



Commercial Real Estate Distress: An Introduction to Debt-for-Equity Exchanges (Part 1)

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Commercial real estate is in a sorting period. The Mortgage Bankers Association estimates roughly [\\$5 trillion in commercial mortgages](#) will mature between 2025 and 2029, with approximately \$875 billion maturing in 2026 alone. Many of those loans were originated in a low interest rate environment, on assumptions about cap rates, occupancy, and refinancing terms that no longer hold. As that paper matures, lenders and borrowers are working through a familiar but expanded menu of options, including extension, modification, discounted payoff, foreclosure, deed-in-lieu, loan sale, or property sale. One viable alternative is a **debt-for-equity exchange**.

This is the first article in a three-part series providing an overview of debt-for-equity exchanges in distressed or refinancing situations. Subsequent articles will address the keys to [tax structure in debt-for-equity exchanges](#), considerations for debtor partnerships and creditors, and the [complex dynamics in a debtor partnership](#), specifically when a former creditor becomes a partner.

What Is a Debt-for-Equity Exchange?

Most commercial real estate is held through limited liability companies or limited partnerships taxed as partnerships. In a debt-for-equity exchange, the partnership's lender — typically a senior mortgage holder or a mezzanine lender — agrees to forgive some or all of the outstanding loan balance in exchange for an equity interest in the partnership.

A representative fact pattern may look like the following: A property owned by a partnership carries a \$70 million mortgage and is appraised at \$80 million. Although the loan is performing and the property has a positive net value, a refinance at a current market loan-to-value ratio and interest rate would require a significant capital infusion, which the partnership's limited partners are reluctant to do. Although the property has been slow to stabilize, it

is starting to show positive momentum, and both the sponsor and the lender acknowledge the existence of upside. This is a common fact pattern for multifamily deals that were being repositioned across the country utilizing collateralized loan obligation or debt fund financing with regard to renovations made over the past five years.

One logical path forward would be a sale of the property to a third party. However, this is dependent on market forces, and potential upside is not always properly recognized by the sale market. In such a case, where there is both equity and upside, the lender could agree to convert the debt (or some portion thereof) to an interest in the partnership. This would allow both parties to maintain upside and, if structured properly, could result in advantageous tax consequences compared to other available structures.

Why Debt-for-Equity Exchanges Matter Right Now

Since interest rates were near all-time lows prior to 2020, many partnerships utilized debt financing to enhance growth. However, a combination of rising interest rates and slower-than-expected asset appreciation in some markets have led to a disproportionate number of properties where there is real underlying value, but the existing capital structure is broken, and a straightforward loan modification is no longer sufficient.

While there are multiple ways to reset a capital structure, including a property sale, there can be scenarios where those options are not optimal. While a debt-for-equity exchange is rarely the first tool reached for, it can be a viable option where (a) the asset has a credible path to significant appreciation, (b) both sponsor and lender believe in the asset (particularly where they disagree with the existing limited partners in that regard), (c) the sponsor is part of the solution rather than the problem, and (d) the lender has the institutional appetite to hold an equity position. This last item can be a notable challenge for banks and other financial institutions that do not want to own property other than as a short-term REO (real estate owned) position.

Tax Structuring in Debt-for-Equity Exchanges

That is not to imply that debt-for-equity exchanges are not without complication. On the contrary, they are complex and often difficult to accomplish in practice, having the qualities of one or more of the following: a loan workout, a discounted payoff, a limited partner buyout, a new joint venture and a property transfer. Because of these complex mechanics, the documentation and tax structuring of such deals requires significant attention.

Businesses' tax interests often change based on their view of the economy. When times are good, their goals may be deferral of income, acceleration of deductions, or a preference for capital gains. But when asset values fall, interest rates rise, or leverage is too high, businesses may do debt exchanges with the goal of reducing income from discharge of indebtedness.

Generally, borrowed funds are not income for tax purposes. However, under Section 61(a)(12) of the Internal Revenue Code (IRC), a taxpayer may realize income when the taxpayer's debt is discharged without payment unless an exception applies. This is cancellation of debt (COD) income. Fortunately for taxpayers that are partnerships, one such exception is a debt-for-equity exchange.

If no exception applies, a debtor partnership may recognize COD income when the amount of debt is reduced or reacquired at a discount. IRC §61(a)(12). For the partnership, COD income is "phantom" income, meaning it is income that the partnership is deemed to have received despite the lack of receiving cash. Any COD income recognized by the partnership flows through as ordinary income to each of its partners, with tax attribute reduction applied at the partner level. The tax attributes that are reduced by the amount of any debt cancellation excluded from income include, in order of reduction, net operating losses, general business credit, minimum tax credit, capital losses, asset basis, passive activity losses and credit carryovers, and foreign tax credit carryover. IRC §108(b). Similarly, if the entity is classified as a disregarded entity for U.S. federal income tax purposes, the exceptions are applied at the owner level, rather than the entity level.

Limiting or avoiding the recognition of such phantom COD income is oftentimes crucial to the structuring of debt-for-equity exchanges, and will be the topic of the second article in this series. At a high-level, a debt-for-equity exchange and discounted payoff often occur together and documenting their timing, terms, the reduced payoff amount, a payment deadline, liability releases, and other tax structuring details is crucial.

Practical Takeaways for Borrowers, Partners, and Lenders

The conversion of partnership debt to equity carries both traps and opportunities for borrowers and lenders. From the debtor partnership's perspective, a debt-for-equity exchange can enable the partnership to continue operating, reduce principal and interest payments, and avoid bankruptcy or losing the asset in a foreclosure or deed-in-lieu transaction. This alternative must be weighed against the complexities of diluting current ownership, buying out existing partners, and a possible change in management rights of the business. From the lender's perspective, a debt-for-equity exchange can allow value to be recovered, avoid the business complexities of a more aggressive exercise of remedies, and provide the potential to participate in the upside appreciation of the business. Lenders should be prepared to weigh this against changing their position in the capital stack, with debt having priority in payment over equity, and the incumbent entrepreneurial risk in taking on an equity stake and operational control of the asset.

Evaluating the risks involved, identifying whether a debt-for-equity exchange is a good fit for a given scenario, determining the list of issues to be negotiated, and determining proper tax structuring are all crucial to effectively navigating such exchanges. Please contact the authors or any attorney with FBT Gibbons' [Commercial Real Estate Finance team](#) if you want to discuss a potential debt-for-equity exchange. You can also visit [The Carveout](#) to get our latest insights and analysis.

This article is for general informational purposes only and does not constitute tax or legal advice. The tax consequences of any

transaction depend on specific facts and circumstances, and readers should consult their own professional advisors before undertaking any transaction.

Commercial Real Estate in Distress Series

- **Part 1 — An Introduction to Debt-for-Equity Exchanges**
 - [Part 2 — Debt-for-Equity Exchanges: What to Consider When Your Lender Becomes Your Partner](#)
 - [Part 3 — Practical Tax Considerations for Borrowers and Lenders in Debt-for-Equity Exchanges](#)
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