

# COVID-19: DISTRESSED DEBT AND TAX - PART I - LENDER AND DEBT HOLDER CONSIDERATIONS

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## U.S. Tax Alert

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In response to the economic havoc resulting from the onset of the coronavirus ("COVID-19") pandemic, Congress has enacted wide-ranging legislation to help keep businesses open and to help borrowers and lenders deal with debts that cannot be repaid on the repayment schedules anticipated when loans were made and debts incurred.

The Coronavirus Aid, Relief, and Economic Security Act ("CARES Act") establishes new lending programs, such as the Paycheck Protection Program, which includes the unique feature that some portions of loans made under the program may be completely forgiven if certain requirements are met. The CARES Act also provides that the forgiveness of Paycheck Protection Program loans will not result in the receipt of taxable income by the borrowers. This added legislative benefit serves as a reminder that typically debt forgiveness and restructuring of distressed debt will have tax consequences both to borrowers and to lenders or other debt holders.

The CARES Act includes provisions granting lenders short-term relief in accounting for loans that become non-performing due to pandemic-related economic disruption, as well as directing lenders to provide certain borrowers with forbearance on their loans. The CARES Act provisions dealing with debt forbearance and debt modification raise questions about tax consequences, and the Internal Revenue Service ("IRS") is starting to provide guidance.

Although further guidance can be expected (such as recently issued Revenue Procedure 2020-26 providing safe harbors for securitization vehicles with respect to modifications to certain mortgage loans) on technical tax issues arising from the implementation of CARES Act programs, the tax consequences of loan forgiveness, forbearance, and modification are unlikely to change without further Congressional action. In the days ahead, many businesses and individuals will be dealing with distressed debt issues and should keep in mind the tax consequences of the decisions they will be making when they are making their plans. This client alert focuses on some of the tax considerations relevant to lenders and debt holders with respect to distressed debt planning. A follow-up alert will focus on similar issues for borrowers.

## SOME TAX ISSUES FOR LENDERS AND DEBT HOLDERS TO KEEP IN MIND

### When to Stop Accruing Interest, OID, and Market Discount on Debt that May Go Unpaid?

Generally, the original issue discount ("OID") rules under the Internal Revenue Code of 1986, as amended (the "Code"), require debt holders to include in ordinary income OID as it accrues before the receipt of cash attributable to such income, regardless of the debt holder's method of accounting. Similarly, the market discount rules provide that any gain recognized by a debt holder that purchased debt subsequent to its original issuance upon a sale or other disposition of a debt instrument will be treated as ordinary income rather than capital gain to the extent of that portion of the market discount that accrued prior to such disposition. In addition, the accrual method of accounting requires a taxpayer to include amounts in income when all events have occurred that fix the

right to receive such income and the amount thereof can be determined with reasonable accuracy. The OID rules and the accrual method of accounting are based, in part, on the reasonable expectation of the future receipt of the items of income that will be required to be reported in a taxpayer's taxable income before the receipt of cash. The market discount rules are based in part on the premise that market discounts associated with secondary debt purchases are caused by changes to interest rates (rather than the credit quality of the borrower or market conditions in general) and as such should be taxed similarly to OID as ordinary interest income rather than as capital gains.

As a borrower's financial condition deteriorates, it may be the case that previously-accrued interest and OID income becomes uncollectable and has "no reasonable expectation of payment." In that case, those previously-accrued amounts are not reversed but are instead analyzed as additional bad debts owing to a lender. As a borrower's financial condition deteriorates, once interest has become uncollectable, which is a fact-specific determination (especially for secured loans where the security may be adequate to fund principal and interest) that amounts have no reasonable expectation of payment, further interest accruals may not be required. E.g., Rev. Rul. 80-361, 1980-2 CB 164. In the case of market discount, spreads embedded in distressed debt arguably bear little resemblance to interest but instead are more similar to equity and should not be recast as interest income when, and if, realized. The IRS has suggested in criticized guidance that such an analysis would not necessarily apply to worthless OID and market discount accruals. In the current market environment, holders of distressed debt that previously accrued OID and market discount should consider whether interest treatment is appropriate despite the IRS's stated position on this issue.

### **Phantom Income on Debt Exchange**

The Code provides that cancellation of indebtedness is includible in gross income. When debt is restructured, cancellation of debt ("COD") income may be triggered as a result of a deemed exchange of one debt obligation for a new debt obligation or as a result of a modification of an existing debt obligation (e.g., the partial write-off of principal that may result in a deduction to the lender may also result in COD income to the borrower).

If a modification of the terms of a debt instrument is considered to be a "significant modification" under the Treasury Regulations, then for U.S. federal income tax purposes, the unmodified debt instrument (the "original debt instrument") is treated as if it were satisfied and reissued in exchange for a new debt instrument (the "modified debt instrument") for an amount equal to the issue price of the modified debt instrument. In such a case, (i) the issuer of a debt instrument will realize COD income to the extent the issue price of the modified debt instrument is less than the outstanding principal amount of the original debt instrument and (ii) unless the deemed exchange is considered a tax-free recapitalization, the debt holder may recognize income, gain, or loss (which may be a capital gain or loss or ordinary income or loss, depending on the nature of the debt instrument to the holder) equal to the difference between the holder's adjusted tax basis in the original debt instrument and the issue price of the modified debt instrument. As a surprise to many purchasers of distressed debt with embedded market discount, the significant modification rules present a risk of recognizing phantom income when debt is subsequently worked out after purchase, although, arguably, the debt holder's expectation of repayment has not changed.

### **Tax-free Reorganization Qualification**

As discussed above, a debt holder will generally recognize COD income if its adjusted basis in the original debt instrument is less than the issue price of the modified debt instrument. However, an actual or deemed exchange

may qualify as a tax-free reorganization under Code Section 368(a)(1)(E) if (i) the issuer of the debt is a corporation and (ii) the original debt instrument and the modified debt instrument each constitute a “security” for federal income tax purposes. Unfortunately, the determination of whether a debt instrument constitutes a security is not always clear. A debt instrument with a maturity of 10 years or more is generally a security; five years or less is not; and anything in between is facts and circumstances.

### **ECI Considerations with Multiple Debt Modifications**

Workouts of distressed loans by a foreign debt investor require careful tax planning to avoid having the foreign investor become subject to general U.S. taxation and generating income that is effectively connected with a U.S. trade or business.

A non-U.S. person is subject to U.S. federal income tax on a net basis on income that is “effectively connected” with the conduct of a U.S. trade or business (such income, “ECI”) at rates that are applicable to U.S. persons. Absent a treaty exemption or reduction, a foreign corporation could also be subject to a 30 percent branch profits tax on its ECI. If a foreign investor owns an interest in a partnership, and the partnership is considered to be engaged in a U.S. trade or business, the foreign investor will be considered to be engaged in the business conducted by the partnership and will be subject to tax on its distributive share of ECI. Moreover, a partnership that recognizes ECI must withhold tax at the highest applicable tax rate on each foreign partner's distributive share of such ECI.

For the most part, neither the Code nor Treasury Regulations provide any specific guidance on what constitutes the conduct of a U.S. trade or business. Moreover, the IRS does not ordinarily issue private letter rulings on whether a person is engaged in a U.S. trade or business and whether income is effectively connected with the conduct of a U.S. trade or business. However, foreign debt investors have historically relied on the “securities trading safe harbor” under which investing in or trading stocks and other securities (as compared with loan origination activity) is not considered engaging in a trade or business within the United States.

The securities trading safe harbor does not apply, however, to a non-U.S. person engaging in the active conduct of a banking, financing, or similar business within the United States. A foreign investor will be treated as so engaged if, among other things, it is engaged (directly, or indirectly through a partnership in which it is invested) in making loans to the public. As noted above, modifying a troubled loan can be treated for tax purposes as making a new loan and exchanging it for a prior loan, thus potentially creating a lending business where perhaps none originally existed. Where a borrower or issuer was not in financial distress at the time of the purchase of a debt instrument, and the debt is later modified due to the onset of financial distress in order to protect the debt holder's investment in the borrower or issuer, workout activities resulting in a significant modification arguably should not constitute a level of trade or business activities resulting in ECI. On the other hand, where a non-U.S. debt holder regularly engages in purchasing debt of distressed borrowers with the intention of doing workouts, the non-U.S. person could be deemed to be engaged in a banking or finance business. Both non-U.S. holders of debt acquired when borrowers were not in financial distress and purchasers of distressed debt need to carefully consider the threshold for being deemed engaged in a trade or business prior to initiating debt workout activities.

The securities trading safe harbor likewise will not apply if a non-U.S. person is considered to be a dealer in securities. In this context, a dealer in securities is a merchant regularly engaged in the activity of purchasing and selling securities to customers in the ordinary course of its trade or business. The activity of working out of distressed loans (if characterized as loan origination activity) followed by the sale of those loans to unrelated third

parties may amount to dealer activity causing a foreign investor modifying its debt portfolio to become engaged in a U.S. trade or business.

### **Special Entities and Situations**

Many types of lenders and debt holders, such as banks, REITs, fixed investment trusts, and REMICs, have additional rules to follow or constraints on their ability to acquire or workout troubled loans.

## **KEY CONTACTS**



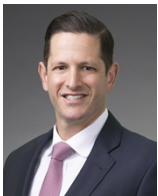
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