IRS Adopts New Treasury Regulation on Modification of Distressed Debt

In June of last year, the IRS issued proposed amendments to Treasury Regulations (the “Regulation”), relating to the modification of debt instruments. The proposed amendments clarified the extent to which the deterioration in the financial condition of the issuer is taken into account to determine whether a modified debt instrument will be treated as reissued for U.S. federal income tax purposes and/or recharacterized as an instrument or property right that is not debt for U.S. federal income tax purposes. Last week, the IRS adopted these amendments in final form.

The Regulation provides rules for determining when a modification of a debt instrument results in an exchange for U.S. federal income tax purposes, which generally is treated as a taxable event. In general, a “modification” that is “significant” (as such terms are defined in the Regulation) results in a deemed exchange of the original debt instrument for a modified debt instrument. A modification of a debt instrument that results in an instrument or property right that is not debt for U.S. federal income tax purposes is considered to be a “significant” modification. In making these determinations, any deterioration in the financial condition of the issuer between the issue date of the unmodified debt instrument and the date of modification (as it relates to the issuer’s obligation to repay the debt instrument) is not taken into account, unless there is a substitution of a new obligor or the addition or deletion of a co-obligor.

Although the original preamble to the Regulation, and the general position of the IRS, had been consistently clear that any deterioration in the financial condition of the issuer is not taken into account (except as provided above) for any purpose under the Regulation, the literal language of the Regulation (prior to the amendments) could have been interpreted as ignoring a deterioration in the issuer’s financial condition only for purposes for determining whether a modification is “significant,” and not for other tax purposes. For example, taxpayers had been concerned that under a literal reading of the Regulation, a decline in the creditworthiness of the issuer, under certain circumstances, may have been taken into account in determining the proper classification for U.S. federal income tax purposes of a modified debt instrument resulting from a deemed exchange caused by other alterations to the debt.

In addition, there had been some concern that the financial condition of the issuer might have been relevant for purposes of determining whether a modification is “significant,” other than the direct effect such change may have had on the status of the instrument as debt for U.S. federal income tax purposes. For example, the terms of a publicly traded debt instrument could be changed resulting in a slight increase in the yield of the debt instrument. This change may be treated as a “modification” to the instrument, but not a modification that is “significant” (assuming one ignores the financial condition of the issuer). However, if the issuer’s financial condition has deteriorated such that the debt is trading below par, then taking into account such reduced trading value, the effective change in yield actually could be significantly greater than provided in the terms of the instrument. This higher effective yield could cause the instrument to cease to be viewed as debt for U.S. federal income tax purposes (resulting in a modification that is “significant”).

To address these concerns, the IRS has adopted certain amendments to the Regulation. Specifically, the amendments clarify that determining whether a modified instrument resulting from an exchange is debt for U.S. federal income tax purposes requires an analysis of all of the factors (*e.g.*, creditor rights or subordination) relevant to a debt determination of the modified instrument at the time of an alteration or modification. However, any deterioration in the financial condition of the issuer between the issue date of the debt instrument and the date of the alteration or modification (as it relates to the issuer's ability to repay the debt instrument) is not taken into account, unless there is a substitution of a new obligor or the addition or deletion of a co-obligor.

For example, under the amended Regulation, any decrease in the fair market value of a debt instrument (whether or not publicly traded) between the issue date of the debt instrument and the date of the alteration or modification is not taken into account to the extent that the decrease in fair market value is attributable to the deterioration in the financial condition of the issuer and not to a modification of the terms of the instrument. Consistent with this rule, if a publicly traded debt instrument is significantly modified, any increased effective yield on the modified debt instrument attributable to the new fair market value issue price generally is not taken into account in determining whether the modified debt instrument is debt or some other property right for U.S. federal income tax purposes. However, any portion of the increased yield that is not attributable to a deterioration in the financial condition of the issuer, such as a change in market interest rates, is taken into account.

The amendments make the language of the Regulation more consistent with the language in the original preamble to the Regulation, and should help allay certain concerns of issuers and obligors involved in restructuring of distressed debt.

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