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Debt Renegotiation: Tax Traps for the Unwary Business

By *Ellen L. Joseph, CPA*



In these challenging economic times, many businesses are renegotiating debt with their lenders. This debt renegotiation process may entail many changes: extensions of maturity dates, changes in interest rates, reductions of principal, etc. A “significant modification” of the debt may cause the debtor to realize income from the “exchange of the original debt instrument for a modified instrument that differs materially either in kind or in extent” [Regulations Section 1.1001-3(b)]. Whether the modification of a debt

instrument is a significant modification is determined under the rules of Regulations Section 1.1001-3(e). If a significant modification has occurred, IRC Section 108 and its underlying regulations determine whether the income created there by is excludible from gross income.

Significant Modifications

First, there must be a modification to the debt. Modifications are defined, rather broadly, by Regulations Section 1.1001-

3(c)(1)(i) as “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, whether the alteration is evidenced by an express agreement (oral or written), conduct of the parties, or otherwise.” In general, an alteration of a legal right or obligation that occurs by operation of the terms of a debt instrument is not a modification [Regulations Section 1.1001-3(c)(1)(ii)]. An annual adjustment to the interest rate based upon a specified index, such as LIBOR (London Interbank Offered Rate), illustrates this exception. Thus, an extension of maturity date, change in interest rate or reduction of principal is a modification to the debt instrument. But are these modifications significant?

A change in yield is a significant modification if the yield of the modified instrument varies from that of the original instrument by the greater of (A) 25 basis points, or (B) 5 percent of the annual yield of the unmodified instrument (.05 × annual yield) [Regulations Section 1.1001-3(e)(2)(ii)].

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VIERA WILLIAMS, P.A.

-----Attorneys at Law-----

Complex IRS Tax Audits
IRS Criminal Tax Investigations

Robert S. Williams, Esq.

625 E. Tennessee Street, Suite 220, Tallahassee, Florida 32308
(850)222-0013 • (850)222-9047 Fax • (850)210-3480 Cell
www.VieraWilliams.com rwilliams@vierawilliams.com