Restructuring Development and Real Estate Debt

Weighing the short-term and long-term impacts of each option.

By Tom O'Rourke

Downsized operations and a lack of qualified tenants have temporarily left many business partners with too much real estate and too much debt. Refinancing is often the solution of choice, but doing so isn't always viable. Even if selling the property or development were an option, businesses want to be positioned 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 in the short term. Raising capital is tough, so restructuring the debt may be the best option. One of the most common questions that arises is: why is re-negotiating the debt terms the best option? The answer lies in lengthening the debt terms, if possible, as this typically is the most expedient solution, reducing payments now, while giving owners the opportunity to recoup value and utilize the property down the road.

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The workout needs to be accomplished so that the modified debt issue price is not less than the old debt, which can be a complex calculation. Partners can research the tax impact under the original issue discount calculation provision provided for in IRC 1273 and 1274.

It is also imperative to examine whether or not raising capital to pay down the debt is a possibility. Bringing in a partner is a common option. By doing that, a business can increase its cash flow and have capital to pay down the instrument or help fund the difference between the original note and the property's current value for refinancing purposes. Many traditional sources of cash have dried up, so builders and developers seeking funds will have to be creative and look outside the box. Possibilities include institutional investors, pension funds, life insurance companies, and even friends and family who might want to invest. Be aware that infusing capital into an existing partnership may create a step-down in basis under new mandatory basis adjustment rules that are just now having an impact, given the recent losses in real estate values.

Converting lenders into partners is an additional option. 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. Be aware, however, that forgiving debt or cancelling debt is usually 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.

Finally, business owners should consider the option of foreclosure and filing for bankruptcy protection, as both of these tactics are options. However, the decision often hinges upon whether the indebtedness was secured through partners' personal guarantees. When liabilities are reduced or are deemed to be distributions, partners can be charged with the gains, and they'll have to come up with the cash to pay the additional tax, unless they can find an appropriate exclusion.

What's most important is that businesses take into account all options available to them. Though short-term business survival and debt reduction may be the current focus, eventually the economy will turn and partners want to be ready to capitalize on the rebounding marketplace.

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Fast Facts

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