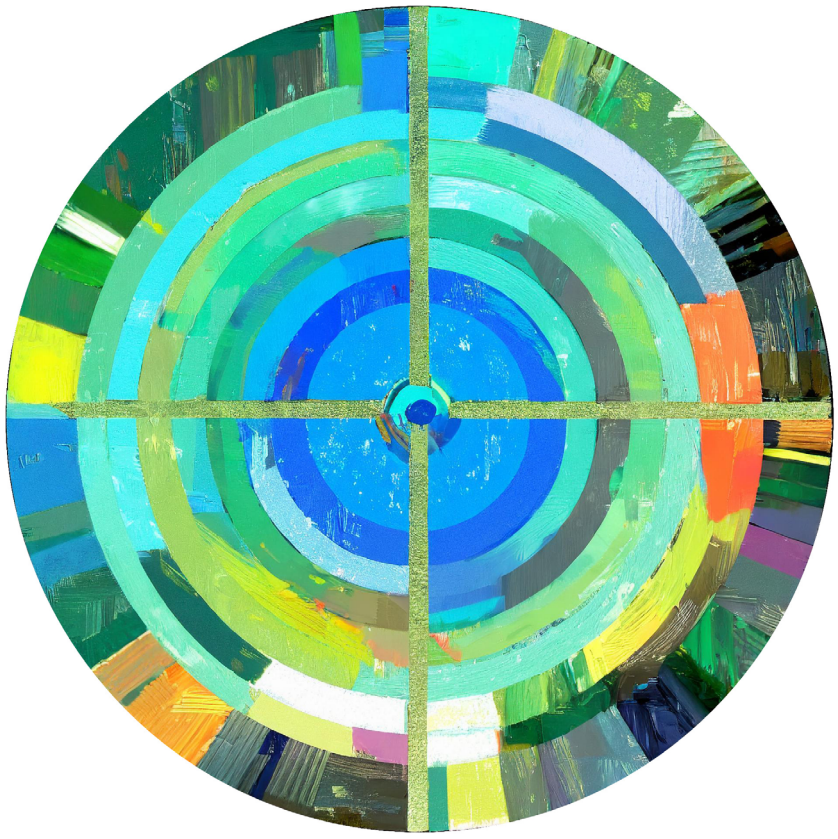


M&A Tax Talk

Liability management exercises and related tax implications

Introduction

With debt approaching maturity, rising borrowing costs, loan covenant limitations, and the need for sponsors and equity holders to preserve or unlock value, borrowers and sponsors increasingly turn to liability management exercises (LMEs) as a preferred strategy for restructuring. A LME can broadly be defined as a set of out-of-court financial strategies companies use to proactively restructure debt without the cost, complexity, and disruption of a bankruptcy proceeding.

While LMEs offer meaningful commercial advantages, they introduce a range of complex tax considerations that can significantly affect outcomes for all parties involved. As such, early, proactive tax planning is essential. This article explores how LMEs work, the commercial motivations behind debt restructurings, and some of the complex tax considerations that borrowers, creditors, sponsors, and equity holders should weigh—equipping stakeholders to navigate these issues more effectively.

What are LMEs?

LMEs enable borrowers to strategically manage, modify, and enhance their outstanding debt to:

- Deleverage the organization;
- Reduce interest expenses;
- Extend maturities to ease financial pressure;
- Increase flexibility by modifying or relaxing debt covenants; and
- Proactively optimize the capital structure.

LMEs are executed through a variety of structures—cash transactions such as repurchases, redemptions, and tender offers, as well as non-cash approaches like exchange offers and consent solicitations.

Ultimately, the execution of LMEs is shaped by the commercial goals and tax considerations of borrowers, creditors, and equity holders. By understanding these drivers, organizations and stakeholders can better align their capital structure with long-

term strategic objectives while mitigating potential adverse tax consequences.

Commercial objectives

Each stakeholder in a LME brings distinct objectives to the transaction. Borrowers focus on extending debt maturities, raising additional cash, reducing current payments or principal, and avoiding default or bankruptcy. Creditors seek to enhance their recovery, secure fees or higher yields, obtain additional security or priority, and potentially gain control of the borrower. Sponsors and equity holders aim to capture equity upside, enhance shareholder value, preserve the borrower's overall worth, and, at times, acquire distressed debt for strategic advantage. These objectives may align or cause conflict. For example, ad hoc groups of creditors often form during LME negotiations and may take actions such as "up-tiering" new or existing debt to a more senior, secured position or extracting additional fees (e.g., backstop fees) that benefit their own group but disadvantage other creditors—a dynamic the market has come to call "creditor-on-creditor violence." Although some issues are particular to each constituent, tax efficiency and limiting tax leakage for the debtor company is a consideration that the parties generally agree on. As such, some of the tax issues discussed below are often considered and negotiated collaboratively among the parties.

Tax considerations come into play early and can be decisive. Without proactive tax planning, parties risk unintended or adverse tax consequences, complicating the path to a successful restructuring.

Debtor tax considerations

One of the borrower's primary tax concerns in any debt restructuring is the potential risk of generating cancellation of debt income (CODI). CODI may arise when a borrower's debt is reduced/forgiven or satisfied through the issuance of its own equity or its equity of its affiliates. Even modifications of debt that do not reduce the principal amount can lead to CODI if the fair market value of the debt is less than par.

A. Deemed debt exchanges—significant modifications

Whether a debt modification constitutes a "significant modification"—and therefore a deemed retirement and re issuance of the debt instrument—is based on a detailed analysis that looks to many of the debt terms. When a "significant modification" occurs, the debt is deemed to be reissued for an amount equal to the "issue price" of the modified debt. If the debt is "publicly traded" for tax purposes (meaning trades or quotes are generally available), the issue price of the debt is based on fair market value, and the transaction can result in CODI even if the principal amount owed is not reduced. See M&A Tax Talk: US debt modification tax rules for further discussion.

B. Related-party acquisition of indebtedness

Equity holders who acquire third-party debt from existing creditors should be aware that such purchases may trigger CODI. Under the tax rules, when a person related to the debtor (generally requiring greater than 50% ownership under section 267(b) or section 707(b)(1), as modified by Treas. Reg. §1.108-2(d)) acquires debt from an unrelated creditor, the transaction is treated as if the debtor itself repurchased its debt. It is common in LMEs that these acquisitions are often at a discount that can result in CODI. The amount of CODI depends on the adjusted issue price of the debt, the equity holder's basis in the debt or the debt's fair market value, and timing of the creditor's acquisition of the debt prior to the equity holder's acquisition. The acquired debt is treated as new indebtedness issued by the borrower to the equity holder, with an issue price determined by the equity holder's basis in the debt or the debt's fair market value. Because these related-party debt purchases are common in LMEs, equity holders should work closely with tax advisers to fully understand and address the potential CODI implications and structure transactions appropriately to mitigate unintended tax liabilities.

C. CODI and consequences of excluding CODI—attribute reduction

For an actual exchange or a deemed exchange, the next step is analyzing whether the CODI is taxable under the general rule or qualifies for an exclusion from income—requirements that hinge on the borrower's facts and circumstances.

When CODI is excluded from taxable income under one of the section 108 exclusions that requires attribute reduction (e.g., the insolvency or bankruptcy exceptions), the taxpayer must reduce certain tax attributes (e.g., net operating losses [NOLs], credit carry forwards, tax basis of assets, etc.).

Notably, section 163(j) disallowed interest carry forwards are not listed among the attributes subject to reduction under section 108(b)(2) and therefore survive the CODI exclusion intact, although they remain subject to section 382 limitation upon any subsequent ownership change. Attribute reduction serves as a "trade-off" for the exclusion, such that the benefit of the CODI exclusion is offset by diminished future tax benefits.

These reductions can have long-lasting effects on future tax planning and cash flow, making it critical to model the impact carefully before finalizing any restructuring. Early planning can help enhance the value of retained tax attributes.

See the M&A Tax Talk: Debt restructuring transactions for further discussion on key tax considerations related to various debt restructuring transactions.

Creditor tax considerations

As creditors seek to extract value and improve their position in a debt restructuring, careful attention to tax treatment is essential. Key considerations include timing, character (ordinary vs. capital), and potential withholding tax obligations related to various fees, such as consent fees and backstop fees.

A. Potential for recognition of gain or loss

Because a significant modification results in a debt instrument being reissued for an amount equal to the "issue price" of the modified debt, the creditor generally realizes gain or loss to the extent that its adjusted tax basis in the debt instrument is less or more, as the case may be, than the issue price.

Creditors should determine the character and tax treatment of the gain or loss, including treatment of "boot" (additional property or cash), accrued market discount (e.g., ordinary gain) and whether it may convert to original issue discount (OID), and potential acquisition or amortizable bond premium. Creditors should assess whether the transaction qualifies as an installment sale, which affects timing of recognition. In some cases, the exchange of debt may qualify as a recapitalization that may offer tax deferral. Early and thorough analysis of these factors helps creditors optimize their tax outcomes and anticipate the impact of the restructuring on financial reporting and tax compliance.

B. Treatment of consent fees and backstop fees

Consent fees may be paid for agreeing to waive or modify covenants or other debt terms—often to prevent default. If a "significant modification" occurs, the consent fee is considered part of the repayment of the debt. Absent a significant modification, tax treatment is less definitive; commonly, fees are allocated between accrued unpaid interest and principal per payment ordering rules. Creditors should also analyze whether consent fees are subject to withholding tax.

Lead creditors may receive backstop/commitment fees for providing financial commitments in debt exchanges or cash infusions. Commitment fees may be treated like option premiums and can affect the determination of a debt's issue price, possibly generating OID (income that accrues over time). Timing and character of income recognition for these fees should be closely analyzed.

C. Bad debt deduction

A creditor may be eligible to claim a bad debt deduction if its debt claim becomes wholly or partially worthless. However, this determination is fact-specific and requires careful analysis and documentation. To substantiate a bad debt deduction, it is necessary to assess, among other things:

- Whether the debt is business debt or non-business debt;
- The worthlessness of the debt;
- The tax year in which the debt became worthless;
- Solvency of the debtor;
- The creditor's basis in the debt; and
- Whether the debt is a security within the meaning of section 165(g)(2)(C).

Best practices include maintaining thorough records of all analyses and communications supporting the deduction, including financial statements, correspondence, and recovery efforts. Proper documentation is essential to withstand IRS scrutiny and avoid disallowed deductions.

D. Holding structure/exit considerations

As a creditor that may be exchanging their debt instrument for an equity position, consideration may also need to be given to the fund-level holding structure of the investment (i.e., blocked and unblocked) for the various investor tax profiles (e.g., foreign, tax-exempt, US taxable, etc.). The optimal go-forward holding structure will vary by fund and depend on the specific facts and tax profile.

Sponsor/equity holder tax considerations

Sponsor/equity holders aim to enhance shareholder value while maintaining value of the company that indirectly impacts them. When a company is too levered to repay or restructure/refinance its debt, sponsors and equity holders may surrender control of the company to creditors usually in a debt-for-equity exchange. In other scenarios, sponsors and equity holders may acquire distressed debt to put themselves in a more senior, secured position. However, certain actions taken during LMEs can result in adverse tax consequences for the company, potentially reducing shareholder value unintentionally. Equity holders should be mindful of certain

traps when assessing certain LMEs or other debt restructuring.

A. Partnership considerations

Sponsors and equity holders should be cautious when contemplating a LME transaction when the debtor is a partnership. When a partnership recognizes COD in connection with the transaction, that COD "passes through" to the partners. Importantly, whether COD is excluded from taxable income, due to the insolvency or bankruptcy exception, is determined at the *partner* level versus the *partnership* level. As a result, unless the sponsor/equity holder is insolvent or in bankruptcy, it may be allocated CODI that must be included in its taxable income, creating "phantom income."

B. Worthless stock deductions

Sponsors and equity holders of a distressed corporation may want to claim a "worthless stock deduction" for tax purposes. However, equity holders who own 50% or more of the corporation should proceed with caution, as this deduction can trigger significant tax consequences under section 382. If a 50% or greater shareholder claims a worthless stock deduction, the tax law treats it as if that shareholder sold and immediately repurchased their shares at the start of the following tax year. This deemed disposition and reacquisition, when combined with other owner shifts during the testing period, may contribute to an "ownership change" under section 382.

C. Section 382 ownership changes

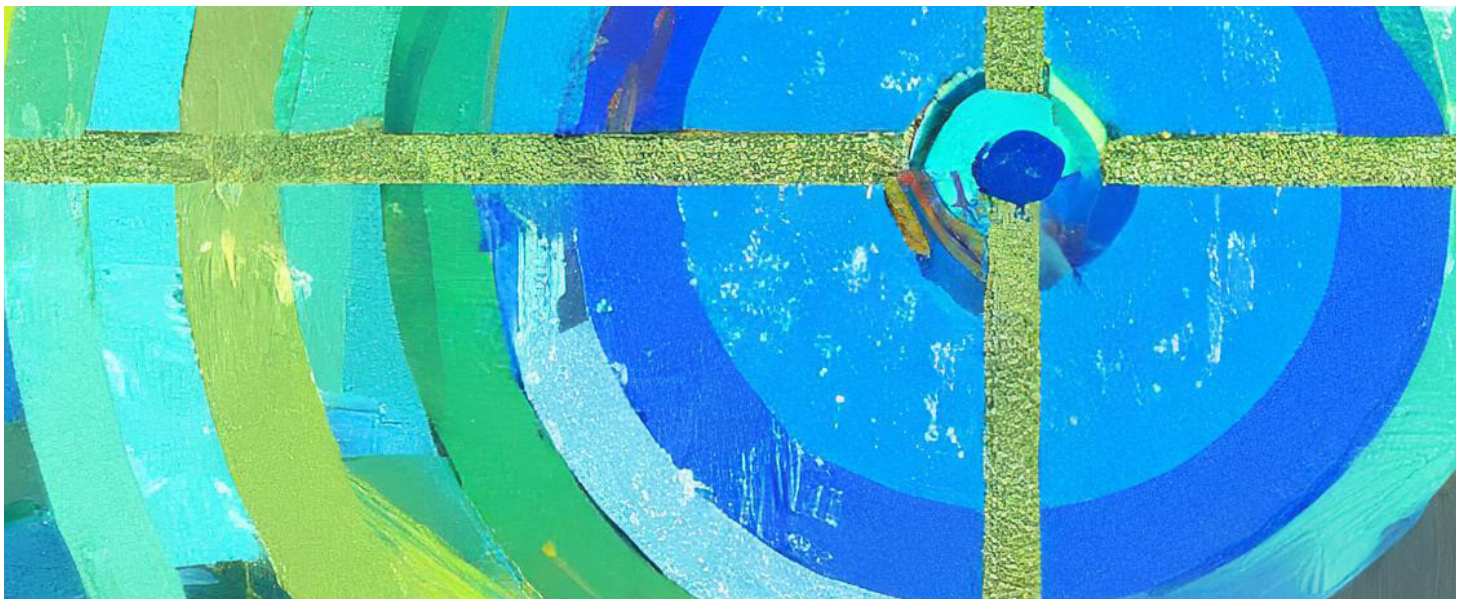
In the event of a cumulative greater-than-50-percentage-point increase by 5% shareholders, utilization of certain tax attributes (e.g., NOLs, capital loss carry forwards, section 163(j) carry forwards) are subject to an annual limitation. The annual amount of these attributes useable post-change is typically sharply reduced, especially when the pre-change stock value is low. For distressed companies, the reduction can be so significant that NOLs and other tax attributes may become unusable, eliminating potential future tax benefits. Special rules under sections 382(l)(5) and (l)(6) may relax these consequences for ownership changes occurring in title 11 or similar bankruptcy cases, but these provisions are generally unavailable to out-of-court LMEs.

Conclusion

Tax considerations play a critical role in LMEs and related debt restructurings, especially when a significant modification is involved. Borrowers, creditors, sponsors, and equity holders should address potential tax implications early in the negotiation process. Proactive, scenario-based tax analysis can help optimize after-tax returns, ensure compliance, and mitigate the risk of adverse or unexpected tax outcomes. Consultation with tax advisers is recommended to navigate complex or ambiguous situations.

Other resources

- US debt modification tax rules
- Tax implications of in-court and out-of-court debt restructurings
- Debt restructuring transactions



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