Income Tax Consequences of Debt Modification

Kevin M. Zanni and Robert F. Reilly, CPA

Debt restructurings are common among financially troubled debtor corporations. And, debt restructurings are common among corporations within bankruptcy protection. However, debt restructurings can have unfavorable income tax consequences to the debtor, the creditor, and the third party holding the debt instrument. This discussion summarizes the income tax consequences that all parties should consider in a corporate debt modification.

INTRODUCTION

Debt restructuring is a common aspect of corporate bankruptcies. Debt restructuring is also common to many financially troubled creditors, even if they do not pursue a bankruptcy filing. And, debt restructurings may relate to real-estate-related debt, leveraged buyout debt, and secured or unsecured general corporate debt.

This discussion summarizes the potential income tax consequences to debtors, creditors, and purchasers of debt in connection with a debt modification.

A debt modification may result in the deemed taxable exchange of the old debt instrument for a new debt instrument. The deemed exchange could trigger the recognition of cancellation of debt (COD) income.

The deemed exchange could also trigger the following:

1. To the debtor, the accrual of original issue discount (OID) deductions over the remaining debt term
2. To the creditor, immediate gain/loss recognition and OID income

Interest limitations may also affect the deductibility of the OID. A two-step analysis is required to determine whether a deemed exchange has occurred.

The first analysis considers: were the terms of the debt modified?

The second analysis considers: was the modification significant? If the modification was significant, then both the debtor and the creditor should consider the associated income tax consequences.

STEP ONE ANALYSIS: HAS A DEBT MODIFICATION OCCURRED?

The term “modification” is broadly defined in the Treasury regulations. A modification typically means any alteration, including any deletion or addition, in whole or in part, of a legal right or obligation of the issuer or debt instrument holder. The alteration can be evidenced by an express agreement (oral or written), conduct of the parties, or otherwise.

A modification can occur as a result of either of the following activities:

1. Amending the debt terms
2. Exchanging one debt instrument for another

There are three principal exceptions to the definition of a modification.

Exception 1: Debt Instrument Terms

An alteration of a legal right or obligation that occurs by operation of the debt terms is not a modification. For example, an annual interest rate resetting based on an interest rate index is not a modification.
However, certain alterations do constitute a modification, even if the alterations occurs by operation of the debt terms. An example is a change in the nature of the debt, from recourse to non-recourse or vice versa.

**Exception 2: Failure to Perform**
The failure of an issuer to perform its debt obligations is not a modification. However, while the issuer's nonperformance is not a modification, the agreement of the holder not to exercise its contractual remedies under the debt instrument may be a modification.

**Exception 3: Failure to Exercise an Option**
If a party to the debt has an option to change the terms of the instrument, the failure of the party to exercise that option is not a modification.

**STEP TWO ANALYSIS: WAS THE DEBT MODIFICATION SIGNIFICANT?**
Assuming a modification has occurred, Treasury regulation 1.1001-3 provides six tests for analyzing whether the debt modification is significant:

1. Facts and circumstances
2. Changes in yield
3. Changes in payment timing
4. Change in obligor or security
5. Changes in debt instrument nature
6. Change in accounting or financial covenants

The determination of whether the modification of any debt term is a significant modification is analyzed under each applicable test.

**1. Facts and Circumstances**
Under this general test, the debt modification is significant only if, based on all facts and circumstances, the legal rights or obligations are altered to a degree that is economically significant.

In making a determination under the facts and circumstances test, all debt modifications should be considered collectively. Therefore, a series of modifications may be significant when considered together although each individual modification, if considered alone, would not be significant.

This general test does not apply if there is a specific test that applies to the particular modification.

**2. Change in Yield**
This test specifically applies to debt that has the following attributes:

1. Provides for fixed payments only
2. Has alternative payment schedules (e.g., debt subject to contingencies)
3. Provides for a fixed yield (such as certain demand loans)
4. Has a variable interest rate

If the debt does not fall within one of these four categories, then whether a change in yield is a significant modification is determined under the facts and circumstances test.

A change in yield is a significant debt modification if the yield varies from the annual yield on the unmodified debt (determined as of the modification date) by more than the greater of (1) one-quarter of 1 percent (25 basis points) or (2) 5 percent of the annual yield of the unmodified debt (0.05 x annual yield).

A reduction in debt principal reduces the total payments on the modified debt and would result in a reduced yield on the instrument, often resulting in a significant modification. Therefore, the regulations treat a change in debt principal the same as to a change in interest rates.
3. Change in Payment Timing
In general, a modification that changes the timing of the debt payments is a significant modification if it results in the material deferral of scheduled payments. Examples include an extension of the final maturity date or a deferral of payments due prior to maturity (such as a deferral of interest payments).

To assess this exception test, the considerations include the following:
1. The length of the deferral
2. The original debt term
3. The amounts of the payments deferred
4. The time period between the modification and the actual deferral of payments

The regulations provide a safe harbor that the debt modification will not be significant if the deferred payments are required to be paid within the lesser of (1) five years or (2) one-half of the original term of the instrument.

For purposes of this safe harbor, the debt term is determined without regard to any option to extend the original maturity. And, deferrals of de minimis payments are ignored. Deferrals are tested on a cumulative basis so that when payments are deferred for less than the full safe-harbor period, the unused portion of the period remains for any subsequent deferrals.

4. Change in Obligor or Security
The substitution of a new obligor on nonrecourse debt is not a significant modification. In contrast, the substitution of a new obligor on recourse debt generally is a significant modification. There are a few exceptions for substitutions of obligors on recourse debt, including the following:
1. The new obligor is an acquiring corporation to which Internal Revenue Code Section 381(a) applies.
2. The new obligor acquires substantially all of the obligor’s assets.
3. The change in obligor is a result of either a Section 338 election or the filing of a bankruptcy petition.

For an exception to apply, the change in obligor must not result in either (1) a change in payment expectations or (2) a significant alteration.

The alteration would be a significant debt modification but for the fact that the alteration occurs by operation of the debt terms.

A change in payment expectations occurs if, as a result of a transaction, there is a substantial enhancement or impairment of the obligor’s capacity to meet the payment obligations after the modification—as compared to before the modification.

The addition or deletion of a co-obligor on the debt is a significant debt modification if the addition or deletion of the co-obligor results in a change in payment expectations.

For recourse debt, a modification that releases, substitutes, adds, or otherwise alters the collateral for, a guarantee on, or other form of credit enhancement for, recourse debt is a significant modification if it results in a change in payment expectations.

For nonrecourse debt, a modification is a significant debt modification if it releases, substitutes, adds, or otherwise alters a substantial amount of the collateral for, a guarantee on, or other form of credit enhancement for, nonrecourse debt.

5. Change in Debt Instrument Nature
A change in the debt nature from recourse to nonrecourse, or vice versa, is a significant debt modification. There are two exceptions to this test.

First, the defeasance of a tax-exempt bond is not a significant debt modification if the following statements apply:
1. The defeasance occurs by operation of the terms of the original bond.
2. The issuer places in trust government securities or tax-exempt government bonds that are reasonably expected to provide interest and principal payments sufficient to satisfy the bond payment obligations.

Second, a modification that changes recourse debt to nonrecourse debt is not a significant debt modification if the following statements apply:
1. The debt continues to be secured only by the original collateral.
2. The modification does not result in a change in payment expectations.

A debt modification that results in an instrument that is not debt for federal income tax purposes is a significant debt modification.

6. Change in Financial and Accounting Covenants
A modification is not a significant debt modification if it adds, deletes, or alters customary accounting or financial covenants.
However, the issuer may make a payment to the lender in consideration for agreeing to the modification. That payment should be considered in applying the change in yield test. Therefore, a debt covenant modification can result in a significant debt modification if the lender receives a payment for agreeing to the modification.

**DEEMED EXCHANGE INCOME TAX CONSEQUENCES**

Once a debt modification is determined to be significant, both the debtor and the creditor should analyze the income tax consequences. The debtor’s income tax consequences are determined by comparing (1) the new debt issue price to (2) the old debt adjusted issue price.

The adjusted issue price typically is the principal amount if the following is true:

1. The debt was not issued at a discount.
2. The debt provided for current interest payments at a fixed or variable rate.

Gain or loss to the creditor is measured by the difference between (1) the new debt issue price and (2) the old debt tax basis.

The debt holder can have a different tax basis than the adjusted issue price. For instance, the debt holder may have bought the debt from the original creditor at a discount. To conclude the new debt issue price, the analyst should determine whether or not the debt is publicly traded.

For this purpose, either the old debt or the new debt (or both) can be publicly traded. If the debt is publicly traded, the issue price is equal to the debt instrument fair market value (FMV).

The regulations address the following:

1. Publicly traded debt issued for property
2. Non-publicly-traded debt issued for publicly traded property

The property is the old debt that is exchanged for the new debt.

If the debt is not publicly traded, the issue price is equal to the debt principal amount if the debt has adequate stated interest. The debt has adequate stated interest if the stated principal amount is less than or equal to the imputed principal amount.

Typically, debt is considered to have adequate stated interest if it bears interest at least equal to the applicable federal rate (AFR) under Section 1274(d).

**WHEN IS DEBT PUBLICLY TRADED?**

Under the current regulations, the publicly traded debt issue price is generally determined in the following order:

1. The amount of money paid for the debt instrument
2. If the debt is publicly traded and is not issued for money, the debt instrument FMV
3. If the debt is not publicly traded and not issued for money but is issued for property that is publicly traded (including a debt-for-debt exchange where the old debt is publicly traded), the debt issue price is the publicly traded property FMV
4. If none of the above applies, then Section 1274 applies and the issue price will be the stated principal amount where there is adequate stated interest

Under the current regulations, property (including debt) is considered to be traded on an established market if it is property described in regulation 1.1273-2(f) at any time during the 60-day period ending 30 days after the debt issue date. Property described in regulation 1.1273-2(f) includes the following:

1. Exchange listed property
2. Market-traded property (i.e., property traded on a board of trade or in an interbank market)
3. Property appearing on a quotation medium
4. A readily quotable debt instrument

Since few debt instruments are listed on an exchange, the relevant question is whether the instruments appear on a quotation medium or are readily quotable.
A quotation medium is defined as a system of general circulation that provides a reasonable basis to determine FMV by disseminating either (1) recent price quotations from one or more identified brokers, dealers, or traders, or (2) actual prices of recent sales transactions.

In January 2011, the Internal Revenue Service issued a proposed regulation that addresses when debt is considered to be publicly traded for purposes of determining the debt issue price.

In the proposed regulation, the Internal Revenue Service explained that taxpayers had criticized the current definition of “established market” as being difficult to apply in practice. Due to the increased amount of debt workouts in recent years, this issue is topical.

Few debt instruments are listed on an exchange. Rather, they are typically traded in privately negotiated transactions between a securities dealer or broker and a customer. A dealer or broker may quote a price that enables a customer to buy or sell at that price subject to volume limitations, which is referred to as a “firm quote.”

A dealer, broker, or listing service may also quote a price that indicates a willingness to buy or sell a specific debt instrument—but not necessarily at the specified price. This price is referred to as an “indicative quote.”

The proposed regulation identifies the following characteristics of an established market:

1. The property is listed on an exchange.
2. A sales price for the property is reasonably available.
3. A firm (or executable) price quote to buy or sell the property is available.
4. One or more indicative quotes (price quotes other than firm quotes) are available from a dealer, broker, or pricing service (an indicative quote).

In each case, the time period for determining whether the property is publicly traded is the 31-day period ending 15 days after the debt issue date.

For the second characteristic, a sales price is considered reasonably available if the sales price (or information sufficient to calculate the sales price) appears in a medium that is made available (1) to persons who regularly purchase debt instruments or (2) to persons who broker such transactions.

The proposed regulation provides that the FMV of property described in regulation 1.1273-2(f) is presumed to be equal to its trading price, sales price, or quoted price, whichever is applicable. If there is more than one price or quote, the taxpayer may use any reasonable method to determine the price.

When there is only an indicative quote, the taxpayer can use any method that provides a reasonable basis to determine FMV if the taxpayer determines that the quote (or average quotes) materially misrepresents FMV. This rule applies if the taxpayer can establish that the selected method more accurately reflects the property value.

The proposed regulation would apply to debt issued on or after the publication date of the Treasury decision adopting the proposal as a final regulation.

The proposed regulation should resolve a number of uncertainties regarding whether debt is publicly traded. Unfortunately, for many financially troubled debtors, the proposed regulation appears biased toward treating certain debt as publicly traded.

Given that the FMV of most troubled loans is significantly less than the principal amount of these loans, the debtor may realize COD income if there is a significant debt modification that results in a debt-for-debt exchange.

**Summary and Conclusion**

Given the volume of debt restructurings, both debtors and creditors should be aware of the income tax consequences of debt modification. Such consideration is necessary to avoid unpleasant surprises related to debt workouts. All debt workout parties should know both (1) when a debt-for-debt exchange is deemed to take place and (2) the resulting income tax consequences.

These parties should consider the recent developments in the area, including regulations addressing whether a deterioration in the issuer’s creditworthiness may cause debt to be reclassified as equity. Such developments also include the proposed regulation that would expand the definition of “publicly traded” to encompass more debt instruments.

Kevin Zanni is a manager in our Chicago office. Kevin can be reached at (773) 399-4333 or at kmzanni@willamette.com.

Robert Reilly, CPA, is a managing director of the firm and is resident in our Chicago office. Robert can be reached at (773) 399-4318 or at rfreil-ly@willamette.com.