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Navigating the Recession:

What Companies Need to Consider Today

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Finance: Issues for Corporate Borrowers in the Current Credit Markets

John Lawlor, Partner in Finance/Leveraged Finance
David Wiles, Partner in Finance/Leveraged Finance
Jim Barry, Partner in Tax Transactions

Overview of Topics Covered

- Amendments of Credit Agreements in Today's Markets – various issues and practices
- Issues raised by Defaulting Lenders
- Borrower "Buybacks" of Term Loans
- Cancellation of Debt Income - involved in loan buybacks, amendments of credit facilities, etc.

Amendments of Credit Agreements

- The amendment process for credit agreements has become very difficult as credit markets have tightened
- Many lenders look to amendment requests by borrowers as an opportunity to reprice deals to current market pricing
- Repricing can include the insertion of concepts to deal with pricing risks that have become apparent during the credit crunch, such as LIBOR floors to deal with volatility in LIBOR
- Lenders also seek to tighten restrictive covenants, in many instances taking away flexibility that was negotiated in better times

Amendments of Credit Agreements (cont'd)

- Cost of covenant relief (fees and spread) has increased as debt trading prices have suffered
- Recently, one-month LIBOR has often been below 1%, with three-month LIBOR and LIBORs for other durations also low
- Pricing on older deals often much lower than the prices that would attach to those deals if they were done today
- In new deals, borrowers and arrangers often need to provide investors in bank debt with pricing incentives, such a LIBOR floors
- LIBOR floor: loan always maintains a minimum yield no matter how low the London interbank offered rate goes
- In some deals, have even seen a Base Rate floor
- Borrowers also need to pay large one-time amendment fees to get amendments done

Amendments of Credit Agreements (cont'd)

- Lenders frequently use amendment requests as an opportunity to tighten (or eliminate) baskets in restrictive covenants (debt, liens, investments, dividends, etc.) that were negotiated earlier and are borrower-friendly
- Lenders concerned about cash payments to equity and junior creditors
- Lenders focused on reducing exposure (seeking amortization, increases in prepayments, through excess cash flow, asset sales or otherwise)
- Lenders will focus on improving their collateral position

Defaulting Lenders: Issues for Borrowers

- Certain lenders have defaulted in funding loan commitments under existing credit agreements
- Borrowers will not get all their money in terms of requested loans
- For LC facilities and swing lines, Borrowers may need to post cash collateral to cover the defaulting lender's share – also for fronted foreign currency facilities (meaning cash collateral must be posted in foreign currencies) – lenders who take inter-lender risk will want the Borrower to bear that risk
- Agents in current deals insist that interest and fees continue to be paid to lenders even if such lenders default due to pro rata sharing clause
- Need to examine on a contract by contract basis
- May be able to fix in an amendment (assuming requisite lender consent) or new deal – Hard to fix otherwise

Defaulting Lenders: Issues for Borrowers (cont'd)

- In some existing deals, Borrowers have right to remove defaulting lenders
  - May be required under the loan documents to replace with another lender, and *at par*, which may be difficult in the current market.
- In new deals, some borrowers are requesting the capability to remove defaulting lenders without replacing them. And some, for rights to replace defaulting agent banks, as well.
- Also in new deals, some borrowers are seeking additional provisions (a) to block payment of fees to any defaulting lenders, and (b) to permit borrower setoffs against any defaulting lender – among other rights.

Borrower "Buybacks" of Term Loans

Introduction and Overview

- Hot topic recently, as trading prices of term loans have dropped in the secondary market – in many cases, in the 80s, 70s or even lower. And even when these are good performing loans.
- Trend has continued over the past 12-18 months or more. Now, borrower "buybacks" of term loans have become a more established practice in the market.
- Initially, there was some resistance by Lenders and a "moral question" surrounded such buybacks, probably for several reasons: e.g., borrower purchases, at a discounted price, and non-pro rata paydown effect.
- Now, however, Agents/Arrangers and other Lenders are more comfortable with concept. Perhaps 26+ organized buybacks have occurred in the market.
- Borrower buybacks at a discount also have some appeal to Lenders: e.g., as a way to lower borrower debt/leverage levels, to reduce Lenders' exposures to a credit, and to provide more market liquidity for Lenders willing to sell.

Borrower Buybacks of Term Loans (cont'd)

Overview of Process

- Can generally be done in two different approaches, either through (a) a purchase of loans by assignment, or (b) a voluntary prepayment of loans (which seems to be more common today). Either one is done at a discounted price, and on a *non-pro rata* basis.
- Either approach typically requires a 3 or 4 step process: (i) Borrower approaches the Agent or Arranger to facilitate buybacks with Lenders; (ii) Borrower seeks amendment of credit agreement, as needed, to permit the transaction; (iii) Borrower then offers a series of tenders at a specified price or price range, inviting willing Lenders' to sell; and (iv) the prepayments or purchases occur, perhaps over several months.
- Transparent process: Most major Agent/Arranger Banks today require a "fair and transparent" process to manage the buyback transaction, including sharing all material information with all Lenders, offering same terms of buyback to all Lenders, and using a fair tender/auction process.

Borrower Buybacks of Term Loans (cont'd)

Quick Lenders Checklist – to guide Borrowers. Lenders generally expect the following to be true, which serve as a useful guide:

- Borrower has significant cash available to paydown or repurchase existing term loans, from:
  - Cash balances on hand
  - Equity contributions from Sponsor, if any
  - Subordinated loans from Sponsor
  - NOT from asset sales or draws on Revolver
- Tendered debt (if purchased) is usually retired and canceled. (And thus not held by Borrower or Sponsor, which would raise other issues.)
- Borrower is not at risk of violating its loan covenants – or using the buyback to avoid covenant default or excess cash-flow recapture requirements. (Lenders tend to reign this in, or would reject otherwise.)

Borrower Buybacks of Term Loans (cont'd)

Other Trends in these Amendments / Tenders.

- Typically, the Credit Agreement should provide a simple majority vote (51%) of Lenders is needed to amend and permit the non-pro rata paydown. 100% votes are difficult, but possible.
- Time Window for tenders – can range widely, from 45 or 90 days up to one year after the amendment is approved.
- Maximum total amount of loan buybacks – usually required by Lenders. Varies by deal size and other factors. Also affected by impact on Revolver.
- Number of Purchases and certain Increments – often required to buyback loans in $10MM or $5MM increments per tender. Also, watch out for "clean up" remainder below any increment amount.
- No right to withdraw: Typically, these are *irrevocable* tenders by the Borrower, and irrevocable offers to sell by willing Lenders.
- Agent banks, or its Arranger affiliate, usually are engaged by Borrowers to run and manage the tender process.

Borrower Buybacks of Term Loans (cont'd)

Other Trends in these Amendments / Tenders – cont'd.

- Process for Paydowns or Buybacks. Typically uses either (a) a specified price below par, such as 85; or (b) a specified price range or reverse Dutch Auction, e.g. 82-89. And in (b), there are different ways to accept or fill the bids in the range – could be that all Lenders' bids within the range are filled, pro rata, at the highest price of such bids, or that the lowest Lenders' bids are filled first.
- Disclosure of all Material Information. Borrowers should consider whether they possess material non-public information that should be disclosed to all Lenders in this process – e.g., where a tender and repurchase would seem to be unfair to some Lenders (as when the Borrower has information indicating the credit is improving). Same risk could apply to the Agent/Arranger bank.
  - In general, Borrowers and Agents should disclose all such material information.
- Other Operational Details with Agent: Agent may want to address several key details such as (i) advance notice provisions for tenders/offers to sell; (ii) timing to allow Agent to calculate interest and revised interest rates and amortization from such prepayments; and (iii) temporary cessation of par-loan assignments during any tender process.

Borrower Buybacks of Term Loans (cont'd)

Review of Document Issues –What's the Big Deal Anyway?

Buybacks often raise multiple issues in the Credit Agreement, including:

- Assignment provisions – typically will prohibit Borrower or its Affiliates from purchasing its own loans and becoming a "Lender". Fixing this requires an amendment or waiver, usually by a majority Lenders vote (e.g., 51% of Lender interests).
- Pro Rata Payments or Sharing provisions – often implicated. Require Borrower to make prepayments of loans on a *pro rata* basis among all term loan Lenders. Amending this is often required, and sometimes by a majority Lenders vote. Mostly requires a 100% Lenders vote.
  - Pro Rata Sharing language sometimes expressly captures purchases – e.g., including any payment "obtained by a Lender as consideration for the assignment of loans to Borrower."
- Source of Funds – Lenders typically will want to block use of any draws on a Revolver, and may expressly require other new or free sources of cash.

Borrower Buybacks of Term Loans (cont'd)

Review of Document Issues –What's the Big Deal Anyway? – cont'd

Buybacks often raise multiple issues in the Credit Agreement, including:

- Covenants, including financial covenants: such as Excess Cash Flow sweep, exclusion of taxable COD gain from Consolidated Net Income or EBITDA, and impact on Leverage Ratio by reducing term loans.
  - Lenders may exclude impact on Leverage ratios, for all or certain purposes.
  - Consider excluding impact on Excess Cash Flow sweep/repayment.
- Other Negative Covenants and impact, such as Permitted Investments or Restricted Payments?

Other Implications on Borrower – Tax Impact. See next section.

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Cancellation of Indebtedness Income

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James R. Barry
Mayer Brown LLP

Section 61 and COD Income

- Section 61: "gross income means all income from whatever source derived"
- Section 61(a)(12) specifically includes "income from discharge of indebtedness"
- Treas. Reg. Section 1.61-12 provides that discharge of indebtedness "may result in the realization of income"
  - Provides that on a repurchase of debt, the measure of realized income is the excess of the adjusted issue price over the repurchase price (Treas. Reg. Section 1.61-12(c)(2)(ii))
  - Repurchase at more than adjusted issue price may create a repurchase premium deduction (Treas. Reg. Section 1.61-12(c)(2)(iii))
- The general question is: As a result of the cancellation, modification, or repurchase of debt at a discount, has the taxpayer's balance sheet net worth improved (i.e., has there been an "accession to income")? See *United States v. Kirby Lumber Co.*, 284 U.S. 1 (1931)

What COD Income is **NOT**

- Rule No. 1: COD is a *residual* concept: It is what is left over that cannot otherwise be explained
- If the debt discharge can be explained in another way, it will be. For example, COD income is not:
  - Cancellation of employee debt by an employer, which is taxable to the employee as compensation (Treas. Reg. Section 1.61-12(a))
  - Cancellation of debt owed by a shareholder to his corporation, which is taxable as a distribution (Treas. Reg. Section 1.301-1(m))
  - Cancellation of debt owed by corporation to its shareholder, which is treated as capital contribution (Treas. Reg. Section 1.61-12(a)) (*see, however,* Section 108(e)(6) removing this treatment from Section 118 rules and providing special rule)
  - Cancellation of a pre-existing debt owed by a seller of property to the buyer if debt is cancelled in connection with the sale, which is treated as part of the purchase price of the property. Treas. Reg. Section 1.1001-2(a)(i) (sales price includes the amount of liabilities from which the seller is discharged)
- Rule No. 2: COD income will not arise unless the debt being discharged is fixed and determinable and was an absolute obligation that gave rise to a tax asset or deductible item (on the taxpayer's balance sheet). Thus, for example, COD does not arise from discharge of a contingent obligation.

Debt Exchanges

- When outstanding debt is exchanged (or deemed exchanged) for new debt then COD is recognized to extent "issue price" of new debt is less than "adjusted issue price" of old debt. IRC Sec. 108(e)(10). This is the alleged measure of the accession to wealth.
- Determination of Issue Price.
  - Publicly Traded Debt. Issue price is measured under section 1273(a)(1). First price at which a substantial amount of debt instruments is issued for money or, if issued in exchange for publicly traded property, the fair market value as of the date when a substantial amount of the debt instrument in the issue is traded.
    - Per Treas. Reg. § 1.1273-2(f), property is "traded on an established market" if at any time 30 days before or after the issue date:
      - It is traded on a registered national securities exchange or interdealer quotation system;
      - It is traded on a designated contract market or "interbank market;"
      - It "appears on a system of general circulation (including a computer listing disseminated to subscribing brokers, dealers, or traders) that provides a reasonable basis to determine fair market value by disseminating either recent price quotations (including rates, yields, or other pricing information) of one or more identified brokers, dealers, or traders or actual prices (including rates, yields, or other pricing information) of recent sales transactions (a quotation medium).
    - Temporary restrictions to avoid 30 day publicly traded rules are ignored.
    - Compare to FAS 157.
    - Bank debt and other non-traded debt now changes hands frequently and freely through Internet media, often unbeknownst to the issuer until it learns of such transfer after the fact. See Reuter's Loan Connector and Investinginbonds.com.
  - Nonpublicly Traded Debt. Issue price is principal amount of debt unless the debt does not bear adequate stated interest. IRC Sec. 1274.

Debt Modification Rules

- Whether there is an exchange of debt for tax purposes does not depend on whether a new debt instrument is issued. Instead there will be an exchange for tax purposes if there is a "significant modification" of the terms of the original debt instrument. Treas. Reg. Sec. 1.1001-3(a). First determine if there has been a modification and then whether the modification is significant.
- Modification: Generally includes any alteration of legal rights that is not pursuant to terms of instrument except:
  - Changes that always result in a modification, including a unilateral right.
    - Change in obligor, including an addition of co-obligor (e.g., an assumption of debt in an acquisition always is a modification even if permitted under debt terms);
    - Change in nature from recourse to nonrecourse and vice versa;
    - Change to instrument that is not debt (unless is conversion right of holder under terms of instrument);
  - Unilateral options unless the exercise by the holder's option results in a deferral or reduction in a scheduled payment of interest or principal or the exercise results in more than a de minimis amount of consideration;
  - Certain failures to perform;
  - Temporary forbearance unless the forbearance is more than two years (a longer period during a Title 11 or similar case); or
  - A failure to exercise an option.

Debt Modification Rules (cont'd)

- Significant Modification. Merely having a modification of the debt is not sufficient to cause a deemed exchange. The modification must be "significant". For this purpose must look at all modifications collectively.
- General Test: A modification is significant if, based on all facts and circumstances, the modification is "economically significant".
- Automatic Tests: The following modifications are always significant:
  - Change in Yield.
    - Test: A change in yield will be significant if the annual yield on the old debt increases by more than the greater of:
      - 25 basis points or
      - 5% of the annual yield of the old debt instrument.
    - Measurement: Base yield on adjusted issue price of old debt instrument and include all remaining payments on the debt instrument (including fees paid for covenant waivers, etc.).
    - Commercially reasonable prepayment penalties are not taken into account for this purpose.

Debt Modifications

- Automatic Tests (Con'd).
  - Changes in Payment Timing.
    - A change in timing will be significant if it results in a material deferral of scheduled payments.
    - Safe Harbor: The period beginning on the original due date of the first scheduled payment being deferred and ending on the period equal to the lesser of:
      - 5 years or
      - 50% of the original term of the debt instrument.
  - Change in Obligor. A substitution of an obligor on a recourse instrument will be a significant modification unless the change results from:
    - A section 381(a) transaction (i.e., a tax free reorganization or liquidation).
    - An acquisition of substantially all of the assets of the obligor coupled with no change in payment expectations.
    - Tax exempt bonds if related entity and same collateral.
    - Section 338 election.
    - Bankruptcy petition by itself.
  - Addition or Deletion of Co-obligor. Only significant if it results in a change of payment expectations.
  - Changes in Security or Credit Enhancement.
    - Recourse debt. Change in collateral or guarantee is significant if it results in a change in payment expectations.
    - Nonrecourse Debt. Significant if release, substitute, add or alters a significant amount of collateral unless the collateral is fungible.
  - Change in Nature of Debt Instrument.
    - Property that is not debt (more than mere deterioration)
    - Change in recourse nature.

Recourse vs. Nonrecourse Debt

- In foreclosure or similar situations, the debtor often surrenders its assets in cancellation of debt
- Tax treatment and application of COD rules vary dramatically depending on whether the debt cancelled is recourse or nonrecourse
- Recourse debt:
  - A liability is "recourse debt" if debtor remains liable for deficiency remaining after sale or transfer of the property securing the debt
  - With respect to recourse debt, taxpayer recognizes gain or loss on the transferred property equal to the difference between FMV of the property and its tax basis. The excess, if any, of the amount of the debt cancelled above the value of the collateral foreclosed upon is treated as COD income to which Section 108 applies, rather than as proceeds from the sale of the collateral (*Gehl v. Comm'r*, 102 T.C. 784 (1994), *aff'd* 50 F.3d 12 (8th Cir. 1995) (unpublished); *Danenberg v. Comm'r*, 73 T.C. 370 (1979), *acq.* 1980-2 C.B. 1); Treas. Reg. Section 1.1001-2(c))
- Nonrecourse debt:
  - A liability is "nonrecourse debt" if the lender has no recourse against the debtor for any deficiency remaining after the sale of the property securing the debt
  - With respect to nonrecourse debt, the entire amount of the cancelled debt is treated as proceeds from the disposition of the transferred property, even where the property is worth less than the amount cancelled. There is no COD income because the entire gain results from an exchange of property. (Treas. Reg. Section 1.1001-2(a)(1); Treas. Reg. Section 1.1001-2(c), Ex. 7; *Comm'r v. Tufts*, 461 U.S. 300 (1983); *Estate of Delman v. Comm'r*, 73 T.C. 15 (1979))

Recourse vs. Nonrecourse Debt (cont'd)

Example: Insolvent Debtor owes $100 to creditor. Debtor transfers property with a basis of $60 and a FMV of $70 to creditor in partial satisfaction of its debt:

- If debt is recourse:
  - Debtor's amount realized on the property transfer is $70, and debtor recognizes gain of $10 ($70 FMV minus $60 basis)
  - Debtor has COD income of $30 ($100 debt owed minus $70 FMV paid)
- If debt is nonrecourse:
  - Debtor's amount realized on the property transfer is $100, and debtor recognizes gain of $40 ($100 debt owed minus $60 basis)
  - No COD income

Treatment of COD under Section 108 – In General

Section 108(a) provides that COD income is excluded from gross income if either:

- "the discharge occurs in a Title 11 case" (the "Bankruptcy Exclusion") or
- "the discharge occurs when the taxpayer is insolvent" (the "Insolvency Exclusion")
- Certain other limited situations (qualified farm indebtedness; qualified real property business indebtedness of a non-C corporation; qualified principal residence indebtedness)

- Availability of Bankruptcy Exclusion and Insolvency Exclusion is determined on a separate entity basis (i.e. insolvent sub within otherwise solvent group still excludes COD income to extent of its insolvency). Exclusion is not, however, available to insolvent DRE if owner is solvent
- Under Section 108(b), amounts excluded from gross income under Section 108(a) are applied to reduce specified tax attributes of the debtor, including its NOLs and tax basis
- Section 108 thus generally sets up a deferral mechanism: exclusion of COD from gross income, but offsetting reduction of tax attributes

New Code Section 108(i) – COD Deferral

- Under the economic stimulus package, signed into law on February 17, 2009, taxpayers may elect to defer COD income for "applicable debt instruments" repurchased in 2009 and 2010 by the taxpayer or a related party.
- Subject to certain limitations and qualifications, an election will defer COD income for a period of five years for debt instruments repurchased in 2009 and four years for debt instruments repurchased in 2010.
- Partnerships must allocate the deferred income to the partners when the debt is repurchased; however the partners are permitted to defer any income or gain from the COD for the four or five year deferral period, as applicable.
- The term "applicable debt instruments" includes most bonds, debentures, notes or other forms of indebtedness issued by C corporations or other trades or businesses. The repurchase of indebtedness may be effectuated through a repurchase for cash, debt, or stock; a contribution of the debt to capital; or even the complete forgiveness of the debt by the holder.
- After the deferral period, the COD income is taken into taxable income ratably over a five year period. However, liquidation, cessation of business, sale of substantially all of the business assets, or bankruptcy will cause an acceleration of the deferred income to the taxable year in which such event occurs. This acceleration rule is expanded for pass-thru entities to include the sale, exchange, or redemption of an ownership interest in the pass-thru entity by an interest holder.

New Code Section 108(i) – COD Deferral (cont'd)

- The new provision also limits deductions of OID on debt instruments used to repurchase debt.
  - This OID can arise not only when a debt instrument is issued at a discount to produce the cash proceeds to repurchase the debt, but also when debt is repurchased by the issuance of new debt, is repurchased by a related party, or has its terms significantly modified. To the extent the new debt is, or is deemed to be, reissued at an amount less than the face value, such instrument may be recharacterized as a debt instrument issued with OID.
  - Generally, the debtors accrue a deduction for OID as interest expense over the life of the instrument. Under the new law, a debtor who makes a Section 108(i) election must defer some or all of such OID deductions for the years in which the COD income is deferred and, then, such deductions will be taken ratably over the following five years, subject to certain limitations. The deductions, however, will be accelerated in the same cases that COD income is accelerated, as discussed in the previous paragraph.
- An election to apply this new Section 108(i) eliminates the availability of certain other exceptions to the rules requiring the inclusion of COD income (see discussion below). For example, bankrupt or insolvent debtors are allowed to exclude COD income from their taxable income and never take it into account. Therefore, debtors who are at risk of becoming insolvent, filing for bankruptcy, or are otherwise entitled to another exclusion for COD income should consider whether the benefit of the deferral is preferable to the exclusion.

Insolvency Exclusion

- Definition of insolvency: “the excess of liabilities over fair market value of the assets” (Section 108(d)(3))
- Amount of COD income that can be excluded is limited by the amount of insolvency (Section 108(a)(3))
- Insolvency is measured immediately before discharge (Section 108(d)(3))
- Definition of “liabilities”
  - Liabilities for this purpose means adjusted issue price of debt, not its fair market value, e.g. the amount of nonrecourse debt that is discharged over the fair market value of the property securing the debt (“excess nonrecourse debt”) is considered a liability (Rev. Rul. 92-53)
  - Uncertainty regarding extent to which contingent liabilities are considered liabilities for this purpose. The Ninth Circuit held that a contingent obligation constitutes a liability under Section 108(d)(3) only when it is “more likely than not” that the taxpayer will be required to pay such liability (Merkel v. Comm’r, 192 F.3d 844 (9th Cir. 1999))
- Assets: includes both tangible and intangible assets
- Valuation of troubled companies is difficult and almost always requires an appraisal if company is relying on the Insolvency Exclusion

Bankruptcy Exclusion

- Bankruptcy Exception applies to exclude all COD income from income if:

  (i) the taxpayer is in bankruptcy under Title 11 of the USC and is under the jurisdiction of a bankruptcy court, and

  (ii) the discharge of debt is granted by the bankruptcy court or is pursuant to a bankruptcy plan confirmed by the bankruptcy court

- Applies whether or not the taxpayer is insolvent and excludes all COD income, eliminating problems with determining amount of insolvency

Statutory Exceptions to COD Income

- Lost deductions (Section 108(e)(2))
  - To the extent that payment of a liability would have given rise to a deduction by the debtor, no COD income is realized from the discharge of such liability
- Purchase money debt (Section 108(e)(5))
  - If debt owed by a buyer of property to the seller of such property is reduced, the reduction is not treated as COD income but as an adjustment of the purchase price, so long as the buyer is solvent
- Contributions to capital (Section 108(e)(6))
  - If a debtor corporation acquires its indebtedness from a shareholder as a contribution of capital, the debtor corporation is treated as having satisfied the indebtedness with an amount of money equal to the shareholder's adjusted basis in the debt. Any amount of debt in excess of the amount deemed satisfied is potential COD income
- Stock for debt Section 108(e)(8) (and extension to transfers of partnership interests)
  - If a debtor corporation transfers stock to a creditor in satisfaction of its indebtedness, the debtor corporation is treated as having satisfied the indebtedness with an amount of money equal to the fair market value of the stock (Section 108(e)(8)(A))
  - In 2004 as part of the American Jobs Creation Act of 2004, Section 108(e)(8) was extended to partnership interests: If a debtor partnership transfers a capital or profits interest in the partnership to a creditor in satisfaction of its indebtedness, the partnership is treated as having satisfied the indebtedness with an amount of money equal to the fair market value of the partnership interest (Section 108(e)(8)(B))

Overlap of Contribution-to-Capital and Stock-for-Debt Rules

- Example: Parent holds $100 of Sub debt with a basis of $50. Sub is solvent. Compare results if (1) Parent contributes the debt to Sub's Capital ($50 of COD if Section 108(e)(6) is applied) or (2) Sub issues $100 FMV of its stock to Parent in exchange for the debt (no COD if Section 108(c)(8) is applied)
  - What result in this case?
  - IRS has concluded that whether a transaction should be treated as a contribution to capital under Section 108(e)(6) or a stock for debt exchange under Section 108(e)(8) depends on the form of the transaction (PLR 9830002 (March 20, 1998); PLR 9018005 (November 15, 1989))
  - Compare with the "meaningless gesture" doctrine applicable in other wholly or commonly-owned contexts

Treatment of Partnerships, S Corps and Disregarded Entities

- Application of Section 108 to Partnerships:
  - Section 108(a) excluding COD income from gross income and Section 108(b) reducing tax attributes when COD income is excluded both apply at the partner level (§ 108(d)(6)). Also, test insolvency, bankruptcy at partner level, instead of entity level.
- Application of Section 108 to S Corporations:
  - Section 108(a) exclusion of COD income and Section 108(b) attribute reduction apply at the corporation level (§ 108(d)(7))
- Application of Section 108 to DREs – What if DRE is insolvent or bankrupt but owner is not?
  - Section 108 does not contemplate DREs, and there is uncertainty with respect to their treatment under Section 108
  - Insolvency Exception forgives indebtedness only if the taxpayer is insolvent (Section 108(a)(1)(B)), and because DRE owner and not DRE is taxpayer, it would seem that DRE's insolvency is irrelevant
  - By contrast, there may be an inconsistent result with respect to the application of the Bankruptcy Exception to DREs, because the Bankruptcy Exception does not require the Title 11 case to be the taxpayer's case (Section 108(a)(1)(A)), whereas the Insolvency Exception does. IRS, however, seems to think owner needs to be in bankruptcy for exception to apply

Attribute Reduction under Section 108(b)

If COD income is excluded under Section 108(a), it must be applied to reduce tax attributes in the following order under Section 108(b)(2):

1. Net operating losses (NOLs)
2. General business credits
3. Minimum tax credits
4. Capital loss carryovers
5. Tax basis in assets
6. Passive activity loss and credit carryovers
7. Foreign tax credits

Tax Basis Reduction

- In the case of the Bankruptcy Exception or the Insolvency Exception, tax basis in assets is reduced, but only to the extent of the excess of the taxpayer's aggregate bases in the property over its liabilities, both of which are calculated immediately after the discharge of indebtedness (Section 1017(b)(2)). Thus, basis reduction is limited to remaining outstanding liabilities.
- Basis of assets is reduced in the following order (Treas. Reg. Section 1.1017-1(a)):
  1. Real property used in trade or business or held for investment that secured the discharged indebtedness immediately before the discharge, other than real property under Section 1221(1))
  2. Personal property used in trade or business or held for investment that secured the discharged indebtedness immediately before the discharge, other than inventory, accounts receivable, and notes receivable
  3. Remaining property used in a trade or business or held for investment, other than inventory, accounts receivable, notes receivable, and real property described in Section 1221(1)
  4. Inventory, accounts receivable, notes receivable, and real property described in Section 1221(1)
  5. Property not used in a trade or business or held for investment
- To this extent, excluded COD is eventually picked up in income by reason of reduced depreciation or increased gain on sales
- Particular problems of “quick turn” assets (inventory and A/Rs)

Timing of Attribute Reduction

- Timing of attribute reduction
  - Attributes are reduced after determination of tax for the taxable year during which the excluded COD income is realized (Section 108(b)(4))
  - Only the basis of *property held* at the beginning of the taxable year *following* the year in which excluded COD income is realized is subject to reduction (Section 1017(a))
- Example: Corporation X is in bankruptcy. In 2008, X owes $400 to a creditor and has a $200 NOL, property with a basis and fair market value of $100, and no other tax attributes. In 2008, X is discharged of $300 of indebtedness under the bankruptcy plan.
  - If X does not sell its property in 2008: X will have $300 of COD income in 2008 that that will be applied first to reduce its NOL to zero and then to reduce the basis of its property to zero. If X then sells its property in 2009 for its $100 FMV, X will realize $100 of gain ($100 amount realized minus zero basis)
  - If X sells its property in 2008: X will have $300 of COD income in 2008 that will be applied to reduce its NOL to zero. X's property will not be subject to basis reduction because X did not hold the property at the beginning of 2009 (i.e. the "beginning of the taxable year following the year in which excluded COD income is realized"). Thus, X will not realize any gain on the sale of its property ($100 amount realized minus $100 basis)

Election to Reduce Basis First

- Election to reduce basis first
  - Debtor with COD income excluded under Section 108(a) may elect to first reduce basis in depreciable property before any other tax attributes are reduced under the normal ordering rules (Section 108(b)(5))
- Election to treat stock of consolidated group member as depreciable property
  - Stock of a subsidiary included in a consolidated return for the year in which the discharge occurs may be treated as depreciable property for this purpose, if the subsidiary consents to a corresponding reduction in the basis of its depreciable property (Section 1017(b)(3)(D))

“Black Hole” COD - Excluded COD Income in Excess of Attributes

- Amounts of COD excluded from gross income under Section 108(a) that exceed tax attributes (including tax basis in its assets) available for reduction are permanently excluded and never reflected in income
- There may, however, be collateral consequences in a consolidated group
- Note importance of the Section 1017(b)(2) cap on asset basis reduction – this cap may leave taxpayer with significant asset basis notwithstanding “Black Hole” COD

Application of COD Rules to Consolidated Group

- Insolvency Exclusion and Bankruptcy Exclusion to recognizing COD income are determined on a separate company basis (i.e. insolvent subsidiary within an otherwise solvent group still excludes COD income to extent of its insolvency)
- Consolidated return rules require that a tiering approach be applied to consolidated attribute reduction. If insolvent debtor member realizes COD income, tax attributes must be reduced in the following order (Treas. Reg. Section 1.1502-28(a)(2)-(4)):

1. Reduce tax attributes of the debtor member (other than asset basis)
2. Reduce basis of the debtor member's assets to the extent of the excess of the debtor member's aggregate bases over its liabilities, including stock of its subsidiaries
3. If the basis of stock of a subsidiary is reduced, the subsidiary must reduce its tax attributes (including tax basis in its own assets) as if it itself had realized excluded COD income equal to the amount of the basis reduction
4. Finally, any remaining COD is applied to reduce certain consolidated tax attributes attributable to other members of the group (but not asset basis of other members)

“Black Hole” COD and Excess Loss Accounts

- Generally – “Black Hole COD” – is excluded from income and there is no additional tax liability
- BUT there is an exception if there is an excess loss account (“ELA”) in the stock of the debtor member, because the existence of Black Hole COD will trigger into income all or part of any ELA
- What is an ELA?
  - Also referred to as “negative basis”
  - Designed to recapture economic/tax benefits that consolidated group receives from a subsidiary member (“S”) in excess of consolidated group’s investment in S
  - Under the “investment adjustment” rules of Treas. Reg. Section 1.1502-32, parent (“P”) must reduce its basis in S stock by certain items, including distributions with respect to S stock
  - When P reduces basis in S stock by so much that S stock basis turns negative, ELA is created
  - ELA does not generate tax liability until it is triggered
  - The existence of Black Hole COD is one of the triggers of an ELA
- If debtor member has ELA of 100M, but Black Hole COD of only 20M, is the entire 100M ELA triggered into income?
  - No. The ELA is only triggered to the extent of the Black Hole COD, so the ELA amount that is triggered and taxed is 20M (Treas. Reg. Section 1.1502-19(b)(1)(ii))

Related Party Debt

- If debt is acquired by a party related to the debtor from an unrelated creditor, the debt is treated as acquired by the debtor under Section 108(e)(4)
  - Acquisition results in realization of COD income to debtor, which is excludible from income to the extent provided under Section 108(a) (Treas. Reg. Section 1.108-2(a))
  - The amount of such COD income is the difference between the adjusted issue price of the debt and the purchase price paid by the holder (i.e. cost basis), if the debt was acquired in a "purchase" transaction (Treas. Reg. Section 1.108-2(f)(1))
  - The acquired debt is treated as new debt issued by the debtor to the related holder with an issue price equal to the purchase price of the acquired debt
  - For example, if a parent company purchases a $100 bond issued by its subsidiary for $90 on the open market, the subsidiary realizes $10 of COD income ($100 adjusted issue price less $90 purchase price). The acquired bond is treated as newly issued by the subsidiary to the parent for $90 (Treas. Reg. Section 1.108-2(g)(4), Ex. 1)
- Debt cancellation can also occur from indirect related party acquisitions
  - Indirect related party transactions are transactions in which the holder of the debt becomes related to the debtor, if the debt was acquired by the holder in anticipation of the relationship (Treas. Reg. Section 1.108-2(c))
  - In the event of an indirect related party acquisition, the cancellation event occurs when the relationship is established
  - The amount of COD income realized is either:
    (i) the difference between the adjusted issue price of the debt and the purchase price of the debt, if the debt was acquired by the related party in a purchase transaction within six months of the party becoming related to the debtor (Treas. Reg. Section 1.108-2(f)(1)), or
    (ii) the difference between the adjusted issue price of the debt and the fair market value of the debt, if the debt was acquired by the related party in a purchase transaction more than six months before the party became related (Treas. Reg. Section 1.108-2(f)(2))
  - The acquired debt is treated as new debt issued by the debtor to the related holder with an issue price equal to the amount realized by the debtor, i.e. either the purchase price or the fair market value of the acquired debt, as applicable

Qualified Mortgage Indebtedness Exception

- The Mortgage Forgiveness Debt Relief Act of 2007 created a new income exclusion for "qualified principal indebtedness," which applies to such indebtedness that is discharged on or after January 1, 2007 and before January 1, 2010 (Section 108(a)(1)(E))
- "Qualified principal residence indebtedness" means acquisition indebtedness on the taxpayer's principal residence, up to a $2 million limit ($1 million for married individuals filing separately) (Section 108(h)(2))
- Exclusion will not apply if the discharge is on account of services performed for the lender or is otherwise not directly related to a decline in the value of the residence or to the financial condition of the taxpayer (Section 108(h)(3))
- If there is an exclusion, the taxpayer must apply the excluded amount to reduce the basis of its principal residence (but not below zero) (Section 108(h)(1))
- If a loan is discharged, in whole or in part, and the loan is only partially "qualified principal residence indebtedness," then the exclusion only applies to the discharged amount that exceeds the amount of the loan that is not "qualified principal residence indebtedness"

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