It's About Time: Taxation of Delayed Draw Term Loans

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Many companies are well versed in the adage that "cash is king, but credit is power." Most commonly, credit takes the form of two types of borrowings: (1) revolvers that can be drawn and repaid when needed, like a credit card, and (2) term loans (or debt securities) that are drawn once, usually on the closing date for the facility, and remain outstanding for a term of years. These two types of facilities satisfy the borrowing needs of many companies. But what if a borrower needs ready access to credit for an acquisition or large capital expenditure in the future, and that need is not solid enough for the borrower to want the cash now in the form of a term loan? If the borrower's revolver is large enough (or the expenditure is small enough), then the borrower could draw upon it, but would no longer have that revolver available for future cash-flow needs. In addition, because revolvers can be drawn at any time and are typically available for five years or more, the market of revolving lenders is potentially smaller than that of term loan lenders. A middle ground has become more popular in recent years: the Delayed Draw Term Loan ("DDTL").

A DDTL is a type of term loan that is available to be drawn for a certain period (or at a certain point) after the closing date for the facility under which it is established.[1] DDTLs are often established as one of several facilities within an overall credit agreement and are typically intended to be used for specifically identified acquisitions or general expansions (such as for making capital expenditures).[2] Due to the flexibility DDTLs provide, the syndicated leveraged loan market has experienced an increased use of DDTLs in recent years.[3] They are now popular among both borrowers and lenders (including non-bank lenders[4]) and featured in many leveraged financing transactions.

DDTL facilities combine some of the most flexible aspects of revolvers and term loans. They provide easy access to a preestablished and committed source of funding like a revolver. But once drawn, they act—and may be treated for corporate law purposes (but, as discussed below, perhaps not tax purposes)—like an existing term loan. Once funded, DDTLs generally carry the same terms as the term loans (included as part of the overall credit facility) and the parties generally view the DDTLs as an upsize of the initial term loans, as opposed to a standalone tranche of debt. For example, a typical bank facility in the syndicated leveraged

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loan market might feature a term loan of $400 million that matures seven years from the closing date, a revolving facility of $60 million available for a commitment period of five years from the closing date, and a $100 million DDTL facility available to draw for two years from the closing date.

But, as with most things in life, the flexibility that DDTLs provide does not come free. The cost comes in the form of various fees the borrower must pay to the committed lenders when the facility is established, while it is available to be drawn, when a draw is made and, potentially, when the facility terminates.

Life is easier when draws under a DDTL are tax fungible with the term loans comprising part of the same credit facility. But good things in life rarely come easy.

The unique nature of DDTLs (with both revolver-like and term loan-like characteristics) poses challenges in analyzing their U.S. tax treatment. As discussed above, DDTL commitments are normally extended in connection with larger term loans drawn on the closing date[5] and, if drawn, are generally intended to be a fungible increase of the initial term loan. From a U.S. tax perspective, however, tax fungibility largely depends on the tax treatment of the loan (and any associated fees). Given that the closing-date term loan is often a substantially larger amount, the DDTL trading together with the closing-date term loan would increase the liquidity of the tranche and simplify original issue discount ("OID")[6] tax reporting. On the flipside, the lack of tax fungibility can be undesirable. Although the parties are usually not overly concerned about the amount, or the accrual schedule, of the OID on the loans (which was the intended concern of the tax fungibility regime[7]), they are often concerned about tax fungibility due to its economic implications on trading and reporting. For a DDTL facility with tax fungibility not assured at the outset due to its fee structure, the parties may have to determine, based on the circumstances, whether each DDTL draw is tax fungible. If the draw is not fungible, the parties then must track the subsequent loans as separate from the initial term loan and, potentially, from other draws. This article analyzes certain unique tax questions that arise from DDTLs in typical leveraged-finance transactions and illustrates the concepts with several examples.

Fees on DDTLs

Before we turn to the topic of fungibility, we must first discuss the treatment of fees on a DDTL. The characterization of fees not only can have a direct impact on whether the draws on a DDTL meet the standards for tax fungibility, but also can affect the deductibility of the fee for the issuer (both as to timing and whether Code Sec. 163(j) applies), the character and timing of the income, and the potential application of the withholding rules for the lender.[8] Consider a typical DDTL fact pattern:

Example 1. Borrower and lenders agree that the lenders will extend to the borrower on the closing date a term loan of $400 million with a 2% fee calculated as a percentage of the term loans to be funded (*i.e.*, $8 million). The parties also agree that the borrower will have access to a $100 million DDTL facility for two years from the closing date that can be drawn on one or more occasions. In connection with the facility, the borrower agrees to pay to the lenders the following fees:

(1) "Ticking Fees," paid periodically on the principal amount of the unused DDTL commitments held by a lender at a rate (as a percentage of the unused commitment amount) equal to (x) 0.0% for the period up to three months after the closing date, (y) 1% for the period from three months after the closing date through one year following the closing date and (z) 2% for the period after one year following the closing date;

(2) a 1% "Closing Fee," calculated as a percentage of total DDTL commitments (*i.e.*, $1 million) payable on the closing date, on a nonrefundable basis regardless of whether DDTLs are ever drawn; and

(3) a 1% "Funding Fee," calculated as a percentage of the amount of any DDTL funded, payable if and when funded (*e.g.*, if the borrower draws $25 million, the borrower will pay a fee of $250,000).

Ticking Fees

The Ticking Fees resemble typical commitment fees paid on the undrawn portion of a line of credit.[9] The question then is whether this type of periodic commitment fee

constitutes OID, or another form of interest, for U.S. federal income tax purposes (which may affect the yield to maturity of the debt).[10] In nonprecedential guidance, the IRS has indicated that periodic commitment fees paid based on the average undrawn amount under a line of credit are not OID, but instead are deductible under Code Sec. 162 in the tax year incurred.[11] In so concluding, the IRS considered whether the commitment fee could be viewed as a premium paid on an option contract (*i.e.*, an option to borrow under the line of credit), and concluded that even if the fees were treated as option premiums, because the amounts were paid in arrears, they should nevertheless be deducted currently.[12] Although taxpayers may not rely on this guidance, the IRS's analysis appears reasonable and is generally consistent with how many tax advisors have historically viewed periodic fees with respect to revolving facilities. It seems to make sense to treat Ticking Fees consistently with periodic fees on revolving facilities. Accordingly, it is fair to assume that Ticking Fees are deductible by the issuer as a Code Sec. 162 expense (and do not create OID on the loan).[13]

Closing Fee

Closing Fees are generally stated as a fixed amount (usually a percentage of the total commitment) payable regardless of how long it takes for loans to be drawn (or whether they are drawn). One approach is to view Closing Fees as a commitment fee that does not reduce the issue price under Reg. §1.1273-2(g)(2)(i), which provides that:

> In a lending transaction to which section 1273(b)(2) applies [i.e., debt issued for money], a payment from the borrower to the lender (*other than a payment for property or for services provided by the lender, such as commitment fees or loan processing costs*) reduces the issue price of the debt instrument evidencing the loan. (Emphasis added.)

This position would be based on the fact that the fee is payable regardless of whether the loan is drawn and thus should be analyzed separately from the loan. To take this position, however, the facts should indicate that there is no certainty that the DDTL will be drawn—because if a loan will most likely be drawn, the parties should not be able to change the tax treatment of a fee that would otherwise be considered OID by designating it as a "commitment fee" and providing the fee be paid, for example, a few days before the draw. For most DDTL facilities, the amount, if any, of the DDTLs that will be drawn is uncertain, so this factual hurdle ultimately might not be hard to overcome.

This approach of relying on Reg. §1.1273-2(g)(2)(i) does not entirely resolve how lenders and borrowers should account for this fee, since it is a lump sum fee paid upfront (as opposed to a Ticking Fee, which is paid periodically and whose amount is based on the passage of time). Closing Fees are commonly analogized to option premiums the issuer pays to the DDTL lenders for agreeing to stand ready to buy its debt (*i.e.*, lend the issuer money) on pre-agreed terms. This approach is consistent with the treatment of similar fees in *Fed. Home Loan Mortg. Co.*, in which the Tax Court treated the nonrefundable portion of certain "commitment fees" for entering into prior-approval contracts with originating banks as put option premiums.[14] The IRS took a similar approach in Rev. Rul. 81-160,[15] which treats a commitment fee as a premium paid for a property right (an option). In the ruling the IRS stated:

> A loan commitment fee in the nature of a standby charge is an expenditure that results in the acquisition of a property right, that is, the right to the use of money. Such a loan commitment fee is similar to the cost of an option, which becomes part of the cost of the property acquired upon exercise of the option. Therefore, if the right is exercised, the commitment fee becomes a cost of acquiring the loan and is to be deducted ratably over the term of the loan. *See* Rev. Rul. 75-172, 1975-1 C.B. 145, and *Francis v. Commissioner*, T.C.M. 1977-170. If the right is not exercised, the taxpayer may be entitled to a loss deduction under section 165 of the Code when the right expires. *See* Rev. Rul. 71-191, 1971-1 C.B. 77.[16]

Viewed through this lens, the Closing Fee (although paid upfront) would be treated as an adjustment to the purchase price of the debt if and when it is ultimately issued. However, simply concluding that the fee ought to be treated as a purchase price adjustment does not complete the analysis—there is also a question about how the fee should be allocated and accounted for following a draw under the DDTL. There are various approaches to how these purchase price adjustments can be treated.

Under the first approach ("Deferred OID Approach"), a *pro-rata* portion of the Closing Fee would be allocated to each draw (if and when drawn). The allocated Closing Fee

would be deemed to reduce the issue price and create OID. Under this approach, if the amount of the Closing Fee (as a percentage of the face amount) is equal to the amount of OID (as a percentage of the face amount) on the original loan, each additional draw would have the same amount of OID as the original loan but a shorter term over which to amortize the amount, because the DDTL loan would have a shorter term than the original loan (and hence, a higher yield).[17] Under the Deferred OID Approach, as discussed later in this article, the DDTL draws may not constitute a "qualified reopening" (depending on the time of the draw and the amount of OID) and there could be a tax fungibility concern.

Under the second approach ("Market Discount Approach"), the Closing Fees would be allocated in the same manner as the Deferred OID Approach, but the Closing Fee allocated to each draw would result in market discount (instead of OID) from the lender's perspective. The argument here would be that the "option" transaction is separate from the actual loan and, even though the option premium should reduce the lender's tax basis, it should not create OID on the loan. This approach may be supported by one reading of Reg. §1.1273-2(g)(2)(i), indicating payments "for property or for services" do not reduce issue price. Under the Market Discount Approach, assuming the lenders do not receive any other DDTL fees that should be treated as OID, the DDTL draws would be deemed to be issued at par and be tax fungible regardless of when they are drawn (assuming the DDTL is otherwise identical from a non-tax perspective).

Under the third approach ("Amortization Approach"), the Closing Fee could be treated as a premium paid for a series of daily options (for each day during the delayed draw period). Under this approach, a portion of the Closing Fee (relating to the undrawn amount—*i.e.*, the unexercised option) would be taken into account on a *pro-rata* basis on each day over the course of the DDTL commitment period.[18] Upon a draw, a *pro-rata* portion of the remaining (unamortized) fee would be treated as a purchase price adjustment (resulting in OID). Under the Amortization Approach, if the Closing Fee on the DDTL does not exceed the OID on the initial term loan (and there are no other fees payable with respect to the DDTL that can create OID), the DDTLs would be expected to have no more OID than the unamortized OID on the initial term loan (and therefore would be tax fungible regardless of when they are drawn). Notably, most revolvers in the market also feature Closing Fees and the more typical borrower-side treatment of these fees is to deduct them over the life of the revolving facility (*i.e.*, the time period over which the revolvers can be drawn), regardless of when or whether the loans are drawn. The Amortization Approach would be comparable to the general treatment of Closing Fees for revolving facilities. However, this treatment is inconsistent with the tax treatment of options generally, which are often analyzed as single options (as opposed to a series of independent options each of which expires daily if unexercised).[19]

Given the ambiguity over how to properly analyze the adjustment to purchase price resulting from a Closing Fee, a fourth potential approach ("Immediate Income Approach") could be for the lenders to pick up the Closing Fee as income upon receipt (*i.e.*, at closing). This approach seems to be supported by IRS guidance addressing commitment fees received by lenders, which require such fees to be included in income currently (as opposed to being amortized or treated like interest).[20] Although the character of the fee under this approach could continue to be an option premium (as that treatment appears to be the closest analogy, and is still relevant to determine the source of income for withholding tax purposes), U.S. taxable lenders would "conservatively" report the fee as ordinary fee income upon receipt. Under this approach, the DDTL draws would once again be deemed to be issued at par and automatically tax fungible regardless of when they are drawn (assuming the DDTL is otherwise identical from a non-tax perspective).

The approach that taxpayers select will impact more than simply tax fungibility. It will also affect the timing and character (*i.e.*, whether or not the fee constitutes an item of interest) of any income/deduction, as well as the treatment of foreign lenders (*e.g.*, withholding and any U.S. trade or business concerns). Whether the IRS would challenge any of these approaches may ultimately depend instead on these ancillary considerations, rather than fungibility. Nevertheless, while the treatment of Closing Fees under existing law is ambiguous, arguments can be made that Closing Fees do not create OID for purposes of the tax fungibility analysis.

Funding Fees and Commitment Termination Fees

The Funding Fee more squarely resembles OID. It is paid at funding and payable only if the loans are funded.[21] From a tax perspective, labeling this amount as the payment of a fee is the same as stating that any draws are advanced at a discount. Thus, the Funding Fee generally would affect the yield to maturity of the instrument.

The potential payment of a Commitment Termination Fee, however, could make it less clear that the Funding Fee should be treated as OID.

> **Example 2.** Same facts as Example 1, except, if the DDTL commitments are not entirely drawn, the borrower will pay a Commitment Termination Fee equal to 1% of the undrawn portion of the DDTL commitments, at the time the commitments are terminated or expire.

In this example, ultimately, the borrower has agreed to pay a 1% fee regardless of whether the DDTLs are borrowed; whether the loans are drawn only changes the timing of the fee payment. As a result, one could argue that together the Funding Fee and the Commitment Termination Fee are in substance the same as a Closing Fee (except for the timing of the payment). Because Commitment Termination Fees are relatively rare, the practice around their tax treatment (and their impact on the tax treatment of Funding Fees) is less clear.

Having explained the various fees that may be incurred, we next provide an overview of the qualified reopening rules before discussing their application to DDTLs.

The Qualified Reopening Rules—An Overview

Since this article examines the application (or not) of the qualified reopening rules, we briefly summarize the rules in the context of common bank financing transactions before going into the intricacies of how they apply to DDTLs. The qualified reopening rules apply in situations in which an issuer of debt wants to issue additional debt with identical terms (often called a "tack-on" or an "incremental") that is "fungible" with the original issuance.[22] Here, the term fungible, a non-tax term, means the debt is indistinguishable from another debt such that it is given the same Committee on Uniform Securities Identification Procedures ("CUSIP"), International Securities Identification Number ("ISIN"), or other identifying number, and therefore trades in the market no differently from the original debt.[23] To achieve fungibility, the additional debt instruments must also bear the same tax characteristics—such as the amount of OID—often referred to as "tax fungibility."

Turning to why the rules exist in the first place, recall that taxpayers often desire that additional debt that is economically fungible with existing debt also be fungible from a tax perspective. If additional debt instruments meet the requirements to be a qualified reopening, they are treated as having the same issue date, issue price, and, with respect to holders, adjusted issue price as the original debt instruments, thus ensuring fungibility.[24] However, the taxpayer's desires and the government's interest are not necessarily aligned in this respect, primarily because of the distinction between the taxation of OID and market discount.

In analyzing the purported tax treatment, the IRS will focus on the substance of the transaction (and any associated fees), so taxpayers should ensure that the substance of the transaction aligns with the purported tax treatment. Nevertheless, taxpayers need not despair because they have at their disposal several potential approaches to achieving tax fungibility.

A debt instrument is treated as issued with OID if the principal amount of the notes exceeds their issue price by more than a *de minimis*[25] amount (discussed below).[26] A lender accrues OID into income (as interest income) on a constant-yield basis over the term of the note regardless of whether the lender is an accrual or cash-method taxpayer. A debt's OID carries over to assignees, regardless of the assignees' purchase price.[27] On the other hand, any decline in the value of a note after the date of issuance until the date of purchase by an investor, other than a *de minimis* amount, is considered market discount.[28] Unlike with OID, a lender does not have to accrue market discount over the term of the debt. Instead, unless a holder makes a special election to include market discount in income currently, market discount is taxed only when principal payments are received or the debt is disposed of, and in the latter case, only to the extent the holder recognizes gain.[29] If additional debt is treated as part

of the same issue as outstanding notes, the additional debt would have the same issue price and OID (if any) as the original debt, such that any additional discount would be market discount. By contrast, if the additional debt were not fungible with the outstanding debt, all of the discount on the additional debt would be treated as OID (if not *de minimis*). Due to this distinction between OID and market discount, the qualified reopening rules impose limitations on circumstances in which parties to a financing can convert what would otherwise be OID into market discount, and thereby defer the recognition of income.

As a threshold matter, the qualified reopening rules require that the additional instruments:

(a) Are part of a single issue of debt instruments;
(b) Are not part of the same issue as the original debt instruments; and
(c) Have terms that are in all respects identical to the terms of the original debt instruments as of the reopening date.[30]

For purposes of this article, assume these requirements are satisfied with respect to DDTL draws (though careful attention should be paid to these requirements, particularly (c)), as is the case for typical DDTL facilities.

The qualified reopening rules also contain rules focused on the time elapsed since the original instruments were issued—whether the original debt instruments are publicly traded[31] or issued at an arm's-length price to persons unrelated to the issuer—and the yield of the additional debt instruments (at issuance) relative to the yield of the original debt instrument.[32] In certain cases, additional requirements outside the qualified reopening regulations may also need to be satisfied.[33]

Regardless of when the additional debt instruments are issued, under most circumstances,[34] the additional debt instruments will automatically be considered fungible with original debt instruments if the additional debt instruments are issued with *de minimis* OID. Otherwise, the rules apply differently depending on whether the additional debt instruments are issued within six months of the original issue date.

If the reopening occurs within six months after the date on which the original debt instruments were issued, a reopening for cash (at an arm's-length price) will generally be a qualified reopening if the yield to maturity of the additional debt instruments (based on their cash purchase price) is not greater than 110% of the yield to maturity of the original debt instruments (on their issue date).[35] On the other hand, if the reopening occurs more than six months after the date on which the original debt instruments were issued, a reopening issued for cash (at an arm's-length price) will generally be a qualified reopening if the yield to maturity of the additional debt instruments based on their cash issue price is not greater than 100% of the yield to maturity of the original debt instruments (on their issue date).[36] This 100% yield test rule functionally requires that the additional debt instruments have no more OID (as a percentage of the amount of debt to be issued) than the amount of unamortized OID on the original debt instruments (as a percentage of the amount of debt outstanding). For both the 110% yield test and the 100% yield test, the yield of the original debt is assumed to be the coupon rate (or put differently, OID on the original debt is assumed to be 0%) if the OID on the original debt is *de minimis*.[37] For purposes of the 100% yield test and 110% yield test, the yield of the additional debt instruments is determined on the date on which the price of the additional debt instruments is established (or, if earlier, announcement date).[38] It is not entirely clear what relevance such date has when the yield tests are analyzed using the actual issue price.[39]

The 100% yield test and 110% yield test described above can be also applied based on the trading price of the original debt on the date on which the price of the additional debt instruments is established (or, if earlier, announcement date), instead of the cash issue price.[40] However, if parties are evaluating tax fungibility of a future tack-on (as in the case of DDTL draws), the trading price tests are of limited use in providing advance comfort regarding tax fungibility. Furthermore, the date on which "the price of the additional debt instruments is established" or "the announcement date" is unclear for a DDTL facility. As a result, the trading price tests are not usually relied upon in DDTL tax fungibility analyses and will not be further addressed in the examples below.

How Do the "Qualified Reopening" Rules Apply to DDTLs?

Having discussed what fees may constitute OID on a DDTL and how the qualified reopening rules apply in the abstract, we now turn to how those rules apply to specific situations involving DDTLs.

DDTL Draws with *De Minimis* OID

Under most circumstances,[41] a DDTL draw would generally be considered automatically fungible if issued with *de minimis* OID. The *de minimis* limit is 25 bps[42]

multiplied by the number of complete years from the date drawn to maturity (or, if the loan is amortizing, the weighted-average maturity).[43] Thus, whether the DDTL draws are fungible may depend on when they are drawn.

Example 3. Lenders will extend to the borrower on the closing date an initial term loan with a six-year term to maturity (with no principal amortization) and a 5% coupon.[44] Lenders will also extend a DDTL facility with a commitment period of two years with the same terms. The initial term loan and all DDTL draws will be extended with 1.20% OID. Assume the borrower makes two draws—the first draw is nine months after the original issue date and the second draw is 13 months after the original issue date. The lenders are otherwise not related to the borrower within the meaning of the qualified reopening rules.

Analysis. Under this fact pattern, with respect to the initial term loan, the *de minimis* OID limit would be 1.50% (*i.e.*, 25 bps × 6, the number of complete years to maturity). The initial term loan with 1.20% OID would therefore be considered to have *de minimis* OID. The first DDTL draw would have five complete years to maturity and, therefore, the *de minimis* OID limit would be 1.25%. Accordingly, the 1.20% OID on the first DDTL draw would be *de minimis* and the first DDTL draw would be tax fungible. The second DDTL draw, however, would have four complete years to maturity and, therefore, the *de minimis* OID limit will be 1%; as a result, its OID of 1.20% would not be *de minimis*. The second DDTL draw would, therefore, not be tax fungible with the initial term loan.

Interestingly, if a DDTL draw is not fungible, such that it is treated as a standalone debt instrument, the tax fungibility analysis restarts as applied to that standalone debt instrument. In that case, it is possible that subsequent DDTL draws may not be fungible with the initial term loan but may be fungible with previous draws that were not fungible with the initial term loan.

DDTL Draws Within Six Months

If the DDTL draws have more than *de minimis* OID and the initial term loan has *de minimis* OID (or both the DDTL draws and initial term loans have more than *de minimis* OID), the DDTL draws can potentially still be tax fungible if they are drawn within six months of the initial term loan, depending on the application of the 110% yield test. However, if the DDTL commitment period exceeds six months, this safe harbor may not provide sufficient protection for all potential DDTL draws.

Example 4. Lenders extend to the borrower on the closing date an initial term loan with a six-year term to maturity (with no amortization) and a 5% coupon. The lenders also extend a DDTL facility with a commitment period of two years with the same terms. Both the initial term loan and the DDTL draws will be extended with 1.40% OID. The borrower makes two draws: the first draw occurs three months after the original issue date, and second draw occurs nine months after the original issue date. The lenders are otherwise not related to the borrower within the meaning of the qualified reopening rules.

Analysis. Under these facts, the OID on the initial term loan would be *de minimis* (*see* the analysis of Example 3). However, the OID on the DDTL draws would not be *de minimis*; therefore, the *de minimis* safe harbor would not be available. However, the 110% yield test safe harbor would be available for the first six months after closing and, for a draw three months after the closing date, would allow OID of up to approximately 2.40%.[45] Accordingly, the first draw, with OID of 1.40%, would be fungible with the initial term loan. However, the second draw would not be fungible because the 110% yield test does not apply beyond six months after the closing date (and the OID on the second draw is more than *de minimis*).

Initial Term Loan With More Than *De Minimis* OID

For any DDTL drawn more than six months after the initial term loan is issued and with more than *de minimis* OID, the only remaining qualified reopening safe harbor is the 100% yield test. The 100% yield test essentially requires that the additional debt instruments have no more OID (as a percentage of the amount of debt to be issued) than the amount of unamortized OID on the original debt instruments (as a percentage of the amount of debt outstanding). Furthermore, under the

100% yield test, the OID of the original debt is assumed to be 0% if it is *de minimis*. Therefore, if the subsequent DDTL draw has any OID (even if *de minimis*), the 100% yield test is only helpful if the initial term loan is issued with more than *de minimis* OID. Similar to the 110% yield test, the qualified reopening limit under the 100% yield test would change based on the exact time of the DDTL draw.

Example 5. Lenders will extend to the borrower on the closing date an initial term loan with a six-year term to maturity (with no amortization) and a 5% coupon. Lenders will also extend a DDTL facility with a commitment period of two years with the same terms. The initial term loan will be extended with 2% OID and the DDTL draws will be extended with 1.50% OID. The borrower makes two draws—the first draw is eight months after the original issue date and the second draw is 24 months after the original issue date. The lenders are otherwise not related to the borrower within the meaning of the qualified reopening rules.

Analysis. Under these facts, the OID on the initial term loan as well as the DDTL draws would not be *de minimis*; as a result, the *de minimis* safe harbor would not be available. Furthermore, both DDTL draws are made more than six months after the closing date, making 110% yield test safe harbor unavailable. However, because the OID on the initial term loan was not *de minimis*, the 100% yield test may be satisfied. For a draw eight months after the closing date, the 100% yield test would allow OID of up to approximately 1.80%. Accordingly, the first draw, with OID of 1.50%, would be fungible with the initial term loan. For a draw 24 months after the closing date, however, the 100% yield test would allow OID of up to approximately 1.40%. Accordingly, the second draw, with OID of 1.50%, would not be fungible with the initial term loan.

How to Address Fungibility Concerns

As the examples in preceding section demonstrate, DDTL draws over the course of the DDTL commitment period may not be tax fungible with the initial term loan depending on the time of the DDTL draw and the amount of any associated OID. That raises the question: Can a DDTL (and the associated fees) be structured to provide the same general economics in a manner that ensures fungibility for all draws over the DDTL commitment period? Several approaches may be taken, each raising its own interesting tax issues/challenges.

Changing Terms of Fees

One potential approach would be to restructure any Funding Fee on the DDTL as a Closing Fee[46] and take the view that, under these revised terms, the fee does not constitute OID on the new debt. To demonstrate, under Example 3 above, the parties could structure the 1.20% fee on the DDTL as entirely (or partially) a Closing Fee that is paid at closing as a percentage of the total DDTL commitments. As discussed above in the more detailed discussion of Closing Fees, this change in terms, while ambiguous, allows an argument that the DDTL draws have no (or low enough) OID, such that the OID on the DDTL would be considered *de minimis* and the DDTL draws would be automatically fungible with the initial term loan, regardless of when the DDTLs are drawn during the two-year commitment period. However, this type of a change in the fee structure could be an unacceptable commercial deviation from the agreed terms from the perspective of the borrower because it would require the borrower to pay a fee upfront with respect to its DDTL commitments, as opposed to paying a fee only when DDTLs are actually drawn.

Original Issue Date as Qualified Reopening Measuring Date

As noted above, even where a cash issue price is used to measure tax fungibility, both the 100% yield test and 110% yield test described above are applied on the date on which the price of the additional debt instruments is established (or, if earlier, the announcement date).[47] This approach differs from most rules governing debt instruments in that it is not applied on the settlement date. The apparent intent of this rule is to permit taxpayers to know, prior to the closing date of a reopening, whether debt that was going to be reopened would be part of a qualified reopening—though, as discussed previously, it is not entirely clear why such date is relevant for a test based on a cash issue price.[48] In any event, the drafting of the qualified reopening regulations could allow taxpayers to argue that the price of a DDTL is "established" on the closing date, and therefore, that the qualified reopening rules are satisfied for all draws (under the 110% yield test for the draws within six months, and under the 100% yield test thereafter) if the expected OID on the DDTL

draws would not exceed the OID on the initial term loan on the closing date.[49]

Stapling Techniques—*Pro-Rata* Syndications

Assuming DDTLs have too much OID to be tax fungible with the initial term loans, the parties may consider whether fungibility (or, more importantly, liquidity) can be achieved in a different manner. The answer usually depends on who holds the DDTLs. If the DDTL facility is syndicated *pro rata* at the same percentages as the initial term loan, it may be possible to "staple" the DDTL commitments to the initial term loans to create a single unit (which itself can be traded). Although, under tax law, stapled securities are typically considered a single item of property,[50] in this context, treating each strip as separate may achieve the government's goal of accurate reporting of OID accruals, especially because there is no direct economic linkage between the various components (*i.e.*, they do not offset or otherwise rely on one another).

Example 6. Lenders will extend to the borrower on the closing date a $100-million initial term loan with a six-year term to maturity (with no amortization). Lenders will also extend a DDTL facility with a commitment size of $100 million and a commitment period of two years with the same terms. Both the initial term loan and the DDTL draws will be extended with 1.20% OID. The borrower makes two draws—the first draw of $35 million is nine months after the original issue date and the second draw of $15 million is 13 months after the original issue date.

Parties agree any assignment of any portion of the initial term loans shall include a simultaneous assignment of a proportionate amount of the DDTL commitments and any DDTLs draws held by the assigning lender (together, a "stapled unit"). Parties further agree to treat the initial term loans (for this purpose, including any fungible DDTL draws) and each non-fungible DDTL draw that comprises each stapled unit as separate instruments for U.S. income tax purposes.

Analysis. As discussed in Example 3 above, the first draw will be considered to have *de minimis* OID and be fungible with the initial term loan. The second draw will be considered to have more than *de minimis* OID and, given the other safe harbors do not apply, will not be tax fungible with the initial term loan.

Since the first draw is fungible, it would increase the outstanding loan from $100 million to $135 million. The stapling mechanics does not achieve fungibility for the second draw of $15 million. However, it allows parties to report every $1 of principal amount of loans held by the lenders as consisting of two strips—a 90% strip with *de minimis* OID consisting of the initial term loan and the first DDTL draw and a 10% strip attributable to the second DDTL draw with a separate OID accrual schedule.

The drawback of the stapling approach is that, to facilitate accurate reporting, the initial term loan and the DDTL commitments must be syndicated and transferred *pro rata* over the course of the DDTL commitment. In Example 6, a lender that buys a percentage of the initial term loan of $100 million in the original syndication would also have to agree to take on the same percentage of the total DDTL commitments of $100 million. If the lender later wants to assign part of its interest in the initial term loan, it would have to transfer that interest and a *pro-rata* portion of any DDTL draws to a person who would agree to take on a *pro-rata* portion of the outstanding DDTL commitments. Furthermore, the stapling approach may pose difficulties in the future—for example, when the borrower is looking to issue an incremental debt intended to be fungible with the initial term loan or when the borrower is looking to increase DDTL commitments with new lenders.

Notably, the stapling approach would be consistent with how revolving facilities in the market currently function. That is, in most revolving facilities in the market, lenders must hold their *pro-rata* share of the revolving commitment exposure at all times and funded portions of the revolvers cannot be separated from the unfunded revolving commitments. To demonstrate numerically, consider a fact pattern where an existing lender holds a revolving facility of a total of $100 million—$75 million already funded and $25 million in unfunded commitments. If a revolving lender were to assign $10 million of the facility, it must transfer both $7.5 million of the funded portion and $2.5 million of the unfunded commitments.

Nonetheless, stapling is more straightforward to implement for revolvers. Revolvers often do not involve Funding Fees, so they can more easily be analyzed as being funded with no OID (and, under normal circumstances,

automatically fungible) for U.S. federal income tax purposes. In addition, revolving facilities do not trade as frequently, so liquidity and tax fungibility considerations are less material. Term loans, on the other hand, are much more liquid and often fund with OID (especially when they involve Funding Fees) so tax fungibility is both more important and harder to analyze. Even if stapled to achieve fungibility, OID reporting for DDTLs would be more complicated when there are various strips with different OID accrual schedules. Furthermore, banks, which are typical revolving credit lenders, have historically been more accommodating of holding commitments. By contrast, term loan lenders may have more limitations against the amount and duration of the delayed draw commitments they want to hold.

In sum, stapling is a potential solution that can allow increased liquidity when the initial term loan and the DDTL commitments can be syndicated and transferred *pro rata* over the course of the DDTL commitment period. However, stapling could constrain trading and any future upsize or similar transactions.

Stapling Techniques—Non-*Pro-Rata* Syndications

Syndicating and trading initial term loans and DDTL commitments on a *pro-rata* basis is not always commercially possible. In that situation, parties may attempt to achieve *pro-rata* status by a deemed transaction across the various holders. Under this approach, if the parties determine that any of the DDTL draws will not be fungible for U.S. federal income tax purposes with the initial term loan, the parties could use self-help to put in place a reallocation arrangement. If necessary to facilitate the reallocation arrangement, there could be a deemed-sale mechanism for the lenders to swap positions in initial term loans and DDTL draws such that each lender owns a *pro-rata* portion of each portion of the initial term loan and the DDTL draws, and thereby the initial term loans will trade as a unit with each of the DDTL draws. Under this approach, the lenders holding DDTL commitments would effectively be selling their DDTL draws to lenders holding initial term loans in return for the corresponding portion of the initial term loans effectively to achieve *pro-rata* stapling as the DDTLs are drawn.

The drawback of this approach is that finding substance in such a deemed transaction is difficult because the parties would not actually enter into separate agreements to buy or sell interests in various pieces of the loan. Because the deemed transactions would also change the OID profile of the loans held by each lender, they might draw IRS attention as well. Furthermore, depending on fluctuations in the price of the loan, the selling lenders may arguably[51] be required to recognize gain (and potentially not loss, under wash sale or similar doctrines). It is not clear whether this mechanism would be analyzed as a non-significant modification of the debt instrument (or the stapled unit) that changes nothing but its tax treatment, or whether the correct approach is to analyze this fact pattern as the purchase and sale of debt instruments for U.S. federal income tax purposes.[52] Gain recognition may come as a surprise to the lenders and may also require parties to agree on a deemed transaction price to account for any gain realized. To add, if this approach were possible, it presumably could be used to resolve tax-fungibility issues generally for incremental loans.

Parting Thoughts

Life is easier when draws under a DDTL are tax fungible with the term loans comprising part of the same credit facility. But good things in life rarely come easy. Such is the case with applying the qualified reopening rules to DDTLs—in particular, because of the unclear treatment of various fees paid in connection with DDTLs. Although this lack of clarity may provide structuring opportunities to achieve tax fungibility, it also creates uncertainty as to whether a taxpayer's expected tax treatment will be respected in all cases. In analyzing the purported tax treatment, the IRS will focus on the substance of the transaction (and any associated fees), so taxpayers should ensure that the substance of the transaction aligns with the purported tax treatment. Nevertheless, taxpayers need not despair because they have at their disposal several potential approaches to achieving tax fungibility.

ENDNOTES

* The views expressed are those of the authors and do not necessarily reflect the views of EY or any other member firm of the global EY organization.

This article is provided solely for the purpose of enhancing knowledge on tax matters. It does not provide accounting, tax, or other professional advice because it does not consider any specific taxpayer's facts and circumstances.

1 *See* description of "Delayed Draw Term Facility" at Latham & Watkins, THE BOOK OF JARGON—US CORPORATE AND BANK FINANCE, available online at *www.lw.com/bookofjargon-apps/boj-us-corporate-and-bank-finance*.

2 *Id*.

3 *Delayed Draw Term Loan Definition*, Investopedia, Nov. 30, 2020, available online at *www.investopedia.com/terms/d/delayeddrawtermloan.asp*

("Since 2017, however, DDTLs have seen increased use in the larger, broadly syndicated leveraged loan market in loans worth several hundred millions of dollars."); Corporate Finance Institute, *Delayed Draw Term Loan*, available online at *corporatefinanceinstitute.com/resources/knowledge/credit/delayed-draw-term-loan-ddtl/*. ("Recently, with DDTLs migrating "upmarket," they are being seen in the larger, syndicated leveraged loan market.")

[4] Randy Schwimmer, *Sponsors Holster Revolvers for Delayed-Draw Loans,* Creditflux, Jan. 4, 2016, also available online at *www.churchillam.com/sponsors-holster-revolvers-delayed-draw-loans/*. ("Delayed-draw term loans are lender-friendly. Unlike revolvers, which are generally unfunded, delayed-draw term loans fund over time, with the unfunded portion eventually reduced to zero. That's good news for non-bank providers, which have struggled to compete with banks in offering revolvers.")

[5] In fact, many collateralized loan obligation funds ("CLOs") operate under tax guidelines that prohibit the CLO from acquiring the DDTL unless the CLO is also acquiring the associated term loan or certain other requirements are met. *See* BNA Portfolio 6585-1st: Collateralized Loan Obligations, Part X.D.5.g.

[6] OID is defined as the excess of the "stated redemption price at maturity" over the tax issue price of a debt instrument. Code Sec. 1273(a)(1). Unless determined to be *de minimis*, OID must be accrued over the term of the loan by the issuer (as interest expense) and the holder (as interest income) under the constant-yield method. *See* Code Sec 163(e)(1) (issuer deduction of OID) and Code Sec. 1272(a)(1) (holder inclusion of OID).

[7] *See* Preamble to T.D. 8934, 66 FR 2811, 2812 (Jan. 12, 2001).

[8] This article is not intended to be an in-depth discussion of debt-related fees generally. For a more detailed discussion of the treatment of commitment fees (and other debt-related "fees"), *see* David H. Shapiro, Michael Yaghmour, and Ryan Schneider, *A Tax Field Guide to Debt-Related "Fee" Income*, 143 Tax Notes 1027 (June 3, 2014).

[9] The term "commitment fee" is not defined for U.S. federal income tax purposes. The type of fee to which we are referring may also be called an "unfunded fee," "line of credit fee," or "standby charge." Ultimately, it is the substance of the fee and not its label that is important for the tax analysis. Note that the IRS priority guidance plan has included guidance on debt fees for several years. *See* IRS Priority Guidance Plans, available online at *www.irs.gov/privacy-disclosure/priority-guidance-plan*. We welcome this article's discussion of fees becoming moot if this project comes to fruition.

[10] As discussed below in the context of Closing Fees, the regulations under Code Sec. 1273 (defining OID) could be read to exclude "commitment fees" from the definition of OID. *See* Reg. §1.1273-2(g)(2)(i). However, because the regulations are subject to other interpretations, and do not define "commitment fee," we believe that the analysis cannot necessarily begin and end with this regulation.

[11] Field Attorney Advice (FAA) 20182502F (June 22, 2018). The conclusion that the Ticking Fees are Code Sec. 162 expenses also indicates that they are not limited by Code Sec. 163(j). *See* Reg. §1.163(j)-1(b)(22) (defining interest for purposes of Code Sec. 163(j)).

[12] FAA 20182502F (June 22, 2018). With respect to treating the commitment fees as an option premium the IRS provided that:

> Under the Agreement, it appears that the payment of a Commitment Fee did not create an option within the meaning of [Reg. §]1.263(a)-4(d). Rather, each Commitment Fee was related to the rights and benefits maintained by the Taxpayer during the three-month period prior to the date that the payment was due under the Agreement. However, even if the payment of a Commitment Fee was an amount paid to create an option, we believe such option would only relate to the three-month period preceding the payment date (and would not extend beyond the close of the taxable year), and accordingly the timing of the Taxpayer's deduction under the Taxpayer's method of accounting would clearly reflect income on the facts of this case.

The treatment of commitments fees is also discussed in David Garlock, Federal Income Taxation of Debt Instruments, ¶203.05 (2021 ed.) and in Shapiro *et al.*, *supra* note 8, at 1032–1034.

[13] However, if a Ticking Fee were paid only if the amount was drawn, the characterization as a Code Sec. 162 expense is called into question.

[14] *Fed. Home Loan Mortg. Co.*, 125 TC 248, 269, Dec. 56,199 (2005). ("Because the terms and the economic substance of the prior approval purchase contracts indicate that petitioner and originators entered into option contracts, we hold that petitioner properly treated the 0.5-percent nonrefundable portion of the commitment fees as option premiums.")

[15] Rev. Rul. 81-160, 1981-1 CB 312.

[16] However, Rev. Rul. 81-160 could be distinguished from a typical DDTL because the total commitment amount in that ruling was to be advanced (rather than merely being available to be drawn as in case of a DDTL).

[17] The lender would take into income the portion of the Closing Fee allocated to any remaining undrawn portion when the commitment terminates and the option lapses.

[18] For example, assume once again that the original loan was issued at 98% of its face amount (*i.e.*, with 2% OID) and that a 2% "commitment fee" was paid with respect to the DDTL. The delayed draw period is two years. Under the Amortization Approach, the commitment fee would be amortized over the term of the delayed draw period (*i.e.*, over two years). As a result, because the same 2% fee is being amortized over a shorter period under the DDTL (*vis-à-vis* the original loan), upon a draw the amount of OID allocated to each draw on the DDTL under the Amortization Approach will be less than the amount of unamortized OID on the original loan (and thus would satisfy the 100% yield test even if drawn more than six months after the issue date of the original loan).

[19] It is worth observing that, because DDTLs typically cannot be repaid and redrawn, the Closing Fee functions less like independent daily options than the commitment fees paid in connection with a revolver. Once drawn, the "option" to draw a particular dollar of the total commitment terminates.

[20] *See, e.g.*, Rev. Rul. 70-540, 1970-2 CB 101 (Situation 3). It is not entirely clear whether this ruling was effectively obsoleted by Rev. Rul. 81-160. One possible interpretation is that the IRS prefers taxpayers to treat commitment fees asymmetrically—Rev. Rul. 70-540 (Situation 3) continues to govern lenders' treatment of commitment fees, whereas Rev. Rul. 81-160 governs the borrowers' treatment of commitment fees.

[21] *See* Reg. §1.1273-2(g)(2) (treating payments "from the borrower to the lender (other than payments for services or property provided by the lender, such as commitment fees or loan processing costs)" as creating OID by reducing the issue price of the debt).

[22] Under Reg. §1.1275-1(f), any loan with the same credit and payment terms extended within 13 calendar days of an original loan and as part of a common plan or the same transaction or series of related transactions (regardless of its pricing) is considered automatically the same "issue" and thereby fungible for U.S. federal income tax purposes. However, since DDTLs are usually drawn more than 13 calendar days after the closing date of the initial term loan, this safe harbor is usually not particularly helpful.

[23] For a helpful summary of the tax fungibility rules, *see, generally*, Latham & Watkins LLP Client Alert 1417, *New Treasury Regulations Make It Easier to Issue Tack-On Bonds or Loans*, Oct. 6, 2015, available online at *www.lw.com/thoughtLeadership/easier-to-issue-tack-on-bonds-or-loans*.

[24] Reg. §1.1275-2(k)(1).

[25] More specifically, the amount of OID must be *less than* a "de minimis amount," as defined in Reg. §1.1273-1(d)(2). Interestingly, the qualified reopening rules apply where the amount of OID is "no more than a de minimis amount," which suggests that the amount of OID can be equal to the *de minimis* amount to qualify. *See, e.g.*, Reg. §1.1275-2(k)(3)(ii)(C). Certain tax practitioners believe the difference in wording was unintended. *See* NYSBA Tax Section, *Report on Tax Fungibility of Debt Instruments*, Nov. 5, 2019, available online at *archive.nysba.org/Sections/Tax/Tax_Section_Reports/*

Tax_Section_Reports_2019/Tax_Reports_2019.html ("We assume that the difference highlighted above between the language in Treas. Reg. § 1.1275-2(k)(3)(iii)(B) and the language in Treas. Reg. § 1.1273-1(d)(1) was unintentional and that the generally applicable test for measuring de minimis OID should also apply to the qualified reopening rules.") (hereinafter *NYSBA Report*). This article uses the phrase "*de minimis* OID" to refer to an amount of OID less than the *de minimis* amount in the case of the Reg. §1.1273-1(d)(2), or to an amount of OID equal to or less than the *de minimis* amount in the case of the qualified reopening rules.

[26] Reg. §1.1273-1. As a technical matter, the question is whether the debt's "stated redemption price at maturity" exceeds the issue price. A debt instrument's stated redemption price at maturity is equal to all payments provided by the debt instrument other than "qualified stated interest." For purposes of this article, assume that the debt's stated redemption price at maturity is equal to its principal amount. Reg. §1.1273-1(a), (b).

[27] However, the OID rules are turned off if the holder purchased the debt at a premium (*i.e.*, if the holder's basis exceeds the debt's stated redemption price at maturity). Reg. §1.1272-1(a), (b)(2). *See also* Reg. §1.1272-1(b)(3) for the "acquisition premium" rules, which apply to purchases of debt for an amount in excess of the tax-adjusted issue price but less than the stated redemption price at maturity.

[28] Code Sec. 1278(a)(2).

[29] Code Secs. 1276(a)(1), (3), 1276(b)(2).

[30] Reg. §1.1275-2(k)(2)(ii). Interestingly, to be part of the same "issue" the debt need only have the same "credit and payment terms" rather than be "in all respect identical." *See* note 22. It is unclear why the two provisions use different terms.

[31] The definition of what constitutes "publicly traded" debt is provided in Reg. §1.1273-2(f). In our experience, most widely held debt issuances (with principal amounts over $100 million; *see* Reg. §1.1273-2(f)(6)) are publicly traded on account of the presence of indicative quotes for the debt.

[32] The purpose of the yield test is to ensure that taxpayers do not use the qualified reopening rules to convert too much OID into market discount. *See* Preamble to T.D. 8934, 66 FR 2811, 2812 (Jan. 12, 2001). As discussed above, market discount, unlike OID, is not required to be accrued currently into income.

[33] The qualified reopening rules do not apply to contingent payment debt instruments ("CPDI"). *See* Reg. §1.1275-2(k)(3)(vi). As a result, if the original debt instrument is a CPDI, the additional debt instruments cannot be a qualified reopening. Furthermore, it is possible that the original debt instrument avoided CPDI status or had a certain payment schedule based on the probability or materiality of certain events happening at the time of the issuance of the original debt instrument (*e.g.*, remote or incidental rules under Reg. §1.1275-2(h) or the "significantly more likely than not" rule under Reg. §1.1272-1(c)(2)). If those assumptions change by the time additional debt instruments are issued, it is not entirely clear whether the additional debt instruments technically qualifying as a qualified reopening would be sufficient for them to be considered tax fungible. Nonetheless, because the qualified reopening rules treat the debt as having the same issue date and, with respect to holders, the same adjusted issue price of the original debt instruments, they may be read to imply that the additional debt instruments do not need to be retested for remote/incidental contingencies or alternative payment schedules. The rules for remote and incidental contingencies are discussed in Garlock, *supra* note 12, ¶902, and the rules for alternative payment schedules are discussed in Garlock, *supra* note 12, ¶510.

[34] Under the qualified reopening rules, additional debt instruments that are issued with *de minimis* OID are automatically fungible if either the original debt instruments are publicly traded at the time of the reopening or the additional debt instruments are issued for cash to unrelated parties. Reg. §1.1275-2(k)(3)(iii)–(iv).

Furthermore, if the original debt instruments were issued with *de minimis* OID, the additional debt instruments, if they have *de minimis* OID, should once again be considered "practically fungible" regardless of the application of the qualified reopening rules. In other words, if neither the original debt instruments nor the additional debt instruments have OID from a tax perspective, there would be no practical reason to distinguish between the two debt instruments.

However, in certain situations, having *de minimis* OID may not be sufficient to achieve practical fungibility. For example, once qualified reopening rules apply, original debt instruments and additional debt instruments would generally obtain the same "issue price" and "issue date" for U.S. federal income tax purposes. That could mean, for example, any change in law regarding taxation of debt instruments that grandfathers existing debt based on their "issue date" would apply to the original debt and the additional debt in the same manner if the additional debt is a qualified reopening. On the other hand, absent a qualified reopening, there may be situations where original debt and additional debt, even if they are both issued with *de minimis* OID, are subject to different tax rules due to a change in law between original issue date and the issue date of the additional debt and therefore are not practically fungible. To add, even if original instruments and additional debt are both otherwise issued with *de minimis* OID, additional debt may not be considered fungible if, as a result of different application of remote/incidental contingencies or alternative payment schedules rules, the additional debt has a different tax profile and the qualified reopening safe harbors are not otherwise available. *See also* note 33.

[35] Reg. §1.1275-2(k)(3)(ii), (iv). The heading of Reg. §1.1275-2(k)(3)(iv) ("Non-publicly traded debt issued for cash") implies that the cash issue price tests under the qualified reopening rules may be limited to cash offerings of non-publicly traded debt. *See* NYSBA Report, *supra* note 25, n. 41. However, the actual text of the rule is not limited to non-publicly traded debt. Practitioners are also still seeking guidance on how to apply these rules to bank financings, which are often "variable rate debt instruments" that use a benchmark (such as, LIBOR) in determining the rate. NYSBA Report, *supra* note 25, Part III.

[36] Reg. §1.1275-2(k)(3)(iv).

[37] Oddly enough, because original debt instruments with *de minimis* OID are treated as having a yield equal to their coupon rate, additional debt instruments that cannot qualify for the *de minimis* qualified reopening rules (*e.g.*, because they are not publicly traded and are sold to a related party) will not constitute a qualified reopening if they have any OID, even if they were issued with less OID than the unamortized *de minimis* OID on the original debt instruments (*i.e.*, would have otherwise passed the 100% yield test if the *de minimis* OID on the original debt were considered in determining their yield). Nevertheless, as discussed above, where both the original and additional debt instruments have *de minimis* OID, they may still be indistinguishable from a tax perspective, and thus may be referred to as "practically fungible."

[38] Reg. §1.1275-2(k)(3)(iv). ("For purposes of paragraph (k)(3)(ii)(C) of this section, the yield test is satisfied *if, on the date on which the price of the additional debt instruments is established (or, if earlier, the announcement date)*, the yield of the additional debt instruments (based on their cash purchase price) is not more than 110 percent of the yield of the original debt instruments on their issue date (or, if the original debt instruments were issued with *de minimis* OID, the coupon rate.") (Emphasis added.)

The "announcement date" is further defined in Reg. §1.1275-2(k)(2)(iv) as:

> [T]he later of seven days before the date on which the price of the additional debt instruments is established or the date on which the issuer's intent to reopen a security is publicly announced through one or more media, including an announcement reported on the standard electronic news services used by security broker-dealers (for example, Reuters, Telerate, or Bloomberg).

[39] *See* NYSBA Report, *supra* note 25. ("The 2012 Final Regulations provide that the Testing Date for Actual Issue Price Testing with respect to arm's length cash offerings to unrelated parties is the Pricing Date (or, if earlier, the Announcement

Date). There is no reason to use the Pricing Date or the Announcement Date for Actual Issue Price Testing.")

[40] Reg. §1.1275-2(k)(3)(ii), (v). Note that, Reg. §1.1275-2(k)(3)(v) refers to yield of the "additional" debt instruments even though, under the framework of this test, the yield is measured before the additional debt instruments are outstanding. Tax practitioners are seeking guidance that the regulations intended to refer to "original" debt instruments in this fact pattern. *See* NYSBA Letter, *Comments on Final "Publicly Traded" Regulations under Code Sec. 1273*, Nov. 12, 2012, available online at *nysba.org/app/uploads/2020/03/1276-Letter.pdf*. ("When an issuer is relying on the publicly traded condition, the term 'their fair market value' should be replaced with 'the fair market value of the original debt instruments.")

[41] *See* note 34.

[42] One basis point (bp) is equal to 0.01%.

[43] Reg. §1.1273-1(d)(1)-(3), (e)(3).

[44] The examples in this article assume that, even though the amount of OID on the DDTL draws are determined upfront, such amounts would be considered "arm's length" within the meaning of the qualified reopening rules. Furthermore, the examples in this article have been simplified to include no amortization, such that complete years to maturity (as opposed weighted-average complete years to maturity) can be used in the *de minimis* OID limit calculations. In real life, most term loans that feature DDTL facilities have 1% annual amortization, paid quarterly in 25 bps installments. For the calculation of the *de minimis* OID limit for such loans, please *see* Latham & Watkins, *OID Threshold Calculator*, available online at *www.lw.com/bookofjargon-apps/latham-OID-threshold-calculator*.

[45] Yield calculations are available from the authors upon request.

[46] Although less common, an alternative approach could be to add a Commitment Termination Fee for any DDTLs that are not drawn and argue such change makes the tax treatment of a Funding Fee comparable to a Closing Fee.

[47] For 110% yield test, *see* Reg. §1.1275-2(k)(3)(iv). ("For purposes of paragraph (k)(3)(ii)(C) of this section, the yield test is satisfied *if, on the date on which the price of the additional debt instruments is established (or, if earlier, the announcement date)*, the yield of the additional debt instruments (based on their cash purchase price) is not more than 110 percent of the yield of the original debt instruments on their issue date (or, if the original debt instruments were issued with no more than a de minimis amount of OID, the coupon rate)." Emphasis added.) For the 100% yield test, *see* the similar rule under Reg. §1.1275-2(k)(3)(v).

The "announcement date" is furthered defined in Reg. §1.1275-2(k)(2)(iv) as:

> [T]he later of seven days before the date on which the price of the additional debt instruments is established or the date on which the issuer's intent to reopen a security is publicly announced through one or more media, including an announcement reported on the standard electronic news services used by security broker-dealers (for example, Reuters, Telerate, or Bloomberg).

[48] *See* note 39.

[49] This approach could be justified in the context of the underlying rationale of the qualified reopening rules, which is to limit the ability of lenders to selectively convert OID into market discount by reopening an existing debt instrument (at a time when prices have decreased). Because the terms of a DDTL (and any associated fees) are negotiated at the same time as the original debt instruments comprising part of the same overall credit facility, they arguably do not present the same selectivity concerns.

[50] *See, e.g.*, *Universal Castings Corp.*, 37 TC 107, Dec. 25,101 (1961) (treating notes stapled to stock as equity); Rev. Rul. 88-31, 1988-1 CB 302 (treating common stock and contingent value right as separate because they were separately tradeable, the holder did not have to surrender the stock to receive a payment on the right, and the value of the components varied inversely); Rev. Rul. 2003-97, 2003-2 CB 380 (treating debt of corporation and forward contract to purchase stock as separate because they were separable and the holder was not economically compelled to hold them together).

[51] We use the term "arguably" because there are strong arguments that the pieces of property being exchanged (*i.e.*, the initial term loan and DDTL draws, with identical terms) are not materially different in kind or extent (as required under Code Sec. 1001), and therefore the exchange would not be treated as a taxable disposition.

[52] The stapled unit approach envisioned here resembles "income deposit securities" that were issued a handful of times. These securities are investment units comprising one share of common stock together with a specified principal amount of debt instruments, paying out its yield as dividends and interest on the underlying instruments. These securities carried similar automatic exchange mechanisms to allow future issuances with OID to be automatically fungible with outstanding securities. These securities also posed similar taxable disposition considerations. *See* Section 7.05 of Andrew R. Walker, Eileen M. Marshall, and David R. Gerson, More from the Abyss of Debt and Equity by New York University 63rd Annual Institute on Federal Taxation, 2005.