Financing Focus

Redefining Debt

Examine the alternatives for overleveraged properties.
By Tom O'Rourke, CPA

Downsized operations and scarcity of tenants have temporarily left many business owners and developers with too much real estate and too much debt. Refinancing often is the solution of choice, but doing so isn't always viable. Owners or developers may owe more than a project's or property's current value. Or, they may face a maze of servicing agents behind highly securitized notes, making it nearly impossible to identify the lender, let alone build a relationship that would favor loan renegotiation. Even if selling the property or development is an option, owners want to be in a position to resume expansion plans and occupy the space when the economy rebounds.

Down the road, these businesses will benefit from owning the facilities, but they have to survive the short term. Restructuring debt, raising capital, partnering, and bankruptcy are the strategies available to most property owners. While debt restructuring may be the best option, there are pluses and minuses to each alternative. Borrowers should consider each option carefully before proceeding.

Modifying Loan Terms
One of the most common questions is: Why is renegotiating debt the best option? The answer lies in lengthening the debt terms, if possible, as this typically is the most expedient solution. Reducing payments now gives owners the opportunity to recoup value and utilize the property down the road.

But borrowers must use caution, because what appears to be a simple modification could end up generating forgiveness of debt income, which creates tax implications. These implications may or may not hurt, depending on the borrower's particular tax attributes. Often the distressed real estate is a result of other losses that may provide shelter from the forgiveness of debt tax liability.

If the borrower has assessed the situation and the forgiveness causes an unacceptable tax burden, analysis should be conducted to provide negotiation parameters. Ideally, the workout should be accomplished so that the modified debt issue price is not less than the old debt, which can be a complex calculation.

Internal Revenue Code Sections 1273 and 1274 provide guidance for tax impacts under the original issue discount calculation provision. However, understanding the amount of the incremental changes in the note and how it impacts the tax liability after considering one's tax attributes is extremely beneficial in the negotiation.

Raising Capital
Another angle to consider is whether raising capital to pay down the debt is still possible. Bringing in a partner who can provide cash to pay down the instrument or help fund the difference between the original note and the property's current value for refinancing purposes is an option.

Infusing capital is an excellent way to strengthen the balance sheet and maintain control of the property while giving up some upside in the investment. Many traditional sources of cash have dried up, so owners must be creative and look to institutional investors, pension funds, life insurance companies, and even friends and family who might want to invest.

However, be aware that infusing capital into an existing partnership may create a step-down in basis under new mandatory basis adjustment rules or a limitation on the transferability of losses that are just now having an impact due to recent real estate value declines. In an effort to eliminate Congress's belief that the partnership rules allowed the transfer of losses, numerous partnership tax laws have changed since the last market downturn. A transaction that worked in the past may not be without a tax cost today. So model the new structure and plan to protect tax attributes.

Partnering With a Lender
Some owners have successfully converted lenders to partners. If you have a relationship with the lender, selling him or her on the debt in exchange for an equity stake in the business is another possibility. The true benefit of equity versus debt depends on the impact on the business plan.

For example, if the goal is to exit the business through a sale and restructuring the debt improves operating profits, the company's increased value could offset the equity cost. Be aware, however, that forgiving debt or canceling debt usually is treated as income to the partners, unless there's an exception.

The American Jobs Creation Act eliminated the exception of using partnership equity to cancel indebtedness income. Under the revision, the partnership is treated as paying off the debt in exchange for the fair-market value of the interest transferred, and the excess principal is forgiven, which creates tax consequences at the partner level.

Under some circumstances, where the partnership agreement requires a deficit obligation restoration or guarantee, these gains can be mitigated, but both come with onerous economic considerations. It's not that bringing in a lender as a partner isn't plausible; it's just not a slam-dunk solution due to the tax implications, especially for taxpaying partners.

Bankruptcy Protection
Finally, business owners should consider the option of foreclosure and filing for bankruptcy protection, as both of these tactics are options. Bankruptcy protection is not a decision to make lightly. Appropriate and experienced legal counsel coupled with valuation experts and tax professionals are necessary in this critical analysis.

The decision often hinges upon whether the indebtedness was secured through owners' personal guarantees and the liquidating value of the all assets subject to the guarantee or collateral arrangements. Creating a model that reflects all exposed assets, proceeds net of tax, has multiple benefits. It assists in determining the ultimate value the creditor may target while providing the

borrower accurate and current data regarding an asset's ability to provide future or immediate cash. Owners may discover that a current asset is costing them the ability to service the debt in the first place.

In the case of partnerships, it is important to remember that if liabilities are reduced or deemed to be distributions, partners can be charged with the gains. In this case they must come up with enough cash to pay the additional tax, unless they can find an appropriate exclusion.

The most important aspect of debt restructuring is to consider all options and the consequences of each choice, while also weighing the long-term business impacts. Though short-term survival and debt reduction may be the current focus, eventually the economy will turn and business owners and developers should be ready to capitalize on the rebounding market.

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