New York Real Estate Journal

nyrej

THE LARGEST COMMERCIAL/INVESTMENT NEWSPAPER COVERING THE STATE

Reprint | nyrej.com | Tuesday, April 23, 2013

Examining the tax consequences of debt modifications with regards to IRS regulations

Sandy Klein

Shanholt Glassman Klein Kramer & Co.

In general, it is safe to say that most changes that in any way affect the risk or the return to a holder of the debt instrument constitute modifications. For example, any alteration in any legal right or obligation of the lender or the borrower of a debt instrument will constitute a modification whether evidenced by an amendment to the debt instrument, conduct of the parties, or otherwise.

There have been countless stories in the news over the last year about the deteriorating condition of the U.S. real estate market. Residential real estate is currently going through one of the worst periods in recorded history. The effects of the souring economy are now beginning to take a toll on commercial real estate values as well. Facing the inevitable, banks are more willing to renegotiate the financing arrangements of many real estate projects to help ensure their continued economic vitality rather than foreclose on the property.

In some cases, the modification of the loan may not result in a tax event to either the borrower or the lender. In other cases, the debt modification may be treated as a deemed exchange of the old debt for the new debt giving rise to "cancellation of indebtedness" (COD) income unless a non-recognition provision (such as insolvency, bankruptcy or qualified real property business indebtedness) applies.

The Internal Revenue Service (IRS) has published regulations that provide guidance for determining whether a change in the terms of a debt instrument will result in a deemed exchange resulting in a taxable event. The general rule is that only a "significant modification" of the debt instrument will result in a deemed exchange.

The first question that must be asked is whether the alteration of the debt instrument constitutes a "modification." If so, the modification must be reviewed to determine whether it is significant. The regulations also set forth rules for analyzing whether multiple changes to the terms of a debt instrument constitute a significant modification.

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The regulations provide the general rule that a modification is significant, "...only if, based on all facts and circumstances, the legal rights or obligations that are altered are economically significant."

In making this determination, the regulations require that all modifications not otherwise addressed in the regulations (see discussion which follows) be considered collectively.

The regulations address the following five specific modifications that commonly arise in debt modifications:

1. Changes in yield;
2. Change in timing of payments;
3. Change in obligor and security;
4. Changes in the nature of the debt instrument; and
5. Accounting or financial covenants.

A change in the annual yield of a debt instrument will be significant if it varies the annual yield by more than one-fourth of 1%. Deceptively simple on its face, the regulations provide a somewhat complex method of determining the annual yield based on "adjusted issue price" and the "applicable federal rate." The result is that in most common workouts, this modification will not be considered significant.

A change in the timing of payments is considered a significant modification if the change results in a "material deferral" of scheduled payments. A safe harbor provision allows a deferral of both interest and principal for a period that begins on the original due date of the payment and ends at the end of the earlier of five years or 50% of the original term of the instrument.

Generally, a change in the obligor of a recourse debt will be considered a significant modification while a change in the obligor of a non-recourse obligation will not. The addition or deletion of a co-obligor is usually not a significant modification in the case of either recourse or non-recourse debt.

Any change in the debt instrument that causes it to be not properly characterized as debt for federal income tax purposes will be considered significant. A change from recourse to non-recourse debt is a significant modification unless the debt continues to be secured by the original collateral and there is no change in the payment expectations.

A modification that adds, deletes or alters customary accounting or financial covenants is not a significant modification.

As suggested by the above, it is difficult for borrowers to avoid COD income resulting from a deemed exchange in a typical restructuring.

Sandy Klein, CPA, is a partner at Shanholt Glassman Klein Kramer & Co., New York, N.Y.