# Key Tax Implications Of Debt Restructuring During COVID-19

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The global COVID-19 pandemic has placed an unprecedented stress on the ability of businesses to service their debt. Certain businesses — such as oil and gas, airline, cruise line, hospitality, brick-and-mortar retail, and small business generally — are being hit harder by the pandemic than others.

The vast majority of businesses expect to return to a normal pace once the uncertainty of this pandemic has subsided. Nevertheless, many of these businesses need some form of relief on their debt obligations in order to avoid triggering defaults, foreclosures and collection activity during this extraordinary period of economic inactivity.

The Coronavirus Aid, Relief, and Economic Security, or CARES, Act, signed by President Donald Trump on March 27, generally provides American individuals and businesses with multiple forms of economic relief. Of relevance to the workout discussion herein, the CARES Act provides relief to debtors with federally backed residential mortgage loans.[1]

In all other cases, debtors need to negotiate their own form of relief with their lenders. Debtors may find that their lenders are willing to work something out. If those lenders believe the borrower will be able to service the debt on some reasonable terms once the COVID-19 pandemic runs its course, restructuring the debt is very likely a better option than instituting foreclosure or collection proceedings. Generally it is in both parties' best interests to work something out.

There is no one way to structure a debt workout.

It can include one or more of the following features, among other things: (1) lender's agreement to forbear any foreclosure/collection efforts for a period of time following a failure to timely pay or meet financial covenants, (2) deferral of interest or principal amortization, (3) reduction of interest rate, (4) forgiveness of interest for a period of time, (5) reduction of principal obligation, (6) extension of maturity date, or (7) debtor's issuance of warrants or other equity interests to lender.

This article focuses on how the workout structure can be influenced by the federal income tax considerations for the parties.

For the distressed debtor, often the principal goal is to avoid cancellation of indebtedness, or COD, income or loss of valuable tax attributes. That goal may have greater or lesser significance depending on whether the debtor is insolvent or in bankruptcy, the extent of the debtor's net operating losses, or NOLs and the value of those NOLs beyond their availability to offset COD income.

For the lender, often the principal goal is to avoid creating original issue discount, or OID, on the restructured debt or otherwise incurring taxable income without receiving cash.[2] Whether COD income and OID are generated from the workout generally requires that, first, the debt undergo a significant modification and, second, the debt be publicly traded. COD income and OID also could be generated from a workout of non-publicly traded debt if the debtor issues warrants or other equity interests to the lender.

**COD Income and Other Debtor Concerns**

As a general matter, COD income arises if a debtor repurchases its debt for an amount less than the adjusted issue price of the outstanding debt. The repurchase can occur through the retirement of debt, the transfer of property such as stock in exchange for the debt, or through the issuance of a new debt instrument.

However, whether there has been a discharge of indebtedness is not always as obvious as it appears. The repayment of debt for cash is relatively simple. COD income would be the difference between the adjusted issue price of the debt and the amount of cash used to repay the debt.

Similarly, when property is transferred in repayment of debt the debt is treated as repaid for the fair market value of the property transferred in satisfaction of the debt (although the rules can be different if the debt in question is nonrecourse). Where many of the complications arise is when debt is repaid with the issuance of a new debt instrument.

The repayment of debt with a new instrument raises two main questions.

The first question is whether a new debt instrument has been issued. As will be discussed in more detail below, the actual issuance of a new debt instrument is irrelevant. What matters is whether there has been a significant modification in the terms of the original debt.

If there is a significant modification then the old debt instrument is deemed to be exchanged for a new debt instrument. The second question is how to calculate the amount of COD income arising from the significant modification. When debt is repaid with the issuance of a new debt instrument, COD income is the difference between the adjusted issue price of the old debt instrument and the adjusted issue price of the new debt instrument.

If either the old or new debt instrument is publicly traded (see discussion below) then the old debt instrument is treated as being repaid for an amount equal to the fair market value (ordinarily the sales price or quoted price) of either the old or new debt instrument.

When neither the existing debt or new debt is publicly traded, then no COD income will arise so long as the old debt instrument and new debt instrument have an interest rate at least equal to the applicable federal rate, or AFR, and the principal amount does not change. Under this rule, due to the currently low AFR,[3] the parties could significantly reduce the interest rate of a debt instrument without giving rise to COD income so long as the principal amount remains unchanged.

If the debtor is not bankrupt or insolvent when the debt is cancelled, then the COD income is taxable ordinary income to the debtor. However, the debtor can reduce the tax on that income with any net operating losses from the current year or carried forward from previous years.

If, however, the debtor is insolvent or in bankruptcy at the time the COD income is recognized then some or all of the COD can be excluded from income. If the debtor is in bankruptcy, then all of the COD income is excluded. If the debtor is insolvent (based on the amount of debt in excess of the fair market value of the debtor) then the COD is excluded from income to the extent the taxpayer is insolvent.

For example, assume a debtor has $1,000 in assets and $1,500 of debt (i.e., is $500 insolvent). If $800 of debt is cancelled then the first $500 of COD income is excluded under the insolvency exception and the other $300 of COD income potentially is subject to tax.

However, as noted above, the debtor can use any of its net operating losses to reduce the tax on that income. Any amount of COD that is excluded from income under the bankruptcy or insolvency exceptions will reduce tax attributes such as any net operating losses remaining after those losses are used in the current year and tax basis in assets (subject to certain limits).

It is important to note that in the case of partnerships, the bankruptcy and insolvency exceptions are applied at the partner, rather than the partnership, level. Thus, COD income arising from a partnership in bankruptcy will only be excluded if the partner also is in bankruptcy.

It is relatively common for lenders modifying debt to insist on a warrant or other equity interest in the borrower as part of the workout package, allowing the lender to share in the upside when things turn around for the borrower.

If the warrant or other equity interest has no value at the time when it is issued then the COD analysis described above should not change. However, if the warrant or other equity interest has value, then it must be determined how to treat that amount.

If the debt is not modified enough to cause a significant modification, then the warrant or other equity interest likely would be treated as additional interest paid on the debt instrument, some type of fee paid by the debtor or possibly as a basis reduction transaction.

If there is a significant modification of the debt, then some portion of the new debt instrument would be treated as paid for the warrant or other equity interest (based on the relative fair market values of the debt and warrant/equity). Whether there is COD income on the deemed exchange would depend in part on the adjusted issue price of the new debt and the fair market value of the warrant or other equity interest received.

Although the main focus of the debtor is COD income, the debtor also has to consider other issues that can arise as a result of the significant modification. For example, if the interest rate on the new debt instrument is too high then the applicable high yield discount obligation rules can apply even if those rules did not apply when the original debt was issued.

The significant drop in the AFR means that the threshold to be subject to the applicable high yield discount obligation rules has dropped as well.

In addition, partnerships have to consider how the reduction in debt will affect the amount of debt allocated to particular partners.

**OID and Other Lender Concerns**

Two consequences arise for lenders when a change to a debt instrument in a workout is treated as a significant modification: (1) gain or loss could be triggered,[4] and (2) the new instrument could be treated as issued with OID.

A significant modification results in a deemed exchange of the old debt instrument for a deemed new debt instrument, which may be taxable to the lender to the extent the issue price of the new instrument exceeds the lender's adjusted tax basis in the instrument.

Again, the federal income tax consequences depend on whether the old debt instrument or the new debt instrument is treated as publicly traded as defined in the regulations (and as discussed in more detail below).[5] The potential consequences for a lender are best seen by way of example.

Assume a five-year debt instrument was issued at par on Feb. 1, 2018, for $1,000, and pays 5% fixed interest annually. Assume that in April 2020, the parties to the debt instrument agree to reduce the amount of interest payments going forward, and that this change results in a significant modification. Further, assume that the modified debt instrument has a fair market value of $900 at the time.

If either the original debt instrument or the new deemed reissued debt instrument is publicly traded, then the old debt instrument with a tax basis of $1,000 is treated as exchanged for the $900 fair market value of the new debt instrument.

Accordingly, a U.S. lender of such instrument could have a $100 loss. In addition, since the $900 is deemed to be the issue price of the instrument under the relevant regulations, there is $100 of OID on the new instrument.

Unless OID can be treated as de minimis, a U.S. lender of a deemed reissued instrument issued with OID would be required to accrue the $100 OID as additional interest income over the term of the debt. While a deductible loss can be beneficial, many lenders would rather avoid both the deductible loss and the taxable OID.

If neither the original debt instrument nor the deemed reissued debt instrument is publicly traded, then the old debt instrument with a tax basis of $1,000 is treated as exchanged for the $1,000 principal amount of the new instrument so long as yield on the new instrument exceeds the AFR.

Accordingly, a U.S. lender would not likely recognize gain or loss on the deemed reissuance. Note, however, if the U.S. lender had acquired the old debt instrument at a discount to its face amount, a workout resulting in a significant modification could cause the lender to recognize a gain to the extent the U.S. lender's adjusted tax basis was less than the $1,000 principal amount.

In addition, as discussed above, lenders may require some incentives to agree to a workout, such as a warrant or other equity in the workout.

The tax treatment to the lender depends on whether the debt is modified enough to cause a significant modification, and the value of the warrant or other equity interest. If the warrant or other equity interest has no current value, then there likely are no tax consequences to the lender.

To the extent the warrant or other equity interest has value but there is no significant modification of the debt, the lender could be taxed currently on that value; however, if there is a significant modification of the debt, the allocation of a portion of the new debt's issue price to the warrant or other equity interest will cause the new debt to have OID for the lender, even in cases where the old debt instrument was not publicly traded.

Separately, many non-U.S. entities invest in debt instruments of U.S. issuers. In many cases, care is taken to ensure that such investment activities do not cause a non-U.S. entity to be engaged in the U.S. trade or business. If a change in a debt instrument in a workout is a "significant modification," the instrument is treated as reissued for federal income tax purposes.

The question of whether a workout can result in a non-U.S. entity being treated as engaged in a U.S. trade or business is complex, fact specific and not necessary to delve into here, but as a general matter, frequency may create more risk.

**When Does a Significant Modification Occur?**

***Lender's Forbearance of Foreclosure or Collection Efforts***

The U.S. Department of the Treasury regulations provide a specific rule for when a forbearance will be treated as a significant modification. Under Treasury Regulation Section 1.1001-3(c)(4)(ii), a lender's agreement to stay collection does not result in a modification (and therefore not a significant modification) unless and until the forbearance period exceeds two years plus any additional period in which the parties are conducting good faith negotiations.

Because this provision is so generous, the mere forbearance by the lender to pursue foreclosure or collection rarely triggers a significant modification.

As mentioned, the CARES Act grants forbearance rights and protection against foreclosure to borrowers with a federally backed mortgage loan for residential housing.

First, under Section 4022 of the CARES Act, lenders of federally backed mortgage loans may not institute foreclosure proceedings during the 60-day period between March 18 and May 17.

Second, under Section 4022, debtors other than multifamily debtors (mortgages involving five or more units) are entitled to request forbearance from their lenders for up to two consecutive 180-day periods based on financial hardship, meaning that the debtors will not owe any payments of interest or principal for up to 12 months and lenders may not charge any fees, penalties or additional interest during that period.

Third, under Section 4023, multifamily debtors are entitled to request forbearance from their lenders for up to three consecutive 30-day periods based on financial hardship, providing they do not evict their tenants for nonpayment of rent during the forbearance period plus a 30-day notice period.

Note these forbearance periods generally only go up to 360 days, well within the period permitted by the regulations.[6]

Any forbearance, however, may also involves either an express or implied deferral of any interest or principal payments that are due. It is that deferral that has the potential for triggering a significant modification, as discussed in more detail below.

***Deferral of Interest***

A significant modification occurs if there is a material deferral of interest payments. The materiality of a deferral is generally determined based on the overall facts and circumstances.

However, a safe harbor provides that deferrals of payments within a period that begins on the due date of the first payment deferred and ends five years (or, if a lesser period, 50% of the original term of the debt instrument) later will not be a significant modification.[7] The unused portion of a deferral period may be used in respect of a subsequent deferral.

For example, assume a five-year debt instrument pays interest annually at the end of each year. If the first interest payment is deferred until the second interest payment date one year later, the deferral would not be a significant modification because the one-year deferral is less than 30 months (one-half of the original 60-month term). A subsequent payment could be deferred for 18 months without causing a significant modification (the original 30-month deferral term less the 12 months used in the first deferral).

If an interest payment is deferred until some date after the safe harbor period (e.g., at maturity of the debt), whether the deferral is a significant modification will depend on the facts and circumstances such as "the length of the deferral, the original term of the instruments, the amount of the payments that are deferred, and the time period between the modification and the actual deferral of the payments."[8]

Using our same example, assume the lender agrees that the first annual interest payment is not due until the five-year maturity date.

If it is concluded that this deferral is a significant modification, the deemed new debt will likely be an OID instrument (if it is not already one, e.g., as might occur when the old debt or new debt is publicly traded), subject to some exemptions for certain non-publicly traded debts of $1 million or less. That is because the interest payments on the new debt will no longer be qualified stated interest due to the double interest payments due at maturity.

Applying the OID rules in this situation may reduce the rate of interest accrued by accrual basis taxpayers on a going forward basis if the deferred interest payment does not itself accrue interest. The OID rules also force cash basis taxpayers to report the interest income or expense on an accrual basis and implicate some additional tax reporting requirements for the borrower.

Continuing our example, assume the annual interest rate is 5%, the stated principal of $1,000 is due at maturity, the parties agree on the first annual interest payment date to defer the first $50 interest payment to the maturity date, and the debt is not publicly traded.

The new debt requires payments of $50 at the end of years two, three and four, and a payment of $1,100 ($1,000 principal plus $100 of interest) at the end of year five. There is $250 of OID, equal to the excess of the $1,250 stated redemption price at maturity over the $1,000 issue price.

The interest rate, or yield to maturity, on the new debt is 4.812%,[9] which is used to determine the interest income and interest expense of the lender and debtor, respectively, for tax purposes.

Note that if the deferred payment due at maturity was $50 plus accrued interest at 5%, the yield to maturity would remain at 5%. Also note that the issue price of the new debt is the $1,000 stated principal amount because the yield exceeds the AFR.

***Deferral of Principal Amortization***

Whether a deferral of principal amortization is a significant modification is determined by the same safe harbor and facts-and-circumstances rules applicable to deferred interest payments. Unlike a deferral of interest, a deferral of principal amortization, by itself, will not cause a non-publicly traded, non-OID debt instrument to become an OID instrument.

***Reduction of Interest Rate***

A reduction in the interest rate results in a significant modification if the change in yield of the modified debt exceeds the greater of 25 basis points and 5% of the yield on the unmodified debt instrument. The yield of the modified debt is determined by comparing the adjusted issue price of the unmodified debt to the payments that are scheduled to be made on the modified debt from the date of modification.[10]

Again, using the same example, assume the parties agree on the first annual interest payment date to drop the 5% interest rate to 3%, starting with the first interest payment. This will be a significant modification because the 2% drop in yield exceeds 0.25% (5% of 5% interest rate).

However, the 3% interest payments will be qualified stated interest because they will continue to be owed on an annual basis, and the 3% rate is still above the AFR. Accordingly, the stated redemption price at maturity and the issue price of the new debt will each be $1,000, meaning the new debt will not become an OID instrument.

***Forgiveness of Interest for Period of Time***

Another possibility is that the lender agrees to not charge interest at all for the remainder of 2020 but otherwise not change the payment terms. There is first a question of how the parties treat the forgiveness of this interest obligation for tax purposes, apart from the question of whether a significant modification occurs.

Assume under our example that the debtor and lender are calendar year taxpayers, and the $1,000 debt was issued on Jan. 1. If the debtor is a cash basis taxpayer, the lender's forgiveness of debtor's obligation to pay $50 interest on Dec. 31 is not COD income on the theory that the debtor's payment of the interest would be deductible and, therefore, there is a wash of income and deduction.[11]

The same rule should apply if the debtor is an accrual basis taxpayer, even though debtor may have already accrued interest expense for the first part of 2020, on the theory that the accrued interest has not yet been claimed as a deduction on a tax return, and interest for the remainder of 2020 has not even been accrued.

For the accrual basis lender, there is a more complicated question of whether the accrued interest income for the first part of 2020 must be reported, and then offset by a deduction, or the lender can report zero income and deduction, similar to a cash basis lender, based on a similar "wash" theory.[12]

***Reduction of Principal Obligation***

Any reduction of the principal obligation will generate COD income to the extent of the reduction under general tax principles. Assume under our example that lender agrees to reduce the principal obligation due in five years to $700. That will generate $300 of COD income to the debtor and, generally, a $300 ordinary loss to the lender.

In this case, the question of whether the principal reduction caused a significant modification is somewhat of a moot point since taxable income and loss have already been triggered.

Nevertheless, a reduction of principal will cause a significant modification if the change in yield of the modified debt exceeds the greater of 25 basis points and 5% of the yield on the unmodified debt instrument. If the principal is reduced and the interest rate going forward is not increased, the yield on the modified debt instrument will necessarily be less than what it was.

***Extension of Maturity Date***

Whether an extension of the maturity date is a significant modification is determined by the same safe harbor and facts-and-circumstances rules applicable to deferred interest and principal amortization payments

**When Is Debt Considered Publicly Traded?**

As discussed above, the distinction of whether a debt instrument is publicly traded is pivotal in determining the federal income tax consequences to the parties of a workout that results in a significant modification.

A debt instrument is treated as publicly traded if at any time during the 31-day period ending 15 days after the issue date (or in the case of a workout that is treated as a significant modification, the deemed reissue date) there is available for the instrument (1) a sales price, (2) a firm quote, or (3) an indicative quote.

These rules were added to the regulations in 2012 under Section 1.1273-2(f), and are generally viewed to cast a wide net in terms of what can cause an instrument to be treated as publicly traded.

Keep in mind, no instrument (even if it falls into one of the below categories) is treated as publicly traded under the regulations if the outstanding principal amount of the issue that includes the debt instrument does not exceed $100 million.

***Sales Price***

A sales price exists if the price for an executed purchase or sale of the debt instrument is reasonably available within a reasonable period of time after the sale. For this purpose, the price of a debt instrument is considered reasonably available if the sales price appears in a medium that is made available to issuers of debt instruments, persons regularly purchasing or sell debt instruments, or persons brokering purchases or sales of debt instruments. For example, if a debt instrument’s price can be found on a Bloomberg terminal, it likely meets this definition.

***Firm Quote***

A debt instrument has a firm quote where a price quote is available from at least one broker, dealer, or pricing service (including a price provided only to certain customers or subscribers) for the debt instrument and the quoted price is substantially the same as the price for which the person receiving the quoted price could purchase or sell the instrument (i.e., where the quote functions as a firm quote as a matter of law or industry practice). Note that here, the identity of the person providing the quote must be reasonably ascertainable.

***Indicative Quote***

A debt instrument has an indicative quote when a price quote is available from at least one broker, dealer, or pricing service (including a price provided only to certain customers or subscribers) that is not necessarily substantially the same as the price at which the person receiving the quoted price could purchase or sell the instrument.

In general, it is up to the issuer of a debt instrument to make the determination of whether an instrument is publicly traded.[13] After making this determination, the issuer must make the information available to holders within 90 days of the issue date of the instrument in a commercially reasonable fashion (which can include electronic publication).

The issuer’s determination is generally binding on holders unless such holders disclose the reasoning behind a different determination on their federal income tax return.

**Looking Ahead**

Making modest adjustments to the terms of a debt instrument, even ones that are entirely reasonable in light of the COVID-19 pandemic, can introduce significant federal income tax complexity. Industry groups such as the Structured Finance Association have already asked the Internal Revenue Service for relief for certain COVID-related amendments.[14]

It is possible that the Internal Revenue Service could provide flexibility under Section 1.1001-3 for certain workout strategies, such as temporary forbearance or deferral of interest, if entered into in relation to the current pandemic. Unless the Internal Revenue Service issues guidance providing relief, a borrower and lender in a workout must craft their amendments with the above considerations in mind.

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[1] For an overview of the U.S. federal income tax relief in the CARES Act, see our Legal Update, available at https://www.mayerbrown.com/en/perspectives-events/publications/2020/03/us-tax-relief-in-cares-act. For a detailed discussion of the NOL relief provided in the CARES Act, see our Legal Update, available at https://www.mayerbrown.com/en/perspectives-events/publications/2020/03/cares-act-adds-five-year-carryback-period-and-suspends-80-limitation-for-2018-2019-and-2020-net-operating-losses.

[2] OID is generally the excess of all of the payments on the debt instrument, other than stated interest payments accruing at a single fixed rate (or certain variable rates) and unconditionally payable at least annually, over the issue price of the debt instrument.

[3] For reference, the mid-term AFR in April 2020 is 0.99%. The mid-term AFR in April 2019 was 2.55%. See the Internal Revenue Service index of AFR rulings, available at Treas. Reg. § 1.1001-3(e)(2) https://apps.irs.gov/app/picklist/list/federalRates.html/.

[4] However, the lender will not recognize gain or loss if the exchange (including a deemed exchange) of the old debt for the new debt is treated as a recapitalization under Code section 368(a)(1)(E) unless "boot" is involved. To be a recapitalization, the lender must exchange one "security" for another "security." Whether an instrument is a "security" depends on the facts and circumstances with term being a significant factor. Cf. Rev. Rul. 2004-78, I.R.B. 2004-31.

[5] See Treas. Reg. § 1.1273-2(b) and (c).

[6] Also, note that on April 13, 2020, the Internal Revenue Service released Rev. Proc. 2020-26, which provides specific guidance with respect to COVID-19 related forbearance and real estate mortgage investment conduits. A separate Legal Update covering this and other industry-specific federal tax considerations in the current distressed environment is forthcoming.

[7] Treas. Reg. § 1.1001-3(e)(3).

[8] Id.

[9] Yield to maturity is determined by a mathematical formula as the interest rate which, when used to determine the present value of all the payments on the debt instrument other than stated interest, will arrive at a present value equal to the issue price.

[10] Treas. Reg. § 1.1001-3(e)(2)

[11] I.R.C. § 108(e)(2).

[12] Cf. Rev. Rul. 80-361.

[13] See Treas. Reg. section 1.1273-2(f)(9).

[14] The Structured Finance Association letter is available at https://structuredfinance.org/wp-content/uploads/2020/04/SFA-letter-IRS-Treasury-Final.pdf.