

Discharge of Indebtedness Tax Implications

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Familiar with these lyrics, “What is love? Baby don’t hurt me, no more...” Well, in today’s environment, the words could be changed to, “What is debt? Banker don’t hurt me, no more...” The current economic tsunami has caused us all to re-think how we approach our businesses and what strategic decisions need to be made; included in that mix should be some planning for dealing with debt forgiveness income.

Cancellation of indebtedness (COD) income is simply being treated as earning taxable income when a taxpayer does not have to pay back everything they owe. This income can also result when existing debt is restructured with more favorable terms, such as a lower interest rate and or extended repayment term. The current laws were not designed for the banking sector melt down which has encouraged widespread defaults. This unbalanced scenario warrants full utilization of the current tax and debtor laws to restructure for long-term viability and business growth.

When debt is discharged, the calculation of COD income will depend upon whether the debt is recourse or nonrecourse. Property conveyed to the lender in satisfaction of recourse debt will generate COD income to the extent that the fair market value of



the property is less than the principal amount of the debt. Property conveyed to a lender in satisfaction of nonrecourse debt is treated as a sale, and gain results to the extent the principal amount of the debt exceeds the tax basis of the property. However, COD income can also result when existing debt is

significantly modified, when outstanding debt is acquired by a related party, and when debt is exchanged for an equity interest in a corporation or partnership.

The laws allow for COD income to be excluded from being treated as taxable income and were commonly applied in the early 1990’s. The world at that time was a bit less complicated and lenders had a more direct relationship with borrowers to negotiate debt work outs. Today things are not quite as simple. For the average commercial loan, the lender has turned into a plethora of multi-tiered, multi-partied financial instrument arrangements. The borrower may have a hard time figuring out who the lender is as the loan has been sliced and diced into tranches of securities. The borrower who is in a default situation may be stuck working with a loan servicer that may not be able to or be unwilling to work with the borrower.

Currently, borrowers still have ways to exclude COD income from taxation; however, it takes much more proactive planning in today’s environment to ensure

a tax benefit. COD income can be excluded in a Title 11 Bankruptcy, case when the taxpayer is insolvent, when the debt is considered to be qualified real property business indebtedness, and other exemptions. The cost of exclusion can be the reduction of the tax basis of existing assets and the elimination of net operating loss and credit carryovers. In addition, for 2009 and 2010, an eligible taxpayer may elect that COD income incurred when debt instruments are reacquired be deferred and be included into income over a five year period starting in 2014. Because of the complexities of the tax laws and the environment of securitized debt, proactive planning is essential for debt workouts to be not only financially viable but also to be tax-free or tax deferred.

Many borrowers are in the situation of having their loan in limbo with the FDIC. It has been estimated for 2010 that banks will lose up to two trillion of loan base and the FDIC will take over approximately 200 banks. The impression is that the government is accelerating the process of bank closures. That being said, it has also been reported that the FDIC is running out of money while hiring more resources to deal with this cri-

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sis. This all adds up to more bureaucracy in the transaction, which can leave many unanswered questions for borrowers, including, "How will personal loan guarantees be dealt with?" Questions such as these affect how COD income is excluded.

In the navigation of debt workouts, no matter what course is taken for the given situation, it is imperative in the current environment to leave nothing to chance, such as making timely elections. Being conscientious, diligent, and resolute sooner rather than later in dealing with every possible aspect of the debt situation will give the debtor a better chance for a workable solution. With the law being applied properly in tandem with vigilant negotiation, possibly with the FDIC, debtors can maintain more control of the situation. Maybe this tapestry of ingredients is the new normal and the best way to deal with it is to get used to it. This is just the start of more to come.

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