



Tax Issues for Hard Times – Including NOL Rules, Distressed Debt, and Cancellation of Indebtedness Income

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NOLS

POLLING QUESTION 1

NOL Utilization

- The Tax Cuts and Jobs Act of 2017 generally limited the deduction for NOLs to 80 percent, including life insurance companies, and permitted carryover to future years only.
- The “Old Rule” still applies for non-life insurance company losses
 - the two-year carryback and 20-year carryforward utilization period is retained.
 - use of NOLs by a nonlife insurance companies are not subject to the 80 percent taxable income limitation.
- In 2022, the CARES Act provided relief on the NOLs utilization limits
 - allows for the carryback of NOLs from 2018 - 2020 for five years and does not apply the 80 percent limit on utilization in those years.

NOL Calculation – Consolidated

- Effective for tax years generally beginning after December 31, 2020, final regulations were published providing guidance on utilization of NOLs by consolidated group members.
- The new rules provide guidance on quantifying the amount of CNOL permitted to be recognized in a taxable year
 - the calculation is done by grouping - the non-life group (non-life insurance companies) and the other group (non-insurance companies and life insurance companies).
 - This results in allocation of losses after netting against similar type entities rather than overall allocation of losses to loss members only.
- Income for non-life insurance members and “Other Members” is separately pooled and pre-2018 NOLs are pooled based on relative amount of income between the two pools.
- Separate company NOL allocable to a member is equal to the separate NOL of the member divided by the total amount of NOL for all members.
- Special recomputations are required if a member’s NOL is absorbed or reduced on a non-pro-rata basis (for example, under the 1.1502-36 Unified Loss Rules)
- The Separate Return Limitation Year (SRLY) register is adjusted for the amount of income needed to use the NOL.
 - Special rule for dual consolidated loss utilization, however.
- Limitation on 80 percent income utilization is only computed with respect to items of the non-life subgroup.

Carryback Waiver Election

- Temporary regulations issued in July 2020 allow a taxpayer to make an election to relinquish the carryback period for a consolidated NOL for any consolidated return year.
- Provide a “split-waiver election” to allow a taxpayer to waive the carryback years of an acquired member NOL without having to waive the carryback of the entire consolidated group for years 2018 - 2020.
- Results in limitation on the availability of utilization of losses on a going forward basis.
- Restoration of the application of the operating loss deduction rules to life insurance company losses.

Section 382(h): Current Law

- Section 382 generally restricts a corporation's utilization of net operating losses (NOLs) and potentially built in deduction items by limiting the amount of income earned by the corporation after the ownership change that may be offset by losses incurred prior to the ownership change.
- An ownership change occurs if one or more "Five-Percent Shareholders" increase ownership in the corporation stock, in aggregate, by more than 50 percent, over a three-year period.
- The "Section 382 limit" is equal to the value of the loss corporation on the change date multiplied by the long term tax exempt rate provided by the IRS. Because based on interest rates, 382 limit very low.
- If the company is in a built in gain position, built in gains recognized in the first five years after the ownership change (up to the amount of the net built-in gain) may increase the Section 382 limit.
- If the company is in a built-in loss position, built-in losses recognized in the first five years after the ownership change (up to the amount of the net built-in loss) are also subject to the Section 382 limit.
- In 2003, the IRS issued Notice 2003-65 which provided two safe harbor methods ("338 Approach" and "1374 Approach") for a taxpayer to determine the amount of net unrealized built in gain (NUBIG) or loss (NUBIL) and identification of items that are recognized built-in gains (RBIG) and losses (RBIL) - which in turn impact the Section 382 limitation for the first five years after an ownership change.

“338 Approach” vs. “1374 Approach”

- Notice 2003-65 provides safe harbor settlement guidelines regarding the determination of NUBIG/NUBIL and the identification of RBIG/RBIL
- Two approaches for determining when items of income, gain, deduction, and loss are treated as RBIG and RBIL:
 - “1374 approach”
 - “338 approach”
- Similar results under both approaches for dispositions
- Different results with respect to items of income and deductions:
 - 1374 approach more narrow approach with few items as RBIG and RBIL
Generally, the 1374 approach may be favorable for companies with an overall built in loss because fewer items may be treated as RBIL, or post-close deductions that would also be subject to the Section 382 limitation.
 - 338 approach increases Section 382 limitation for recognized built-in gains from “deemed” amortization of certain assets.
Generally, the 338 approach may be favorable for companies in an overall built-in gain position because it allows for incremental loss utilization as a result.

Section 382: Proposed 382(h) Regs

- On September 9, 2019, the IRS and Treasury released Proposed Regulations under section 382 of the Internal Revenue Code (“Proposed 382(h) Regulations”) regarding items of income and deduction that are treated as built-in gains and losses under section 382.
- Under the Proposed 382(h) Regulations, the 338 Approach is eliminated and the 1374 Approach is adopted with certain modifications, including:
 - Treating contingent deductible liabilities paid or accrued during the recognition period (the five years after the ownership change) as recognized built in deduction items.
 - Treating bad debt deductions recognized during the recognition period as recognized built-in deduction items (compared to 12 months under section 1374).
 - COD income is limited and distinguished between recourse (limited RBIG adjustment) and non-recourse debt (no RBIG adjustment).

Section 382: Proposed 382(h) Regs

- The 338 Approach is viewed as more complex than the 1374 Approach.
- The preamble to the proposed regulations identify the following reasons for the 338 Approach is viewed as more complex than the 1374 Approach. The following reasons were identified:
 - The incremental allowable limitation under the 338 Approach for “forgone amortization” is not based on actual recognition of additional income or gain.
 - Ambiguity in the case of deemed tiered 338 elections
 - In light of the TCJA, complexities around the interest stripping rules, net operating losses, and other items result in different income before the TCJA.

Effective Date

- On January 10, 2020, the IRS issued additional proposed regulations under Section 382(h) addressing the date the final Section 382(h) regulations will become applicable in response to comments to allow for a seamless transition between reliance on Notice 2003-65 and the provisions in the Proposed 382(h) Regulations.
- The Proposed 382(h) Regulations will take effect 30 days after finalization and published in the Federal Register (the Delayed Applicability Date).
- Under transition rules, the final Section 382(h) regulations would not apply after the Delayed Applicability Date in the following circumstances:
 - Pursuant to a binding agreement in effect on or before the Delayed Applicability Date and at all times thereafter;
 - Pursuant to a specific transaction described in a public announcement made on or before the Delayed Applicability Date;
 - Pursuant to a specific transaction described in a filing with the Securities and Exchange Commission submitted on or before the Delayed Applicability Date;
 - By order of a court (or pursuant to a plan confirmed, or a sale approved, by order of a court) in a title 11 or similar case (as defined in Section 382(l)(5)(F)), provided that the taxpayer was a debtor in a case before such court on or before the Delayed Applicability Date; or
 - Pursuant to a transaction described in a private letter ruling request submitted to the IRS on or before the Delayed Applicability Date.
- While taxpayers can continue to rely on Notice 2003-65 either (i) up to the Delayed Applicability Date or (ii) indefinitely with respect to any ownership change qualifying for transition relief under this provision, they instead may choose to apply the final regulations to such an ownership change.

POLLING QUESTION 2

DEBT

POLLING QUESTION 3

Debt-for-Debt Exchanges

- An exchange of an old debt instrument (DI) for a new DI between the issuer and holder may result in COD income for the issuer.
- COD Income: excess of (i) Adjusted Issue Price (AIP) of the old DI (Old Debt) over (ii) the issue price of the new DI (New Debt)
 - COD exceptions may apply, *e.g.*, for insolvent or bankrupt debtors.
- AIP = Issue price of the DI increased by any original issue discount (OID) previously includible in gross income by any holder, and reduced by the amount of any payment previously made on the debt instrument other than a payment of qualified stated interest (QSI).
- Issue Price = stated principal amount, if neither the Old Debt nor the New Debt is publicly traded and New Debt pays interest of at least AFR (other than in “potentially abusive situations”).
- If either New Debt or Old Debt is deemed to be “publicly traded” for tax purposes within the period 15 days before and 15 days after the issue date, then New Debt’s issue price = FMV.
- Thus, if the face amount of New Debt is the same as Old Debt, generally the issuer should not recognize COD income on an exchange of Old Debt for New Debt if neither DI is publicly traded
 - But in practice, assume that all debt is publicly traded!

Public Trading Perils

- Debt may be considered publicly traded if:
 - Sales price for an executed purchase or sale becomes reasonably available within reasonable period of time (TRACE, etc.)
 - Firm quote available (price at which broker or dealer willing to buy or sell, even if not legally bound to do so)
 - Indicative quote available (daily runs sent by dealers through Bloomberg, LSTA services)
 - This is why (almost) everything is publicly traded – if you called them up and asked, odds are a banker would give you a quote
 - Reasonable diligence required
 - Small Issuance Exception: if at time of determination, both New Debt and Old Debt have an outstanding stated principal amount of \$100M or less, debt is treated as not publicly traded

Public Exchange Example

- Holder and issuer agree to exchange Old Debt with a \$1,000 principal amount for New Debt with a \$1,000 principal amount (and AIP) bearing five percent interest. Due to a deterioration of the issuer's financial condition, the FMV of New Debt is \$700.
- If neither the New Debt nor the Old Debt is deemed to be publicly traded for tax purposes, the issue price of the New Debt will be \$1,000 (*i.e.*, the face amount) and there will be no COD income.
- If within 15 days of the exchange, pricing information relating to transfers of the debt is reported on a quotation medium or is otherwise available, and the New Debt is trading at \$700, then the issue price of the New Debt will be \$700, which results in:
 - \$300 of COD income to issuer
 - \$300 of OID deductions for issuer and \$300 of OID income for holder going forward

AHYDO

- Debt issued in a difficult borrowing situation (including in a debt-for-debt exchange) must also be tested under the Applicable High Yield Debt Obligation (AHYDO) Rules
 - An AHYDO is a debt instrument issued by a corporation that has a term of >5yrs, a yield > 5% or more in excess of the AFR in effect when the DI was issued and “significant” OID. (163(i)(1))
 - Significant OID is most likely to occur in zero coupon instruments or payable in-kind notes (PIK)
 - If the yield on an AHYDO DI does not exceed the AFR by more than six percent, issuer is denied a deduction for OID on the AHYDO until paid
 - If the yield on an AHYDO DI exceeds the AFR by more than six percent, a portion of the total return on the DI (the "disqualified portion") is not deductible at all by the issuer
 - The disqualified portion is treated when accrued as a distribution eligible for the dividends received deduction for corporate holders
- Policy rationale is to limit or disallow deductions with respect to instruments that do not look like debt
- In current interest rate environment, the AFR is **extremely low** – October 2020 long-term AFR = 1.12%!
- If debt must be long maturity and high OID, consider “AHYDO saver” that partially prepays the note in year 5.

Debt Modifications

- Under Reg. §1.1001-1(a), gain or loss is realized upon the exchange of property for other property "different materially either in kind or in extent."
- Under Reg. §1.1001-3, changes to the terms of a DI which constitute a "significant modification" of the DI will be treated as a deemed exchange of the existing DI for a new DI for tax purposes.
 - Significance is generally tested on a facts and circumstance basis
 - The "significant modification" determination applies whether the terms of the existing DI are amended or the existing DI is exchanged for a new DI.
- Significant modification may therefore result in COD income to the issuer.
 - The deemed exchange of a DI issued by a corporation also requires the modified DI to be re-tested under the AHYDO rules. (But if less than five years remain on the maturity, no problem)
- A "significant modification" of a DI may include:
 - Change in interest rate or extension of term (but safe harbors available)
 - Substitution of obligor on recourse debt
 - Modification that results in the DI no longer being treated as debt for tax purposes (but ignore the financial deterioration of the debtor for purposes of this determination)
- The addition, deletion or alteration of customary accounting or financial covenants generally are not significant modifications.
- If a scheduled payment is missed, failure to perform is not itself a modification, nor is a temporary waiver by the holder of its right to accelerate the debt, unless the other terms of the debt are altered by the parties

Related Party Debt Purchases

- If a purchaser who is related to the borrower acquires Old Debt from a 3rd party (who is not “related” to borrower), then:
 - Potential COD Event: Borrower is treated as having acquired the debt for value equal to the price paid by Purchaser.
 - Deemed Reissuance of Old Debt: Old Debt is deemed to be reissued by Borrower with an issue price equal to the price paid by Purchaser.
 - OID/AHYDO issues may arise: The deemed New Debt may be subject to OID and AHYDO rules. It will likely not be fungible with the Old Debt.
- If a Purchaser acquires Old Debt at a discount and then subsequently becomes related to the Borrower:
 - Potential COD Event: Borrower may have a COD event on the date that Purchaser becomes related to it, and the analysis set forth above will apply.
 - If purchase occurred > six months before, then a facts and circumstances test is applied.
 - If purchase occurred < six months before, then it is presumed the debt acquisition was in anticipation of becoming related.

Investing in Distressed Debt

- The tax rules applicable to a DI generally contemplate that the DI will be repaid in accordance with its terms. This underlying assumption can often lead to troubling and arguably inappropriate results where a DI is valued at a steep discount to its stated redemption price at maturity.
- Doubtful Collectibility: Accrual rules generally provide for current inclusion of interest, even where the borrower is distressed. However, a judicially-driven exception may allow the holder to stop accruing QSI where interest is “of doubtful collectability or it is reasonably certain that it will not be collected” based on all facts and circumstances. (*see Corn Exchange Bank v. United States*, 37 F.2d 34 (2d Cir. 1930).
- Payment Ordering: A payment under a DI is generally treated first as a payment of accrued and unpaid QSI or OID, and then as a payment of principal. (*see* Treas. Reg. §§ 1.446-2(e) and 1.1275-2(a)(1)).
 - Ex. On a DI with a 10-year term, an issuer pays interest in years one through four but does not pay any interest in year five. Assume holder did not include the year five interest in income. In year six, a payment is made on the debt equal to year five and six’s interest, but it is reasonably certain that the full amount of the debt will not be repaid
 - Should the holder be taxed on the entire payment in year six as “interest”?
 - The interest first rule could also produce an anomalous result where a DI is settled at a discount outside of the normal terms of the DI.
 - If at maturity the holder is owed \$1000 plus \$100 of interest but the holder agrees to accept \$800 in full settlement, does the holder have a loss of \$200 or must it treat \$100 as interest income and take a loss of \$300?
 - The settlement payment does not appear to be a payment “under” the loan, and therefore, an argument can be made that the ordering rule under the Section 446 regulations should not apply.
 - In practice, taxpayers often take the position that the usual payment ordering rules do not apply in the context of final payments in settlement of a distressed DI.

POLLING QUESTION 4

Market Discount

- “Market discount” means the excess of (i) the stated redemption price at maturity over (ii) the basis of the DI immediately after acquisition.
- In general, market discount accrues ratably.
 - Life insurance companies generally not subject to market discount rules, unlike P&C companies and holding companies. IRC 811(b)(3)
- Any partial principal payment with respect to a market discount DI is treated as ordinary income to the extent of accrued market discount. (Holders can also elect to accrue in income currently)
 - Gain on the disposition of a market discount DI is treated as ordinary income to the extent of accrued market discount
- With few exceptions, market discount is taxed as interest for all purposes of the Code.
 - Intended to act as substitute for additional interest that would have been accrued if the DI had been issued at higher prevailing market rate (rather than the purchaser getting the same yield through acquisition discount)
- However, in distressed scenarios, sharp discounts can be attributable to collectability concerns, not market interest rate fluctuations
 - The purchaser of the discounted DI faces ordinary income despite taking a “capital-like” bet that the debt will pay off in full
 - Particularly problematic for DIs with short remaining maturities
- IRS guidance confirms that TCJA “super-accrual” provision obligating taxpayers to include income when reflected on an applicable financial statement does not apply to market discount. Prop. Reg. 1.451-3.

Holder Tax Treatment in Debt Exchange

- Will a debt workout be a taxable transaction for the holder?
 - A taxable event may be preferable for investors who could recognize (and utilize) a loss on the transaction – most likely in the case of holders who acquired the DI at issuance. Note that losses of “related parties” may be disallowed.
 - However, an investor who bought the debt after the issuer became distressed may hold at a gain and prefer nonrecognition
 - Note that the interests of the debt holders may not align
 - Borrower COD analysis is unaffected by holder tax treatment
- Tax-free Recapitalizations
 - IRC 368(a)(1)(E) provides holder nonrecognition treatment for an exchange of old debt for new debt if both qualify as “securities”, or exchange of old debt for stock of issuer, if old debt is a “security”
 - What are securities? Term <5 years, generally not securities; term >10 years generally will be securities. Less clarity if the term is between 5 and 10 years.
- Transactions that are not recapitalizations may qualify under Section 351 or other nonrecognition provisions

Limitation on Interest Deduction: 163(j)

- In distressed scenarios (particularly where debt becomes expensive), increased pressure on ability to deduct interest
- Under the current Section 163(j), the amount of business interest expense that may be deducted for a taxable year is limited to:
 - Business interest income for such year,
 - 30 percent of “adjusted taxable income” (ATI) for such year, and
 - Floor plan financing indebtedness (used to finance the acquisition of motor vehicles held for sale or lease)
- Any excess business interest is carried forward to next succeeding taxable year with no expirations.
- “Business interest” means any interest paid or accrued on indebtedness properly allocable to a trade or business
- “Business interest income” means the amount of interest includable in the gross income of the taxpayer for the taxable year which is properly allocable to a trade or business
 - Regulations clarify that all interest income and expense of a corporation is business interest
- ATI roughly amounts to EBITDA pre 2022, and EBIT post 2022, which may result in lower capacity to claim interest deductions
- The CARES Act modified Section 163(j), allowing taxpayers to elect to use 50 percent of ATI (as opposed to 30 percent) for taxable years 2019 and 2020 and use their 2019 ATI to calculate their 2020 business interest expense deduction limit.
 - This does not apply to partnerships, but 50 percent of any business interest of the partnership that is disallowed to the partners in 2019 will not be subject to the 163(j) limitation in 2020.

163(j) and Insurance Groups

- Insurance companies typically are not limited by 163(j) because their investment portfolios generate significant business interest income, granting capacity to deduct business interest expense on a one-to-one basis.
- However, insurance groups often issue debt from nonlife holding companies, given the regulatory difficulties of issuing debt at regulated insurance companies
- Recently finalized regulations provide for a single consolidated group level limitation that disregards affiliate transactions.
 - However, Treasury has signaled that it plans to issue further guidance regarding the interaction between 163(j) and the rules for consolidated groups that include both life insurance and non non-life members (“life/nonlife groups”).
 - Will Treasury seek to impose separate limitations on life and nonlife subgroups?
- Even with aggregation within consolidated groups, issues can remain:
 - For groups with life and nonlife entities that do not make a “life/nonlife election,” no ability to use life company business interest income against nonlife business interest expense
 - Intercompany surplus notes can sometimes be used to push interest deductions to life companies and interest income to nonlife companies
 - For life/nonlife groups, newly acquired life insurance companies must wait for five years before they may join the consolidated group, and thus for their business interest income to be included in the groupwide calculation
 - For partnership borrowers, business interest limitation determined at partnership level
 - However, partnership-level investment interest is treated favorably – no limit at partnership level and treated as business interest for corporate partner