Katten

TRANSACTIONAL TAX PLANNING ADVISORY

Tax Implications of Debt Restructuring and Workouts During Difficult Times

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KEY POINTS

As economic pressure intensifies on borrowers, we anticipate debt restructuring and workout transactions will become increasingly necessary. Similarly, dislocations in the debt markets may present opportunities for borrowers or their affiliates to acquire debt instruments that may be trading at substantial discounts. These transactions may have significant federal and state income tax implications, including cancellation of indebtedness income (CODI) that may exacerbate the financial distress of a corporate borrower or the owners of a "flow-through" entity. This advisory discusses:

- Certain tax consequences of modifying debt instruments and debt repayments or acquisitions.
- Related planning techniques that may be useful during difficult economic times.

How Amendments to Debt Instruments May Cause CODI

Pursuant to Treasury regulations governing modifications of debt instruments, many common amendments to existing debt instruments (e.g., change in interest rate, reduction of principal, extension of maturity date or deferral of interest payments) will cause a deemed exchange of the old debt instrument for a deemed new debt instrument. The applicable rules are generally intended to result in a deemed exchange whenever an economically significant modification has taken place. Fortunately, there are several bright-line tests that provide a fair measure of certainty in most cases. For example, changes in yield that exceed the greater of 25 basis points and 5 percent of the annual yield on the unmodified debt instrument will result in a deemed exchange.

If a modification of a debt instrument is a "significant modification" pursuant to the applicable Treasury regulations, the federal income tax consequences of the deemed exchange are generally determined by comparing the issue price of the new debt instrument to the adjusted issue price of the old debt instrument.[1] If the new debt instrument's issue price is less than the old debt instrument's adjusted issue price, the transaction is treated as if the old debt instrument was satisfied at a discount, and the discount is generally CODI.

[1] Generally, the adjusted issue price of a debt instrument is the original issue price plus the amount of any accrued original issue discount (OID) and decreased by the amount of payments previously made on the debt instrument other than qualified stated interest.

For debt instruments that are publicly traded, if a deemed exchange as a result of an amendment occurs at a time when the trading price of the applicable debt is depressed, the issue price of the deemed new debt instrument will be determined based on the depressed trading price. Thus, the borrower could have a significant amount of CODI. Whether a debt instrument is "publicly traded" depends on the circumstances, but almost all debt instruments having a CUSIP number are likely publicly traded for this purpose. However, there is a safe harbor such that any debt instrument that is part of a debt issuance that does not exceed $100 million is not treated as publicly traded.

An amendment resulting in a deemed exchange may have other collateral consequences, particularly for lenders who may have a taxable gain on such deemed exchange. Other potential issues include (1) the conversion of market discount into OID which can result in "phantom" income for lenders, (2) potential new or increased limitations on borrower deductions for interest and unamortized debt issuance costs, and (3) lack of fungibility (i.e., the ability to trade interchangeably) of the deemed new debt instrument with other unmodified debt instruments from the same issuance (if any), which may impact trading liquidity.

Mitigating the Impact of CODI

CODI is included in the borrower's gross income, unless a specific exclusion applies. In a distressed environment, we expect many borrowers may seek to rely on the applicable bankruptcy and insolvency exclusions. The bankruptcy exclusion applies to the extent the CODI occurs in a title 11 case, and the discharge is granted by the bankruptcy court or pursuant to a bankruptcy plan approved by the court. The insolvency exclusion applies to the extent the borrower is insolvent, measured by reference to the excess of the liabilities of the borrower over the fair market value of the borrower's assets immediately before the applicable discharge, whether or not the borrower is in bankruptcy.

The bankruptcy and insolvency exclusions allow borrowers to exclude CODI from gross income, but this comes at the cost of tax attribute reduction. Generally, tax attributes are reduced in the following order: NOLs, general business credits (e.g., work opportunity credits, rehabilitation credits and energy credits), capital loss carryovers, asset basis, passive activity loss and credit carryovers, and foreign tax credit carryovers. If preferred, the borrower may elect to reduce the basis of depreciable property first. Traditionally, this election has been useful in cases in which the borrower has depreciable asset basis with which to absorb any reduction and would prefer to conserve its NOLs, which may be viewed as relatively more valuable if anticipated to be utilized more quickly than the depreciable asset basis in the future.[2] In light of the 80 percent limitation on the utilization of carryover NOLs (generally suspended by the CARES Act for 2018, 2019 and 2020, but returning in 2021), taxpayers should carefully model whether the election to first reduce the basis of depreciable property may be worthwhile based on their particular circumstances.

Significantly, the tax attribute reduction described above is limited, subject to certain exceptions, such that the tax basis of the borrower is not reduced below the liabilities of the borrower immediately after the CODI event (the so-called "liability floor"). As a result, in some cases, the quantum of the tax attribute reduction may be less (sometimes significantly less) than the excluded CODI. This excess CODI that is excluded but does not reduce tax attributes is referred to as "black hole" CODI and represents a permanent benefit to the borrower when available. The incurrence of "black hole" CODI in the context of consolidated groups of corporations can create special problems and should be carefully evaluated.

Application of CODI Exclusions to Insolvent/Bankrupt Partnerships — Conversion to a C-Corporation

Debt restructurings and workouts involving borrowers taxed as partnerships for federal income tax purposes present special CODI concerns. Tax partnerships (including limited liability companies that have not elected to

[2] Notably, the determination of the tax attributes subject to reduction is generally made after determining the borrower's tax for the tax year of the CODI event. As a result, borrowers that have or expect to have NOLs eligible for the expanded 5-year carryback under the CARES Act may be able to utilize such NOLs to obtain a refund with respect to prior tax years rather than losing such NOLs through tax attribute reduction.

be taxed as corporations for federal income tax purposes) are generally not subject to entity-level federal income taxes. Instead, the partners of the applicable partnership are taxed on their distributive share of the partnership's taxable income on a "flow-through" basis. In addition, for purposes of the exclusions discussed above, insolvency and bankruptcy are measured at the partner level rather than at the partnership level. Therefore, CODI incurred by an insolvent or bankrupt partnership will not be excluded from taxable income by the partners unless the partners themselves satisfy the insolvency and/or bankruptcy requirements.

As a result, a partnership facing financial difficulties may want to consider, ideally well in advance of any debt restructuring, converting from a partnership to a corporation for federal income tax purposes.[3] Any such conversion effectuated via a "check the box" election or an actual state law conversion or merger would present complicated issues and should be carefully evaluated for tax and non-tax risks. For example, the transaction itself may be taxable to the partners if the liabilities of the partnership exceed its tax basis in assets, could result in a step-down in tax basis in assets if there is an aggregate built-in loss in the partnership's assets and/or may be subject to challenge by the Internal Revenue Service under a special anti-abuse rule.

Acquisitions or Refinancing of Debt at a Discount

In light of depressed debt trading prices, (1) borrowers may consider repurchasing their own debt or refinancing such debt at a discount, and (2) private equity firms or their affiliates may consider purchasing debt of their portfolio companies as an investment. These transactions can have significant tax consequences for the applicable borrower/ portfolio company and should be carefully analyzed.

If a portfolio company repurchases its own debt for less than the amount owed, subject to the exclusions discussed previously, the portfolio company will recognize CODI generally equal to the difference between the adjusted issue price and the repurchase or refinancing price of the debt.[4] To the extent the portfolio company has or expects to have NOLs or can otherwise exclude such CODI through the applicable CODI bankruptcy or insolvency exclusions, the cash tax impact from the CODI inclusion may be mitigated. Taxpayers should carefully consider the timing of any such transaction in light of the expanded ability to carryback NOLs under the CARES Act and the 80 percent limitation on the utilization of carryover NOLs (generally suspended by the CARES Act for 2018, 2019 and 2020, but returning in 2021).

Similarly, the acquisition of portfolio company debt by a related party of the borrower (e.g., the investment fund that owns the portfolio company or an affiliate of the borrower's private equity sponsor, potentially including another investment fund of the sponsor) generally would be treated as if the portfolio company had repurchased its own debt at a discount and issued a new debt instrument having an issue price equal to the purchase price paid by the related party. This transaction would generate CODI to the portfolio company as described in the paragraph above. Additionally, the discount on the new debt instrument would constitute OID that is required to be included as "phantom" income by the related party as it accrues over the remaining term of the debt instrument. The portfolio company and the related party could be subject to other adverse consequences (e.g., the new debt instrument may no longer be fungible with the remaining debt in the original issue, and there may be new or increased limitations on borrower deductions for interest and unamortized debt issuance costs on the new debt instrument).

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[3] For smaller businesses anticipating a rebound in equity valuations, a collateral benefit of a corporate conversion is the potential eligibility for the exclusion from gross income for gain from the sale of qualified small business stock (QSBS). For this purpose, a small business is one with gross assets not in excess of $50 million before and immediately after the issuance of the applicable stock. This exclusion may be available on a per-taxpayer basis to the former partners with respect to QSBS held for more than five years up to the greater of (a) $10 million or (b) 10 times the taxpayer's original adjusted tax basis in the QSBS sold. Note, real estate, banking and financial services, and certain other businesses are not eligible, and there are additional significant requirements and limitations on the availability of this exclusion.

[4] In a debt for equity exchange (i.e., a repurchase of debt using the borrower's equity rather than cash), the fair market value of the newly issued equity is generally treated as the repurchase price; however, there is a special rule applicable to contributions of capital to a corporation that, if applicable, permits CODI to be measured based on the adjusted tax basis of the lender in the repurchased debt instrument.

For this purpose, a related party is generally one that is related by more than 50 percent overlapping beneficial ownership. However, the applicable attribution rules are complex. In certain circumstances, a portfolio company debt acquisition may be structured in a manner that does not trigger the related party debt acquisition rules even if there is substantial overlapping beneficial ownership. Any such planning needs to be tailored to the applicable situation to address interest deductibility on debt owed to a related party, withholding concerns on debt owed to foreigners, and other issues that may arise.

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