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# Avoiding Negative Tax Consequences In Loan Modifications

By **Aman Badyal** (June 26, 2023, 5:15 PM EDT)

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The perfect storm is coming. It appears that the convergence of rapidly rising interest rates, workers' reluctance to return to the office and growth of e-commerce is leading to a dramatic uptick in nonperforming commercial real estate loans.

In the first half of this year alone, three trophy downtown Los Angeles office buildings and two of the five largest hotels in San Francisco went into default. Barring some unforeseen shift in conditions, it is likely that major city centers will continue to experience diminished business activity relative to pre-pandemic levels.

Leaving aside the many emotional and nontax financial impacts on those affected, income tax factors could result in considerable phantom income for borrowers that engage in loan workouts, foreclosures and deed-in-lieu transactions.

A loan workout can generate a considerable amount of cancellation of debt, or COD, income for a borrower, while a foreclosure or deed-in-lieu can give rise to capital gain or COD income. This article will discuss how such negative tax results may be triggered and strategies to avoid them.

**Loan Workouts**

Any significant modification to the terms of a loan could cause the borrower to realize COD income, which is taxable at ordinary income rates.

A significant modification results in the deemed sale of the loan for a new loan. If the issue price of the new debt is less than the adjusted issue price of the old debt, the debtor will realize COD income. The issue price of nonpublicly traded debt is generally the stated principal amount unless the borrower is paying interest at a rate less than the applicable federal rate.

The threshold question is whether the loan is "recourse" or "nonrecourse." A debt is considered nonrecourse if the lender may only proceed against property securing the debt — i.e., the lender's rights are limited to instituting foreclosure proceedings — and cannot seek repayment from the borrower's other assets.

In the case of recourse debt, the lender can seek payment from the property owner and from the property itself.

***Extensions and Forbearances***

Many loan workouts involve extending the repayment period. The lender may decrease the monthly obligation, or agree not to foreclose or exercise other rights for some period of time. In the early months of the Great Recession, this often referred to as the extend-and-pretend approach because market conditions were deemed unlikely to change during the extension period.

In today's situation, experts disagree as to the depth and duration of the anticipated distress — depending, in large part, on whether they believe work from home will be a lasting phenomenon.

Extensions and forbearances may constitute significant modifications. Fortunately, the Treasury regulations provide a safe harbor for certain loan extensions and forbearance agreements. A modification within the safe harbor will not be treated as a significant modification.

The safe harbor protects extensions that do not either (1) cover a period exceeding the five years or 50% of the original loan term, whichever is less; or (2) cause a change in the anticipated yield of the loan of more than the 0.25% or 5% of the yield of the unmodified loan, whichever is greater.

Any extensions or forbearances that fall outside the safe harbor will likely be treated as significant modifications.

***Substitution of Obligors, Guarantors, Changes in Security and Credit Enhancements***

With respect to a recourse loan, the substitution of obligors will generally be deemed a significant modification. However, the addition or deletion of a co-obligor will result in a significant modification only if the addition or deletion results in a change in payment expectations.

And a modification that releases, substitutes, adds or otherwise alters the collateral for, a guarantee on or other form of credit enhancement is a significant modification if the modification results in a change in payment expectations.

In the context of a nonrecourse loan, any changes to the collateral will almost certainly be considered a significant modification. However, improvements to property securing nonrecourse debt — e.g., constructing a building on land securing a note or adding square footage to an existing building — will not be a significant modification.

A change in the nature of the loan from a recourse to nonrecourse loan, or vice versa, is generally a significant modification.

An addition, modification or deletion of a customary loan covenant is not typically a significant modification. However, where a modification may not itself constitute a significant modification, the parties must consider whether loan modification fees borrowers are required to pay increase the yield in an amount that causes a significant modification.

***Exceptions from COD Income***

Because COD income is taxable at ordinary income rates, borrowers will seek to avoid realizing it.

In the event of a significant modification, borrowers may still be able to avoid or reduce COD income if (1) the borrower has filed for bankruptcy protection; (2) the borrower is insolvent; (3) the modified debt represents seller-financing; or (4) the debt was to acquire, construct or substantially improve real property that secures the debt and is used in the borrower's trade or business.

The use of COD income exclusions may require borrowers to reduce their other tax benefits — e.g., a reduction in adjusted basis or net operating loss carryforwards. Therefore, using COD income exclusions to reduce a borrower's current tax liability could generate additional taxes in the future.

**Foreclosure or Deed-in-Lieu**

Unlike loan modifications, the transfer of property in satisfaction of nonrecourse debt produces capital gain or loss and the COD income exclusions discussed above would not apply. However, there may be alternative structures and planning techniques to avoid or minimize tax liability in connection with such transfers.

For example, an underwater Internal Revenue Code Section 1031 exchange may be an effective strategy to avoid capital gain.

The transfer of property in satisfaction of a recourse obligation is bifurcated into two separate transactions.

The first transaction is a sale or exchange of the property for fair market value, and the difference

between fair market value and basis is taxed as capital gain or loss. And debt discharged in excess of the fair market value is considered COD income, subject to the potential exclusions discussed above.

**Partnership Transactions**

Additional complexities must be considered where the borrower is a tax partnership, such as a multi-member LLC. The character and calculation of income from the discharge of debt is determined at the partnership level. However, the application of certain COD income exceptions — e.g., bankruptcy and insolvency — are determined at the partner level.

Under general partnership tax rules, partners are each allocated a share of a partnership's liabilities. A decrease in the amount of debt allocable to a partner could potentially cause that partner to realize either a capital gain or ordinary income depending on the circumstances.

Fortunately, partnerships also provide additional opportunities, such as preferred equity recapitalizations. This type of recapitalization involves admitting a new partner who receives partnership interests that entitle it to preferences on all distributions plus a preferred return. The new partner's equity contribution would be used to pay down or replace debt.

**Conclusion**

A material increase in the number of distressed loans can be expected in the coming months. Borrowers who are engaging in loan workouts should consider whether they are able to address their financial needs without triggering a significant modification, and if a significant modification is unavoidable, whether they qualify for any COD income exclusions.

Borrowers who are considering walking away from their properties should consider whether such a move will give rise to COD income or capital gains, and if so, whether they qualify for a COD income exclusion or another nonrecognition provision of the Internal Revenue Code — e.g., Section 1031 — that allows them to avoid recognizing capital gains.

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