Miller Canfield

Corporate and Tax Update

Tax Issues Associated with Discharge of Indebtedness

May 7, 2009

Due to the recession and the related credit crisis, many companies are in a position of being unable to timely pay their debts. As a result, businesses have increasingly become compelled to negotiate reductions in their obligations and/or surrender property to creditors in settlement of such debts. Often, creditors are agreeing to such debt modifications, as many creditors are now under secured due the fact that the value of their collateral has substantially diminished. Despite the increasing frequency of debt modifications and cancellations, many taxpayers are unaware that there are potentially significant tax implications associated with such debt reductions.

As a general rule, the tax law requires a taxpayer that is neither bankrupt nor insolvent to recognize cancellation of indebtedness income ("COD Income") to the extent that its debts are reduced for inadequate consideration. COD Income is treated as ordinary income. If a taxpayer is bankrupt or insolvent,[1] then any COD Income realized by such taxpayer may be excludable from gross income.

1. Modification of Recourse Obligations

The reduction of a recourse obligation or the transfer of property to a creditor in settlement of such an obligation generally results in COD Income. For example, if a taxpayer has a $10,000,000 recourse obligation that a creditor voluntarily reduces to $7,000,000, then the taxpayer would realize $3,000,000 of COD income. Similarly, if a taxpayer transfers real property with a fair market value of $8,000,000 to a creditor in full settlement of a $12,000,000 recourse obligation, then the taxpayer would realize $4,000,000 of COD Income. In this latter example, the exchange of the obligation for the real property is also treated as a taxable exchange of the property.[2] As a result, such a transfer may not only cause the taxpayer to realize COD Income, but may also result in gain or loss on the disposition of the property.

Assume that, as in the previous example, the solvent taxpayer transfers real property worth $8,000,000 in settlement of a $12,000,000 recourse debt. Further assume that the taxpayer has a basis in such property of $10,000,000. As a result of the property for debt swap, the taxpayer would realize COD Income to the extent the recourse debt exceeds the fair market value of the transferred property, which, in this case, would be $4,000,000 ($12,000,000 debt (-) $8,000,0000 FMV property). In addition, the taxpayer would also realize gain or loss based on the difference between its basis and the fair market value of the property, which, in this example, would be a loss of $2,000,000 ($10,000,000 basis (-) $8,000,000 FMV property). Therefore, the taxpayer would recognize $4,000,000 of COD income and a $2,000,000 loss on the disposition of the property.[3] The character of this loss would depend on whether the property was a capital, business or other asset in the hands of the taxpayer. However, if the loss is a capital loss, then such loss generally cannot be used to offset COD Income.

If the taxpayer in the above example was insolvent, then the taxpayer would still recognize the $2,000,000 loss associated with the disposition of the property; however, the $4,000,000 COD Income would not be recognized. Instead, various tax attributes of the taxpayer (i.e. net operating losses; basis of assets) would be reduced by the amount of the COD Income.

2. Modification of Non-Recourse Obligations

If a taxpayer transfers property in settlement of a non-recourse liability (i.e. a liability secured only by a particular property), then, on the disposition of the property, the taxpayer is treated as realizing the higher of: (i) the fair market value of the property; or (ii) the amount of the non-recourse liability. As a result, the taxpayer will realize gain or loss based on the difference between such amount and its basis in the property. However, any gain realized on the transfer of property in settlement of a non-recourse debt is not treated as COD Income. Instead, it is merely recognized as gain from the exchange of property and the character of such gain will depend on the purpose for which the taxpayer held the property. Because such income is not treated as COD Income, it cannot be excluded from gross income by a taxpayer that is bankrupt or insolvent.

3. Debt/Equity Conversions

One type of property that debtors often transfer to creditors in exchange for a cancellation or modification of debt is stock or other ownership interests in the debtor. Similarly, creditors often have the option of converting debt into such equity interests. In such cases, the taxpayer is treated as exchanging the debt obligation for the stock or other equity interest and recognizes COD Income to the extent that the amount of the debt exceeds the fair market value of the stock or other equity interest transferred to the creditor.

4. Debt Discharge Rules for Certain Business Entities

The tax consequences associated with discharges of indebtedness vary significantly based on the type of the business entity whose debts are being modified.

a. Partnerships

In the event that the obligations of a partnership (or LLC treated as a partnership for federal tax purposes) are discharged, the partnership realizes COD Income and such income is generally allocated among the partners based on their profit sharing ratios. Although COD Income is realized at the partnership level, the determination regarding whether it is includible in income is made on a partner-by-partner basis. As a result, if any partner is bankrupt or insolvent, then that partner would generally not recognize the COD Income allocated to it by the partnership; however, any solvent partners would be required to take their share of the partnership's COD Income into account. Therefore, if a partnership has a solvent partner who is an individual (or other non-corporate entity), then the partnership (or solvent partner) should consider potential defensive measures to mitigate the adverse tax consequences associated with the partnership recognizing COD Income.

b. Corporations

The tax consequences to corporations and their shareholders in connection with discharges of corporate debts are substantially different than those for partnerships. The determination of whether a corporation is solvent is made at the corporate level. This applies with respect to both C and S corporations. Unlike most income derived by S corporations, COD Income realized by an insolvent or bankrupt S corporation is not allocated to the S corporation's shareholders, but the tax attributes of the corporation will be reduced.

5. Purchase Price Reduction Exception

One important exception to the general rule that debtors who are neither bankrupt nor insolvent recognize COD Income when a debt is cancelled or modified is if the debt is owed to the seller of property acquired by the taxpayer. In such case, the reduction in the debt is typically treated as a purchase price adjustment and, rather than recognizing COD Income at the time of the debt modification, the debtor would reduce its basis in the purchased property. For example, if a debtor purchased real property in exchange for issuing a $10,000,000 note to the seller and the seller later reduced the amount of this debt to $6,000,000, then the debtor would be required to reduce its basis in the real property by $4,000,000.[4] This exception therefore defers the income recognition event until the debtor disposes of the property. It should be noted that there is little guidance regarding whether the purchase price adjustment exception is available if the seller has transferred the debt or if the debtor has disposed of the acquired property.

A partnership can utilize the purchase price adjustment exception without regard to whether the partnership is solvent or insolvent, but, in order to do so, each partner must treat the modification of the debt as a purchase price reduction. Therefore, a partnership that has seller financed debts modified will reduce its basis in the acquired property and prevent the allocation of COD Income to its partners.

6. Election to Defer COD Income on Certain Debt Reacquisitions

Pursuant to the recently enacted American Investment and Recovery Act of 2009, a taxpayer may generally elect to defer recognizing COD Income realized in 2009 or 2010 if the taxpayer (or a related party) reacquires an outstanding debt instrument for less than the adjusted issue price of the obligation. Any COD Income deferred under this provision must be recognized by the taxpayer during the 2014 through 2018 tax years. If this election is made, then the COD Income exclusions for bankruptcy and insolvency will not allow the taxpayer to avoid COD Income in future tax years.

7. Defensive Measures to Avoid COD Income

As discussed above, COD Income realized by C corporations or insolvent S corporations should not adversely affect the shareholders of such entities; however, such income can have a significant adverse effect on solvent partners of partnerships (or members of LLCs). Accordingly, non-corporate partners or LLC members should consider potential defensive measures to mitigate the adverse impacts of COD Income allocations.

One method that may allow a solvent non-corporate partner to avoid recognizing COD Income allocated to him from a partnership is to abandon the partnership interest prior to the time the partnership realizes the COD Income. The abandonment may be treated as a sale of the partnership interest for tax purposes. Moreover, in order to be effective, an abandonment generally be acknowledged by the partnership prior to the date that any COD Income is recognized. This could be problematic if all of the partners are solvent, because, in such case, abandonment by one partner would increase the COD Income allocated to the other partners.

Another potential alternative that could be used to avoid COD Income of a partnership is for the partnership to elect to be treated as an S corporation. Such an election could prevent any COD Income from being allocated to the partners, because COD Income realized by an insolvent S corporation is not allocated to the S corporation's shareholders. However, electing to treat the partnership as a corporation is not without potential adverse tax consequences, as the transfer of the partnership's liabilities to the S corporation may result in the recognition of gain.[5] It is also possible that

the IRS may disregard the conversion of a partnership into an S corporation if it views the conversion as being undertaken for a tax avoidance purpose.

Another potential method that a solvent partner could use to prevent the allocation of COD Income from a partnership is to contribute his partnership interest to a wholly-owned S corporation prior to the time the partnership recognizes the COD Income. Any COD Income allocated by a partnership to an insolvent S corporation partner should be suspended at the S corporation level and should not be allocated to the S corporation's shareholder. The contribution of the partnership interest to an S corporation may require the partner to recognize a significant amount of gain; however, such gain should be capital gain rather than ordinary gain from COD Income. It is also possible that the IRS may disregard the contribution of partnership interests to an S corporation if it is considered as being done for a tax avoidance purpose.

8. Conclusion

The rules regarding the tax consequences of debt modifications are complex and vary significantly based on the nature of the debt obligation, the type of business entity involved, and the solvency of the business (and potentially its owners). As a result, these rules should be carefully considered prior to entering into any agreement to modify debt or transferring any property in settlement of debt obligations. As discussed above, failure to do so may result in the taxpayer (and potentially its owners) suffering significant adverse tax consequences.

DISCLOSURE UNDER TREASURY CIRCULAR 230: The United States Federal tax advice contained in this document and its attachments, if any, may not be used or referred to in the promoting, marketing or recommending of any entity, investment plan or arrangement, nor is such advice intended or written to be used, and may not be used, by a taxpayer for the purpose of avoiding Federal tax penalties. Advice that complies with Treasury Circular 230's "covered opinion" requirements (and thus, may be relied on to avoid tax penalties) may be obtained by contacting the author of this document.

For more information, contact:

Ryan J. Riehl
Associate, Tax Group

Richard A. Walawender
Corporate Group Director
+1.313.496.7628
walawender@millercanfield.com

Gary R. Glenn
313.496.7852
glenn@millercanfield.com

---

[1] A taxpayer is insolvent to the extent that its liabilities exceed the fair market value of its assets immediately prior to the debt discharge/modification.

[2] A taxable sale or exchange is deemed to occur without regard to whether the transfer is voluntary or whether it is pursuant to a foreclosure or other involuntary seizure by the creditor.

[3] Note that if the taxpayer's basis had been $5,000,000, rather than $10,000,000, then the taxpayer would have recognized a $3,000,000 gain ($8,000,000 FMV property (-) $5,000,000 basis).

[4] In the event that a debt reduction exceeds the debtor's basis in the purchased property, it does not appear that any COD Income must be recognized due to such excess.

[5] However, such gain may be capital gain (depending on the nature of the partnership's assets) whereas COD Income is always recognized as ordinary income.