Phantom Income From Cancellation of Debt: A Potential Menace for Borrowers and Investors?

October 24, 2023 Kenneth Bezozo, Jeremy Herskowitz, Don Shiman

PRACTICES Tax

The below article was published in *Pratt's Journal of Bankruptcy Law.*

In this article, the authors discuss some of the income tax risks that investors can face when 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.

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 takes a close look at some of the income tax risks inherent in such a situation that apply to both new and existing investors.

THE GENERAL RULE
As a general matter, under the U.S. Internal Revenue Code (IRC), 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.

[Read the full article in *Pratt's Journal of Bankruptcy Law* here.]

© 2026 Haynes Boone