Repayment of Debt May Result in Taxable Income

By: Cory Ouellette, CPA

In most circumstances, repayment of debt is not a taxable transaction. However this is not the case in all circumstances. Business owners operating in the real estate industry are some of the more likely individuals to find themselves in a situation where repayment of debt can result in taxable income.

For various reasons, real estate tends to be held in entities known as pass-through entities which consist of partnerships, S corporations and limited liability companies (LLCs). One of the benefits of operating a business within a pass-through entity is the potential ability of the owners to deduct the losses on their individual returns. Generally losses can only be deducted to the extent that the owner has put his money at-risk in the business. This is referred to as “basis” and can be achieved a few ways. The most common way is through an equity investment. If an owner invests $100,000 in an entity, he can deduct $100,000 of losses that flow through to him. Another similar way to achieve basis is by loaning money to the business. The potential deductibility of losses is the same as with an equity investment, but the basis is achieved by a loan. The final method to achieve basis, one that is not available to S corporation owners, is to personally guarantee a debt of the business.

As many businesses in real estate and other industries have suffered losses over the past several years, owners have deducted these losses on their individual returns. These losses were first taken against the owners equity investments, and as losses continued to accumulate, they were taken against owner loans and possibly third party debt that was guaranteed by the owners. From a cash flow standpoint, deducting these losses was beneficial as it allowed owners to offset other taxable income and therefore reduce their tax liability.

The hope for any business owner whose company is suffering losses is for the company to eventually turn around, become profitable and generate positive cash flow. The entity eventually may even have enough cash to start paying back some of the debt on its books. Be mindful though that the payment of debt, whether debt to an owner or debt to a third party that was guaranteed by an owner, may result in taxable income to the owners.

Although this may seem unjust to the owner and seem like phantom income, it in fact is reasonable treatment. In deducting losses against debt basis in prior years, the owner essentially has written off the loan as a loss. Therefore any future collection of debt would be considered income in order to recapture the prior year losses and put the taxpayer back to his original position. The timing is actually favorable to the owner because he was allowed to take losses in earlier years to offset income, with the understanding that income will have to be recognized in future years.

If you are an owner of a pass-through entity that previously had losses, we recommend that you contact
your tax advisor before you start paying down large amounts of debt. Even if there is not a way to avoid recognizing the taxable income, you at least want to know how much taxable income may be created and how much cash you should set aside for any tax liability that was created. You would much prefer to find out the tax implications ahead of time and not in April when your CPA informs you that you have to write a big check to the government.

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