2023 YEAR–END TAX PLANNING GUIDE FOR BUSINESSES

Financial Transactions & Instruments

FustCharles

INTRODUCTION

FustCharles has had a very eventful 2023. We moved our headquarters from Widewaters Parkway to Merchants Commons in downtown Syracuse, embarked on a major rebranding, and opened a second location in Rochester. It's been an exceptional year and we're excited to continue our commitment to talent development, innovation and teamwork to provide our clients with a best-in-class service experience.

As of the date of this publication, 2023 has been a relatively quiet year in tax legislation. The IRS has been busy issuing guidance for both the 2022 tax legislative changes and pieces of the Tax Cuts & Jobs Act (TCJA). Given the upcoming US presidential election, there may be continued stalemate in Congress or the potential for more robust legislative changes – only time will tell.

FustCharles Tax professionals grasp the intricate connections between evolving laws, economic dynamics, and the tax implications of various business decisions and are well-positioned to serve as strategic advisors, steering companies toward success. Tax planning remains a vital aspect for businesses seeking to optimize cash flow by managing their long-term tax obligations. Our 2023 Year-End Tax Guide delves into effective tax strategies, taking into account recent administrative guidance and potential legislative changes that are currently under review. For further information and assistance, please reach out to a member of our expert tax team.

Unless explicitly stated otherwise, the information provided in this guide is based on existing tax laws and policies as of the publication date, and it may be subject to adjustments in response to future legislative or tax policy changes.

Financial Transactions & Instruments

The tax rules dealing with financial transactions and instruments can be complicated, but failure to understand these rules and their application to your business's transactions could result in negative tax consequences or forgone opportunities. As part of year-end planning and looking ahead to next year, there are a few steps that companies might want to take with respect to their financial transactions during the course of the year:

- Consider Tax Implications of Debt Refinancing Transactions
- Review Tax Hedging Identification and Documentation Processes
- Consider Deductibility of Eligible Bad Debts

Consider Tax Implications of Debt Refinancing Transactions

Many companies refinanced existing indebtedness over the past year to lock-in current interest rates. Refinancing transactions that result in a "significant modification" of the debt under applicable regulations can have disparate tax consequences depending on the specific circumstances. Although the regulations provide relatively clear rules for determining when a modification is "significant," the application of these rules is highly fact-dependent and frequently requires relatively complex calculations.

Companies should review their debt modification transactions undertaken during the year to confirm their tax impact. Companies that are considering changes to existing credit facilities in the coming year should likewise assess whether the proposed change would amount to a significant modification and, if so, determine the tax implications of the modification.

Tax Treatment of Debt Modifications

The U.S. federal income tax treatment of debt refinancing transactions is highly fact-specific and requires careful analysis. Certain refinancing transactions may be treated as a taxable retirement of the existing (refinanced) debt, which may give rise to the ability to write-off any unamortized debt issuance costs and original issue discount, the latter as "repurchase premium." However, in certain situations a refinancing transaction may also give rise to taxable ordinary income in the form of "cancellation of indebtedness income."

The tax consequences of a debt refinancing transaction hinge in part on whether the transaction results in a "significant modification" of the debt under rules set out in Treas. Reg. §1.1001-3, which results in a deemed retirement of the existing debt in exchange for a newly issued debt instrument.

When Is a Modification Significant?

As a threshold matter, a modification includes not only a change to the terms of an existing debt instrument but would also include an exchange of an old debt instrument for a new one or the retirement of an existing debt instrument using the proceeds of a new debt instrument. Stated differently – it is the substance, not the form, that governs whether debt has been modified for federal income tax purposes.

Whether a modification of a debt instrument constitutes a significant modification depends on the materiality of the changes. The regulations provide a general "economic significance" rule and several specific rules for testing whether a modification is significant. In practice, most debt modifications are covered by two specific rules governing changes in the yield to maturity of a debt instrument (the change in yield test) and deferrals of scheduled payments (the deferral test).

Under the change in yield test, a modification will be significant if the yield of the modified debt instrument varies from the yield of the unmodified debt instrument by more than the greater of 25 basis points (i.e., 1/4 of 1%) and 5% of the unmodified yield. The regulations include specific rules for making this determination. However, it is important to observe that a number of changes to a debt instrument may cause a change in the yield. Examples include changes to the interest rate, deferral (or acceleration) of scheduled payments, and payment of a modification or consent fee in connection with the modification. It is not uncommon for a modification with only a minor (or no) change to the stated interest rate to result in a significant modification due to changes in the yield to maturity that result from the payment of modification fees or changes to the due dates for certain payments. This issue is often overlooked.

Under the deferral test, a modification will be significant if it results in a material deferral of scheduled payments. The deferral test does not define what constitutes a material deferral, but instead provides a deferral safe harbor pursuant to which a modification to defer payments will not be significant as long as all deferred payments are unconditionally payable by the end of the safe harbor period. The safe harbor period begins on the due date of the first scheduled payment that is deferred and extends for a period equal to the lesser of five years or 50% of the original term (e.g., the deferral safe harbor for a five-year debt instrument would be two-and-a-half years).

In applying both the change in yield test and the deferral test, taxpayers are required to consider the cumulative effect of the current modification with any prior modifications (or, in the case of a change in yield, modifications occurring in the past five years). This cumulative rule is particularly noteworthy for taxpayers who routinely modify their indebtedness (and often incur modification fees in connection with the modification), as the results of certain modifications may not be significant when viewed in isolation but may be significant when combined with prior modifications.

Tax Implications of Significant Debt Modifications

A significant modification results in the deemed retirement of the existing debt instrument in exchange for a newly issued debt instrument. The existing debt instrument will be deemed retired for an amount equal to the “issue price” of the newly issued debt instrument, together with any additional consideration paid to the lenders as consideration for the modification.

The issue price of a debt instrument depends on whether the debt instrument was issued for cash or property. If a significant amount (generally 10%) of the debt was issued for money, the issue price will be the cash purchase price. Otherwise, assuming the debt instrument is in excess of $100 million, the issue price will be its fair market value (or the fair market value of the property for which it was issued) if it is “publicly traded.” In all other cases, the issue price of the debt instrument will generally be its stated principal amount.

If the issue price of the modified debt instrument (i.e., the repurchase price) is less than the tax adjusted issue price of the old debt instrument, a borrower will incur cancellation of indebtedness income, which is generally taxed as ordinary income in the current tax year. If instead the repurchase price exceeds the adjusted issue price (this may occur when the old debt instrument had unamortized original issue discount or where the debt is publicly traded and has a fair market value in excess of its face amount), the borrower will incur a "repurchase premium." Repurchase premium is deductible as interest expense. Special rules apply to determine whether such repurchase premium is currently deductible or is instead amortized over the term of the newly issued debt instrument.

The retirement of an existing debt instrument may also give rise to the ability to deduct any unamortized debt issuance costs. As a general matter, the determination of whether any unamortized debt issuance costs should be written off or carried over and amortized over the term of the new debt instrument generally follows the same analysis as repurchase premium. Notably, debt issuance costs are deducted as ordinary business expenses under Section 162, and therefore are not subject to the limitation on business interest expense deductions under Section 163(j).

Finally, a significant modification may give rise to a number of additional tax implications that companies should consider, including the potential for foreign currency gain or loss and the need to "mark-to-market" existing tax hedging transactions.

Review Tax Hedging Identification and Documentation Processes

Most companies enter into hedging transactions to manage risk that arises in their business, such as interest rate and currency risk. These transactions are subject to tax hedging rules, and failure to follow the requirements under those rules could result in negative tax consequences. The tax hedging rules impose a same-day identification requirement with timing and character whipsaw rules that may apply if such transactions are not timely identified.

As part of year-end reviews and planning for next year, companies should review these rules and the sufficiency of their hedging identification and documentation processes to ensure that they meet the requirements.

Tax Hedge Qualification & Character

To qualify as a tax hedge, the transaction must occur within the normal course of business and be used to manage either interest rate, currency, or price risk with respect to ordinary property or ordinary obligations (incurred or to be incurred) by the taxpayer. For this purpose, property is ordinary if a sale or exchange of the property could not produce capital gain or loss under any circumstances. Taxpayers may manage risk on a transaction-by-transaction basis or, alternatively, may manage aggregate risk (i.e., they may enter into one or more foreign currency contracts to manage aggregate foreign currency risk).

Gain or loss on a tax hedging transaction will be ordinary income or loss if the transaction is properly identified and documented in a timely manner.

Same-Day Identification Requirement

The tax hedging rules require that each tax hedging transaction be identified as such no later than the close of the day on which the hedge was entered into. The hedged item must be identified substantially contemporaneous with the tax hedging transaction, but in no case more than 35-days after the hedging transaction was entered into.

An identification must identify the item, items, or aggregate risk being hedged. Identification of an item being hedged involves identifying a transaction that creates risk and the type of risk that the transaction creates. This identification is made in (and retained as part of) the company's tax files and is not sent to the IRS. A GAAP (or IFRS) hedge identification will not satisfy the tax hedge identification requirement unless the taxpayer's books and records make clear that such identification is also being made for tax purposes. Additional regulatory guidance is provided for certain categories of hedging transactions, including hedges of debt issued (or to be issued) by the taxpayer, inventory hedges, and hedges of aggregate risk.

Taxpayers are given significant flexibility regarding the form of such identification. For companies that enter into tax hedging transactions infrequently, a same-day identification may be prepared and saved in the company's tax files. However, this approach is often challenging for taxpayers that enter into hedging transactions routinely (often on a daily basis). For taxpayers who enter into hedging transactions more frequently, the same-day identification requirement can be satisfied through a tax hedging policy. A tax hedging policy will identify the types of transactions entered into to manage risk and the risk managed (and how such risk is managed) and will identify all transactions described in the policy as tax hedging transactions. If properly prepared, the tax hedging policy will serve as identification (for tax hedging purposes) of any transactions described in the policy.

Hedge Timing Rules

Treasury regulations provide special tax accounting rules for tax hedging transactions known as the "hedge timing rules." The hedge timing rules provide a general requirement that the method of accounting used to account for hedging transactions must clearly reflect income by matching the recognition of income, deduction, gain, or loss on the hedging transaction to the recognition of income, deduction, gain, or loss on the hedged item. Special rules are provided for specific types of hedging transactions.

Failure to Identify – Timing & Character Whipsaws

Failure to properly identify a hedging transaction generally establishes that the transaction is not a tax hedging transaction. As a result, gain or loss on the hedging transaction is determined under general principles. However, the regulations provide a broad anti-abuse rule that will frequently treat any gains as ordinary, which may result in a character whipsaw in which losses are capital and any gains are ordinary income. An inadvertent-error exception is provided in the regulations which, if applicable, may allow taxpayers to treat losses in some circumstances as ordinary.

A properly and timely hedge identification also prevents the application of certain loss deferral rules. One example is the tax "straddle" rules, which may defer losses (but not gains) on certain unidentified hedging transactions.

Planning Considerations

With highly volatile commodity prices, and the ever-changing interest and foreign exchange rates, many businesses are likely considering increasingly relying on hedging activity to manage risk. To avoid the character and timing whipsaws described above, and ensure that gain or loss on such hedging transactions is reportable as ordinary income in the same period as the income, deduction, gain, or loss on the hedged item, companies should review their existing tax hedge identification policies (or draft such identifications, if none currently exist). While the identification and documentation requirements can be complex, insufficient attention to the rules could potentially result in negative tax consequences.

Consider Deductibility of Eligible Bad Debts

Accounts receivable, loans, and other debts due to a business are not always collectible in full. A current tax deduction for such losses can yield a tax benefit which takes some of the sting out of the loss. Realizing this tax benefit requires careful and prompt attention to the details of the tax rules governing bad debt deductions.

Special rules apply for determining what is a bona fide debt and the worthlessness of a debt. A tax deduction may be permitted when a debt is determined to be partially worthless, but only to the extent that the debt is also written down (charged off) on the company's books during the year. A tax deduction may also be permitted for debt that becomes wholly worthless during the year.

As part of year-end planning, companies should consider the tax rules governing bad debt deductions and how they affect the company's eligibility to deduct losses on account of partially or wholly worthless debts.

Overview of Bad Debt Deduction Tax Rules

Only a bona fide debt arising from a valid and enforceable obligation to pay a fixed or determinable amount of money can support a bad debt deduction. Accordingly, to support a bad debt deduction, companies must first confirm that the purported debt is properly characterized as debt for tax purposes. This analysis can be challenging in the context of related party indebtedness.

The tax rules applicable to bad debts distinguish between debt held by corporations and debt held by other taxpayers. Corporations can take ordinary deductions for bad debts owed to the corporation. Taxpayers other than corporations can take ordinary deductions for bad debts only if the debt was created or acquired in connection with the taxpayer's trade or business or the worthlessness of the debt was incurred in the taxpayer's trade or business. Non-business bad debts realized by taxpayers other than corporations constitute short term capital losses rather than ordinary deductions.

Further, the bad debt rules do not apply to "securities," which is broadly defined as debt issued by a corporation (or by a government or political subdivision thereof) with interest coupons attached or in registered form. The precise scope of the term "registered form" for these purposes is unclear, but in general, for an instrument to be in registered form, transfer of an interest in the principal or interest of the instrument from one holder to another must require entry on a register maintained by the issuer or a clearing organization or the physical surrender and reissuance of the instrument. A worthless security deduction is permitted only on complete worthlessness and is treated as a loss from the sale or exchange, on the last day of the tax year, of a capital asset.

A determination of worthlessness must be based on all relevant facts and circumstances. Complete worthlessness must generally be established through an identifiable event during the tax year. Where the surrounding circumstances indicate that a debt is worthless and uncollectible and that legal action to enforce payment would in all probability not result in the satisfaction of a judgment, a showing of these facts is usually sufficient evidence of worthlessness. Bankruptcy is generally an indication of the worthlessness of at least a part of an unsecured and unpreferred debt. In bankruptcy cases, a debt may in some instances become worthless before and in other cases only when a settlement in bankruptcy has been reached.

If a (non-security) debt becomes partially uncollectable during a tax year, corporations (or other taxpayers that acquired such debt in the course of their trade or business) may take a partial bad debt deduction for the amount that they can demonstrate is uncollectable. In this case, the specific amount must also be written off on the taxpayer's books for the year.

Year-End Planning Tip

As part of year-end planning, companies should analyze whether indebtedness they hold is partially or wholly worthless. For debt that is determined to be partially worthless, companies should make sure to charge the debt off in their books and records as required to establish an ordinary bad debt deduction.

Proactive tax planning and seamless tax compliance are essential components of financial success. At FustCharles, we are dedicated to providing year-round support, ensuring you stay informed about emerging opportunities, evolving tax laws, and optimal strategies. Our commitment is to guide you towards the most advantageous course of action aligned with your objectives, ultimately contributing to your business's financial well-being.

For more information, please reach out to our Tax Team Leaders:

Thomas J. Giufre, CPA
tgiufre@fustcharles.com

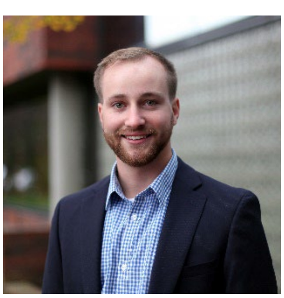
Patrick A Capella, CPA
pcapella@fustcharles.com

Kelly A. Redmond, CPA
kredmond@fustcharles.com

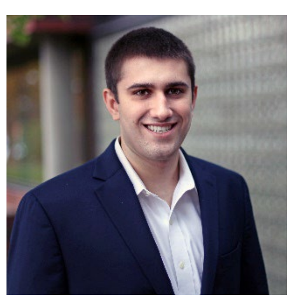
Joseph L. Charles, CPA
jcharles@fustcharles.com

Mary Ellen Luker, CPA, JD, LLM
mluker@fustcharles.com

Desireé M. Bennett, EA
dbennett@fustcharles.com



Michael W. Hartwell, CPA
mhartwell@fustcharles.com



Marek M. Gonzalez, CPA
mgonzalez@fustcharles.com

Candice M. Pack, CPA, EA
cpack@fustcharles.com

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