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Debt Restructuring and Repurchases: Tax Implications for Borrowers and Lenders

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Today's faculty features:

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Katten

Debt Restructuring & Repurchases: Tax Implications for Borrowers and Lenders

July 23, 2020

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Firm Overview

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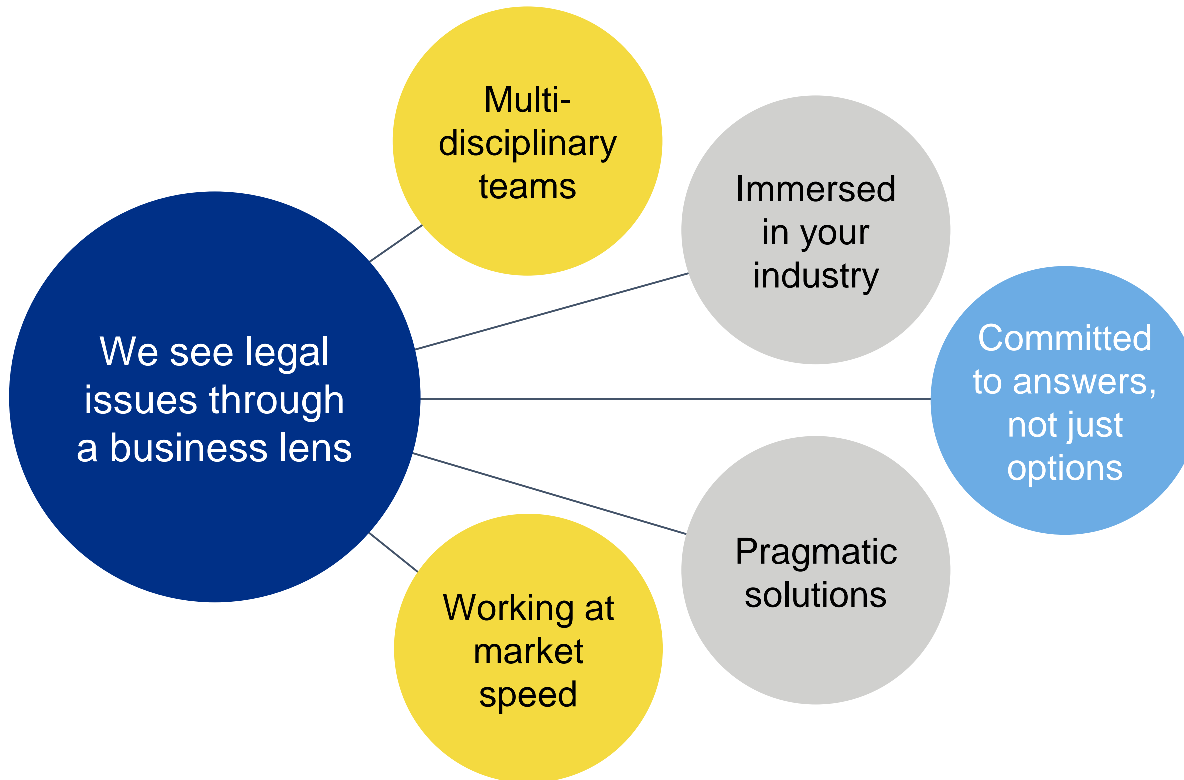

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Robert G. Stuckey,
Managing Director,
The Carlyle Group

Debt Workouts

- As economic pressure intensifies on borrowers, debt restructuring and workout activity is increasing
- These transactions may have significant federal income tax implications, including cancellation of indebtedness income (“CODI”) that may exacerbate the financial distress of the borrower
- Participants should also consider potential gain/loss recognition, new or increased original issue discount (“OID”), fungibility and other issues

Debt Workouts—How Amendments to Debt Instruments May Cause CODI

- Under the "significant modification" rules of Treas. Reg. 1001-3, many common amendments to existing debt instruments may cause a deemed exchange of the old debt instrument for a deemed new debt instrument

- If a deemed exchange as a result of an amendment occurs at a time when the trading price of the applicable debt instrument is depressed, the borrower may have a significant amount of CODI

- The deemed exchange may have other collateral consequences, including the creation of new OID, limitations on interest deductions, fungibility concerns, etc.

Debt Workouts—How Amendments to Debt Instruments May Cause CODI

Examples of Significant Modifications:

- Change in yield by more than greater of 25 basis points or 5% of the original yield
- "Material" deferral of scheduled payments
  - —Safe harbor for deferrals no longer than the lesser of 5 years or 50% of the original term
  - —Note temporary forbearance permitted for two years or longer during good faith negotiations or chapter 11

Debt Workouts—How Amendments to Debt Instruments May Cause CODI

Examples of Significant Modifications (cont'd):

- Replacement of obligor on recourse debt instruments
- Changes in co-obligors or collateral that result in a "change in payment expectations" (from speculative to adequate or vice versa)
- Other ***economically significant*** modifications
  - —Note safe harbor for modification of accounting/financial covenants

Disregarded Entities: CODI and Exclusions

- A "disregarded entity" (a "DRE") is generally disregarded as separate from its owner for federal income tax purposes despite having a separate existence under state corporate law
- Recourse indebtedness of a DRE that is non-recourse to the DRE owner raises difficult issues:
  - — Is the debt recourse or non-recourse for purposes of 1001-3?
    - See, e.g., PLR 200630002 (conversion of borrower to a DRE does not change recourse nature of debt instrument) and PLR 201010015
  - — Does a transaction in which the debt is cancelled/exchanged give rise to CODI or capital gain?
    - See Reg. § 1.108-9 and PLR 201644018 supporting capital gain
- Bankruptcy and insolvency exclusions are applied by reference to the DRE owner (as with partnerships, discussed later)

Issue Price of Significantly Modified Debt

- The issue price of the "new" debt after a significant modification is key because the debtor is treated as if it paid that price for its old debt
- If either the old debt or new debt is publicly traded, the issue price is determined by the public trading price
- In the case of non-publicly traded debt that is deemed exchanged, the issue price of the new debt ordinarily is its stated principal amount, provided that it pays interest at least annually and the interest rate of the new debt equals or exceeds the AFR. This means no OID, and possibly less CODI than would be the case if the debt were publicly traded

Significant Modifications of Publicly v. Non-Publicly Traded Debt

Hypotheticals:

- Publicly traded debt– adjusted issue price and outstanding stated principal is $150 million, currently trading at $110 million at the time of a significant modification
  - — $40 million of CODI for the debtor company
  - — Issue price of the new debt will be $110 million
  - — "New" debt has $40 million OID
- Non-publicly traded debt has adjusted issue price and outstanding stated principal of $90 million, trading at $50 million at the time of a significant modification
  - — Issue price of the new debt will be $90 million (as long as it pays interest annually and the interest rate equals or exceeds the AFR)
  - — This means zero CODI
  - — Both the old and new debt must be deemed non-publicly traded for tax purposes (per the definition in Treas. Reg. § 1.1273-2) for this to work, but can actually be publicly traded (in the non-tax sense) if the outstanding stated principal ≤ $100 million

Debt Workouts—Cancellation of Debt Income

- CODI is included in the debtor's gross income, unless a specific exclusion applies. *See* Section 61(a)(11); *Kirby Lumber*

- **Bankruptcy and insolvency exceptions** allow debtors to exclude CODI from gross income, but this comes at a cost
  - The bankruptcy exception applies to the extent the CODI occurs in a title 11 case and the discharge is granted by the bankruptcy court or pursuant to a bankruptcy plan approved by the court
  - The insolvency exception applies to the extent the debtor is insolvent immediately before the COD event

Debt Workouts—Cancellation of Debt Income

Tax Attribute Reduction under Section 108:

— While the taxpayer may exclude CODI from gross income if an exception applies, in many cases, certain tax attributes will have to be reduced (e.g., net operating losses, capital losses, asset basis)

— Attribute reduction is generally applied after the determination of tax for the taxable year

- Note refund potential under the CARES Act

— Reduction of tax basis subject to liability floor—unapplied reduction results in so-called "black hole" CODI

Debt Workouts—Application to Insolvent Partnerships

- For partnerships, insolvency and bankruptcy are measured at the partner-level rather than the partnership level. As a result, CODI may not be excluded if an insolvent or bankrupt partnership has solvent or non-bankrupt partners
- A partnership facing financial difficulties may want to consider, prior to any debt restructuring, converting from a partnership to a corporation for income tax purposes.
- A collateral benefit of the conversion is that the entity may be eligible for qualified small business stock treatment

Converting an Insolvent Partnership to a Corporation

- Converting a partnership to a corporation to access the insolvency exception at the entity level
  - — While a solvent partner in an insolvent partnership cannot exclude its share of an insolvent partnership's COD income under the insolvency exception, an insolvent corporation can exclude its own COD income to the extent of its insolvency
  - — A partnership may consider converting to a corporation through a check-the-box election or state law formless conversion, which would be treated for federal tax purposes as a transfer of its assets and liabilities to a newly formed corporation in exchange for stock of the corporation (in a section 351 transaction), followed by the liquidation of the partnership
- Potential hurdles/issues include § 357(c) (if liabilities exceed tax basis) and § 269

Converting an Insolvent Partnership to a Corporation (cont.)

Section 357(c)

- Requires gain recognition in a Section 351 transaction if the amount of the liabilities assumed exceeds the total of the adjusted basis of the property transferred.
- Consider the situation where solvent partners own a partnership that has a $125 basis in its assets with a fair market value of $50 and $150 of liabilities, and anticipates that it will have debt cancelled, which would generate COD income.
  - — Because liabilities exceed basis by $25, there generally would be $25 of 357(c) gain.
- Note: the withdrawn "no net value" regulations would have hindered the above tax planning by requiring gain recognition where the liabilities assumed by the corporation (plus money and value of boot the transferor receives) exceed the fair market value of the assets.

Converting an Insolvent Partnership to a Corporation (cont.)

Section 269

- Generally, if a taxpayer acquires control of a corporation and the principal purpose of doing so is to avoid federal income tax by securing the benefit of a deduction, credit, or other allowance that would otherwise not be enjoyed, the IRS may disallow that benefit
- Unclear to what extent Section 269 may apply to an incorporation intended to secure the benefits of CODI exclusion at the corporate level:
  - — Arguably the "control" requirement is not satisfied
  - — Application of 108 exclusion is not clearly a "deduction, credit, or other allowance"
  - — The 108 exclusion is a benefit that is clearly anticipated and contemplated by Congress

Qualified Small Business Stock Treatment Post-Conversion

- For smaller businesses anticipating a rebound, the conversion to a corporation may provide other benefits. Generally, a non-corporate taxpayer may exclude, subject to certain limitations, gain from the sale or exchange of qualified small business stock ("**QSBS**") held by the taxpayer for more than five years
- Note: the partnership to corporation conversion itself may present technical issues under the QSBS regime. Current law does not provide an unambiguous answer as to whether the stock from such a conversion could be QSBS, although caselaw indirectly hints that it should work. It is possible that in the future the IRS might challenge this

Qualified Small Business Stock Treatment Post-Conversion

- Generally, QSBS is stock:
  - —(i) in a corporation acquired from the corporation at original issue in exchange for money, other property (other than stock), or compensation for services,
  - —(ii) where the aggregate assets (measured by adjusted basis) immediately after the issuance (and at all times prior to original issuance) does not exceed $50 million, and
  - —(iii) where at least 80% of the corporation's assets have been used in the active conduct of a qualified trade or business during substantially all of the shareholder's holding period
- Note that in the case of an incorporation of a partnership, special rules apply to prevent pre-conversion gain from being excludable under the QSBS rules

Buying Portfolio Debt at a Discount

- In light of depressed debt trading prices, (a) borrowers may consider repurchasing their own debt, and (b) private equity firms or their affiliates may consider purchasing debt of their portfolio companies as an investment
- If a portfolio company acquires its own debt for less than the amount owed, subject to the exclusions discussed previously, the portfolio company will recognize CODI. To the extent the portfolio company has any net operating losses or is eligible to exclude CODI, the cash tax impact from the transaction may be mitigated

Buying Portfolio Debt at a Discount

- Similarly, the acquisition of portfolio company debt by its PE sponsor may be treated as if the borrower had purchased its own debt at a discount and issued a new debt instrument having an issue price generally equal to the purchase price paid by the PE sponsor. This can result in other adverse consequences for the portfolio company and the PE sponsor (e.g., fungibility issues, interest deduction limitations, etc.)

Note: It may be feasible to structure a portfolio company debt acquisition in a manner that does not trigger the related party debt acquisition rules. Any such planning needs to be tailored to the applicable PE sponsor to address interest deductibility, withholding concerns and other issues that may arise

Buying Portfolio Debt at a Discount

- The acquisition of portfolio company debt at a discount by a related party is generally treated as:
  - — a repurchase of the debt at a discount by the portfolio company, and
  - — a reissuance of debt by the portfolio company to the related party for the price originally paid, with the discount treated as OID
- For the portfolio company, it will generally be able to deduct OID as it accrues subject to certain exceptions (e.g., 163(j) interest deduction limitation and applicable high-yield discount obligation rules—discussed later)
- The related party will generally incur phantom income from the OID (i.e., it will generally have to include the OID in income with no corresponding receipt of cash)

Example: Related Party Debt Acquisition

Modified hypothetical:

- Non-publicly traded debt has adjusted issue price and outstanding stated principal of $90 million, trading at $50 million at time of a related party purchase
  - — $40 million of CODI for the debtor company
  - — Issue price of the new debt will be $50 million
  - — “New” debt has $40 million OID
  - — There are additional rules relating to “indirect” related party debt acquisitions that can impact the amount of CODI realized if the debt was acquired in anticipation of the holder becoming related to the debtor
  - — Similar rules apply in the context of acquisitions of related party debt by members of a consolidated group

Fungibility

- When an issuer plans to issue additional debt instruments with terms identical to outstanding debt, the issuer typically prefers that the additional debt have the same CUSIP number as the outstanding debt so that they can trade together on a fungible basis
- Fungible debt often has better market liquidity, better pricing, and lessens the bookkeeping burden on agents
- Subject to limited exceptions, two debt instruments with identical terms are treated as not fungible for tax purposes if:
  - — one is issued with OID and the other is not, or
  - — they are issued with differing amounts of OID

Fungibility – Limited Exceptions

- Additional debt is fungible if it is issued --
  - — pursuant to a single transaction (or related transactions) within 12 days of the original debt
  - — with no (or de minimis) OID and either:
    - the additional debt is issued for cash to persons unrelated to the issuer for an arm's-length price or
    - the original debt is publicly traded for tax purposes
  - — for cash to parties unrelated to the issuer for an arm's-length price and the yield on the additional debt is no greater than the yield (or coupon rate if issued with no more than de minimis OID) of the original debt on its issue date
  - — the original debt is publicly traded for tax purposes and the yield on the additional debt is no greater than the yield (or coupon rate if issued with no more than de minimis OID) of the original debt on its issue date
- For additional debt instruments issued within 6 months of the issue date of the original debt the yield test is slightly higher (110%)

Effectively Connected Income (“ECI”) Concerns

- Non-US persons pay US taxes on certain types of periodic payments like interest and dividends and US trade or business income
- For investments in US debt, foreign investors generally avoid US tax on the interest income under the "portfolio interest exemption" or a US tax treaty
- If, however, a foreign investor is treated as engaging in a US trade or business as a result of lending, financing or similar activities in the United States, all of its income in connection with those activities will be subject to US income tax
- Debt restructuring activities may cause a foreign investor to be subject to tax in the United States, such as:
  - — engaging in significant modifications of debt instruments, except to the extent those modifications are necessary to protect a pre-existing investment
  - — making additional funds available in connection with add-on or DIP financings
  - — engaging in structuring or arranging activities of an agent or arranger normally conducts, or in negotiating loan terms

Consents of Offshore Funds

- Many debt modifications require the consent of one or more foreign investors, many of which are offshore CLOs or investment funds related to US lenders
- To avoid being engaged in a US trade or business, CLOs and investment funds often have operating guidelines that limit their ability to amend or restructure transactions, including requirements that they
  - — not engage in negotiation of loan terms
  - — not accept or reject an amendment or modification of a loan that is a significant modification for tax purposes
  - — can accept or reject an amendment or modification of a loan if the borrower is in financial distress (default or reasonably foreseeable default) and such action is to protect a pre-existing investment
  - — use an independent investment professional to accept or reject an amendment or modification relating to a loan originated by an affiliate
  - — seek the advice of a nationally recognized law firm for situations not covered by the guidelines or that would require an exception to the guidelines

AHYDO

- Certain debt instruments with excess OID (such as many PIK instruments) can run afoul of the "applicable high-yield discount obligation" ("AHYDO") limitations on interest deductibility
- If treated as an AHYDO, then a portion of the interest accruals are treated as dividends and the remainder is deductible only when paid in cash

- AHYDO means any debt instrument if:
  - — issued by a corporation
  - — with a term in excess of 5 years,
  - — a yield to maturity equal to or exceeding the AFR plus 5%, and
  - — “significant OID.”
- A debt instrument has "significant OID" if for any interest accrual period after the 5th anniversary of the debt, the aggregate amount of accrued but unpaid interest exceeds the annual yield of the debt instrument

Adding Credit Support: Guarantees

- In certain cases, the parent's guarantee of a subsidiary's debt can cause the parent to be treated as the true borrower of the debt for US federal tax purposes (*Plantation Patterns*)
- If the parent is treated as the true borrower for tax purposes:
  - tax-exempt investors in the parent fund could recognize debt-financed income, which may violate fund covenants
  - the parent fund may recognize income when the portfolio company borrower pays the debt from its own cashflow or refinances the debt in the future without the parent guarantee, which may cause withholding taxes
  - the debt may be treated as significantly modified
- Limiting the amount of the guarantee or providing an equity commitment instead may decrease the risk that the parent will be treated as the true borrower

Adding Credit Support: CFCs

- CFC Stock Pledges and Guarantees
  - — US borrowers general avoid looking to controlled foreign corporation (CFC) subsidiaries for credit support to avoid income inclusions that may be triggered under Section 956, including:
    - Avoiding guarantees of the US debt and
    - limiting pledges of the CFC stock to 65% of the voting stock
  - — The 2017 TCJA and subsequent regulations revised Section 956 such that, generally speaking, a CFC that has been owned by a US corporation for more than one year may have 100% of its stock pledged to support a US debt and may guarantee the US debt
- Foreign Cash and Upstream Loans
  - — CFCs may distribute previously taxed earnings & profits
  - — CFCs may distribute cash to US corporate parents subject to the dividends received deduction
  - — CFCs may make intercompany loans, although the interest paid may be subject to US withholding taxes

§ 163(j) Relaxation

- The TCJA overhauled § 163(j), prohibiting many businesses from deducting more than 30% of “adjusted taxable income” (“ATI”) for tax years beginning in 2018
- “Adjusted taxable income” is defined in § 163(j)(8) as:

“…the taxable income of the taxpayer— computed without regard to— any item of income, gain, deduction, or loss which is not properly allocable to a trade or business, any business interest or business interest income, the amount of any net operating loss deduction under section 172, the amount of any deduction allowed under section 199A, and in the case of taxable years beginning before January 1, 2022, any deduction allowable for depreciation, amortization, or depletion”

So, ATI = EBITDA until 2022

- CARES Act § 2306 adds new § 163(j)(10), which provides that for businesses other than partnerships, the limit on business interest deductions in tax years 2019 and 2020 will be 50%, and not 30%, of ATI. Partnerships will have a limit under § 163(j) of 50% of ATI in 2020, but are still subject to the 30% limit in 2019, with a special form of carryforward for 2019

Net Operating Losses

- The 2017 Tax Cuts and Jobs Act ("TCJA") revised the Code to prohibit net operating loss ("NOL") carrybacks for tax years beginning in 2018 and later for most taxpayers. While carryforwards were still allowed after TCJA, they were then limited to offsetting 80% of a taxpayer's taxable income
- The CARES Act § 2303 repeals the 80 percent income limitation on losses for tax years beginning before 2021 and allows 100 percent of loss carryforwards and carrybacks to be used for those years
- In addition, the CARES Act permits taxpayers (other than REITs and life insurance companies) to carryback for up to five years NOLs arising in tax years beginning 2018, 2019 and 2020. For corporations, NOLs carried back to tax years before 2018 will be particularly valuable because the corporate income tax rate was 35 percent

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Thank you!

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