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Tax Issues to Consider in Buying or Holding Distressed Debt

Insights: Restructuring Indebtedness & Leases

April 10, 2020

Federal Income Tax Consequences of Defaults and Restructurings Under Lease Agreements

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Overview of the Federal Income Tax Consequences of Defaults and Restructurings Under Loan Agreements

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In times of economic tumult, many an entrepreneur's fancy turns to thoughts of acquiring, and profiting from, distressed debt. That is, acquiring debt of highly leveraged companies that are no longer able to service their indebtedness so that the debt is available for purchase at a significant discount to its face. Buying, or trading in, distressed debt can allow an investor to benefit from the need of debt holders, such as debt funds, for liquidity to meet redemption demands. It also allows such investors to speculate whether the creditworthiness of certain borrowers was unfairly downgraded so that the debt can be purchased now at a greater discount. Equity owners of the business may see this as an opportune time to retire some portion of their businesses' outstanding debt at a favorable discount. There are a lot of reasons why investors believe that they can profit handsomely from acquiring debt of distressed companies.

Assuming that a distressed debt investor is comfortable with its evaluation of the underlying credit risk of the issuer or the collateral, there are several income tax considerations that the purchaser should take into account in acquiring a debt position.

This paper identifies some of the income tax issues purchasers of distressed debt of non-publicly traded entities face when making individual investments, acquiring a portfolio of distressed debt at an unallocated price, and considering how to fund the acquisitions. It is no substitute for tax and legal advice addressed to your specific circumstances. It expressly does not consider the use of REMICs or distressed debt funds as vehicles to acquire distressed debt and, therefore, does not address the possibility that the transfer of a renegotiated loan to a REMIC could result in the recognition of the accrued market discount, or that the organization of a fund to purchase distressed debt could result in the creation of a "taxable mortgage pool."

Throughout this paper, we have used the terms "debt," "bond," "note," "loan," and "obligation" interchangeably. In addition, in cases where we have referred to entities classified as partnerships, limited liability companies with multiple members are also treated partnerships, unless specifically identified otherwise.

Some Fundamental Income Tax Rules for Dealing with Distressed Debt

Before diving into the uncertainties that surround the income tax treatment of distressed debt, we thought it would be useful to set forth some important income tax principles applicable to distressed debt planning. Certain of these principles were discussed in greater detail in our earlier paper in which we discussed the tax consequences of loan defaults and restructurings. We also discussed some of the tax consequences of lease restructurings in a separate paper.

Generally, the mere fact that a borrower is in default is not a circumstance that triggers debt cancellation income or a constructive modification of the debt.

Whether there is a "significant modification" of the debt instrument as a result of a renegotiation of

the terms of the debt and the resulting tax consequences is addressed in our earlier paper.

Assuming that the borrower and the holder of the debt are on the accrual method of accounting, whether the holder needs to continue to accrue the defaulted interest into income depends on whether there is "doubt as to the collectability" of the unpaid interest. To the extent the interest relates to periods when the borrower was solvent, but the interest was not paid, the holder must continue to accrue the amount of the unpaid interest into income. To the extent that the interest relates to periods when it is doubtful that the borrower will be able to make the interest payment, the doubt as to collectability doctrine provides the holder a basis on which to avoid the accrual of the interest income. It is the long-standing position of the IRS that interest income, once accrued, that becomes uncollectible is treated as a bad debt deduction (nonbusiness bad debts of individuals are reported as short-term capital losses). Holders cannot simply "reverse" the earlier accrual.

Traditionally, the IRS has taken the view that holders of OID debt instruments must include the OID in income regardless of the doubt as to the collectability of the OID, a view that may not be widely shared by practitioners.

Pass-through entities that have UBTI-sensitive or foreign equity investors may find it problematic to acquire distressed debt instruments with the view to restructuring the borrower and the indebtedness. Those actions could be viewed as engaging in a trade or business, which could put UBTI investors in the position of having income from an unrelated trade or business and foreign investors in the position of having income that is "effectively connected" with a U.S. trade or business.

An investment plan that involves purchasing distressed debt with a view to restructuring the borrower and/or the debt instrument and then selling the restructured debt could also be viewed by the IRS as purchasing the debt instrument with the intent to hold the debt for resale. The IRS could assert that the gain on the resale should be treated as ordinary income.

Loan restructuring strategies that are based on an assumption the borrower will surrender a share of the upside in the business in the form of net profits, net cash flow, or favorable warrants must take into account the special needs of the holders. Some holders may not be able, for income tax reasons, to even entertain those types of workout strategies. Creating debt with interest that is based on net income or net cash flow could result in the interest income being classified as "bad" gross income for a REIT, UBTI for a tax-exempt holder, potentially a prohibited transaction for a REMIC, or interest income that no longer qualifies for the portfolio interest exemption for a non-U.S. holder.

With that background, we turn to one very common strategy for dealing with distressed debt, particularly where the holder has signaled that it would like to exit its ownership positon — have the borrower or a person related to the borrower, e.g., a principal shareholder or member, acquire the debt from the holder at a favorable discount. Assuming that the borrower or its affiliate has adequate liquidity, that seems like a simple solution. The income tax rules create some complications, however.

Acquisitions by persons related to the borrower can trigger cancellation of indebtedness income (COD income) to the borrower and its members

In the case of closely held, nonpublic entities, one natural buyer for a debt holder that is willing to offer a discount on the outstanding amount of debt in exchange for being able to sell or dispose of its position for cash is the issuer of the debt or, more likely, owners of a significant interest (usually equity) in the issuer.

Example One: MG LLC is a pharma startup that is taxed as a partnership for income tax purposes. MG was capitalized with third-party investor equity of $6 million for a 75 percent equity interest and a combination of nonrecourse debt and warrants of $4 million ($4 million note and $1,000 for warrants to acquire 25 percent of the common units in MG with a strike price based on the current value). The note bore interest at a market rate for mezzanine debt. The debt was acquired by D Fund I, a debt fund with non-U.S. investors, and the warrants were acquired by W Fund X, a U.S. based fund with only U.S. owners. The interest on the debt qualified for the portfolio interest exception.

D Fund I finds itself in a liquidity crisis brought on by significant redemption requests from its investors. D Fund I offered MG the opportunity to buy the $4 million note at a discount, and W Fund X offered to transfer the warrants for nominal consideration, but MG turned the offers down because of its own lack of liquidity. Assume that MG is otherwise solvent, although only barely. CARPE LLC, an opportunistic buyer, has offered to purchase the $4 million note position at a 30 percent discount to the original issue price of the debt instrument and D Fund I has decided to accept the offer. CARPE LLC will also acquire the warrants for nominal consideration. CARPE already owns 50.1 percent of the capital and profits of MG and has an additional 20 percent carried interest above a 5 percent IRR. MG and CARPE are not under common control.

In Example One, if CARPE purchases the note from D Fund I at a discount to its outstanding balance: (i) MG would recognize COD income equal to approximately $1,200,000 that would be allocated among all of the members of MG, including CARPE; (ii) the MG debt, post-acquisition, would be treated as new indebtedness of MG that has an issue price of $2,800,000 and a stated redemption price at maturity (the amount payable at maturity without regard to any regularly payable, stated interest, SRPM) of $4,000,000; (iii) the deemed-reissued note would be treated as issued with original issue discount of $1,200,000 that would then accrue into the taxable income of the holder over the remaining term of the loan; and (iv) 100 percent of the indebtedness would be allocated to CARPE under the partnership liability sharing rules of Section 752 and stripped from the other members of MG. The debt reallocation could result in a constructive cash distribution in excess of the adjusted basis of the non-CARPE members of MG, triggering taxable gain to those members. This is a risk that is typically a concern of real estate owning partnerships, but that applies across all types of partnership entities.

The tax carnage resulting from this poorly planned acquisition, for both CARPE and the other members of MG, could be significant. Because the transaction generated COD income, MG will report and allocate to its members (including CARPE) $1,200,000 of COD income for the year the debt is acquired by CARPE. It matters not whether MG is insolvent. The ability of the members of MG to exclude any portion of the COD income from their respective gross incomes depends upon whether the members, individually, satisfy any of the exceptions to recognizing COD income in Section 108 of the Code.

There are two important reasons why the transaction described in Example One is so tax inefficient: (i) COD income was generated because of the acquisition of the MG debt by a person related to MG from a person not so related and the amount of the COD income was measured by the excess of the outstanding amount of the debt over the amount paid by the related person to acquire the debt; and (ii) the MG debt was then reallocated among the members, resulting in deemed cash distributions to the members other than CARPE LLC, because of the IRS Regulations on the proper allocation of partnership debt to partners and persons related to partners.

Acquisition of debt by persons related to the borrower. Section 108 of the Code generally requires the borrower to report COD income when it acquires its outstanding debt for an amount less than the outstanding amount of the debt plus accrued interest. COD income is also realized when a person related to the borrower under the income tax attribution rules acquires the debt (from a person unrelated to the borrower), such as in the case in Example One where the debt was acquired by a member of MG. A partner is related to a partnership if the partner owns more than 50 percent of the capital or profits interest in a partnership.

The rules for determining ownership of an interest in partnership capital or profits under the attribution rules, including whether and to what extent the partner is treated as constructively owning the interests of other members, are complex. Sorting through the ownership of interests requires determining who the actual owner is, a task made more difficult by the commonplace tiered ownership of interests in entities. It is as important to then determine whether any other person or entity is deemed to own the interests constructively under the attribution of ownership rules. In Example One, CARPE also owns a profits interest that may or may not entitle CARPE to distributions currently and the ownership analysis must account for that right to distributions in measuring CARPE's ownership in MG. If CARPE did not own a more-than-50 percent ownership in MG initially, the presence of the profits interest might complicate the analysis whether CARPE's interest, in the aggregate was greater than 50 percent of the MG capital or profits.

Another area of uncertainty in the case of partnerships is to how to measure the ownership of a partnership capital interest where there are interests in partnership or LLC capital that have priority rights to operating and capital transaction proceeds. There are few hard and fast rules in making the determination of the percentage interest owned by such investors, although the IRS generally takes the view that a partner's or member's interest in capital is a function of the relative amount that would be distributed in the event that the partnership or LLC sold its assets at their FMV, paid its outstanding liabilities, and distributed the net proceeds under the agreement. In the case of a business entity where there is a significant decline in value, the ownership of the capital interest in the business may have migrated solely to the holders of the preferred capital, which may provide a benefit or a disadvantage to planning options for the acquisition of the debt. Only careful analysis of the facts can help to overcome this hurdle.

Further, in the case illustrated by Example One the fact that the warrants are transferred by W Fund X to the buyer of the debt must also be taken into account. Generally, warrants are "options" for the purpose of determining constructive ownership under the Code. Curiously, the ownership attribution rules in Section 108 do not make the person or entity that has an option to acquire an equity interest the constructive owner of the interest. In planning for the acquisition of debt by a person related to the borrower, that gap in the rules sometimes provides an advantage. Notwithstanding that potential advantage, the use of an option in planning for the debt acquisition could be problematic where: (i) the structure of the option makes it reasonably certain that it will be exercised, particularly if the only real condition to exercise is the passage of time, because the IRS could take the view the option holder was actually the owner of the interest for tax purposes; or (ii) the existence of the option, combined with the ownership of the debt position, could be viewed as the ownership of a partnership interest under the "noncompensatory option" Regulations, causing the owner of that position to be treated as a partner. Although the deemed ownership of a partnership interest might not cause the debt holder to be treated as owning a more-than-50 percent interest in the capital or profits of a partnership, the requirement in the Regulations that nonrecourse debt of a partnership be allocated exclusively to a partner holding that debt, except in narrowly defined cases, creates the risk that the other members of the partnership could experience taxable gain from a constructive cash distribution in excess of basis arising out of the reallocation of the debt. Using options in connection with the acquisition of distressed debt requires very careful planning.

Finally, the relationship between the debt acquirer and the borrower needs to be tested both at the time of the acquisition of the debt and later, if the debt acquisition falls within the rules governing debt that was acquired "in anticipation" of becoming related, that are forth in the Regulations.

Some partnership and LLC agreements and loan agreements, might be drafted to make void *ab initio* any transfers of partnership or LLC interests, or the ownership of debt of the borrower, that would cause the debt to be treated as partner nonrecourse debt under Section 752 of the Code or result in COD income to the partnership. Such restrictions would need to be understood in planning any transaction such as the one in Example One.

The Section 108 related party COD income rules, although they might pose a significant threat to the acquisition of a borrower's debt at a discount by persons related to the borrower, rely on a system of very precise relationships to determine "relatedness." As in any rule-based system, there are gaps or asymmetries (such as the absence of option attribution noted above) that can be used to defer or avoid COD income. Careful analysis of the underlying ownership positions and relationships could allow borrowers and holders to complete discounted re-purchase transactions in a tax efficient way.

The "market discount" rules can convert what was otherwise capital gain income to ordinary taxable income

For most purchasers, the most important point about the acquisition of distressed debt is not the possibility of triggering COD income to the borrower because it is likely the borrower is recognizing operating losses that could be used to offset COD income. Further, a properly structured debt acquisition with cooperative and well advised parties can usually be carried out so that COD income can be deferred or avoided entirely. In the case where an investor or a private equity fund acquires distressed debt expecting to hold the debt until the borrower recovers or the economic turmoil subsides, the real issue is whether some appreciable portion of the economic

return from holding the debt could be taxable as ordinary income rather than capital gain income under the market discount rules. This result often comes as a surprise to noncorporate buyers of distressed debt. The ordinary income tax result is a product of the so-called “market discount” rules of the Code.

The market discount rules were added to the Code in 1984 as part of a set of rules intended to rationalize the treatment of interest accruals and to bring the computation of interest income and deductions into the modern era by introducing time-value-of money concepts into the calculation of interest income and expense. The market discount rules were added to avoid the tax asymmetry between buying a debt instrument at original issue and purchasing a debt with equivalent credit risk and maturity, but with a lower coupon interest rate, in the market. Assuming an equivalent credit and comparable maturity, the latter position could have provided the buyer an opportunity to recognize the discount from the debt instrument’s face as capital gain income, rather than interest, notwithstanding the instruments were fungible economically. In the pre-1984 world, taxpayers could make a leveraged purchase of a discount debt instrument, claim ordinary deductions against their ordinary investment income for the interest incurred to finance their purchase, and recognize long-term capital gain income when the debt instrument matured or was sold.

Market discount arises in connection with the acquisition of a debt instrument (other than at issuance) at a price that is less than the instrument’s SRPM. SRPM includes any accrued and unpaid interest that had been deferred to maturity. The basic market discount rule requires the holder of debt having market discount to treat gain realized upon the disposition of the market discount debt obligation as ordinary income to the extent of the economically accreted market discount. Unless the holder elects for the market discount to accrete at a constant interest rate, market discount accretes ratably over the remaining term of the debt. A holder of market discount debt that is an accrual method taxpayer is not required to accrue the ratable portions of market discount as income.

Example Two: In May 2018, LG2, an LLC taxed as a partnership, issued a 10-year note (secured by real estate of LG2) for $10,000,000, interest only, with semiannual interest payable at 6 percent, per annum. The note was acquired at original issue by Mezz Fund Alpha. As a result of the economic turmoil and despite the fact that LG2 was not in monetary default, the creditworthiness of LG2 became suspect. In addition, Mezz Fund Alpha needed to generate liquidity to meet redemption requests. In May 2020, Mezz Fund Alpha sold the debt at a loss to an opportunistic distressed debt buyer (Tiger Fund II) for $8,500,000. Tiger Fund II is unrelated to the borrower. On January 2, 2022, Tiger Fund II sells the LG2 debt to a private equity investment fund for its outstanding face amount ($10,000,000). LG2 never missed a payment and did not default.

The sale of the note at a discount to Tiger Fund II does not result in COD income to LG2 because Tiger Fund II is not a person related to LG2. In the hands of Tiger Fund II, however, the debt instrument is a “market discount bond.” Although Tiger Fund II expected that 100 percent of its $1,500,000 gain would be taxed as long-term capital gain (if held for one-year), it discovered that approximately $312,500 of the gain recognized on the sale to the private equity fund was classified as ordinary taxable income under the market discount rules.

The SRPM of the note acquired by Tiger Fund II was $10,000,000, the amount payable at the maturity date of the note, exclusive of the regular stated interest that was payable at least annually. The acquisition price was $8,500,000, the amount paid by Tiger Fund II to Mezz Fund Alpha. The difference between the SRPM and the acquisition price of the note is the amount of the market discount ($1,500,000).

The $312,500 ordinary income amount was the approximate amount of the market discount that accrued over the period that Tiger Fund II held the obligation (20 months out of approximately 96 months remaining to maturity (when acquired) equals about 21 percent of the market discount accruing ratably).

The market discount rules generally affect only the characterization of the gain, i.e., capital gain versus ordinary income. As noted above, however, the holder can elect to take the market discount into account using a compound yield, i.e., using a methodology comparable to the calculation of the accrual of OID. In that case, the amount accruing over a given period will depend whether the holder elected the compound yield method or relied on the ratable accrual method.

The market discount rules also can cause the holder to defer the deduction for interest incurred or continued to purchase a market discount bond (direct interest). Therefore, if Tiger Fund II incurred debt to purchase the LG2 debt from Mezz Fund Alpha, some or all of the Direct Interest expense may be deferred. Unless the holder elects otherwise, the excess of the direct interest expense over the amount includible in the holder's income with respect to the debt is disallowed as a deduction. The amount disallowed is treated as interest paid in the year in which the debt obligation is disposed of.

The Code permits holders with direct interest that would otherwise be disallowed to elect to include the market discount on the debt into income using the constant yield methodology. In that case, the amount of the disallowed interest expense may be reduced and any disallowed interest is treated as paid or accrued in the succeeding taxable year, rather than on the disposition of the market discount debt instrument.

Unfortunately, the IRS has never released any guidance concerning how the market discount rules take into account principal amortization payments or partial principal payments. In fact, given the absence of guidance with respect to these rules, there are opportunities, consistent with the purposes of the rules, to achieve tax-efficient structures for the ownership and disposition of market discount debt obligations.

The market discount rules may not fairly measure the extent to which the discount from the SRPM represents an interest-substitute return in the case of defaulted debt instruments

As described above, the amount of the market discount for any debt obligation is the excess of the SRPM over the acquisition price for the debt instrument. The market discount is then accrued ratably over its remaining term. Assume that a taxpayer purchases a deeply discounted debt instrument ($5,000,000 outstanding amount with accrued interest and 24 months remaining to its maturity) for $250,000. The loan is in default and is "non-performing." After 12 months, the purchaser then makes a deal with the borrower to accept $1,750,000 in satisfaction of the loan. The borrower is indifferent to the recognition of COD income because it is insolvent and not rendered solvent from the satisfaction of the loan. The purchaser recognizes some portion of the gain as market discount, but how much?

What happens under the market discount rules where the debt instrument, when acquired, is in monetary default and, under the terms of the debt instrument, the outstanding balance of the debt (plus accrued interest) can be called by the holder immediately? For these types of obligations, which are the prime targets for a distressed debt investor, the market discount rules yield no answers. Consider the following example:

Example Three: Attila Fund I, LLC (AF) is an opportunistic, distressed debt investor. AF identified private equity fund Zeta as a fund that largely made subordinated loans to energy sector borrowers. Most of those loans are now in default because of the oil price war and the state of the economy. AF has the opportunity to acquire a $50 million subordinated note of one energy company (due in 35 months) from Zeta for $20 million. Assume that the SRPM of the note is $55 million because of accrued and unpaid interest and charges and that the note is in default and can be called at any time, i.e., there is no forbearance agreement. AF purchases the note for $20 million paid to Zeta.

If the market discount rules are applied as drafted, the amount of the market discount would be $35 million (SRPM equals $55,000,000 – $20,000,000). It is unclear on these facts over what period the market discount should be accrued. Among the possible accrual periods are: (i) from the acquisition date to the original maturity date; (ii) from the acquisition date to the date on which the notes are called by the holder; or (iii) from the acquisition date to some other date. The determination of that date is important because it determines how much of the market discount is deemed to accrue economically during the time that AF holds the note.

The case in Example Three illustrates just how much the market discount rules fail when dealing with distressed debt. First, the market discount rules were intended to address the possible income tax character asymmetry between the purchase of lower coupon yielding debt obligations securities versus higher coupon yielding securities, where the borrowers had comparable credit

risks and the debts had comparable maturities. It eliminated the character benefit that would otherwise have accrued in favor of a purchaser of the lower coupon debt instrument. Second, the market discount rules assumed that the debt instruments would be paid according to their terms so that the market discount calculations could be determined based on the objective terms of the debt instrument. In the case of distressed debt, however, the difference between the SRPM and the cost of the obligation reflects much more than changes in market yield. It reflects a significant decline in the creditworthiness of the borrower. In addition, when the debt is in monetary default, the calculation system relied upon by the market discount rules breaks down because it is unlikely that payments will be made in accordance with the terms of the debt obligation, thrusting the holder into uncharted waters. In truth, the return, if any, from the investment is far more likely to be attributable to the holder's ability to achieve a successful modification and workout of the defaulted debt than to accrue a rate of return over time.

Example Four: Assume the same facts as in Example Three, except that AF makes a deal to accept a partial prepayment of principal equal to $25,000,000 at a date that is 13 months after AF acquired the note. The interest rate on the note will be lowered to the AFR and the balance of the note, with all accrued and unpaid interest, will be payable at its original maturity.

What is the tax treatment to AF of the $25,000,000 principal prepayment? If you were AF, you would be expecting capital gain income (why wait for more than 12 months otherwise?). If you were AF, you would be wrong. Under the market discount rules, the statute provides that, if a partial payment of principal is made on debt having market discount, the payment is treated first as a payment of accrued market discount, resulting in ordinary income, and then as a non-taxable recovery of principal. Because of the absence of guidance regarding the application of the market discount rules in the case of distressed debt obligations, whether the partial payment rule should apply may be open to interpretation and guidance should be sought in those cases.

Notwithstanding that the market discount rules are a solution for an entirely different problem, they are applicable to the cases in Examples Three and Four on their face. In the last debt crisis, some investors took the view that the market discount rules did not apply to cases of deeply distressed debt obligations and that the investors were entitled to treat payments on the obligations first as a recovery of their adjusted basis in the debt obligations, rather than as first allocable to accrued market discount as described above in Example Four. Other investors took the view that, because the market discount rules were premised on the debt being paid according to its terms, those rules should have no application to cases involving distressed debt obligations. Finally, the market discount rules apply only to debt with a definable term. Loans payable on demand or with a fixed maturity date of not more than one year from the date of issue were excluded from the market discount rules. It may be possible that the loan in Examples Three and Four falls outside of the market discount rules because it is in default and, therefore, callable at the option of the holder, i.e., should be treated as a demand loan?

Even if the market discount rules do not apply, can AF be certain that the gain on the note would be capital gain income? If the intention of AF at the time of the purchase, as reflected in the AF investment committee minutes, was to "flip" the note to a buyer as soon as it was able, was this property held for sale?

The market discount rules, once triggered, are far reaching and can "taint" the market discount debt instrument in the hands of a transferee

The market discount rules were drafted to preserve the amount of the market discount as ordinary taxable income notwithstanding a transfer of the debt instrument by the holder. The scope of these rules is broad and detailed.

Under the general rule of the Code, upon the disposition at a gain of a debt instrument having accreted market discount, market discount must be recognized to the extent of the gain realized, "notwithstanding any other provision of this subtitle." Where the market discount obligation is disposed of other than pursuant to a sale, the transferor is treated as realizing an amount equal to the fair market value of the debt obligation.

Some of the important consequences of this general rule include the following:

If the market discount debt is contributed to a corporation (other than the borrower corporation) in

a transaction to which Section 351 applies, the market discount rules require the recognition of the accreted market discount to the extent of gain realized in the transaction. Thus, the market discount rules override the otherwise applicable nonrecognition rules of Code Sec. 351. This would include having a disregarded entity, e.g., a single member LLC, which is holding the market discount debt make an election to be taxed as a corporation.

If a holder of a portfolio of market discount obligations secured by real estate elects to treat this portfolio as a REMIC, the better view is that the election to classify the portfolio as a REMIC results in the recognition of the accreted market discount notwithstanding that there is no transfer of the portfolio to another entity. Notwithstanding the likelihood that accrued market discount would be recognized on the election to treat the portfolio as a REMIC, recent guidance from the IRS (in the form of a Revenue Procedure) provided that certain modifications to some mortgage loans made pursuant to a forbearance program will not be treated a constructive exchange of the old debt obligation for a newly issued obligation, thereby giving rise to REMIC prohibited transactions, or indicating a power to vary the investments when determining the federal income tax status of securitization vehicles that hold the loans. Regardless of this guidance, important questions remain regarding the circumstances in which a REMIC could be viewed as having improper knowledge of an anticipated default.

The general rule requiring the recognition of market discount is overridden in certain specific cases where the market discount debt is transferred in a nonrecognition transaction.

If the market discount debt is contributed to a partnership (not the issuer of the debt), the Section 721 nonrecognition rules continue to apply. No gain or ordinary income is recognized by the contributor or the partnership under Section 721, and the debt obligation in the hands of the partnership is tainted by the transferor's market discount (a "step-in-the-shoes" rule). That is, on the sale or other disposition of the market discount debt by the partnership, the partnership would take into account the market discount, including the transferor's market discount to which it succeeded as a result of the contribution. Careful attention needs to be paid to the Code Sec. 704(c) provisions of the transferee partnership in that case. The amount of the market discount would be Section 704(c) built-in gain and the market discount also is treated as a Section 751(c) unrealized receivable in the hands of the partnership.

If a partnership distributes a market discount debt that it holds, whether in complete or partial liquidation of the partner's interest in the partnership, the accreted market discount generally is not recognized at the time of the distribution. Under a special market discount rule, the market discount obligation distributed by the partnership treated as so-called "transferred basis property" so that the distributee steps into the shoes of the partnership transferor with respect to the accreted market discount. If the distributee partner disposes of the debt instrument at a gain immediately after the transfer, the gain will be characterized as ordinary income to the extent market discount economically accreted in the hands of the partnership. Where the distributee took a basis in the market discount debt equal to the then FMV of the debt, however, it is unclear how the accrued market discount would even be recognized under the market discount rules. In that case, the accreted market discount may appear to escape taxation. On the other hand, consideration must be given to: (x) the rules of Section 751 of the Code that, in the case of a non-pro-rata distribution, could trigger taxable gain to the distributee or to the other partners, and (ii) the rules of Section 731(c) dealing with distribution of marketable securities that are treated as cash.

Other cases where the broad income recognition rule of the market discount rules is overridden are debt-for-stock "E" recapitalizations and distributions in liquidation of a corporation governed under Section 337(a) of the Code. To the extent that gain is otherwise required to be recognized under the rules of the Code, that gain is subject to characterization as market discount.

These rules are very complex and have not been the subject of IRS guidance. One area lacking guidance involves taxpayers that acquire pools of market discount debt instruments, e.g., by purchasing a portfolio of such debt obligations from investors, where it is unclear whether the market discount rules should be applied on a debt-for-debt basis or whether the rules can be applied on a portfolio basis. The answer to this question is important for a number of market discount obligation reasons.

Assuming that the pools of distressed loans are debt-financed, allocating the debt incurred to purchase or carry the distressed loans will be important. Because of the limitation on the deductibility of interest incurred to purchase or carry market discount obligations, it is important to understand how to allocate the interest to the pool. The language of the statute implies that it is debt-by-debt. These determinations are made with respect to "such bond." That language implies a debt-by-debt approach that only increases the record-keeping burden by requiring a tracing of acquisition debt proceeds to particular market discount obligations. In addition, it would prevent aggregating interest on the pooled debts for the purpose of determining net direct interest expense on a portfolio basis. Being able to determine the deductible interest expense on the pool of distressed debt on a combined basis could enable the holder to maximize the amount of interest that is deductible currently.

A significant portion of the loans originated to fund U.S. businesses, particularly those lenders lending to real estate entities, are structured to qualify for the portfolio interest exception from withholding on payments to non-U.S. persons. Under these rules, market discount is not classified as "interest" income under Sections 871(a) and 881, so that non-U.S. persons not engaged in a U.S. trade or business would not be taxed on their shares of market discount. Rather, it continues to be treated as "gain" from (presumably) a capital asset that would generally be treated as foreign source income to the non-U.S. persons. On the other hand, if the distressed debt investor is treated as conducting a U.S. trade or business by purchasing the debt, renegotiating the terms, and reselling the debt, non-U.S. persons and U.S. tax-exempt investors could find that they recognized income from a trade or business conducted in the U.S. Therefore, careful planning is required in structuring the workout entity and its activities in order to avoid the entity being treated as engaged in a trade or business in the U.S. that is classified as "effectively connected" income.

The market discount rules make organizing a fund to acquire distressed debt more challenging

Organizing a fund to acquire and work-out distressed debt is made more challenging by the market discount rules.

The ratable accretion rules break down when applied to amortizing loans, loans with irregular payments or loans with alternative payment schedules, which is likely to be the case with distressed debt where the parties are trying to restructure the debt. Although the IRS has authority to provide guidance on this point, no guidance has been published. Following the strict wording of the statute in a distressed debt case could result in the holder of the distressed debt recognizing more interest income over the term of the obligation than the holder's economic return, with a resulting capital loss on disposition of the obligation. For example, the holder (AF) in Example Four would recognize $13,000,000 of ordinary income in month 13 under the partial payment rule ($1,000,000 accrued market discount accrues each month under the ratable accrual method) and the balance would be a recovery of capital. If the only other payment from the debt obligation was $1,000,000 upon the payoff of the obligation on the second anniversary of its acquisition by AF, AF would have recognized ordinary income of $13,000,000 where, on the facts, it realized only $6,000,000 of real economic income (total payments of $25,000,000 + $1,000,000 = $26,000,000 – investment of $20,000,000 = $6,000,000).

Could the solution to the situation noted above be the basis recovery method accounting method, by which the first dollars of cash received are allocated to the recovery of the holder's adjusted basis in the distressed debt instrument. Investors and advisers need to carefully consider the income tax risks involved in using that approach or other solutions. Representatives of the IRS have stated their belief that basis recovery is not an acceptable method of accounting for holders of distressed debt.

Another open question is whether the rules of Section 451(b) of the Code enacted as part of the Tax Cuts and Jobs Act would permit holders of market discount debt to accrue income in accordance with the method of accounting used for book purposes.

As noted in our paper discussing modifications of debt instruments, the process of negotiating and restructuring a debt in default creates a real risk that the debt holder (organized as an entity taxed as a partnership) would be regarded as engaged in a U.S. trade or business. That might be especially the case if the loan is sold or disposed of shortly after the completion of a successful

restructuring. If the debt holder is treated as engaged in a U.S. trade or business, the non-U.S. members of the entity (organized as an entity taxed as a partnership) would be subject to U.S. tax because the income would be effectively connected with a U.S. trade or business, including on their sale of their interest in the entity.