Debt Forbearance/Settlement Agreements: One of the Most Important and Often Overlooked Clauses

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The economic impact of the global COVID-19 pandemic will likely result in a considerable number of borrower defaults, workouts and debt restructurings. An often overlooked but significant consequence of debt modifications or settlement agreements are the substantial tax issues that arise, many of which create bountiful opportunities and potential pitfalls for borrowers. However, depending upon how a debt modification or settlement is structured, and in particular whether the property which is collateral for the debt is transferred to the lender, the tax consequences need to be carefully considered, and in certain cases they can be drastically mitigated.

One of the most important tax issues of a debt forbearance or settlement agreement is whether "cancellation of debt" occurs for income tax purposes. Cancellation of debt occurs if a lender does not collect the amount a borrower is obligated to pay. Further, when property is collateral for a debt, cancellation of debt can occur through a foreclosure, repossession, mortgage modification, voluntary transfer of the property or abandonment. Cancellation of debt income is taxed at ordinary income rates while gain on the transfer of real property is generally taxed at lower capital gain rates, subject to ordinary income characterization for depreciation recapture.

When a lender cancels a borrower's obligation to repay a debt, the borrower may be required to include the amount of that canceled debt in its gross income for the year the cancellation occurs. For debt that is used to finance property, the characterization of the debt as recourse debt and non-recourse debt, and whether the property is transferred to the lender, will significantly impact the tax consequences. The following is a list of "cancellation of debt" threshold issues that lenders and borrowers should keep in mind when negotiating debt modification, forbearance or settlement agreements.

Transfers of Property to the Lender

The threshold tax question is whether the financed property is transferred by the borrower to the lender in whole or partial satisfaction of the debt. In the case of a transfer of property to the lender in satisfaction of the debt, such as a deed-in-lieu of foreclosure, Section 1001 of the Internal Revenue Code of 1986, as amended (Code), and the Treasury Regulations issued under Code Section 1001, state that the transfer is treated as a sale of the property by the borrower to the lender. The manner of taxing this sale depends on whether the debt is recourse or non-recourse, the fair market value (FMV) of the transferred property, the extent to which the debt is discharged as a result of the transfer, and the tax basis in the property.

Debt is treated as "recourse" debt for tax purposes when the borrower is personally liable for the payment of the debt, even if the amount of the debt exceeds the FMV of the debt. The amount realized on the transfer of property subject to recourse debt is the <u>FMV of the property</u>. For tax purposes, the amount of the debt in excess of the FMV of the property will be the cancellation of debt income and must be included in the borrower's gross income, subject to certain exclusions. Under these tax rules, transfers of property subject to recourse debt result in the bifurcation of the transfer into two parts. First, there is cancellation of debt income (taxed at ordinary income rates) where the amount of the recourse debt is in excess of the FMV of the transferred property. Second, there is gain or loss on the sale of the property based on the difference between the FMV of the property and the tax basis of the property. As noted above, the sale generally results in capital gain (or loss), subject to the depreciation recapture rules.

If non-recourse debt is used to finance property, the tax treatment is very different. Debt is treated as "non-recourse" for tax purposes when the borrower is not personally liable for the payment of the debt and the lender's only option of recovery is against the financed property, not against the other assets of the borrower. The amount realized on the transfer of property subject to non-recourse debt is the amount of the debt and no portion of the potential gain is treated as cancellation of debt income. This means that the transfer of property to a lender subject to non-recourse debt does not trigger ordinary income under the cancellation of debt tax rules while identical property subject to recourse debt can, depending of the FMV of the property and the amount of the debt, trigger ordinary income under the cancellation of debt tax rules.

Non-Transfers of Property to the Lender

If the debt reduction does not involve the transfer of the property to the lender, then a debt reduction can result in cancellation of debt income to the borrower. In this case borrowers need to examine the various exceptions to income recognition under Code Section 108. The tax treatment of debt discharges under Code Section 108 depends on many factors, such as the tax classification of the borrower (*e.g.*, partnership, limited liability company (LLC) taxed as a partnership, single member LLC or S corporation) and whether the borrower is insolvent or subject to a bankruptcy proceeding. The Code Section 108 rules are complicated and should be carefully reviewed with the borrower's tax advisors.

Reporting the Transaction for Tax Purposes

How each party will treat the transaction for tax purposes, and whether any party will report any cancellation of debt income to the Internal Revenue Service (IRS), should be specifically and clearly stated in each agreement which reduces or eliminates debt. Some courts have held that an agreement's silence with respect to the tax consequences allows the lender to determine how to report the transaction to the IRS. As a result, when possible, an agreement should explicitly address how the lender will report cancellation of debt income on IRS Form 1099-C (Cancellation of Debt) or IRS Form 1099-A (Acquisition or Abandonment of Secured Property), as applicable. As noted above, the tax classification of the debt as recourse or non-recourse impacts the cancellation of debt issue and tax reporting needs to be consistent with the underlying tax classification.

If debt is being cancelled, forgiven or discharged it is important to recognize and understand this technical area of tax law. In order to prevent adverse tax results in these situations, it is imperative to analyze tax consequences of the structure of the deal and its impact on cancellation of debt income.