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Who Pays When a Retailer Is Hacked?

Lending Law Update

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Modifying Loans for Distressed Debtors: Debt Relief or Tax Trap?

Easily accessible credit and relaxed institutional standards gave rise to the most significant financial collapse since the Great Depression. From 2005 through 2008, investors lost nearly a decade of investment growth. As a result, creditors and debtors continue to restructure or modify under-collateralized loans and, in some cases, unintended tax consequences occur. In any loan restructuring or modification, the parties should proceed with the advice of sophisticated tax counsel to ensure that tax consequences and planning opportunities are considered.

Generally speaking, a debtor will recognize cancellation of indebtedness income ("COD Income") when a creditor forgives a debtor's loan. In many situations, the parties can easily determine and identify COD Income. For example, if a creditor gratuitously forgives $100,000 of debtor's loan by reducing the principal amount from $500,000 to $400,000, the debtor will have $100,000 of COD Income. COD Income, however, can result from more innocuous situations including, "substantial modifications" of an existing loan.

Under the Internal Revenue Code of 1986, as amended (the "Code"), a "modification" is any alteration of a legal right or obligation of the holder or the issuer of the loan, including the addition or deletion of a right or obligation. If a modification is "substantial", then under Code, the original loan is deemed exchanged for the new loan. The Treasury Regulations contain complex rules and safe harbors concerning when a modification is "substantial". Examples of modifications that may be "substantial" depending on their nature, include: (i) changes in the interest rate; (ii) maturity extensions; (iii) changes in the obligor; (iv) addition or material enhancement of a guarantee; (v) a change in collateral; and (vi) changes in the nature of the loan (recourse vs. non-recourse).

A debtor will realize COD Income after a substantial modification if the issue price of the new modified loan, as determined under the original discount rules, exceeds the issue price of the old loan. In many cases, notwithstanding a substantial modification and deemed exchange, COD Income can be avoided if the new loan is not publicly traded, has the same face amount as the old loan and provides for an interest rate equal or greater than the applicable federal rate. If a debtor does realize income in the substantial modification, however, the debtor will be required to recognize the gain in the year in which the substantial modification occurred. Notably, in some cases debtors may desire to intentionally trigger COD Income in a particular year to offset losses.

In cancellation of debt situations, the IRS requires that certain creditors (such as banks) issue a Form 1099-C. Creditors should tread carefully and seek appropriate legal advice when issuing Form 1099-C. With some exceptions, the IRS may impose civil monetary penalties for a creditor's failure to file Form 1099-C by the due date and for failure to furnish the required information to the debtor. In addition, some lower courts, following the minority view, have held the filing of Form 1099–C with the IRS constitutes prima facie evidence of an intent to discharge a loan, at which point the burden shifts to the creditor to proffer evidence that the Form 1099-C was filed by mistake or pursuant to an implied discharge triggering event. If a creditor is operating in a jurisdiction following the minority view, it should be careful with the filing of Form 1099-C because such filing may have the unintended consequence of prohibiting further collection of the debt.