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Will Modifying the Terms of a Debt Instrument Result in a Taxable Transaction?

Creditor's Rights Toolkit

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This article will explore how modifying a debt instrument could lead to tax consequences for the debtor and creditor in a bankruptcy case.

When a borrower struggles to meet the payment obligations of a debt instrument, the borrower and creditor may work together to modify some of the terms to give the borrower a little breathing room or provide the creditor with more security. The parties may agree to change the interest rate, extend the repayment period, change collateral, or make a variety of other modifications to the debt instrument. What the parties may not realize is that the modifications could result in a taxable exchange of the "old" (pre-modification) note for a "new" (modified) note.

KEY ISSUES

DEBT INSTRUMENT

A debt instrument generally means any instrument or contractual arrangement that constitutes indebtedness under general principles of federal income tax law (including, for example, a certificate of deposit or a loan).

TAXABLE DISPOSITION

Under Section 1001 of the Internal Revenue Code, a taxpayer realizes gain or loss on the sale or disposition of property. A disposition includes only the exchange of property for other materially different property. The underlying Treasury Regulations provide that if a modification to a debt instrument is significant, it will be deemed an exchange of the original debt instrument for a new, modified one.

INCOME REALIZATION

Even if a significant modification results in a deemed exchange, the parties may not realize any income, gain, or loss. The borrower recognizes cancellation of indebtedness income (CODI) if the adjusted issue price of the original instrument is less than or greater than the issue price of the new instrument. Whether the creditor recognizes gain or loss will depend on what the issue price (treated as the amount realized by the creditor on the exchange) of the new instrument is relative to the creditor's basis in the original instrument. Adjusted issue price typically is equal to the amount that the borrower economically owes under the debt instrument (including accrued and unpaid interest). In general, assuming the debt is not publicly traded for tax purposes, and the interest rate on the debt is greater than the relevant current applicable federal rate (AFR), the issue price of the new debt instrument in the deemed exchange is its stated principal amount (face amount). Even if gain is realized, it may be deferred in the corporate context where the deemed exchange could be treated as part of a tax-free recapitalization and can sometimes be deferred via the installment method of accounting.

MODIFICATION

A modification means any alteration, including any deletion or addition, in whole or in part, of a legal right or obligation of the issuer or a holder of a debt instrument. An alteration that occurs by operation of the terms of the debt instrument generally is not a modification. This type of alteration can occur automatically, such as the annual resetting of the interest rate based upon the value of an index, or as a result of the exercise of an option provided to an issuer or a holder to change a term of a debt instrument. There are, however, exceptions to this rule. If, for instance, the obligor or the recourse nature of the instrument is changed, then the change is a modification even if it occurs by operation of the terms of the debt instrument.

SIGNIFICANT MODIFICATION

As noted above, a deemed exchange will only occur if the modifications are significant. The Treasury Regulations have provided bright-line tests for when certain modifications will be treated as significant, and cover: (1) changes in yield, (2) changes in the timing of payments, (3) changes involving the source of repayment or collateral security, (4) changes in the nature of the instrument (e.g., changing from debt to equity or recourse to nonrecourse debt). The Treasury Regulations also state the changes involving customary financial and accounting covenants are not significant modifications. The Treasury Regulations, for example, go into detail in describing when a change in yield will constitute a significant modification, generally if the yield changes by more than the greater of 0.25% or 5% of the pre-change yield. If modifications are not significant under one of the bright-line tests, then all the modifications that are not subject to the bright-line tests are aggregated together to determine if they are, when considered together, economically significant. So, if a change constitutes a modification, it needs to be examined under the bright-line tests, and if it does not qualify under one of those tests, it needs to be grouped with any other non-bright-line modifications to determine if the modifications are economically significant.

DEBTOR’S TAX CONSEQUENCES

When there is a deemed exchange of a debt because of a significant modification, the debtor must determine whether it will recognize CODI. Assuming no exceptions to recognizing CODI apply, the debtor generally recognizes CODI to the extent the issue price of the “new” modified debt instrument is less than the adjusted issue price original obligation. A creditor may be required to file a Form 1099-C for each debtor for whom the creditor is treated as canceling a debt. CODI income is generally “ordinary” in character and often will flow through to owners of a passthrough debtor like a partnership, creating “phantom” income for investors in the flow through entity.

CREDITOR’S TAX CONSEQUENCES

For the creditor, assuming the deemed exchange is not part of a tax-free recapitalization (less likely if the term of the debt is under five years), it will have to calculate whether it recognizes gain or loss on the deemed exchange. The creditor will realize gain to the extent that the issue price of the “new” modified debt (the amount realized) exceeds the creditor’s adjusted tax basis in its “old” debt and will realize loss if the creditor’s adjusted tax basis in the “old” debt exceeds the issue price of the “new” debt. Any gain realization generally will result in “phantom” income for the holder, but there may be beneficial character aspects to the gain (e.g., potentially converting unaccrued original issue discount (OID) — typically taxed as ordinary income as accrued — into capital gain that can be reported under the installment method). The creditor's tax basis in the "new" debt should equal the amount realized and the creditor's holding period should begin the day after the deemed exchange. In determining whether the new debt contains OID, the parties need to determine the "new" debt's stated redemption price at maturity and compare it to the "new" debt's issue price. Any OID needs to be accounted for over the life of the "new" debt as ordinary income to the creditor.

TAKEAWAY

When debtors and creditors renegotiate the terms of an existing debt, they must be aware that even though a new debt instrument is not legally issued, for tax purposes the modifications can result in a deemed exchange of an "old" debt instrument for a "new" debt instrument. This deemed exchange can have significant tax consequences for both parties.

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