



# Restructuring of indebtedness: US tax points

This briefing explains the US tax consequences of restructuring debt instruments – particularly distressed debt – from both the debtor's and the creditor's perspectives. Debtors may recognise cancellation of debt income from restructurings but exceptions may apply to prevent current taxation. Holders may recognise losses, which generally would be ordinary losses for banks and capital losses (which cannot offset ordinary operating income) for non-bank creditors.

This briefing provides only general information, not advice on which you can rely to avoid US tax penalties.

## Is it debt for US tax purposes?

The threshold question in determining the US federal income tax consequences of restructuring an instrument is whether it is debt for tax purposes. An instrument may be debt for accounting or legal purposes and not be debt for US federal income tax purposes. This briefing considers only the consequences of modifying, otherwise restructuring or settling instruments that are debt for US tax purposes. Whether an instrument is debt for those purposes is based on a number of factors developed by the courts and tax authorities that include not only legal form but also the existence of creditor's rights, payment expectations, issuer's structure, maturity, yield and overlapping ownership with equity. This is a 'facts and circumstances' test, applied as of the date of issuance and not as of the later date of restructuring or settlement.

## Debtor side

### Repurchases of outstanding debt obligations for cash and debt waivers

If a debtor repurchases or settles its outstanding debt at a discount, it generally realises cancellation of debt (COD) income. The amount of COD income generally equals the excess of the initial issue price (adjusted by repayments of principal and accrued issue discount or premium), together with any accrued but unpaid interest, over the payment made to retire the debt.

The acquisition of a debt instrument by a person related to the debtor from an unrelated person is treated as an acquisition by the debtor for this purpose, and thus can result in COD income. If a person acquires a debt instrument in anticipation of becoming related to the debtor, the transaction in which that person becomes related to the debtor is treated as an indirect acquisition of the debt instrument by a related party. Any acquisition of debt within six months of becoming related to the debtor is deemed to be in anticipation of becoming related. The amount of COD income is generally measured by reference to the price paid for the debt instrument by the related party or, in certain circumstances, the instrument's fair market value. Since a debt instrument that is acquired by a related person is not actually retired but remains outstanding, it is treated as reissued at a price equal to the amount used to measure the debtor's COD income. The new debt instrument will have original issue discount (OID) equal to any excess of the total amount payable under the new debt instrument (other than certain stated interest) over this issue price. Subject to certain limitations, OID is deductible to the debtor as it accrues.

### Debt-for-debt exchanges

When a debtor exchanges one debt instrument for another, it is treated as having settled the original debt instrument with an amount of money equal to the issue price (as determined for US federal income tax purposes)

of the new debt instrument. If the new debt instrument is publicly traded,<sup>1</sup> its issue price is its fair market value on the date of issuance. If the new debt instrument is not publicly traded but the original debt instrument was, the issue price of the new debt instrument is the fair market value of the original debt instrument on the date of the exchange. Where neither instrument is publicly traded but the interest rate on the new debt instrument at least equals the US Treasury's borrowing rate (the 'applicable federal rate', as published monthly by the Treasury) at the time of issue, the issue price is generally the stated principal amount of the new debt instrument. If neither instrument is publicly traded and the new instrument does not bear interest at least at that rate, its issue price is determined by discounting payments on the instrument at that rate. The new debt instrument will have OID equal to any excess of the total amount payable under the new debt instrument (other than certain stated interest) over its issue price. An exchange of a debt that is publicly traded and trading at a discount will therefore result in the new debt instrument having OID, which may be substantial.

Under special rules governing applicable high yield discount obligations (AHYDOs) the issuer of such an instrument may not deduct accrued OID to the extent it exceeds the applicable federal rate plus 6 per cent and may deduct accrued OID below this rate only when actually paid. An AHYDO is any debt obligation that has a term of more than five years, a yield to maturity of at least the applicable federal rate plus 5 per cent and 'significant OID'.<sup>2</sup> Recently enacted legislation suspends these rules for debt instruments issued in many debt-for-debt exchanges (including deemed exchanges) of instruments that were not AHYDOs when issued, provided the exchange occurs before 1 January 2010. However, the suspension does not apply to debt obligations acquired by related parties.

### **Certain amendments of the terms and conditions treated as debt-for-debt exchanges**

Certain modifications of the terms of an existing debt instrument that change the legal rights of the parties in an economically significant way are treated for US federal income tax purposes as deemed exchanges of the original debt instrument for a reissued debt instrument. Significant modifications include:

- a change in the yield of a debt instrument. Generally, a change in yield of more than the greater of 25 basis points and 0.05 times the original annual yield is significant;
- a change in the timing of payments that results in the material deferral of scheduled payments due under the instrument. A deferral that does not exceed a safe harbour period equal to the lesser of five years and 50 per cent of the original term of the instrument is not material for this purpose, provided all deferred amounts are unconditionally payable no later than at the end of the safe harbour period;
- the substitution of a new obligor on a recourse debt instrument, except where the new obligor is a successor corporation in a reorganisation or has acquired substantially all the assets of the original obligor and there has been no change in payment expectations on the debt instrument. The filing of a bankruptcy petition does not result by itself in a change of obligor;
- the addition or deletion of a co-obligor if it results in a change in payment expectations on the debt instrument;
- the release, substitution, addition or other alteration of the collateral for, a guarantee on, or another form of credit enhancement for a recourse debt instrument if the modification results in a change in payment expectations;
- the release, substitution, addition or other alteration of a substantial portion of the collateral for, a guarantee on, or another form of credit enhancement for a nonrecourse debt instrument. The substitution of fungible collateral does not, however, constitute a significant modification;
- a change in the priority of the debt if it results in a change in payment expectations;

<sup>1</sup> In addition to exchange-listed securities, publicly traded securities for this purpose include securities appearing on a quotation medium of general circulation (such as computer listings disseminated to brokers, dealers and traders) and, subject to certain exceptions, securities for which price quotes are readily available from dealers, brokers or traders.

<sup>2</sup> An instrument has 'significant OID' if accrued OID (and interest) remaining unpaid as of the first payment date after the fifth anniversary of issuance exceeds the sum of (i) interest payable on that date and (ii) the product of the yield and the instrument's issue price. Thus, AHYDO treatment can generally be avoided by requiring payments to 'catch up' to within the first year's worth of OID on the instrument by the first payment date after the fifth anniversary of issuance.

- a change in the nature of the debt instrument from (substantially all) recourse to (substantially all) nonrecourse or vice versa. Legal defeasance of a debt instrument therefore constitutes a significant modification; and
- a change causing the instrument no longer to qualify as debt for US federal income tax purposes.

For these purposes, a change in payment expectations occurs if there is (1) a substantial enhancement (from primarily speculative to adequate) or (2) a substantial deterioration (from adequate to primarily speculative), in each case, of the obligor's capacity to meet payment obligations. In general, if an instrument has an investment grade rating, the obligor's capacity should be viewed as adequate for these purposes but if an instrument has a below investment grade rating, the obligor's capacity should be viewed as primarily speculative.

Certain other changes are not considered 'modifications', or if they are, are not considered 'significant'. These include:

- a change in the terms of a debt instrument occurring under the original terms of the instrument other than (1) a change in obligor (including co-obligor), (2) a change in the recourse nature of the instrument, (3) a conversion to equity or (4) a change resulting from the exercise of an option other than certain unilateral options;
- a change of obligor on a nonrecourse debt instrument;
- an addition, deletion or alteration of customary accounting or financial covenants; and
- the issuer's failure to perform or a holder's temporary forbearance.

### **Debt-for-equity exchanges**

If a debtor corporation transfers stock or a debtor partnership transfers a partnership interest in satisfaction of a debt instrument, the debtor is treated as having satisfied its indebtedness with an amount of money equal to the fair market value of the transferred equity interest. Therefore, the debtor will generally recognise COD income if the face amount of the exchanged debt exceeds the fair market value of the transferred equity interest.

### **Contributions to capital**

If a debtor corporation receives its own indebtedness as a capital contribution from a shareholder, the debtor is treated as having satisfied the indebtedness with an amount of money equal to the shareholder's adjusted basis in the indebtedness. Generally, a shareholder who has lent money or transferred property to a corporation in exchange for a debt instrument will have a basis equal to the face of the debt (subject to rules governing amortisation of discount or premium). If the shareholder's basis in the debt is less than its face amount, however, the debtor corporation will recognise COD income. That may be the case if the shareholder bought the debt in the secondary market.

### **Exceptions from current taxation of COD income**

COD income does not include amounts the payment of which would have given rise to a deduction, such as accrued interest expense for which the debtor has not yet taken a deduction.

A reduction in a debt owed by a solvent purchaser of property to the seller of that property is treated as a purchase price adjustment and not as a transaction giving rise to COD income.

COD income of a debtor subject to bankruptcy proceedings or of an insolvent debtor (but only to the extent of its insolvency) is not taxed. However, the debtor is required to reduce its tax attributes (including net operating losses, tax credits, capital loss carryovers and asset bases), which may have the practical effect of simply deferring taxation.

Recently enacted legislation permits a corporation or, with respect to business debts, any other taxpayer irrevocably to elect to defer COD income recognised as a result of repurchases of its own debt, actual or deemed debt-for-debt exchanges, debt-for-equity exchanges, contributions of debt to capital or forgiveness of debt, in each case occurring during 2009 and 2010. Deferred amounts must be included ratably over five taxable years beginning in the taxpayer's 2014 taxable year. If a debtor elects to defer COD income, OID deductions on any debt instrument issued or deemed issued in exchange for the cancelled obligation will be deferred and then taken into account over the same five-year period. Deferred income

and deductions will generally be accelerated if the electing taxpayer liquidates or sells substantially all of its assets (including in bankruptcy) or ceases to do business. If a taxpayer elects to apply this deferral provision, it will not be permitted to apply the bankruptcy or insolvency exception with respect to the same debt instrument for the year of realisation or any later taxable year.

### **Opportunity to ‘freshen’ tax losses**

A (deemed) debt-for-debt exchange of publicly traded debt trading at a discount (or another (deemed) exchange resulting in the reissuance of new debt at a discount) can present an opportunity for the debtor to refresh its tax losses. As discussed above, the (deemed) exchange would give rise to COD income, which could be offset currently by the net operating losses of the debtor or its consolidated group, which might otherwise expire unused. Since the reissued instrument would be issued with OID, the debtor then should be able to benefit from increased deductions over the life of the deemed new instrument in an amount equal to the COD income recognised.

## **Creditor side**

### **Repurchases, debt-for-debt exchanges and write-offs**

The holder of a debt instrument generally recognizes gain or loss on the sale or exchange of the debt instrument equal to the difference between the amount realized and the holder’s adjusted basis in the debt instrument. In the case of a debt-for-debt exchange (including a deemed exchange resulting from a modification of terms, as discussed above), the amount realised attributable to the new (or deemed new) debt instrument is its issue price. As explained above, that is generally fair market value if either the ‘old’ or ‘new’ instrument is publicly traded, and otherwise is face value if the new instrument has adequate stated interest. Thus, in measuring the holder’s loss – as in measuring the issuer’s income – it is critical to determine if the debt is publicly traded either before or after the exchange.

The holder of a debt instrument that is repurchased (or deemed repurchased, in a debt-for-debt exchange) at a discount will generally recognize a capital loss on the

repurchase. Corporations can only use capital losses to offset capital gains and individuals can use capital losses to offset capital gains plus a fixed dollar amount of ordinary income. Capital losses not usable because of these limits can be carried forward indefinitely by individuals and, by corporations, forward five years and back three years. Dealers, banks or persons holding debts that are trade accounts receivable will recognise an ordinary loss that can be used to offset operating income.

If a corporation or, with respect to business debts, a non-corporate creditor forgives or otherwise writes off a wholly or partially worthless loan or other debt obligation that is not in the form of a bond, note or certificate with interest coupons or in registered form (a ‘debt security’), it will generally recognise an ordinary loss. To prove the existence and time of (partial) worthlessness may require extensive development of factual information. Worthlessness is presumed, however, when a bank or other regulated corporation writes off a debt under orders of, or a policy established by, a supervising authority.

If a ‘debt security’ becomes worthless, a creditor will generally recognise a capital loss, except that the loss will be ordinary to the extent it is attributable to accrued interest. A loss cannot be taken merely because of a decline in market value but a taxpayer may claim a loss if it abandons the debt security. Losses on worthless bonds and other debt securities are ordinary in the hands of banks and of certain US corporations affiliated with a US or foreign corporate debtor.

### **Debt-for-debt recapitalisations**

If an exchange (including a deemed exchange) of a debt instrument for a new debt instrument qualifies as a recapitalisation that is a corporate reorganisation, the holder will not recognise loss. In general, an exchange of a corporate debt instrument treated as a ‘security’ for another such instrument or for shares would be treated as such a recapitalisation. Securities received in exchange for accrued interest may be treated as a payment of that interest. While a number of factors are relevant in determining if a debt instrument is a ‘security’ for this purpose,<sup>3</sup> under a widely used rule of thumb,

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<sup>3</sup> The meaning of ‘security’ for this purpose is not the same as the meaning of ‘debt security’ for purposes of the rules just discussed that determine if losses are ordinary or capital although the two may often overlap.

instruments with an initial term of at least five years are generally considered securities. If an exchange (including a deemed exchange) qualifies as a reorganisation, the holder's adjusted basis in the original debt carries over to the new instrument and the holding period of the new instrument will include the holding period of the original debt.

### Debt-for-equity exchanges

If a holder receives stock for debt with accrued interest, any stock received for the accrued interest may be treated as a payment of that interest.

If a holder transfers a debt instrument that qualifies as a security to its corporate issuer in exchange for stock, the holder will not recognise a loss. The holder's adjusted basis in the transferred security carries over to the new stock and the holding period of the stock will include the holding period of the transferred security.

If a creditor transfers a debt instrument that is not a security to its corporate issuer in exchange for stock, the transfer is treated as a taxable sale or exchange so that, subject to certain limitations (including that the transferor is not related in certain ways), a loss may be allowed.

### Consequences to holder going forward

If the holder of a debt instrument receives or is deemed to receive a new debt instrument and that debt instrument is (deemed) issued with OID, the holder will be required to accrue OID currently at the new instrument's yield to maturity. Accrual is required even if the debtor elects to defer COD income and therefore is required to defer OID deductions or if the issuer's deductions are denied and/or deferred under rules governing AHYDOs. A US corporate holder, however, may claim a dividends-received deduction for the portion of OID on an AHYDO for which a deduction is denied to the extent that the amount would have been treated as a dividend had it been distributed with respect to the issuer's stock.

If a holder exchanges a debt instrument for preferred stock that is subject to mandatory redemption, a holder put option or certain issuer calls, in each case at a more than *de minimis* premium over issue price, the holder will be required to take this premium into income currently (applying OID principles) as constructive dividends.

### Disadvantage to holder of recognising loss on debt-for-debt exchange

As described above, many creditors will recognize a capital loss on a debt-for-debt exchange. Going forward, this loss will be offset by increased OID income, which is ordinary income and so cannot be offset by capital losses (except to a limited extent in the case of individuals). Thus, unless the holder can treat the loss as ordinary or use capital losses in the year of the exchange or within the permitted carry-over periods, it may suffer a permanent tax disadvantage from a debt-for-debt exchange. Exchanges of publicly traded debt instruments will be most likely to create this disadvantage since the issue price of the reissued debt instrument will be determined by the trading price of the instrument. That price may be substantially lower than the face amount, resulting in a correspondingly high amount of OID.

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