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BORROWERS AND LENDERS COMING TO GRIPS WITH THE PITFALLS AND OPPORTUNITIES WHEN MODIFYING THE TERMS OF DISTRESSED DEBT

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According to First American CoreLogic, almost $165 billion of commercial real estate loans will mature in 2009. Trepp LLC, a commercial bond and real estate loan statistician based in New York City and London, reported that another $3.8 billion of commercial mortgage loans were transferred to special servicers in June, increasing the total balance of securitized commercial mortgages under the control of special servicers by 10%, to almost $40 billion. As the per square foot office rents in places like New York City plummets and US commercial real estate prices decline nationally, pressure will rise and the ability of owners to refinance or extend maturing real estate commercial mortgage debt will be impacted severely. One way that this impact will manifest itself is in sales of existing mortgage loans to opportunistic buyers seeking to purchase pools of distressed real estate loans, with a view to profitably working out the loan or using the acquisition of the loan as the first step in the acquisition of the underlying asset.

Routine loan workout transactions present subtle pitfalls, and planning opportunities, for both borrowers and holders of the debt instrument. This Update reviews some recent developments, and variations on proven techniques, for restructuring mortgage debt instruments.

OVERVIEW

Participants in otherwise routine loan modification and workout transactions are often surprised to learn that almost any significant amendment to a loan agreement can have tax consequences to the borrower and the lender. These consequences can occur even if there is no change to the amount of the debt outstanding and, as described below, some of these consequences can be quite severe.

- The adverse tax consequences arise from the fact that any substantial modification of a debt instrument is treated for tax purposes as if the unmodified debt instrument were exchanged for a newly issued debt instrument in a taxable transaction. Where loans traded at or near par, the adverse consequences of the deemed exchange largely fell on the borrower. Where the borrower is a passthrough entity, the prevalence of state income tax withholding now places the borrower's managers at risk personally if the exchange results in debt cancellation income. Moreover, where the holders have acquired the indebtedness at a substantial discount, significant adverse tax consequences from the deemed exchange can fall on the holders as well. This is particularly true in cases where distressed debt was purchased with a view to executing a favorable debt restructuring transaction.
- With the current turmoil in the debt markets and the potentially significant effect this disturbance can have on attempts to renegotiate or workout existing financing, the possibility of a deemed exchange of the debt for tax purposes, and the impact that such an exchange can have on the borrowers and the holders, can be highly significant and must be on the checklist of items considered in connection with debt modification transactions.

BACKGROUND

Simple modifications to the terms of debt instruments, even a mere extension of their term or change in the payment terms that affects the yield on the debt by more than 25 basis points, can lead to a deemed taxable "exchange" of the old debt instrument for the modified debt instrument. This deemed exchange can occur even if the principal amount of the debt is unchanged. A deemed exchange can have tax consequences for the borrower, e.g., cancellation of indebtedness income, and for the holder of the debt, particularly a holder that acquired the debt at a discount from its face amount, e.g., gain or loss on the deemed exchange, recognition of accrued "market discount", and additional interest income in the form of original issue discount ("OID") over the remaining term of the debt. One reason why negotiating the modification of debt instruments held by REMICs is so difficult is

that REMICs are loath to risk experiencing a Treas. Reg. § 1.1001-3 deemed exchange of debt instruments that they hold. A deemed exchange generally would cause the REMIC to be treated as having acquired a new mortgage loan. A REMIC's acquisition of new mortgage loans after its startup is prohibited and could threaten the REMIC's status, unless the modification falls within the limited REMIC safe harbors.

The deemed exchange can not only generate federal income tax consequences, it can also impact adversely on the holder's and borrower's State or local income taxes for those jurisdictions that do not follow the federal exclusions and elections in all respects. The impact of debt modifications on State or local taxable income and withholding for nonresidents is a minefield that often borrowers wake up in only after the debt modification is complete.

Although most tax practitioners focus on the direct tax consequences to the borrower and the lender from restructuring the debt, including cases in which some portion of the debt is cancelled, there are more subtle issues that can arise as a result of the mortgage debt having been modified under the tax rules.

How can a restructuring of a borrower's indebtedness create a taxable exchange?

Under the IRS Regulations promulgated in response the Supreme Court's decision in the Cottage Savings case, a "substantial modification" of a debt instrument creates a taxable exchange of the unmodified debt for the modified debt. These Regulations define a substantial modification to include: (i) a change in the yield on the debt (either an increase or decrease) by more than the greater of 25 basis points or 5 percent of the yield on the modified debt, (ii) a change in the maturity date of the debt, such as by an extension of the term that was not part of the original loan agreement, beyond the lesser of 5 years or 50 percent of the debt's original term, and (iii) a change in the collateral or security for the loan that results in a material change in the payment expectations of the parties, e.g., the substitution of a new obligor for a recourse loan or the addition or subtraction of a substantial amount of the collateral or other credit enhancement for a nonrecourse debt instrument. The above listing shows that it is relatively easy for a simple debt modification to create a taxable exchange of the unmodified debt instrument for the new.

Does every debt restructuring that is a deemed exchange result in taxable gain or loss to the borrower and the lender?

Fortunately, the answer is no. The overwhelming majority of common debt modifications between the borrower and a holder who was either the original lender or who acquired the debt at par, where the modification does not result in the cancellation of some portion of the outstanding amount of the debt, do not result in taxable gain or loss to the borrower or the lender. Where the loan is held by REMIC, however, the absence of taxable gain or loss may not be sufficient to avoid adverse tax consequences to the REMIC which, as noted above, is one reason why REMICs may not be motivated to modify mortgage loans.

The critical inquiry is whether the so-calle "issue price" of the modified debt instrument is different from the "issue price" of the unmodified debt instrument. The issue price is a tax term of art. Where the terms of a loan are modified, the calculation of the issue price of the modified debt instrument will determine: (i) whether the borrower recognizes cancellation of indebtedness ("COD") income as a result of the modification, (ii) whether the modified debt instrument will be treated as issued with original issue discount ("OID"), resulting in the borrower accruing deductions for the annual OID and the holder being required to recognize taxable income from the accrual of the OID, and (iii) the amount of the taxable gain or loss recognized by the holder of the modified debt. Under the tax rules,

- The borrower recognizes COD income if the issue price of the modified debt is less than the outstanding balance of the unmodified debt.
- The adverse tax consequences arise from the fact that any substantial modification of a debt instrument is treated for tax purposes as if the unmodified debt instrument were exchanged for a newly issued debt instrument in a taxable transaction.
- The holder would recognize taxable gain or loss from the deemed exchange, measured by the difference between the issue price of the modified debt instrument and the holder's adjusted basis in the unmodified debt. Where the holder acquired the debt at a discount from its face amount and the debt is then restructured, the modification could result in gain and that gain could be taxable as ordinary income under the market discount rules regardless of the period of time that the debt was held.

Where the modified debt is not "traded," which describes virtually all real estate mortgage and mezzanine debt, the issue price of the modified debt instrument will be either its face amount, if it provides for regular payments of stated interest, or its imputed principal amount, i.e., the issue price computed by discounting to present value (the "imputed principal amount") all of the payments of principal and interest due under the debt at the relevant AFR. As long as the yield payable on the modified debt instrument is at least an amount equal to the relevant AFR (the long-term AFR is now hovering around 4.26-4.36 percent), it is unlikely that the borrower or the original holder would recognize taxable gain or loss from the deemed exchange unless some

portion of the outstanding amount is cancelled as well or there is some other material change to the terms of the debt.

More than anything, this summary of the potential tax consequences of a debt modification shows that both borrowers and holders need to be cognizant of the tax issues involved in a debt restructuring before, rather than after, the debt is modified.

What are some of the commonly encountered pitfalls in a working out distressed debt, particularly mortgage and mezzanine financing?

1. *Opportunistic debt purchasers can recognize taxable gain from the deemed exchange and may be required to accrue OID with respect to the modified debt going forward.*

   The holder of a debt that acquired the debt at a discount is required to account for the difference between the holder's acquisition price and its face amount at maturity as "market discount." Market discount is treated as ordinary income rather than capital gain income. Unless the holder elects otherwise, the market discount is recognized when principal payments are received on the debt instrument and partial payments of principal are allocated first to accrued market discount.

   If a holder restructures the debt in a transaction resulting in a substantial modification of the debt, e.g., an extension of the maturity date beyond the safe harbor described above, and the imputed principal amount of the modified debt exceeds the holder's adjusted basis in the debt, the holder will recognize taxable gain at the time the modification becomes effective. That gain will be taxed as ordinary income to the extent of the accrued market discount on the debt. Moreover, the difference between the outstanding amount of the debt at maturity and the imputed principal amount will be treated as OID and the holder will be required to accrue the OID in income over the remaining term of the debt.

   Although there may be several approaches to minimizing the adverse tax consequences to the holder, a key component of any solution is to avoid passing the threshold for a substantial modification of the debt instrument. One approach may be to grant the borrower the option to extend the maturity date, exercisable at a future date upon the payment of an extension fee at that time. Because the extension requires some action on the part of the borrower, it probably remains inchoate for tax purposes, deferring the time when the holder would be subjected to the deemed exchange. The holder could then dispose of the restructured debt in a taxable transaction for consideration, thereby matching the taxable event with the receipt of consideration.

2. *Nonresident partners should consider abandoning their interests in a real property owning LLC or LP before the real estate is foreclosed upon by the holder of the debt.*

   Many states now impose a tax payment requirement on partnerships and LLCs measured by the share of the entity's taxable income that is allocable to nonresidents of the State where the entity does business. In some States, this withholding requirement is enforceable against the person having control over the disbursement of funds in the partnership or LLC. Where the nonresident partner or member is not subject to State income tax in his or her State of residence, or where the available credit is less than the local tax withheld, this withholding tax can be an added burden on the nonresident partner and a real exposure to the persons managing the partnership or LLC. This is particularly true where the amount of the withholding tax exceeds the funds available to the entity following a transfer of the real estate to the holder of the debt in a foreclosure or by deed in lieu.

   One approach to dealing with this burden would be to cause the nonresident partners and members to voluntarily abandon their interests in the entity prior to the transfer of the property to the lender and the recognition of taxable gain. Although the members generally will recognize the same amount of taxable income as if they remained a member when the property was transferred, they may be able to treat the gain as realized with respect to the transfer of an intangible asset, the partnership or LLC interest, which takes place solely in their State of residence and is taxable only in that State. There is an added benefit to this abandonment-before-conveyance-in-foreclosure strategy. For federal income tax purposes, the abandonment of the entity interest avoids characterizing any potion of the taxable gain as depreciation recapture, taxable at a 25 percent tax rate rather than a 15 percent tax rate.

   This approach benefits both the entity and the nonresident member. For the entity and its manager, it avoids the cash drain that would otherwise be imposed because of the withholding obligation and the risk that the state might attempt to impose personal liability on the manager as a "responsible person."

   For the nonresident member, it avoids the incremental State taxes produced by the out-of-State withholding and allows the member to report all of the gain from the disposition of the interest as capital gain income. Implementing such a program is not without risk, however. The timing and the implementation need to be choreographed carefully so that the intended consequences can be realized.

3. *Corporate taxpayers should consider whether electing to defer COD income under Code Sec. 108(i) permits them to avoid State income taxes on the COD income entirely.*

   Corporate taxpayers know that they cannot avail themselves of the basis election to avoid COD income by reducing the adjusted basis of their real estate assets. Therefore, a corporate taxpayer that is solvent following the realization of COD income will recognize taxable income. In most cases, the COD income will be taxable for both federal and State tax purposes.

   The American Recovery and Reinvestment Act of 2009 added a new COD deferral provision to the Code, Code Sec. 108(i). The provision permits a taxpayer to elect to defer COD income arising from a "reacquisition" of "an applicable debt instrument" after December 31, 2008, and before January 1, 2011. Income deferred under this provision must be included in the gross income of the taxpayer ratably in the five taxable years beginning with (1) for repurchases in 2009, the fifth taxable year following the taxable year in which the repurchase occurs or (2) for repurchases in 2010, the fourth taxable year following the taxable year in which the repurchase occurs.

   For solvent corporate taxpayers, this election may give them the opportunity to avoid State taxes otherwise applicable to the COD income. Suppose a corporation owns commercial property in a high State tax jurisdiction, this asset is its only nexus with the State, and, as part of a restructuring of its indebtedness secured by the property, it incurs substantial COD income. Ordinarily, the COD income would be taxable for State purposes. If the corporation can make the Code Sec. 108(i) election, it will defer the recognition of the COD income and this deferral would be effective for State purposes as well if there is federal-State conformity on this point. Next, the corporate taxpayer may be able to sever the taxable nexus with the State where it recognized the COD income. For example, it might cut off nexus by contributing the asset to a subsidiary corporation that files its tax return on a stand alone basis. Once the corporate taxpayer has severed nexus with the high tax State, it will have avoided the imposition of State income taxes when the COD income is recognized in the succeeding taxable years.

   Obviously, orchestrating such a strategy can be very complicated. This approach not only implicates State and local realty transfer and mortgage recording tax questions, it also requires a careful analysis of the relevant taxing nexus and rules permitting or requiring unitary tax return filings. Nevertheless, if the corporation recognizing the COD income could cut off nexus with the high State tax jurisdiction before the COD income was recognized, particularly where it could locate or relocate to a low or no tax jurisdiction, the savings could be material.

4. *Real property owners subject to the Code Sec. 465 at-risk rules need to be concerned that a deemed exchange of an old debt for a modified debt, as described above, does not lead to a recapture of prior years' losses because of a reduction in their amount at-risk with respect to the investment.*

   Since 1987, losses and deductions from real property generally have been subject to the "at-risk" rules. Under those rules, the amount of a taxpayer's losses or deductions from a real estate activity is suspended to the extent that they exceed the aggregate amount with respect to which the taxpayer is at risk at the close of the taxable year. Real estate activities are subject to a special rule that permits real estate owners to be considered at risk with respect to "qualified nonrecourse financing" that is secured by the real property used in the activity. Among other statutory requirements, qualifying indebtedness must be borrowed from a "qualified person." To constitute a qualified person for this purpose, the person must be "actively and regularly engaged in the business of lending money" and meet other conditions.

   The active lending requirement would ordinarily be problematic for debt held by investors that acquire distressed real estate debt from traditional, long-term holders. Many of those investors are affirmatively not engaged in any business because of the need to accommodate the presence of non-US investors in their ownership structure. Fortunately, provided that the transfer from a qualified person takes place more than one year after the initial borrowing, the subsequent transfer of an otherwise qualified nonrecourse debt to someone not a qualified person under these rules will not have an adverse impact on the borrower's amount at risk.

   The problem arises when the indebtedness held by the opportunistic holder is modified and the modified debt is treated for tax purposes as newly issued. At the time that the modified debt instrument is treated as newly issued, the holder will not be a "qualified person" under the at risk rules and the debt will not constitute "qualified nonrecourse financing" as to taxpayers subject to the at risk rules. As a result, the taxpayers' amounts at risk will be reduced. Under Code Sec. 465(d), when the taxpayer's amount at risk is reduced below $0, which would occur if the debt ceases to be qualified nonrecourse financing and the amount of the taxpayer's prior losses and distributions exceeded the taxpayer's cash investment, the taxpayer would recognize taxable income to the extent that his at-risk basis is reduced below zero. This income is recognized

without regard to the amount of any cash distributed. Because distressed mortgage and mezzanine loans are likely to be in default and accruing interest, it is reasonable to assume that borrowers in such cases are relying on the amount of the qualified nonrecourse financing to claim losses from those investments.

There may be solutions to the problem of a reduction in the amount that the borrower is at risk with respect to the activity. The solutions, which could include "bottom guarantees" and other types of undertakings, are not "one size fits all", however, and need to be tailored carefully to the underlying facts.

The attorneys at Cozen O'Connor have a proven expertise in dealing with all of the tax issues involved in a debt restructuring, whether on behalf of borrowers or lenders.

If you would like to discuss strategies to help manage the tax issues involved in a debt modification or restructuring transaction, or the other practical considerations related to participating in debt restructuring transactions, please contact any of the attorneys in our Tax Group listed below.

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