MITIGATING FINANCIAL DISTRESS AMID A GLOBAL PANDEMIC

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With You Today

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Today’s Agenda

- Introduction
- Current State of the Economy
- Identify and Understand Symptoms of Distress
- Action Plan for Companies Experiencing Distress
- Tax Implications
CURRENT STATE OF THE ECONOMY
Economic Overview

US GDP GROWTH FORECAST

- 2020 GDP growth (current forecast): -6.10%
- GDP loss to be more than 3 times the drop during the Great Recession

GLOBAL GROWTH FORECAST

- IMF projects total global output to fall 3.0% in 2020
- World economy contracted by less than 1% between 2008 and 2009

2020 and 2021 Projected Unemployment

8.9% 2020
6.5% 2021

Oil Price Collapse

Corporate Bankruptcy Outlook

- Business bankruptcy filings trending slightly higher compared with this time last year
- Business filings under Chapter 11 rose sharply in March
- 37 companies filed for Ch. 11 from March 1 to May 1, 2020, according to Debtwire
- The first wave of corporate bankruptcies will likely involve companies that were already struggling ahead of the pandemic, with COVID-19 being the final accelerant
- Bankruptcies are expected in the coming months in the retail, restaurant, travel and energy industries

### TOTAL CHAPTER 11 FILINGS FROM MAR 1 - MAY 1, 2020

<table>
<thead>
<tr>
<th>Industry</th>
<th>No. of Filings</th>
</tr>
</thead>
<tbody>
<tr>
<td>Oil &amp; Gas</td>
<td>10</td>
</tr>
<tr>
<td>(9 in TX, 1 in CO)</td>
<td></td>
</tr>
<tr>
<td>Retail</td>
<td>6</td>
</tr>
<tr>
<td>Telecommunications</td>
<td>3</td>
</tr>
<tr>
<td>Consumer Products</td>
<td>2</td>
</tr>
<tr>
<td>Restaurants</td>
<td>2</td>
</tr>
<tr>
<td>Healthcare</td>
<td>2</td>
</tr>
<tr>
<td>Entertainment</td>
<td>2</td>
</tr>
<tr>
<td>Technology</td>
<td>2</td>
</tr>
<tr>
<td>Other Industries</td>
<td>8</td>
</tr>
<tr>
<td><strong>Total</strong></td>
<td><strong>37</strong></td>
</tr>
</tbody>
</table>

Source: Debtwire Restructuring Database
Benefits of a Chapter 11 Bankruptcy Filing

- Automatic stay
- Preservation of business - can continue to operate
- Temporary deferral of obligations incurred pre-bankruptcy petition
- Debtor may use cash collateral or borrow post-petition
- Sell property free and clear of liens and interests (section 363)
- Assume or reject executory contracts and unexpired leases
- Restructure secured debts
- Avoidance and recovery of certain pre-petition payments
- Extend payment of unsecured tax debts
- Pro-rata payment of general unsecured claims
IDENTIFY AND UNDERSTAND SYMPTOMS OF DISTRESS
Some of the Key Signs of Distress Include...

- **Tight liquidity**
  - Insufficient cash on hand
  - Inability to obtain new financing for the business
  - Inability to pay debts as they come due

- **Fully drawn on credit facilities**
  - Covenant violations lower borrowing base availability
  - Deteriorating relationship with lenders

- **Declining profitability**

- **Debt in excess of book value of assets**

- **Other signs of distress**
  - Loss of key customers/vendors
  - Management and employee turnover
  - Layoffs, product line reductions, etc.
  - Retention of restructuring professionals (attorneys, investment bankers, etc.)
ACTION PLAN FOR COMPANIES EXPERIENCING DISTRESS
TRIAGE
Implement your Operational Resiliency Plans

- Business Continuity
- Cyber Resilience
- IT Disaster Recovery
- Third Party Risk Management
- Insurance
- Crisis Management
- Pandemic Plan

BDO WEBINAR: MITIGATING FINANCIAL DISTRESS AMID A GLOBAL PANDEMIC
The 4 Phases of Recovery

- **PERSEVERE**
  - Survival

- **MAINTAIN**
  - Reopening

- **RECOVER**
  - Return to some level of sustainable business activity

- **THRIVE**
  - Economy regains strength and employment levels return to pre-COVID-19 levels
Liquidity Management

1. Create a cash-oriented culture
2. Maintain liquidity position and aggressively manage cash
3. Take measures to reduce operating costs
4. Prepare a robust cashflow forecast and update weekly
5. Perform multiple financial forecast scenarios and update them often
6. Use the Balance Sheet to create cash
7. Utilize the available Government economic programs
8. Commence Lender discussions
The CARES Act Part I & II

$2.78 TRILLION IN DIRECT ASSISTANCE

- Airlines: $46B
- State & Local Gov: $339.8B
- Midsized & Larger Businesses: $454B
- Public Health: $161B
- Small Businesses: $377B + $320B = $697B
- Individuals: $510B

(As of April 24, 2020)

1 Indicates both CARES Act(s) as well as special appropriations and administration costs.
BDO’s CARES Act Support Programs

<table>
<thead>
<tr>
<th>Program</th>
<th>Amount</th>
<th>Description</th>
</tr>
</thead>
<tbody>
<tr>
<td>Corporate Credit Facility</td>
<td>$750B</td>
<td>Administered by The Federal Reserve - designed for businesses with access to public debt/equity markets</td>
</tr>
<tr>
<td>Main Street Loans</td>
<td>$100B</td>
<td>Administered by The Federal Reserve - similar to TARP in 2009 designed to highly liquid portfolios of debt</td>
</tr>
<tr>
<td>Paycheck Protection Program</td>
<td>$600B</td>
<td>Administered by The Federal Reserve - designed for businesses under $5B in revenue</td>
</tr>
<tr>
<td>Corporate Credit Facility</td>
<td>$659B</td>
<td>Administered by the SBA - Extension of existing 7(a) Loan Program - can be forgiven</td>
</tr>
<tr>
<td>Economic Injury Disaster Loans</td>
<td>$20B</td>
<td>Administered by FEMA - program extended for C-19 injury</td>
</tr>
</tbody>
</table>
Managing Lending Relationships

- Lenders are also in “crisis management mode”
- Triage actions underway
- CARES program support
- Second quarter “passes” have been issued by many lenders
- Open and honest communications are important
- Be prepared - realistic forecasts, business plans, requests
- Take action - don’t wait
- Retain professionals - legal and business
- The challenge - Who will fund cash shortfalls?
- Senior, second lien, mezzanine, ownership negotiations
- Collateral, valuation, priority, strategic alternatives
Keys to a Successful Restructuring

- A hard-hitting yet realistic forecast for the business
- Entering a different cycle, slow growth acceptable, forecasting accuracy very important
- Have realistic and attainable revenue forecasts
- Slow ramp-up of personnel, reopening of factories, warehouses
- Take the required actions to reduce costs and eliminate inefficient and/or bloated expense structure
- Utilize zero-based budgeting methodologies
- Eliminate marginal operations, locations and initiatives
- Manage cash, including CAPEX and projects
BDO Methodology

Restructuring and Turnaround Services Best Practices

PHASE I: Evaluate & Assessment
- Evaluate company financials and KPIs
- Liquidity and capital needs
- Develop company viability assessment
- Determine implications of strategic alternatives to company and its creditors

PHASE II: Restructuring
- Identify necessary changes to operations - the turnaround plan
- Develop post-implementation financial projections and cash requirements
- Develop communication plan for key stakeholders
- Develop financial and operational implementation plan

PHASE III: Implementation
- Implement the plan
- Ongoing assessment and communication of progress and performance
- Negotiate agreement with lenders and other creditors for ongoing support
What’s to Come...

- After the COVID-19 threat dissipates, recovery likely slow
- The Consumer has been severely damaged and likely will not be spending at previous levels
- Stock Market values still down in a number of important industries
- The Federal deficit is expanding rapidly - More to come as tax receipts fall and more programs likely needed
- Slow recovery, Recession likely
- Third Quarter will be very active for restructuring activity
- Expect more Bankruptcies and “forced sale” transactions
- Not all companies will make it
Hundreds of billions of speculative grade debt will mature between 2020 to 2027 given the current credit environment, these companies will find refinancing efforts to be challenging.

Speculative Grade Debt Maturities to Step up as % of Corporate Debt through 2025 ($bn):

Source: Oxford Economics/Haver Analytics
## Winners & Laggards Post-COVID

<table>
<thead>
<tr>
<th>HIGH</th>
<th>MODERATE</th>
<th>LOW</th>
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</thead>
<tbody>
<tr>
<td>DIRECTION OF IMPACT</td>
<td>POSITIVE</td>
<td>NEUTRAL</td>
</tr>
<tr>
<td>Video Conferencing</td>
<td>Sharing Economy</td>
<td>Consumer Discretionary</td>
</tr>
<tr>
<td>Delivery Services</td>
<td>Event Tech</td>
<td></td>
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<tr>
<td>Supply Chain Tech</td>
<td>Travel &amp; Hospitality</td>
<td></td>
</tr>
<tr>
<td>Distance Learning</td>
<td>Restaurants</td>
<td></td>
</tr>
<tr>
<td>Artifical Intelligence</td>
<td>Pet Food</td>
<td></td>
</tr>
<tr>
<td>Claims Automation</td>
<td>Baby Food</td>
<td></td>
</tr>
<tr>
<td>Video Games</td>
<td>Life Insurance</td>
<td></td>
</tr>
<tr>
<td>Consumables</td>
<td>Money Transfer Services</td>
<td></td>
</tr>
<tr>
<td>Cybersecurity</td>
<td>Digital Brokerages</td>
<td></td>
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<tr>
<td>Healthtech</td>
<td>Advertising</td>
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TAX IMPLICATIONS
Tax Implications Overview

- AMT Credit Planning
- Net Operating Loss Planning
- Cancellation of Debt Income
- Debt Modifications
- Insolvency/Bankruptcy Planning
The CARES Act (Public Law 116-136)

- The Coronavirus Aid, Relief, and Economic Security Act (CARES Act), which was signed into law by President Trump on March 27, 2020, contains a significant number of individual and business-related tax provisions aimed at stimulating our economy to put cash back into the hands of taxpayers.

- The tax treatment of business net operating losses (NOLs), for corporations and other taxpayers, was a large part of the stimulus package. Given the potential impact of the NOL provisions for putting cash back into businesses that have been hit hard by the recent pandemic, these provisions have become a very important area for many businesses.

- Discussion of Key Provisions aimed at putting roughly $2 trillion in economic relief in the hands of businesses and individuals adversely affected by the COVID-19 pandemic.

- The key is to provide liquidity to businesses to prevent economic hardships, up to and including bankruptcy, and to provide incentives to keep their workers gainfully employed.
Under the Tax Cuts and Jobs Act of 2017 (TCJA), corporate AMT credits became refundable over a four-year period from tax years beginning in 2018 - 2021.

Under the CARES Act, any remaining corporate AMT credit is fully refundable for the tax year beginning in 2019.

As an alternative, a taxpayer may elect to make the credit fully refundable for the tax year beginning in 2018. If a taxpayer elects to claim the AMT credit refund for its taxable year beginning in 2018, the taxpayer is allowed to file Form 1139 to claim the refund as long as the form is filed before December 31, 2020.

Given uncertainty surrounding application of the change in ownership rules under Internal Revenue Code Section (Section) 383 rules to AMT credits post-TCJA, strong consideration should be given to making the election for 2018.

If a taxpayer is subject to Section 383, and taxable income exists, it could impact the refundability of the credit in the later year.
Net Operating Losses - Historical Perspective

**PRE-TCJA**
- 2-year carryback, 20-year carryforward.
- No limitation on ability to offset current taxable income with NOL deduction, 90% AMT limitation.

**POST-TCJA**
- No carryback, indefinite carryforward for NOLs generated in taxable years ending after December 31, 2017.
- For taxable years beginning after December 31, 2017, limited to 80% of taxable income computed without regard to NOL deduction. Ordering of pre-2018 NOLs ambiguous.

**CARES ACT**
- For years beginning after December 31, 2020, NOL deduction limited to 80% of taxable income following the deduction of any pre-2018 NOLs, before any Section 199A or Section 250 deduction.
NOLs generated in taxable years beginning after December 31, 2017, and before January 1, 2021, can now be carried back 5 taxable years with the following unique applications:

- Technical correction to the TCJA - indefinite carryover and prohibited carryback (other than for special 5-year carrybacks) effective for taxable years **BEGINNING** after December 31, 2017.

- Special carryback rules do not apply to NOLs generated by REITs.

- Life insurance company carrybacks to years beginning before January 1, 2018, are treated as Section 810 operations loss carryback.

- CERT rules eliminated by the TCJA not revived in CARES Act.

- Short periods from M&A activity are treated as a full carryback year - carryback may not span 5 calendar years.
NOL Carryovers/Carrybacks (cont’d)

NOLs generated in taxable years ending in 2018, 2019, or 2020 years may be carried back 5 taxable years.

- Election to forego carryback can be found on Form 1120, Schedule K, box 11.

- A split-carryback election is available under Treas. Reg. Sec. 1.1502-21(b)(3)(ii)(B) for certain add-on stock acquisitions. These elections are not allowed for actual taxable or tax-free asset acquisitions, deemed asset acquisitions under Sections 338(h)(10) or 336(e), or tax-free asset transactions under Section 368(a).

- A taxpayer’s election to forgo carrybacks for 2018 and 2019 NOLs by the due date (including extensions of time) for filing the return for the taxpayer’s first taxable year ending after March 27, 2020 (October 15, 2021 for 2020 a properly extended calendar year taxpayer).

- Form 1139 must be filed within 12 months of year-end under Section 6411 but the Service granted a six month extension to file for 2018 under Notice 2020-26.

- Form 1139 is the recommended method of filing if qualified as it reduces the refund period to 90 days.

- For taxable years beginning before January 1, 2018, but ending after December 31, 2017, taxpayers were granted 120 days following the enactment of the CARES Act (July 27, 2020).
For taxable years beginning after December 31, 2020, the NOL deduction is limited to the sum of:

- NOLs generated in taxable years beginning before January 1, 2018, plus
- The lesser of:
  1. NOLs generated in taxable years beginning after December 31, 2017, or
  2. 80 percent of taxable income computed after the reduction for any pre-2018 NOLs but before any deduction pursuant to §§ 199A and 250

NOLs generated in 2018 through 2020 are subject to the limitation, but the limitation only comes into effect in 2021.

The 80 percent application is done after the reduction for pre-2018 NOLs. This change clarifies the ambiguity in TCJA as noted in the JCT Blue Book.
Variables in NOL Utilization

Maximizing a carryback involves understanding how the NOL deduction interacts with other provisions and the effective rate:

- The income tax rate in the NOL year will be a flat 21 percent federal rate but the income tax rate in the carryback period (pre-2018) could in a year when the average rate was 35 percent or the marginal rate was 38.33 percent.

- The DPAD (which was repealed for 2018 and later) is limited to taxable income so it could be reduced by the carryback claim.

- The section 179 election to expense depreciable assets limited to taxable income, but otherwise carried forward so its impact is temporary.

- Charitable contribution deduction pursuant to Section 170(b)(2)(A) was limited to 10 percent of taxable income, but it carries forward up to a maximum of five years. The new law increased the 10 percent limitation to 25% of taxable income for contributions made in 2020.

- Section 250 deduction relating to GILTI and FDII income is limited to 50 percent of taxable income.
Tax Planning to Increase NOLs Available For Carryback

- Accelerate Deductions
  - Prepaid Expenses
  - Software Development Costs
  - Inventory Capitalization
  - Cost to LOCM for Inventory
  - Tax accounting method changes for liabilities

- Defer Income under Section 451(b) for Goods or Services

- Accrual to Cash Method of Accounting - Consider $26 Threshold

- Qualified Improvement Property - Technical Corrections Method Change
- Cost Segregation Studies
- Actual or Deemed Asset Sale Acquisitions of a Trade or Business
- Worthless Stock Deductions
Reminders on SALT Considerations

► For state corporate income tax purposes, a minority of states allow an NOL carryback. Some states conform to the federal NOL provisions, some conform but only on a fixed-date basis and will not conform to any CARES Act modifications unless or until they update their conformity date to the Internal Revenue Code to include the date of the CARES Act enactment, and some provide their own NOL carryback rules, which may be subject to state-specific limitations or modifications.

► Whether these states and other states that impose a corporate income tax will conform to the CARES Act suspension of the 80% taxable income limitation is another variable.

► State conformity, and lack thereof, will vary for corporations, so we encourage you to consult with a State and Local Tax specialist when applying these complex provisions to the respective state and local income tax returns.
This section provides an overview of the tax implications of cancellation of debt income (CODI) that results from bankruptcy or insolvency, with a focus on the differences in the tax treatment for C corporations, S corporations, and partnerships.

CODI occurs if a borrower’s obligation to repay is reduced or eliminated.

Section 61(a)(11), which codified the landmark case of *Kirby Lumber Co.*, 284 U.S. 1 (1931), provides that gross income includes “income from discharge of indebtedness.”

A CODI event doesn’t always occur in conjunction with a formal cancellation. It could occur where a holder:

- Converts or otherwise exchanges investment for new investment, *i.e.*, a debt for equity exchange;
- Contributes the debt to capital; or
- Agrees with the Issuer to revise the terms and debt is deemed exchanged under the significant modification rules.
The following modifications could result in a deemed exchange of one debt instrument for another which could result in CODI debt:

- Reducing the interest rate;
- Deferring payments;
- Changing obligor or adding guarantor or co-obligor;
- Extending the maturity date; and
- Reducing the principal.

If the terms of a debt instrument are modified in a manner deemed “significant” under Treas. Reg. Section 1.1001-3, a new debt instrument may be deemed issued in exchange for the old debt instrument for tax purposes.

A “significant modification” can create tax exposure or be a “non-event” but it depends on the profile of the debt (publicly traded, OID, etc.) and the positions of the parties (group members or related parties or third-parties).

The one certainty is that it is usually never that simple of an analysis as each case often results in a complex computational analysis.
Insolvency Exception

- The exception under Section 108(a)(1)(B) applies when a taxpayer is insolvent (outside of bankruptcy).

- Insolvency for this purpose is defined in Section 108(d)(3) as the excess of liabilities over the fair market value (FMV) of assets, as determined immediately before the debt discharge and including the debt to be discharged. This is not book insolvency but the FMV of all intangible and tangible assets relative to liabilities.

- The amount excluded from income by reason of a debtor’s insolvency cannot exceed the amount of the debtor’s insolvency (Sec. 108(a)(3)).

- CODI is only excluded to the extent of insolvency while the remainder is recognized into taxable income (before NOL).

- An CODI after NOL can result in attribute reduction in the following taxable year.
Insolvency Exception

- Attribute reduction:
  - NOLs,
  - Unused general business credits,
  - Minimum tax credits,
  - Net capital losses;
  - Basis - § 1017; Floor rule is very important.
  - Passive activity losses and credits; and
  - Foreign tax credits.

- Caution - Section 163(j) is currently not subject to reduction.

- Tremendous complexity exists when applying these rules in a consolidated return context (Treas. Reg. Section 1.1502-28).

- There is an election to reduce the tax basis of assets first under section 108(b)(5) as a potential tax planning strategy.
Bankruptcy Planning

▶ Under Section 108(a)(1)(A), COD income is excluded from gross income where the discharge of indebtedness is granted in a Title 11 case, which includes Chapter 11 reorganizations, Chapter 7 liquidations, and Chapter 13 bankruptcy proceedings under Title 11 of the U.S. Code.

▶ This exclusion applies only if the discharge of indebtedness is granted by a court order or in a court-approved plan under Section 108(d)(2).

▶ When debt is discharged in bankruptcy, the bankruptcy exclusion rules govern, even if one of the other exceptions would have applied (Section 108(a)(2)(A)).

▶ This treatment is important since the required reduction of tax attributes differs depending on which COD income exclusion applies.
In Title 11 cases, debtors frequently pay off creditors by issuing new equity. This stock-for-debt exchange could trigger an “ownership change” as defined in Section 382 to the extent that “old” equity is replaced.

An ownership change under Section 382 occurs with respect to a corporation if it is a loss corporation on a testing date and, immediately after the close of the testing date, the percentage of stock of the corporation owned by one or more 5% shareholders has increased by more than 50 percentage points over the lowest percentage of stock of such corporation owned by such shareholders at any time during the testing period, which is generally a three-year lookback period.

The measure of the change is based on stock value rather than the absolute number of shares held, which is an important distinction when there is more than one class of stock.

When an ownership change occurs, Section 382 limits a corporation’s ability to use tax attributes from before the change in ownership, including NOL carryovers and certain built-in losses, to offset post-change taxable income.
Mutually exclusive rules contained in Sections 382(l)(5) and 382(l)(6) allow an insolvent company to preserve its NOLs. This alternate set of taxpayer-favorable limitations applies in lieu of the general Section 382 limitation.

A company that qualifies under Sec. 382(l)(5) can use its pre-change NOLs in full, unrestricted by the Section 382 limitation. To qualify, the corporation must be under the jurisdiction of a bankruptcy court immediately before the change and the corporation’s shareholders and qualifying creditors must own at least 50% (both in vote and value) of the stock immediately after the change.

The toll charge is a statutory cut on the amount of interest expense that went into the NOL on debt converted to stock in the last three years plus the year of the change, and a second ownership change in two years would subject the NOLs to a zero limitation.

Under Section 382(l)(5)(H), a taxpayer may elect out of the Section 382(l)(5) rules and into Section 382(l)(6). This provision allows a loss corporation to value its stock after the Section 382 change by multiplying the long-term tax-exempt rate by the lesser of the pre-change gross asset value, or the post-change stock value.

Significant tax planning is required to model out which bankruptcy rule to utilize based on planned ownership changes in the future and other matters affecting the future NOL utilization.
The application of the CODI rules to S corporations and their shareholders has several unique features including the following:

- CODI income exclusion and attribute reduction provisions are applied at the S corporation level. Therefore, insolvency or bankruptcy is determined at the S corporation level rather than at the shareholder level.

- CODI amounts that are excluded from the S corporation’s income may reduce the losses that are suspended for a particular shareholder, but only in the immediately succeeding year.

- CODI does not create a tax liability at the S corporation level. The income passes through to the shareholders who increase their basis for stock or debt by an equal amount under Section 1367.
S Corporations - Considerations (cont’d)

- If any shareholders have suspended losses, the basis increase could free up suspended losses to offset the taxable CODI in the year of the discharge.

- Taxable CODI not only increases tax basis, but it also increases an S corporation's accumulated adjustments account (AAA), which may allow for a non-dividend distribution if the corporation has accumulated earnings and profits.

- Since the CODI does not provide the S corporation with any cash to distribute, the corporation may simply have a net increase in the AAA.

- Outside tax basis is not increased by excluded CODI pursuant to Section 108(d)(7)(A). This codification was made after the unfavorable result in the Supreme Court decision in Gitlitz, 531 U.S. 206 (2001).
Partnership - Considerations

- CODI recognized at the partnership level must be allocated in accordance with Section 704(b) and the applicable Treasury regulations.

- The receipt of CODI increases a partner’s tax basis in his or her partnership interest under Section 705. The partner’s basis is increased even if the CODI is excluded at the partner level.

- Under Section 108(d)(6), the CODI exclusion rules are applied at the partner level. However, attribute reduction can impact the partnership. For example, an election to reduce depreciable basis under Section 108(b)(5) requires an adjustment to the partnership’s basis in the underlying depreciable property.
  - Insolvent partners may exclude all or a portion of their allocable share of CODI.
  - Consideration must be given to the allocation of liabilities as that can influence insolvency.
  - Solvent partners would be taxed on their allocable share of CODI despite the underlying level of insolvency of the partnership, unless another exclusion under Section 108 applies.
When debt is exchanged for an interest in a partnership, Section 108(e)(8) applies to partnership interests.

- The partnership will recognize CODI to the extent the adjusted issue price of the debt is greater than the fair market value of the partnership interest issued. This is based on Section 704(b) value for these purposes.

- On the other hand, the holder of the debt does not get a deduction for the debt, but instead increases its basis in the newly acquired partnership interest.

- This can and often does result in disparate treatment between the debtor and the creditor.

Partnership debt resolution presents planning opportunities related to the character, of the income, *i.e.*, the income could be ordinary CODI or capital gain. This of course depends on the type of debt (recourse/nonrecourse) and the manner of resolution (*i.e.*, principal reduction/deed in lieu).