LOOK BEFORE YOU LEAP:

RULES ON CANCELLATION OF INDEBTEDNESS INCOME CHANGED

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As we are all aware the current real estate market is experiencing a significant downturn in activity and, due to the current economic climate, it can be anticipated that a significant number of loans will have to be "worked out" or, in other words, restructured. This is largely the result of either the current fair market value of the property being less than the amount of debt that is encumbering the property, or of the cash flow generated from the property being insufficient to service the debt. When restructuring any debt instrument the parties should proceed with caution due to the fact that undesirable tax consequences can result.

As a general rule, when a lender forgives a portion of the borrower's loan (also known as a cancellation of indebtedness), the borrower will recognize cancellation of indebtedness income ("COD income"). In some situations, it is easy to determine when there has been a cancellation of indebtedness. For example, if the lender forgives a portion of the debt such that Borrower is no longer required to repay it, there has been a cancellation of indebtedness. In other cases, however, such as when the lender and borrower simply modify the terms of the original loan instrument, a resulting cancellation of indebtedness is not so easily identified. This is exactly what was occurring during the real estate crash of the early 1990's, which in turn prompted the government to adopt new rules governing cancellation of indebtedness income.

During the real estate crash of the early 1990's, lenders and borrowers were able to easily modify and restructure loans while avoiding any possible COD income. For example, extending the maturity date of the loan, changing the interest rate, and even converting the debt into an equity interest in a partnership that owned the property were all implemented successfully without resulting in COD income.

Subsequent changes in the law have made it much more difficult to restructure loans and avoid COD income. Under current law, many of the aforementioned loan modifications can now result in COD income to the borrower if such modification is deemed to be a "substantial modification". The new rules basically apply a two-part test to determine if and when there has been a substantial modification. First, has there been a "modification" of a debt instrument? If so, is the modification "substantial" so as to amount to a taxable exchange? And if there has been a taxable exchange, what is the amount of COD income realized by the borrower?

Has there been a Modification?

A "modification" generally is any alteration (including any deletion or addition, in whole or part) of a legal right or obligation of the issuer or holder of a debt instrument. This is essentially a "hair-trigger" definition, and in almost all cases a modification will likely occur.

Is the Modification Substantial?

A modification is deemed substantial if any of the following occur:

(i) A change in the yield to maturity of more than twenty-five (25) basis points;

(ii) An extension of the final maturity which is greater than the lesser of five (5) years or fifty percent (50%) of the original term;

(iii) The addition or deletion of put or call rights if such rights have significant value at the time of the addition or deletion;

(iv) Changes in the obligor of recourse (but not nonrecourse) debt;

(v) The addition or material alteration of a guarantee or other form of credit enhancement in a nonrecourse debt;

(vi) A change in collateral securing nonrecourse debt if a substantial portion of the collateral is released or replaced with other property;

(vii) A modification of a fixed rate instrument to a variable rate instrument or a contingent payment instrument;

(viii) A modification of a variable rate instrument to a fixed rate instrument or a contingent payment instrument;

(ix) A modification of a contingent payment instrument to a fixed rate instrument or a variable rate instrument;

(x) A change of the currency in which payments on the debt instrument are made; and

(xi) A modification from recourse to nonrecourse indebtedness or vice versa.

If the modification is deemed "substantial", the Internal Revenue Code treats the borrower as having exchanged the old unmodified debt for the new modified debt in a taxable exchange.

Tax Effect of a Substantial Modification.

The tax consequences of such exchange are tested under the original issue discount rules. Under those rules, the borrower will realize COD income equal to the amount by which the adjusted issue price of the new debt exceeds the issue price of the old debt. If such income is

realized, such recognition will be included in the borrower's income in the year in which the substantial modification took place.

Reporting Requirements.

In the event that there has been a cancellation of indebtedness, the IRS is now requiring the lender to act as a policeman to monitor such cancellations. The IRS requires all "applicable financial entities", such as banks, to issue what is known as a Form 1099-C to their debtors. This form must be issued by the lender to the borrower if the lender cancels or is deemed to have cancelled all or a portion of the borrower's debt.

In addition to instances where a lender has affirmatively cancelled indebtedness or has entered into a loan modification with a borrower that is deemed to be a cancellation of indebtedness, if during any 36-month period the borrower has not made any loan payments to the lender, it raises a rebuttable presumption that a cancellation of indebtedness has occurred and the IRS will require the lender to issue a Form 1099-C to the borrower.

It is inevitable during these economically turbulent times that a significant number of loans will have to be restructured. The most important thing to keep in mind when considering such restructurings is to be very cautious so that hidden tax consequences will not surprise you.

If you have any questions tax consequences of loan restructurings, or if you have any other tax-related needs, please contact Zachary Conjeski (at 410-649-1240) or zconjeski@rosenbergmartin.com) or any attorney in out tax group:

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