Top ten tax consideratons for holders of distressed debt

As the global economic outlook remains uncertain, the need to consider the tax issues that arise from distressed debt investments (whether related party or otherwise) is more important than ever.

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

Can a holder of distressed debt stop accruing into income interest and OID?

It depends. If the doubtful collectability exception applies, a holder of distressed debt may be able to stop including accrued interest in income. Whether this same exception applies to original issue discount (OID) is less clear. The IRS has issued informal guidance taking the position the exception does not extend to OID. Many practitioners disagree with the IRS's conclusion however, and there may be a position to go on nonaccrual with respect to OID.

02

What if a holder bought distressed debt at a discount?

If a holder buys a debt instrument in the secondary market at a price less than its principal amount (or "adjusted issue price" in the case of a debt instrument issued with OID), then that debt instrument has "market discount," unless it comes within one of a few exceptions. Very generally, the effect of the market discount rules is to convert what otherwise might be capital gain into ordinary income. As applied to distressed debt, however, the market discount rules can create timing and character issues that arguably are inconsistent with the policy behind the market discount rules. In certain cases, there may be arguments to turn off the application of the market discount rules.

03

If a holder receives a payment on a debt instrument, how should that payment be allocated?

In general, under the payment ordering rules, payments received must be allocated first to accrued interest and OID and then to principal. This can create unexpected results if a holder has ceased accruing interest and OID based on doubtful collectability and otherwise expects to suffer an overall loss with respect to the debt investment.

04

Will a holder's loss be ordinary if the borrower partially or fully pays off its debt?

Frequently not. Under section 1271, amounts received by the holder on retirement of any debt instrument shall be considered as amounts received in exchange therefor. Under this rule, losses associated with partial and full debt retirements likely will be capital if the debt is a capital asset in the hands of the holder. If the holder is related to the borrower, losses may be disallowed under section 267 or 707.

05

Are debt workouts taxable to the holder?

It depends. Gain or loss realized in connection with a debt workout that results in a debt-for-debt exchange under section 1.1001-3 may not be a recognition transaction if the transaction qualifies as a tax-free recapitalization. If it does not so qualify, a holder may recognize gain or loss on the deemed exchange, depending on the facts (e.g., whether the debt is publicly traded for tax purposes and has a fair market value issue price, the holder's basis in the debt, etc.).

06

When can a loss be taken on debt that is worthless?

A holder generally may claim a loss with respect to a debt instrument if the debt becomes wholly worthless during the taxable year. Whether and when the debt becomes worthless depends on the facts and circumstances. Generally, there must be an identifiable event with respect to the borrower that establishes that debt is wholly worthless, such as bankruptcy, termination of operations, liquidation, or receivership. The burden is on the holder to substantiate that worthlessness occurred during the tax year.

07

If debt becomes wholly worthless, what is the character of the holder's loss?

It depends. With limited exceptions, if the debt is a security (as defined in section 165(g)(2)) and a capital asset in the hands of the holder, the holder's worthlessness loss is treated a capital loss from a sale or exchange on the last day of the tax year (if not a capital asset, the loss generally would be ordinary). The term "security" for this purpose includes debt issued by a corporation, government, or political subdivision that is in registered form. If the debt is not a security (e.g., it is issued by a partnership or is not in registered form), then the loss may be ordinary under section 166 if the holder is a corporation, or the debt is a business debt. If the holder is not a corporation and the debt is not a business debt, the loss generally will be a short-term capital loss under section 166(d).

08

What if the debt is only partially worthless?

If a debt becomes partially worthless during the taxable year, corporate holders and non-corporate holders of business debt may be entitled to an ordinary bad debt deduction under section 166 for the partial worthlessness, but only to the extent the debt is also charged-off on the taxpayer's books. Whether and when debt becomes partially worthless depends on the facts and circumstances. Importantly, partial worthlessness losses may not be claimed with respect to debt that is a security as defined in section 165(g), or to nonbusiness debts held by noncorporate taxpayers.

09

Can debt that is a security be converted to a nonsecurity by taking it out of registered form so that it is subject to section 166 rather than section 165?

Possibly. IRS guidance suggests that it may be possible to take a debt instrument out of registered form, thereby causing it to no longer meet the definition of a section 165(g) security and thus causing it to be subject to the bad debt rules of section 166. This may have character and timing benefits if it would allow a holder to take partial or wholly worthless bad debt deductions that are ordinary in character rather than capital.

10

Does it always help to take debt out of registered form?

No. Section 165(j) denies a taxpayer a deduction for any loss sustained on a registration-required obligation if the obligation is not in registered form. As a result, taking a debt instrument out of registered form to claim ordinary losses under section 166 generally only works if the debt instrument is not a registration-required obligation.

Contact us

For more information about tax considerations for holders of distressed debt, contact your local KPMG adviser or one of the following WNT FIP professionals:

Liz Dyor
Managing Director, WNT FIP
T: 425-503-9871
E: ldyor@kpmg.com

Hubert Raglan
Managing Director, WNT FIP
T: 313-230-3000
E: hraglan@kpmg.com

Nancy Mah
Senior Manager, WNT FIP
T: 617-988-6766
E: nancymah@kpmg.com

Some or all of the services described herein may not be permissible for KPMG audit clients and their affiliates or related entities.

kpmg.com/socialmedia