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Client Alert
White Paper

Latham & Watkins Transactional Tax Practice | April 16, 2020 | Number 2700

Tax Considerations for Financing and Refinancing Transactions in Turbulent Times

Volatile trading markets and economic instability may prompt taxpayers to modify, purchase, or repurchase debt; participants should consider the tax consequences.

Key Points:

- Issuers may incur immediate income in the form of cancellation of indebtedness income (CODI) upon an amendment or exchange of existing debt if the existing debt is trading at a discount.
- Debt repurchases, or purchases by related parties, may result in similar CODI concerns.
- Borrowers can explore various ways to expand credit support and/or increase liquidity, including by pledging tax refunds, foreign guarantees, and foreign cash, and potentially by issuing incremental debt fungible with existing debt.
- In committed acquisition financings, there are numerous traps for the unwary, including those resulting from funding itself, as well as resales and the exercise of securities demand and market flex provisions.

Cash management, preservation of liquidity, and execution of committed financings are of paramount importance during periods of market uncertainty, but volatile market conditions also present a unique opportunity for borrowers or private equity funds with available cash to purchase existing debt at a discount. This *Client Alert* discusses key US federal income tax considerations and offers practical takeaways.

1. MODIFYING EXISTING DEBT

a. Amendments of Existing Debt May Result in CODI, Fungibility Issues, OID, AHYDO, Debt Issuance Costs, and Potential Recharacterization as Equity

Significant Modification of Debt and a Deemed Reissuance: During periods of market uncertainty and trading volatility, issuers may need to restructure their existing debt (or may find it beneficial to do so). Depending on the terms, modifying existing debt may give rise to a deemed reissuance, specifically, if, based on all facts and circumstances, the legal rights or obligations that are altered and the degree to which they are altered are, collectively, economically significant (a "significant modification"), the existing debt instrument is generally treated as exchanged for a deemed newly issued debt instrument. Special rules apply with respect to modifications that consist of or result in a change in yield, a change in the timing of payments, a change in borrower or security, a change in accounting or financial covenants, or a temporary forbearance:

- Change in yield: A change in yield is a significant modification if the annual yield on the modified debt instrument varies from the annual yield on the unmodified debt instrument by more than the greater of (a) 25 basis points and (b) 5% of the annual yield of the unmodified debt instrument.

- Change in timing of payments: A modification changing the timing of payments is a significant modification if the modification results in a material deferral of scheduled payments. Under an applicable safe harbor, the deferral of scheduled payments does not constitute a significant modification if the deferral is less than the lesser of (a) five years or (b) 50% of the original term of the debt instrument.

- Change in collateral or guarantee: A modification altering collateral or guarantees, or adding or deleting a co-obligor, is a significant modification if it results in a "change in payment expectations." A change in payment expectations occurs if there is (a) a substantial enhancement of the borrower's capacity to service the debt instrument and that capacity was primarily speculative prior to, and is adequate after, the modification or (b) a substantial impairment of the obligor's capacity to meet the payment obligations under a debt instrument and that capacity was adequate prior to the modification and is primarily speculative after the modification.

- Change in covenants: A modification adding, deleting, or altering customary accounting or financial covenants is not a significant modification. There is no definition of the term "customary accounting or financial covenants" in IRS rules and regulations. However, many taxpayers take the position that amendments to baskets, leverage ratios, and similar provisions constitute alterations of customary accounting or financial covenants.

- Temporary forbearance: An agreement by a holder to stay collection or temporarily waive an acceleration clause is not a significant modification so long as it does not exceed a period of two years, plus an additional period during which parties negotiate in good faith or the borrower is in bankruptcy or a similar proceeding. A longer waiver may constitute a significant modification.

CODI: If a modification constitutes a significant modification, the issuer is deemed to have issued a new debt instrument in satisfaction of the existing debt instrument. If a borrower is deemed to have issued a new debt instrument at an issue price less than the adjusted issue price of the existing debt instrument, the borrower generally realizes CODI currently in an amount equal to such excess. For example, if an existing debt instrument issued at par undergoes a significant modification and trades at 60% of the face amount immediately after the modification, the issuer could recognize CODI in an amount equal to 40% of the face amount, as further explained below.

- The "issue price" of a "new" debt instrument deemed issued in exchange for an existing debt instrument is equal to:

  - The fair market value of the new debt instrument, if the new debt instrument is "publicly traded" (which is often the case, as explained below)

  - The fair market value of the existing debt instrument, if the existing debt instrument, but not the new debt instrument, is publicly traded

  - The stated principal amount of the new debt instrument (or, in certain circumstances, its stated redemption price at maturity), if neither the new debt instrument nor the existing debt instrument is publicly traded

- A debt instrument is generally considered to be "publicly traded" if, at any time during the 31-day period ending 15 days after the issue date or deemed issue date (*i.e.*, the date of significant modification), a sales price or one or more quotes (including indicative quotes) are available with respect to such debt instrument, unless its outstanding principal amount is less than or equal to US$100 million.

- Accordingly, a borrower with debt that is traded in the market generally incurs CODI if there is a significant modification of such debt and the debt is trading at a discount.

- CODI realized by a corporate borrower is generally excluded from taxable income if and to the extent that the borrower is insolvent or if the borrower is in bankruptcy; however, a borrower is generally required to reduce tax attributes by the amount of CODI excluded from income. These exclusions from CODI are unlikely to be applicable in ordinary circumstances.

Deemed Reissuance and Fungibility: If a significant modification of an existing debt instrument is combined with upsizing of the facility or tranche, a deemed reissuance of the existing debt instrument (resulting from such significant modification) would facilitate "fungibility." In such case, so long as the modification and the issuance of the additional debt instrument close within 12 days of each other, the existing debt instrument (as modified) and the additional debt instrument (or the tap) should be fungible (assuming the terms are otherwise identical).

OID and AHYDO: If the face amount (or, if not all the interest payments are required to be made in cash, the stated redemption price at maturity) of the deemed newly issued debt instrument resulting from a significant modification exceeds the issue price of such debt instrument (determined as discussed above), the debt instrument may be treated as issued with original issue discount (OID) for US federal income tax purposes. Such OID is generally equal to the CODI (as calculated above) that is currently includible as income. OID is generally deductible over the term of the new debt instrument, though such deductions may be subject to significant limitations.

- For example, net business interest deductions are generally limited to 30% of "adjusted taxable income." The Coronavirus Aid, Relief, and Economic Security Act (CARES Act) increases this cap to 50% of adjusted taxable income generally for taxable years beginning in 2019 and 2020, and allows taxpayers to elect to determine the dollar amount of the cap for 2020 based on 2019 adjusted taxable income. For taxable years beginning prior to January 1, 2022, adjusted taxable income is determined without regard to deductions for depreciation, amortization, or depletion, but no such adjustment is made for taxable years beginning on or after January 1, 2022.

- In addition, if the new debt is an applicable high yield discount obligation (AHYDO), OID may not be deductible until paid in cash, and a portion of the OID may never be deductible even if paid in cash. An AHYDO is, very generally, a debt instrument issued by a corporation having a yield exceeding the Applicable Federal Rate plus 5%, a term exceeding five years, and a significant amount of OID.

- As a result of these limitations, there could be a significant mismatch, or permanent difference, in timing and amounts between the income inclusion in respect of CODI and the deduction of OID, particularly for a company that is highly leveraged.

Unamortized Debt Issuance Costs: In the event of a significant modification, any unamortized debt issuance costs remaining on the existing debt instrument often will be immediately deductible by the issuer, and thus potentially available to offset CODI arising from the modification. However, proposed

Treasury Regulations generally treat debt issuance costs as interest for purposes of the net business interest expense deduction limitations.

Potential Recharacterization: The status of a deemed newly issued debt instrument as “debt” for tax purposes is required to be re-tested as of the date of the deemed issuance. Accordingly, modifications to an existing debt instrument can result in the recharacterization of that debt instrument as equity for tax purposes.

- However, as long as the borrower on the debt instrument remains the same, and no co-borrowers were added or removed from the debt instrument, any deterioration in the financial condition of the borrower between the original issue date of the debt instrument and the date of the significant modification is ignored for this purpose.

b. Modifying Debt of Foreign Subsidiaries May Result in Adverse Tax Consequences to US Shareholders

In addition to debt restructuring by US borrowers, a US parent of a foreign borrower subsidiary may consider repurchasing or modifying existing debt of such subsidiary. A foreign subsidiary owned more than 50% by a US shareholder (or shareholders) is generally considered to be a controlled foreign corporation (CFC). If the repurchase or modification (as discussed above) of the CFC’s debt gives rise to CODI at the level of the CFC, such CODI may cause the CFC’s US shareholder to recognize additional income under the complex rules governing “global intangible low-taxed income” (GILTI).

Generally, a US shareholder’s GILTI is the amount of its CFCs’ net income in excess of 10% of the CFCs’ adjusted basis in its tangible depreciable assets (a 10% deemed tangible income return amount). A US shareholder is subject to US tax on GILTI regardless of whether the US shareholder receives any distributions from its CFCs. Corporate US shareholders are allowed a deduction equal to 50% of their GILTI and foreign tax credits for 80% of foreign taxes paid on that GILTI in that year (without a carryback or carryforward). However, the manner in which this 50% GILTI deduction and foreign tax credits must be taken into account by a US shareholder may significantly reduce the benefit to such US shareholder of any net operating loss (NOL) carryforwards or carrybacks.

- If a debt repurchase or modification results in CODI to the CFC (applying the same rules discussed above in *Amendments of Existing Debt May Result in CODI, Fungibility Issues, OID, AHYDO, Debt Issuance Costs, and Potential Recharacterization as Equity*), a US shareholder of such CFC may be required to include additional GILTI corresponding to such CODI in the absence of offsetting tested losses from other CFCs.

- If CODI recognized by an insolvent CFC is excluded from taxable income by reason of such insolvency, how the CFC’s various tax attributes may be affected is unclear, but if the CFC is required to reduce tax basis in its depreciable tangible property, such a reduction could increase potential GILTI inclusions in future years by decreasing the 10% deemed tangible income return amount.

- If CODI caused by a debt repurchase or modification is not subject to current foreign taxation, such event may result in a timing mismatch such that the GILTI arising from the CODI is included in a US shareholder’s income currently while foreign taxes may not be paid until a later year, and therefore the associated foreign tax credit does not arise.

- A US shareholder in an overall net loss position or with NOL carryovers for the taxable year in which CODI is recognized by a CFC could be losing the benefit of the 50% deduction for GILTI and NOL carryovers, as well as foreign tax credits related to that GILTI.

- Because general US tax rules apply to CFCs in a similar fashion as to US corporations, the concerns relating to limitations on deductibility of OID (including any OID on an AHYDO) that may be created in a debt modification or a related party purchase could apply to CFCs in the same way as discussed above in *Amendments of Existing Debt May Result in CODI, Fungibility Issues, OID, AHYDO, Debt Issuance Costs, and Potential Recharacterization as Equity* and below in *Repurchase of Debt at a Discount — Purchase by Related Party*.

c. Fund Guarantees of Portfolio Company Debt May Create Tax Issues

Tax Issues Arising From Fund Guarantees: As private equity funds look to restructure a portfolio company's debt, obtain a waiver of financial covenants with respect to existing portfolio company debt, or have a portfolio company borrow incremental amounts, lenders may ask the fund to guarantee the portfolio company's debt. The existence of a fund guarantee raises the issue, often referred to as the *Plantation Patterns* issue,[1] of whether the fund (not the portfolio company) should be viewed as the true borrower of the debt for US federal income tax purposes.

- If the fund is treated as the borrower, tax-exempt investors in the fund could recognize unrelated business taxable income (UBTI) as a result of the fund being treated as borrowing money to make an investment in a portfolio company. However, this should only occur if the fund is treated as the borrower and the fund recognizes income in respect of its investment in the portfolio company during the tax year in which the fund is viewed as the borrower, or if the fund sells its investment in the portfolio company at a gain and the fund was treated as the borrower within the 12-month period ending prior to the sale.

- If the fund is treated as the borrower for US federal income tax purposes, the fund may recognize income when the portfolio company repays all or a portion of the debt from its cash flow or when the portfolio company refinances its debt in the future without a fund guarantee, as the repayment or refinancing could be treated as a distribution of cash from the portfolio company to the fund. In such a case, the fund would recognize income, and have a withholding obligation with respect to its non-US investors, to the extent the deemed distribution is treated as a dividend from a corporation for US federal income tax purposes.

- Because the incurrence of UBTI can violate covenants in fund agreements or side letters and given the other issues noted above, it is important to carefully consider whether providing a fund guarantee creates any tax issues for the fund's investors. If a fund guarantee causes the fund to be treated as the borrower, the debt may be treated as significantly modified and deemed reissued or the fund could be treated as assuming the debt of the portfolio company. In addition, even if the fund is treated as a mere guarantor, a change in collateral or guarantee can result in a significant modification of the debt in certain situations. See above in *Amendments of Existing Debt May Result in CODI, Fungibility Issues, OID, AHYDO, Debt Issuance Costs, and Potential Recharacterization as Equity*.

- Whether the fund should be viewed as the borrower is fact-specific. In the case of an unsecured guarantee provided to lend additional credit support to a portfolio company when the bank is not looking primarily to the fund to repay the debt, the portfolio company should continue to be respected as the borrower.

- In addition, limiting the amount of the guarantee or providing an equity commitment in lieu of a guarantee can decrease the risk the fund is viewed as the borrower.

Guarantee Fees: Another issue to consider is whether a fund that guarantees debt of a portfolio company should be deemed to receive a guarantee fee even if no fee is charged to the portfolio company. If the answer is yes, a question arises as to whether the deemed fee could be treated as UBTI or as income that is effectively connected with a trade or business in the United States. While the law is not entirely clear, case law supports not imputing a guarantee fee when no actual fee is charged.[2]

2. REPURCHASE OF DEBT AT A DISCOUNT

a. Repurchase by Issuer

- Issuers with cash may find periods of market dislocation and volatility pose a unique opportunity to repurchase their existing debt at a discount to its face amount. However, the repurchase by a company of its debt at a discount generally results in the recognition of CODI. The amount of CODI equals the difference between the adjusted issue price of the debt and the repurchase price.

- If the issuer of a debt is a corporation, CODI creates a cash tax liability for the corporation unless the corporation has an NOL or current deductions that can be used to offset this income (assuming the insolvency or bankruptcy exceptions discussed above are not applicable).

- If the issuer is a partnership or other entity taxed as a partnership, CODI creates a cash tax liability for the partners of the issuer unless current deductions of the issuer, or other losses or deductions of such partners, can be used to offset this income.

b. Purchase by Related Party

Many private equity funds take advantage of periods of market dislocation and volatility to purchase debt of their portfolio companies at a significant discount to the face amount of the debt. However, the acquisition of debt by an entity that is treated as "related" to the issuer under Section 108 of the Internal Revenue Code (Code) can raise tax issues for both the issuer of the debt and the entity acquiring the debt.

- Determining whether the issuer and purchaser of debt are related is complex and depends, in part, on the tax classification of the issuer and the purchaser of the debt, as different rules apply to determine if two corporations, two partnerships, or a partnership and a corporation are related. In addition, attribution and constructive ownership rules apply, making the determination difficult in certain situations (such as if the issuer of the debt is owned by multiple funds). These rules can lead to counterintuitive results.

In the case of a related-party purchase, the purchased debt is generally treated as having been acquired by the issuer for the price paid by the related party and reissued to the related party for the same amount. This generally results in the recognition of CODI unless an exception applies as discussed above in *Repurchase by Issuer*.

In such below par purchases, the deemed reissuance generally results in the new debt being issued with OID. The related purchaser of the debt is required to take such OID into account on a yield to maturity basis over the remaining term of the debt instrument, and therefore recognizes taxable income prior to the receipt of cash payments from the purchased debt.

While an issuer of debt acquired by a related person will incur additional interest deductions over time as a result of the new debt being issued with OID, the issuer may not be able to deduct all of the OID as a result of various limitations. See discussions above in *Modifying Existing Debt*.

With limited exceptions, once a bond or loan is acquired at a discount by a related person and deemed reissued as new debt with OID, it will no longer be fungible from a tax perspective with the other bonds or loans of the same series that remain outstanding and, therefore, it is unlikely to be traded as freely as the "old" debt.

In some circumstances, it may be possible to structure a fund's purchase of debt of one of its portfolio companies in a manner in which the purchaser of the debt is not treated as related to the issuer of the debt. In this case, the rules discussed above will not apply. However, the debt purchased at a discount will be acquired with market discount and all or a portion of the income recognized on the sale or repayment of such debt will be ordinary income.

Latham & Watkins recently published a *Client Alert* analyzing key tax and non-tax issues arising in connection with debt repurchases, available here.

3. EXPANDING CREDIT SUPPORT AND UTILIZING FOREIGN CASH

a. Using Foreign Collateral to Generate Liquidity

Historically, US borrowers were reluctant to look to their non-US subsidiaries to provide material credit support because doing so often triggered US tax under Section 956 of the Code (a Section 956 deemed dividend). Recent changes to applicable US Treasury Regulations alleviated this concern for US corporate borrowers as long as certain conditions are met. As a result of these changes, as US corporate borrowers look to modify their existing debt, refinance existing debt, or initiate new financing, they may find their non-US subsidiaries provide a valuable untapped source of credit support.

More specifically, Treasury Regulations issued in May 2019 effectively turned off the application of Section 956 for any previously untaxed offshore earnings of a non-US subsidiary that is a CFC when such CFC guarantees or provides certain pledges in support of debt of a related US borrower or makes loans to or other investments in a US affiliate provided that the following conditions are met:

- The US corporate borrower (or its US corporate affiliate that owns the relevant CFC equity) satisfies a one-year holding period requirement with respect to the CFC (this requirement may be satisfied retrospectively, by continuing to own the CFC after the date of the deemed dividend).

- The dividend is not a "hybrid dividend" (generally, a dividend for which the CFC would receive a deduction or other tax benefit with respect to taxes imposed by a foreign country had the CFC paid an actual dividend).

- The dividend is foreign source (generally meaning the CFC does not own a US business or US assets).

In addition, a Section 956 deemed dividend arises only to the extent the CFC has undistributed earnings and profits that have not previously been subject to US tax. By contrast, sufficient previously taxed earnings and profits (PTEP) allocable to a US shareholder that have not been distributed may shield such a US shareholder from US tax consequences under Section 956.

Latham & Watkins published a *Client Alert* last year analyzing the final Section 956 regulations in greater detail, available [here].

b. Utilizing Foreign Cash

Distributing Foreign Cash: To remedy liquidity concerns, US taxpayers may seek to access cash held by foreign subsidiaries. Under certain circumstances, US shareholders of CFCs may be able to receive distributions from their CFCs free of US federal income tax (although such distributions may be subject to foreign withholding taxes).

- For both corporate and non-corporate US shareholders, distributions are generally treated first as distributions of PTEP (to the extent thereof). PTEP generally represents amounts of undistributed earnings of a CFC that have already been taxed to US shareholders of such CFC under various provisions (such as GILTI). Distributions of PTEP do not result in the recognition of dividend income by the US shareholder, but such distributions do give rise to an immediate reduction in the US shareholder's tax basis in its CFC stock. If the amount of the distribution exceeds the US shareholder's tax basis, it generally gives rise to the recognition of capital gain.
    - A US shareholder considering a mid-year distribution of PTEP should be aware of the risk of inadvertently triggering capital gain at the time of the distribution due to timing mismatches in stock tax basis adjustments.
- A corporate US shareholder may also qualify for a 100% dividends received deduction (the foreign DRD) with respect to the foreign source portion of a dividend received from its CFC that is not a distribution of PTEP.
    - To be eligible for the foreign DRD, a US shareholder must satisfy a one-year holding period requirement with respect to the CFC stock giving rise to the distribution (although this requirement may be satisfied retrospectively, by continuing to own the CFC after the date of the distribution) and certain other requirements similar to those discussed above in *Using Foreign Collateral to Generate Liquidity.* Any foreign withholding tax on a distribution qualifying for the foreign DRD would not be creditable against US tax.

Upstream Loans: A loan from a CFC to a US shareholder may be an attractive alternative to a distribution of cash to address liquidity concerns. As discussed above in *Using Foreign Collateral to Generate Liquidity*, Treasury Regulations issued in May 2019 effectively turn off the application of Section 956 to a loan from a CFC to its US affiliate if certain requirements are met. In addition, many CFCs now have large amounts of available PTEP (and limited amounts of untaxed earnings and profits) due to GILTI inclusions and the mandatory repatriation tax enacted in 2017 as part of the Tax Cuts and Jobs Act.

- An upstream loan from a CFC generally would not create a risk of capital gain on the stock of the lender CFC.
- Additionally, unlike legal distributions, the advance of funds upstream is often (but not always) exempt from foreign withholding taxes. However, making interest payments on a loan from a foreign affiliate may attract US withholding tax or, to the extent such payments are not subject to US withholding tax, the interest deduction arising from such interest payments may increase the likelihood of the US parent in the future being subject to the base erosion and anti-abuse tax.

c. Tax Refunds Under the CARES Act

Under the CARES Act, signed into law on March 27, 2020, borrowers may be entitled to receive certain refunds from the IRS, which could prove to be a valuable source of additional collateral. Notably, the CARES Act:

- Removes the 80% taxable income limitation on the use of NOLs for taxable years beginning in 2018, 2019, and 2020
- Provides for a five-year carryback for NOLs of a corporation generated in taxable years beginning in 2018, 2019, and 2020
- Makes corporate AMT credit carryovers fully refundable in the taxpayer's taxable year beginning in 2018 (under prior law, such carryovers were refundable over four years ending in 2021)

Taxpayers may be able to make elections or engage in transactions that accelerate deductions or losses to the taxpayer's 2020 taxable year, increasing the amount of NOLs available to carry back to produce an immediate cash refund. In addition, taxpayers may be able to use the newly relaxed net business interest expense deduction limitations for taxable years beginning in 2019 and 2020 (as discussed above in *Modifying Existing Debt*) to increase the amount of NOLs that may be carried back.

Borrowers may be able to offer these tax refunds as collateral and lenders may even be able to collect a refund payment directly from the IRS if certain forms are filed.[3] The nature of the procedures to obtain a refund and the timing of receipt of the refund will vary depending on the year in which the NOL arose.

Latham & Watkins recently published a *Client Alert* analyzing the tax aspects of the CARES Act, including the procedure for obtaining tax refunds under the CARES Act, available here.

4. TAX ISSUES ARISING FROM COMMITTED FINANCING

Depending on the relevant facts, borrowers as well as lenders can face significant tax issues when committed financings are funded during times of market distress.

a. Exercising Market Flex After Funding

A market flex provision generally allows arrangers of a debt financing to change certain key terms of the debt to assist in the syndication of the debt. If a market flex is exercised after the debt is funded, certain potential tax issues can arise, including possible CODI if changes caused by the exercise of the market flex result in a significant modification of the debt instrument and the debt is trading below par. There are also potential AHYDO risks and fungibility issues. For more on the meaning of significant modification and the determination of the issue price of the debt deemed reissued as a result of a significant modification, see *Modifying Existing Debt*.

- While there are arguments supporting the position that exercise of market flex should not cause tax issues even if exercised after funding, there is no clear guidance. Accordingly, if market flex continues after funding, particularly in a distressed market, parties may want to take mitigating steps. Such steps include:
  - Requiring a one-time exercise
  - Allowing the issuer to trigger a partial or full exercise prior to the funding

  - Funding the debt with fully flexed terms, coupled with a reverse flex in the event the debt can be syndicated with more favorable terms
  - Adding an AHYDO savings clause

b. Firm Commitment Underwriting (a "Bought Deal")

In a firm commitment underwriting, an underwriter commits to buy debt instruments at a certain price and purchases them at such price. However, particularly in periods of market volatility, the underwriter may end up selling the debt instruments to the ultimate investors for a price below the price at which the underwriter bought the debt instruments from the issuer. In such a case, the following potential tax issues must be considered:

- The issue price of the debt for US federal income tax purposes is generally equal to the price at which a substantial portion of the debt is sold to investors (excluding sales to underwriters or anyone acting in a similar capacity). If the issue price so determined is significantly below par, the debt may be considered an AHYDO (if other conditions are also met). If possible, parties should consider inserting an AHYDO savings clause where relevant.

- If the issuer receives proceeds from the underwriter exceeding the issue price of the debt (which, as discussed above, will generally be the price at which investors buy the debt), the treatment of such excess with respect to the issuer is not clear. While there is risk the excess is income (potentially recognized on a current basis) to the issuer (although such income may be offset by increased OID deductions over the term of the debt, subject to applicable limitations on deductibility), based on authorities in analogous areas, it may be reasonable to treat such excess proceeds as an adjustment to the deduction of interest and OID over the term of the debt.

- If the underwriter does not resell all the debt at the original closing or within 12 days of the closing date, the parties may need to consider whether and how the tax fungibility rules apply to subsequent resales (as also discussed below in *Upsizings or "Taps" of Outstanding Debt*).

c. Securities Demand

Bridge financing documentation for non-investment grade borrowers often contains a provision obligating the borrower to issue and sell permanent debt to refinance the funded bridge loan if certain conditions are satisfied. This provision is typically called a "securities demand" and the permanent debt is often called a "demand security." In a distressed market, it may be difficult to place a demand security with investors unrelated to the bridge lenders. If a demand security is instead acquired by the bridge lenders, the bridge loan may be treated as being effectively exchanged with a demand security. This exchange could be viewed as a debt-for-debt exchange involving a significant modification for US tax purposes (rather than a repayment of the existing bridge at par pursuant to the securities demand provisions of the bridge financing documentation). If so, the issuer is at risk of recognizing CODI, as discussed above in *Modifying Existing Debt*.

- Bridge commitment papers generally allow the issuer to refuse to comply with the securities demand to avoid any CODI risks or for other reasons. In such case, a "demand failure" would result, which generally triggers an automatic adjustment to certain terms of the bridge loan (as previously agreed among the arranger and the borrower). While not clear, depending on the exact terms, there may be arguments that such automatic adjustments do not result in a deemed exchange of the bridge loan for US tax purposes.

- To prevent a demand security from being treated as an AHYDO, where relevant, it would be prudent to insert an AHYDO savings clause in the terms of the demand security.

5. UPSIZINGS OR "TAPS" OF OUTSTANDING DEBT

An upsize or tap results when a borrower issues additional debt instruments with the same terms as, and which are intended to trade on a fungible basis with, an outstanding tranche of original debt instruments. In order for the additional debt instruments to be fungible with the existing debt instruments, one of the "qualified reopening" tax safe harbors permitting such fungibility must be met.

- The most commonly used safe harbor for tax fungible tack-ons requires the additional debt to be issued with less than a *de minimis* amount of OID. OID on a cash-pay debt instrument is generally considered less than *de minimis* if it is less than 25 basis points multiplied by the number of complete years to maturity (or weighted average maturity in the case of an amortizing debt instrument) remaining on the debt instrument.

- Assuming the *de minimis* safe harbor is not available, taxpayers may be able to take advantage of special safe harbors that apply if the incremental debt is issued within six months of the original debt instrument (assuming it meets the "110% yield test") or, in certain cases if the original debt was issued with more than *de minimis* OID, the incremental debt is issued at a price equal to or more than the accreted amount of the original debt. In certain cases, taxpayers may be able to look to the trading price of their original debt on a pricing date (or, if earlier, the date of announcement of the intent to issue additional debt) to determine compliance with such rules.

If the original debt is modified and the modification is a significant modification causing a deemed reissuance, as discussed above, there should be no fungibility issue so long as the amendment and the issuance of the additional debt close within a 12-day period.

Latham & Watkins published a *Client Alert* analyzing the tax fungibility rules in greater detail, available here.

6. HEDGING

a. Putting in Place New Hedging Transactions

During periods of market volatility, taxpayers may have more incentive to enter into hedges (such as currency and interest rate hedges) to reduce their exposure to dramatic market movements with respect to financing transactions. As taxpayers consider entering into hedges, they should be aware of certain elections that may be available to eliminate or alleviate timing and character mismatches between the economically offsetting income and loss items arising from the financing and hedge on a go-forward basis. These elections, when made, may permit the taxpayer to "integrate" the hedge and the underlying financing for tax purposes, and thus to treat the two transactions as a single integrated debt instrument. Even if integration is not possible, a taxpayer may be permitted to identify the hedging transaction as a proper hedge of a specific financing transaction for US federal income tax purposes, which may similarly eliminate some of the aforementioned mismatches. These tax elections are time-sensitive — they generally must be made on the day the hedging transaction is entered into to be valid. Taxpayers should maintain close coordination between their tax departments and treasury departments so tax advisers can ensure that any required tax elections are made on a timely basis.

b. Amendments of Existing Hedging Transactions

Taxpayers considering a refinancing or debt restructuring may need to modify existing hedging transactions. Such taxpayers should be mindful of any resulting tax consequences. Similar to the rules outlined above in the context of the modification of a debt instrument, such changes, depending on their nature, may result in a significant enough change to the hedging transaction to be treated as a taxable exchange, requiring the taxpayer to recognize gain or loss for US federal income tax purposes. The guidance as to when a modification of a hedging transaction is a taxable event is more limited than in the context of debt instruments and may require a closer analysis.

The tax consequences of such significant modification to a hedging transaction may also depend on whether the company previously made an election to integrate the hedge with a financing transaction, or elected to identify such hedge as a hedge of a specific financing transaction, as described above in *Putting in Place New Hedging Transactions*.

7. CONSIDERATIONS FOR PURCHASERS OF DISCOUNTED DEBT

Investors purchasing debt at a significant discount to the face amount, and investors who own debt trading at distressed levels, should consider to what extent, if any, now, or in the future, they can:

- Stop recognizing interest income, including OID, as it accrues (as to stated interest, a consideration only for accrual basis investors)
- Avoid applying the market discount rules (which would otherwise require gain recognition to be treated as ordinary income to the extent of accrued market discount)

The ability to take such positions requires a highly factual analysis. For example, if the discount in the trading price arises from an increase in market interest rates or short-term market dislocations, it may be difficult to take such positions. On the other hand, if the discount arises because the issuer's ability to pay interest and principal is in doubt, such positions may be supportable (especially if a payment default has occurred).

Guidance in this area is not always clear or consistent, and may apply differently to OID, for example, than to stated interest or market discount.

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Endnotes

[1] See *Plantation Patterns v. Commissioner*, 462 F.2d 712 (5th Cir. 1972) (Shareholder of a corporation treated as borrower of debt where shareholder guaranteed debt, corporation was thinly capitalized and guarantee was "regarded as the real undergirding for the deal").

[2] See *Seminole Thriftway Inc. v. United States*, 42 Fed. Cl. 584 (1998) (Fees paid to shareholders who guaranteed debt of corporation treated as constructive distributions where shareholder did not demand compensation for prior or future guarantees).

[3] In order to obtain a perfected security interest over a tax refund, a security agreement covering the tax refund and a UCC-1 filing generally would be required.