



# Distressed debt restructuring

Tax structures that influence CODI, character,  
and economic outcomes



In today's distressed debt environment, tax considerations can shape final outcomes as much as, if not more than, the economic terms themselves. Recent insights from [KPMG TaxWatch webcast](#) highlight how relatively small changes, such as how a debt modification is classified under Section 1001 or whether a reduction in principal becomes cancellation of indebtedness income (CODI) can determine whether a restructuring yields orderly results or major tax liabilities.

Structurally similar workouts may ultimately diverge if Sections 1001 and 108, along with partnership allocation rules, are not managed carefully. By recognizing these hidden pressure points ranging from ordinary income "magnifiers" to character mismatches, stakeholders can better align a transaction's tax profile with its economic objectives, thereby preserving value and reducing the risk of unintended costs.

## Debt modifications: When principal reduction produces more CODI than expected

A modification of a debt instrument that is treated as significant under the Treasury Regulations is analyzed as a deemed exchange under Section 1001. Once that threshold is crossed, the issue price of the modified debt becomes central to the tax analysis. In many distressed scenarios, particularly where debt is publicly traded, the issue price of the new debt is determined by reference to fair market value rather than stated principal. As a result, CODI may exceed the negotiated principal reduction.

For example, an issuer has publicly traded debt with a face amount of \$1,000 and a trading value of \$720. If creditors agree to reduce the principal amount to \$800, then the modification is treated as an exchange. The new debt's issue price is \$720, resulting in CODI of \$280 under Section 108(e)(10), not 200.



### Why this matters

The tax result is driven by valuation mechanics, not by the amount of debt forgiven. In distressed environments, where pricing is often depressed, this dynamic can significantly increase ordinary income recognition at a time when liquidity is constrained.

## Pro rata prepayments: Narrowing CODI, but only if nothing else moves

One structure that can help mitigate valuation-driven CODI is a pro rata prepayment under Treasury Regulation 1.1275-2(f). If a portion of a debt instrument is retired through a prepayment that proportionately reduces all remaining payments, then the instrument is bifurcated:



The retired portion is treated as satisfied on the prepayment date.



The remaining portion survives as the continuing debt instrument.

When structured cleanly, CODI is measured only on the portion retired.

For example, using the same facts above, if the issuer pays \$1 to retire \$200 of the debt and leaves the remaining \$800 entirely unchanged, then CODI is expected to be \$199, rather than \$280, because only the retired portion is taken into account.



### The critical limitation

If the remaining \$800 of debt is modified in any way, even a maturity extension that would not be significant if analyzed on a stand-alone basis, then the entire transaction may risk being recharacterized as an exchange of the full \$1,000 of old debt for cash and modified debt. In that case, the valuation-based CODI reappears.

Key insight: In pro rata prepayment structures, the absence of additional changes is not incidental; it may be determinative.

## Partnership CODI: Ordinary income meets capital loss

In partnership restructurings, CODI is determined at the partnership level but applied at the partner level under Section 108(d)(6). Bankruptcy and insolvency exclusions are tested by reference to each partner's circumstances, not the partnerships.

This framework often produces a character mismatch:



CODI allocated to partners is ordinary income.



The loss reflected in the partnership interest is capital.

Many partnerships do not make tax distributions in restructuring scenarios, leaving partners with taxable income and no cash to fund the liability.

Certain revenue rulings permit partners to treat their share of excess nonrecourse liabilities allocated under Section 752 as liabilities for purposes of measuring insolvency, even where the partner is not personally liable under state law. While this may mitigate CODI for some partners, it does not address broader investor-base challenges.

# Corporate blocker structures: Relocating CODI to reduce distortion

One response to partnership-level CODI exposure is the use of a corporate blocker. In this structure:



Individual partners contribute their partnership interests to a corporation, often in a transaction intended to qualify under Section 351.



The corporation's basis in the partnership interests is subject to the Section 362(e) (2) basis limitation rules.



A subsequent debt-for-equity restructuring allocates CODI to the corporate owner rather than to individual partners.

Because CODI is recognized by the corporation, it may be excluded under the bankruptcy or insolvency rules of Section 108. Former partners hold stock reflecting their economic investment, without recognizing ordinary income they cannot offset with capital losses.

Key considerations raised by this structure include:



Potential reallocation concerns under Treasury Regulation 1.704-1(b)(1)(iii) and Section 482 principles.



The application of Section 1032 to stock issuance.



The presence of a Section 743(b) inside-basis adjustment.

The core premise is not tax avoidance, but distortion correction, preventing an economically losing investor from ending in a net taxable position due solely to character mismatches.

## Check-the-box elections: Sequencing CODI through regulatory timing rules

Another approach involves an insolvent partnership electing to be treated as a corporation for federal income tax purposes immediately before a debt restructuring.

Treasury Regulation 1.1274-5 governs situations where a debt instrument is assumed in connection with a sale or exchange of property and a significant modification occurs. The regulation treats the modification as a separate transaction occurring either immediately before or, by election, immediately after the exchange.

By coordinating a check-the-box election with the regulatory timing election under Treasury Regulation 1.1274-5(b)(2), CODI may arise at the corporate level rather than at the partner level, even when the restructuring plan is already in place.

This framework directly addresses historical concerns that Section 482 would reallocate CODI back to partners based on timing alone. The regulation provides explicit ordering rules that govern the tax consequences.

## Nonrecourse debt: Gain versus CODI turns on structure

When property subject to nonrecourse debt is transferred to a creditor in satisfaction of the debt, the amount realized is generally the full amount of the liability under Section 1001 and the principles of Commissioner v. Tufts. This can produce taxable gain even when asset values are significantly below the debt balance.

Attempts to interpose third-party sales at fair market value may still be treated as economically equivalent to a foreclosure, preserving the gain result.

By contrast, where a transaction is structured to fall within Treasury Regulation 1.1274-5, the debt modification may be treated as occurring separately from the asset transfer. In that case, the obligor may recognize CODI rather than gain, allowing potential application of the bankruptcy or insolvency exclusions under Section 108.

## Closing observation

Across these structures, a consistent theme emerges in distressed debt restructurings; Tax outcomes are shaped less by the amount of debt reduced and more by valuation, character, and sequencing.

Pro rata prepayments, corporate blockers, check-the-box elections, and the application of Treasury Regulation 1.1274-5 are not tactical afterthoughts. They are structural tools that can materially influence whether a transaction preserves value or introduces unintended tax consequences.

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