

## Topic: Debt Restructuring

### I. Background

- A. Actions taken to settle debt or rehabilitate a troubled company (such as the exchange of property or equity securities for debt, the modification of a debt agreement, etc.) in either an out-of-court settlement or a Chapter 11 reorganization can have significant federal tax consequences for the debtor and creditors. The consequences can influence creditors' decisions about whether to accept a Chapter 11 plan of reorganization. Thus, federal tax considerations can influence decisions such as whether to file for bankruptcy and how to structure the plan of reorganization.
- B. A financially troubled company that has secured debt may settle the debt by transferring the collateral assets to the creditor. The company may take such an action in an out-of-court settlement or in a bankruptcy proceeding. The action will have tax consequences that differ depending on the nature of debt involved (recourse debt or nonrecourse debt) and on whether the company is solvent or insolvent or in bankruptcy. The transfer may result in a gain or loss and in debt forgiveness income.

### II. Debt Forgiveness Income

- A. **Business debt forgiveness** - The general rule is that debt forgiveness income results from the settlement of debt for less than its full amount. However, tax rules provide exceptions for insolvent and bankrupt companies in which debt forgiveness income is not recognized for tax purposes. IRC Section 108 provides exceptions to the general debt forgiveness rule for debtors that are insolvent or in a bankruptcy proceeding.
  - 1. Under IRC Section 108(a), all debt forgiveness income is excluded from taxation if the debtor is in a bankruptcy proceeding.
  - 2. Under IRC Section 108(a)(3), if the debtor is insolvent but not in a bankruptcy proceeding, debt forgiveness income up to the amount of the insolvency is excluded from taxation; debt forgiveness income in excess of the amount of insolvency is taxable.
    - a. Insolvency is when liabilities exceed the fair market value of assets immediately before debt discharge.

#### ***Example 1 – Insolvency Debt Forgiveness***

Assume a nonbankrupt company has \$15 million of assets and \$18 million of liabilities that should be counted in determining the extent of insolvency immediately before debt of \$2 million is forgiven. The extent of insolvency before debt forgiveness is \$3 million (equals \$18 million liabilities minus \$15 million assets). No debt forgiveness income is recognized because the \$2 million is less than the \$3 million. If however, \$4 million of debt was forgiven, then the \$1 million excess over the extent of insolvency would be recognized as debt forgiveness income.

**B. Reduction of Tax Attributes** – The IRC Section 108(a) exception to debt forgiveness income has a cost, namely, the IRC Section 108(b) requirement to reduce tax attributes or the basis of depreciable property to the extent of debt forgiveness income not recognized. Tax attributes are factors used in calculating taxes that typically carry over from year to year, for example, net operating losses and tax credits or carryovers. When debt forgiveness income arises but is not recognized, the following tax attributes and property basis are reduced in the following order:

1. *Net Operating Losses* – Net operating losses incurred in the year of the debt discharge and net operating losses carried over to the year of debt discharge, reduced dollar-for-dollar.
2. *General Business Credit Carryovers* – That is, any credit carryover to or from the year of discharge, including the investment tax credit, research credit, targeted jobs credit, alcohol fuels credit, low-income housing credit, etc. These credits are reduced  $\$.33 \frac{1}{3}$  for every \$1 of debt discharged to reflect the fact that they reduce tax liability rather than taxable income, as the other tax attributes do.
3. *Minimum Tax credits* – These credits are determined as of the beginning of the tax year immediately following the tax year of the debt forgiveness. The credit is reduced by  $\$.33 \frac{1}{3}$  for every \$1 of debt discharge for the reason explained in item b. above.
4. *Capital Losses* – Capital losses for the taxable year and capital loss carryovers to the taxable year, reduced dollar-for-dollar.
5. *Basis of Property* – There is a prescribed order for reducing the basis of different types of depreciable property and then other property dollar-for-dollar: (a) real property used in business, **other than real property held as inventory**, that secured the discharged debt, (b) personal property used in a trade or business, other than inventory, accounts receivable, and notes receivable that secured the discharge of debt, (c) remaining property used in the trade or business, other than inventory, accounts receivable, notes receivable, and real property held as inventory, (d) inventory, accounts receivable, notes receivable, and real property held as inventory, and (e) property not used in the business nor held for investment. If an election is made (see below) to reduce the bases of assets rather than tax attributes and the bases are insufficient to offset the entire amount of excluded income, the remaining tax attributes must be reduced in the order listed in items (1) – (5). The amount of any bases reduction may not exceed the excess of (1) the aggregate of the adjusted bases of property and the amount of money held by the taxpayer immediately after the discharge over (2) the aggregate of the liabilities immediately after the discharge.

**Election: Form 982 (See Exhibit A)** –The taxpayer must make a valid election to exclude income from discharge of debt. It is made on Form 982 and attached to the taxpayer's return for the year the discharge occurs. The debtor may elect to first reduce the basis

of all or some depreciable property to zero (but not below zero) before reducing the other tax attributes. Note that, if this election is made, the limitation on the extent of basis reduction mentioned in the preceding paragraph item 5. does not apply. This alternative may be **advantageous** because it preserves loss carry forwards for use in future profitable years. Bankrupt or insolvent corporations **can** elect to treat real property held as business inventory as depreciable property for purposes of the election to first reduce the basis of depreciable property before reducing other tax attributes.

6. *Passive Activity Loss and Credit Carryovers from the Tax Year of the Debt Forgiveness*- These credits are reduced  $33\frac{1}{3}\%$  for every \$1 of debt discharge for the reason explained in item b. above.
7. *Foreign Tax Credit Carryovers* – These credits are reduced  $33\frac{1}{3}\%$  for every \$1 of debt discharge for the reason explained in item b. above.

The reduction occurs **after** the determination of taxable income for the year of the debt forgiveness, thus allowing the debtor one more chance to use credits and carryovers and to reduce the basis of depreciable assets through a depreciation deduction. Also, if the amount of tax attributes is less than the amount of debt forgiveness income not recognized, the excess income is eliminated. That is, attributes acquired in future years need not be reduced.

**C. Forgiveness of Qualified Real Property Business Debt of Debtors Other Than C Corporations That Are Neither Insolvent nor Bankrupt** – IRC Section 108(a)(1)(D) provides certain taxpayers with an election to exclude certain debt forgiveness income from taxable income. The IRC Section pertains to taxpayers other than C corporations, including partnerships and S corporations, that are neither insolvent nor in bankruptcy and that are forgiven qualified real property business debt. The election allows those entities holding real property that is of less value than the debt it secures to restructure the debt without having to recognize debt forgiveness income. The cost of the exclusion is that the basis of depreciable real property is reduced; thus, the debt forgiveness income is not permanently excluded but only deferred. The deferred income is later recognized for tax purposes through lower depreciation deductions or a higher gain (or lower loss) on disposition.

1. Depreciable Real Property
  - a. Does not include land because it is not depreciable.
  - b. Generally considered as anything affixed to the land.
2. Qualified real property business debt is debt that was:
  - a. Incurred or assumed in connection with real property used in a trade or business and that is secured by such real property and
  - b. Was incurred or assumed before January 1, 1993 or
  - c. Was incurred or assumed after January 1, 1993 and was used to acquire, construct, reconstruct, or substantially improve the trade or business real

property that secures the debt or was used to refinance existing qualified debt.

3. There is a limitation on the amount of debt forgiveness income on qualified real property business debt that may be excluded from income. That limit is the lesser of the following:
  - a. FMV Limitation: The excess of the principal amount of the outstanding debt (immediately before the forgiveness) over the fair market value of the real property securing the debt (reduced by the principal amount of any other qualified real property business debt secured by the property)(see example 1) or
  - b. Overall Limitation: The aggregate adjusted bases of all depreciable real property, determined as of the first day of the tax year after the year in which the forgiveness occurs (or, if earlier, the date the property is disposed of). The adjusted bases must be determined after any reductions made in accordance with IRC Section 108(b) applicable to a bankrupt or insolvent corporation (see example 2).
  - c. **Advice:** Because the FMV of the secured property plays a key role in determining the amount of excludable debt discharge income, taxpayers will often benefit from an appraisal that minimizes the property's FMV.

***Example 1 – Limitation on the Amount of Debt Forgiveness Income on Qualified Real Property Business Debt***

Assume that an S corporation that is neither insolvent nor bankrupt owns a building used in the business with a fair market value of \$300,000. The building secures a first mortgage of \$220,000 and a second mortgage of \$180,000. It has an adjusted basis of \$350,000. (The building was originally purchased for \$400,000 but has declined in value to \$300,000.) Assume that the holder of the second mortgage agrees to reduce it from \$180,000 to \$60,000, resulting in debt forgiveness income of \$120,000. The fair market limitation (item a. above) limits the total amount of debt forgiveness income that can be excluded to \$100,000, which is the amount by which the principal of the forgiven debt (\$180,000) exceeds the fair market value of the collateral property, reduced by other qualified business debt securing the property, that is, reduced by the first mortgage [the \$100,000 limitation equals the \$180,000 second mortgage minus (the \$300,000 fair value minus the \$220,000 first mortgage)]. Thus, of the \$120,000 debt forgiveness income, the S corporation will exclude \$100,000 from income and will report \$20,000 as income.

4. The election to exclude debt forgiveness income under IRC Section 108(a)(1)(D) must be made in the tax return for the year in which the debt forgiveness occurs. For a partnership, the determination of whether debt is qualified real property business debt and the application of the fair market value limitation on the amount of the exclusion is made at the partnership level. However, the election to apply the

exclusion is made on a partner-by-partner basis. For an S corporation, the election, the amount of exclusion, and the reduction of the basis of depreciable property are made at the corporation level.

***Example 2 – Electing to adjust the basis of real property subject to the cancellation of qualified real property debt.***

Terry Tones is a 50% partner in the The Tones Company, a general partnership that owns land used as a parking lot. He is also a 25% partner in the The Stadium Company, a general partnership that owns a football stadium that has a \$400,000 depreciable basis. The land held in The Tones Company was purchased just prior to a significant decline in value of real estate. It has a \$150,000 FMV, and secures a \$110,000 first mortgage from a bank and a \$90,000 second mortgage from the same bank. Both mortgages were obtained when the property was purchased. After lengthy negotiations, the bank agrees to reduce the second mortgage to \$30,000 as of December 2009. Terry has not experienced any financial difficulties himself. His personal financial statements show that he is solvent.

The mortgage from the bank meets requirements to be considered qualified real property business indebtedness to The Tones Company. Upon the discharge of \$60,000 of the second mortgage by the bank, it is determined (at the partnership level) that the amount of the debt discharge income that can be excluded cannot exceed \$50,000 [\$90,000 less \$40,000 (the FMV of the property, \$150,000, reduced by the first mortgage, \$110,000)]. The remaining \$10,000 will be recognized as income to the respective partners. Terry's share of the amount to be recognized is \$5,000. Terry's share of the debt discharge income that is eligible for exclusion is \$25,000 and will be reported as a separately stated item to him on his Schedule K-1. He will have to determine if he can make the election to exclude the debt discharge income on his individual return.

Although the land used as a parking lot is not depreciable real property, Terry has sufficient basis (\$100,000) from his proportionate share of The Stadium Company's depreciable real property to allow for the exclusion of his portion of the debt discharge income from The Tones Company. He requests to exclude the \$25,000 of income from the basis in his share of The Stadium Company's depreciable property. Since Terry does not own more than 50% of The Stadium Company, the partnership is not required to grant its consent, which is required for Terry to reduce his share of depreciable basis in The Stadium Company's depreciable real property [Reg 1.1017-1(g)(2)(ii)(C)].

5. **Commentary:** It is important to note that the taxpayer was able to reduce his basis in depreciable real property in a company outside of the company that had its debt reduced.
6. **Election E1008 (See Exhibit B) – Consent to Treating a Partnership Interest as Depreciable Property.** A taxpayer can request that a partnership reduce the inside basis of its depreciable property [or depreciable real property (in the case of qualified real property business debt)] for that taxpayer. However, the partnership must consent if the request is made by (1) partners owning (directly or indirectly) an aggregate of more than 80% of the capital and profits of the partnership or (2) five or fewer partners (directly or indirectly) an aggregate of more than 50% of the capital and profits interests in the partnership. Also, a taxpayer must request consent if (1) he owns (directly or indirectly) more than 50% of the partnership's capital and profits or (2) reductions to the basis of the taxpayer's depreciable property are being made with respect to the taxpayer's distributive share of discharge of indebtedness income from the partnership.

#### **D. Special Rules for Principal Residence Debt**

1. Taxpayers can exclude from gross income a discharge (in whole or in part) of qualified principal residence indebtedness before January 1, 2013 [IRC Sec. 108(a)(1)(E)]. The exclusion applies where taxpayers restructure their acquisition debt on a principal residence or lose their principal residence to in a foreclosure. But the exclusion does not apply if the discharge is on account of services performed for the lender or any other factor not directly related to a decline in value of the residence or to the taxpayer's financial condition.
  - a. \$2 million limit (\$1 million for married filing separately)
  - b. Does not apply to Title 11 bankruptcy
  - c. Includes refinanced debt to the extent the refinancing does not exceed the amount of the refinanced acquisition indebtedness.
2. Most residential mortgages are classified as recourse debt. As such, a foreclosure involving recourse debt is treated as a deemed sale with proceeds equal to the lesser of FMV at the time of foreclosure or the amount of secured debt. If the amount of debt exceeds FMV, the difference is treated as debt discharge income if it is forgiven. Therefore, it is possible for a residential foreclosure transaction to result in either a gain or loss from the sale of property and debt discharge income. However, only the portion of the transaction treated as debt discharge income is available for the special exclusion rule for qualified principal residence indebtedness; any income from the foreclosure treated as gain is not eligible for the exclusion rule.

**Example 1 – Exclusion for mortgage debt** – Tim, who is not in bankruptcy and is not insolvent, owns a principal residence that is subject to a \$300,000 mortgage secured by the residence. The original cost of the home was \$270,000 and lender foreclosed on the loan in 2009 when property’s FMV was \$280,000.

The foreclosure results in a taxable gain of \$10,000 (\$280,000 less \$270,000) and debt discharge income of \$20,000 (\$300,000 less \$280,000). The \$10,000 gain must be recognized, but the \$20,000 of debt discharge income is excluded.

3. In a rare case that a residential mortgage is nonrecourse, a foreclosure transfer is treated as a sale or exchange with the full amount of the debt as the amount realized, even if it is greater than the FMV of the property at the time of the foreclosure. Therefore, there is no debt discharge income and the exclusion rule does not apply.

#### **E. Debt Discharge Income – Bankrupt or Insolvent Taxpayer**

1. Special mandatory relief provisions apply to debt discharge income of bankrupt or insolvent taxpayers [IRC Sec. 108(a)]. These relief provisions allow such taxpayers to exclude debt discharge income from gross income. However, certain tax attributes are reduced by the amount of excluded debt discharge income. To the extent the excluded income exceeds the tax attributes available for reduction, the “excess” income, in effect, disappears (with no further tax consequences to the debtor).
  - a. These relief provisions do not apply to any portion of a debt relieved when property is surrendered as a part of a debt restructuring or cancellation. Instead, the transfer of the property is treated as a sale or exchange, and gain or loss is recognized.
2. Bankrupt Taxpayers – Bankrupt taxpayers exclude all debt discharge income from taxable income under these rules.
3. Insolvent Taxpayers – Insolvent taxpayers exclude debt discharge income from taxable gross income to the extent of insolvency before the debt discharge transaction [IRC Sec. 108(a)(3)]. Any debt discharge income in excess of insolvency is taxable income. The extent of insolvency is the excess of the taxpayer’s liabilities over the FMV of his assets immediately before the debt discharge.

***Example 1 – Excludable debt discharge income for insolvent taxpayer***

All of Max's personal assets and liabilities are from his sole proprietorship business. As of August 1, 2009 business operating debts owed to Last Bank were \$500,000, and the FMV of business assets was only \$350,000.

The bank discharges \$200,000 of Max's debts in exchange for his promise to take no money out of the business until it becomes healthy. This debt discharge occurs outside of bankruptcy in a voluntary "workout" between the borrower and lender.

Just before the debt discharge, Max was insolvent to the extent of \$150,000 (\$500,000 of liabilities less \$350,000 FMV of assets). Thus, he can exclude \$150,000 of the \$200,000 discharge from income. However, he must reduce tax attributes by up to \$150,000.

The remaining \$50,000 of debt discharge income must be included in Max's income. After the debt discharge, his assets are still worth \$350,000, and his liabilities are only \$300,000. Thus, \$50,000 is taxable because he has been solvent by that amount as a result of the debt discharge transaction.

4. When an insolvent taxpayer's debt is partly discharged and partly satisfied by the transfer of property, the transaction must be bifurcated between the debt discharge and the property distribution. The amount of debt satisfied by the transfer of the property is treated as sales proceeds for the property, from which gain or loss is computed. The separate debt discharge amount is eligible for exclusion under IRC Sec. 108, to the extent the taxpayer is solvent.

***Example 1 – Property transferred by insolvent debtor***

Tad transfers a vacant lot with a FMV of \$30,000 and \$5,000 cash in complete settlement of a \$50,000 unsecured loan from the bank. The bank forgives the remaining \$15,000 of the loan. Assume Tad is insolvent both before and after the debt discharge. His basis in the lot was \$25,000. The transfer of the property and the debt discharge are treated as two separate transactions. The transfer of the lot is considered a sale of the property, so Tad has a \$5,000 taxable gain based on the difference between the FMV and basis (\$30,000-\$25,000). The \$15,000 debt discharge amount is excluded from Tad's income under the insolvency rule.

5. **Commentary** – Insolvent taxpayers must be especially careful when they transfer property in connection with debt relief or discharge. Even though the transfer of

property may be compulsory and part of an overall agreement with the lender to have the debt discharged, the transaction is divided into two parts. Depending upon the facts and the extent of the taxpayer's insolvency, it may be beneficial to minimize the FMV assigned to the property transferred so more debt is treated as discharged by the lender (and therefore eligible for the exclusion). This option is only available if more than one appraisal has been obtained from qualified appraisers and one of the appraisals gives heavier weight to factors that would minimize the FMV of the property.

- a. **Ethical Issues** – Since an appraisal is an imperfect science, FMV of the property can vary significantly from various appraisals. Selecting the FMV that minimizes the FMV may bring in ethical dilemmas.
6. **Reduction of Tax Attributes** – While bankrupt and insolvent taxpayers can exclude debt discharge income from taxable gross income, they must reduce (to the extent possible) certain tax attributes [IRC Sec. 108(b)]. This reduction of attributes means (as mentioned in section B. above) that some or all of the excluded debt discharge income will eventually be recognized because of reduced tax attributes or basis in property. The tax attributes are reduced in the same manner as in Section B. above.
7. **Basis Reduction Elections** – Two basis reduction elections are available to bankrupt and insolvent taxpayers. Instead of reducing tax attributes (as mentioned above) the taxpayer can elect under IRC Sec. 108(b)(5) to first reduce the basis of depreciable assets. Excluded debt discharge income in excess of the basis of depreciable assets is then used to reduce other attributes according to the normal ordering procedures. This “basis reduction” election can be beneficial to taxpayers with NOL or credit carryovers (that will be used in the near future) and long-lived depreciable property. See Election E1006 (see Exhibit C) for more information on how to make the election. Bankrupt or insolvent taxpayers who make the Section 108(b)(5) election can also elect under IRC Sec. 1017 to treat real property inventory as depreciable property.
8. Form 982 must be filed whenever debt discharge income is excluded from gross income. The two basis reduction elections described earlier are made on Form 982. No additional election needs to be made(see Exhibit A).