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Top ten tax considerations for borrowers

As the global economic outlook remains uncertain, with rising interest rates and a drying up of liquidity, many businesses are looking to renegotiate their debt. Some businesses want to lower their cost of borrowing; others are concerned that they may violate a debt covenant; many need additional capital. Whatever the reason, altering the terms of a debt instrument raises a host of tax questions, and some of the results can be unexpected.

To assist you in navigating these issues, the Financial Institutions & Products (FIP) group in the KPMG Washington National Tax (WNT) practice has outlined the following top considerations:

01 Is every debt amendment a taxable event?

Not all alterations or amendments to debt instruments result in taxable events. Although a modification generally includes any alteration of a legal right or obligation of the issuer or a holder of a debt instrument, the modification must be "significant" for a taxable event to occur. Regulations under section 1001 provide guidance as to which alterations are modifications and which modifications are significant. For example, a change in yield or material deferral of payments can be a significant modification. Significant modifications result in the borrower being treated as issuing new debt to retire existing debt in a taxable event (i.e., a section 1001 debt-for-debt exchange).

02 What if a debt amendment is not a taxable event?

If a debt amendment is not a significant modification, then there is no deemed section 1001 exchange of the modified debt for the unmodified debt. Nevertheless, some nonsignificant modifications may affect the tax accruals on the debt, so the debt's tax calculations for interest, original issue discount (OID), and debt issuance costs may need updating.

03 What if a debt amendment is a taxable event?

If a debt amendment results in a taxable event, the tax impact depends on the facts. In some cases, there may be no material tax impact. In other cases, the tax impact can be consequential and may involve the triggering of cancellation of debt income (CODI), or repurchase premium, as well as foreign exchange gain or loss, and consequences to any associated hedging transactions. Furthermore, the deemed newly issued debt may have different tax accruals than the original debt, including potentially more limited tax deductions.

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04

When could a debt amendment trigger CODI?

A borrower will realize taxable income (i.e., CODI) upon any complete or partial satisfaction of debt for less than the debt's adjusted issue price (i.e., a repayment of the debt for an amount less than the amount owed). Thus, if a borrower exchanges (or is deemed to exchange) new debt for old debt in a taxable event, the borrower will realize CODI to the extent the adjusted issue price of the old debt exceeds the issue price of the new debt. Determining the issue price of the new debt depends on the facts, including whether any of the new debt was issued for cash (e.g., there was an upsizing at the time of the significant modification), or whether the debt is publicly traded within the meaning of section 1.1273-2(f).

05

When could a debt amendment trigger deductions?

Conversely to the triggering of CODI, an actual or deemed debt-for-debt exchange may trigger bond repurchase premium (which is generally deductible under section 163, subject to section 249, which can limit such deductions with respect to convertible debt) in situations where the adjusted issue price of the old debt is less than the issue price of the new debt.

06

If a debt amendment is a taxable event, what happens to any associated hedges?

A debt amendment that results in a taxable event also can break hedging relationships (whether with respect to interest rate or foreign currency hedges) and result in a deemed termination of hedges associated with the debt. That deemed termination can result in gain or loss that may need to be recognized under the timing rules applicable to tax hedges. The particular tax impact under the hedge timing rules depends on the specific facts.

07

If a debt amendment is a taxable event, what happens to the debt issuance costs associated with the retired debt? Are new tax calculations needed?

When a debt amendment results in a taxable event, unamortized debt issuance costs with respect to the retired debt may be deductible at the time of the debt-for-debt exchange in certain situations, depending on the nature of the exchange, and the issue price of the new debt. In addition, the newly issued debt may need its own tax calculations to account for the new debt's tax attributes, including interest, OID, issuance premium, amortizable repurchase premium, and debt issuance costs, if any. The old debt's tax calculations will be largely irrelevant upon the issuance of the new debt.

08

If a debt amendment is a taxable event, will there be any limits on the issuer's ability to deduct interest and OID that accrues with respect to the new debt?

Maybe. If the new instrument is more properly viewed as equity, no interest or OID deductions will be available. If instead the new instrument is more properly viewed as debt, a fresh analysis regarding interest deductibility is required. This is true anytime new debt is issued. Accordingly, interest limitation provisions that were determined not to apply to the old debt may apply to the new debt, so it is important to reconsider relevant limitations, including section 163(l) and the applicable high yield discount obligation rules in section 163(e)(5), to name a few.

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09 Are there any reporting requirements?

Issuers of debt instruments may have an obligation to issue Form 1099-INT, Interest Income, or Form 1099-OID, Original Issue Discount, for interest and OID that accrues on their debt instruments. Issuers may also have an obligation to file Form 8937, Report of Organizational Actions Affecting Basis of Securities, with the IRS and holders of their debt if they engage in an organizational action that affects the holders' basis in the debt. An organizational action can include a debt-for-debt exchange. Further, if debt is significantly modified, has OID, and is publicly offered within the meaning of section 1.1275-2(h), the issuer is required to file a Form 8281, Information Return for Publicly Offered Original Issue Discount Instruments, with the IRS within 30 days of the significant modification. Additionally, pursuant to section 1.1273-2(f)(9), if debt is significantly modified, the borrower may be required to disclose within 90 days the fair market value issue price of the modified debt if its issue price is determined under the rules for publicly traded property (or debt issued for publicly traded property).

10 What if the debt is partially paid off instead of renegotiated?

When debt is partially repaid and the prepayment meets the definition of a pro rata prepayment, a portion of the unamortized debt issuance costs (if any) associated with the debt generally is currently deductible. Further, depending on the facts, the borrower may realize CODI or repurchase premium with respect to the retired portion of the debt. With a pro rata prepayment, the remaining tax calculations for the debt should remain, albeit proportionally reduced. If the prepayment is not pro rata, the tax calculations still may need updating, but an accelerated deduction for debt issuance costs is less likely to be available.

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