

CANCELLATION OF INDEBTEDNESS HOLDS TRAPS FOR THE UNWARY

In today's economic environment, businesses are looking to modify and re-structure debt to pull through until the economy turns around. Rather than allowing so many loans to go bad, lenders are working with debtors to re-structure loans in a manner that allows the debtor to stay in business. For example, a lender may allow a debtor to cease making payments for six months in exchange for increasing the interest rate for the life of the loan. Another example would be a lender who might agree to reduce the principal amount of a loan increasing the probability of receiving some return of capital rather than risking that the borrower would stop paying altogether.

In re-structuring debt, a borrower (debtor) needs to be aware of potential tax consequences that will cause the debtor to recognize taxable income even though not receiving any additional payments. If a debtor is relieved of a valid debt (or any portion of a loan), the debtor must recognize ordinary income in the amount of the debt cancelled. Although there are some situations where such "cancellation of indebtedness income" or "CODI" may be excluded,¹ in many situations a debtor must pay tax when relieved of debt.

For example, business X owes Bank \$500,000 and Bank agrees to accept \$400,000 in full payment of the loan. Because Bank has forgiven \$100,000 of indebtedness for X (and no exclusion from income applies), X must recognize \$100,000 of ordinary income in the year the debt is forgiven. If X is an individual or the sole owner of a pass through entity (such as a limited liability company), and if X pays tax at the highest income tax rates, the forgiveness of debt results in \$35,000 of tax payable to the IRS (plus additional tax for state income tax).

Although the example above appears bad (with the accrual of phantom taxable income), at least the taxpayer can see it coming and try to take steps to avoid it. There are other situations where CODI can accrue even though no actual debt was forgiven. This problem is most severe, and perhaps least fair, in certain debt modifications. That's right, a business can modify a debt, maybe agree to a higher interest rate, and have to pay tax because the statute will deem CODI to arise.

Accrual of CODI will not occur in all debt modifications, but in some cases such accrual of income can surprise everyone involved. If the debt is traded on an "established market", then any significant modification to the debt will be deemed to be the re-purchase of the debt by the debtor at the debt's fair value and then the re-issuance of new debt to the lender. When such debt is deemed to be re-purchased by the debtor, the debt's fair value will most likely be less than the face amount. For example, business X owes Bank \$1,000,000, but at the time of the modification, the fair value of the debt is \$700,000. X will be deemed to have purchased the debt for \$700,000, and accrue CODI for the remainder of the debt of \$300,000. The debtor is then deemed to have issued to the lender new debt.² Therefore, even if the only debt

¹ There are several exclusions for CODI listed in Section 108 of the Internal Revenue Code. The two most important exclusions are applicable if the debtor, at the time the debt is forgiven, is either insolvent or in bankruptcy.

² Other than the CODI issue described in this article, there are further tax consequences (original issue discount issues) due to the issuance of the new debt, but a description of such is beyond the scope of this article.

modification is that X agreed to an adjusted interest rate, X will have to be taxed on \$300,000 of phantom income.

The problem described above occurs only if the debt is traded on an established market. However, the meaning of “traded on an established market” can be broader than it at first appears. The Treasury Regulations describe a debt as traded on an established market if: (i) it is traded on a registered national securities exchange, interdealer quotation system, or certain foreign exchanges; (ii) it is traded on a designated contract market or “interbank market”; (iii) it appears on a system of general circulation . . . that provides reasonable basis to determine fair market value by disseminating either recent price quotations (including rates, yields, or other pricing information) of one or more identified brokers, dealers, or traders or actual prices (including rates, yields, or other pricing information) of recent sales transactions (a quotation medium); or (iv) it is a debt instrument for which “price quotations are readily available from dealers, brokers, or traders”. Although the description contained above is somewhat simplified, in today’s banking environment, many loans taken from large national banks will fall into one of the categories listed above and therefore the debt will be deemed to be “traded on an established market”.

Although it is unclear what modifications will be deemed to be “significant modifications”, clearly an interest rate change will qualify. Also, some modifications to the number or terms of payment will qualify.

Congress has taken action to provide some relief for taxpayers getting caught in this CODI trap during the current economic conditions by adding new Section 108(i) to the Internal Revenue Code. New Section 108(i) allows taxpayers to elect to defer taxation of CODI on “applicable debt instruments” on transactions which occur in 2009 or 2010. If a taxpayer accrues CODI during 2009 or 2010, the taxpayer can elect to defer recognizing such income (and thus deferring the obligation to pay tax on such income), until 2014. The taxpayer can then further defer the recognition of such income by recognizing only a pro rata portion for each of the years 2014 – 2018. Therefore, even though the taxpayer will eventually have to pay the tax on such income, the taxpayer can elect to defer that obligation to later years (and spread out the pain over a 5 year period).

An “applicable debt instrument” is any debt instrument issued: (i) by a corporation; or (ii) by either an individual or a pass through entity (such as a partnership or limited liability company) if such debt was issued in connection with a trade or business.

The moral is that you need to involve your tax advisor in most business transactions that involve loan modifications. Even if you simply agree to pay more interest (and thus not receive any increase to your net wealth), you could suffer an adverse tax consequence.

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