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Restructuring Development And Real Estate Debt

BY TOM O'ROURKE

Downsized operations and a scarcity of tenants have temporarily left many business partners with too much real estate and too much debt. Refinancing is often the solution of choice, but it's not always a viable option. Owners may owe more than the project's current value, or they may face a maze of lenders and servicing agents behind highly securitized notes—making it nearly impossible to identify the lender, let alone build a relationship that favors loan renegotiation.

Even if selling the property or development is an option, partners want to be positioned to resume expansion plans and occupy the space when the economy rebounds.

Although businesses can benefit from owning their facilities down the road, they have to survive in the short term. Because raising capital is tough, restructuring debt may be the best option.

Lengthening the debt terms typically is the most expedient solution. Reducing payments now gives owners the opportunity to recoup value and utilize the property down the road.

However, what appears to be a simple modification could end up generating forgiveness of debt income, which has tax implications. The modified debt issue price should not be less than the old debt, which can be a complex calculation. Property owners can research the tax impact under the original issue discount calculation provision in Internal Revenue Code 1273 and 1274.

Also, consider if raising capital to pay down the debt is possible. Another option is bringing in a partner that will provide the cash to pay down the instrument or help fund the difference between the original note and the property's current value for refinancing purposes.

FINDING CREATIVE INVESTORS

Many traditional sources of cash have dried up, so partners must be creative and look to 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 can create a step-down in basis under new mandatory basis adjustment rules that are now having an impact, given the recent losses in real estate values. Be sure to model the new structure and plan to protect tax attributes.

Some owners have successfully converted lenders to partners. If a relationship

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exists, selling the lender on the debt in exchange for an equity stake in the business is another possibility. Be aware, however, that forgiving debt or cancelling 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.

In circumstances in which the partnership agreement requires a deficit obligation restoration or guarantee, these gains can be mitigated, but both come with onerous economic considerations. Bringing in a lender as a partner is plausible, but it's not a slam-dunk solution because of the tax implications, especially for tax-paying partners.

Finally, business owners should consider the option of foreclosure and filing for bankruptcy protection. However, the decision often hinges on 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 partners consider all options and the long-term business impacts of each choice. Though short-term business survival and debt reduction may be the current focus, property owners should be ready to capitalize on the rebounding marketplace when the economy improves.

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