



INSIGHTS FROM THE BDO PRIVATE EQUITY PRACTICE

# RESTRUCTURING CONSIDERATIONS AND OPPORTUNITIES FOR PRIVATE EQUITY & PORTFOLIO COMPANIES IN TIMES OF ECONOMIC UNCERTAINTY

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# Contents

## EXECUTIVE SUMMARY ..... 2

## OVERVIEW OF IMPORTANT CARES ACT PROVISIONS ..... 3

Employee Retention Tax Credit  
 Delay of Payment of Employer Payroll Taxes  
 Alternative Minimum Tax Credit  
 NOL Carryback  
 Excess Business Loss Limitations  
 Business Interest Expense Limitations  
 Bonus Depreciation on QIP

## OPPORTUNITIES AVAILABLE VIA AMENDING PARTNERSHIP TAX RETURNS ..... 6

In General  
 Claiming Additional Bonus Depreciation  
 Maximizing the Individual Business Loss Deduction  
 Increasing Corporate NOL Carrybacks  
 Other Considerations

## PARTNERSHIP INCOME/LOSS ALLOCATION PLANNING ..... 7

Gross vs. Net Income Allocations  
 Maximizing Loss Allocations  
 Partnership Freeze Structures

## DEBT RESTRUCTURING AND RELATED CONSIDERATIONS ..... 9

Overview  
 Transfer of Property in Satisfaction of Debt  
 Exchange of Debt for Partnership Interest  
 Loan Modification  
 Statutory Exclusions of Cancellation of Indebtedness Income  
 Worthless Stock Deductions  
 Partnership Allocation of Cancellation of Indebtedness Income  
 Abandonment of Partnership Interests

# Executive Summary

Given the economic impact of the novel coronavirus (COVID-19) pandemic, many private equity-owned businesses are evaluating their existing capital structures, overall income and loss allocation methodologies, and considering opportunities to maximize cash flow via available tax incentives. This includes evaluating loan arrangements and potential opportunities to restructure existing facilities.

With the recent enactment of the Coronavirus Aid, Relief, and Economic Security (CARES) Act as well as guidance published by Treasury and the IRS, private equity funds and their portfolio companies are faced with a myriad of new rules that must be carefully navigated to enjoy the potential benefits while avoiding several pitfalls.

This report is intended to provide an overview of key tax considerations for private equity and portfolio companies as they navigate these uncharted waters. Topics within this report include:

- ▶ Overview of important CARES Act provisions
- ▶ Opportunities available by amending partnership tax returns
- ▶ Partnership income and loss planning
- ▶ Debt restructuring and related considerations



# Overview Of Important Cares Act Provisions

The CARES Act included several individual and business tax provisions with a goal of putting trillions of dollars back into our economy through small business loans and tax incentives that provide cash to businesses and their owners. With proper income tax planning, these government dollars can end up inside of your portfolio company investments, as well as go to those investments' employees, which secures the loyalty of the workforce at a time when most of your investments could use the additional funding. These incentives will help keep your respective businesses viable and operational until the pandemic comes to an end and things return back to a sense of normalcy. We summarized many of these business provisions below.

## EMPLOYEE RETENTION TAX CREDIT

The CARES Act provides a payroll tax credit of up to \$5,000 per employee for eligible employers. The credit is equal to 50% of "qualified wages" paid to employees during a quarter, capped at \$10,000 of "qualified wages" per eligible employee. The credit is available for wages paid from March 13 to December 31, 2020, for businesses that are not also receiving Small Business Loans under the CARES Act. In order to be eligible, employers must have experienced a greater than 50% reduction in quarterly receipts, measured on a year-over-year basis, or must have partially or fully suspended business operations during the crisis.

## DELAY OF PAYMENT OF EMPLOYER PAYROLL TAXES

The CARES Act permits employers to forgo timely payment of the employer portions of Social Security and certain railroad retirement taxes that would otherwise be due from March 27, 2020 through December 31, 2020, without penalty or interest charges. This can provide much needed cash to the employers as their share of employee Social Security is 6.2% per employee up to the first \$137,700 of their wages. Employers must pay 50% of the deferred amount

by December 31, 2021, and the remainder by December 31, 2022, hopefully at a time when most businesses turn back to profitability.

Self-employed individuals can take an equivalent tax deferral on 50% of the old age, survivors, and disability insurance, or OASDI tax imposed on self-employment income under IRC Section 1401(a) and will not be penalized for failing to make estimated tax deposits on that amount during the deferral period.

## ALTERNATIVE MINIMUM TAX CREDIT

Under the Tax Cuts and Jobs Act (TCJA), corporate alternative minimum tax credits were refundable over a four-year period from tax years beginning in 2018 through 2021. The CARES Act allows the refundable alternative minimum tax credit to be completely refunded for taxable years beginning in 2019, or by election, for taxable years beginning in 2018. Under the TCJA, the credit was refundable over a series of years with the remainder recoverable in 2021. Given the change in ownership rules that apply under IRC Section 383 to net operating losses (NOLs) that may have existed before the acquisition by a private equity fund, strong consideration should be given to making the election to receive the refund for the 2018 tax year.

## NOL CARRYBACK

Under tax law preceding the TCJA, NOLs could be carried back two years and forward 20 years with no limitation on the amount of NOL that could offset taxable income in the carryforward year. The TCJA changed the rules to deny carrybacks of NOLs and to allow for unlimited carryforwards. While the NOL carryforward period was indefinite, the NOL deduction in a carryforward year was generally limited to 80% of taxable income. The CARES Act changed the playing field once again, as it now allows for a five-year carryback of NOLs generated in taxable years beginning after December 31, 2017, and before January 1, 2021. Therefore, calendar year portfolio companies with NOLs in 2018, 2019, and 2020 can take advantage of the new NOL carryback rules.

In addition, the 80% limitation on NOL deductions arising in taxable years beginning after December 31, 2017, has temporarily been pushed to taxable years beginning after December 31, 2020. NOL carryovers generated in taxable

years beginning after December 31, 2017, are subject to the 80% limitation once they are carried over to a period in which the limitation applies.

The new law also included a technical correction to the TCJA relating to the effective date of the NOL carryback repeal affecting only fiscal-year taxpayers for the year that began in 2017 and ended in 2018. NOLs that arose in a taxable year that straddled this period are now eligible for the two-year carryback period and 20-year carry forward period of the pre-TCJA law.

While taxpayers may elect to relinquish the entire five-year carryback period with respect to a particular year's NOL, with the election being irrevocable once made, most taxpayers will not elect to relinquish the carryback period. This is because many portfolio companies will take advantage of the new rule carrying back losses to tax years where the federal corporate tax rate was 21% to earlier years where the highest federal corporate rate was 35%.

Taxpayers that elected to waive the carryback period before the new law was passed, now have an opportunity to revoke that election and take advantage of this new favorable carryback provision so long as a proactive waiver of the election is filed by July 27, 2020, under Revenue Procedure 2020-24.

This provision should have portfolio companies considering tax accounting method changes to accelerate deductions and defer income where the opportunity exists, which can maximize current losses and increase the potential NOL carryback. Moreover, portfolio companies should take advantage of the new rules that allow for the expensing of qualified improvement property (QIP), as well as potential worthless stock deductions, which is discussed in more detail under the section titled "Worthless Stock Deductions," to increase the potential ordinary loss and carryback potential.

Additionally, the bill provides for two special rules for NOL carrybacks to years in which the taxpayer included income from its foreign subsidiaries under IRC Section 965. Moreover, the impact of NOL carrybacks on tax calculations in the carryback year, including foreign tax credit, alternative minimum tax, and global intangible low-taxed income calculations, or GILTI, as well as the state and local tax treatment must also be considered to maximize tax planning.

## EXCESS BUSINESS LOSS LIMITATIONS

Beginning in 2018, net business losses for non-corporate taxpayers in excess of \$500,000 for joint filers (\$250,000 for all other taxpayers) were not allowed as a current deduction against nonbusiness income. These threshold amounts were indexed for inflation and, in 2020, were scheduled to be \$518,000 for joint filers (\$259,000 for all other taxpayers). The disallowed business losses became NOLs which carried forward to subsequent taxable years.

The CARES Act suspends the application of this excess business loss rule for 2020, and retroactively suspends the excess business loss limitation rule for 2018 and 2019. Thus, taxpayers will be allowed to offset their business losses against nonbusiness income for 2018, 2019, and 2020.

If a private equity investment into a portfolio company is held in non-corporate form, individual investors could potentially benefit from the losses that flow out of the fund subject to other possible restrictions (i.e., at-risk rules or passive activity rules). If a private equity fund is looking to create a capital loss, it may be possible to do so by converting a corporate portfolio company into a limited liability company. Since this conversion is considered a taxable liquidation transaction, while oftentimes beneficial, it could have adverse tax consequences if not modeled out in advance. The potential benefit is that in some cases, the deemed liquidation could create a capital loss (which is not subject to the related party disallowance rules as it occurs as part of a complete liquidation) and could potentially offset other capital gains in the same year. Under certain circumstances, if the capital loss on the conversion is created in 2020, it could be attributed to an earlier year in which other capital gains exist under IRC Section 165(i). Please read more below on the application of IRC Section 165(i) for federally declared disaster areas.

## BUSINESS INTEREST EXPENSE LIMITATIONS

The CARES Act amends IRC Section 163(j) solely for taxable years beginning in 2019 and 2020. With the exception of partnerships, and solely for taxable years beginning in 2019 and 2020, in computing their deductible business interest expense, taxpayers may use 50% of their adjusted taxable income (ATI), an increase from 30% of adjusted taxable income under the TCJA, unless an election is made to use the lower limitation for any taxable year.

Additionally, for any taxable year beginning in 2020, the taxpayer may elect to use its 2019 adjusted taxable income for purposes of computing its 2020 IRC Section 163(j) limitation.

This election will benefit most corporations since the pandemic will have had an adverse effect on 2020 ATI, and by allowing the use of 2019 adjusted taxable income in the later year, more interest expense will become deductible in 2020, possibly increasing an NOL in that year that could qualify for the five-year NOL carryback.

With respect to partnerships, the increased IRC Section 163(j) limit from 30% to 50% of adjusted taxable income only applies to taxable years beginning in 2020. However, in the case of any excess business interest expense allocated from a partnership for any taxable year beginning in 2019, 50% of such excess business interest expense is treated as not subject to the IRC Section 163(j) limitation and is fully deductible by the partner in 2020. The remaining 50% of such excess business interest expense shall be subject to the limitations in the same manner as any other excess business interest expense so allocated. Each partner has the ability, under regulations to be prescribed by Treasury, to elect to have this special rule not applied. No rules are provided for the application of this rule in the context of tiered partnership structures.

## BONUS DEPRECIATION ON QIP

The CARES Act contains a technical correction to a drafting error in the TCJA that required QIP to be depreciated over 39 years, rendering such property ineligible for bonus depreciation. With the technical correction applying

retroactively to 2018, QIP is now 15-year property and eligible for 100% bonus depreciation. This will potentially provide immediate current cash flow benefits and relief to taxpayers, especially those in the retail, restaurant, and hospitality industries.

Taxpayers that placed QIP into service in 2019 can claim 100% bonus depreciation prospectively on their 2019 return and should consider whether they can file Form 4466 to quickly recover overpayments of 2019 estimated taxes. Taxpayers that placed QIP in service in 2018 and that already filed their 2018 federal income tax return treating the assets as bonus-ineligible 39-year property should consider amending that return to treat such assets as bonus-eligible. For C corporations in particular, claiming the bonus depreciation on an amended return can potentially generate NOLs that can be carried back five years under the new NOL provisions of the CARES Act to taxable years before 2018 when the tax rates were 35%, even though the carryback losses were generated in years when the tax rate was 21%.

With the taxable income limit under IRC Section 172(a) being removed, an NOL can fully offset income to generate the maximum cash refund for taxpayers that need immediate cash. Alternatively, in lieu of amending the 2018 return, taxpayers may file an automatic Form 3115, Application for Change in Accounting Method, with the 2019 return to take advantage of the new favorable treatment and claim the missed depreciation as a favorable IRC Section 481(a) adjustment.







# Opportunities Available Via Amending Partnership Tax Returns

## IN GENERAL

For taxable years beginning after December 31, 2017, all partnerships (unless eligible to elect out) are subject to a new centralized partnership audit regime. Because of the ownership structure involving private equity investors, neither the private equity fund nor portfolio companies taxed as partnerships are typically eligible to opt out of these rules. Partnerships subject to the centralized partnership audit regime rules are generally prohibited from filing amended partnership returns.

Instead, under the centralized partnership audit regime rules, the partnership files an administrative adjustment request (AAR). Filing an AAR results in the partners only being eligible to receive any benefits from that relief on the current taxable year's federal income tax return. Thus, if an AAR was filed during 2020, affecting taxable years that began in 2018 or 2019, the partners generally would not be able to take advantage of CARES Act benefits from an AAR until they file their current year returns, which could be in 2021. To the extent a partner is required to make estimated tax payments, they could proactively reduce these amounts for the anticipated reduction on their 2020 income tax return.

This process would significantly delay the relief under the CARES Act that is intended to provide an immediate benefit to taxpayers. Consequently, on April 8, 2020, the Internal Revenue Service issued Revenue Procedure 2020-23, which allows a partnership subject to the centralized partnership audit regime rules to file an amended partnership return and issue amended Schedules K-1 for taxable years that began in 2018 or 2019.

This is a significant development in that it creates a number of potential opportunities for partners to more quickly monetize benefits under the CARES Act. Considerations are outlined as follows:

## CLAIMING ADDITIONAL BONUS DEPRECIATION

One of the principal tax benefits under the CARES Act for which partnerships may now file amended returns is the correction of the so-called "retail glitch" that prevented investments in QIP from qualifying for bonus depreciation. This drafting error in the TCJA significantly increased the after-tax cost of making QIP investments. Partnerships who amend

2018 and 2019 tax returns to report bonus depreciation on QIP will issue amended Schedules K-1 to their partners, who can file their own amended tax returns to potentially obtain refunds of taxes previously paid.

Notwithstanding the ability to claim bonus depreciation via filing amended returns, partnerships may want to consider filing Form 3115 instead. By filing a Form 3115, the partnership will report a favorable adjustment reducing current year taxable income. The benefit of this adjustment will be allocated to the existing partners, which may not be the same partner group as existed during the 2018 and 2019 taxable years.

## MAXIMIZING THE INDIVIDUAL BUSINESS LOSS DEDUCTION

The TCJA added limitations on excess business losses for non-corporate taxpayers (IRC Section 461(l)) for tax years beginning after December 31, 2017, and before January 1, 2026, limiting the ability above a threshold amount to offset business losses against non-business income. The CARES Act suspended these excess loss rules for tax years 2018 through 2020. If non-corporate partners (e.g., individuals) are allocated additional expenses or loss not otherwise subject to another limitation and they amend their 2018 or 2019 income tax returns, assuming that other loss limitation rules do not apply (e.g., basis, at-risk or passive activity limitations), they are not subject to the excess loss rules and may generally take a deduction against non-business income without limitation.

## INCREASING CORPORATE NOL CARRYBACKS

The CARES Act permits taxpayers to carry back NOLs that arise in taxable years 2018, 2019 and 2020 to their five preceding taxable years. If a bonus depreciation deduction allocated to a partner results in generating an NOL for that partner, the partner can potentially obtain a refund of taxes paid by carrying back the NOL to its five preceding taxable years. To the extent a partner generates an NOL and does not want to utilize the carryback, they may proactively make an irrevocable election out of the carryback.

## OTHER CONSIDERATIONS

The relief provisions under Revenue Procedure 2020-23 are not limited to items originating from the CARES Act. Partnerships can take advantage of these rules to amend their 2018 and 2019 tax returns for other matters. For example, an amended return could be filed to correct prior income or loss allocations, which could create NOLs eligible for the carryback provisions.

# Partnership Income/ Loss Allocation Planning

## GROSS VS. NET INCOME ALLOCATIONS

Under general partnership tax rules, the allocation provisions of a partnership agreement should be respected when those allocations have substantial economic effect. Partnership agreements that utilize targeted allocations or liquidate based on a waterfall—rather than in accordance with positive capital accounts—typically do not meet the economic effect “safe harbors.” Consequently, income and loss allocations often are determined based on the partner’s interest in the partnership (PIP). These rules are based on facts and circumstances but generally require allocations of income or loss (or gross items of income or loss) in any manner that allows the partner’s capital account to match their liquidating distribution rights.

In many private equity (PE) transactions, the investor will contribute cash to the partnership in exchange for preferred units. These preferred units often provide the private equity investor with priority rights to capital upon liquidation. For example, upon liquidation, the private equity investor may receive their initial capital contribution plus any accrued but unpaid preferred returns before any other members receive cash. The partner’s expectations are that the return of capital and preferred return will be funded through overall net income or net appreciation. However, many agreements do not limit the distributions to these funding sources. Instead, a typical agreement would require liquidating distribution to the private equity investor even if funded with original capital of the other members.

It is not uncommon for a partnership agreement to specifically require the allocation of only net profits or net losses. The intent of this allocation language is to limit situations where gross income is allocated to one partner in a year in which the partnership operates at loss. Such an allocation of gross income often requires a tax distribution that results in a reduction of much-needed cash flow within the partnership. Notwithstanding the partner’s intent to allocate only net income or net loss, the tax rules would appear to require allocations of gross income.

Given the lack of clarity around the PIP rules, taxpayers and their advisors are frequently exploring ways to modify

operating agreements to allow partnerships to minimize or reduce the amount of gross income allocated. Care should be taken in evaluating the reasonableness of these modifications to ensure satisfaction of the PIP rules. Example approaches often considered in practice include:

- ▶ Explicitly limit the payment of the preferred returns to actual cumulative net income or net gains. This, however, may fundamentally change the business deal by placing added risk on the private equity investor and the likelihood of earning the preferred return. Consequently, this option may not be a universally practical solution.
- ▶ Revalue the partnership capital accounts in order to allocate unrealized gains to “fill up” the private equity investors capital account to cover the preferred return.
- ▶ Modify the manner in which preferred returns are earned. For example, consider 100% accrual of a preferred return of the first day of the tax rather than proportionately throughout the year.
- ▶ Limit rights to receive payment of preferred return by requiring board approval before the partnership becomes obligated to make distribution.

## MAXIMIZING LOSS ALLOCATIONS

Although partners often times would like to avoid gross income allocations, consideration should be given to the overall tax consequences. A gross income allocation clearly results in the allocation of taxable income to the private equity investor. However, this also results in a greater loss allocation to the non-private equity members. Depending on the respective tax positions of the members, this may result in greater overall tax benefits. For example, in situations where the private equity investor's limited partners are comprised of non-taxpaying entities such as tax-exempt entities, non-U.S. investors, or corporate partners with NOLs, the allocations of taxable income may not result in an actual out-of-pocket tax liability. Alternatively, the allocation of additional losses to the other members may be eligible to reduce otherwise taxable income recognized by these other members.

Care should be taken, however, when attempting to shift the manner in which losses may be allocated among the partners. For example, partners often want to specially allocate losses to a partner currently paying taxes in order to reduce that partner's tax liability. These arrangements frequently include a future agreement to reverse the special loss allocation. Existing regulations may prevent such an allocation to the extent there is an overall tax benefit, but no net impact to the economic effect of the allocation.

## PARTNERSHIP FREEZE STRUCTURES

When an investment is held through a taxable corporation, a partnership freeze structure can shift future appreciation away from the corporation. In effect, the structure “freezes” existing appreciation at the corporate level while subsequent appreciation is shifted to the other owners. These structures are most often used by closely-held corporations contemplating expansion of an existing business line, entering a new line of business, or maximizing value of real estate not used in regular business. Given this typical profile, a partnership freeze structure becomes a relevant consideration for private equity making an initial investment in an existing, closely-held business.

In a partnership freeze, the existing corporation will contribute the business assets and liabilities to a newly-formed entity, typically a limited liability company, in exchange for preferred units. Simultaneously, the corporate shareholders will make a nominal contribution in exchange for common units. The private equity investor will make its investment in the newly-formed entity in exchange for a different class of preferred unit.

The preferred units held by the existing corporation will generally provide a preferred return with most of the future appreciation allocable to the other preferred units and common units. Although the concept of a partnership freeze is relatively straightforward, several important issues need to be considered, including:

- ▶ Valuation and nature of the preferred interest. This includes evaluating potential deemed dividend, gift, or compensation issues. Consideration will need to be given to the rate attributable to the preferred units, participation in future profits and appreciation, and volatility in the underlying operating assets.
- ▶ Validity of the partnership, including application of the partnership anti-abuse rules. Consideration must be given to issues such as business purpose of the partnership, control and management of operating assets, relative valuation of the common units, and overall economic substance.

In addition to the foregoing structure, utilization of a partnership freeze may be valuable for existing corporate investments. A similar structure would be used to freeze the current appreciation within the existing corporation while shifting future appreciation directly to the shareholders, including a private equity fund.



# Debt Restructuring and Related Considerations

## OVERVIEW

The COVID-19 pandemic has resulted in the unfortunate and harsh reality that many portfolio companies will experience severe financial distress in the coming months. During these difficult times, some portfolio companies will struggle to resolve growing concerns unless they act proactively to reduce their required debt service.

When this occurs, it becomes very important to help these businesses restructure their outstanding debt in a tax-efficient manner. These debt modifications should be restructuring in an effort to ensure the minimization of cancellation of indebtedness (COD) income and to help preserve future tax attributes, such as NOLs, tax credits and asset basis.

Each form of restructuring will involve many complex tax issues. Key considerations include:

- ▶ Transfer of property in satisfaction of recourse or nonrecourse liabilities
- ▶ Exchange of outstanding debt for partnership interests
- ▶ Loan modification transactions
- ▶ Statutory exclusions of cancellation of indebtedness income (CODI)
- ▶ Other CODI planning considerations
- ▶ Partnership allocation of CODI

## TRANSFER OF PROPERTY IN SATISFACTION OF DEBT

In general, the transfer of property in satisfaction of a recourse liability is treated as if the debtor sold the property for consideration equal to the fair market value of the property. To the extent debt in excess of the fair market value of the property is cancelled, the debtor recognizes CODI. Alternatively, where the property is transferred in satisfaction of a nonrecourse liability, the entire balance of the relieved liability is treated as proceeds on the sale of the property. Finally, the cancellation of outstanding debt, without a transfer of property, will result in recognition of CODI regardless of whether the underlying debt was recourse or nonrecourse.

Whether a partnership recognizes CODI and/or capital gains or losses on a workout transaction can have significant net tax liability consequences. CODI may be preferable in situations where the partners are eligible to exclude this income. Alternatively, recognizing capital gain may result in a lower overall net tax liability due to lower tax rates. Given the potential differences in overall tax liabilities, careful planning is advisable prior to executing a transaction. For example, consideration should be given to potential loan modifications where obtaining a targeted mix of capital gains and/or CODI may be the objective. Additionally, it is not uncommon for certain liabilities to be subject to full or partial guarantees.

In situations involving partial guarantees, care must be taken to ensure the proper determination of the character of income recognized.

## EXCHANGE OF DEBT FOR PARTNERSHIP INTEREST

A common planning strategy is for the lender, whether a third party or existing partner, to exchange the outstanding liability for an equity interest in the partnership. However, careful planning is required to avoid potentially adverse tax consequences including the recognition of CODI coupled with an inability to currently deduct any loss on the exchange. When a creditor contributes an outstanding liability to a partnership, the creditor and debtor face diverging tax consequences.

The creditor is required to capitalize the outstanding principal balance into the basis of the partnership interest received. Consequently, the creditor is not entitled to a current deduction associated with the loan. This result occurs regardless of whether the value of the loan contributed exceeds the value of the partnership interest received.

The partnership, on the other hand, is treated as satisfying the outstanding loan in an amount equal to the fair market value of the partnership interest exchanged. To the extent the fair market value of the partnership interest transferred to the creditor is less than the outstanding loan balance, CODI will be recognized. Consequently, it is necessary to accurately value the partnership interest.

## LOAN MODIFICATION

If the terms of a debt instrument are modified in a manner deemed significant, the debt instrument may be deemed canceled and reissued for tax purposes. The deemed reissuance could give rise to unexpected tax consequences if the borrower and lender are not properly advised on important matters, including:

- ▶ CODI
- ▶ Bad debt deductions
- ▶ Change in deductible interest expense
- ▶ Change in interest income

If an instrument is significantly modified, there can be material tax impacts even if the principal and yield owed at maturity remain the same (e.g., significant modification of publicly traded debt with a discounted fair market value).

### Loan Modification

A modification is broadly defined to mean any alteration, including any deletion or addition, in whole or in part, of a legal right or obligation of the issuer or a holder of a debt instrument. A modification can occur from amending the terms of a debt instrument or through exchanging one debt instrument for another. However, a modification does not have to be written, and the conduct of the parties can give rise to a modification. Exceptions to the broad definition of modification include:

- ▶ Modification by operation of the terms of a debt instrument. However, there are certain exceptions to this rule (e.g., change in obligor, change due to non-unilateral option, etc.);
- ▶ Modification by failure of the issuer/borrower to perform its obligations. However, the agreement of the holder to forgo remedies may be a modification; or a
- ▶ Modification by failure of the party to exercise an option.

### Significant Modification

Not all “modifications” are “significant” for tax purposes. The regulations provide six rules for addressing whether a modification is significant, including: (1) a general facts-and-circumstances test, (2) change in yield, (3) change in timing of payments, (4) change in obligor or security, (5) changes in the nature of a debt instrument, or (6) changes to accounting or financial covenants.

Each of these items are discussed in more detail below.

### Facts and circumstances

Under the facts-and-circumstances test, a modification is a significant modification only if, based on all facts and circumstances, the legal rights or obligations are altered to a degree that is economically significant. In making a determination under the facts-and-circumstances test, all modifications to the debt instrument are considered collectively, so that a series of such modifications may be significant when considered together although each modification, if considered alone, would not be significant. The facts-and-circumstances test does not apply if there is a specific rule that applies to a particular modification.

### Change in yield

In general, a change in the yield of a debt instrument is a significant modification if the yield varies from the annual yield on the unmodified instrument (determined as of the date of the modification) by more than the greater of: (1) one-quarter





of 1% (25 basis points) or (2) 5% of the annual yield of the unmodified debt instrument (0.05 times annual yield).

This test applies to debt instruments that provide only for fixed stated payments, alternative payment schedules subject to Treas. Regs. Section 1.1272-1(c) (instruments subject to contingencies), fixed yield subject to Treas. Regs. Section 1.1272-1(d) (such as certain demand loans) and variable-rate debt instruments. If a debt instrument does not fall within one of these categories (e.g., a contingent payment debt instrument), a significant modification is determined under the general facts-and-circumstances test. A reduction in principal reduces the total payments on the modified instrument and would result in a reduced yield on the instrument, often resulting in a significant modification.

### Change in timing of payments

A modification that changes the timing of payments (including any resulting change in the amount of payments) due under a debt instrument is a significant modification if it results in the material deferral of scheduled payments. Key facts to consider include:

- ▶ Form of deferral including an extension of the final maturity date or a deferral of payments due prior to maturity (such as a deferral of interest payments);
- ▶ The original term of the debt instrument;;
- ▶ The amounts of the payments that are deferred;; and
- ▶ The time period between the modification and the actual deferral of payments.

The regulations provide for a safe harbor where the modification will not be significant if the deferred payments are required to be paid within the lesser of five years or one-half of the original term of the instrument. Deferrals are tested on a cumulative basis so that, when payments are deferred for less than the full safe-harbor period, the unused portion of the period remains for any subsequent deferrals.

### Change in obligor or security

Generally, a substitution of a new obligor on a recourse debt instrument is a significant modification. There are a few possible exceptions for substitutions of obligors on a recourse debt instrument including:

- ▶ The new obligor is an acquiring corporation to which IRC Section 381(a) applies;
- ▶ The new obligor acquires "substantially all" of the assets of the obligor; and
- ▶ The change in obligor is a result of the filing of either a deemed asset sale election or a bankruptcy petition.

For an exception to apply, the change in obligor must not result in a change in payment expectations or a significant alteration. In general, a change in payment expectations occurs if, as a result of a transaction, there is a substantial enhancement or impairment of the obligor's capacity to meet the payment obligations after the modification as compared to before the modification.

The addition or deletion of a co-obligor on a debt instrument is a significant modification if the addition or deletion of the co-obligor results in a change in payment expectations.



For recourse debt instruments, a modification that releases, substitutes, adds or otherwise alters the collateral for, a guarantee on or other form of credit enhancement for a recourse debt instrument is a significant modification if the modification results in a change in payment expectations. For nonrecourse debt instruments, a modification that releases, substitutes, adds or otherwise alters a substantial amount of the collateral for, a guarantee on or other form of credit enhancement for a nonrecourse debt instrument is a significant modification.

### Changes in the nature of a debt instrument

In general, a change in the nature of a debt instrument from recourse to nonrecourse, or vice versa, is a significant modification. A modification of a debt instrument that results in an instrument that is not debt for federal income tax purposes is a significant modification.

### Changes to accounting or financial covenants

A modification that adds, deletes or alters customary accounting or financial covenants is not a significant modification. However, the issuer may make a payment to the lender in consideration for agreeing to the modification. The payment would be taken into account in applying the change-in-yield test. A modification to a debt instrument's covenants can result in a significant modification if the lender receives a payment for agreeing to the modification. The characterization of a modification as significant should be under each applicable rule and, if not specifically addressed by another rule, under the general test.

## STATUTORY EXCLUSIONS OF CANCELLATION OF INDEBTEDNESS INCOME (CODI)

When there is a substantial modification of a debt instrument that gives rise to CODI, analyze whether any exceptions exist to defer or eliminate the income for tax purposes.

These tax rules are extensive, and they generally allow taxpayers to exclude or defer CODI under the appropriate circumstances (i.e., the insolvency or bankruptcy exclusions). When CODI is recognized by a partnership, it is often necessary to consider the applicability of these exclusion and deferral opportunities at the partner level. Consequently, it is possible that CODI recognized by a partnership may be excluded or deferred by one partner, but recognized by another. Careful consideration of these opportunities is necessary to minimize the overall tax consequences of the CODI event.

The following section discusses the most typical exclusions and important considerations.

### Bankruptcy Exclusion

In general, the ability of a portfolio company taxpayer to exclude CODI from taxable income requires the debt discharge to occur in connection with a bankruptcy court proceeding. This debt discharge exception occurs at the corporate level. Additionally, if the portfolio company is held in the form of a partnership, then the partner must be subject to the purview of the bankruptcy court. It is not entirely clear what it means for a partner to be subject to the purview of a bankruptcy court addressing a partnership bankruptcy case. Careful consideration is necessary to determine whether the particular facts will allow the partner (or partners) to exclude their allocable share of partnership CODI.

### Insolvency Exclusion

This exclusion is also determined at the corporate level for portfolio companies. However, if the investment is in the form of a partnership, then similar to the bankruptcy exclusion, the ability to exclude CODI is measured at the partner level. Further, partners may exclude CODI only to the extent of their insolvency. For purposes of the insolvency exclusion, partner insolvency is equal to the excess of liabilities over the fair market value of assets measured immediately before the discharge. For purposes of measuring assets and liabilities, the following considerations are necessary:

- ▶ All assets of the partner are included in the computation;
- ▶ Uncertainty exists as to whether contingent liabilities are included in the calculation;
- ▶ Inclusion of a partner's share of nonrecourse liabilities may create planning opportunities or traps for the unwary; and
- ▶ Determining the partner's share of partnership assets and liabilities may become complicated based on the overall economic arrangement amongst the partners.

### Required Basis Reduction

When a partner excludes CODI under either the bankruptcy or insolvency rules, a corresponding reduction in tax attributes is necessary. In general, relevant rules require a taxpayer to reduce basis in the following tax attributes (in the order presented):

1. NOLs,
2. General business credits,
3. Minimum tax credits,
4. Capital loss carryovers,
5. Basis of the taxpayer's property,
6. Passive activity losses, credits and carryovers, and
7. Foreign tax credit carryovers.

These reductions are made after the taxpayer determines his or her tax liability for the taxable year of the discharge and, thus, do not impact the taxpayer's tax liability for that year. Additionally, taxpayers may have an ability to elect to first reduce basis in depreciable property. When this election is made by a partner, it will be necessary for the partnership to agree to reduce basis in the partnership's depreciable property attributable to the requesting partner's interest in the partnership.

### Qualified Real Property Business Indebtedness

Partners other than C corporations may exclude CODI to the extent generated from qualified real property business indebtedness. For purposes of this exclusion, qualified real property business indebtedness includes liabilities that (1) were incurred in connection with real property used in a trade or business, (2) were incurred before January 1, 1993, or incurred or assumed after such date to acquire, construct, reconstruct or substantially improve the property and (3) the eligible taxpayer makes an election to exclude CODI under these rules.

Partners seeking to exclude CODI under these rules are subject to two important limitations. First, the amount of excluded CODI cannot exceed the excess of the outstanding principal balance over the net fair market value of the qualifying real property measured immediately before the discharge. Second, the amount of excluded CODI cannot exceed the aggregate adjusted basis of all depreciable real property held by the taxpayer immediately before the discharge reduced by the sum of (1) current year depreciation claimed with respect to

the property and (2) reductions required under the general attribute reduction rules described above.

A taxpayer is required to reduce basis in depreciable real property to the extent of the CODI exclusion. A partnership interest can be treated as an interest in depreciable real property to the extent of the partner's share of partnership depreciable real property.

## WORTHLESS STOCK DEDUCTIONS

One way to generate or increase an NOL of a portfolio company is to have the parent company of the group deduct a loss under IRC Section 165(g)(3) for the stock of a subsidiary that has become worthless. If the requirements of IRC Section 165(g)(3) can be met, this loss will be treated as an ordinary loss, as opposed to a capital loss, even though the stock is a capital asset.

As an ordinary loss, a deduction for worthlessness in the current year could create or increase an NOL in a year from which it may be carried back and result in a tax refund from earlier years. Since the five-year carryback is only available for NOLs generated in taxable years beginning in 2018, 2019 or 2020, a worthless stock deduction can be particularly useful in these years, provided that enough taxable income exists in the carryback years to absorb the NOL created or enhanced by the worthless stock deduction.

If it can be determined that the worthlessness arose due to the recent pandemic, then IRC Section 165(i) could apply.



IRC Section 165(i)(5) defines a federally declared disaster to include any disaster determined by the president to warrant federal assistance under the Stafford Act. As a result, when President Trump made an emergency determination in response to the COVID-19 pandemic under the Stafford Act, the complete worthlessness of an asset caused by the pandemic could be considered a qualifying IRC Section 165(i) asset.

IRC Section 165(i) allows a taxpayer who has sustained a loss attributable to a federally declared disaster in a taxable year to elect to deduct that disaster loss in the preceding year.

In order to qualify for an IRC Section 165(g)(3) ordinary income tax deduction, a determination of worthlessness must be made with respect to both domestic and foreign subsidiaries. If the worthless subsidiary is a domestic corporation that is included in a consolidated return, the amount of the write-off will be determined by the amount of the tax basis in its subsidiary, as determined under the consolidated return basis adjustment rules.

The otherwise allowable loss, however, may be reduced or eliminated altogether pursuant to other consolidated return rules, so a detailed analysis would be required. If that domestic subsidiary has NOL carryforwards that might otherwise be limited by IRC Section 382 or the Separate Return Limitation Year rules, those attributes will be lost, but the immediate write-off of tax basis would be an ordinary loss not subject to those restrictions and potentially available for carryback, if such potential exists.

It is also possible to obtain a worthless stock deduction for a U.S. corporation that owns a foreign subsidiary. The basis in a foreign subsidiary is generally the investment made to acquire and fund the foreign subsidiary (with adjustments for certain types of income in the U.S. under the Subpart F rules) and is unaffected by the consolidated return adjustment rules. When IRC Section 165 applies, the stock, which is a capital asset, is treated as having been sold or exchanged on the last day of the taxable year and a capital loss is realized. However, if the requirements of IRC Section 165(g)(3) and Treas. Reg. Section 1.165-5 are met, subsidiary stock that has become wholly worthless is not treated as a capital asset. Accordingly, the complete worthlessness of such stock generates an ordinary loss deduction equal to the basis of the stock of the subsidiary in the hands of its immediate corporate parent.

IRC Section 165(g)(3) requires that the worthless subsidiary meet an affiliation test as well as a gross receipts test in addition to meeting the other requirements of IRC Section 165. The affiliations test requires the corporate owners hold at least

80% of the voting power and 80% of the value of non-voting stock (excluding certain preferred stock). The gross receipts test requires that more than 90% of the aggregate gross receipts of the affiliated subsidiary corporation for all taxable years during which it has been in existence must be from non-passive sources.

In addition to meeting the gross receipts and affiliation tests, the successful application of IRC Section 165(g)(3) requires the taxpayer to establish that the stock is wholly worthless and that the identifiable event has occurred that fixes such worthlessness. While in most cases the affiliation test is usually easy to prove, the determination of worthlessness is much more difficult. A determination must be made that the stock has no liquidating value and no potential or future value.

Once worthlessness is established, there must be an "identifiable event" that triggers the deduction for income tax purposes. An "identifiable event" could typically include:

- ▶ A legal dissolution of the subsidiary;
- ▶ A formal or informal liquidation;
- ▶ A "check-the-box" election, or entity classification election, to treat a foreign subsidiary as a disregarded entity (U.S. corporations are "per se" corporate entities so an entity classification election is generally not available); or
- ▶ A state law formless conversion of the subsidiary from a corporation to an entity may be classified as a disregarded entity (i.e., a single-member LLC).

The continuance of a subsidiary's business following the worthless stock deduction for any purpose other than a winding down of the business operations must be done in a manner that separates the circumstances supporting the deduction from subsequent events that allows the business to continue.

For example, a substantial capital infusion after the liquidation can be indicative of worthlessness at the time of the deemed liquidation and, absent the infusion, the remaining liabilities would have needed to have been satisfied with any remaining assets. Otherwise, it could be argued that the subsidiary was a going concern since it sustained itself without the need for additional capital.

IRC Section 165(g)(3) can provide significant tax benefits, particularly given the five-year NOL carryback that is now available in 2018, 2019 and 2020. Given the enormous economic harm caused to many businesses by the COVID-19 pandemic, a careful application of IRC Section 165(g)(3) is especially important to consider, and any assertion of worthlessness should be supported by a qualified appraisal.



## PARTNERSHIP ALLOCATION OF CANCELLATION OF INDEBTEDNESS INCOME

Partners have great flexibility in terms of structuring allocations of income and loss. This flexibility, however, can become limited in the context of allocating CODI. In many cases, the amount of outstanding debt exceeds the partner's cumulative economic capital accounts. In these situations, the CODI reduces partner or partnership minimum gain and will need to be charged back to the appropriate partners. In order to ensure an accurate allocation of the CODI, the partner's share of minimum gain will need to be calculated. This can be accomplished through the accurate rollforward of the partner's economic capital accounts.

Where there is not any partner or partnership minimum gain, the general economic effect rules will apply. While there is generally more flexibility to allocate CODI in these situations, many private equity investments utilize so-called "targeted" allocation agreements. These arrangements can be significantly more complex and require a careful evaluation of the partners' interests in the partnership.

## ABANDONMENT OF PARTNERSHIP INTERESTS

A partner may seek to abandon a partnership interest due to worthlessness or in an effort to avoid recognition of CODI. The IRS has provided guidance regarding the consequences

to a partner upon the abandonment of a partnership interest. Specifically, the IRS has considered whether the loss generated upon the abandonment of a partnership interest will be capital or ordinary in nature. Based on this guidance, the determination of capital loss versus ordinary deduction determines whether the abandoning partner is to be allocated partnership liabilities prior to abandonment.

If the partner was allocated even \$1 of partnership liabilities, it is likely that the abandonment of the partnership interest will be viewed as a sale transaction with \$1 of consideration. This will generate capital loss. Alternatively, where no liabilities have been allocated to the abandoning partner, there is no consideration and the abandonment is not viewed as a sale transaction. Therefore, any sustained loss would be ordinary.

Based on this guidance, there are potential opportunities to obtain an ordinary deduction on the abandonment of a partnership interest. Critical to this result is the determination of the partner's share of partnership liabilities. Careful analysis and planning prior to making a final decision to abandon a partnership interest is necessary to maximize the likelihood of sustaining an ordinary deduction. This analysis should focus on the partnership liability allocation rules with a focus towards ensuring no liabilities are allocated to the abandoning partner.

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