

## Debt-for-Equity Exchanges in Restructuring LLCs:

### COD Income for the Lender?

*When a lender and borrower determine that borrower's obligations need to be restructured, one proposal considered is an exchange of some or all of borrower's debt for newly-issued equity of borrower. Such debt-for-equity-exchanges are often considered by both lender and borrower because, by reducing borrower's current debt service obligations and improving borrower's balance sheet, a debt-for-equity exchange may enable the borrower to continue to operate and may enhance the magnitude of the lender's recovery from its investment in borrower (albeit as a return on equity rather than a repayment of a loan). Many lenders, however, may not be aware that a debt-for-equity exchange with a borrower organized as a limited liability company, rather than a "C" corporation, may cause certain lenders (as well as other equity holders) to incur current taxable income in a manner and amount that they would never have anticipated.*

In the last restructuring cycle, many of the borrowers that were restructured were entities organized as "C" corporations under the Internal Revenue Code. Today there is a greater likelihood that borrowers needing to be restructured will be entities organized, not as C corporations, but as limited liability companies. As a result of the proliferation of LLCs in recent years, lenders have come to understand that an LLC-borrower differs from a C corp-borrower in that an LLC-borrower needs to make tax distributions to its owners with respect to the income generated by borrower. However, the wide use of corporate terminology by many practitioners in the organization, governance, and operation of LLCs and an incomplete understanding of tax rules applicable only to partnerships and LLCs have led many lenders (and perhaps even some borrowers and their owners) to believe that, except for that one tax distribution concept, corporations and LLCs are essentially the same and will be treated similarly in most "corporate-type" transactions. As a result, many lenders and their borrowers may not be aware that the federal income tax ramifications of restructuring a debt issued by an LLC-borrower may be dramatically different from those obtained from restructuring a debt issued by a C corp-borrower. These differences are particularly apparent when a restructuring involves a debt-for-equity exchange.

When a C corp-borrower restructures its debt by issuing equity in connection with the retirement of some or all of the debt and the amount of debt retired exceeds the fair market value of the equity issued in exchange for such debt, the corporation recognizes cancellation of indebtedness (COD) income to the extent of such excess.<sup>1</sup> Thus, if a C corp-borrower owes \$10M to a lender and such borrower issues and the lender accepts stock having a fair market value of \$7M in exchange for that debt, \$3M of the debt is deemed cancelled in that debt-for-equity exchange and the borrower recognizes \$3M of COD income. If the C corp-borrower is insolvent<sup>2</sup> the Internal Revenue Code provides an "insolvency exception" to the corporation,

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<sup>1</sup> See, section 108(e)(8) of the Internal Revenue Code. Prior to 1993, many corporations relied on a common law "stock for debt exception" to COD income that was based on a "substitution of liabilities" theory that one "liability" (the corporation's stock) was being substituted for another liability (the corporation's debt). However, amendments to the Code in 1993 made it clear that to the extent the fair market value of a corporation's stock issued in exchange for debt was less than the "adjusted issue price" of the debt, the corporation must recognize COD income.

<sup>2</sup> Insolvency is defined as "the excess of liabilities over the fair market value of assets" (measured immediately prior to the discharge of debt). See, section 108(d)(3) of the Code.

recognizing that an insolvent corporation is not likely to be in a position to pay the tax associated with the COD income. The “insolvency exception” permits an insolvent corporation to defer its obligation to pay federal income tax on the COD income.<sup>3</sup>

While these rules are well-understood for corporations, the application of the same set of rules to a borrower organized as an LLC may produce a substantially different result.<sup>4</sup> The primary reason for the different result is that the “pass-through” nature of an LLC causes the COD income that is incurred by the LLC-borrower to be *passed through* to the members of the LLC-borrower. Because the COD income is allocated to, and recognized by, each member of the LLC-borrower, each member will have income allocated to it unless an insolvency defense (or other exception)<sup>5</sup> is available to such member. The insolvency of the LLC-borrower is irrelevant because it is the members that have the COD income. Many members of an LLC-borrower will be solvent and, as a result, will be required to include in their income the COD income allocable to them.<sup>6</sup>

Thus it is important in any debt restructuring of an LLC that generates COD income that the interests of a number of the constituent parties to the transaction be considered: (i) the non-lender members; (ii) the lender that becomes a member in the debt-for-equity exchange; and (iii) the lender that is a member prior to the debt-for-equity exchange.

*Non-lender member.* As noted above, any member of an LLC that is engaged in a restructuring that will generate COD income needs to consider the tax ramifications of such restructuring. An equity sponsor that holds a majority stake in an LLC-borrower may confront

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<sup>3</sup> *Unlike the common law insolvency exceptions, which discharged an insolvent corporation’s obligation to pay tax with respect to the COD income, the Code’s insolvency exception merely defers the tax obligation by reducing the insolvent corporation’s tax attributes, beginning with the corporation’s net operating losses, such that the corporation may, in later years, be required to pay tax that it would not otherwise have had to pay as a result of the loss of those attributes. See, section 108(b) of the Code. See also Note 6 below.*

<sup>4</sup> *Prior to the amendments to section 108 of the Code (that were included as part of the American Jobs Creation Act of 2004 (the “Jobs Act”)) entities treated as partnerships might have taken the position that a debt-for-equity exchange involving a borrower organized as a partnership did not give rise to the partnership’s recognition of COD income since section 108(e)(8) only spoke about corporate debtors. However the Jobs Act’s amendment of section 108(e)(8) of the Code made it clear that a debtor organized as a partnership recognizes COD income if it satisfies an indebtedness by issuing a partnership interest, at least to the extent the indebtedness satisfied exceeds the fair market value of the partnership interest issued.*

<sup>5</sup> *Separate exceptions are available for certain real estate, farming and home mortgage indebtedness.*

<sup>6</sup> *The American Recovery and Reinvestment Act of 2009, H.R.1, 111th Cong. §1231 (2009) (the “Stimulus Act”) signed into law by President Obama on February 17, 2009 amended section 108 of the Code to permit certain taxpayers incurring COD income as a result of a “reacquisition of an applicable debt instrument” during calendar year 2009 or 2010 to include such COD income in gross income ratably over a five-taxable year basis starting in the fifth or fourth taxable year following the year in which the reacquisition of debt occurs. There are a number of complex rules that are set forth in section 108(i) of the Code that should be reviewed in the context of this new exception from current COD income recognition, including rules defining “applicable debt”; rules for LLCs that describe how and to whom the COD income is to be allocated; and rules accelerating the deferral upon a liquidation of the business or, in the case of a pass-through entity, upon the sale of an interest in the equity by a holder of such interests. See, section 108(i) of the Code.*

large COD income allocations as part of the transaction. The debt-for-equity exchange may also have a material adverse impact on the personal tax situation of many members with minority interests in the LLC, many of whom may lack the ability to influence the structure of the transaction that will create the COD income allocated to them.<sup>7</sup> Members that are unable to shelter themselves from the recognition of the COD income will have to take these tax results into account in evaluating the proposed restructuring transaction. Lenders in such transactions may also have to take into account the impacts of the proposed debt-for-equity exchange on all of these members, even if the transaction has no direct impact on the lender.<sup>8</sup>

*Lender that becomes a member in the debt-for-equity exchange.* A lender that is not a member of its LLC-borrower prior to the debt-for-equity exchange should not be directly affected by the COD income generated by the exchange. Section 108 of the Code makes it clear that the COD income that is generated by an LLC-borrower's issuance of equity to its lender in a debt-for-equity exchange will not be allocated to the lender that becomes an owner as part of the transaction.<sup>9</sup> However, out of abundance of caution, any lender engaged in a debt-for-equity exchange with an LLC-borrower should consider requiring as a pre-condition to the exchange that the LLC "close its books" immediately prior to the closing of the exchange so that the requisite internal income allocations of the LLC are consistent with the requirements of Section 108(e)(8) of the Code<sup>10</sup> and so that any other income that the LLC may have earned during the same tax year, but prior to the closing of the exchange transaction, is allocated to the former equity ownership group and not to the lender.

*Lender that is a member prior to the debt-for-equity exchange.* The lender that is most vulnerable to, and must give close consideration to the impact of, these rules is a lender that is a member of an LLC-borrower prior to the closing of the restructuring. Although at one time it would have been highly unusual for a lender to be a member of its borrower, in recent years it has become very common for mezzanine lenders and certain other lenders to purchase equity in an LLC-borrower as part of a financing transaction. In addition, it has become common for

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<sup>7</sup> *For those equity holders that are individuals and are solvent (even taking into account the allocation of the borrower's debt to them that might be required under partnership tax rules), the use of an S corporation may be advantageous in this regard because even though an S corporation passes through tax attributes to its owner (enabling the owner of the S corporation to continue to receive the tax benefits of holding the LLC interests), the insolvency test for purposes of section 108 of the Code is made at the S corporation level rather than the ultimate ownership level. An individual holding an interest in an LLC might consider contributing his or her interest in the LLC to a wholly-owned S corporation and thus using the S corporation to shelter the COD income generated by, and otherwise allocable to it as a result of, the restructuring. The S corporation is not available to many other holders of the LLC's equity (e.g., the equity sponsor) because of various S corporation rules restricting the number and type of shareholders of an S corporation.*

<sup>8</sup> *For instance, it may not be desirable for a lender to proceed with a debt-for-equity exchange that imposes millions of dollars of COD income on the very persons whom the lender is relying on to operate the borrower going forward.*

<sup>9</sup> *Section 108(e)(8) of the Code, as amended by the Jobs Act, states that the COD income generated shall be included in the taxable income of the members of the LLC immediately before the restructuring that generated the COD income.*

<sup>10</sup> *By "closing the books" the COD and other pre-transaction income will, by the terms of the LLC agreement, be allocated to the pre-restructuring members.*

such lenders to require that an LLC issue equity interests to such lenders in lieu of warrants because of the potential tax advantages of owning LLC interests.<sup>11</sup>

Thus, lenders that also hold equity interests in their LLC-borrowers need to examine and consult with their advisers concerning the tax ramifications of a debt-for-equity exchange involving such borrowers. As a result of a lender's being a member of an LLC that incurs COD income through a debt-for-equity exchange, such lender will receive an allocation of its portion of the COD income generated by such exchange.<sup>12</sup> Such lender will likely be required to bear the full tax impact of such income allocation, as it is unlikely that the restructured LLC-borrower would be in a position to make a tax distribution that might otherwise have been expected to accompany an allocation of operating income.<sup>13</sup>

Further complications loom for the lender that is a member of its LLC-borrower. Under partnership tax law principles, a lender that is a member of its LLC-borrower is allocated a portion of the LLC-borrower's debt (including the debt owed to the lender). A lender may decide to sell or transfer its membership interest as part of the transaction either to raise cash or to transfer the membership interest to a party to the transactions that can shelter the income.<sup>14</sup> If the lender sells or transfers its equity, in addition to any cash actually received from any such sale, the lender will also be deemed to have received cash in the amount of the debt that is associated with the equity being transferred. To the extent the sum of the cash received and deemed received exceeds the lender's basis in the equity transferred, the lender will have a taxable gain. A lender will need to carefully analyze the sale of its membership interest as a possible solution to its COD income problem and consider the impact that a possible receipt of additional taxable income will have on the lender.<sup>15</sup>

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11 *Many mezzanine lenders that would have utilized a warrant for common stock in a financing involving a C corporation will require that an LLC issue equity to the lender. By owning LLC equity interests from the time of the initial financing rather than waiting to exercise a warrant as part of an exit transaction, such lender is entitled to benefit both from the pass through of operating tax losses by the LLC-borrower and from the increase in such lender's basis in its equity interest as a result of allocations of income generated by the LLC-borrower. By actually owning the equity interest, the lender will generally also become entitled to receive tax distributions, whereas the holder of a warrant in an LLC would not typically be entitled to receive tax distributions even if the warrant were treated as an issued equity interest for tax purposes.*

12 *The incurrence of an allocation of COD income may only "add insult to injury" since, as part of the transaction, such lender will not only incur COD income but also experience losses as a result of the write-down of the loans made to the LLC and the write-down of the LLC equity that it owned.*

13 *The lender is also likely to be solvent and thus unable to avail itself of the insolvency exception to the current recognition of COD income. Note, however, that the Stimulus Act provides a right for many recipients of COD income to elect to defer the recognition of the COD income for a number of years, which may alleviate the immediate cash flow burden of the COD income recognition. A number of questions are raised by the application of this right to refer in the context of an LLC. See also note 6 above.*

14 *See discussion at note 7 above.*

15 *The lender's initial basis in its equity will be the purchase price for the equity plus the lender's allocable share of the debt. Allocations of income or loss, payments on the debt, and other events will cause positive and negative adjustments to the lender's basis. Although in a perfect world any gain realized on the sale may be in the same amount as losses previously taken in respect of the LLC, there will often be differences in timing and character such that there may be not a perfect offset between gains and losses.*

Finally, the lender that is a member of an LLC-borrower should also be aware of proposed modifications to the recognition rules that are applicable to a debt-for-equity exchange. Proposed Treasury regulations issued by the IRS on October 31, 2008<sup>16</sup> would prohibit a lender from recognizing a gain or loss on the debt-for-equity exchange. Instead, such lenders would be required to carryover the tax basis that they have in the debt to the equity received in the exchange. As a result, a lender will be required to defer the recognition of the loss on such transaction until the equity is ultimately disposed of or sold. If these regulations become final, a lender engaged in a debt-for-equity exchange runs the risk of incurring COD income (in an amount equal to its share of the debt deemed cancelled) and then being denied a current bad debt deduction for the debt deemed cancelled as a part of the debt restructuring.<sup>17</sup>

*Lenders that restructure their LLC-borrowers should understand and then take into account partnership tax rules that allocate the COD income generated from the restructuring transaction to the various members of the LLC in order to avoid creating additional financial problems for such members and, in certain circumstance, for the lenders themselves.*

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<sup>16</sup> *Indebtedness Satisfied by Partnership Interest, Nonrecognition of Gain or Loss on Contribution*, 73 Fed. Reg. 64905 (proposed Oct. 31, 2008) (to be codified at 26 CFR. Pt. 1).

<sup>17</sup> *Under proposed Treasury regulations issued by the IRS on October 31, 2008 (see footnote 16 above), a lender and its LLC-borrower that are engaged in a debt-for-equity exchange can utilize the liquidation value of the equity as its fair market value for determining the amount of the COD income generated by the transaction. The liquidation value of the transferred interest is the amount of cash that a lender would receive if, immediately after the transfer, the LLC-borrower sold all of its assets (including goodwill and other intangibles) for cash equal to their fair market value and distributed the cash in liquidation of the LLC-borrower. Although in many cases this “liquidation value” may be higher than the “willing buyer-willing seller” fair market value (because of the discounts on liquidation value that are normally applied to determine the market value of an interest in an LLC), the “liquidation value” of the interest will be used both to determine the amount of COD income that is created by the debt-for-equity exchange and to determine the amount of the bad debt deduction that the lender will realize (if any). By using a “higher” liquidation value the COD income generated will be reduced, though the lender’s bad debt deduction will be reduced as well. Because the proposed regulations also would disallow any loss on the transaction, the use of higher value to determine the amount of COD might be viewed as beneficial to the lender.*

*If you would like more information about these issues, please feel free to contact Van E. Holkeboer at (312) 845-3401 or holkeboer@chapman.com.*

## Example

### Facts:

Mezzanine Lender financed an Equity Sponsor's acquisition of Borrower with a \$10M subordinated loan. Borrower's equity is owned as follows:

Equity Sponsor	500 Equity Units (50%)
Executive	250 Equity Units (25%)
Mezzanine Lender	250 Equity Units (25%)

Two years after the financing closed Borrower's EBITDA falls significantly and Borrower, Mezzanine Lender, and Equity Sponsor agree that Borrower will only survive if Borrower's debt is decreased. Mezzanine Lender agrees to accept 250 additional equity units in exchange for the cancellation of \$4,100,000 of debt. The 250 additional equity units have a current market value of \$100,000. Since the dollar amount of the debt cancelled exceeds the market value of the equity by \$4,000,000, the exchange transaction will generate \$4,000,000 of COD income. After giving effect to the debt-for-equity exchange, Borrower's equity is owned as follows:

Equity Sponsor	500 Equity Units (40%)
Executive	250 Equity Units (20%)
Mezzanine Lender	500 Equity Units (40%)

### C Corporation Analysis:

If Borrower is a C corporation, Borrower will recognize \$4,000,000 of COD income. Assuming that Borrower is insolvent, Borrower will not recognize any COD income, \$4,000,000 of Borrower's tax attributes (e.g. NOLs) will be eliminated, and no shareholder will bear any of the COD income as a result of the exchange.

### LLC Analysis:

If Borrower is an LLC, the LLC will recognize \$4,000,000 of COD income. However, even though Borrower is insolvent, \$4,000,000 of COD income will pass through to Borrower's members as follows:<sup>1</sup>

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<sup>1</sup> *Absent further analysis and agreement there is some uncertainty as to whether the \$4M of COD income will be allocated based on the pre- or post-restructuring percentage interests. In addition, one of more of the members may be insolvent, and, as a result, would not bear any COD income. The elections to defer recognition of COD income that were included in the Stimulus Act would also need to be considered.*



Equity Sponsor	\$2,000,000 (50%)
Executive	\$1,000,000 (25%)
Mezzanine Lender	\$1,000,000 (25%)

or

Equity Sponsor	\$1,600,000 (40%)
Executive	\$ 800,000 (20%)
Mezzanine Lender	\$1,600,000 (40%)

*Possible Solution to Mezzanine Lenders Tax Problem:* If Mezzanine Lender is willing to forego the receipt of equity and give up all of its current equity, the Mezzanine Lender may be able to shelter the impact of the COD income by selling its current equity stake to another equity holder (likely Executive). If Executive purchases the equity from the Mezzanine Lender prior to the cancellation of indebtedness transaction, Executive will bear 50% of the COD income. If Executive is insolvent, 50% of the COD income (\$2,000,000) will be sheltered.

One further word of caution, by selling the equity to Executive, Mezzanine Lender will be deemed to have received in exchange for such equity not only the cash paid by Executive but also the amount of Borrower's debt allocable to the equity interest sold (25% of the equity, thus \$2,500,000 of debt). If the cash deemed received is in excess of Mezzanine Lender's basis in its equity, Mezzanine Lender will also recognize gain to the extent of such excess.