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Liability Management: The Tax Angle

May 6, 2020

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Agenda

- Debt repurchases
- Debt modifications or debt-for-debt exchanges
- Debt-equity exchanges
- Bankruptcy restructurings

Debt repurchases

Debt repurchase for cash

- Repurchase at discount
  - Issuer: generally cancellation of indebtedness (COD) income equal to adjusted issue price over repurchase price
  - Holder: capital gain, subject to market discount rules, (or loss) to the extent repurchase price is greater (or less) than adjusted basis
- Repurchase at premium
  - Issuer: repurchase premium may be deductible by the issuer as interest expense (Treas. Reg. section 1.163-7(c))
    - Amount in excess of adjusted issue price
    - Section 249: deduction only for a reasonable premium in the case of convertible bonds
  - Holder: capital gain, subject to market discount bond rules

Debt repurchase for cash *(cont'd)*

- Related party (50% by value) debt repurchase - COD still realized by debtor
  - Direct purchase by related party
  - "Indirect" purchase where purchaser becomes related
- Exception for debt to be retired within a year
- Deemed issuance to related holder
  - Can create OID – issue price is deemed to be amount paid by related party for the debt
  - No gain or loss to related holder for deemed issuance, but potential for OID

Debt repurchase for cash *(cont'd)*

- Repurchases of "contingent payment debt instruments"
  - Issuer:
    - Price more than projected contingent payment (a "net positive adjustment")--interest deduction
    - Price less than projected contingent payment (a "net negative adjustment")--ordinary income
  - Holder:
    - Net positive adjustments--interest income
    - Net negative adjustments--ordinary loss to the extent of current and prior year income inclusions, then capital loss

Debt modifications or exchanges

Exchanges and modifications: overview

- “Significant modification” rules
- Consequences to parties
  - In general
  - Publicly traded?
  - Issuer
  - Holder
  - Consent fees

“Significant modification” rules

- A modification of existing debt will be treated as an exchange of such debt for new debt if the modification is “significant”
  - A modification is significant only if the legal rights or obligations that are altered and the degree to which they are altered are economically significant
  - Generally, modifications are “significant” if, among other things:
    - The yield changes by the greater of 25 basis points and 5% of the existing yield
    - Scheduled payments are materially deferred
      - Safe harbor equal to the lesser of 5 years or 50% of the original term
    - Modified credit enhancements change payment expectations
    - The nature of the security changes (*e.g.*, from debt to equity (without regard to decline in credit quality) or from recourse to nonrecourse)
  - Consent solicitations that seek to change “customary accounting or financial covenants” would not, in themselves, be significant modifications

Consequences to parties: in general

- Rules apply the same whether there is debt-for-debt exchange or an amendment of terms
- Where an amendment of terms, deemed exchange of the “old” note for a “new” note

Consequences to parties: publicly traded?

- A debt instrument will be publicly traded if, within 15 days before or after the deemed exchange, there is:
  - A sales price
  - One or more firm quotes
  - One or more indicative quotes
- Exception—A debt instrument will not be treated as publicly traded if the principal amount for the issue (generally the class) is $100MM or less at the time of determination
- Anti-abuse rule

Consequences to parties: issuer

- Potential for COD and OID
  - Exception for issuers in bankruptcy or that are insolvent
- Corporations that issue obligations with OID as part of their restructuring need to be mindful of potential limitations on the deductibility of this discount
- Repurchase premium may be deductible by the issuer as interest expense

Consequences to parties: issuer *(cont'd)*

- For corporations that issue certain high yield obligations with significant OID ("AHYDO"), a portion of the discount is treated as a non-deductible dividend, with the remaining discount not deductible until actually paid
- Section 163(e)(5): OID deductions on "applicable high yield discount obligation" ("AHYDO") issued by a corporation (in excess of "disqualified portion") deferred until OID paid.
- Section 163(i): AHYDO means any debt instrument if:
  - The maturity date of such instrument is more than 5 years from the issue date,
  - The yield to maturity on such instrument equals or exceeds the sum of – (i) the AFR for the calendar month in which the obligation is issued, plus (ii) 5 percentage points, and
  - Such instrument has "significant OID."
    - An instrument has significant OID if at the end of any accrual period ending more than 5 years after issue date, the aggregate amount of accrued but unpaid OID > (issue price * YTM).
- If AHYDO, then the "disqualified portion" of OID deductions is permanently disallowed, and the remainder is deferred until OID paid.

Consequences to parties: issuer *(cont'd)*

- Suppose a note is issued with the following terms:
  - Principal Amount = $1,000
  - Maturity = 8 years
  - Thus, YTM = 14.27%
  - Issue Price = $800
  - Coupon = 10%, paid semi-annually

- AHYDO Analysis:
  - Maturity > 5 years? Yes
  - YTM ≥ AFR + 5%? Yes - 14.27% > AFR (1.09%) + 5%
  - Significant OID? Yes
    - Sometime after the 5th anniversary of the issue date, the aggregate amount of accrued OID would exceed (issue price * YTM = $800 * 14.27% = $114.2).
    - Specifically, on the 6th anniversary of the issue date, the aggregate accrued OID would be $128.

Consequences to parties: holders

- Tax consequences for holders depend on whether the restructuring constitutes a “recapitalization” under the Code
  - Generally debt exchanges of securities with terms longer than 10 years will qualify as recapitalizations
  - Gray area: 5-10 years
  - More uncertainty with respect to securities with shorter terms

Consequences to parties: holders *(cont'd)*

- If an exchange or modification of debt constituted a recapitalization, the holder should generally not recognize gain or loss
  - However, depending on the terms of the new debt relative to the old, there may be tax consequences
  - If the principal amount of the new debt exceeds that of the old, the holder could recognize gain equal to the fair market value of the excess
    - Gain also recognized to the extent of "boot"
  - Exchanges and modifications also can create OID, or conversely, an amortizable premium, due to differences in the issue price of the new debt and the stated redemption price at maturity

Consequences to parties: holders *(cont'd)*

- If an exchange or modification of debt is not a recap, holder will generally have gain or loss equal to the difference between the issue price of the new debt and the holder's basis in the debt instrument, which will usually be a capital gain or loss (except for accrued market discount)
  - If the holder acquired the debt with market discount (as secondary market purchaser), a portion of any gain may be characterized as ordinary income

Consequences to parties: holders *(cont'd)*

- Non-US investors careful not to overdo it
- Non-U.S. persons are subject to U.S. net basis income tax on income that is "effectively connected" with the conduct of a "trade or business within the United States."
- *Securities Trading Safe Harbor*. No U.S. trade or business results from merely trading in stocks and securities within the United States by a non-dealer.

Consequences to parties: consent fees

- Tax treatment of consent fees is unclear
  - Tax treatment to holders?
  - Subject to withholding tax if paid to non-US holders?
  - PLR 201105016

Debt-equity exchanges

Debt-equity exchanges

- Tax treatment of debt with an option component
  - Investment unit versus convertible debt
- Debt-equity exchange
  - Issuer: recognizes ordinary COD income to the extent the adjusted issue price of the outstanding debt exceeds the fair market value of the equity issued
    - Compare vs. contribution of debt to capital
  - Holder: If a debt-equity exchange constitutes a recapitalization, it should not result in gain or loss to the holder
    - Market discount accrued on the exchanged debt will carryover to the equity
  - Special entity considerations – REITs and non-US lenders may not want equity

Bankruptcy restructurings

Bankruptcy restructurings

- COD excluded from gross income if taxpayer bankrupt or insolvent
- Tax attributes reduced to the extent of COD excluded:
  - NOLs
  - Credits
  - Minimum tax credits
  - Capital loss carryovers
  - Basis reduction

Bankruptcy restructurings *(cont'd)*

- Generally, NOLs subject to reduction under section 382 where there is an ownership change
- Section 382(l)(5): section 382 does not apply to NOLs that survive the attribute reduction for COD
  - Shareholders and "old and cold" creditors of old loss corporation own at least 50% of emerging corporation
  - No ownership change for two years after emerging from bankruptcy
  - Losses reduced for interest payments to creditors-turned-shareholders in 3 previous years
- Section 382(l)(6): if taxpayer elects out or does not qualify for (l)(5), (l)(6) may be available. Section 382 limitation, but takes into account increase in value from COD