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M&A Tax Talk

US Debt Modification Tax Rules

Why a company could realize "phantom" taxable income from minor modifications to the terms of its debt

Your issue

If you are modifying or restructuring existing debt, you may be surprised to learn that your company could realize cancellation of debt income (CODI) when the debt is modified, even though the amount owed on the debt is not reduced. This result can occur when the debt is considered to be "publicly traded" for tax purposes and has a trading price that is less than par.

Given the broad definition of "publicly traded" under the tax rules, many debt instruments are treated as publicly traded, including revolvers. This increases the likelihood that a "significant modification" of the debt would result in "phantom income" to the debtor company.

As discussed below, in a deemed debt-for-debt exchange that occurs when the terms of the debt are sufficiently altered, the CODI is generally taxable if the debtor does not otherwise qualify for a full or partial exclusion (i.e., debtor is either insolvent or in a Chapter 11 proceeding). If the taxpayer has net operating losses (NOLs) or other tax attributes, those tax attributes may be available to offset the resulting CODI included in taxable income, but only to the extent the tax attributes are not subject to any restrictions on use.

Significant modifications and deemed debt-for-debt exchanges

When the terms of a debt instrument are modified, the modification must be tested to determine if it is "significant" under the relevant tax rules. In the case of a "significant modification," the outstanding debt is deemed to be retired in exchange for an amount equal to the "issue price" of the modified debt. The rules governing when a modification of outstanding debt is a "significant modification" are complex and may be tripped by a number of common types of modifications, including the payment of consent fees to cure a covenant default or the deferral of payments on a debt instrument.

Why "publicly traded" classification matters

The tax rules for determining the issue price of a debt instrument issued for property draw a distinction between publicly traded and non–publicly traded debt. The distinction is particularly important when a debt-for-debt exchange is taking place, including a deemed exchange resulting from a "significant modification" of the terms of an existing debt instrument, as described above.

If the debt is not treated as publicly traded, the issue price of the new debt is generally equal to its stated principal amount, and the taxpayer is treated as retiring the old debt for new debt with the same principal amount. As a result, the taxpayer would only have CODI to the extent the modification results in an actual reduction in the principal of the debt.

In contrast, if the terms of a publicly traded debt instrument are "significantly modified," the issue price of the new debt is determined generally based upon the fair market value of the new debt (based upon the trading or quoted price). Consequently, the issuer may have CODI (at the time of the exchange) and an offsetting amount of original issue discount (OID) (in the future). The OID is generally treated as deductible interest expense, but would be subject to interest expense limitation provisions described below.

Potential interplay with interest limitation rules

Any future deductions for OID as it accrues would be subject to several rules that may limit the ability of the borrower to deduct the future OID as interest expense, including section 163(j) and potentially the rules governing applicable high yield discount obligations (AHYDOs). As illustrated below, these interest limitation rules, including section 163(j), could apply in a manner that effectively results in a permanent disallowance of the future OID interest deductions (i.e., no offset to the CODI included as part of the deemed exchange).

Illustration

DebtCo has a publicly traded debt instrument with $200 outstanding and a maturity date at the end of year 5. At the end of year 1, the debt is modified and treated as retired for a new debt instrument with a fair market value of $100. Assume that DebtCo's section 163(j) limit is $15 per year, based on 30 percent of DebtCo's adjusted taxable income. As a result, DebtCo has CODI of $100 in year 1 and $100 of OID that would be interest expense in years 2–5.* However, this deduction would be subject to limitation under section 163(j) in each of those years. If the taxpayer does not generate sufficient adjusted taxable income in future years, the disallowed section 163(j) OID interest would never be deducted by DebtCo.

* For simplicity purposes, we have reflected the OID being amortized on a straight-line basis rather than the yield-to-maturity method.

		Income (deduction)	163(j) carryforward
Year 1	CODI	$100	
Year 2	$25 OID	($15)	$10
Year 3	$25 OID	($15)	$10
Year 4	$25 OID	($15)	$10
Year 5	$25 OID	($15)	$10
		$40	**$40**

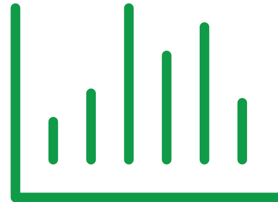
Publicly traded determination

The criteria for determining whether a debt instrument is publicly traded was expanded in 2012. Debt can be treated as publicly traded if there are available (i) sales prices for actual trades or (ii) firm or indicative price quotes from a broker, dealer, or pricing service. Prices or quotes are only taken into account if they apply with respect to the 31-day period beginning 15 days before the transaction date and ending 15 days after the transaction date.

If debt is publicly traded, the sales price or price quote will generally be used to determine the fair market value of the debt. In certain cases, if the pricing information is incomplete or inconsistent, the taxpayer may use a reasonable method to determine the fair market value. However, if there are no sales prices or firm price quotes available, the taxpayer may disregard an indicative price quote in determining fair market value if the indicative price quotes (or average) materially misrepresent the fair market value of the instrument. In such case, the taxpayer would determine the fair market value by using a method that more accurately reflects the fair market value of the instrument than the indicative price quote (or quotes).

Many bonds and bank loans issued by companies will be considered publicly traded under these rules. Frequently, private placement debt, syndicated bank loans, and revolvers have some quotations available in the marketplace. For example, syndicated bank loans frequently appear on loan-pricing services.

The regulations provide an important exception for small debt issuances with an outstanding principal amount of not more than $100 million at the time of issuance (or at the time a deemed exchange takes place). If an instrument meets the small debt exception, by definition it will not be treated as publicly traded under the regulations.



Other considerations

The regulations impose reporting requirements on debt issuers. If an issuer determines that debt is publicly traded, the issuer is required to disclose that determination (and the fair market value or the issue price) to the holders within 90 days of issuance by using any commercially reasonable method, including electronic publication. Each such determination by the issuer is binding on a holder unless the holder discloses a contrary position on a timely filed tax return. Further, in the case of a debt-for-debt exchange, the borrower is also generally required to file IRS Form 8937 to provide certain information to the debtholders.

Conclusion

If your company is modifying or restructuring existing debt, it is important that an analysis be performed to determine whether a "significant modification" has occurred and whether the debt is "publicly traded," as this could result in unexpected income inclusions for tax purposes.

Want to learn more?
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