will be the original issue discount, which must be amortized as income to the investor and expense to the debtor.

Partnership debt for equity swaps

The exchange of debt on a property for corporate stock will result in COD income if the FMV of the stock is less than the amount of the debt. This result can be avoided if the lender cancels the debt in exchange for an equal amount of capital in the corporation and has sufficient basis in the debt. The exchange of debt for an interest in a partnership also will result in COD. In this case, COD income is equal to the difference between the debt and the FMV of the partnership interest. Even if a substantial amount of debt remains in place, the admission of a creditor into the partnership may convert debt to "partner nonrecourse debt." Such debt will be allocated to the creditor/partner, resulting in a deemed distribution to the other partners.

Expert Guidance Needed

Due to the technical nature of debt cancellation, there may be other rules and exceptions not addressed here. To help ensure that your next investment doesn't result in unexpected tax liability or land you in hot water with the IRS, please consult your CPA.

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