DOWNTURN TAX PLANNING

DEBT MODIFICATIONS IN GENERAL

By: Layton L. Pace, Esq.

June 4, 2020

Many individuals and business entities have a capital structure that includes debt. It may be the American way to make money on other people's money through leverage. So, what happens when the borrower cannot afford to make timely interest and principal payments on debt? Obviously, from a legal standpoint, the borrower and creditor need to reach some form of workout arrangement to satisfy or restructure the debt or result to legal remedies.

Perhaps less obvious, the borrower and creditor may face income tax consequences from the workout arrangement. The workout arrangement may include among many other modifications, deferring interest payments, changing the interest rate, extending the maturity date, changing the amortization schedule of principal payments, reducing the principal payments owing, adding alternative payment schedules for different circumstances, adding options to call or pre-pay the debt, changing the debt from nonrecourse to recourse or vice versa, adding or changing collateral, adding new borrowers or guarantors, paying some of the debt with stock or other equity of the borrower or affiliates, having a friendly party buy the debt, selling the collateral, or refinancing the debt with new loans or capital. Many and differing detailed tax rules may apply, depending upon the chosen alternative. Needless to say, borrowers and creditors need tax advice from professionals before undertaking the workout arrangement.

For the borrower, the tax consequences of a workout arrangement are generally cancellation of indebtedness (COD) income or gains at both the Federal and state level or changing the amount or timing of interest or other deductions.

For the creditor, the income tax consequences are generally claiming bad debt losses, avoiding the acceleration of income and changing the character of income between ordinary and capital gains taxed at different rates.

For a creditor that also owns some or all of the borrower, the tax consequences generally are to attempt to match the amount, character and timing of COD income of the business with losses of the owner. For instance, COD income from a partnership may pass through to a partner as ordinary income while the partner recognizes a capital loss as a bad debt in the same or other years. The two items do not offset.

Articles that follow address planning ideas to minimize the consequences of debt restructuring, including avoiding significant modifications of debt and relying upon exclusions and exceptions provided by Section 108 of the Internal Revenue Code.

The preceding discussion is not and should not be construed as legal or tax advice or representation on specific legal matters for any client or jurisdiction, but rather as a general commentary. The information provided should not be acted upon without specific legal advice based on particular situations.

layton@pacetaxlaw.com Copyright ©2020. All rights reserved (310) 379-5805