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Overview of the Federal Income Tax Consequences of Defaults and Restructurings Under Loan Agreements

Businesses of all types are facing many challenges and uncertainties as a result of the dramatic economic and social forces at work in our current economic environment. In many cases, one of those areas of uncertainty involves the renegotiation of economic obligations undertaken in much different times. It doesn't take a Cassandra to realize that there will be a period of significantly more defaults under debt instruments than previously. Unfortunately, without careful planning, defaults and restructurings may also have negative tax consequences that can exacerbate economic hardships. Borrowers and lenders need to understand whether there are tax consequences to their defaults and debt restructurings. In particular, they need to appreciate upfront the tax rules that can permit more tax efficient restructurings.

At Cozen O'Connor, we have worked with our clients through economic downturns throughout our legal careers, representing both borrowers and lenders, to achieve tax-efficient solutions. With that background, we decided to publish a series of short papers intended to alert borrowers and lenders to some of the significant tax issues presented by attempts to restructure and renegotiate debtor/creditor relationships, whether by modifying the terms of the economic arrangement or restructuring the arrangement in its entirety. This paper tries to identify those issues at a high level. With the advent of private equity funds as an important source of credit in recent years, some tax issues that borrowers might have been able to ignore in earlier crises are far more important and can complicate loan adjustments and workouts. Borrowers and lenders need to be alert to the effect of the changed lending landscape on the tools available to restructure borrower/lender relationships.

This paper summarizes the consequences to lenders and borrowers from defaults and restructurings. It is no substitute for tax and legal advice addressed to your specific circumstances and does not take into account the CARES Act or other proposals pending in Congress for a significant fiscal stimulus.

Subsequent papers will look at those issues from the point of view of landlords and tenants, will discuss the tax issues involved in purchasing distressed debt at a discount, and will summarize IRS guidance on restructuring tax-exempt bonds without the risk of triggering adverse tax consequences by causing the bonds to be deemed "reissued" and, therefore, refunded.

First, Some Basic Rules

In general, the mere occurrence of a default in payment under a loan does not cause the borrower to recognize income or gain for income tax purposes. Generally, the borrower recognizes income from the cancellation of indebtedness (COD Income) only where there is some identifiable event indicating that the debt and/or interest on the debt will never be paid by the borrower in full, such as a bona fide settlement agreement between borrower and the holder of the debt. Absent some identifiable event, or one of the circumstances described below, the borrower does not recognize COD Income as a result of a default in payment of the debt.

The Code and Regulations provide that certain adjustments or revisions to the terms of a debt instrument, referred to as "substantial modifications," result in the constructive exchange of the old debt instrument for a new debt instrument and may also result in the borrower recognizing COD Income in certain circumstances. In the constructive exchange, the borrower is treated as satisfying the old debt with an amount of money equal to the "issue price" (not face amount) of the new debt. If the issue price of the new note, computed in accordance with these rules, is less than the outstanding balance of the old note, COD Income is recognized by the borrower to the extent of the difference. There are complex rules for determining the issue price of the new debt

instrument. In the usual case, however, the issue price of the new instrument will be the present value of the payments under the modified debt determined using a rate of interest based on the applicable federal rate.

What is a significant modification for these purposes?

A modification is any change, e.g., a deletion or addition, of a legal right or obligation of the borrower or a holder of a debt instrument, other than a change made in accordance with the terms of the debt instrument, e.g., resetting of the interest rate based on the value of an index. As described in more detail below, agreeing to extend the maturity of a debt obligation is a modification. The IRS Regulations state clearly that the mere failure of the borrower to perform its obligations under a debt instrument, e.g., to make payments when due, is not itself an alteration of a legal right or obligation and is not a modification.

For example, the substitution of a new borrower, the addition or deletion of a co-borrower, or a change (in whole or in part) in the recourse nature of the instrument (from recourse to nonrecourse or from nonrecourse to recourse) is a modification for these purposes.

An agreement by the debt holder to stay collection or temporarily waive an acceleration clause or similar default right (including such a waiver following the exercise of a right to demand payment in full) is not a modification unless the period of deferral or delay exceeds certain specified time periods. The safe harbor period in the Regulations for a deferral that does not lead to a modification is:

1. Two years following the borrower's initial default, **plus**
2. Any additional period during which the parties conduct good faith negotiations or during which the borrower is in a Title 11 or similar case.

As a practical matter and for so long as the parties negotiate in good faith, no modification can occur during the time that the parties continue to work out the terms of the defaulted obligation.

The modification occurs for tax purposes when the parties *enter into* the agreement, even if the change is not effective immediately. Therefore, if the parties agree unconditionally to reduce the interest rate or forgive a portion of the principal of the debt at a future point in time, the modification is deemed to take effect immediately. The parties cannot delay the date of the modification by imposing closing conditions that are other than reasonable conditions, e.g., lender consents. In that case, the modification occurs when the closing occurs.

What makes a modification "significant"?

In short, the change must be significant economically. The two most common changes that give rise to "significant modifications" in debt restructuring debts are:

Changes in the yield of the debt — A change in yield is significant if it is greater than the yield of the old debt instrument by more than the greater of: (i) 25 basis points or (ii) 5 percent of the yield on the old debt.

Changes in timing of payments under the debt — A change in the timing of the payments under the debt instrument, e.g., a deferral of the payments or the extension of the maturity date, is significant if it results in a material change in the payment terms. Under a safe harbor, if the deferred payments are unconditionally payable no later than the due date of the first deferred payment **plus** a period equal to the lesser of five years or 50 percent of the original term of the instrument, the deferral is not significant.

The substitution of a new borrower on recourse debt is a significant modification because it can change fundamentally the credit on which the lender is relying for payment. The substitution of a new obligor on nonrecourse debt is not a significant modification, although it could have other important tax consequences. The focus in these cases is changes in the parties' "payment expectations." That is, by virtue of changing the obligor or the collateral, have you increased or decreased the likelihood that the debt will be paid. A change in payment expectations often arises from the addition of collateral securing a nonrecourse debt.

Although the modification of a debt instrument that causes the instrument to be classified as equity,

in whole or in part, rather than debt is a significant modification, absent a substitution of a new obligor or the addition or deletion of a co-obligor, any deterioration in the financial condition of the borrower is not taken into account in determining whether the modified instrument is properly characterized as debt. This continues the theme of the Regulations and case law, that the mere deterioration in the financial condition of the borrower, without more, does not divest the borrower of the ownership of the property securing the debt or make the lender a partner for income tax purposes.

Why do we care whether a debt is modified significantly?

If you are the borrower, you care because of the possibility of recognizing COD Income as a result of the deemed exchange of the old debt for the modified debt. If you are the holder of the debt, you care because it could give rise to a taxable loss immediately and put you in the position of recognizing original issue discount (**OID**) going forward.

In addition to the deemed exchange discussed below, a debt restructuring could result in the lender being treated as a partner in or with the borrower.

How do the rules work in the case of a borrower under a loan made to a business entity for cash where that loan is not publicly traded and becomes a distressed loan? Borrowers that are taxed as partnerships need to be cautious of such a result. The loss of the debt from the adjusted basis of the members of the borrower as a result of its reclassification as equity could result in the immediate recognition of taxable gain to those members. This is a significant risk in the case of members with deficit tax capital accounts. Deficit tax capital accounts often are found where the borrower refinanced its loans and distributed excess proceeds to its members.

The lender is usually also very concerned about such reclassification. If the loan was reclassified, in whole or in part, the borrower could find itself subject to a new tax withholding obligation if members of the lender (now an equity holder) were non-U.S. persons. A borrower might have been indifferent to withholding when the obligation was merely a debt instrument on account of the so-called portfolio interest rules that generally absolve the borrower from any withholding obligation for payments of interest on such debt. The reclassification of the obligation to equity, however, could impose an additional periodic cost on the borrower and its members.

The old loan is treated as exchanged for a new debt instrument. The payments under the new debt instrument are then tested to determine whether the issue price of the new debt plus the fair market value of any property, stock and cash received by the lender in satisfaction of the old debt is less than the adjusted issue price of the old debt (basically, the outstanding balance plus accrued interest).

Example: XYZ LLC is the borrower under a $10 million nonrecourse debt obligation held by SG LLC (an unrelated person) requiring payments of interest at a fixed rate and the balance of the loan at its maturity. XYZ and SG enter into a restructuring at a time when the loan has an adjusted issue price of $12 million. XYZ and SG amend and restate the debt so that no fixed payment is required to be paid during the next 48 months, at which time the loan matures and the entire outstanding balance ($12 million — no additional interest) is due. SG is also entitled to periodic payments of interest based on the available cash flow of XYZ. (Assume that the debt is debt for income tax purposes.) The parties expect that, if the business stabilizes, there will be payments based on the cash flow of XYZ.

On those facts, a “fixed to-contingent-debt restructuring,” and assuming that the long-term AFR was 2 percent, the borrower would recognize about $466,000 of COD Income as a result of the restructuring. This occurs because the contingent payments, regardless of the likelihood of payment, are ignored in computing the issue price of the new debt instrument. Therefore, the “imputed issue price” of the new debt instrument is less than the adjusted issue price of the old debt and COD Income therefore results. This is but a single example of the complexities of these rules in restructuring debt obligations.

What about the lender in the above case? Can the lender experience an adverse tax result or does the lender simply recognize a taxable loss? On the above facts, the lender would recognize a taxable loss. The loss would be a bad debt and, unless the lender was in the trade or business of making loans, the loss would be a capital loss. Further, because the new debt is treated as having

been issued with OID (excess of the amount payable at maturity over the issue price), the lender would recognize ordinary income in the form of OID over the remaining term of the loan, in addition to income/gain on the receipt of any contingent payments.

It has been the long-standing position of the IRS that the accrual of the OID is required for income tax purposes, regardless of the collectability of the deferred interest. On the other hand, practitioners generally believe that doubt as to the collectability of the OID can, in appropriate cases, be a basis for not accruing the income. The failure to accrue the OID must be based on annual determinations regarding the value of any security for the debt and the financial condition of the borrower.

Lenders that are taxed as partnerships for income tax purposes generally cannot take the position that they are engaged in a trade or business if they have non-U.S. partners or tax-exempt partners such as pension funds, either directly or through one or more flow-through investor entities. If the lenders were engaged in a U.S. trade or business, their income could be classified as income effectively connected with a U.S. trade or business, subject to withholding and taxable to the non-U.S. investors, and as income from an unrelated trade or business, taxable to U.S. tax-exempt entities. This adverse tax consequence can reduce the flexibility such lenders have to be creative in restructuring loans.

In addition, the interest payments in the above example that are based on cash flow of the borrower would not be exempt from withholding as "portfolio interest," so that, as a practical matter, debt holders that include non-U.S. persons (e.g., debt funds) are unlikely to be receptive to a structure that moves interest that would be portfolio interest to interest that is no longer eligible for the exclusion from U.S. withholding.

Restructuring the debt to provide the holder with warrants can be problematic as well. The portfolio interest exemption is not available in the case of debt held by a 10 percent owner of the borrower. In the case where the borrower is a partnership for U.S. tax purposes, attribution of ownership rules apply to determine whether the person making the loan is treated as a 10 percent owner. For example, an option (in the form of a warrant) to acquire a greater than 10 percent ownership interest that is granted in connection with the restructuring and held by the lender would be treated as exercised for this purpose. Thus, giving the lender some form of conversion right into a greater-than-10 percent ownership interest would cost the lender the advantage of the portfolio interest exemption. A well advised lender would likely want to recover that as part of the restructuring.

Restructuring the loan in a way that the loan is converted, in whole or in part, to equity creates the risk that the lender would be treated as engaged in a U.S. trade or business, thereby requiring all of its non-U.S. members to report income that is effectively connected with a U.S. trade or business and its U.S. tax-exempt members to report taxable income from an unrelated trade or business.

Non-U.S. and tax-exempt members of debt funds must be careful regarding the manner in which the funds attempt to restructure debt owed by U.S. businesses organized as LLCs and partnerships. Under the so-called noncompensatory partnership option regulations, the IRS can recharacterize certain options or warrants (or other rights to acquire an equity position in a business or assert managerial control) as constructively issued partnership interests, with the consequence that the debt holder is treated as a partner in a U.S. trade or business with its attendant tax issues for non-U.S. and tax-exempt persons.

Suppose that the debt is modified significantly and cod income is generated for the borrower. can't the borrower just reduce its adjusted basis in its property and elect to exclude the cod income from gross income?

The short answer is, in a lot of common situations, a qualified "maybe." In order to exclude COD Income from a borrower's gross income, the borrower and the debt must meet certain conditions. Although an "insolvent" corporate borrower can exclude COD Income from gross income (to the extent not rendered solvent), rules for partnerships and LLCs are different. The availability of the insolvency exception is measured at the partner/member level, not the entity level, in the case of a

partnership or LLC classified as a partnership. That means the gross income from the COD Income is an item of income on the information return provided by the partnership or LLC and it is up to the partner/member to find an applicable exclusion.

The rules for S corporations are a hybrid. The S corporation is not a taxpaying entity, so that COD Income flows through ratably to its shareholders, but applicability of the insolvency exception is determined at the S corporation level. COD Income of an S corporation that falls within one of the exclusions from gross income is not passed through to the shareholders.

A real estate owner that borrowed to finance the acquisition, construction, or improvement of real property can elect to reduce the adjusted tax basis of its depreciable improvements, but only to the extent of the excess of: (i) the outstanding amount of the debt immediately before the debt discharge or modification giving rise to COD Income, over (ii) the FMV of the property (reduced by any other qualified debt secured by the property). A partner can elect to treat a portion of her partnership interest as depreciable property and make the basis reduction (which flows through to the partnership).

In the case of real estate acquired or recently financed, one key landmine pops up in cases where the debt was refinanced and the excess proceeds distributed by the borrower to its members for use in other transactions or for individual investment purposes. The excess refinancing proceeds would not be qualified real property business indebtedness in that case and the basis reduction rules otherwise available to avoid COD Income would be unavailable.

In addition to the possible federal pitfalls, state and local income tax regimes may not permit the COD Income to be excluded. For example, there may be no exclusion for COD Income under the Pennsylvania Personal Income Tax (because Pennsylvania law does not recognize an equivalent to the exclusion for COD Income from “qualified real property business indebtedness”) and, for the purposes of the Philadelphia Business income and Receipts Tax (BIRT), partnerships that have elected to report their BIRT based on their federal taxable income will find the federal rules require that the full amount of the COD Income be reported as an item of partnership income to the members by the partnership. The members individually make their elections to exclude COD Income, if available. There is no mechanism to avoid reporting the gross income for BIRT purposes or to reduce the adjusted basis of the depreciable property owned by the entity.

Summary

Because of the multiplicity of lenders in the current market and the extent that debt was relied upon, rather than equity, to shape more tax-efficient capital structures, restructuring debt is now more complicated than at any point in the past. There are numerous obstacles to completing a successful restructuring without incurring an unfavorable income tax result for the lender and the borrower. Successfully negotiating all but the most plain vanilla restructurings requires understanding not only the tax objectives and limitations of your position (as lender or borrower) but also the tax objectives and limitations of the other party.