

## M&A Tax Talk

### Debt restructuring transactions

*This article outlines key tax considerations associated with various debt restructuring transactions, including debt modifications, debt-for-debt exchanges, and debt-for-equity exchanges that may result in taxable cancellation of indebtedness (“COD”) income.*

#### Introduction to Key Tax Considerations

##### **Taxable Cancellation of Indebtedness Income**

A restructuring transaction often has as one of its central goals reducing the amount of debt and therefore can frequently result in COD income. Additionally, certain

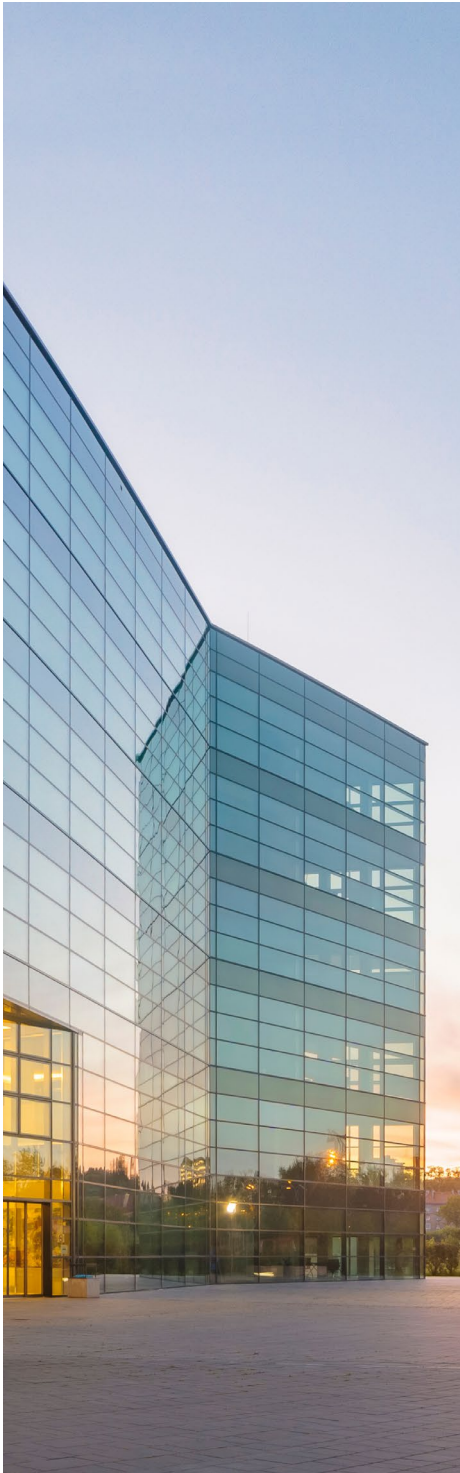
modifications to the terms of existing debt can result in COD income for tax purposes even when the amount owed is not reduced.<sup>1</sup> This can often present an unexpected cost to the restructuring, which may not provide any economic benefit (i.e., tax basis or future interest deductions).

Any COD income resulting from these transactions is generally subject to federal and state tax as ordinary income.<sup>2</sup> Because COD income is generally taxable, companies must analyze whether current year losses (from operations or otherwise) or tax attribute carryforwards (e.g., NOLs)

are available to offset the COD income. Importantly, COD income cannot be offset by capital losses or capital loss carryforwards because it is ordinary in character, and NOLs generated after the Tax Cuts and Jobs Act (tax years 2018 and after for calendar year taxpayers) are limited to offsetting a maximum of 80% of taxable income in any given year. The ability to utilize NOLs can be further limited if a corporation has previously experienced a section 382 “ownership change” or if an “ownership change” results from the restructuring transaction itself. Finally, state tax implications associated with COD

<sup>1</sup> Refer to M&A Tax Talk, “[Debt modification tax rules](#)” (March 2020) for a further discussion.

<sup>2</sup> COD income is generally taxable unless the taxpayer qualifies for either (i) the bankruptcy exclusion or (ii) the insolvency exclusion. These exclusions can each be limiting in their own ways. The bankruptcy exclusion only applies if the taxpayer is under the jurisdiction of a court in a title 11 or similar case, which is often a “last resort” and gives rise to many non-tax implications that must be considered. The insolvency exclusion only applies to the extent of the insolvency, and generally requires a factual/valuation analysis. Moreover, in the partnership context, these exclusions are applied at the partner-level. Thus, partners of a partnership that realizes COD income are not able to exclude the COD income allocated to them unless the partners themselves are either insolvent or under the jurisdiction of a court in a title 11 or similar proceeding.



## Key Tax Considerations & Attributes to Offset Taxable COD Income

- **Use of Current-Year Losses**
  - Available to offset 100% of current-year taxable income.
  - Current year section 382 ownership change could impact generation /availability of current year losses.
  - Heightened importance placed on refining projections.
  - Other tax planning / loss generation considerations.
- **Use of NOL Carryforwards from Prior Years**
  - Post-TCJA NOLs (i.e., those generated after the 2017 tax year for calendar-year taxpayers) are limited to offsetting 80% of taxable income in any given year.
  - Pre-TCJA NOLs are not subject to this 80% limitation.
  - Availability of NOL carryforwards can be impacted if the company has experienced a section 382 ownership change in the current year or in prior years.
- **Use of Section 163(j) Carryforwards from Prior Years**
  - Taxable COD generally increases section 163(j) limitation for the current year (generally increases ability to deduct interest by 30 cents on the dollar).
  - However, availability of section 163(j) carryforwards can be impacted if the company has experienced a section 382 ownership change in the current year or in prior years.
- **State Considerations**
  - As noted above, state tax implications frequently differ from federal and must be analyzed carefully.

income frequently differ significantly from federal and must be carefully analyzed as they can often be traps for the unwary.

Consequently, a heightened importance is placed on refining current year taxable income/loss estimates for federal and state purposes, developing calculations of the amount of projected COD income for tax purposes, and tax planning considerations.

### **Section 382 “Ownership Change”**

The above “tax attributes” along with current year loss are thus key in mitigating tax leakage. In the corporate context, capital structure modifications (particularly debt-for-equity exchanges) often result

in section 382 implications which may significantly limit the ability to use “tax attributes” (including NOLs, section 163(j) carryforwards, and potentially built-in deduction items and built-in losses in assets). An “ownership change” for this purpose occurs when one or more 5-percent shareholders increase their ownership, in the aggregate, by more than 50 percent over a rolling three-year period.<sup>3</sup> When this occurs, pre-change losses are generally subject to an annual limitation equal to the long-term tax exempt rate (AFR) multiplied by the pre-change equity value (which may be depressed in restructuring scenarios).<sup>4</sup>

<sup>3</sup>Section 382(g).

<sup>4</sup>Refer to the M&A Tax Talk, “[Tax Implications of in-court and out-of-court debt restructurings](#)” (October 2020) for additional information.

## Common Debt Restructuring Transactions

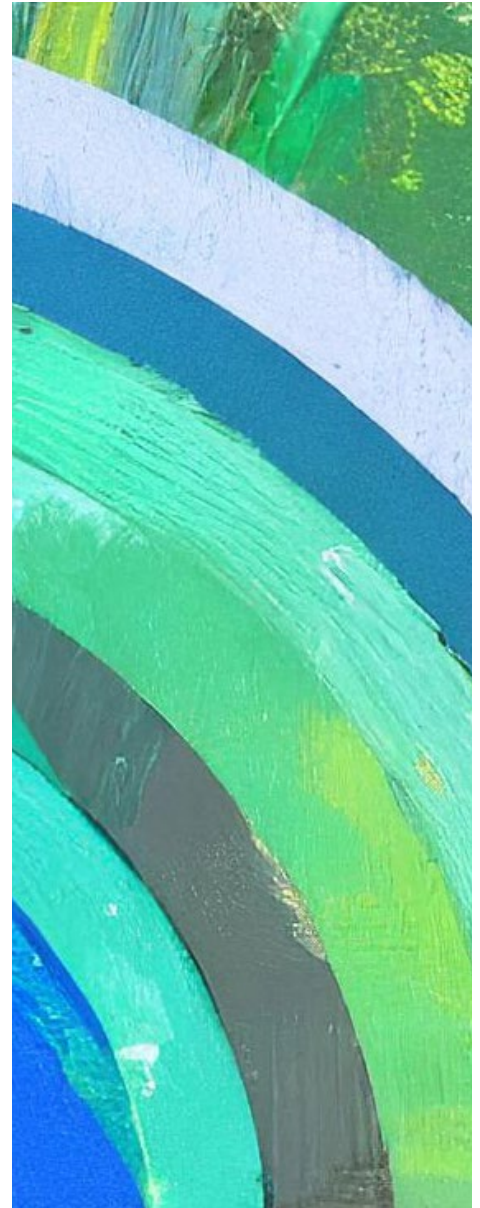
Companies can use several methods to modify their debt or capital structures, including exchanging existing debt for new debt, modifying existing debt, exchanging debt-for-equity, or repurchasing debt. Some of the potential tax implications that should be considered in connection with each type of transaction are summarized below.

### Debt-for-Debt Exchanges and Debt Modifications

Although debt modifications do not require an actual “exchange,” we will discuss debt-for-debt exchanges and debt modifications together as the tax consequences are similar. A taxpayer that exchanges its existing debt for new debt is generally treated for tax purposes as if it repaid the existing debt for an amount of money equal to the “issue price” of the new debt. Accordingly, a taxpayer can realize COD income if the issue price of the existing debt is less than the issue price of the new debt. This same treatment also results when the terms of existing debt are modified, if the modification is considered to be “significant modification” for tax purposes. The rules governing when a modification of debt constitutes a “significant modification” are complex and may be unintentionally 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.<sup>5</sup>

The issue price of debt for tax purposes can differ from the face amount in various circumstances. For example, 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. 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 COD income to the extent the modification results in an actual reduction in the principal of the debt.

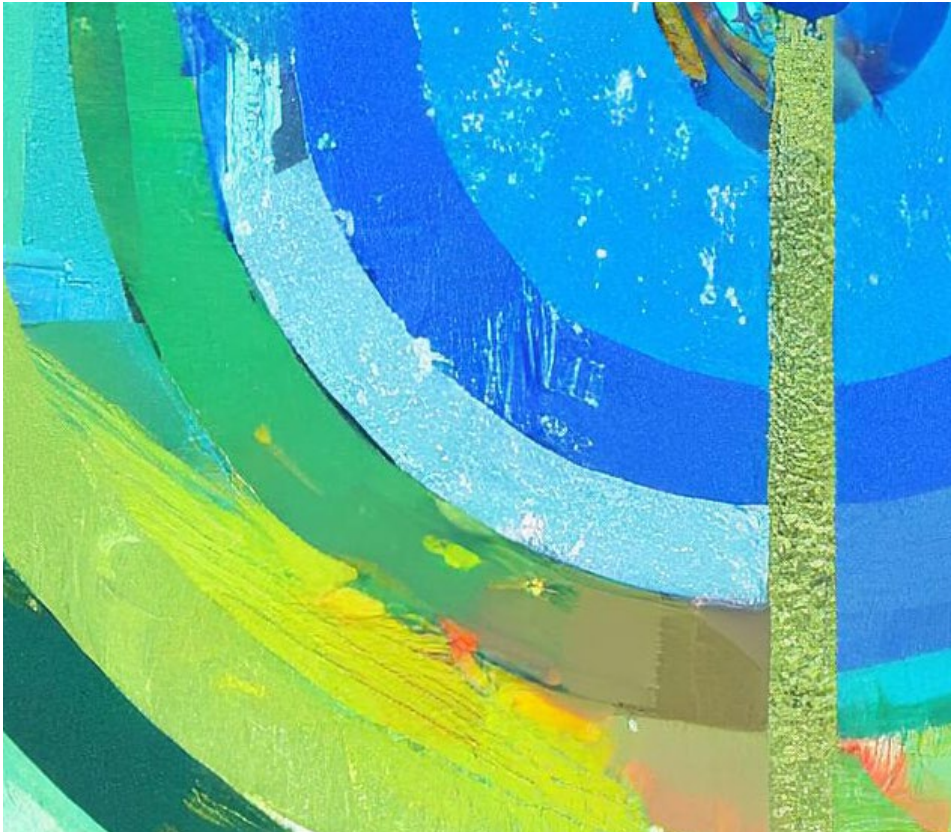
In contrast, if the terms of a debt instrument are “significantly modified” and debt is considered to be publicly-traded, the issue price of the new debt is determined generally based upon the fair market value of the new debt (based upon the trading or quoted price). Consequently, the issuer may have COD income (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, including section 163(j).<sup>6</sup> In addition, taxpayers should note that the term “publicly traded” is broadly defined for this purpose.<sup>7</sup> The issue price of debt for tax purposes can also differ from the stated principal amount when it is issued as part of an “investment unit” (e.g., when debt is issued along with other consideration, such as equity, warrants, etc.)



<sup>5</sup>Pursuant to Treas. Reg. § 1.1001-3, a modification is “significant” if the legal rights and obligations of the debt instrument that are altered are described in certain categories of modifications or otherwise treated as economically significant. Examples of these potential “significant modifications” include changes to the interest rate, timing of payments (e.g., deferral of payments), and changes in the obligor or security. A taxpayer should also note that even seemingly minor modifications, including those that do not change the amount owed, may result in COD income. This determination is important because if a modification is deemed “significant,” the existing debt is deemed to be exchanged for a new debt instrument, and COD income may be realized. On the other hand, if the debt is not “significantly” modified, the existing debt is not treated as exchanged, and COD income is not realized. Refer to M&A Tax Talk, “[Debt modification tax rules](#)” (March 2020) for a further discussion.

<sup>6</sup>Section 163(j) generally limits a taxpayer’s interest deduction to 30% of “adjusted taxable income” plus business interest income. Any disallowed business interest expense is generally “carried forward” for tax purposes and treated as interest expense paid in the subsequent year. For a variety of reasons, many taxpayers may be severely limited by section 163(j) in the current environment. For example, many companies are facing increasing interest rates and declining revenues. In addition, taxpayers must take into account deductions for depreciation, amortization, and depletion in determining “adjusted taxable income” in taxable years beginning after January 1, 2022, which significantly reduces the section 163(j) limitation relative to prior years for many taxpayers. Consequently, section 163(j) could result in a significant deferral of deductions for interest (as well as OID resulting from debt restructurings) for many companies.

<sup>7</sup>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 within the 31-day period beginning 15 days before the transaction date and ending 15 days after the transaction date. Many bonds and bank loans issued by companies will be considered publicly traded under these rules, and private placement debt, syndicated bank loans, and revolvers frequently have some quotations or otherwise appear on loan-pricing services.



### Debt-for-Equity Exchanges

Another typical debt restructuring transaction involves satisfying existing debt with equity of the borrower. In these debt-for-equity exchanges, a borrower generally realizes COD income if the adjusted issue price of the debt is greater than the fair market value of the equity received by the creditor. For corporate borrowers, depending on the ultimate structure, these types of transactions may result in a section 382 ownership change, as described

above. This is especially important for debt restructurings that occur outside of court, because section 382 provides two favorable exceptions that only apply to ownership changes that occur in bankruptcy. These exceptions (i.e., section 382(1)(5) and section 382(1)(6)) can have an impact on preserving tax attributes; however, they require an in-court bankruptcy proceeding.<sup>8</sup> The potential impacts of these exceptions need to be considered in the broader context of a debt restructuring.<sup>9</sup>

More broadly, these debt-for-equity transactions can frequently be structured as either nontaxable or taxable stock or asset transactions to the borrower. Detailed tax structuring and modeling analysis is frequently performed to assess alternative structures.<sup>10</sup>

### Debt Repurchases

Another type of debt restructuring involves a borrower, sponsor, or a related party repurchasing the debt for FMV or at a discount. A borrower generally does not realize COD income if its debt is purchased by an unrelated third party. However, a borrower could realize COD income if it repurchases its debt at a discount or if the debt is purchased by a related party (e.g., a private equity sponsor or shareholder who owns more than 50% of the stock of the debtor, or potentially a subsidiary or other entity related to the borrower). In those instances, the debtor may be treated as satisfying the debt in an amount equal to the price paid to repurchase the debt and COD income generally results if the debt was repurchased at a discount.<sup>11</sup>

### Conclusion

The potential tax implications and planning considerations in connection with capital structure modifications can be significant and should be considered early in the negotiation process, particularly when use of tax attributes is being considered to offset any resulting COD income.

<sup>8</sup> Refer to the M&A Tax Talk, “Tax Implications of in-court and out-of-court debt restructurings” (October 2020) for additional information.

<sup>9</sup> Refer to the M&A Tax Talk, “Protecting tax attributes in an uncertain environment” (April 2020) for further information on this topic.

<sup>10</sup> Refer to the M&A Tax Talk, “Tax Implications of in-court and out-of-court debt restructurings” (October 2020) for additional information.

<sup>11</sup> Determining “relatedness” for this purpose involves analyzing various indirect ownership and attribution rules and must be analyzed on a case-by-case basis.

## Get in touch

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