Commercial Real Estate Distress: Practical Tax Considerations for Borrowers and Lenders in Debt-for-Equity Exchanges (Part 3)

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Changing market conditions have pushed many real estate borrowers and lenders to rethink how capital structures are put together. When interest rates rise, values soften, or loans approach maturity, a debt-for-equity exchange can offer a practical way to stabilize a project while preserving long-term upside for both sides.

This is the final article in a three-part series. Our first article introduced debt-for-equity exchanges, while our second article covered common issues that arise when your lender becomes your new joint venture partner. Here, we examine key U.S. federal income tax considerations that arise when partnership debt is converted into equity.

The discussion is meant to be practical, focusing on the issues borrowers and lenders most commonly face in real estate restructurings rather than on every technical variation in the tax rules.

Why Tax Planning Is Central to Debt-for-Equity Transactions

Understanding when cancellation-of-debt (COD) income may arise is critical, and some typical situations are when: (1) debt is cancelled, (2) loans are modified, and (3) property is surrendered for debt cancellation. Once a borrower or lender identifies that COD income may arise, the focus naturally turns to how that income can be managed or mitigated. The available solutions depend heavily on the facts of the deal, the partnership structure, and the financial position of the parties involved.

For real estate partnerships, tax planning typically requires coordinating partnership tax rules with the COD income provisions,

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while also accounting for rules that apply differently at the entity and owner levels. Debt-for-equity exchanges are often attractive because they can reduce debt burdens while allowing projects to continue operating and to reposition for recovery.

Key Considerations for the Borrower Partnership

In a typical debt-for-equity exchange, a partnership issues a capital or profits interest to a lender in satisfaction of all or part of its outstanding debt. For tax purposes, the partnership is treated as if it paid the debt with cash equal to the value of the equity issued. As a result, valuation becomes a central issue in the transaction.[1]

Treasury Regulations provide a safe harbor that allows the value of the equity to be measured by its liquidation value so long as certain conditions are met.[2] Put simply, liquidation value is what the lender would receive if the partnership sold its assets at fair market value and immediately liquidated after the exchange.

If the forgiven debt exceeds the liquidation value of the equity issued, the partnership may recognize COD income. That income is allocated to the partners who were in place immediately before the exchange. In tiered real estate structures — such as holding-company and property-level entities — this analysis must account for value at each level of the structure.[3]

In some situations, recognizing COD income may be manageable. Individual partners may qualify for insolvency or other exclusions, or may prefer to reduce their tax basis in depreciable real estate rather than recognize current income. These outcomes are highly fact-specific and reinforce the importance of coordinating tax planning early in the process.

What Lenders Should Expect from a Tax Perspective

From the lender's standpoint, debt-for-equity exchanges are often structured to avoid immediate tax recognition. In many cases, the lender will not recognize gain or loss on the exchange and will take a tax basis in the partnership equity equal to its basis in the debt.[4]

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However, variations in structure can change the result. If the exchange includes cash or other property, part of the transaction may be taxable.[5] Similarly, unpaid or accrued interest embedded in the debt can lead to ordinary income recognition.[6] These issues often surface in distressed situations and should be addressed explicitly in structuring discussions.

When equity received has limited current value but significant upside potential — such as a profits interest — valuation assumptions and holding-period considerations become especially important. If the equity later becomes worthless, any resulting loss may trigger recapture on a subsequent sale, an issue that lenders should factor into their long-term modeling.

Choosing the Right Equity and Structure

The form of equity issued in a debt-for-equity exchange matters. Common and preferred equity carry different economic rights and liquidation priorities, and those differences can affect liability allocations and the measurement of COD income for tax purposes.

In real estate transactions, debt-for-equity exchanges are most often completed at the holding-company level. This approach typically avoids unintended tax consequences that could arise if a property-level entity were converted from a disregarded entity into a partnership, an area where IRS guidance remains limited.

Special Rules for Related-Party Transactions

Extra care is required when debt is acquired by a party related (i.e., generally more than 50% ownership) to the borrower partnership. In those cases, discounted debt acquisitions can trigger COD income even if the partnership itself did not directly retire the debt. These rules are intended to prevent insiders from effectively eliminating debt at a discount without tax consequences and should be considered early in the restructuring process.

Planning Opportunities to Reduce COD Income

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One common goal in debt-for-equity exchanges is minimizing COD income. In some transactions, this can be achieved by structuring the equity so that its liquidation value closely approximates the adjusted issue price of the debt being exchanged.

Reaching that result typically requires careful financial modeling and supportable valuations, including real estate appraisals and reliable financial information. Transactions structured to resemble arm's-length negotiations are more likely to fit within available safe harbors and withstand scrutiny.

Key Takeaways for Borrowers and Lenders

Debt-for-equity exchanges can provide meaningful benefits to both borrowers and lenders by reducing debt burdens, avoiding forced exits, and preserving future upside. At the same time, these transactions raise complex tax issues that affect both immediate results and long-term economics.

Successful transactions usually reflect early coordination among borrowers, lenders, accountants, and legal counsel. Understanding how the tax rules intersect with business goals helps ensure that a debt-for-equity exchange strengthens the capital structure rather than creating unintended surprises down the road.

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

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- 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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[1] IRC §108(e)(8); Treas. Reg. §1.108-8(a).

[2] Treas. Reg. §1.108-8(b)(2).

[3] Treas. Reg. §1.108-8(b)(2)(ii).

[4] IRC §722.

[5] IRC §1001; Treas. Reg. §1.707-3.

[6] Treas. Reg. §1.721-1(d)(2).

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