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Phantom Income from Cancellation of Debt – A Potential Menace for Borrowers and Investors?

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

As a general matter, under the U.S. Tax Code, 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.

A cancellation of debt event or other settlement of debt for a discounted amount often occurs when an entity is in bankruptcy (including when the entity files for bankruptcy protection or is involuntarily placed into bankruptcy by another party(ies)), but it can also apply any time there is a restructuring of existing indebtedness that results in a partial or complete discharge of such indebtedness. If an entity has indebtedness that it cannot service or that is not reasonably proportionate to the value of the entity's assets, then a debt discharge scenario may become a real possibility. In the case of distressed commercial real estate, this frequently occurs in connection with (1) short sales (i.e. transactions in which a lender permits its borrower to sell the underlying real estate that secures the subject loan for less than the full loan amount and agrees to accept the sales proceeds in satisfaction of the entire loan) and (2) deed-in-lieu of foreclosure transactions. If any of these facts exist or occur, an owner may be able to attempt to avoid the potential for an unforeseen taxable event by disposing of its interest in the entity before the occurrence of the CODI event or other tax realization event. In most cases, however, that likely will be impossible to achieve. There may be certain alternative planning possibilities

available to an owner in specific scenarios, but these are very fact-dependent and should be discussed with the owner's tax advisor.

Note that certain debt may be treated as non-recourse debt for federal income tax purposes, including, for example, certain loans that are secured by real estate and are either (1) made on a non-recourse basis or (2) made on a recourse basis to a borrower that is a single purpose, wholly owned subsidiary entity. In such cases, a settlement of that debt – including, potentially, certain short sales and deeds-in-lieu of foreclosure – may not result in CODI, although it could still result in the realization of other taxable gain which, in turn, may cause a timing mismatch (i.e., the taxable gain is realized in an earlier year than the offsetting taxable loss). However, the question of whether a debt may be treated as non-recourse debt that does not result in CODI is entirely dependent on the specific facts of the debt in question (including, among other things, the nature of any guaranties delivered in connection with such debt and the identity of the guarantors) and would also need to be analyzed on a case-by-case basis by the relevant parties' tax advisors.

The following hypothetical case study provides a more detailed description of discharge of indebtedness and CODI in the context of pass-through entities.

Background

In 2017, Investor invested in a real estate joint venture partnership that acquired an office building (the "***Partnership***")[1]. For each year since the initial investment, Investor has received from the Partnership both cash distributions and an IRS Form K-1 stating Investor's allocable share of the Partnership's income, gains, losses, deductions, etc. Although Investor's proportionate share of the Partnership's income was consistently allocated to Investor, the resulting annual tax liability was always less than the amount of cash distributions that Investor received from the Partnership for such tax year. However, in 2022, the Partnership experienced difficulty in collecting rents at the subject office building and, accordingly, the cash distributions ceased (although the annual Form K-1 still appeared). Recently, Investor received a notice from the Partnership stating that (1) the Partnership is in default on its debt service payments to its lender, (2) the Partnership is engaging in potential workout and/or restructuring discussions with the lender, which may include a reduction of the outstanding debt amount, and (3) the investors in the Partnership may be subject to adverse tax consequences as a result thereof. Investor now seeks to understand what these adverse tax consequences may be.

A partnership is a pass-through entity for federal income tax purposes

In the case of a partnership, all items of income, gains, losses, deductions, etc. are "passed through" to its constituent owners, regardless of the partnership's or its owners' particular circumstances. For example, if an investor acquires a partnership interest immediately prior to the occurrence of an event that causes income to be recognized by the partnership, that investor may be allocated its proportionate share of the relevant income, even though it receives no cash with respect to this income.

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[1] Although this hypothetical case study discusses a partnership, the same analysis would apply if the applicable joint venture entity was a limited liability company rather than a partnership.

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Cancellation of indebtedness income (CODI) in the context of a partnership

As noted above, when debt is cancelled or forgiven for less than full payment, the amount so cancelled or forgiven is treated as taxable income to the entity that owed the debt. However, because a partnership is a pass-through entity, the CODI that would otherwise have been charged to the partnership is instead allocated among its constituent owners in accordance with the governing partnership agreement, which could result in the owners receiving an unexpected allocation of taxable income without a related cash distribution.

Is there an exception to recognizing CODI in bankruptcy or due to insolvency?

There are certain limited but important exceptions to the rule requiring the recognition of CODI, the most significant of which are the "bankruptcy exception" and the "insolvency exception." The bankruptcy exception essentially provides that if the taxpayer is bankrupt when the CODI occurs, then the applicable income will not be recognized by the taxpayer (i.e., it will not be included in the taxpayer's income). Similarly, the insolvency exception essentially provides that if the taxpayer is insolvent when the CODI occurs, then the applicable income will not be recognized by the taxpayer, but only to the extent of the taxpayer's insolvency. For this purpose, the "amount" of the taxpayer's insolvency (and thus the resulting amount of CODI that the taxpayer is not required to recognize) is generally interpreted to mean the amount by which the taxpayer's liabilities exceed the fair market value of its assets. It is important to note that these exceptions would only apply to CODI, which generally arises from recourse debt and the cancelation of non-recourse debt; however, any taxable income realized from the settlement of non-recourse debt in exchange for the property encumbered by such debt (as is often the case in the context of commercial real estate, e.g., a foreclosure or deed-in-lieu of foreclosure) would not be subject to any of these exceptions.

How do the CODI rules apply to pass-through entities?

In the case of a pass-through entity like the Partnership, the two exceptions noted above are applied to the entity's constituent owners (i.e., at the owners' level) and not at the partnership-entity level. This means that if a pass-through entity recognizes CODI in connection with its bankruptcy or insolvency, the bankruptcy or insolvency exception would not apply to protect the owners when this income is passed through to them – unless such owners themselves were in bankruptcy or insolvent (separate and apart from the bankruptcy or insolvency of the partnership) at the time that the event causing the CODI occurred. Assuming the owners were not bankrupt or insolvent at such time, then neither of the bankruptcy or insolvency exceptions would apply to them, and such owners would receive a tax liability without any offsetting cash distribution.

The importance of the partnership agreement

The governing partnership agreement is of paramount importance in such instances, as it defines how income, gains, losses, deductions and other items are allocated among the various owners. For example, the partnership agreement may include special allocations of specific types of income to certain owners and not to others. This is a prime example of why it is essential to have all partnership agreements reviewed by tax counsel prior to entering into the same.

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Is there any good news?

It depends how "good news" is defined, but the short answer is – unfortunately, not really. If an owner is allocated CODI or other phantom taxable income or gain by a partnership, this income is treated as regular, ordinary income or gain (as opposed to capital income or gain), which will increase the owner's tax basis in its investment. In turn, when the owner ultimately disposes of its interest in the partnership, the increased tax basis will reduce the amount of gain or increase the loss recognized by the owner with respect to this investment. However, if and to the extent there is a loss with respect to this investment (which may very well be the case given the likely distressed nature of the asset), the loss will be treated as a capital loss for all purposes and can generally only be offset against capital gains. This is not a favorable tax result in light of the fact that the CODI itself is treated as ordinary income that is taxed at the significantly higher ordinary income tax rates.

This article should not be construed as legal advice because, among other things, it does not take into consideration specific facts of any particular transaction or situation. If you have any questions about its content or about issues specific to your concerns, please contact one of the authors listed above or another Haynes Boone real estate or tax attorney.

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