Phantom Income from Cancellation of Debt – A Potential Menace for Borrowers and Investors?

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In the current environment of rising interest rates and various other factors leading to increased financial distress in the overall commercial real estate market, investment companies are experiencing difficulty in refinancing existing debt and obtaining new lines of credit. One way for these companies to raise additional capital in situations where new credit is simply unavailable (or too expensive to be feasible) is to bring in new investors by issuing additional equity interests at a discount. While this may seem like a sound strategy for both the company and the new investors, there are several potential issues that need to be analyzed.

One such issue for the investors is the possibility of incurring phantom income if a debt of the company in which they are investing – for example, a mortgage or mezzanine loan – is ultimately cancelled or forgiven in whole or in part. This article will take a closer look at some of the income tax risks inherent in such a situation that apply to both new and existing investors.

As a general matter, under the U.S. Tax Code, when debt is cancelled or forgiven for less than full payment, the portion of the debt that is so cancelled or forgiven is treated as taxable income to the entity that owed the debt. However, in the case of a pass-through entity (e.g., a partnership or other entity that is disregarded for income tax purposes), that income flows through to its constituent owners. For example, if a bank loans a partnership or limited liability company (“Borrower”) $1,000,000 on a recourse basis and later agrees to accept $500,000 in full satisfaction of this indebtedness, then the Borrower will recognize $500,000 as cancellation of indebtedness income (“CODI”). Since the Borrower is a pass-through entity, the CODI is allocated among its constituent owners in accordance with the Borrower’s partnership agreement or operating agreement. This means that because of the CODI, an owner of an interest in a partnership or limited liability company may receive an unexpected allocation of taxable income without an accompanying cash distribution. To make matters worse, this income is classified as ordinary income (rather than capital gains). Although exceptions to this rule do exist in certain limited circumstances, those exceptions generally will not apply to the majority of beneficial owners.

A cancellation of debt event or other settlement of debt for a discounted amount often occurs when an entity is in bankruptcy (including when the entity files for bankruptcy protection or is involuntarily placed into bankruptcy by another party(ies)), but it can also apply any time there is a restructuring of existing indebtedness that results in a partial or complete discharge of such indebtedness. If an entity has indebtedness that it cannot service or that is not reasonably proportionate to the value of the entity’s assets, then a debt discharge scenario may become a real possibility. In the case of distressed commercial real estate, this frequently occurs in connection with (1) short sales (i.e. transactions in which a lender permits its borrower to sell the underlying real estate that secures the subject loan for less than the full loan amount and agrees to accept the sales proceeds in satisfaction of the entire loan) and (2) deed-in-lieu of foreclosure transactions. If any of these facts exist or occur, an owner may be able to attempt to avoid the potential for an unforeseen taxable event by disposing of its interest in the entity before the occurrence of the CODI event or other tax realization event. In most cases, however, that likely will be impossible to achieve. There may be

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certain alternative planning possibilities available to an owner in specific scenarios, but these are very fact-dependent and should be discussed with the owner's tax advisor.

Note that certain debt may be treated as non-recourse debt for federal income tax purposes, including, for example, certain loans that are secured by real estate and are either (1) made on a non-recourse basis or (2) made on a recourse basis to a borrower that is a single purpose, wholly owned subsidiary entity. In such cases, a settlement of that debt – including, potentially, certain short sales and deeds-in-lieu of foreclosure – may not result in CODI, although it could still result in the realization of other taxable gain which, in turn, may cause a timing mismatch (i.e., the taxable gain is realized in an earlier year than the offsetting taxable loss). However, the question of whether a debt may be treated as non-recourse debt that does not result in CODI is entirely dependent on the specific facts of the debt in question (including, among other things, the nature of any guaranties delivered in connection with such debt and the identity of the guarantors) and would also need to be analyzed on a case-by-case basis by the relevant parties' tax advisors.

Read the full article.

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