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Client Alert

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The AHYDO Rules and the PIK Toggle Feature

The recent appearance and proliferation of "PIK Toggle" features in high yield bonds and term loans raises some interesting issues under the Internal Revenue Code of 1986, as amended (the Code). The purpose of this *Client Alert* is to review the provisions of the Code known as the applicable high yield discount obligation (AHYDO) rules that limit the deductibility of interest on certain debt instruments with non-cash interest features and to explore how those rules apply to PIK Toggle features in high yield bonds and term loans.

"The "PIK Toggle" feature has recently become very popular in the high yield bond market and the leveraged loan market."

The AHYDO Rules

Before analyzing the impact of the AHYDO rules on debt instruments with a PIK Toggle feature, let's first review the basics of the AHYDO rules. The AHYDO rules apply to any debt instrument that:

- is issued by a corporation,[1]
- has a term of more than five years,
- has "significant original issue discount (OID)," *and*
- has a yield to maturity that equals or exceeds the applicable federal rate for the month of issuance (the AFR) plus 500 basis points.

"Significant OID" exists on a particular debt instrument if, at the end of any interest accrual period ending at least five years after the issue date, the amount of OID that has previously accrued on the instrument minus the amount of OID that is *required* to be paid in cash[2] on or before such date exceeds the "First Year's Yield" (which is the issue price of the debt instrument multiplied by its yield to maturity).[3] A simplified way to think about "significant OID" is that it exists whenever the debt instrument permits the borrower to pay more than one year's worth of interest expense "in kind" over the course of the first five years of the debt instrument. In other words, "significant OID" is not a function of how much the borrower actually elects to pay in kind, it is a function of how much it *could* elect to pay in kind during the first five years of the debt instrument.

The PIK Toggle Feature

The "PIK Toggle" feature has recently become very popular in the high yield bond market and the leveraged loan market. This new feature provides the borrower with a choice as to how to pay accrued interest for each interest period during the first several years of the debt instrument: (1) pay the interest completely in cash, (2) pay the interest completely "in kind" by simply adding it to the principal amount (or by issuing new debt instruments having a principal amount equal to the interest so paid), or (3) pay half of the interest in cash and half "in kind."

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Application of the AHYDO Rules

As discussed above, for purposes of the AHYDO rules, "significant OID" exists on a particular debt instrument if the instrument permits the borrower to pay more than one year's worth of interest expense "in kind" over the course of the first five years of the debt instrument. Accordingly, the addition of a PIK Toggle feature will likely cause a debt instrument to be subject to the AHYDO rules (so long as the instrument has a term of more than five years and its yield is equal to or more than the AFR plus 500 basis points), even if the borrower in fact pays all interest in cash.

In applying the AHYDO rules, the following points should be noted.

- The AHYDO rules do not apply to a debt instrument that has a maturity date of five years or less.
- If a debt instrument provides for a variable rate, it is treated as providing for a fixed interest rate equal to the variable rate in effect on the issue date for purposes of determining "significant OID."
- The AFR is a series of yields that is published monthly by the Internal Revenue Service (short-term, medium-term and long-term rates are published, using a variety of compounding assumptions). It is intended to track the yields for US Treasury securities of comparable maturities.

From the borrower's perspective, if the AHYDO rules apply to a debt instrument, the consequences are dramatic:

- the borrower must generally defer the entire amount of its deductions for OID until that OID is paid in cash (typically at maturity), and
- if the yield to maturity of the debt instrument exceeds the AFR plus 600 basis points, that portion of the yield in excess of the AFR plus 600 basis points will be disallowed permanently.

From the investor's perspective, if the AHYDO rules apply to a debt instrument, the consequences are more benign:

- even though the borrower's deduction for all of the OID is deferred until paid in cash, the holder of the debt instrument must nevertheless include all OID in income as it accrues under the regular OID method (subject to the following bullet point), and
- with respect to that portion of the yield in excess of the AFR plus 600 basis points, "interest" from the debt instrument is treated as a dividend (to the extent it would have been treated as a dividend had it been a distribution by the borrower with respect to its stock) for purposes of the dividends-received deduction rules; accordingly, a corporate holder may be entitled to a dividends-received deduction on that portion of the yield in excess of the AFR plus 600 basis points.

The Catch-up Payment Option

It is possible to avoid "significant OID" – and thereby avoid the AHYDO rules altogether – by providing for a "catch-up" payment to holders at approximately the fifth anniversary of the original issuance of the debt instrument. The purpose of the "catch-up" payment is to pay enough of the OID in cash so that the issuer is not more than one year's worth of interest behind at the five-year marking date.

Set forth below are the requirements for a catch-up payment that will provide a complete escape from the AHYDO rules:

Amount. The catch-up payment must be required to be made in cash[4] in an amount equal to the excess of (x) the aggregate amount of unpaid OID that has accrued on the debt instrument from the issue date until the date of the catch-up payment over (y) the First Year's Yield. A simplified way to think about this is the catch-up payment must

cause the borrower to be fully paid up on all interest accrued from the time the debt instrument was created through the five-year marking date, except for up to one year's worth of interest.[5]

Timing. The catch-up payment must be required to be made by the end of the first interest accrual period ending *after* five years after the issue date; for a typical high yield bond that pays interest semi-annually, a catch-up payment would be required to be made no later than five and one-half years after the issue date. If the accrual period is annual, a catch-up payment would be required to be made no later than six years after the issue date. In the case of a LIBOR-based variable rate term loan, the timing of the catch-up payment will be based on the accrual period in effect on the fifth anniversary of the date the loan was created.

Conditionality. The catch-up payment must be an unconditional obligation of the borrower under the indenture (or the credit agreement or other document) governing the debt instrument. In addition, there should be a reasonable expectation that the borrower will be able to make the required catch-up payment.

This unconditionality requirement results in an interesting intercreditor issue. Even if a debt instrument with a PIK Toggle or other pay-in-kind feature provides for an unconditional catch-up payment, limitations or conditions under a more senior debt instrument relating to payments on the pay-in-kind debt could raise issues as to the effectiveness of the catch-up payment for purposes of the AHYDO rules. The analysis of whether a particular catch-up payment is unconditional will depend on all applicable facts and circumstances of a particular case. Covenant restrictions in a more senior debt instrument should not raise any issue if (i) the senior debt is due before the catch-up payment is due; or (ii) the senior debt unconditionally permits the catch-up payment to be made on schedule.

If a catch-up payment is properly structured, a pay-in-kind debt instrument will not have significant OID and, accordingly, the AHYDO rules will not apply. Assuming there are no other applicable limitations on the borrower's interest deductions, the borrower will be permitted to deduct all of the interest (including the pay-in-kind portion) on the debt instrument as it accrues.

Conclusion

Although the addition of a PIK Toggle feature will likely cause a high-yielding debt instrument to be subject to the AHYDO rules, a properly structured catch-up payment at or near the end of the fifth year after the closing, or a maturity of less than five years, is a complete cure. Please fee free to call Jiyeon Lee-Lim at (212) 906-1298 or Kirk A. Davenport at (212) 906-1284 or any of your contacts at Latham & Watkins, if you have any questions about the AHYDO rules or PIK Toggle features.

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Endnotes

[1] Even though the AHYDO rules generally apply only to a debt instrument issued by a corporation, the AHYDO rules also apply to a debt instrument issued by a partnership if the partnership has a corporate partner in determining the deductibility of such corporate partner's distributive share of the partnership's interest expense.

[2] The rules treat interest payments in the form of property other than cash (but not counting PIK payments) as cash for this purpose.

[3] Please be aware that "significant OID" is a concept that is unique to the AHYDO analysis. It does not bear on whether OID on a debt instrument is *de minimis* and is not the converse of *de minimis* OID.

[4] Again, property other than cash (excluding PIK payments) is treated as cash for this purpose.

[5] In addition, in order to avoid significant OID for any subsequent period, at the end of each subsequent accrual period, the borrower must be required to pay cash in a sufficient amount so that the accrued and unpaid interest or OID at the end of each subsequent accrual period does not exceed the First Year's Yield. This is generally achieved by requiring cash-pay interest for subsequent accrual periods.

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