

# Income Tax and Other Considerations Related to Debt Restructuring and Debt Cancellation

C. Ryan Stewart

*In an environment caused by the COVID-19 pandemic, many debtor entities have become financially distressed—due to decreased revenue and inconsistent cash flow. As a result, these debtor entities may take advantage of government-sponsored aid programs as well as opportunities to work with creditors to gain relief through debt restructuring. When debt is forgiven in a debt restructuring, it causes the debtor taxpayer to recognize cancellation of debt (“COD”) income for federal income tax purposes. However, under certain circumstances, the debtor taxpayer can avoid recognition of a portion—or all—of the COD income to the extent that the debtor taxpayer is insolvent or in bankruptcy. This discussion summarizes (1) the federal income tax rules for COD income recognition and (2) the provisions for the nonrecognition of COD income in certain circumstances. Further, this discussion summarizes both the income tax and valuation considerations that boards of directors, debtor company managers, and valuation analysts may consider when evaluating debt restructuring strategies.*

## INTRODUCTION

On March 11, 2020, the World Health Organization declared COVID-19 a pandemic.<sup>1</sup> The advanced spread of COVID-19 and the ultimate impact on the economy, consumer confidence, and market valuations were highly uncertain and susceptible to speculation.

Due to certain strategies employed in an attempt to slow the spread of the virus, including stay-at-home orders, social distancing, indoor capacity restrictions, supply chain disruption, public fear, uncertainty, and doubt, many businesses were forced to shut down operations.

Often, the businesses that were able to withstand the initial waves of the pandemic were left

in a distressed financial state and challenged in terms of the ability to fund operating expenses and service debt.

As a result, the government and many lending institutions implemented programs designed to provide relief to debtor entities. This relief was provided in the form of loans, debt forbearance, renegotiation of debt terms, and debt cancellation among other forms of assistance. By early April 2021, Congress had passed several rounds of legislation to address the financial and economic impact of the pandemic on individuals and companies.

New legislation can often be complicated to evaluate and put into practice. Prior to the date of this publication, the Internal Revenue Service was

in the process of reviewing the American Rescue Plan Act of 2021<sup>2</sup> (signed into law March 11, 2021<sup>3</sup>). Therefore, its precise impact on taxpayers was not understood at the time of preparing this discussion. Additionally, nothing in this discussion should be construed as tax, legal, or investment advice.

This discussion provides an overview of the income tax implications of several of the aforementioned debt relief alternatives when viewed in the context of restructuring the debt of debtor entities during times of financial distress.

This discussion also focuses on certain exceptions to the recognition of cancellation of debt (“COD”) income as well as the resulting considerations that advisers, managers, and boards of directors should be aware of when analyzing debt restructuring opportunities for distressed companies.

## CANCELLATION OF DEBT INCOME

COD income occurs when debt is forgiven, discharged, or canceled for less than the full amount owed on the debt. The amount of debt that is canceled is considered income, and it is typically included as taxable income on the debtor’s income tax return corresponding to the year in which the cancellation occurred.

Internal Revenue Code Section 108 provides exclusion provisions for the recognition of COD income. These exclusions include the following:

1. The bankruptcy exception
2. The insolvency exception

These exceptions are designed to preserve the debtor taxpayer entity’s “fresh start” and reduce or eliminate the burden of an immediate income tax liability when debt is forgiven.

## DEBT RESTRUCTURING EVENTS THAT TRIGGER COD INCOME

Typically, a distressed debtor entity will engage in a debt restructuring to stabilize operations and the financial position of the entity as well as enhance cash flow.

Outside of a bankruptcy context, distressed debtor companies typically engage in debt restructuring in the following circumstances:

1. An ownership change is not expected.
2. The creditor and debtor taxpayer entities prefer to avoid a bankruptcy proceeding.

Examples of debt restructuring activities may include, but are not limited to, the following:

1. The distressed debtor entity repurchasing existing debt at a price discount through a debt recapitalization
2. A creditor swapping recourse or nonrecourse debt for newly issued equity securities or instruments (i.e., shares of stock or warrants)
3. The distressed debtor entity raising new equity capital in order to de-lever the balance sheet
4. The distressed debtor entity negotiating with creditors for more favorable debt terms such as loan maturity, debt mix, flexible payment schedules, interest rate reductions or interest only provisions, or payment-in-kind interest features
5. The subordination of shareholder debt to third-party debt

Debtor companies may analyze potential outcomes before engaging in these types of activities in order to assess the income tax implications and whether they would be deemed as significant modifications under current tax rules.

Creditors are often amenable to restructuring debt to be more favorable to a borrower when they believe that the restructuring will increase the chances of repayment. Under certain circumstances, when a business becomes financially distressed, the creditor may partially reduce or even totally discharge the debt.

For example, debt issued to a debtor entity by related parties or shareholders may be totally or partially discharged outside of a bankruptcy scenario. Related-party and shareholder loans are frequent among smaller family-owned or other private businesses.

When debt is forgiven or partially discharged, under Section 61, COD income in the amount of the debt discharged is included in the entity’s gross income. This is because the taxpayer entity did not include the loan proceeds in income when the proceeds were received.

A reduction in liabilities without a corresponding reduction in assets is a discharge of indebtedness income. The COD income quantifies the improvement in the taxpayer entity’s financial position resulting from the restructuring.

For example, if a creditor forgives a \$300,000 debt, the debtor entity financial position would improve by \$300,000 and it would recognize \$300,000 of taxable income.

Creditors frequently require compensating securities such as preferred stock as an inducement to restructure the debt and as compensation for the lost returns on the debt that was restructured or discharged.

In some instances the creditor will receive warrants in exchange for discharging a portion of the debt and adjusting the terms of the remaining debt. The exchange of equity for debt will be discussed further in the next section.

## The Exchange of Equity for Debt

The formula below presents the amount of COD income to be recognized under Section 108 in a debt restructuring that involves the exchange of equity for debt.

$$\text{COD Income} = \frac{\text{Excess of the amount of the debt that is forgiven}}{\text{Fair market value of the equity exchanged in order to cancel the debt}}$$

If the capital structures of the entity post-restructuring are more complex, the calculations that may be required to estimate the amount of the COD income also become more complex. In order to estimate the economic improvement in the debtor entity's debt position following the debt restructuring, the equity securities issued as compensation to the creditor may be valued.

While this provides needed debt relief and improvement in the financial position of the debtor entity during the time of distress, problems could arise when the debtor entity recovers. Equity holders that were not part of the down round equity financing could claim that the new equity holders invested at a price that was too low.

A fairness opinion of the transaction in addition to the valuation of the new equity would help to protect against such claims and bolster the integrity of the restructuring process.

Under Section 108(e)(2), the discharge of the debt will not result in COD income to the extent that payment of the liability would have resulted in an income tax deduction.

## COD INCOME RECOGNITION EXCEPTIONS

Section 108 provides several exceptions to the COD income recognition in the following circumstances:

1. The debtor entity is involved in a Chapter 11 bankruptcy proceeding.
2. The debtor entity is insolvent immediately prior to the forgiveness of debt.

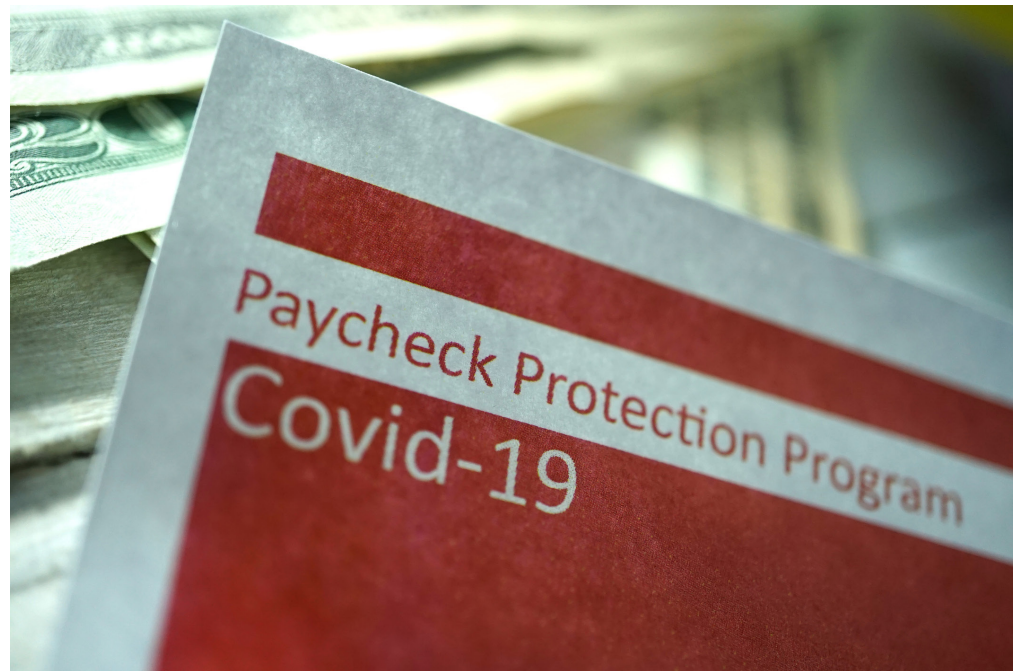
The reasoning behind these exclusions is to allow for an entity that is undergoing bankruptcy to have a "fresh start." Burdening the debtor entity with a large tax liability from relief granted by the bankruptcy process or from the discharge of debt would be counterproductive to the objectives of the Chapter 11 reorganization process.

Additional exclusion provisions under Section 108 that may be applied to COD income include the following:

1. The discharge of qualified farm indebtedness
2. In the case of a business taxpayer other than a C corporation, the discharge of qualified business-related real property indebtedness
3. The discharge of qualified principal residence indebtedness prior to 2012

## Paycheck Protection Program

In addition to relief provided in the tax regulations, Congress passed laws to provide economic aid to qualifying businesses.



As part of the CARES Act of 2020 the Paycheck Protection Program (“PPP”) was introduced in order to provide businesses that were disrupted by COVID-19 related economic impacts with loans so that they could remain in operation.

Under the PPP program, loans are available to fund payroll and group health benefit costs, rent and utilities, and additional items. Additionally, amounts forgiven under the PPP loan program are not considered taxable income for federal income tax purposes.

Subsequent legislation was passed to specify that certain expenses paid using PPP loan proceeds are deductible for federal income tax purposes.

However, depending on the state, any PPP loan COD income and the associated tax attributions may be treated differently for state income tax purposes. Due diligence may be conducted to ensure that any PPP loans can be accounted for as part of either a valuation or a debt restructuring analysis.

## DEBTOR ENTITY INSOLVENCY REDUCES THE RECOGNITION OF COD INCOME

Section 108 provides for the portion of the COD income that is excluded from gross income, based on the debtor entity’s insolvency at the time of the discharge.

According to Section 108(a)(3), if the debt discharge occurs when the debtor entity was insolvent, then the amount of COD income excluded will not exceed the amount by which the debtor entity is insolvent. Therefore, in certain instances, the amount of the COD income will be reduced, but not totally eliminated.

The amount of COD income excluded under this section is applied to reduce the tax attributes of the debtor entity. The debtor entity’s tax position is affected by the COD income whether or not any income is actually realized.

The debtor entity may exclude COD income under Section 108(b) at the cost of decreasing certain tax attributes.

## INCOME TAX ATTRIBUTES

To the extent that the debtor entity excludes any COD income from gross income, a corresponding reduction is applied to the income tax attributes of the debtor entity in the following order:

1. Net operating losses (“NOL”)
2. General business tax credits

3. Minimum tax credits
4. Capital loss carryovers
5. Income tax basis reduction
6. Passive activity loss credit carryovers
7. Foreign tax carryovers

According to Section 108(b)(5), the debtor entity also has the option to elect to reduce the basis of its depreciable property prior to reducing any other entity income tax attributes.

## ILLUSTRATIVE EXAMPLE

For example, let’s consider the following scenario:

1. The debtor entity has an NOL balance of \$333,000.
2. The debtor entity has \$333,000 in implied COD income from debt restructuring.
3. No exclusions of COD income are available.

The debtor entity may use the NOL balance to offset the COD income. Thereby, the debtor entity will decrease the realized COD income to \$0. As a result, the debtor entity’s tax attributes are reduced by \$333,000.

If the debtor entity in the above scenario is insolvent by \$333,000 under Section 108 (a)(1) (B), then the implied COD income and the realized COD income are both \$0. However, due to Section 108(b), the debtor entity’s tax attributes are still reduced by \$333,000.

The Section 108 COD income recognition exceptions are applied differently for partnerships and corporations. Therefore, the type of business entity structure is an important consideration for the purpose of performing an insolvency analysis.

## COD INCOME RECOGNITION FOR DIFFERENT BUSINESS STRUCTURES

Under Section 61, COD income is considered ordinary income and is subject to federal income taxation at the time the debt is discharged. However, these income tax repercussions are different based on the entity structure.

## S Corporations

When an S corporation recognizes COD income, this causes a reduction in the entity’s tax attributes at the corporation level. Since S corporations do not have NOLs, this affects each shareholder’s

distributive share of losses and deductions that have been excluded for the taxable year of the debt discharge.

The result of this calculation is a readjustment of each shareholder's excess losses that carry forward into the years following the year of debt discharge.

Further, if the S corporation's liabilities are cancelled, then the COD income will not be included in the S corporation's taxable income.

The S corporation may consider and comply with the provisions of Section 1366(d) to make the most of a difficult situation and to allow the shareholder to benefit from losses generated at the S corporation level.

The S corporation may accomplish this by structuring the addition of funds as a back-to-back loan—as opposed to either:

1. a guarantee of S corporation debt or
2. a co-borrowing.

This result occurs because neither of these investment structures will generate a tax basis for future S corporation loss recognition purposes.

## C Corporations

When a C corporation recognizes COD income, this also results in a reduction of the entity's tax attributes at the corporation level. The difference relative to S corporations is that C corporations have NOLs.

Therefore, the taxpayer's intent is to typically try to preserve the NOL tax attributes.

## Partnerships

In the event that a partnership defaults on its debt obligations, and a portion or all of that debt is released by the creditor, the partnership will recognize COD income. The COD income realized is allocated among the partners based on their respective ownership percentages.

Even though the COD income is realized at the partnership level, the determination of whether or not that COD income is to be recognized is made at the partner level.

The reason for this is because if one partner is bankrupt or considered insolvent, then that partner



would likely not recognize any COD income allocated by the partnership.

On the other hand, if the other partners are solvent, then the other partners may recognize their respective portion of the realized COD income.

## COD INCOME RECOGNITION REQUIREMENTS RELATED TO RECOURSE DEBT AND NONRECOURSE DEBT

When there is a reduction in debt that is recourse debt, often times, such a reduction will result in taxable COD income. Recourse debt is debt that is personally guaranteed by the debt holder.

That is, in the event that the debt holder defaults on its obligation to the lender, the lender may pursue legal action against the debt holder. When the debt is nonrecourse, the lender does not have the right to pursue anything other than the collateral for the debt.

For example, often private companies need outside capital for an expansion of operations or for working capital needs. The private company owner may personally guarantee the business loan.

That personal guarantee is typically required because private businesses:

1. often have difficulty in accessing capital and
2. are likely to be forced to pay higher interest rates.



In the event the debtor entity defaults in its debt obligations, the lender may bring legal action against not only the debtor entity, but also against the business owner.

On the other hand, if a homeowner defaults on his home loan (nonrecourse), the bank may collect the collateral (i.e., the home). However, the bank may not take further legal action against the homeowner.

When a lender forecloses on real estate as part of a settlement related to a recourse loan, the foreclosure is reflected as a property sale. The proceeds from the foreclosure sale are equal to the lesser of:

1. the amount of the debt or
2. the fair market value of the real estate.

If the debt related to the recourse loan is greater than the fair market value of the real estate, then the taxpayer entity will recognize COD income related to the sale of the real estate.

Since a foreclosure sale is treated as a property sale, the amount of any taxable gain or loss is determined in accordance with the Section 1221 and the Section 1231 requirements.

In the event that the debt related to the recourse loan is less than the fair market value of the real estate, the proceeds from the foreclosure sale are considered to be equal to the amount of the recourse debt. As a result, the debtor entity does not recognize any COD income.

When a lender forecloses on real estate as part of a settlement related to a nonrecourse loan, the foreclosure sale is still reflected as a property sale.

However, the difference is that the proceeds from the foreclosure sale are equal to the amount of the debt related to the nonrecourse loan.

In this case, the fair market value of the real estate is not relevant. It is also noteworthy that the debtor entity will not recognize COD income.

In the event that the discharged debt is greater than the real estate cost basis, the taxpayer entity will recognize either capital gains income or ordinary income according to Section 1231. However, such income will not be treated as COD income.

## FEDERAL INCOME TAX DEFINITION OF INSOLVENCY

According to the U.S. Bankruptcy Code Section 101(32)(A), the term “insolvency” is defined as a financial condition such that the sum of an entity’s debts is greater than all of such entity’s property, at a fair value valuation.

However, the term “insolvent” is defined in Section 108(d)(3) as the excess of the liabilities over the fair market value of the assets as determined immediately before the debt discharge.

## PROCEDURES TO QUANTIFY DEBTOR TAXPAYER ENTITY INSOLVENCY

Insolvency under Section 108 occurs when the debtor entity liabilities exceed the fair market value of the debtor entity assets. The amount by which the debtor entity is insolvent for Section 108(a)(1)(B) exclusion purposes is determined on the basis of the assets and liabilities immediately prior to the debt discharge.

The determination of insolvency (for income tax purposes) depends on the fair market value of the debtor entity assets. Therefore, valuation of the debtor entity is an important element in the insolvency determination.

The valuation methods and procedures for measuring debtor entity insolvency for COD income exclusion purposes should consider the concept of

“highest and best use” (i.e., is the value of the assets greater under a going-concern basis or an orderly liquidation basis?).

## PROPERTY VALUATION APPROACHES

The three generally accepted property valuation approaches used to estimate the fair market value of the debtor entity assets are as follows:

1. The cost approach
2. The income approach
3. The market approach

Once the fair market value of the debtor entity's assets is estimated, the valuation analyst is able to measure the insolvency of the debtor entity. The amount of insolvency is then netted against the amount of the recognizable COD income.

## ILLUSTRATIVE EXAMPLE

For example, if a creditor forgives a \$200,000 debt, the debtor entity will generally recognize \$200,000 of taxable income. However, if the taxpayer entity is insolvent, the debtor entity would be able to exclude part or all of COD income realizable from the debt discharge.

In order to illustrate the process of measuring the debtor taxpayer insolvency and the effect of the insolvency exclusion on recognizable COD income, let's consider the following example.

A valuation is performed and the fair market value of the debtor entity's net assets is estimated to be negative \$100,000 (i.e., total assets of \$200,000 less total liabilities of \$300,000). Let's assume that the creditor forgives \$200,000 of long-term debt. That debt forgiveness will result in \$200,000 of taxable income to the debtor.

This negative net asset value implies that the debtor entity is insolvent by \$100,000. Therefore, the debtor entity may take advantage of the Section 108 insolvency exclusion.

The taxpayer's COD income of \$200,000 will be partially offset by the taxpayer's insolvency amount of \$100,000.

Due to its eligibility for the insolvency exclusion, the debtor entity may net the insolvency amount against the COD income. Therefore, the taxpayer will only recognize \$100,000 of COD taxable income.

## SUMMARY AND CONCLUSION

As a result of the global pandemic, many debtor entities have found the need to restructure their business debt. The debt restructuring may include a renegotiation of the outstanding debt terms. Or, in many cases, the debt restructuring may include the partial forgiveness of debt, resulting in the debtor entity COD income.

Due to the COVID-affected economic environment, many debtor entities would not be able to continue operating without restructuring their business debt. The trade-off of the debt restructuring is that the debtor entity may have to recognize income related to the COD.

Section 108 and the related regulations determine what portion of the COD income is to be excluded from taxable income, based on the determination of the debtor entity insolvency at the time the debt is discharged.

Analysts should consider generally accepted property valuation approaches and methods when analyzing debtor entity debt restructuring alternatives and their respective impacts on income taxes, cash flow, and equity valuation.

Debtor entities should be aware of the COD income recognition tax rules and plan for their impact in the context of debt restructuring. Further, debtor entity managers and boards of directors may make decisions based on a debtor entity net asset valuation analysis. As such an analysis provides insight for decision making.

Additional analyses—such as solvency and fairness opinions—may also help to protect the debtor entity against future claims by any parties to the restructuring transactions.

### Notes:

1. <https://www.who.int/emergencies/diseases/novel-coronavirus-2019/interactive-timeline#event-71>
2. <https://www.irs.gov/newsroom/irs-state-ment-american-rescue-plan-act-of-2021>
3. <https://www.congress.gov/bill/117th-congress/house-bill/1319>

Ryan Stewart is a vice president in our Atlanta practice office. Ryan can be reached at (404) 475-2318 or at [crstewart@willamette.com](mailto:crstewart@willamette.com).



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