

SIGNIFICANT MODIFICATIONS OF DEBT

INTRODUCTION

With U.S. corporate bankruptcies poised to hit a decade-long high as a result of the economic impact of COVID-19, we have prepared these materials that detail the key bankruptcy tax issues and guidance offered by Linda Swartz, the chair of Cadwalader's Tax Group, in old and new speeches and panels. We hope you find this presentation to be both useful and informative.

For additional information, contact [Linda Swartz](mailto:linda.swartz@cwt.com) (linda.swartz@cwt.com).

Upcoming speaking engagements:

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| October 14, 2020 | <ul style="list-style-type: none">• Linda Swartz will be presenting "Tax Strategies for Financially Troubled Businesses and Other Loss Companies" at PLI's Tax Strategies for Corporate Acquisitions, Dispositions, Spin-Offs, Joint Ventures, Financings, Reorganizations & Restructurings 2020 |
| November 5, 2020 | <ul style="list-style-type: none">• Linda Swartz will be presenting "A Cause for Distress? The Ways the Federal Income Tax Pushes Taxpayers into Bankruptcy" at The University of Chicago Tax Conference |
| January 25, 2021 | <ul style="list-style-type: none">• Linda Swartz will be presenting "Distressed Corporations: Creditor and Shareholder Issues" at the 2021 University of Southern California Federal Tax Institute |
| February 8, 2021 | <ul style="list-style-type: none">• Linda Swartz will be presenting "Workouts and Debt Restructurings" at PLI's 23rd Annual Real Estate Tax Forum |
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Linda Swartz, the longtime chair of Cadwalader's Tax Group and member of the Firm's Management Committee, focuses her practice on structuring complex restructurings, bankruptcies, mergers and acquisitions, spin-offs, joint ventures, and foreign tax planning strategies. She also regularly advises clients on fund structures, financings and derivative transactions.

Linda is consistently recognized as one of the leading tax lawyers in the country. She was recently named one of 14 "Influential Women In Tax Law" by *Law360*, noted for her role as "a key architect on billion-dollar transactions involving major multinational companies" with clients describing her tax structuring expertise as "so strong that we don't even go to the IRS to get a blessing from them. We go to Linda to get a blessing from her." She has been described by *Chambers USA* as "acclaimed for her vast reservoir of practical knowledge of the U.S. tax code" and "an expert on the law of today but cognizant of where the law might go in the future, allowing clients to make decisions which last for the next ten years." Clients quoted by *The Best Lawyers in America* have described Linda as "the foremost U.S. tax advisor on structured acquisition and divestiture deals" and "a professional force of nature" with "extraordinary technical ability, coupled with fiercest and most trenchant deal negotiation skills of any transactional tax lawyer." She was also recognized as "2017 Foreign Tax Planning Lawyer of the Year" by *Finance Monthly*, and *Dow Jones*, reporting on Procter & Gamble's Reverse Morris Trust transaction with Coty, noted that "it isn't often you see a tax adviser credited on a deal, but that's exactly what happened for Cadwalader, Wickersham & Taft in P&G's complicated \$12.5 billion unloading of its beauty business to Coty."

Linda is widely regarded as a thought leader in the industry and is a prolific speaker and writer on a wide range of transactional tax issues, with articles that include "Partnership Bankruptcy Tax issues," "Debt Exchanges," "Bankruptcy Tax Issues," and "Bankruptcy Tax 101." She also authors the chapters on Debt Exchanges in *Collier on Bankruptcy Taxation* (Matthew Bender) and Securities Lending Transactions in *Taxation of Financial Institutions* (Clark Boardman Callaghan). In addition to writing, she speaks on a broad range of topics, including each year on workout and bankruptcy tax issues at the corporate and real estate tax PLI conferences.

Linda is a member of the Executive Committee of the New York State Bar Association Tax Section and has chaired its Tax-Free Reorganizations; Corporations; Bankruptcy; Consolidated Returns; Real Property; and Tax Accounting and Basis Committees.

Linda received her J.D. from University of Pennsylvania Law School, and her B.A. from Bucknell University, where she graduated *magna cum laude* and was elected to Phi Beta Kappa.

RETESTING DEBT AS EQUITY

All debt that is modified must be retested to determine whether it qualifies as debt for tax purposes. A significant modification occurs if the resulting instrument is equity.

Long running debate regarding scope of debt-equity retesting under preamble and regulations.

- Broad view - deterioration in financial condition of issuer may be disregarded for purposes of all regulatory tests if no change in obligor or co-obligor.
 - Query why change of obligor on non-recourse debt should trigger retesting.

Regulations amended to adopt a broader view.

1001–3 DEBT vs. EQUITY TEST

Preamble

A number of commentators raised questions regarding the circumstances under which the modification of a debt instrument will require a determination of whether the modified instrument is debt or equity. Many expressed concern that a deterioration in the financial condition of the issuer between the date of original issuance and the date of the modification could lead to a determination that the modified instrument is not debt for tax purposes. **The final regulations address this concern by providing a rule that for purposes of this regulation, unless there is a substitution of a new obligor, any deterioration in the financial condition of the issuer is not considered in determining whether the modified instrument is properly characterized as debt.**

Regulation Text

(5) Changes in the nature of a debt instrument – (i) Property that is not debt. A modification of a debt instrument that results in an instrument or property right that is not debt for federal income tax purposes is a significant modification.

For purposes of this paragraph (e)(5)(i), any deterioration in the financial condition of the obligor between the issue date of the unmodified instrument and the date of modification (as it relates to the obligor's ability to repay the debt) is not taken into account unless, in connection with the modification, there is a substitution of a new obligor or the addition or deletion of a co-obligor.

DEEMED EQUITY QUESTIONS

- What portion of an issuer's equity is a lender deemed to receive?
- Is new "equity" of corporate issuers nonqualified preferred stock? Participating preferred stock? section 305(c) preferred stock?
- Could deconsolidation result, triggering deferred intercompany gains and excess loss accounts, and limiting future use of issuer's NOLs against other group members' income?
- Will new "equity" of LLC issuers trigger liability shifts and minimum gain chargebacks under section 752? Could it cause the liquidation of an LLC or partnership?
- Is new "equity's" (low) fair market value used to measure COD income? Compare (high) stated redemption price at maturity used to calculate COD in case of new privately held debt with adequate interest.
 - Corresponding loss to holders receiving deemed equity in a taxable exchange, *but see* Prop. Reg. Section 1.721-1(d)(1).
- Will "equity" represent newly issued stock for section 382 purposes that could cause an ownership change?
- Could issuers avoid future equity recharacterization by building in equity conversion features contingent on financial covenant defaults at issuance? Could these features cause the debt to be recast as equity upon issuance?

DEBT MODIFICATIONS

Whenever restructuring debt causes a “significant modification” of the debt, new debt (or equity, if new debt is recast as equity) is deemed exchanged for old debt.

- General test is facts and circumstances.
- Specific Rules regarding significant modifications:
 - Change in Yield
 - Change in Timing
 - Change of Obligors
 - Change in Security
 - Change in Nature of Debt Instrument

Whenever new debt deemed to be exchanged for old debt, COD is realized equal to any excess of the Adjusted Issue Price of the old debt over the Issue Price of the new debt.

- The “adjusted issue price” of the new debt instrument generally depends on whether the debt is “publicly traded.”

PUBLIC TRADING & ISSUE PRICE

If debt is
“Publicly Traded”

Issue Price = Fair Market Value of Instrument

If debt is not
“Publicly Traded”

Issue Price = Stated Redemption Price at Maturity*

*so long as the debt bears adequate stated interest (determined by reference to AFR)

PUBLIC TRADING TESTS

Whether old or new debt is “publicly traded” is determined under the 15 before / 15 after rule (*i.e.*, 31-day period ending 15 days after the issue date).

Three ways for debt to be “publicly traded”:

“Reasonably Available” Sales Price

Sales price for executed purchase or sale occurring within the 31-day period ending 15 days after the issue date is “reasonably available” within a reasonable period of time after the sale:

- “appears in a medium that is made available to” issuers of debt instruments, regular purchasers or sellers, or brokers;
- proposed regulation preamble: “pricing services and trading platforms that report prices of executed sales on a general basis or to subscribers”; and
- proposed regulation preamble: TRACE reporting = public trading.

Firm Quote

Price quote from at least one broker, dealer, or pricing service that is “substantially the same as the price for which the person receiving the quote could purchase or sell the property.”

Indicative Quote

Price quote other than firm quote provided by at least one broker, dealer, or pricing service.

POTENTIALLY ABUSIVE EXCHANGES

Issue price of deemed exchanged private debt is FMV if the situation is “potentially abusive,” which may be the case if:

- some or all of the exchanged debt has been acquired recently, and
- there is not a deemed or actual exchange of non-recourse debt for non-recourse debt.

Taxpayers and the IRS can each invoke the exception.

- An issuer’s determination binds all holders, unless a holder explicitly discloses an inconsistent position on a statement attached to holder’s tax return. Treas. Reg. § 1.1274-3(d).

The contours of the “potentially abusive” exception are not clear.