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Debt Renegotiation: Tax Traps for the Unwary Business

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By Ellen L. Joseph, CPA

In these challenging economic times, many businesses are renegotiating debt with their lenders. This debt renegotiation process may entail many changes: extensions of maturity dates, changes in interest rates, reductions of principal, etc. A “significant modification” of the debt may cause the debtor to realize income from the “exchange of the original debt instrument for a modified instrument that differs materially either in kind or in extent” [Regulations Section 1.1001-3(b)]. Whether the modification of a debt instrument is a significant modification is determined under the rules of Regulations Section 1.1001-3(e). If a significant modification has occurred, IRC Section 108 and its underlying regulations determine whether the income created there by is excludible from gross income.

Significant Modifications

First, there must be a modification to the debt. Modifications are defined, rather broadly, by Regulations Section 1.1001-3(c)(1)(i) as “any alteration, including any deletion or addition, in whole or in part, of a legal right or obligation of the issuer or a holder of a debt instrument, whether the alteration is evidenced by an express agreement (oral or written), conduct of the parties, or otherwise.” In general, an alteration of a legal right or obligation that occurs by operation of the terms of a debt instrument is not a modification [Regulations Section 1.1001-3(c)(1)(ii)]. An annual adjustment to the interest rate based upon a specified index, such as LIBOR, illustrates this exception. Thus, an extension of maturity date, change in interest rate or reduction of principal is a modification to the debt instrument. But are these modifications significant?

A change in yield is a significant modification if the yield of the modified instrument varies from that of the original instrument by the greater of (A) 25 basis points, or (B) 5 percent of the annual yield of the unmodified instrument (.05 x annual yield) [Regulations Section 1.1001-3(e)(2)(ii)]. It is important to note carefully that the criterion is a change in yield, not a change in stated interest rate. Changes in yield may result from reductions to principal, payment of consent fees, or a change in timing of payments for debt issued at a discount to principal. If the original yield is 7 percent, the change in yield must be greater than 0.35 percent in order for the modification to be significant. It is important to note that a modification is significant if the yield is greater than or less than the original yield by the threshold amounts discussed above. Change in yield is measured on a cumulative basis.

A modification that changes the timing of payments (including a change in the amount of payments) due under a debt instrument is a significant modification if it results in the material deferral of scheduled payments. The deferral may occur either through an extension of the final maturity date of an instrument or through a deferral of payments due prior to maturity. The materiality of the deferral depends on all the facts and circumstances, including the length of the deferral, the original term of the instrument, the amounts of the payments that are deferred and the time period between the modification and the actual deferral of payments [Regulations Section 1.1001-3(e)(3)(i)]. However, under a safe harbor provision, there is not a significant modification if the deferral is for the lesser of five (5) years or one half of the original term of the debt [Regulations Section 1.1001-3(e)(3)(ii)].

As a general rule, the substitution of a new obligor on a recourse debt is a significant modification [Regulations Section 1.1001-3(e)(4)(i)(A)]. There are exceptions to this significant modification when an acquiring corporation (within the meaning of IRC Section 381) becomes the new obligor pursuant to a transaction to which IRC Section 381(a) applies and certain other criteria are met [Regulations Section 1.1001-3(e)(4)(i)(B)]. A similar exception applies to the substitution of a new obligor if the new obligor acquires substantially all of the assets of the original obligor, and other requirements are satisfied [Regulations Section 1.1001-3(e)(4)(i)(C)].

The substitution of a new obligor on a nonrecourse debt instrument is not a significant modification [Regulations Section 1.1001-3(e)(4)(ii)].

A modification of collateral or guarantee of recourse debt is a significant modification if the modification results in a change of payment expectations [Regulations Section 1.1001-3(e)(4)(iv)(A)]. A modification of a “substantial amount” of collateral for a nonrecourse debt is usually a significant modification [Regulations Section 1.1001-3(e)(4)(iv)(B)].

A change in the recourse nature of the debt is a significant modification [Regulations Section 1.1001-3(e)(5)(ii)(A)]. This applies to both changes from nonrecourse to recourse and vice-versa. The simple addition of a guarantor to a previously nonrecourse debt is a significant modification.

Finally, changes to the debt that are “economically significant” are also significant modifications [Regulations Section 1.1001-3(e)(1)]. Whether or not changes are economically significant is determined by the facts and circumstances of the debt and all modifications are considered collectively. An example would be a change from a variable interest rate to a fixed interest rate.

Computing Income Generated by the Debt Modification

Now that a debt has been determined to have been significantly modified, one must determine if there has been cancellation of debt (COD) income. The issuance of new or modified debt generates COD income if the issue price of the new debt is less than the balance of the old debt [IRC Section 108(e)(10)(A)]. The issue price of any debt instrument for these purposes shall be determined under IRC Sections 1273 and 1274 [IRC Section 108(e)(10)(B)]. The issue price is calculated by determining the current (discounted) value as of the date of modification of all future payments of the modified loan, using the appropriate applicable federal rate (AFR). The calculation includes payments of principal and interest for the life of the modified loan. Under these provisions, the issue price of the modified debt will be its stated principal amount if the modified debt has an interest rate equal to or greater than the AFR compounded semiannually [IRC Section 1274(a)(1)]. Therefore, a significantly modified debt with adequate stated interest will not generate any COD income, unless there have been reductions in principal.

If the significantly modified debt's issue price is less than the balance of the remaining unpaid original debt, the difference between the two amounts is COD income. Further, that same amount is treated as original issue discount (OID) to the borrower (and lender) and is amortized as interest expense (income) under the rules of IRC Section 1274.

Tax Treatment of COD Income

Gross income is defined to include income from the discharge of indebtedness, also referred to as COD income [IRC Section 61(a)(12)]. IRC Section 108(a)(1) lists five exceptions to that broad rule of inclusion:

1. The discharge occurs in a Title 11 case;
2. The discharge occurs when the taxpayer is insolvent;
3. The indebtedness discharged is qualified farm indebtedness;
4. In the case of a taxpayer other than a C corporation, the indebtedness discharged is qualified real property business indebtedness; or
5. The indebtedness discharged is qualified principal residence indebtedness, which is discharged before Jan. 1, 2010. (Extended by PL 110-343 to Jan. 1, 2013.)

If the debtor is a partnership, the provisions listed above are determined at the partner level [IRC Section 108(d)(6)]. Thus, if a debtor partnership files for Title 11 bankruptcy protection, or is insolvent, the partners therein may still recognize COD income. If a partner is solvent and has not filed for bankruptcy under Title 11, he or she will recognize COD income. However, the determination of whether or not discharged indebtedness is qualified real property business indebtedness (QRPBI) is determined at the partnership level [H. Rept. 103-111, PL 103-66].

If a partner is eligible for one of the exceptions determined above, the reduction of tax attributes, treatment of discharge of qualified real property business indebtedness, and special rules for discharge of qualified farm indebtedness are also applied at the partner level. Any interest of a partner in a partnership shall be treated as depreciable property to the extent of such partner's proportionate interest in the depreciable property held by such partnership. The preceding sentence shall apply only if there is a corresponding reduction in the partnership's basis in depreciable property with respect to such partner [IRC Section 1017(b)(3)(C)].

But for an S Corporation debtor, the exceptions listed above, as well as the reduction of tax attributes, etc., are applied at the corporate level [IRC Section 108(d)(7)(A)]. However, the S Corporation shareholder does not include in his/her share of S Corporation income the income excluded from gross taxable income above (i.e., he/she does not receive an increase in his/her shareholder basis as a result of this excluded COD income).

Qualified Real Property Business Indebtedness

Qualified Real Property Business Indebtedness (QRPBI) is indebtedness that was incurred or assumed by the taxpayer in connection with real property used in a trade or business and is secured by such real property, is qualified acquisition indebtedness, and with respect to which a taxpayer makes an election to have IRC Section 108(c)(3) apply. IRC Section 108(c)(4) defines qualified acquisition indebtedness as indebtedness incurred or assumed to acquire, construct, reconstruct or substantially improve such property.

IRC Section 108 does not define “used in a trade or business.” IRC Section 1231(b) defines property used in a trade or business as (real) property used in the trade or business, held for more than one year, which is not (A) property of a kind that would properly be includible in the inventory of the taxpayer if on hand at the close of the taxable year, or (B) property held by the taxpayer primarily for sale to customers in the ordinary course of his trade or business. Therefore, debt on real property held by a partnership or S corporation for investment would not qualify for the COD income recognition exception under IRC Section 108(a)(1)(D). Similarly, debt on lots held by a developer would not qualify for the COD income recognition exception under IRC Section 108(a)(1)(D) because the lots are held primarily for sale to customers of the debtor and are not “used in a trade or business.”

Conclusion

The mere act of renegotiating debt with a lender may have unintended tax consequences for the business debtor. This is especially true if the debtor is a partnership and the debt collateral is property held for investment or inventory. However, close coordination by the debtor with his or her tax advisor during the renegotiation process can avoid or minimize these unintended consequences.

Ellen L. Joseph, CPA, is director of tax at Falcone Group, LLC, and chair of the FICPA Florida Industry Section Steering Committee. She also serves on the State Legislative Policy Committee and has previously served as a member of the Steering Committee of the Florida State Tax Section.

For more information contact: msc@ficpa.org

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325 W. College Avenue Tallahassee, FL 32301 msc@ficpa.org (850) 224-2727 or (800) 342-3197 (within Florida)
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