Debt Restructuring in Troubled Times: Watch for Tax Traps

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Executive Summary

- Many businesses are currently considering how to adjust or reduce their debt in order to preserve and maximize cash flow
- Debt restructuring or modifications can increase the borrower's tax liability, usually by creating "cancellation of indebtedness income" (CODI)
- CODI is created when a taxpayer's existing debt is, or is deemed to be, cancelled, forgiven or partially reduced
- When planning transactions involving debt, early anticipation of tax issues can avoid or minimize potential adverse tax consequences and delay
- We describe below:
  - When CODI is likely to arise
  - Exceptions to CODI
  - Planning options to mitigate CODI

When Is CODI Likely to Arise?

- **Common CODI triggers** include:
  - **Debt Purchases by the Borrower.** CODI may arise if the borrower repurchases its own debt at a discount, including in open-market purchases, debt tender offers or exchanges of property for debt
  - **Debt Purchases by Related Parties**. When related parties buy the borrower's outstanding debt at a discount, CODI may arise even without any actual debt pay-down because the borrower may instead be deemed to have bought its own debt and issued new debt to the related party
  - **Debt-for-Debt Exchanges**. CODI may result from new debt issuances in exchange for old debt, including in "up-tier" exchanges where the new debt has improved collateral rights, in some cases even if the new debt has the same stated principal amount as the old debt
  - **Equity-for-Debt Exchanges**. CODI may result from the issuance of equity for debt

When Is CODI Likely to Arise? (cont'd)

- **Common CODI triggers** include (cont'd):
  - **Changes or Modifications to Debt Terms**. A CODI-producing exchange of new debt for the existing debt can be deemed to have occurred when there has been a **"significant modification"** of debt terms, such as the following:
    - Changes affecting yield (e.g., interest rates, amount of principal, consent fees)
    - Deferral of payments (whether or not the deferral affects yield)
    - Changes in the obligor or guarantors
    - Changes in collateral or recourse/nonrecourse nature of debt
    - Other credit enhancements or covenant relief
  - **Forbearance**. A lender's temporary willingness not to collect interest or principal payments on a loan or exercise its remedies for borrower default may be a "significant modification" that produces CODI. Forbearance that does not extend beyond two years will not be considered a significant modification.
  - **Forgiveness**. A lender's willingness to forego principal or interest payments on a loan will also trigger CODI, even if the cancelled debt is subject to revival upon a contingent future event. Government debt forgiveness can trigger CODI, although the CARES Act explicitly provides that forgiveness of loans made under the PPP program will not create CODI.

When Is CODI Likely to Arise? (cont'd)

- **CODI generally arises when debt is satisfied or deemed satisfied for less than its adjusted issue price ("AIP")**
- Generally, AIP equals the debt's principal amount if the debt was not issued at a discount and provided for current payments of interest at a fixed or variable rate
- However, AIP may be significantly different from the debt's stated principal amount depending on factors including the debt's terms, the amount and type of consideration for which it was issued and whether the debt is "publicly traded"
- AIP for "publicly traded" debt is typically its fair market value
  - "Publicly traded" for tax purposes is not a question of whether the debt is exchange listed or was issued in a registered offering under federal securities law
  - Instead, the test focuses on whether a sales price for the debt is reasonably available or whether firm or indicative price quotes are available during the measurement period. However, a small debt exception applies where the debt does not exceed $100 million in principal amount at the time of determination
- AIP must be calculated both for the original debt and any new debt exchanged (or deemed exchanged) for the original debt

Commonly Used Exceptions to CODI

- **Insolvent Debtors and Debtors in Bankruptcy Proceedings**
  - CODI is not recognized to the extent that a debtor is insolvent or if the CODI arises when the debtor is in bankruptcy proceedings
  - For this purpose, **insolvency is defined as the amount by which the debtor's liabilities exceed its assets**, so CODI could be excluded, but only to the extent the debt reduction does not exceed the amount of the debtor's insolvency
    - A bankruptcy filing is not required to be considered insolvent
    - <u>Caution:</u> Partnerships and other pass-through entities determine insolvency by looking at the financial situation of each partner or member, not the pass-through entity. It is often the case that, while the pass-through entity may be financially troubled, the partner is not, resulting in CODI recognition for that partner
  - If the insolvency or bankruptcy exceptions from CODI are used, the taxpayer/**debtor typically must also reduce certain tax attributes** (such as net operating loss tax benefits and asset basis) by an equal amount, which defers but does not eliminate the tax
    - Taxpayers can elect to reduce basis before losing NOLs, which is often beneficial since NOLs can offset current income (or, under the CARES Act, can be carried back three years which could be useful if the CODI arose in a prior year), while the effect of the reduced basis is often deferred

Commonly Used Exceptions to CODI (cont'd)

- **Purchase Price Adjustment Rather Than CODI Recognition**.
  - If the buyer of assets issues debt to the seller, a later agreement between the buyer and seller to reduce the amount of the debt can, in many cases, be treated as a purchase price reduction, rather than producing CODI, although the buyer's basis in the assets will also be reduced by an equal amount
- **Capital Contribution of Debt to Corporation by Stockholders**
  - If existing stockholders are also a corporation's lender, structuring the debt reduction as a capital contribution by the stockholders of the debt to the debtor corporation may help avoid CODI in certain circumstances
- **Issuance of Stock or Partnership Interests in Exchange for Debt**
  - Where new stock or partnership interests are issued to satisfy the debt, CODI may be avoided up to the fair market value of that equity
- **Contingent or Disputed Debt**
  - If the debt is contingent (for example, certain guarantees) or the liability is contested or disputed, it is possible that its cancellation will not give rise to CODI

Coping with CODI

- While the best way to deal with CODI is to avoid it in the first place, when CODI is unavoidable, consider whether any of the following could reduce its impact:
  - **Offset CODI with Operating Losses.** A corporation may have a net operating loss that it can apply to offset the taxable CODI. Although previously applicable rules limited the use of post-2017 NOLs to offset income to 80% of such income, pursuant to the CARES Act, pre-2021 NOLs may now be used 100%.
  - **Offset with Previously Unusable or Suspended Losses**. CODI is passed through to the partners in a partnership (or LLC), who may then be able to offset the taxable income with losses they have previously derived from the partnership but which they have been unable to use because they were suspended or frozen as passive activity losses.
  - **Offset CODI with OID Deductions.** In a debt-for-debt exchange, the debtor will in some cases be entitled to future deductions for original issue discount (OID) on the new debt that, over time, offset the effect of part or all of the CODI on the exchange, subject to time value considerations and limitations on interest deductibility.

Wrap-Up

- CODI can arise in sometimes surprising ways
- Before altering, forbearing, modifying, or otherwise restructuring debt, consider whether such proposed alterations, forbearance, modifications, or other restructuring could create CODI
- Consider whether business goals could be achieved through an approach or structure where a significant modification does not occur
- Consider whether any exceptions might be available to prevent the recognition of CODI and the consequences of taking advantage of those exceptions
- Legislation similar to the prior financial crisis CODI relief (i.e., 5-year spreading/deferral of tax on CODI) has not been implemented yet, so borrowers cannot rely on any such deferral of the CODI at this time

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