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BAKER DONELSON
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Tax Consequences of Modification of Debt Instruments

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Background

According to news reports, since peaking in early 2007, the value of the nation's commercial property has fallen an estimated 30 to 40 percent. According to the Real Estate Roundtable, approximately $520 billion in commercial real estate debt matures in 2010, followed by $550 billion in 2011.

In this time of economic uncertainty, holders of and obligors on debt instruments should be concerned about the tax consequences of modification of debt instruments. Most obligors are aware that there may be tax consequences. Few holders are aware. This article summarizes the tax consequences to each. The consequences may be radically different.

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Some Lenders May Soon Be Forced to Follow Through With Residential Foreclosures

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Since the onset of the financial crisis and accompanying stagnant real estate market, many lenders have been reluctant to foreclose on delinquent residential properties, especially those subject to a condominium or homeowners association (HOA) regime. This approach lies partly in the fact that banks have not been eager to show "upside-down" properties on their books. In most states, a lender steps into the shoes of the delinquent borrower and becomes liable for condominium and HOA assessments once it takes back title to the property. However, this highly common practice of lenders delaying the foreclosure process to avoid financial responsibility

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Perfection of Security Interests in United States Federal Income Tax Refunds

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From time to time, businesses anticipate receiving a large federal income tax refund. When such a situation arises, there may be a desire to borrow against the proposed refund in order to access the anticipated funds more quickly than they would otherwise be available. Secured lenders may also wish to perfect a security interest in future federal income tax refunds to further collateralize existing loans

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Federal

Intercreditor Agreement. In a late 2009 bankruptcy case, *Ion Media Networks, Inc., et al.*, 419 B.R. 585 (S.D.N.Y., November 24, 2009), the court upheld the general rule that Intercreditor Agreements entered into between secured creditors prior to bankruptcy are enforceable contracts and the bargained-for rights and restrictions, including waivers of rights as unsecured creditors to contest the validity of the other creditor's liens, are enforceable during a debtor's bankruptcy. In this case, pursuant to an Intercreditor Agreement entered into prior to the Debtor's bankruptcy, the Second Lien Lender expressly acknowledged the priority of the First Lien Lender's blanket lien on the Debtor's assets and agreed not to challenge that priority upon any ground. The Second Lien Lender further waived any right to challenge the First Lien Lender's lien as an unsecured creditor. Notwithstanding the restrictions in the Intercreditor Agreement, the Second Lien Lender continually contested the validity of the First Lien Lender's lien on certain collateral. The court rejected the Second Lien Lender's

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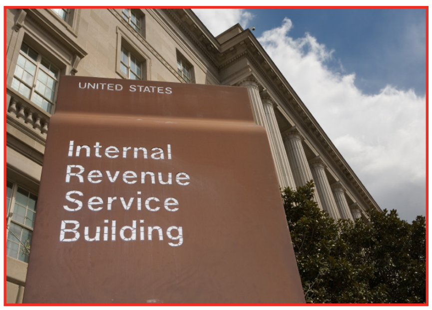
Tax Consequences of Modification of Debt Instruments, *continued*

Holder's Perspective

The modification of a debt instrument may have tax consequences to the lender independent of consequences to the borrower. In the second to last real estate recession, the regulatory agency that regulated thrifts (e.g., savings and loans) recommended that thrifts enter into exchange transactions with other thrifts to recognize tax losses which could be carried back to profitable years to generate tax refunds.

A typical transaction was for one thrift to bundle a group of mortgage loans and swap them for a similar pool of mortgage loans with a similar weighted average maturity and average yield. At that time, virtually all mortgage loans had depreciated in value. For tax law purposes, in order to recognize a loss for income tax purposes, it was and is necessary for there to be a "sale or exchange" in the context of Section 1001 of the Internal Revenue Code of 1986.



Most thrifts followed the regulatory advice and engaged in such transactions. The Service chose *Cottage Savings* to take to the U.S. Supreme Court. The Internal Revenue Service (IRS) took the position that all debt instruments with the same characteristics are fungible and that there was no "sale or exchange" and consequently there was no loss to be recognized.

The Supreme Court held that there had been a "sale or exchange" since there were different obligors and different collateral. This has come to be known as the "hair trigger" theory.

There are many instances where it is necessary to determine whether a substituted debt instrument is the same as an older obligation or is a new obligation. Following the *Cottage Savings* decision, the IRS undertook a regulations project addressing when there has been a "sale or exchange" of a debt instrument, resulting in a gain or loss.

The upshot of this project was a new regulation.

Treas. Reg. §1.1001-3 sets forth "bright lines" on the question of whether for tax purposes one obligation which has been modified is the same as the modified obligation.

In general, subject to many exceptions, there are two tests: (a) has there been a modification and, if so, (b) is the modification significant?

Modification defined:

In general, a modification means any alteration, including any deletion or addition, of a legal right or obligation of the issuer or holder, whether evidenced by express agreement (however evidenced), other than a change occurring by operation of the express terms of the debt instrument. A modification results in a sale or exchange only if it is "significant."

Exceptions:

Like most rules in tax law, there are many exceptions to the definition of

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Legal Developments, *continued*

arguments and found the Second Lien Lender in breach of the Intercreditor Agreement.

Alabama

Lease: Jury Trial Waiver Provision. A tenant to a retail lease alleged fraudulent conduct on the part of Landlord that induced them to enter into the lease agreement. The tenant sought to render the jury waiver provision of the lease agreement ineffective since the alleged fraud occurred before the execution of the lease. The Supreme Court of Alabama issued a writ of mandamus in favor of the landlord. In issuing the writ, the court held that the jury waiver provision was drafted broadly enough to encompass any matter or controversy between the parties, including alleged fraud that induced the tenant to enter the lease. *Ex parte AIG Baker Orange Beach Wharf, L.L.C.*, 2010 WL 1525088 (Ala. April 16, 2010).

Georgia

Lis Pendens. In the case of *Boca Petroco Inc. v. Petroleum Realty II LLC*, 678 S.E.2nd 330 (Ga. 2009), the plaintiff initiated litigation in Florida involving lease contracts for properties located in Georgia. The plaintiff in the Florida litigation also filed notices of lis pendens in various counties in Georgia where the properties that were the subject of the litigated leases were located. The defendant in the case sought to cancel the lis pendens filings. The Georgia Supreme Courted noted that the purpose of a lis pendens is to give notice to prospective purchasers that the real property is involved in a lawsuit and the relief sought in that lawsuit involves the particular property. The court, reviewing the technical requirements for filing of a lis pendens, O.C.G.A.§ 44-14-610, could not find any statute or authority to indicate that scope of lis pendens could include litigation from other states and upheld the lower court's ruling that the notices of lis pendens filed in Georgia were invalid.

Tennessee

Changes to Foreclosure Law. In its last session, the Tennessee legislature passed amendments to its foreclosure statute now requiring new notices to owners of residential property prior to foreclosure. Under Public Chapter No. 834, prior to the first publication

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Tax Consequences of Modification of Debt Instruments, *continued*

modification, including alterations occurring by operation of the terms of the debt instrument. An example of this would be the change in an interest rate by virtue of being linked to an index, e.g., prime.

Exceptions to the exception include the following, all of which are classified as modifications, even though they occur by the express terms of the debt instrument:

(a) A change in the obligor or whether the instrument is recourse or non-recourse.

(b) A change to an instrument which transforms it into equity as opposed to debt.

(c) An alteration resulting from the exercise of an option, unless the option is unilateral and the exercise of the option does not result in a deferral of, or a reduction in, any scheduled payment of interest or principal.

(d) A failure to perform an agreement (e.g., an uncured default) for a period that exceeds two years.

As noted above, a change in an instrument is treated as a new instrument only if the change is "significant."

This determination is highly subjective. The regulations state that a modification is significant, "only if, based on all facts and circumstances, the legal rights or obligations that are altered and the degree to which they are altered are economically significant." The regulations do, however, give several bright lines:

(a) Change in yield. This rule, which applies to debt instruments that provide for only fixed payments, provides that a change in yield is significant if the yield varies from the annual yield on the unmodified instrument by more than the greater of 25 basis points or 5 percent of the annual yield of the unmodified instrument.

(b) Change in timing of payments. In general, subject to exceptions, a change in the timing of payments is significant.

(c) Change in Obligor or Security. A substitution of a new obligor on a recourse debt instrument is generally a "significant" modification.

(d) Change in Security or Credit Enhancement. A modification that releases, substitutes or otherwise alters the collateral on, or other form of credit enhancements for a recourse debt instrument generally results in a change in payment expectations that is significant.

(e) Change in the nature of a debt instrument. A modification that changes the nature of the instrument from debt to equity is always significant. Similarly, a change in recourse nature is significant.

(f) Changes in Covenants. The addition, deletion or alteration of customary accounting or financial covenants is not a significant modification.

In the current times, it is highly unlikely that any change will not result in a loss which can be recognized for tax purposes.

Borrower's Perspective

Initially, it is important to know whether the obligation is recourse or non-recourse. If property is conveyed to a lender in satisfaction of a debt, the amount and existence of cancellation of indebtedness income will depend on whether the obligation is recourse or non-recourse. If the obligation is recourse, the debtor has cancellation of indebtedness income equal to the excess of the amount of the debt over the value of the property. If the obligation is non-recourse, the excess of the debt over the basis of the property is gain and not cancellation of indebtedness income.

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Legal Developments, *continued*

of a notice of foreclosure of a deed of trust, mortgage or other lien securing the payment of money or other thing of value on an owner-occupied resident, the lender, trustee or other creditor must send to debtor and any co-debtor or guarantor notice of the right to foreclose 60 days prior to the first publication for the foreclosure sale. The specific form of notice and the place and method of sending the notice are contained in the statute. The Act took effect on July 1, 2010 and applies to any foreclosure that is initiated by publication on or after September 1, 2010.

Prompt Pay Act. Currently under the Prompt Pay Act if a construction contract calls for a certain retainage, the retained amount must be deposited into a separate interest bearing account T.C.A. §66-34-104. A recent amendment to this Act, Public Chapter No. 875, adds language to provide that if the party retaining the funds fails to deposit the funds into the escrow account, the party will be responsible to pay the owner of the retained funds an additional $300.00 per day that such funds are not deposited into the escrow account and makes it a class A misdemeanor to fail to deposit the retained funds into the escrow account within seven (7) days of written notice.

Tax Consequences of Modification of Debt Instruments, *continued*

Most borrowers will need to be concerned with avoiding taxable income or gain if their debt instruments are modified.

The Code has long provided that cancellation of debt (COD) results in taxable income, subject to many exceptions.

The following are the principal exceptions:

(a) The discharge occurs in a Title 11 Bankruptcy case. The discharge occurs when the taxpayer is insolvent.

(b) The debt discharged is "qualified farm indebtedness." Qualified farm indebtedness is debt incurred directly in connection with the operation of a farm.

(c) In the case of a taxpayer other than a C corporation, the indebtedness discharged is "qualified real property indebtedness." Qualified real property indebtedness is indebtedness incurred after 1992 that is:

(i) indebtedness incurred or assumed to acquire, construct, reconstruct, or substantially improve real property used in a trade or business; or

(ii) indebtedness used to refinance qualified real property business debt incurred or assumed before that date.

(d) The indebtedness discharged is "qualified principal residence indebtedness" discharged after 2006 and before 2013. The limit is $2,000,000 ($1,000,000 in the case of married persons filing separately). Also, the exclusion is available only if the discharge is related to a decline in the value of the residence or to the financial condition of the taxpayer.

Forgiveness of COD income does not come without a price. Various "tax attributes" are required to be reduced. These are, in the following order:

(i) Net operating loss carryovers;
(ii) General business credits;
(iii) Minimum tax credits;
(iv) Capital loss carryovers;
(v) Basis of property;
(vi) Passive activity loss and credit carryovers;
(vii) Foreign tax credit carryovers.

There are important general rules and qualifications:

(A) In general, the acquisition of debt instruments by the debtor or a related person at a discount is treated as a discharge.

(B) In the case of a partnership, the determination of whether the debtor is bankrupt or insolvent, and attribute reduction, is made at the partner level and not the partnership level. Income derived from discharge of partnership debt is not excludable at the partnership level, but is allocable to the partners.

(C) If the particular item discharged would have resulted in a deduction, it is disregarded.

(D) A purchase price reduction is generally not treated as income but reduces the cost basis of the property acquired.

Mr. Haley is an attorney in our Atlanta office.

Some Lenders May Soon Be Forced to Follow Through With Residential Foreclosures, *continued*

for distressed residential properties soon may be coming to an end.

Lenders typically file the foreclosure action on delinquent properties in an effort to preserve their rights to foreclose. Once filed, there is little incentive for the lender to complete the process and take title to the property until it has found a buyer for the property or is otherwise ready to take responsibility for the liabilities associated with the property. Given the judicial backlog in many courts today, lenders can often delay taking back title to a property for several years, thus allowing the lender to avoid assuming significant financial liability for such maintenance costs and assessments. This practice has caused considerable financial strain on many homeowners and condominium associations. In fact, it has been reported that over 60 percent of condominium and HOA associations in Florida currently are struggling from unpaid association dues; these associations have reported recently that more than 50 percent of their unit owners have already missed paying two months or more of their association dues and maintenance fees. Every month of delay usually means another month of potential bad debt write-off for an association, which becomes a common expense to be paid by the rest of the unit or home owners.

In a recent ground-breaking state court decision in Florida, a state particularly hard hit by residential mortgage foreclosures, one court has upheld the HOA's right to recoup these past due assessments and costs from the lender, despite the fact that the lender has yet to take back title to the delinquent property. In *HSBC Bank USA, et al. vs. Keys Gate Community Association, Inc., A Florida Non Profit Corporation, et al.*, the homeowners' association successfully introduced a new procedure, dubbed a "reverse foreclosure."

In *Keys Gate Community Association*, the homeowners' association filed and foreclosed its own claim of lien on the

delinquent property and acquired title to the property through its own foreclosure sale in April 2007. However, the homeowners' association could not sell the property because of the lender's senior priority mortgage. In June 2007, the lender filed its foreclosure against the delinquent property. Yet, two and a half years later, the lender had not completed the foreclosure process. As a last resort to move the case forward, the homeowners' association set for hearing a summary judgment motion against itself, and asked the court to issue partial summary judgment in favor of the lender and to immediately grant the lender's request to take title to the unit as stated in the lender's foreclosure complaint. As part of this procedure, the association waived its rights to the property, and as the current unit owner, waived its rights to a public sale. The court granted the homeowners' association's motion, and directed the Clerk of Court to issue a certificate of title immediately transferring ownership of the property to the lender, thus triggering the lender's requirement to pay its share of past due assessments, legal fees, court costs and all assessments going forward.

It is important to point out that the reverse foreclosure procedure can only be filed after a homeowner is out of the picture and the home is legally the property of the homeowner's association.

The use of this new legal strategy saved the Keys Gate Community Association a minimum of eight months or more of bad debt write-offs. Furthermore, given the current logjam of foreclosure cases pending in many state courts. clerks of court have enthusiastically endorsed this new procedure as an effective means of reducing their backlogs. Until the financial crisis subsides and the housing market regains steam, undoubtedly many homeowners' associations will increasingly use this procedure in their quest to force lenders to take title to financially upside down properties much faster than the lender may have anticipated.

Mr. Tanner is an attorney in our Baton Rouge office.

Perfection of Security Interests in United States Federal Income Tax Refunds, *continued*

secured by all assets of a borrower. Both sides to a loan transaction may therefore be interested in the method to create and perfect a security interest in a federal income tax refund.

1. Execution of Security Agreement Describing the Collateral

Article 9 of the Uniform Commercial Code governs security interests in most types of personal property. Because Article 9 does not expressly exclude federal income tax refunds from its scope, the grant of a security interest in a federal income tax refund is subject to the provisions of Article 9. Del. Code Ann. tit. 6, § 9-109(a). Because no section of Article 9 expressly discusses federal income tax refunds, such refunds are deemed to be "general intangibles." See Del. Code Ann. tit. 6, § 9-102(a)(42).

To create a security interest in a general intangible such as a federal income tax refund, a borrower must grant a lender a security interest through a security agreement or similar instrument. Under Del. Code Ann. tit. 6, § 9-203, a security interest is enforceable with respect to specific collateral against the borrower and third parties when (a) value has been given (i.e., a loan has been made), (b) the borrower has rights in the collateral or the power to transfer the collateral, and (c) the borrower has executed a security agreement or similar instrument that describes the collateral.

The security agreement (and the UCC-1 financing statement to be filed in connection with it) must describe the collateral in reasonable detail. Del. Code Ann., tit. 6, §9-108(a). Though a description such as "all general intangibles" is likely sufficient, a reference to the specific federal income tax refund in question, or at least a reference to "all federal income tax refunds" might be preferable for both the borrower and the lender.

2. Execution of IRS and DOT Forms

The execution and delivery of a security agreement coupled with the filing of a financing statement creates and perfects a lender's security interest in many types of personal property. In the case of a federal income tax refund, however, additional steps are necessary to allow the lender to obtain payment of the federal income tax refund directly from the IRS.

In addition to the security agreement discussed above and the UCC-1 financing statement described below, a lender should also prepare and have the borrower execute the following IRS forms: (a) Form 2848 Power of Attorney ("Form 2848") and (b) Form 8302 Electronic Deposit of Tax Refund of $1 Million or More ("Form 8302"). Form 2848 allows an individual, other than the borrower, to obtain the federal income tax refund on behalf of the Borrower.

Part I, Section 6 of Form 2848 requires the name of an "authorized representative" who will receive the federal income tax refund instead of the borrower. Form 2848 does not, by itself, authorize the "authorized representative" to endorse or cash the federal income tax refund. That requires an additional DOT form described below. For purposes of preparing Form 2848, the person named as the "authorized representative" must either be: (a) an attorney, (b) a certified public accountant, or (c) an "enrolled agent" as defined in Treasury Department Circular No. 230. In order for the IRS to process Form 2848 quickly, the person listed as the "authorized representative" should be an individual that has already received what is known as a "centralized authorization file" or "CAF" number from the IRS. If there is no such person, the IRS will assign a CAF number to the individual listed as the "authorized representative." Form 2848 should be faxed to the appropriate CAF service center.

In cases where the lender expects that the federal income tax refund will equal $1 million or more, the lender should require the borrower to execute a Form 8302 authorizing the IRS to wire the proceeds of the federal income tax refund to an account maintained by the lender for the benefit of the borrower (i.e. an account for the borrower that is located at the lender's financial institution). Form 8302 should be filed with

> Creating and perfecting a lien in a federal income tax return generally requires three steps, described in more detail here:
> (1) First, the taxpayer anticipating the refund (borrower) must execute a security agreement in favor of the proposed lender, describing the anticipated federal income tax return and granting the lender a security interest in the refund;
> (2) Second, the borrower must execute several forms provided by the Internal Revenue Service (IRS) and the Department of the Treasury (DOT) and deliver those forms to the lender; and
> (3) Third, the lender must prepare and file a UCC-1 financing statement which describes the anticipated federal income tax return against the borrower in the applicable recording office. For an entity borrower, this would generally be the state of the borrower's incorporation or organization.

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Perception of Security Interests in United States Federal Income Tax Refunds, *continued*

the borrower's tax return, if possible. Otherwise, Form 8302 should be mailed to the same IRS address where the borrower files its annual tax return.

In addition to the IRS forms referenced above, the borrower must also execute the following DOT forms: (a) Form 235 Resolution By Corporation Conferring Authority Upon An Officer To Execute A Power Of Attorney For The Collection of Checks Drawn On The United States Treasury ("Form 235") and (b) Form 234 General Power Of Attorney For The Collection of Checks Drawn On The United States Treasury ("Form 234"). The DOT forms authorize the lender to endorse the checks, or in the case of a wire transfer, to ultimately deposit the funds in an account for the benefit of the lender.

3. Filing a UCC-1 Financing Statement

To perfect a validly created security interest in a federal income tax return, a lender must file a UCC-1 financing statement using the description of the collateral contained in the security agreement in the appropriate filing office under the UCC. Del. Code Ann. tit. 6, § 9-310(a). In most cases where a lender is filing against an entity borrower, that financing statement should be filed in the Office of the Secretary of State of the borrower's state of incorporation. Del. Code Ann. tit. 6, § 9-307(e).

Lenders should be aware that following the IRS and DOT procedures outlined in Section 2, above, will not absolutely guarantee that the lender will receive the borrower's federal income tax refund directly from the IRS. First, lenders should be aware that the IRS has not always honored Form 8302 and has in some instances mailed checks despite receiving a Form 8302.

Second, a lender must keep in mind that a taxpayer has the right to revoke any of the above referenced IRS and DOT forms. While not a perfect solution to the problem, the loan documents related to the loan secured by the federal income tax refund should prohibit the borrower from revoking any of the IRS or DOT forms and should make any such revocation an event of default. The loan documents should also grant the lender a power of attorney to prepare and submit such forms if and to the extent needed as a result of such revocation (though it is not entirely clear that the IRS or DOT would accept a form executed on behalf of a taxpayer by a power of attorney).

Third, a lender should keep in mind that the IRS has the right to use all or part of a taxpayer's federal income tax refund to offset a prior outstanding balance. Therefore, before making a loan secured by a federal income tax refund, a lender should obtain some familiarity with its borrower's prior tax filings and situation to confirm that no outstanding amounts are owed to the IRS at the time of the loan and that its borrower is not under an active audit at the time of making the loan.

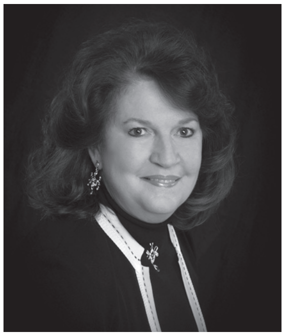
Mr. Strain and Mr. Flock are attorneys in our Memphis office.

Baker Donelson's New Commercial Real Estate Recovery Team

In the financial crisis of the past few years, all areas of the economy have suffered, including commercial real estate. A large number of commercial loans secured by distressed properties are maturing in the next few years. In light of the tremendous challenges facing our clients, both lenders and owners, Baker Donelson has now formed a cross-disciplinary team of lawyers to assist our clients in crafting solutions to assist them in reducing or minimizing risks and maximizing opportunities in today's difficult economic environment. The team is comprised of attorneys with an experienced focus in real estate, finance, zoning, tax, bankruptcy, receiverships, business formation and dissolution, workouts, regulatory rules and capital structures. Examples of tasks that the team may undertake are (a) counseling clients on the tax aspects of debt modification, admission of new equity and debt forgiveness; (b) restructuring landlord tenant relationships, (c) representing equity groups n acquisition of real estate and related assets, (d) representing lender in a large restructure of defaulted debt, and (e) advising clients regarding lender liability claims and defending clients against such claims. If you would like to learn more about our team and the attorneys in this group, please go to http://www.bakerdonelson.com/commercial-real-estate-recovery-team-marketing-practices.

Profile

Susan Elliott Rich



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Susan Elliott Rich, shareholder in the Chattanooga office, concentrates her practice in commercial lending, banking, real estate, corporate and health care law. She was named Chattanooga "Lawyer of the Year" (Real Estate Law) by *The Best Lawyers in America* 2009 and has been listed in The Best Lawyers in America®, Banking Law, Real Estate Law and Structured Finance Law since 2005.

Her experience includes diverse financing transactions, including asset based lending, construction lending, loan rehabilitation, bond financing, ESOPs, letters of credit, commercial and residential real estate development, complex multi-state real estate purchase and sale transactions, mergers and acquisitions, managed care issues, and general corporate and health care related matters, including certificates of need, employment and operational issues. In addition to managing a successful law practice, she is active in charitable causes in the Chattanooga area and was named 2010 Tennessee Woman Of Distinction by the American Lung Association.

Real Estate/Financing/Capital Markets Practice

Baker, Donelson, Bearman, Caldwell & Berkowitz, P.C. is one of the 100 largest law firms in the United States, and since 2004 has been one of the ten fastest growing firms in the country. At present, the Firm includes more than 570 attorneys and public policy advisors, practicing from 15 offices in the south central United States and in Washington, D.C. The Baker Donelson Real Estate Group consists of 80 attorneys supported by 14 legal assistants in offices in Alabama, Georgia, Louisiana, Mississippi, Tennessee and Washington, D.C. Our attorneys have an extensive background in real estate purchase, sale, development, private financing, public financing, leasing and syndication, and we represent institutional investors in debt and equity real estate investment transactions and have assisted clients in numerous economic development transactions. Our lawyers have participated in some of the South's largest real estate development projects, and also serve as counsel to a number of REITs. Our attorneys routinely deal with tax, securities, construction and environmental concerns, and other aspects of real estate, which are pertinent to real estate professionals in the twenty-first century. We are supported by attorneys with significant experience in the areas of construction law, general real estate litigation, bankruptcy and taxation. The newsletter editorial board consists of Mary Aronov (maronov@bakerdonelson.com), Chervis Isom (cisom@bakerdonelson.com), William Mendenhall (bmendenhall@bakerdonelson.com) and Murphy McMillan (mmcmillan@bakerdonelson.com).