PUBLICATION

Modification of Debt Instruments May Have Tax Consequences, Part 5

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Employers during these difficult economic times are sharply focused on various ways to protect their cash reserves. Some employers with significant debt, however, have little if any remaining cash reserves and are in arrears with their lenders. Increasingly, employers in such dire circumstances have approached their lenders with hopes of modifying the underlying debt instruments as one potential way to regain adequate cash flow for survival.

Borrowers and lenders alike must be mindful of the possible tax consequences from modifying debt instruments.

Background

The applicable tax rules have their genesis in the savings and loan crisis that followed the enactment of the Tax Reform Act of 1986 and the consequent devaluation of real estate. Thrift institutions found themselves with illiquid real estate loans worth less than face value. At that time it was common for thrifts to hold their loans until maturity.

The agencies then regulating thrift institutions devised a plan to generate losses which could be carried back to profitable years, thus generating tax refunds. That plan was for thrifts to bundle portfolios of real estate loans and exchange them for similar portfolios bundled by other thrifts having similar characteristics but different borrowers. Needless to say, the IRS was hostile to and contested many of these plans.

The issue found its way to the U.S. Supreme Court. The 1991 decision of the Supreme Court, which some termed the "hair trigger" test, held that any change in the named borrower or in the makeup of the collateral constituted a "sale or exchange" of the debt instrument, which was a tax recognition event. Where the value of the portfolios received was less than the tax basis of the portfolios exchanged, there was a deductible loss which the debt holder could carry back to profitable years, thus generating a tax refund.

In response, the IRS began a regulatory project which resulted in a comprehensive set of regulations published in 1996. See Treasury Regulation § 1.1001-3.

Lender's Perspective

There are two concepts which are relevant from the lender's perspective in determining whether a modification to a debt instrument will be considered a taxable event, to wit: (a) has there been a modification in the debt instrument, and (b) if so, is the modification significant? In general, a modification includes any deletion or addition of a legal right or obligation, other than most changes occurring by operation of the express terms of the debt instrument (such as a change in the rate of interest by virtue of the interest rate being set by reference to an index).

Regulations issued by the IRS in 1996 address when the modification is significant. Changes are significant where, for instance, there is a reduction in yield (other than as provided in the debt instrument); a material alteration in timing of payments; a change in identity of the borrower; a reduction in quality or grade of security or credit enhancement (e.g. the substitution of a letter of credit from a bank rated AA to a bank rated bbb); or a change in the nature of the debt instrument that results in the debt instrument being classified as equity. When the foregoing occurs, the lender experiences a tax recognition event.

Given the general decline in property values and credit quality, virtually all modifications of debt instruments will result in the modified debt instrument having a value less than its basis for tax purposes, resulting in the possibility of a deductible loss.

Borrower's Perspective

Cancellation of Debt. From the borrower's perspective, the typical change that creates a tax consequence for the borrower is the reduction in the amount of debt. Federal tax law has long provided that a cancellation of debt (COD) will result in taxable income unless an exception applies.

In analyzing whether an exception is available to prevent COD from resulting in taxable income to an otherwise cash strapped employer, it is important to know whether the debt instrument is recourse or non-recourse. In essence, a nonrecourse debt instrument generally limits the borrower's liability to the value of the collateral itself. The borrower on a recourse debt is personally obligated regardless of a decline in the value of collateral.

If property is conveyed to a lender in satisfaction of a recourse debt, the borrower has COD income equal to the amount of the debt over the value of the property. If the debt is non-recourse, the excess of the amount of the debt over the tax basis of the property is gain and not COD income.

The principal exceptions to the requirement of including COD income in taxable income include the following:

- The debt discharge occurs in a Chapter 11 bankruptcy reorganization case;
- The debt discharge occurs when the borrower is insolvent;
- The debt discharged is "qualified farm indebtedness;"
- In the case of a borrower other than a C corporation, the indebtedness discharged is "qualified real property indebtedness"; and
- The indebtedness discharged is "qualified principal residence indebtedness" which is discharged before the year 2013.

Should one of these exceptions apply, the COD is not considered as taxable income -- although other tax attributes associated with the borrower or with the subject collateral are required to be reduced. The main attributes that require adjustment in such circumstances include net operating loss carryovers, the tax basis of depreciable property and tax credits.

Borrower's Reacquisition of Debt. In the present business climate, many debt obligations (even of solvent debtors) are worth less than face value. Where feasible, many borrowers are negotiating (either directly or through a related party) with the debt holder to acquire their debt at less than face value. Such an acquisition will generally result in COD taxable income. However, if such debt acquisition occurs in 2009 or 2010, the American Recovery and Reinvestment Tax Act of 2009 allows the debtor to elect that COD income be included ratably over a five-year period. If such an election is made, the exceptions to having to include COD income in taxable income will not apply. This special rule could be of value to debtors whose debt instruments are owned by failed financial institutions as the regulatory authorities frequently sell the debt instruments held by failed financial institutions for a fraction of face value.

Summary

For employers in the role of borrowers, a modification of outstanding debt can potentially provide a source of reprieve and hope in specific qualifying circumstances. However, even where available, the employer must be aware of possible resulting tax consequences. Employers who are lenders must also be aware of tax consequences resulting from such modifications, although such modifications in today's economic climate generally result in losses for the lender.