

May 7, 2009

WEATHERING THE STORM Modifying Your Company's Debt: Tax Trap or Treasure?

Debtors increasingly are requesting that their creditors modify the terms of their debts because of difficulty or inability to service their debts in accordance with the debts' existing terms. Faced with the prospect of debtor defaults and having to foreclose on property securing their loans causing the accrual of financial losses, creditors, too, often have an incentive to restructure debt to maximize their returns. Although debt restructurings can benefit both debtors and creditors, debtors must be mindful of the fact that some of these modifications may result in their recognition of ordinary income (this income commonly is referred to as "cancellation of debt income" or "COD income").

General Rule

A debt "modification" is defined broadly and occurs whenever there is any change or alteration in the legal rights or obligations of the issuer or holder of a debt instrument. In situations where a modification occurs that is considered to be significant for federal income tax purposes, the modification is treated as a deemed exchange of the original debt instrument (the "old debt") for the modified debt instrument (the "new debt"). As a general rule, a modification is significant only if the rights or obligations of the issuer or holder of the debt instrument are changed or modified in an economically significant manner.

The determination of whether there has been an economically significant modification to a debt instrument generally depends on all facts and circumstances. However, Treasury Regulations provide specific guidance regarding when changes in the (i) yield, (ii) timing of payments, (iii) obligor, (iv) security, and (v) nature of a debt instrument (e.g., from recourse to nonrecourse) are considered significant. For example, a substitution or inclusion of a new obligor or changes in the security for a debt often will constitute a significant modification if the original obligor's capacity to satisfy the debt obligation is substantially enhanced or impaired in comparison to the old debt (i.e., excluding the new obligor or changes to the debt instrument). Another example that is considered a significant modification is the material deferral of any scheduled payments (e.g., extension of the final maturity date) required with respect to a debt instrument.

Debtor Tax Consequences Resulting From Significant Modifications

From a debtor's perspective, the most noteworthy tax consequence associated with a significant modification to a debt instrument and the deemed exchange resulting from the modification is the potential recognition of COD income. Because the significant modification of a debt instrument results in a deemed exchange of an old debt for a new debt for federal income tax purposes, there is the potential for COD income recognition, depending on the nature of the modification and the resulting issue price (or fair market value in the case of publicly traded debt) of the new debt. In general, a debtor realizes COD income to the extent it is relieved of an obligation to repay all or part of an existing debt.

Debtors should pay particular attention to any modifications of their debt instruments that are publicly traded because such instruments are subject to special rules. If there is a significant modification of a publicly traded debt instrument, the old debt is deemed to be satisfied and exchanged for a new debt instrument equal to the current fair market value of the publicly traded debt instrument (rather than the stated issue price). Therefore, in the case of a

debt instrument that is trading at a discounted value, the debtor will recognize COD income equal to the difference between the adjusted issue price of the unmodified debt instrument and the fair market value of the publicly traded instrument.

Deferral of COD Income under New Law

COD income generally must be recognized when it arises, unless it is eligible for deferral under certain recently enacted federal tax laws or qualifies for exclusion under an applicable exemption (e.g., the bankruptcy or insolvency exceptions). Subject to certain limitations, new laws allow taxpayers that reacquire trade or business debt (including through a debt-for-debt exchange) in 2009 or 2010 to elect to completely defer the recognition of any resulting COD income for the first four or five years (depending on whether the debt is purchased in 2010 or 2009) following the taxable year in which the discharge occurs and then recognize the COD income ratably over the succeeding five taxable years.

Conclusion

The savings associated with a debt modification clearly can be appealing, especially to a debtor. However, debtors should pay special attention to the debt modification rules and their impact to ensure that a debt modification does not result in an unanticipated tax trap. For more information concerning this issue, please contact:

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