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Restructuring the Financially Troubled Corporation: A Tax Planning Checklist

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Advisors to a financially troubled corporation would do well to keep the tax law in mind as they plan for a restructuring of the company. Indeed, the corporation undergoing a restructuring faces several potential pitfalls. First, the restructuring may cause the corporation to recognize cancellation of indebtedness income (COD), resulting in either an immediate tax to the corporation or the reduction of valuable tax attributes. Second, an exchange of the corporation's outstanding debt or a modification of its terms can create original issue discount (OID), causing debtholders to recognize taxable income without receiving any corresponding cash. The corporation, in turn, may be unable to deduct the full amount of OID accrued on the restructured debt or may at least be forced to defer the deduction until it pays cash to the holders. Finally, the restructuring may significantly limit the corporation's ability to utilize its net operating loss carryforwards (NOLs) to offset future income.

CANCELLATION OF INDEBTEDNESS INCOME

COD arises where debt of the corporation is cancelled or discharged for less than its "adjusted issue price" (generally, its principal amount adjusted for any unamortized premium or discount). The amount of COD generally equals the excess of the adjusted issue price over the amount paid (i.e., the amount of cash, fair market value of stock, and/or the "issue price" of new debt securities exchanged for the outstanding debt) to satisfy the debt.

A solvent corporation not in bankruptcy must recognize COD currently as taxable income (subject to offset by any available NOLs or tax credits). If a corporation is insolvent for tax purposes, but not in bankruptcy, the corporation excludes COD from taxable income up to the amount of the corporation's insolvency. A corporation is insolvent to the extent that the adjusted issue price of its liabilities exceeds the fair market value of its assets, as determined immediately prior to the debt discharge giving rise to the COD. A corporation that is in bankruptcy does not include any amount of COD in taxable income.

The insolvent or bankrupt corporation must reduce various tax attributes by the amount of COD excluded from income after calculating its tax for the taxable year of the discharge. These attributes are reduced in the following order: NOLs, general business credits, minimum tax credits, capital loss carryovers, basis in the corporation's property, passive activity losses and passive activity credits, and foreign tax credits. Alternatively, the corporation may elect to reduce first its basis in its depreciable property before its other attributes. This attribute reduction is required to be made only as of the beginning of the taxable year following the year in which the COD occurs and, accordingly, any taxable income or gain recognized in the year in which the COD

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occurs can be sheltered by the corporation's tax attributes before the attribute reduction takes effect.

Although the issue is not free from doubt, where one or more debtor corporations are members of a consolidated group of corporations, the better view appears to be that determinations of insolvency and asset basis attribute reduction should be made on a member-by-member basis. Accordingly, where a parent holding company recognizes COD, the parent's basis in the stock of its subsidiaries, rather than the subsidiaries' "inside" asset basis, may be reduced under the principles above. The member-by-member approach probably does not apply to other attributes such as NOLs, however, which are viewed as a unitary attribute of the consolidated group.

Under a "related party" rule, if a person or entity that is related to the financially troubled corporation purchases the corporation's debt, it is treated as if the debt had been purchased by the corporation itself and in general the same COD rules discussed above apply to the debtor corporation. Persons or entities that are related, for this purpose, include the following: (i) an individual and a corporation in which the individual owns greater than 50% of the value; (ii) two or more corporations where, in general, each member (other than the common parent) is more than 50% owned (by vote or value) by one or more of the other members and the common parent owns more than 50% (by vote or value) of at least one other member; (iii) two or more corporations where five or fewer persons actually or constructively own greater than 50% of each corporation (by vote or value); (iv) a corporation and a partnership, if the same persons own more than 50% of the equity value of each; (v) two S corporations, or an S and a C corporation, if the same persons own more than 50% of the value of each corporation; (vi) a partnership and its greater than 50% partner; and (vii) two partnerships, if the same persons own greater than a 50% equity interest in each partnership. Additionally, certain constructive ownership rules operate to attribute ownership of stock and partnership interests to persons bearing specified relationships to actual shareholders or partners.

Special rules apply to "indirect acquisitions" where an acquisition of the debt is not by a currently related party, but by a party in anticipation of becoming related. This rule prevents corporations from avoiding the "related party" rule, for example, through the use of a newly formed corporation that purchases the debt and later is acquired by the debtor corporation.

MODIFICATION OF THE CORPORATION'S OUTSTANDING DEBT

Where a restructuring corporation modifies the terms of its outstanding indebtedness but does not redeem or actually exchange its outstanding debt for new debt, the old debt nevertheless may be treated as exchanged for new debt for tax purposes (thus potentially giving rise to COD consequences as well as OID) if the modifications to the debt's terms are "material." If the modifications are not material for tax purposes, no "exchange" of the outstanding debt will be considered to have occurred, no COD will be created, and the debt will be treated for tax purposes as a continuation of the old debt. Any cash or other consideration received by debtholders for their consent to the non-material modification should be treated as compensation to the creditor or a repurchase of the creditor's contractual rights (possibly treated as a recovery of basis), at least to the extent such payment is relatively small in relation to the outstanding debt being modified.

Treasury regulations govern the question of whether modifications to the terms of a corporation's outstanding debt will cause the debt to be treated as having been exchanged for new debt. The regulations contain a two-part test—first, whether a "modification" has occurred and, second, whether that modification is "significant."

A modification is "any alteration . . . of a legal right or obligation of the issuer or holder of a debt instrument," which can occur by formal amendment, conduct of the parties, or otherwise. Debt will not be treated as modified, however, if the alteration occurs by operation of the original terms of the instrument, subject to the following exceptions: First, an alteration that results in the substitution of a new obligor, the addition or deletion of a co-obligor, or a change in the recourse nature of the instrument is a modification; second, an alteration that results in an instrument or property right that is not debt for tax purposes is generally a modification; and third, alterations resulting from the exercise of an option on the party of a holder that results in deferral or reduction in any scheduled payment of interest or principal, and alterations resulting from the exercise of options that are not unilateral, are modifications.

The issuer's non-performance is not a modification. A waiver of rights, however, generally constitutes a modification, subject to an exception for a holder's temporary forbearance during a two-year period or a longer period in which the parties engage in good faith negoti-

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ations or during the pendency of bankruptcy proceedings.

As a general rule, a modification is "significant" (and therefore a deemed exchange of the debt) if the facts and circumstances indicate that the legal rights or obligations that are altered and the degree to which they are altered are economically significant. In addition to the general "facts and circumstances" rule, the regulations provide specific rules to cover various situations. For example, a change in yield of a fixed or variable rate debt instrument is significant if it exceeds the greater of 25 basis points or 5% of the instrument's original yield. A change in the timing of payments is significant if it results in the material deferral of scheduled payments. The regulations provide a safe harbor for a deferral period that lasts for the lesser of five years or 50% of the original term of the instrument, provided the deferred amounts are unconditionally payable at the end of that period. A change in obligor on a non-recourse debt instrument is not significant, whereas a change in obligor on a recourse debt instrument is generally significant (subject to several exceptions). If a co-obligor is added or removed, a guarantee is added, removed, or changed, the priority of the debt instrument is changed, or collateral is released, added, or substituted, the modification is significant if it results in a "change in payment expectations." If a debt instrument goes from being substantially all recourse to substantially non-recourse, or vice versa, the modification is generally significant (subject to certain exceptions). Finally, a modification that adds, deletes, or alters customary accounting or financial covenants is not significant.

CONSEQUENCES OF DEBT-FOR-DEBT EXCHANGE

Where the financially troubled corporation exchanges new debt for old debt or modifies the old debt in a manner that results in a deemed exchange, the new debt will be treated as issued as of the date of the exchange or modification. In general, except as discussed below, if both the old debt and the new debt constitute "securities" for tax purposes, the exchange will constitute a recapitalization and the holder generally will not recognize gain or loss (except to the extent the holder receives property other than stock or securities—including rights to acquire stock—of the debtor and to the extent attributable to accrued interest). Whether a debt instrument is a security for tax purposes is an inherently factual determination, based primarily on whether the debt evidences a long-term investment in the issuer. As a rule of thumb, however, instruments with a term of longer than ten years generally are treated as securities, while instruments with a term of less than five years generally are not.

An actual or deemed exchange of the corporation's debt raises the issue of whether the debt was satisfied at a discount, thereby generating COD to the corporation and OID for the holders, which a holder (other than a tax-exempt holder or foreign holder exempt from interest withholding and not otherwise subject to U.S. tax) must include in taxable income on a current constant-yield basis regardless of whether the corporation makes any cash payments on the debt. The old debt will be treated as having been discharged for an amount of cash equal to the issue price of the new debt. If neither the old debt nor the new debt is "traded on an established securities market" (i.e., is "non-publicly traded"), the new debt's issue price will equal its face amount provided it bears an interest rate at least equal to the applicable federal rate (AFR). Thus, OID can often be avoided in such a situation.

Where either the old debt or the new debt is traded on an established securities market, i.e., "publicly traded," the issue price of the new debt is its trading price or, if the new debt is not publicly traded but the old debt is, the trading price of the old debt. In such a case, OID is much more likely, since the trading price will typically be less than the face amount of the new debt.

Debt is traded on an established securities market if, at any time during the 60-day period ending 30 days after the issue date, it (i) is listed on a national securities exchange, an interdealer quotation system (e.g., Nasdaq), or a designated foreign exchange or board of trade, (ii) is traded on a contract market designated by the Commodities Futures Trading Commission or on an interbank market, or (iii) appears on a system of general circulation that provides a reasonable basis to determine fair market value by disseminating either recent price quotations of identified brokers and dealers (or a single broker) or actual prices of recent sales transactions (but not a "directory or listing of brokers, dealers, or traders for specific securities, such as yellow sheets, that provides neither price quotations nor actual prices of recent sales transactions"), or (iv) price quotations with respect to the debt instrument are "readily available" from dealers, brokers, or traders (the "readily quotable" standard). A debt instrument will not be treated as readily quotable within the meaning of (iv) above if (i) no other debt of the issuer (or of any person guaranteeing the debt) is publicly traded under the foregoing definition, (ii) the aggregate origi-

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nal stated principal amount of the issue that includes the debt does not exceed $25 million, (iii) the conditions and covenants relating to the debt are "materially less restrictive" than those of the issuer's other publicly traded debt (e.g., the debt is deeply subordinated to the issuer's traded senior debt), or (iv) the maturity date of the debt is more than three years after that of any of the issuer's traded debt.

If the corporation exchanges or modifies its old debt at a significant discount, the "high yield discount obligation" (HYDO) rules may apply to the new debt. An HYDO is a debt instrument with a term in excess of five years that bears interest on a yield-to-maturity basis at a rate more than five percentage points above the AFR for the month in which the debt is issued and has "significant OID." In general, a debt instrument has significant OID if the accrued and unpaid OID at the end of any accrual period ending after the five-year anniversary of the debt's issuance exceeds the product of (i) the debt's issue price and (ii) its yield to maturity, i.e., approximately one year's yield on the instrument. The HYDO rules generally disallow the corporation an interest deduction for OID in excess of 6% over the AFR, and require the corporation to defer a deduction for the remaining OID on the HYDO debt until the interest is paid in cash. Thus, although holders will be required to include the full amount of OID in taxable income as it accrues, if the HYDO rules apply, the corporation's tax result will be exacerbated by current income recognition in respect of COD (if solvent) and deferred interest deductions over the term of the new debt.

NOL LIMITATION

The financially troubled corporation's NOLs may be one of its most significant assets. A restructuring will often result in an "ownership change" under Section 382 of the Internal Revenue Code, however, which may severely limit the corporation's ability to use the NOLs going forward. An ownership change occurs if, immediately after the close of a "testing date," the percentage of a corporation's stock owned by 5% shareholders (measured separately for each 5% shareholder and then aggregated) has increased by more than 50 percentage points over the lowest percentage of stock of the corporation owned by such shareholders at any time during the "testing period" (i.e., generally, the three-year period prior to a testing date). In determining 5% shareholders, a corporation generally may rely on the existence (or absence) of SEC Forms 13-D and 13-G. In general, "public groups" of less than 5% shareholders are aggregated and treated as a single 5% shareholder, and a corporation may have more than one public group that must be treated as a 5% shareholder and separately tracked. In addition, constructive ownership and attribution rules apply that may treat related parties as a single 5% shareholder and may cause options and similar rights to be treated as stock. Generally, a testing date occurs on any date on which there is a change in the percentage of stock owned by a person who is a 5% shareholder before or after the change, or on which an option to purchase the corporation's stock is granted or transferred.

In general, where Section 382 applies, a corporation's utilization of its pre-change date NOLs for taxable periods following the change date is limited to an annual amount equal to the product of (i) the value of the corporation's equity immediately before the ownership change multiplied by (ii) the adjusted federal long-term tax-exempt rate on the date of the ownership change. (The long-term tax-exempt rate is announced each month by the Treasury Department and is currently approximately 5%.)

A corporation in bankruptcy that undergoes an ownership change and meets the qualifications set forth below may qualify to apply a special rule which avoids application of the Section 382 limitation but instead requires the corporation to reduce its NOL by the amount of interest paid or accrued during the current year and the three previous years on debt converted into stock in the Title 11 case. The special bankruptcy rule applies only if shareholders and certain "old and cold" and "ordinary course" creditors of a loss corporation own at least 50% of the vote and value of the stock of the loss corporation immediately after the ownership change. In general, old and cold creditors are creditors who held their debt claims for 18 months as of the date the loss corporation filed for bankruptcy. An important exception allows a corporation to assume that certain small creditors owning less than 5% of the stock of the reorganized corporation were qualifying 18 month conditions as of the filing date, absent actual knowledge to the contrary. Ordinary course creditors generally include the loss corporation's trade creditors and other holders of operating indebtedness. Where this special bankruptcy rule applies, if a second ownership change occurs within two years following the first, the NOLs that existed prior to the first ownership change are eliminated, often prompting a bankrupt corporation to institute transfer restrictions after the bankruptcy in order to prevent a second ownership change.

If the bankrupt corporation does not qualify for or

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elects out of the special bankruptcy rule, the value of the corporation for purposes of calculating its annual NOL limitation equals its value immediately after the ownership change (i.e., it reflects the additional value attributable to the cancellation of claims in the transaction).

CONCLUSION

In sum, significant tax issues must be considered in restructuring the financially troubled corporation. Often the potential pitfalls associated with these issues can be reduced or avoided in a manner consistent with business objectives. Where the corporation is in bankruptcy or expects to restructure in bankruptcy (as in a "prepackaged" reorganization plan), for instance, generally more favorable tax treatment is available. Relatively favorable tax treatment is also provided for a corporation that restructures its non-publicly traded debt. To the extent that a modification of the corporation's debt can be accomplished in a manner that does not cause a deemed exchange for tax purposes, adverse tax consequences again may be avoided.

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