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Reducing Debt Can Carry Tax Consequences

Creditors seeking modification of their credit arrangements may face unexpected tax ramifications

By WAYNE R. JOHNSON

This article concludes a two-part examination of the general rules surrounding the tax treatment of debt forgiveness and debt modification.

To traverse difficult financial times, taxpayers commonly approach creditors hoping to win concessions that allow favorable modification of their credit arrangements. Unfortunately, relatively few taxpayers seek concessions armed with knowledge as to what the tax consequences of success might be. This article provides a general overview of those tax consequences. It should be noted that this area of tax law is particularly complex. As such, this article should be considered nothing more than a starting point for research.

Tax treatment of debt modification

Property Exchanges under Code §1001 (all references to the "Code" refer to the Internal Revenue Code of 1986, as amended to the date hereof)

Unless one of several nonrecognition provisions applies, a taxpayer must recognize gain or loss upon the exchange of property for property that differs materially in kind or extent from that which is given up (Treas. Regs. §1.1001-1(a). In layman's terms, whenever a taxpayer exchanges property of one sort for property of another, a taxable exchange of property has occurred. This rule applies to both actual and deemed property exchanges. Because Code §1001 applies to deemed exchanges, it can sometimes be difficult to determine whether a deemed exchange results from a particular transaction. This is especially true in the case of debt modifications.

Treasury Regulations §1.1001-3

To aid taxpayers and address perceived uncertainties in the law relating to deemed exchanges of debt instruments ("DI"), IRS promulgated final regulations under Code §1001 (See Treasury Decision 8675 I.R.B. 1996-29). These regulations apply to all alterations of debt instruments made on or after Sept. 24, 1996 (Treasury Regs.§1,1001-3(h). Regulation (as used herein, the term "Regulation" shall refer to regulations published under Title 26 of the Code of the Federalk Regulations as in effect on the date hereof) 1.1001-3 provides that the alteration of a DI constitutes a deemed exchange under Code §1001 if: (1) the alteration constitutes a "modification" under paragraphs (c) or (d) of the regulation, and (2) the modification is economically significant (Treas. Regs. §1.1001-3(b)). No deemed exchange occurs if the alteration is not economically significant, regardless of whether the alteration results in modification of the DI (Id.)

Regulation 1.1001-3 is drafted in fairly expansive terms. For that reason, the regulation has been criticized as giving significant tax consequences to "routine debt modifications" (See Lipton, *The Section 1001 Debt Modification Regulations: Problems and Opportunities*) 85 JTAX 216 (October 1996)) and transactions that have "minimal (if any) economic consequences." (Id.)

When a DI is significantly modified, Regulation 1.1001-3 treats the issuer of the DI as though he exchanged the original DI for a modified DI having terms that differ materially, either in kind or extent, from those of the original DI. If the modified DI has a value less than that which was owed under the original DI, cancellation of debt income (CODI) results to the taxpayer. Whether and to what extent the taxpayer will be taxed on the CODI will depend upon whether any of the exclusions from income found in Code §108 can be applied (See Johnson, *At Tax Time, Modify Debt with Caution*, California Bar Journal, Pg. 28, (March 2002)).

As suggested above, to determine whether alterations made to a DI trigger the provisions of Treasury Regulation 1.1001-3, we must conduct a two-part inquiry. First, we must determine whether the alteration constitutes a modification of the DI for purposes of Regulation 1.1001-3. If the alteration is a modification, we must next determine whether the alteration is economically significant.

Modification — A modification occurs whenever any legal right or obligation of the issuer or holder is altered in any way, either in whole or part, regardless of whether the alteration is made by express agreement of the parties, their conduct, or otherwise (Treas. Regs. §1.1001-3(c)(1)(i)). Given this broad definition of the term modification, it is hard to imagine an alteration that would not be considered to modify debt. That being said, the Regulations identify several types of alterations not considered modifications.

Alterations Not Considered Modifications — The first type of alterations not considered modifications are those alterations that occur by operation of the DI. Regulation 1.1001-3(c)(1)(ii) provides that, except as provided in Regulation 1.1001-3(c)(2), "an alteration of a legal right or obligation that occurs by operation of the terms of a DI is not a modification." Such alterations may occur automatically (as in the case of an adjustable interest rate) or as the result of an option provided to either the issuer or holder of the DI.

Notwithstanding the foregoing, Regulation 1.1001-3(c)(2) treats each of the alterations as modifications, whether or not they occur by operation of the DI's terms:

1. substitution of a new obligor under the instrument;

2. addition or deletion of a co-obligor under the instrument;

3. a change in the recourse nature of a DI, in whole or part (i.e., from recourse to non recourse, and vice versa);

4. conversion of the DI from debt to an instrument or property right which is not debt for federal tax purposes (this exception does not apply, however, where the alteration occurs pursuant to the holder's option to convert the instrument into equity of the issuer); and

5. alterations resulting from the exercise of an option by either the issuer or the holder that is (a) not unilateral, and (b) in the case of a holder, results in deferral of, or reduction in, any scheduled payment of interest or principal under the DI.

In addition to alterations occurring by operation of the DI, Regulation 1.1001-3 excludes an issuer's failure to perform from the definition of modification. Under Regulation 1.1001-3(c)(4)(i), an issuer's failure to perform is not, in and of itself, an alteration of a legal right or obligation.

When an issuer fails to perform, either the issuer or holder will commonly approach the other seeking debt workout. To provide the parties sufficient opportunity to do so, Regulation 1.1001-3(c)(4)(ii) permits the holder to delay collection and enforcement efforts for up to two (2) years from the date upon which the issuer first failed to perform (subject to extension under certain circumstances) (Treas. Regs §1.1001-3(c)(4) (ii)). Should forbearance extend past the permitted forbearance period, or should the issuer default thereafter, forbearance or default will likely be treated as modification.

Finally, a party's failure to exercise an option that would allow him to change any term of the DI is not considered a modification (Treas. Regs §1.1001-3(c)(5)).

Timing of Modification — Modification occurs at the time the issuer and holder enter into the agreement, even if the alteration does not become immediately effective (Treas. Regs. §1.1001-3(c)(6)(i)). Thus, for example, if the issuer and holder agree on April 1, 2002, to reduce the balance of the issuer's DI from $1,000,000 to $800,000 on April 1, 2003, modification is deemed to occur in 2002, when the agreement is made, rather than 2003, when the agreement is implemented. (Under these facts, the issuer would likely have $200,000 of CODI in 2002.)

Modification can be delayed, however, where the parties condition the alteration on reasonable closing conditions, such as shareholder, regulatory or creditor approval, or when alterations are made pursuant to a plan of bankruptcy reorganization. In each of these instances, modification results, if at all, upon satisfaction of the reasonable closing condition or plan approval.

Significant modification — If an alteration is a modification, one must next determine whether the modification is economically significant. A modification is economically significant if it satisfies either the general rule set forth in Regulation 1.1001-3(e)(1) or any one of several bright-line rules. Modifications that add, delete or alter customary accounting or financial covenants are not considered significant.

General rule of significance — Under the general rule of significance, a modification is significant only if, based upon all facts and circumstances, the legal rights or obligations altered and the degree to which they are altered are economically significant (Treas. Regs. §1.1001-3(e)(1)). For these purposes, all modifications made to a DI, other than those covered by a bright-line rule, are considered collectively. Thus, a series of otherwise insignificant modifications might constitute a significant modification.

While the examples contained in the regulations are somewhat helpful, the regulations offer little guidance as to what constitutes an "economically significant" modification. As a result, the regulations seem to allow the government a fairly free hand in challenging many transactions which taxpayers might otherwise believe outside the purview of the regulations.

Bright-line rules of significance — In addition to the general rule, paragraphs (e)(2) through (e)(5) of Regulation 1.1001-3(e) describe several bright-line rules for determining significance, each of which addresses a particular type of modification. Where these rules apply, the general rule does not.

In general, the regulations treat the following modifications as significant:

1. A change in yield if the change exceeds 25 basis points (.25%) or five percent (5%) of the unmodified instrument's original yield, whichever is greater (Treas. Regs. §1.1001-3(e)(2));

2. A modification in the due date of any payment (i.e., extension of the maturity date, or a payment holiday) if the modification results in material deferral of any scheduled payment (Treas. Regs. §1.1001-3(e)(3)). Deferrals of de minimis payments are ignored. Material deferral results only if payments can be made after expiration of the safe-harbor period described in Regulation 1.1001-3(e) (3)(ii). The safe-harbor period begins on the original due date of the first scheduled payment deferred and extends for a period of 5 years or one-half the original term of the instrument (determined without regard to options to extend), whichever is less. Where deferral extends for a period less than the safe-harbor period, the portion of the period remaining unused may be carried forward for future use;

3. The substitution of a new obligor on a recourse debt (Treas. Regs. §1.1001-3(e)(4)(ii)). This rule does not apply, however, where, among other things, the new obligor acquired the former obligor or its assets in a transaction to which either of Code §§332 (corporate liquidations) or 368(a)(1) (corporate reorganizations) applied; where the new obligor acquired substantially all of the former obligor's assets; or where substitution results from an election made under Code §338 or the filing of bankruptcy. The substitution of a new obligor on a nonrecourse DI is not a significant modification;

4. The addition or deletion of a co-obligor if, as a result of the addition or deletion, there results a change in payment expectations (Treas. Regs §1.1001-3(e)(4)(iii)). For these purposes, a change in payment expectation results if, as a result of the change, the ability of the obligor to meet its obligations under the DI is either substantially enhanced or impaired (Treas. Regs. 1.1001- 3(e)(4)(vi));

5. A change in the priority of the DI if the change results in a change in payment expectations;

6. Modifications made to guarantees of, or credit enhancements for, recourse debt, if the modification results in a change in payment expectations (Treas. Regs. §1.1001-3(e)(4)(iv)(A));

7. Any modification made to a guarantee of, or credit enhancement for, nonrecourse debt (Treas. Regs. §1.1001-3(e)(4)(iv)(B));

8. Conversion of a DI from recourse (or substantially all recourse) to nonrecourse (or substantially all nonrecourse), and vice versa; provided, however, that a modification which converts a recourse DI to a nonrecourse DI will not be significant if the instrument remains secured by the original collateral and the modification does not result in changed payment expectations; and

9. Conversion of a DI to property or rights that are not debt for tax purposes.

Tax Consequences Resulting from Deemed Exchange of Debt Instruments

When a DI is significantly modified, the regulations treat the parties to the DI as if they exchanged the original DI for a modified DI having terms materially different from those of the original DI. Any gain or loss resulting to the parties from this deemed exchange will be treated as income or loss under Code Section 1001, depending upon the modified DI's value (Code §§1273 and 1274 must be employed when valuing the modified DI).

Assuming the modified DI has a value less than the adjusted issue price of the original DI, modification will result in CODI for the issuer. Whether and to what extent the issuer will be required to report such income will depend upon whether the issuer can exclude any part of the CODI under Code Section 108. If not, the entire amount of CODI deemed received will be subject to taxation under Code Section 61(a)(12).

As for the holder of the DI, he may be entitled to claim a deduction for partially worthless debt under Code Section 166. Regulation 1.166- 3(a)(3) allows a holder to claim a deduction for partially worthless debt where a portion of the debt has been deemed charged-off under Regulation 1.1001-3. The amount of the deduction available to the holder cannot exceed the holder's adjusted tax basis in the DI or the amount of income that is deemed recognized by the issuer from the transaction, whichever is less.

Given the breadth and complexity of Regulation 1.1001-3, taxpayers should proceed cautiously when considering any alteration of their debt instruments. Failure to give due regard to the possible tax ramifications of such alterations may result in the taxpayer having to recognize substantial income from a deemed property exchange.

■ *©Wayne R. Johnson is an attorney with the Los Angeles (Century City) law firm of Valensi, Rose & Magaram, PLC, where he specializes in tax, estate and business planning matters.*

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1. Regulation 1.1001-3 applies to all modifications of debt instruments.

2. Regulation 1.1001-3 has been criticized for giving significant tax consequences to insignificant transactions.

3. IRS issued Regulation 1.1001-3 to address uncertainties in the law of debt modification.

4. Gain results to the issuer of debt every time a modification of the debt occurs.

5. Alterations that occur by operation of the debt instrument are never considered modifications.

6. The holder of a debt instrument must immediately commence collection activities following an issuer's failure to perform.

7. The parties to a debt instrument may never delay the effective date of a modification.

8. Shareholder approval is a valid reason for delaying the effective date of a modification.

9. Modifications that add, delete or alter customary financial covenants are not considered significant under Regulation 1.1001-3.

10. A modification covered by a bright-line rule of significance may also be covered by the general rule of significance.

11. All modifications made to a debt instrument are considered when determining whether a significant modification has occurred under the general rule of significance.

12. A debt instrument will be considered significantly modified if, as a result of the modification, the yield changes by more than 5 percent.

13. Conversion of a debt instrument from recourse to nonrecourse is always a significant modification.

14. Modifications made to a guarantee of nonrecourse debt will be considered a significant modification to the debt instrument if the modification results in changed payment expectations.

15. A significant modification will be deemed to have occurred if the holder of a 15-year debt instrument allows the issuer to defer payment of an amount due for six years from the date on which the deferred payment was originally due.

16. Significant modification occurs whenever a new obligor is substituted on a recourse debt.

17. Code §108 may not be relied upon to exclude income resulting from a deemed exchange under Regulation 1.1001-3.

18. The holder of a significantly modified debt instrument is entitled to write-off the entire balance of a significantly modified debt as worthless in the year in which modification occurs.

19. If Code §108 does not apply, the issuer must include in income any gain resulting to him from debt modification.

20. Conversion of a debt instrument into property other than debt will always result in the debt instrument be treated as significantly modified.

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