HUNTON & WILLIAMS

CLIENT ALERT

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IRS Issues New Guidance Impacting the Tax Treatment of Distressed Debt

On January 6, 2011, the Treasury Department ("Treasury") issued proposed regulations that would significantly expand the universe of debt instruments that are treated as "publicly traded" for purposes of determining their issue price (the "Proposed Regulations"). These regulations, if finalized in their current form, would materially increase the amount of cancellation of debt ("COD") income and lender losses recognized as a result of distressed debt restructurings and modifications. However, the Proposed Regulations would likely decrease the amount of "phantom" taxable gain recognized by investors in distressed debt who acquire the debt at a discount and then agree to a modification of the debt. Also on January 6, 2011, the Treasury published final regulations that generally disregard deterioration of an issuer's financial condition in determining whether distressed debt that has been modified continues to be treated as debt for tax purposes (the "FD Regulations"). The FD Regulations will tend to reduce the scenarios in which COD income and lender losses are recognized in connection with distressed debt modifications.

New "Publicly Traded" Definition

Impact of "Issue Price" on Debt Modifications

Although the Proposed Regulations would affect the issue price of any debt instrument issued for property, they are particularly relevant for the deemed exchange of debt instruments that occurs in the context of modifying the terms of distressed debt. When a significant modification is made to a debt instrument (e.g., a material extension of the maturity, a sufficient change in yield or certain changes in obligor or security), the unmodified debt instrument is treated for federal income tax purposes as having been exchanged for the modified debt instrument. If the issue price of the modified debt instrument is less than the adjusted issue price of the unmodified debt instrument, the borrower generally will recognize COD income upon the deemed exchange. In addition, if the issue price of the modified debt instrument is less than the holder's tax basis in the unmodified debt instrument, the holder potentially could recognize a tax loss to the extent of the difference.

The Proposed Regulations would also affect the amount of phantom taxable gain recognized by distressed debt investors who acquire such debt at a discount and then agree to a modification of the debt. If the issue price of the modified debt instrument exceeds the investor's tax basis in the unmodified debt instrument, the investor generally will recognize phantom taxable gain in an amount equal to such excess. Such gain is often referred to as "phantom" gain because it is not accompanied by a corresponding receipt of a cash payment.

The issue price of a modified debt instrument depends on whether the debt instrument is "publicly traded," either before or after modification. If it is, the issue price of the modified debt instrument will be its fair market value on the modification date. If neither the unmodified nor the modified debt instrument is considered publicly traded, the issue price of the modified debt instrument generally will be its principal amount (assuming the stated rate of interest on the modified debt instrument is at least equal to the applicable Treasury rate published by the Internal Revenue Service).

Broad Standard under the Proposed Regulations

Although there is some uncertainty surrounding the issue, it appears that many debt instruments would not be considered publicly traded under the existing regulations. To be considered publicly traded under the existing regulations, a debt instrument generally must (i) be traded on an exchange, (ii) appear on a generally available quotation medium that provides recent price quotations or sales prices or (iii) be one for which price quotations are readily available from broker-dealers, in each case at any time during the 60-day period ending 30 days after the issue or modification date. There are various exceptions from publicly traded status for debt instruments that fall under clause (iii) of the immediately preceding sentence, including for debt that is part of an issue with an aggregate original principal balance of no more than $25 million.

The Proposed Regulations take the position that the "publicly traded" standard should be interpreted broadly. Accordingly, the Proposed Regulations expand the categories of debt instruments that are considered publicly traded to include those for which an indicative or "soft" price quotation is available from at least one broker-dealer or pricing service. Any price quotation qualifies under this provision, regardless of whether it is firm (i.e., there is no requirement that the quoting broker-dealer be obligated to purchase, or that any transactions actually occur, at the quoted price). Moreover, even if the price quotation materially misrepresents the fair market value of the debt instrument, the borrower and the lender cannot default to using the principal balance of the modified debt instrument as its issue price; instead, the parties still must determine the fair market value of the debt instrument using some other valuation method that they determine to be reasonable (e.g., net present value of the projected principal and interest payments). Our understanding is that indicative price quotations are available for most debt instruments.

The Proposed Regulations also (i) expand the list of what qualifies as an exchange for purposes of being exchange-traded, (ii) clarify that sales price information is considered reasonably available even if it is available to only broker-dealers, customers or subscribers and (iii) clarify that a firm price quotation is considered to exist even if it is provided by only a single broker-dealer or pricing service and the provider is not legally obligated to buy or sell at that price (as long as sales transactions typically occur at the quoted price). The Proposed Regulations would reduce the time period for determining whether a debt instrument is publicly traded to the 31-day period ending 15 days after the issue or modification date. Finally, exceptions are provided for debt instruments for which there is no more than *de minimis* trading and for small debt issuances with an aggregate original principal balance of no more than $50 million.

The Proposed Regulations are proposed to be effective for debt instruments that are issued or modified after the publication of such regulations in final form.

Effect of the Proposed Regulations

If adopted in their current form, the Proposed Regulations would make it much more likely that distressed debt instruments that are modified will be considered publicly traded and thus to have an issue price upon modification equal to fair market value. As a practical matter, the fair market value of a debt instrument that has been modified because of borrower distress will likely be significantly less than its principal balance. Thus, the Proposed Regulations likely will cause borrowers to recognize more COD income, and lenders to recognize more tax losses, when distressed debts are modified. However, investors that acquire distressed debt at a discount with the intention of modifying such debt likely will recognize less phantom taxable gain as a result of the modification if the Proposed Regulations are adopted, because the issue price of the modified debt instrument will be based on its fair market value rather than its principal amount.

Deterioration of Financial Condition

As discussed above, a significant modification of a debt instrument causes the unmodified debt instrument to be treated as having been exchanged for the modified debt instrument for federal income tax purposes. Applicable Treasury regulations provide that a modification of a debt instrument that results in an instrument or property that is not debt for federal income tax purposes is a significant modification.

The FD Regulations, adopting proposed regulations published in June 2010, clarify that any deterioration in the financial condition of the borrower generally is not taken into account in determining if the modified instrument should continue to be treated as debt for tax purposes. The FD Regulations provide an example showing that any decrease in the fair market value of a debt instrument between its issue date and its modification date is generally disregarded in determining whether the instrument continues to qualify as debt if the decrease is attributable to a deterioration in the financial condition of the issuer and not to a modification of the terms of the instrument. The FD Regulations should provide comfort to borrowers and lenders seeking to modify distressed debt that the borrower's financial distress alone will not cause the modified debt to be treated as an equity interest in the borrower for tax purposes.

The FD Regulations apply to alterations of the terms of a debt instrument on or after January 7, 2011, but may be relied on by taxpayers for alterations of the terms of a debt instrument occurring before that date.

If you would like to receive more information about the Proposed Regulations or the FD Regulations, please contact George C. Howell, III at (804) 788-8793 or ghowell@hunton.com, Cecelia Philipps Horner at (804) 788-7394 or chorner@hunton.com, or Mark C. Van Deusen at (804) 788-8349 or mvandeusen@hunton.com.