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Purchasing and modifying discount debt — What dealmakers should know

Introduction

In the current economy, a significant amount of outstanding corporate debt is currently valued at a considerable discount to its original valuation. Many investors and issuers are taking advantage of potentially attractive returns by purchasing devalued debt.

Potential acquirors of discounted debt should be aware that purchasing, holding, and disposing of debt can have significant income tax consequences for both the issuer and the holder. Further, negotiated modification of debt instrument terms can have major income tax consequences to the issuer and the holder. Legislation enacted in 2009 provided some relief with respect to certain potential tax consequences, but such legislation does not apply to debt modifications occurring after 2010.

Careful tax analysis and planning from the inception of these transactions can help parties address the risk of adverse tax consequences and preserve the expected economic benefits.

Purchasing debt

There are several ways in which businesses and investors purchase discounted debt. Each has potential tax implications (Figure 1).

Purchase of Debt at a Discount by:

	Issuer	Person Related to Issuer (consequences of buyback itself)	Person Related to Issuer (consequences after buyback)	Person Unrelated to Issuer (consequences after buyback)
Tax Consequences to Issuer	Generally COD.	Generally COD.	Issuer generally deducts discount in purchase price as OID (on "new" debt) as it accrues; however, exceptions may apply.	Assuming debt is not modified, there are generally no consequences.
Tax Consequences to Holder	Selling holder generally recognizes gain or loss.	Selling holder generally recognizes gain or loss.	Purchaser/holder generally includes OID of "new" debt in income during holding period.	Market discount is generally not includable in income during holding period; however, any accrued market discount is treated as ordinary income if debt is retired or sold for more than its purchase price.

Figure 1. Potential tax implications of debt buyback

Purchase of outstanding debt at a discount by the issuer

The income tax consequences associated with an issuer "buying in" its outstanding indebtedness at a discount are relatively predictable. The amount of the discount is generally included in the income of the issuer for tax purposes as cancellation of indebtedness (COD) income, unless the issuer is under the jurisdiction of a bankruptcy court or is insolvent – that is, to the extent the issuer's indebtedness exceeds the fair market value of its assets. If the debtor is a partnership for tax purposes, these exceptions apply only to the extent that a partner is insolvent or bankrupt.

Under 2009 tax legislation, an issuer was permitted to elect to defer recognition of COD income that otherwise would have been triggered in 2009 or 2010. As noted, this election is no longer available (although the existence of such an election by a potential acquisition target remains a tax due diligence issue). Other exceptions to the current taxability of COD income are available under limited circumstances (including certain real estate transactions, purchase price adjustments, and capital contributions). Additionally, such income may often be offset by the issuer's net operating losses, if any exist.

Purchase of outstanding debt at a discount by a person "related" to the issuer

Often, issuers may not be able to repurchase their own indebtedness due to inadequate cash flow, restrictive debt covenants, and legal or regulatory requirements. Nevertheless, investors that already have an equity interest in an issuer may be interested in purchasing the debt of the issuer if they:

- Perceive it to be undervalued;
- Want to improve their priority position; or,
- Simply want to increase their stake in the issuer.

The purchase of debt at a discount by a person treated as "related" to the issuer, however, can result in material, unanticipated income tax consequences.

Definition of related. Complex rules are used to determine whether an issuer and a debt purchaser are treated as related. In a simple case, a private equity partnership that owns more than 50 percent of the stock of a corporate portfolio company would be treated as related to such issuer. However, in certain situations, a purchaser can directly own less than 50 percent of the issuer and still be considered related under complex attribution rules.

Consequences to an issuer at the time of a buyback. When a related party purchases an issuer's debt at a discount, the transaction requires the issuer to recognize COD income for tax purposes equal to the excess of the debt amount (as determined for tax purposes) over the purchase price paid by the related party. However, this COD income may be subject to exclusion or offset as previously described. Similar rules may apply where the holder of the debt becomes related to the issuer after acquisition of the debt.

Consequences to holder and issuer after a related party purchase – general rule. The acquired indebtedness held by a related party is generally treated as new indebtedness issued by the portfolio company to the related debt holder. As such, the existence of this "new" debt would have tax ramifications for both the holder and the issuer:

- The "new" debt is generally treated as having been issued with original issue discount (OID). The holder would have to include the OID in its taxable income over the remaining life of the debt.
- The issuer is generally permitted to deduct the OID as it accrues, subject to the application of potential limitations.
- If the holder of the "new" debt is not a U.S. person, withholding may be required on the payment of interest and the eventual payment of accrued OID.
- For the holder and issuer, the tax consequences of the repayment or settlement of the "new debt" depend, among other things, on whether or not the principal amount is paid in full.

Note that financial investors have implemented strategies that may avoid the recognition of COD income by their portfolio companies in situations where substantial overlap exists between the ultimate owners of the portfolio company and the purchased debt.

Purchase of outstanding debt at a discount by a person "unrelated" to the issuer

Consequences to issuer. Assuming the debt purchased at a discount by a person "unrelated" to the issuer is not modified, there are generally no tax consequences to the issuer.

Consequences to unrelated holder. The holder is treated as having purchased debt at a "market discount." Unlike with OID, the rules do not require the holder to accrue market discount into income while holding the debt unless an election to do so is made. Nonetheless, if the debt is retired or sold for more than the purchase price of the debt, the holder must treat the market discount – to the extent economically accrued during the period the purchaser held the debt – as ordinary income rather than capital gain. Payments of principal before maturity on debt acquired with market discount can also give rise to the recognition of ordinary income by the holder. Limitations apply to the deductibility of interest expense incurred on indebtedness incurred to purchase or carry market discount debt. Note that under limited circumstances, taxpayers may take the position that the market discount rules do not apply to speculative debt purchased at a very deep discount.

Other considerations for purchasing debt – net operating losses

Limitations on net operating loss (NOL) carryover utilization are generally imposed in the event of an "ownership change" with respect to the stock (as opposed to the indebtedness) of a corporation. Nonetheless, the purchase of outstanding debt at a significant discount may cause (or contribute to) an "ownership change" of the issuing corporation. Debt acquisitions might trigger an "ownership change" if, among other factors, the purchased debt "offers a potential significant participation in the growth of the corporation" and is therefore treated like equity for purposes of measuring whether an ownership change has occurred.

Modifications of debt instruments

Issuers and holders of debt also should be wary of the tax implications of changes made to the terms of an outstanding debt instrument. In particular, if a "significant modification" is deemed to have been made, issuers and holders must treat the transaction as if a "new" debt instrument has been "exchanged" for the "old" debt instrument for tax purposes – notwithstanding the fact that no actual exchange of instruments occurred.

Examples of modifications that can create tax consequences

Many different types of alterations to the terms of a debt instrument can result in an exchange being deemed to have occurred. For example, a material tax consequence may arise if there are changes to a debt instrument that:

- Change the yield of the instrument by more than a de minimis amount, including as a result of the payment of a "consent fee;"
- Result in a material deferral of the timing of payments under the debt instrument; or
- Result in changes in collateral for a debt instrument.

Generally, a number of actions do not constitute "significant modifications" and thus do not give rise to a deemed exchange of "new" for "old" debt. These actions include:

- Changes to the terms of a debt instrument that are pursuant to its original terms subject to certain exceptions;

- A holder's forbearance of enforcement of remedies for up to two years or possibly longer; or
- Alterations of customary financial covenants.

Potential tax consequences of a significant modification

If an exchange of debt instruments were deemed to occur, potential material income tax consequences to the parties include:

Issuer. Recognition of COD income is typical when debt is treated as "traded on an established securities market" (i.e., is "publicly traded") and the trading price reflects a discount to the principal amount of the debt. It should be noted that the IRS's definition of "publicly traded" is extremely broad and often includes syndicated bank loans. Application of interest disallowance or deferral provisions on the "new" debt is also typical when the debt is treated as publicly traded.

Holder. When the modified debt is publicly traded, it is typical for the "new" debt to be treated as issued at a discount and for the holder to be required to include OID in income while the "new" debt is held. The holder may also recognize gain or loss on the deemed exchange of "old" for "new" debt depending on the holder's tax basis in the instrument and a number of other factors.

The bottom line

Companies and their financial sponsors that consider a discounted debt buyback or debt modification need to be aware of potential tax consequences that could materially affect the expected economic benefit of a transaction. Careful tax analysis and planning early on in the decision-making process can help parties understand potential risks and avoid unpleasant surprises.

Accounting Considerations – Purchasing and Modifying Discount Debt

While debt buybacks and modifications will also have accounting consequences, those consequences may or may not mirror the tax considerations. A buyback by the issuer, for example, would usually result in a gain on extinguishment for book purposes similar to the treatment afforded by tax. A buyback by a party "related" to the issuer, on the other hand, would likely impact only the entity's tax provision for financial reporting purposes, as opposed to resulting in an actual gain on extinguishment.

Similarly, debt modifications/exchanges that result in debt with "substantially different terms" (such as a greater than 10 percent change in the present value of the cash flows) could also result in a gain on extinguishment. Before making this assessment, however, accounting preparers must first determine whether or not the transaction should more appropriately be characterized as a troubled debt restructuring, in which case some or all of the upfront gain would be eliminated and replaced by lower GAAP interest charges over the remaining life of the debt.

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