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*presents*

# **Minimizing Tax in Commercial Loan Workouts and Debt Modifications**

## **Legal Strategies for Reducing Cancellation-of-Debt Income**

### **A Live 90-Minute Teleconference/Webinar with Interactive Q&A**

#### **Today's panel features:**

Vadim Mahmoudov, Partner, **Debevoise & Plimpton**, New York  
Rafael Kariyev, Counsel, **Debevoise & Plimpton**, New York  
Joseph C. Mandarino, Partner, **Stanley Esrey & Buckley**, Atlanta

### **Thursday, July 15, 2010**

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**1 pm Eastern**

**12 pm Central**

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# **Minimizing Tax in Commercial Loan Workouts and Debt Modifications—**

## **Legal Strategies for Reducing Cancellation-of-Debt Income**

**Vadim Mahmoudov**  
*Debevoise & Plimpton LLP*  
New York City

**Rafael Kariyev**  
*Debevoise & Plimpton LLP*  
New York City

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# Background

- Three types of common transactions
  - Deleveraging (issuer buys back debt)
  - Related party purchases debt
  - Modifications (change terms of the debt)

# Cancellation of Indebtedness (“COD”)

- COD is income (“CODI”). Section 61(a)(12).
- CODI’s inclusion in taxable income may be deferred or excluded
- $CODI = \text{Adjusted issue price (“AIP”) (old)} - \text{FMV} / \text{AIP (new)}$

# Transfer of Assets (Foreclosure)

- CODI or regular income/gain? Depends on nature of liability
  - Transfer of property in satisfaction of recourse liability
    - Sale gain (FMV property – AB property); CODI (AIP debt – FMV property)
  - Transfer of property in satisfaction of nonrecourse liability
    - Sale gain (AIP debt – AB property)
- Example: Debt 1000 retired with Asset FMV 700 / AB 200
  - If recourse, CODI = 300 (AIP-FMV) and sale gain = 500 (FMV-AB)
  - If nonrecourse, no CODI, just gain = 800 (AIP-AB)
- Aggregate income is the same but (i) character may be different and (ii) CODI may be deferred or excluded

# Stock for Debt Exchange

- If issue stock for debt, CODI = AIP – FMV of stock. Section 108(e)(8)
- Shareholder Contribution to Capital: Section 108(e)(6)
  - Debt Deemed Retired for Amount = SH's basis in the debt
  - What if Subsidiary is Insolvent? FSA 199915005
- Section 382 ownership change implications

# Partnership Interest for Debt

- Same general rule as stock for debt: 108(e)(8)
- Prop. Reg. 1.108-8 would allow FMV to be deemed to be liquidation value in an arm's length transaction if the parties report consistently.
- Prop Reg. 1.721-1(d): generally, creditor gets Section 721 contribution treatment unless the underlying liability was unpaid rent, royalties or interest (including OID).
- CODI allocations in a partnership, along with related Section 752 deemed distributions, can raise complicated issues

# Debt-for-Debt Exchange

- Measurement of CODI
  - CODI equals the excess of (i) AIP of the old debt over (ii) the issue price of the new debt. (Section 108(e)(10)(A))
  - “Issue price” is stated principal amount, if neither the old nor new debt is publicly traded and new debt has interest of at least AFR (other than in “potentially abusive situations”)
- Publicly Traded Debt
  - If either New Debt or Old Debt is publicly traded within the period 30 days before and 30 days after the issue date then New Debt’s AIP = FMV
  - Public trading occurs if the instrument “appears on a system of general circulation . . . that provides a reasonable basis to determine fair market value [such as pricing] of recent sales transactions”
  - Bloomberg? Trace?
- Temporary restrictions may not be placed on trading to avoid the Publicly Traded rule, so the issuer is at risk for 30 days with no ability to control it

# Example

- Holder and Borrower agree to exchange New Debt of \$1,000 principal amount bearing 5% interest for \$1,000 of Old Debt. The FMV of New Debt is \$700.
- If the New Debt is not publicly traded, the issue price will be \$1,000 and there will be no COD
- If within 30 days of the exchange pricing information relating to transfers of the debt is reported on a quotation medium, then the issue price of the New Debt will be \$700.
  - \$300 of CODI to Borrower
  - \$300 of OID for Borrower and Holder
- AHYDO
  - Disallow some or even all of the OID deductions
  - Defer any remaining OID deductions until payment of the OID

# Borrower's Related Party Purchases Debt

- If a Purchaser who is related to the Borrower acquires Old Debt from a third party (who is not “related” to the Borrower), then:
  - **Potential COD Event**. The Borrower is treated as having acquired the debt for value equal to the price paid by the Purchaser.
  - **Deemed Reissuance of Old Debt**. The Old Debt is deemed to be reissued by the Borrower with an issue price equal to the price paid by the Purchaser.
  - **OID/AHYDO**. The deemed New Debt may be subject to the OID and AHYDO rules. It will likely not be fungible with the Old Debt.
- What if a Purchaser acquires Old Debt at a discount and then subsequently becomes related to the Borrower?
  - **Potential COD Event**. Borrower may have a COD event on the date that the Purchaser becomes related to it, and the analysis set forth above will apply.
    - 6 month test; if purchase > 6 months before, facts and circumstances test.
- “Related Party” tests. Sections 108(e)(4); 267(b); 707(b)(1); 414(b) or (c).

# Treatment of COD Income

- Section 108
  - In general provides for exclusion of CODI in certain circumstances
    - Bankruptcy in Title 11 Case (108(a)(1)(A))
    - Insolvency (to extent of insolvency) (108(a)(1)(B))
    - Qualified Farm Indebtedness (108(a)(1)(C))
    - Qualified Real Property Business Indebtedness (“QRPBI”) (108(a)(1)(D))
    - Qualified Principal Residence Indebtedness (discharged before 2013) (108(a)(1)(E))
- American Recovery and Reinvestment Act of 2009
  - New section 108(i) provides for election to defer CODI until 2014
  - AHYDO suspended through 12/31/09 in certain cases
  - Notice 2010-11 suspended AHYDO through 12/31/10

# DEBT MODIFICATION RULES

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Joseph C. Mandarino  
Stanley Esrey & Buckley LLP  
Promenade II, Suite 2400  
1230 Peachtree Street  
Atlanta, Georgia 30309  
[www.seblaw.com](http://www.seblaw.com)  
[jmandarino@seblaw.com](mailto:jmandarino@seblaw.com)  
(404) 835-6207



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# Debt Modification

- If the terms of a debt instrument are changed sufficiently, the debt is treated as a new obligation that is exchanged for the old obligation.
- This raises at least two issues:
  - What kind of changes result in a “significant modification”?
  - What happens in this deemed debt exchange?

# Significant Modifications

- To determine whether a modification is significant, the tax regulations contain various tests:
  - a general rule, and
  - several sets of detailed tests that apply only to certain types of modifications
- Analytical Overview
  - list out all the modifications made to the debt instrument
  - if a modification is covered by a specific provision of the regulations, it is only tested under that rule
  - all remaining changes are tested under the general rule

# Significant Modifications - Specific Rules

- The tax regulations contain special rules that apply to specific changes.
- If a modification is described under one of the specific rules, it is only tested under that rule and not under the general rule.
- Therefore, a modification that is described under one a specific rule and “passes” – i.e., is not treated as “significant” – can be ignored

# Significant Modifications – Specific Rules – Change in Yield

- A change in yield of at least 0.25% (25 basis points) or 5% of the annual yield of the old instrument is a significant modification.
- Example:
  - Yield on loan is 6%.
  - Parties agree to reduce rate so that yield will be 5.5%.
  - This is a reduction in 50 basis points (6% minus 5.5%).
  - It is also a reduction of 8.3% of the yield ( $0.5\% \div 6\%$ ).
  - So under either prong of the test the change in yield is significant.

# Significant Modifications – Specific Rules – Timing of Payments

- A change in the timing of payments is a significant modification if it results in a “material deferral” of scheduled payments.
- Safe-harbor
  - A deferral of scheduled payments is not material if deferral is within the safe-harbor period.
  - Safe-harbor period begins on the original due date of the first scheduled payment that is deferred and extends for a period equal to the lesser of five years or 50% of the original term of the instrument.

# Significant Modifications – Specific Rules – Timing of Payments

- Example:
  - In 2003, parties enter into an 8-year balloon loan that matures in 2011.
  - In 2010, the parties extend the final payment date by 4 years to 2014.
  - The original term was 8 years, so a 4-year extension is within the safe-harbor.

# Significant Modifications – Specific Rules– Change in Obligor

- Substitution of a new obligor on recourse debt instruments
  - General – this is a significant modification.
  - Exceptions – there are exceptions in the case of section 381(a) transactions, certain asset acquisitions, tax-exempt bonds, bankruptcy, and section 338 elections.
- Substitution of a new obligor on nonrecourse debt instruments
  - This is not a significant modification.
- Addition/deletion of co-obligor
  - This is a significant modification if it results in a change in payment expectations.

# Significant Modifications – Specific Rules – Change in Security

## Change in security or credit enhancement

- Recourse debt instruments
  - A modification that releases/substitutes/adds/alters the collateral, a guarantee, or other form of credit enhancement for a recourse debt instrument is a significant modification if the modification results in a change in payment expectations.
- Nonrecourse debt instruments
  - General -- a modification that releases/substitutes/adds/alters a substantial amount of collateral, a guarantee, or other form of credit enhancement for a nonrecourse debt instrument is a significant modification.
  - But -- several technical exceptions.

# Significant Modifications – Specific Rules – Change in Priority

## Change in priority of debt

- A change in the priority of a debt instrument relative to other debt of the issuer is a significant modification if it results in a change in payment expectations.

# Significant Modifications – Specific Rules – Change from Debt to Equity

## Change in the nature of a debt instrument

- Property that is not debt – a modification of a debt instrument that results in an instrument or property right that is not debt for federal income tax purposes is a significant modification.

# Significant Modifications – Specific Rules – Recourse/Nonrecourse

## Change from recourse to nonrecourse

- In general, a change in the nature of a debt instrument from recourse (or substantially all recourse) to nonrecourse (or substantially all nonrecourse) is a significant modification.
- Several exceptions apply.

## Change from nonrecourse to recourse

- Change from nonrecourse to recourse is a significant modification.

# Significant Modifications – Specific Rules – Accounting/Financial Covenants

## Changes in accounting or financial covenants

- A modification that adds, deletes, or alters customary accounting or financial covenants is **not** a significant modification.

# Significant Modifications

## General Rule

### General Rule

- A modification is “significant” if – looking at all facts and circumstances – “***the legal rights or obligations that are altered and the degree to which they are altered are economically significant.***”
- In making this determination:
  - all modifications are considered collectively
  - a series of such modifications may be significant when considered together although each modification, if considered alone, would not be significant

# Significant Modifications

## Summary of Tests

Specific changes in:

1. yield
2. payment schedule
3. obligor(s)
4. security/credit enhancement
5. priority
6. nature of debt instrument
7. recourse/nonrecourse nature
8. accounting/financial covenants



Tested individually under specific rules or safe-harbor standards

All changes not listed in left-hand column.



Tested collectively under the general rule.

# Deemed Debt Exchange

- If there is a significant modification, the “new” debt is treated as exchanged for the “old” debt.
- Example:
  - Bigco owes \$100 million to Bank. Bigco has trouble making the payments. Bigco and Bank agree to lower the amount due from \$100 million to \$80 million.
  - Generally, the issue price of the new debt instrument will be \$80 million.
  - Bigco is treated as satisfying the old debt instrument for \$80 million, resulting in \$20 million of COD income

# Deemed Debt Exchange

- We can see that a reduction in principal should give rise to COD income. What if there is a less clear change?
- Example:
  - Same facts, but Bank agrees to lower the interest rate from 8% to 2%. Assume the applicable federal rate (“AFR”) is 4.5%.
  - This is a significant modification. Furthermore, under the tax rules, this interest rate is lower than the AFR. As a result, the issue price of the new debt is computed at \$92.5 million.
  - Bigco is treated as satisfying the old debt instrument for \$92.5 million, resulting in \$7.5 million of COD income.

# Deemed Debt Exchange

## Creditor Issues

- A problem can arise if a creditor is not the original lender and acquired the debt at a discount.
- The deemed debt exchange occurs for both the creditor and the debtor and there is a risk to the creditor that the exchange will trigger gain.

# Deemed Debt Exchange

## Creditor Issues

- Example
  - Bank loans \$100 to Debtor. Later, when Debtor falls behind on the loan, Creditor acquires the bond for \$50.
  - Creditor and Debtor modify the terms of the bond so that there is a deemed debt exchange under IRC §1001.
  - The “new” bond has an issue price of \$70.
  - Debtor has \$30 of COD income
  - Creditor receives new bond with issue price of \$70 but surrendered old bond with tax basis of \$50.
  - Arguably, Creditor has \$20 of gain.

# Reporting Requirements

- Foreclosures and Abandonments
  - if a creditor that lends money secured by property in connection with a trade or business and
  - if that creditor acquires the security in full or partial satisfaction of the debt (or if they have reason to know that the debtor has abandoned the property)
  - then the creditor has to file information a 1099-A in connection with the foreclosure/abandonment.
- some exceptions

# Reporting Requirements

- Debt Discharge
  - if a creditor is an “applicable entity” and
  - Discharge is \$600 or more
  - The creditor has to file a 1099-COD
- applicable entity – generally an entity regulated as a bank, or a non-regulated entity engaged in the business of lending money

# Reporting Requirements

- when does discharge occur for purposes of triggering the 1099-COD?
  - upon discharge date provided for in bankruptcy, receivership, foreclosure, etc.
  - upon expiration of statute of limitation
  - upon voluntary agreement of the parties
  - upon application of a defined policy of the creditor to discontinue collection activity and discharge the debt
  - expiration of 36 month period in which no payments are received

# Reporting Requirements

- Exceptions to 1099-COD reporting
  - discharged interest
  - fees, penalties, etc.
  - foreign debtors (but check)
  - related-party debt acquisition
  - upon release of co-obligors (if remaining debtors are liable)
  - guarantors

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Stanley Esrey & Buckley LLP  
Promenade II, Suite 2400  
1230 Peachtree Street  
Atlanta, Georgia 30309  
[www.seblaw.com](http://www.seblaw.com)  
[jmandarino@seblaw.com](mailto:jmandarino@seblaw.com)  
(404) 835-6207



# New Rules

- Three basic changes
  - Deferral of COD income. Issuer can elect to defer COD income resulting from a “reacquisition” of an “applicable debt instrument”. Deferred COD income is generally recognized ratably over the five-year period beginning in 2014.
    - Only applies if the reacquisition occurs after 12/31/08 and on or before 12/31/10.
  - Deferral of Deduction for New OID. If elect to defer COD income and reacquisition funded (directly or indirectly) by issuing a new debt instrument, the deduction for all or a portion of any OID on the new debt instrument is also deferred.
    - If have NOLs may be better to recognize COD and refresh NOLs with subsequent OID.
  - AHYDO Turnoff Rule. If exchange an old DI for a new DI (including as a result of a significant modification) and the new DI is an AHYDO, the deferral and disallowance rules generally applicable to AHYDOs will not apply.
    - AHYDO turnoff rule does not apply if (i) old DI was an AHYDO, (ii) new DI is issued to a related person, or (iii) new debt has contingent interest
    - Only applies if the exchange occurs b/w 9/1/08 and 12/31/10.

# Basic Impact of New Rules

- Deleveraging transactions are more attractive. Deferral of the COD income makes it more attractive for issuers to repurchase outstanding debt that is trading at a discount.
  - Effectively an interest free loan from the US on the tax.
- Alternative to bankruptcy. Issuers that need to modify their debt can do so outside of bankruptcy.
  - In some cases, current recognition of the COD income would force the issuer into bankruptcy.
  - This alternative is particularly important for partnerships since the bankruptcy and insolvency exceptions are applied at the partner level.
  - Bankruptcy could still be preferable (need to run the numbers).
- AHYDO turnoff rule. Removes a significant cost under existing law of some debt modifications (and debt exchanges).
  - Available inside of bankruptcy and outside of bankruptcy.

# Details and Issues

- Election Eligibility
- Election Mechanics
- Timing Issues
- OID Deferral Rules
- Acceleration Rules
- Special Partnership and Pass-Thru Rules

# Election Eligibility

- Availability of Protective Elections
  - Rev. Prov. 2009-37 provides flexibility to make protective elections.
- Extent of Electivity
  - Rev. Prov. 2009-37 provides flexibility to make partial 108(i) elections.
- Applicable Debt Instrument: any DI issued (i) by a C corporation or (ii) any other person in connection with the conduct of a trade or business by such person.
  - Do 1.163-8T and Notice 89-35 tracing rules apply to a partnership DI?
  - Acquisition of partnership interests with proceeds of a DI?

# Election Mechanics

- Rev. Ruling 2009-37 provides detailed guidance on making election
- Election made on original timely filed tax return
- IRS provides automatic 12 month extension to file
- Annual 108(i) information statements required

# Timing Issues

- When does the deferred COD income increase E&P?
  - Rev. Proc. 2009-37 states that regulations will provide that E&P generally computed without regard to COD and OID deferrals under 108(i).
- Treatment of deferred items under Sections 382 and 384
  - Application of Notice 90-27 (installment sale gain recognized outside of five year period still treated as recognized built-in gain)
  - Application of Notice 2003-65
    - Section 1374 Approach: COD income recognized during the first 12 months of the Section 382 recognition period treated as recognized built-in gain.
    - Section 338 Approach: Built-in COD income upon change of control date treated as recognized built-in gain

# OID Deferral Rule

- Basic Rules:
  - Applies if (i) reacquisition is effected by issuing a new DI with OID in exchange for the ADI, or (ii) the issuer of the ADI issues a new DI with OID and the proceeds are used directly or indirectly to acquire an ADI.
  - Applies to OID accruing prior to the recognition period (up to the deferred COD income).
  - Deduction for that OID is deferred until the recognition period (and then allowed ratably over the recognition period)
- Issues:
  - Interaction with other deferral and disallowance rules
  - Payment of the OID doesn't matter
    - QSI not subject to deferral rules
  - Taxpayer may be worse off or better off (as compared with no reacquisition)
  - Meaning of “directly or indirectly”
    - Rev Proc 2009-37 – indirect acquisition includes 1.108-2(c) (6 month post-acquisition related person rule)
  - Issuance of a DI by an affiliate where proceeds are used to fund a reacquisition

# Acceleration Rule

- Deferred items must be recognized upon:
  - death of the taxpayer,
  - liquidation or sale of substantially all the assets of the taxpayer,
  - cessation of business by the taxpayer,
  - similar circumstances,
  - the sale or exchange or redemption of an interest in a partnership, S corporation, or other pass-thru entity by a partner, shareholder, or other person holding an ownership interest in such entity
- Potential Transactions
  - Sale of stock where a corporation joins or leaves a consolidated group
  - Asset reorganization (e.g., A, C or D reorganization) or Section 332 liquidation
  - Change in status, such as where a C corp becomes an S corp (or vice versa)
  - Transfer of a foreign corporation (PFIC with QEF election)
  - Transfer by a partner just accelerates that partner's deferred items?
  - Application in the case of a tax-free transfer by a partner

# Special Partnership Rules

- Allocation Rule: Rev. Proc. 2009-37 provides flexible rules for partnership to allocate deferred COD among its partners. COD allocated under Section 704 and deferred COD allocated at partnership's discretion. Deferral allocation not subject to "substantial economic effect" requirement.
  - Effectively makes election a partner level decision.
  - Multiple ADIs – Is COD allocated ADI by ADI, resulting in trap for unwary?
- Section 731 Rule: Any decrease in a partner's share of partnership liabilities as a result of such discharge is not taken into account for purposes of Section 752 at the time of the discharge to the extent it would cause the partner to recognize gain under Section 731. Any decrease in partnership liabilities deferred under the preceding sentence is required to be taken into account by such partner at the same time, and to the extent remaining in the same amount, as income deferred under this subsection is recognized.
- Issues:
  - Allocation of the deferred OID? Same as the COD, or based on who bears the loss using normal Section 704(b) principles?
  - Section 731 Rule
    - Impact of other items of income and loss in the year of the reacquisition
    - Impact of other distributions in the year of the reacquisition
    - Capped at amount of COD income

# S Corporation Example

- Example: A and B each own 50 shares of an S corporation. The S corporation reacquires an ADI and elects to defer the resulting \$90 of CODI. Thereafter, the S corporation issues 50 shares to C. Absent any acceleration events, \$18 of CODI would be recognized each year for five years beginning in 2014.
- Questions:
  - How is the \$18 of CODI allocated in 2014? \$9 to A and B or \$6 to A, B, and C.
    - Normally 704(c) type principles do not apply in the S corp context.
    - But acceleration rule indicates a policy to allocate the income to the shareholders at the time of the reacquisition.
  - Rev. Proc. 2009-37 provides that deferred COD income is shared pro rata only among those shareholders that were shareholders of the S corp immediately before the reacquisition transaction.
    - Thus, \$9 to each of A and B.

**Vadim Mahmoudov, Partner, Debevoise & Plimpton LLP**

- Mr. Mahmoudov is a member of the Tax Department whose practice focuses on domestic and cross-border mergers and acquisitions, bankruptcies and restructurings, and private equity fund formation. He is the co-author of the annual PLI outline entitled "Selected Federal Income Tax Issues in Corporate Debt Restructurings."

**Rafael Kariyev, Counsel, Debevoise & Plimpton LLP**

- Mr. Kariyev is a member of the Tax Department whose practice focuses on M&A transactions for private equity and corporate clients, as well as acquisition financing and private fund formation.

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