Watch Your Step with Debt Modifications

By Deanna Huntowski-Nasseh, CPA, MST, Michael Tighe, CPA, MST, and Howard Braithwaite, CPA, MST

Whenever the terms of an existing debt instrument are modified, both the debtor (borrower) and the creditor (lender) must carefully analyze the terms of the altered arrangement to determine if there was a "significant modification." This is very much dependent upon specific facts and circumstances, not all of which can be discussed within the confines of this article. The regulations treat a significant modification as the issuance of a new debt instrument for the old debt instrument in a taxable exchange.

Treasury Regulation Section 1.1001-3

The rules governing the modification of debt instruments are covered under Treasury Regulation (Treas. Reg.) Section 1.1001-3, which stems from the case *Cottage Savings*.[1] The ruling in *Cottage Savings* provided some clarification into the definition of a "disposition" under Internal Revenue Code (IRC) Section 1001(a) in an exchange of debt instruments and set up the foundation for the "significant modification" test. It puts forth the question, does property received differ materially from the property sold, effectively constituting a "disposition of property" under Section 1001?

The Two-Part Test

Treas. Reg. Section 1.1001-3 generally applies to the exchange of debt instruments as well as to amendments of existing ones. Taxpayers must analyze the changes to the debt instrument by applying a two-part test:

- Has a modification occurred?
- If so, is it considered a "significant modification?"

A "modification" is defined, subject to exceptions, as an "alteration of terms of a … legal right or obligation of the issuer or a holder of a debt instrument evidenced by an express agreement (oral or written), conduct of the parties, or otherwise." This is a rather broad classification. On the contrary, with a few exceptions, alterations that occur by the operation of the terms of the debt instrument generally do not constitute a modification. Typically, this means that changes that are already written into the terms of the instrument do not constitute a modification for income tax purposes. For example, automatic annual resetting of the interest rate or the exercising of an option occurring by operation of the debt instrument would not be viewed as a modification if it were in the original terms of the debt instrument.

The second part of the test focuses on the economic significance of the modification. It is important to note that the cumulative impact of prior modifications must be taken into consideration when determining if a modification is significant, assuming the prior changes there were not a significant modification. Therefore, a taxpayer cannot engage in a series of separate minor modifications – even if they occur within different tax periods – in an effort to avoid or ameliorate the impact of this test.

The regulations provide specific guidance regarding which modifications are considered significant (subject to certain exceptions), including a general rule which considers all changes collectively:

- Changes in yield
- Changes in timing of payments
- Changes in the obligor or the security
- Changes in the nature of the instrument
- Changes in accounting or financial covenants

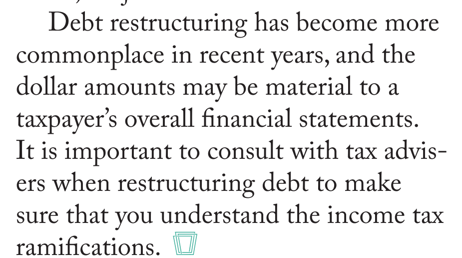
Greater detail into the changes listed above are provided in the regulations.

Tax Consequences

If a modification passes the two-part test, and therefore is considered "significant," it is considered a deemed debt-for-debt taxable exchange. Consequently, a borrower is treated as having satisfied the old debt for an amount equal to the issue price (a defined term) of the new debt. To the extent that the adjusted issue price (a defined term) of the old debt exceeds the issue price of the new debt, ordinary income may result in the form of cancellation of debt income.[2] However, this can potentially be mitigated if the borrower is insolvent or involved in bankruptcy proceedings, among other exceptions. Alternatively, if the adjusted issue price of the old debt is less than the issue price of the new debt, the borrower may be entitled to a repurchase premium deduction.

From the lender's perspective, gain or loss is generally realized, equal to the difference between the issue price of the new debt and the lender's adjusted tax basis in the old debt. Original issue discount can arise if the issue price of a new debt instrument is lower than the stated redemption price at maturity, creating interest income for the lender, as well as generally deductible interest expense for the borrower, subject to other limitations.

Debt restructuring has become more commonplace in recent years, and the dollar amounts may be material to a taxpayer's overall financial statements. It is important to consult with tax advisers when restructuring debt to make sure that you understand the income tax ramifications.



[1] Cottage Savings vs. Commissioner, *499 U.S. 554 (1991).*

[2] *See Section 108(e)(10).*

All three authors work at Global Tax Management Inc. in Wayne. Deanna Huntowski-Nasseh, CPA, MST, is a supervising senior tax analyst, and can be reached at dhuntowski@gtmtax.com. Michael Tighe, CPA, MST, is managing director, and can be reached at mtighe@gtmtax.com. Howard Braithwaite, CPA, MST, is principal, and can be reached at hbraithwaite@gtmtax.com.