

# Taxation of Debt Instruments: OID and AHYDO Rules, Distressed Debt, Contingent Capital

Navigating Latest IRS Rules and Overcoming Complexities in Structuring Capital Arrangements

TUESDAY, JULY 29, 2014

1pm Eastern | 12pm Central | 11am Mountain | 10am Pacific

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# Taxation of Debt Instruments: OID and AHYDO Rules, Distressed Debt, Contingent Capital

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**Strafford Webinars  
Taxation of Debt Instruments  
July 29, 2014**

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# Original Issue Discount: The Basics

# Original Issue Discount: Indebtedness Requirement

Code §1272 imposes accretion rules on debt instruments issued with original issue discount (OID)

- OID definitions and related provisions are set out in Code §§1273 through 1275

The starting point for an OID analysis is whether a purported instrument is properly classified as debt for Federal income tax purposes

- Code Section 1275(a)(1)(A) defines a debt instrument as a bond, debenture, note, or certificate or other evidence of indebtedness
- Per Treas. Reg. §1.1275-1(d), a debt instrument means “any instrument or contractual arrangement that constitutes indebtedness under general principles of Federal income tax law (including, for example, a certificate of deposit or a loan)”

# Original Issue Discount: Indebtedness Requirement (*cont'd*)

Various Sections of the Code and Regulations reference indebtedness without offering a definitive definition

The characterization of an instrument as debt for tax purposes must be determined using factors that have evolved from case law and relevant IRS rulings

- A critical factor is the presence or absence of an unconditional promise to pay a sum certain (or reasonably determinable) on demand or at a fixed future date

# Interest Income and Expense

## General Timing Rules

General rule for including interest in taxable income (holder) or deducting interest expense (issuer):

- For accrual basis taxpayers - interest is taxable (deductible) as it properly accrues under the terms of the underlying debt instrument
- For cash basis taxpayers - interest is generally taxable when received (and deductible when paid)

Original issue discount ("OID") provisions can alter the general timing rules for interest income (expense) by requiring accruals under the constant yield method (Code §1272(a)(1))

# What is OID?

OID is defined in Code §1273 as the excess of an instrument's *stated redemption price at maturity* over its *issue price*

- Unlike other Code Sections, the general OID rules do not require a minimum interest rate, but instead are concerned with the timing of payments of interest
- Contrast the imputed interest rules Code of §§483, 1274 and 7872

# Certain Instruments are Exempt

## Original Issue Discount Exceptions

- Short term debt obligations,
  - Defined in Code §1283 as any bond, debenture, note, certificate, or other evidence of indebtedness which has a fixed maturity date not more than 1 year from the date of issue
  - Special rules apply to certain short-term obligations under Code §§1281 and 1282
- Tax-exempt obligations
- U.S. savings bonds
- Certain loans between natural persons (\$10,000 threshold)

# Stated Redemption Price at Maturity

An instrument's stated redemption price at maturity is defined in the Regulations as the sum of all payments provided by the instrument other than qualified stated interest (QSI) (Treas. Reg. §1.1273-1(b))

- Qualified stated interest is stated interest that is unconditionally payable in cash or property (other than debt instruments of the issuer), or that will be constructively received under Code §451, at least annually at a *single fixed rate* (as defined)
- Special rules are provided for variable rate debt instruments (VRDIs) under Treas. Reg. §1.1275-5
  - qualified floating rates
  - objective rates

# Issue Price Determination

The issue price of an instrument is determined under the priority layering rules of Treas. Reg. §1.1273-2

- First, if a substantial amount of the debt instruments in an issue is issued for money, the issue price of each instrument in the issue is the first price at which a substantial amount of the debt instruments is sold for money (Treas. Reg. §1.1273-2(a))
  - Certain sales are ignored for these purposes (bond houses, brokers, etc.)
- Second, if the instrument is publicly traded (as defined) and is issued for property, the issue price is its fair market value on the date of issue (Treas. Reg. §1.1273-2(b))

# Issue Price Determination

The issue price of an instrument is determined under the priority layering rules of Treas. Reg. §1.1273-2 (*cont'd*)

- Third, if the instrument is not publicly traded, but is issued for publicly traded property, the issue price of the instrument will equal the fair market value of the publicly traded property determined as of the issue date (Treas. Reg. §1.1273-2(c))
- Last, if none of the above applies (i.e., non-publicly traded debt is issued for non-publicly traded property), the issue price is the stated redemption price at maturity assuming the instrument provides for adequate stated interest (Treas. Reg. §1.1273-2(d))

# Issue Price Determination Investment Units

Special issue price determination rules are provided where an instrument is issued as part of an investment unit (Code §1273(c)(2) and Treas. Reg. §1.1273-2(h)(1))

- The issue price of the investment unit is determined under the applicable issue price rules, and is then allocated between the debt instrument and the property right (or rights) that comprise the investment unit based on their relative fair market values
- E.g., an investment unit comprised of a debt instrument and a warrant will give rise to OID if a separate FMV premium is not paid by the investor for the warrant

# When is Property Considered “Publicly Traded”?

In September, 2012, Treasury promulgated final regulations governing the determination of when property (including a debt instrument) is treated as “traded on an established market” (publicly traded) for purposes of determining the issue price of a debt instrument

- The final regulations apply to debt instruments issued on or after November 13, 2012

Under the regulations (Treas. Reg. §1.1273-2(f)), property is considered publicly traded if:

- there is a “sales price” for the property;
- there are one or more “firm quotes” for the property; or
- there are one or more “indicative quotes” for the property
- An exception is provided if the outstanding stated principal amount of the debt does not exceed \$100 million

# De Minimis OID

If the amount of OID is determined to be “de minimis,” the holder is not required to accrue OID

- Under Treas. Reg. §1.163-7, an issuer of a debt instrument with de minimis OID may choose to deduct the OID on a either the constant yield basis or on a straight-line basis over the term of the debt instrument

OID is de minimis OID if less than 0.0025 multiplied by the product of (A) the instrument’s stated redemption price at maturity and (B) the number of complete years to maturity from the issue date (i.e.,  $.0025 \times A \times B$ )

# How is OID Accounted For?

Pursuant to Code §1272(a) OID is accounted for by holders and issuers on a constant yield basis ratably over the life of the instrument (see the 4 step process in Treas. Reg. §1.1272-1)

- Note that OID is unique to the instrument, not to the holder, meaning that if an OID instrument is sold prior to maturity, the remaining OID follows the instrument and is to be included by the purchaser on each day that the purchaser holds the instrument (See Code §1272(a)(1), Treas. Reg. §§1.1272-1 and 1.1272-2)

OID accretions are deductible by the issuer under Code §163/Treas. Reg. §1.163-7 and are includible in the holder's income under Code §61

- OID can give rise to phantom (dry) income to holders
- Issuers can benefit from deductions arising before interest payments

# How is OID Accounted For?

## AYHDO Rules

Issuer deductions for OID can be limited if the instrument is an applicable high yield discount obligation (“AHYDO”)

- No deduction is allowed for the *disqualified portion* of the OID on an AHYDO obligation (generally any yield greater than 6 percentage points above the AFR)
- the remainder of such OID is not be allowable as a deduction until paid

An AHYDO is a corporate debt instrument” that: (i) has “significant OID”, (ii) has a term exceeding five years, and (iii) has a yield to maturity that is at least five percentage points above the AFR in effect for the calendar month during which the debt instrument is issued

# How is OID Accounted For?

## AYHDO Rules (*cont'd*)

A debt instrument is treated as having significant OID if, as of the end of the first accrual period following the fifth anniversary of issuance (or as of the end of any subsequent accrual period), an amount greater than one year's worth of OID (the yield to maturity multiplied by the issue price of the debt instrument) can remain unpaid

- For this purpose, each payment under the instrument is assumed to be paid on the last day permitted under the terms of the instrument

The AHYDO rules can be avoided by including an AHYDO "catch-up" clause

- A catch-up clause requires (i) all accrued but unpaid OID (in excess of one year's worth) to be paid on the first interest payment date following the five year anniversary of issuance and (ii) all interest thereafter to be paid on a current basis

# Market Discount Bonds

Code §1278 defines a “market discount bond” as any bond with a stated redemption price at maturity in excess of a taxpayer’s basis in that bond measured immediately after its acquisition by the taxpayer

-Code §1278(a)(1)(B) excludes certain instruments from the definition of market discount bond, including (1) short-term obligations, (2) United States savings bonds, (3) Code §453B installment obligations

If a market discount bond is also an OID instrument, the amount of the market discount is limited to the excess of the calculated discount, if any, in excess of the OID

# Market Discount Bonds (*cont'd*)

Absent an election to recognize market discount over the life of the instrument, market discount bonds are subject to the following special rules:

- Gain on the disposition of any market discount bond is treated as ordinary income to the extent it does not exceed the accrued market discount on such bond; partial principal payments are similarly characterized as ordinary income
- Under Code §1277, net direct interest expense with respect to any market discount bond is deductible for the taxable year only to the extent that such expense exceeds the portion of the market discount allocable to the days during the taxable year on which such bond was held by the taxpayer

# Market Discount Bonds (*cont'd*)

Under Code §1278(b), holders of market discount bonds can elect to accrue market discount into taxable income using either a ratable daily inclusion method or the constant yield method

- If an election is made under Code §1278(b), the rules of Code §§1276 and 1277 do not apply
- An election under Code §1278 applies to all market discount bonds acquired by the taxpayer on or after the 1st day of the 1st taxable year to which such election applies

# Contingent Payment Debt Instruments

Subject to certain exceptions, Treas. Reg. §1.1275-4 provides that any debt instrument that provides for one or more contingent payments is a contingent payment debt instrument (“CPDI”) subject to the contingent payment debt instrument regulations

- Contingent payments must not be remote nor incidental
- Several exceptions are provided, including an exception for VRDIs
- A conversion feature, by itself, does not cause a convertible debt instrument to be considered a CPDI

A CPDI that is issued for money or publicly traded property is subject to the *noncontingent bond method*

- Under the noncontingent bond method, interest on the CPDI accrues during the term of the instrument as if it is a fixed-payment debt instrument
- This hypothetical fixed-payment debt instrument is constructed by using the contingent instrument’s *comparable yield* and a projected payment schedule

# Contingent Payment Debt Instruments (*cont'd*)

The comparable yield for a CPDI is the yield at which the issuer would issue a non-contingent fixed rate debt instrument with terms and conditions similar to those of the CPDI, including the level of subordination, term, timing of payments, and general market conditions

- The issuer's comparable yield must be a reasonable yield for the issuer and may not be less than the AFR; in certain situations, the comparable yield is presumed to be the AFR
- If the amount of contingent interest actually paid by the issuer differs from the projected payment schedule, the difference is taken into account as either a positive or a negative adjustment to the amount of interest on the instrument for the year

# Contingent Payment Debt Instruments

A CPDI that is issued for non-publicly traded property is subject to the bifurcation method

- Under these rules, payments on the CPDI are separated into noncontingent and contingent payments
- The noncontingent payments are treated as a separate, noncontingent debt instrument
- The contingent payments are taken into account only when paid, with a portion being treated as principal and a portion being treated as interest, determined by discounting the payment from the date made to the issue date at the AFR

# Other Potential Considerations

## OID rules and/or adjustments can also apply to:

- Bond issuance premium (Treas. Reg. §1.163-13), defined as the excess of the *issue price* of a debt instrument over its *stated redemption price at maturity*
- Acquisition premium (Code §171), often referred to as amortizable bond premium
- OID adjustment rules for instruments purchased by a subsequent purchaser at a premium (Code §1272(a)(7) and Treas. Reg. §1.1272-2(b)(4))

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# US Direct Lending & Investment in US Distressed, Scratch & Debt and Non- Performing Loans by Non-US Persons

# The Trading in Securities Safe-Harbor of Non-US Persons

The US tax law does not treat investing for one's own account as a trade or business.

Code § 864(b)(2) provides a safe-harbor from US net income taxation to the extent that the trade or business conducted in the US by a foreign person is limited to trading stocks, securities and commodities for its own account.

The exemption is not vitiated even if the trading is conducted from within the US by an agent with "discretionary authority to make decisions affecting the transactions."

Virtually all in-bound investors rely on the common law and statutory exceptions to avoid US net income taxation on their securities and commodities gains

# Distressed Debt Activities May Give Rise to a US Permanent Establishment

The Managed Fund Association (MFA) wrote to the US Internal Revenue Service on April 8, 2008 asking for a “clarification” that the Code § 864(b)(2) safe-harbor encompasses distressed asset investing and work-outs

While the purchase and sale of loans should be within the securities trading safe-harbor, distressed debt work-outs may give to a US permanent establishment.

## An Independent Agent to Service Distressed Debts May Avoid the Creation of a US PE

Non-US persons resident in a country with a Tax Treaty with the United States must maintain a permanent establishment in the US in order to be subjected to net US taxation on trade or business activities

Can the use of an agent/servicer to work out distressed debts avoid the creation of a permanent establishment?

For example, the US-Netherlands Tax Treaty provides that no PE is created if business is carried on “through a broker, general commission agent or any other agent of independent status, provided such persons are acting in the ordinary course of their business as independent agents.”

# IRS Guidance May Limit the Ability of Non-US Persons to Use Independent Agents

In September 2009, the IRS issued a generic Advice Memorandum concluding that loan origination through an independent agent still caused the non-US person to be considered to be engaged in the conduct of a US trade or business

The hypothetical fact pattern in the AM did not involve a non-US person entitled to Tax Treaty benefits.

IRS position could have implications for distressed debt activities as well as for loan origination activities

## Limits on the Use of An Independent Agent

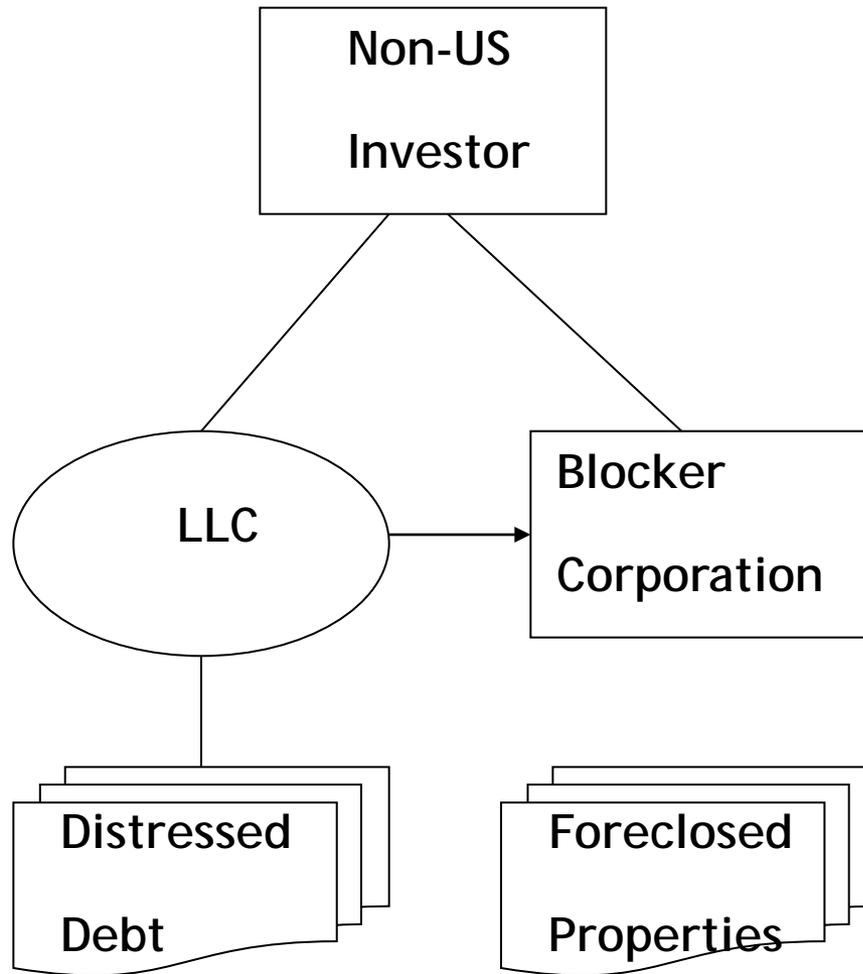
FIRPTA (Foreign Investors in Real Property Tax Act)

Rules override US Treaties and can result in taxation of gains from real property sales

Rents from real property will be taxed under the rules applicable to non-effectively connected income and subjected to a 30% withholding tax.

Given the combination of the FIRPTA tax and the tax on rentals, it might be more advantageous to create a PE

# Common Structure for Distressed Debt Investing by Non-US Persons



# Understanding the Taxation of OID for Non-U.S. Holders

# Overview of the Cross-Border OID Rules

General Rule: Interest is a class of FDAP income and is subject to a 30% withholding tax.

The 30% tax can be reduced by treaty.

OID, however, is excluded from the definition of interest in Code § 871.

Instead, Code § 871(a)(1)(c)(ii) taxes OID to the extent of payment on the debt instrument.

In addition, if a bond with OID is sold, any unincluded OID must be included in income by the non-US holder.

# The Portfolio Interest Exception Applies to OID

Portfolio interest paid to a non-US person is not subject to US tax or withholding.

Portfolio interest does not include (i) most forms of contingent interest, (ii) interest paid to a 10% shareholder or (iii) interest paid to a bank pursuant to a loan agreement entered into in the ordinary course of its business or (iv) paid to a foreign corporation.

Contingent interest includes interest determined with reference to receipts or cash flow, income or profits of the issuer, changes in value of property of the issuer and distributions made by the issuer on its equity.

Contingent interest does not include payments that are uncertain as to timing, payments determined with reference to actively-traded property.

# The Tax Exception for Short-Term OID

Code § 871(g)(1)(B)(i) excludes OID on short-term obligations from US tax. A short-term OID obligation is defined as an obligation payable in 183 days or less from the date of issuance.

This exception is very important in practice. It allows loans between related parties to escape withholding and allows interest based upon performance to be paid free from US withholding.

“Rolling” a short-term obligation can be evidence that the loan was not a short-term loan. In other words, if the loan is constantly renewed by the lender, the IRS could (and has) assert that the loan, in fact, has a maturity in excess of 183 days.

# Determining If a Taxable Holder of Distressed Debt Must Accrue Interest/OID on the Loan

# Law On When Holder Can Cease Accruing Stated Interest

To support non-accrual, there must be doubtful collectability or it is reasonably certain income will not be collected

-**Insolvency.** Jones Lumber (1968). Fact of insolvency alone was insufficient to avoid accrual without a specific showing that insolvency made collection doubtful.

-**Receivership.** Corn Exchange Bank (1930). Creditor was not required to accrue income on loan where debtor went into receivership during the year in which the loan was made.

-**Bankruptcy.** Harmont Plaza (1975). Bankruptcy was sufficient event to allow creditor to cease to accrue interest on debt.

-**Other Factors.** Chicago & Northwestern Railway (1958). Hopelessly past due on payments, coupled with insolvency, allowed non-accrual. Note that postponement (forbearance) is insufficient for cessation of interest accrual.

# The IRS Has a More Restrictive View on OID Accruals

IRS took the view in a TAM 9538007 that this case law does not apply to OID accruals. *On May 28, 2009, IRS announced that it is revisiting these conclusions.*

- This view is inconsistent with GCM 39668, in which the IRS took the view, based on the legislative history to the Tax Reform Act of 1984, that OID on a nonrecourse debt is deductible only to the extent the value of the property exceeds the outstanding amount of the debt at the time of the accrual.
- Also inconsistent with the view that OID and interest are economically equivalent and the purpose of the OID rules was to assure OID is treated as interest.

IRS permits cessation of OID accrual for periods during which debtor is in bankruptcy because bankruptcy law provides no OID accrues after petition is filed.

# The Market Discount Rules Can Result in Taxable Gains From Partial Recoveries

# Overview of the Market Discount Rules

**General Rule:** Gain on the disposition of a market discount debt instrument is treated as ordinary income to the extent of accrued market discount.

Applicable rules provide that partial principal payments are first treated as the payment of accrued market discount, then as non-taxable principal payments

Rules do not distinguish between discount attributable to increases in applicable market rates and discount attributable to doubtful collectability

Also, if debt is part due already, literal application of market discount rules is problematic because market discount accrues to maturity date.

# Market Discount - Literal Application to Distressed Debt

Literal application of rules can produce harsh timing and character results.

Example - Debt with face of 100 purchased for 50 with 2 years to maturity. After 1 year, debtor pays 20 of principal. If rules are applied literally, all 20 would be ordinary income.

Taxpayers have taken the position that:

- rules don't apply to loans in default when acquired
- rules don't apply to "speculative" loans
- market discount accruals can be computed based on taxpayer's expected amount of collection or expected yield.

# When Can Debt Instruments Be Treated as Distressed Debt?

1. The debt is acquired for a price that is less than [80]% of its face amount and, at the time of acquisition, prevailing yields on fully performing highly-rated securities with similar weighted average durations are not greater than the current interest payments specified on the debt.
2. The yield to maturity on the debt, determined as though the MBS were to be paid in full, is greater than the lesser of (i) [20]% and (ii) [five] times the yield to maturity on fully performing highly-rated securities with similar weighted average durations.
3. There have been significant payment defaults by the obligors on the debt underlying the asset-backed securities or in the pool;
4. The loan-to-value ratios for a significant amount of the collateral underlying the loan support the conclusion that if the mortgages went into foreclosure that the mortgages would be satisfied at a significant discount to their face amount.
5. The mortgages underlying mortgage backed securities were issued in 2005 or thereafter and prior to 2009.

# When Can Debt Instruments Be Treated as Distressed Debt?

6. The mortgages underlying the MBS were issued by Countrywide, New Century or another loan originator that has been alleged to have not exercised proper due diligence procedures in the mortgage origination process.
7. The independent credit rating on the loans has been downgraded by a substantial amount from the time of its issuance;
8. A majority of the mortgages underlying the MBS are secured by properties located in a region that has experienced a substantial diminution in real estate values since the time that such mortgages were issued;
9. The financial projections used by the Company in determining the purchase price for the loans support the conclusion that there is no reasonable prospect of recovery of the full principal balance on the MBS.
10. The financial non-tax accounting for the loans is consistent with the treatment of the loans as distressed debt. Examples of such consistent non-tax accounting treatments are the methods described in ASC 325-40 and ASC 310-30.

# When Can Debt Instruments Be Treated as Distressed Debt?

11. In any actual foreclosures of defaulted mortgages underlying the loans, the amount received in the foreclosure was less than the outstanding principal amount and unpaid interest owed on the mortgages.

12. The loans should trade “flat,” that is, the trading price should not be separately adjusted for accrued and unpaid interest.

13. The obligors under the mortgages are classified as “Alt-A” or less creditworthy.

# Market Discount - Potential Interest Carrying Cost Deferral

Unless a taxpayer elects to currently accrue market discount (either ratably or on an economic accrual basis), interest costs incurred to carry market discount debt instruments are deferred to the extent that such interest exceeds the net interest income on the market discount debt.

Net interest income includes stated interest and OID

Example: Fund incurs \$100 of interest expense to carry a distressed debt portfolio, but recognizes only \$60 of interest and OID income from the portfolio in a particular year. In this case, only \$60 of interest expense would be deductible.

# Market Approaches to the Market Discount Conundrum

The “Mass Asset” Approach - No income is recognized until basis recovery has been made in full. This approach has been sanctioned in certain cases in which the loan buyer did not evaluate each loan within the pool.

Middle Ground Approach - Recoveries, regardless of whether denominated principal or interest are treated as income based upon the anticipated yield that the buyer used for financial accounting purposes. Remaining recoveries are treated as payments of principal.

Follow the Market Discount Rules. Payments of interest are treated as fully taxable and payments of principal are treated as income to the extent of the discount. The “true up” is accomplished by claiming worthless security deductions (capital losses) or as bad debts (ordinary).

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# Renegotiation of Distressed Debts Can Result in Phantom Gains

# Significant Modifications

A significant modification of a debt instrument is treated as a taxable exchange of the old debt for a new debt.

Extension of the maturity of the debt by more than the smaller of 50% of the original term or 5 years is a significant modification, as is a change in yield of more than the greater of 25 basis points or 5 percent of the original yield.

For debt that is not publicly traded, the amount realized on the exchange is generally the face amount of the new debt, not its fair market value.

As a result, debt workouts can produce significant phantom gains. These generally can be reported on the installment method (although this can result in an interest charge).

# Financial Intermediation to Enable Private Equity Sponsors to Synthetically Acquire Portfolio Company Debt

# Opportunities for Private Equity Sponsors

Many private equity firms placed substantial amounts of bank debt on their portfolio companies in connection with leveraged recapitalizations or the initial acquisitions.

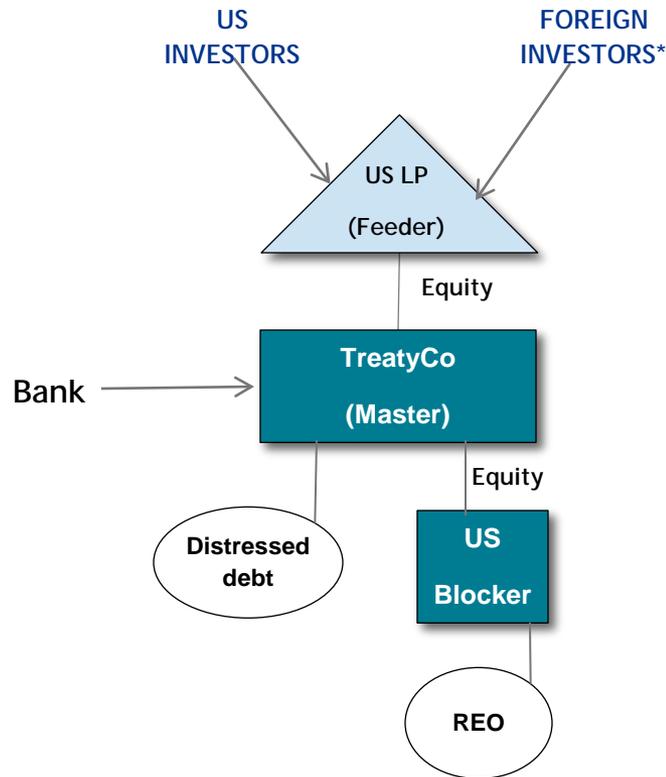
Bank debt now actively trades in an inter-bank market. The debt can physically trade or trade through participation agreements or derivatives. Prices of bank debt have fallen dramatically.

The debt documents generally prohibit a direct acquisition of one or more tranches of such debt by the private equity sponsors or their affiliates.

Many financial institutions are offering intermediary strategies that allow sponsors to obtain derivative exposure to portfolio company bank debt.

# TreatyCo Structure

Type of Investor: Requires more than 50% US Investors, but can also accommodate foreign (including Sovereign) investors



\* Includes Sovereign Investors

## Summary Formation Steps

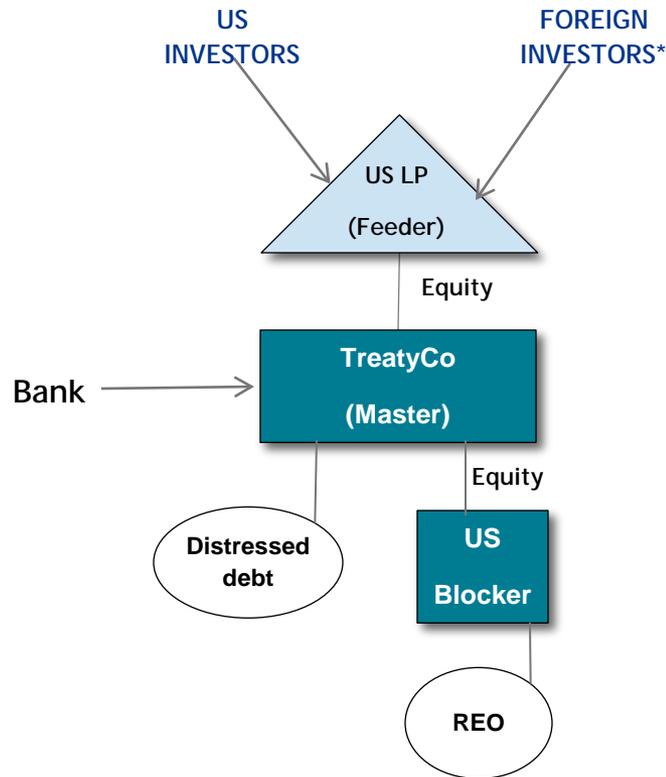
- A US Limited Partnership ("Feeder") is formed to act as the feeder for the US and foreign investors.
- Feeder forms a limited liability company in a favorable treaty jurisdiction to act as the master fund ("Master").
- Master forms a US limited liability company (treated as a corporation) to hold any real estate ("US Blocker"). US Blocker is funded with 100% equity from Master.

## Investment Structure

- The Master will be funded with equity and debt (from the Bank) to purchase mortgage portfolios.
- In the event of a foreclosure, Master will generally foreclose on the property and subsequently transfer REO to US Blocker. If foreclosure activity is expected to be material, Master will transfer the loan to the blocker in exchange for debt & equity & the blocker will foreclose on the loan.

# TreatyCo Structure

Type of Investor: Requires more than 50% US Investors, but can also accommodate foreign (including Sovereign) investors



\* Includes Sovereign Investors

## Tax Consequences

Master is resident of a treaty jurisdiction that provides for 0% withholding tax on interest received from underlying mortgages.  
*Note: qualified US resident investors must have over 50% indirect ownership of Master in order for treaty benefits to apply.*

There shouldn't be significant tax drag associated with US Blocker, as foreclosure activity is expected to be minimal and proposed steps to accommodate transfer of foreclosure assets to US Blocker trigger a gain in the assets outside of the blocker (and this gain is free from corporate tax). Basis of the asset in the hands of the blocker is approximately FMV. Cash distributions from US Blocker are characterized as dividends or return of basis. Any dividends paid will be subject to a maximum withholding tax of 15% based on jurisdiction of Master, although dividends are expected to be immaterial. Any nondividend distributions will be characterized as return of basis and will be free from withholding tax.

Distributions from Master will either be a payment on TPECs (if Master is a Lux vehicle) or payment on a PPL (if Master is an Irish vehicle). Both provide for 0% withholding tax under Lux & Irish domestic law.

# Bank Loan Participation Agreements

Bank loan participations are sold through market-standard documentation developed by the Loan Syndication and Trading Association (LSTA)

A special confirmation is in use for “Distressed Trades.”

Participation can be an assignment in which the acquiror inures to the rights of a direct lender or can be a participation in which the acquiror acquires an economic interest in the bank debt.

Assignments are more likely to be treated as an acquisition in the underlying debt.

## Federal Income Tax Issues Presented by Sponsor Acquisitions of Portfolio Company Debt

Applicable tax rules treat an acquisition of debt by a person treated as “related” to the debtor as an acquisition by the debtor itself.

If acquisition occurs at a price that is less than the “adjusted issue price” of the debt, the debtor may be considered to recognize taxable “discharge of indebtedness income (a/k/a cancellation of debt or COD income).

Exceptions to COD Income exist for bankrupt companies, insolvent companies and certain specified types of indebtedness

# Wall Street Hybrids

# Convertibles with Hedge and “Call Spreads” Higher Strike Warrants

# “Call Spreads”

Call spreads were originally designed to take advantage of different tax and accounting treatment.

Three components:

- Noncontingent convertible debt, with a conversion price in the typical range for convertibles (up 25-35%);
- A call or “note hedge,” purchased from one or more counterparties, which exactly matches the conversion feature of the debt; and
- A warrant, sold to the same counterparties, with a higher strike price (up 40-75%) and a slightly longer term (typically 90 days longer).

Taxpayer elects to integrate convertible and note hedge (but not warrants) under Reg. §1.1275-6.

# Convertible + Hedge and Warrants

## Example -

- 5-Year convertible sold for \$1,000 with conversion price of 130% of current stock price and interest rate of 2 percent
- 5-year option with same strike price purchased for \$300
- 5-year, 3 month warrant with strike price of 175% sold for \$140.

Integration results in taxpayer being treated as having issued a synthetic nonconvertible debt for \$700, with \$300 of deductible OID. Warrant transaction is not taxable under section 1032.

For physically settled convertibles, financial accounting does not separate out conversion right and does not integrate, so \$300 is not shown as an interest expense. But for cash-settled convertibles financial accounting requires bifurcation, much like the tax investment unit rules.

# Call Spreads - Tax Issues

Could the purchased call option and the warrants be treated as a single financial instrument (a “call spread”) and hence prevent separate integration of purchased call?

Can the Commissioner deny integration of the purchased call or force integration of the warrants?

Is the transaction subject to the OID anti-abuse rule?

IRS addressed these issues, and reached a favorable conclusion, in General Legal Advice Memo 2007014.

# Debt + Forward Contract Investment Units

("Mandatory Convertibles")

# Mandatory Convertibles Background

Debt whose principal is fully indexed (up and down) to the issuer's stock almost certainly would be classified as a form of equity.

Under IRC §163(I), debt whose principal is payable in, or determined by reference to the value of, the stock of the issuer or a related party, is a "disqualified debt instrument," with the result that interest thereon is not deductible.

# Mandatory Convertibles (Cont'd)

Feline PRIDES (Merrill Lynch), ACES (Goldman Sachs) and Upper DECS (Citigroup) get around these problems by giving investors an investment unit consisting of a debt instrument and a variable forward contract on the issuer's stock. The principal amount of the debt is equal to the price of the stock under the forward contract.

If the two components are respected as separate for tax purposes, the interest on the debt is deductible and any gain or loss on the forward should be nontaxable to the issuer under IRC §1032. A private ruling confirms the applicability of IRC §1032.

# Mandatory Convertibles (cont'd)

It would be most convenient if the debt matured on the same day as the forward contract. The holder could then use the debt proceeds to satisfy its obligation on the forward and simply receive the stock.

But this looks too much like the parties always intended that the obligations would be netted and there is no real debt.

On the other hand, if the debt matures after the forward contract, the holder has to come up with a second round of cash to exercise the forward.

Solution: remarket the debt a few months before the forward contract matures. Interest rate resets to a market rate so the debt will be worth face. Market settled on 3-year forward contract and 5-year debt term, with remarketing 3 months in advance.

On many early deals, remarketings failed because interest rate was subject to a cap (e.g., spread over Treasury yields could not exceed 150 basis points). The caps seemed unlikely to apply when the deals were structured, but when Treasury yield plummeted, corporate yields didn't drop nearly as much, widening spreads to unprecedented levels. Later deals dropped this feature.

# Revenue Ruling 2003-97

In July 2003, IRS ruled that debt/forward contract units would be respected as separate provided four critical factors are present:

- Components separable and no economic compulsion not to separate
- Upon issuer bankruptcy, forward contract terminates and debt is released to holder
- Period debt remains outstanding after forward contract is significant both absolutely and relatively
- Remarketing of debt is substantially certain to succeed.

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# Contingent Payment Convertibles

# Contingent Payment Convertibles

Contingent payment convertibles are just like ordinary convertibles, except that the holder is entitled to additional interest payments upon the occurrence of a contingency.

Contingency typically relates to the trading price of the convertible (e.g., payable if convertible trades at more than 120% of face). Contingency is designed not to be “remote.”

Amount of contingent interest is designed to be more than an “incidental” amount, but not so large as to be terribly costly (typically 25-50 bps).

# Intended Tax Treatment

Interest contingency makes the convertible a CPDI, avoiding the general exclusion from CPDI treatment for plain-vanilla convertibles.

Comparable yield is based on a comparable non-convertible fixed rate instrument.

Not limited to AFR if issuer can show a higher borrowing cost by clear and convincing evidence.

Accruals at comparable yield on entire issue price of instrument.

# IRS Response - Rev. Rul. 2002-31

The CPDI rules apply as long as the contingent interest is not remote or incidental

The comparable yield is a comparable nonconvertible yield

The OID anti-abuse rule does not apply

IRC §163(1) does not disallow interest deductions

IRC §249 does not disallow interest deductions at the comparable yield, but does apply to positive adjustments

# PHONES

# PHONES

PHONES were a form of CPDI developed in the late 1990s to allow issuers with appreciated stock to -

- Hedge against a decline in the value of the stock without triggering recognition of the gain
- Monetize some of the value of the stock
- Take advantage of the CPDI rules to accrue interest on a borrowing that could be repaid with stock

2004 Act effectively shut down PHONES by expanding IRC §163(I) to include debt payable in stock owned by the issuer of the debt.

Still interesting because of what PHONES teach us about the CPDI rules and debt/equity analysis.

# PHONES - Typical Terms

Denominated as debt.

Issued at price of one share of reference stock on issue date (say \$100)

Pays a small current cash yield (1-2%)

Matures in 30 years

At maturity, pays cash equal to the greater of: (1) then value of one share of reference stock or (2) \$100

In simplest terms, PHONES combine:

- a fixed-rate debt instrument issued at about \$32.45 (at 8% discount) that pays current interest of \$2 annually and \$100 at maturity, and
- a long-term call option written by the issuer for a premium of \$67.55 that gives the holder the right to purchase one share of the reference stock at maturity for \$100.

# Are PHONES Debt?

- Debt is an “unconditional promise to pay a sum certain on demand or at a fixed maturity date that is in the reasonably foreseeable future.” For PHONES, the “sum certain” is 100% of the issue price and the maturity date is 30 years (not unreasonably long). These are terms that are indicative of debt.
- Note, however, that the value of the fixed return represents less than one-third of the total value of the PHONES. That would have been a disqualifying factor under the old IRC §385 regulations, but those are gone.
- Superficially, the holder has no downside risk on the stock, because the imbedded option is “at the money.” But unless the stock appreciates to make up the difference between the stated interest rate and the comparable yield, the investor loses. In fact, PHONES are highly correlated to the underlying stock, both up and down.

# Straddle Issue

Are the PHONES a “position” with respect to the reference stock? Proposed regulations under IRC §263(g) takes the view that it is, effective 1/17/2001.

Are the PHONES “indebtedness incurred or continued to purchase or carry” personal property which is part of a straddle? Proposed regulations again say yes, but what is current law?

# PHONES - Constructive Sale

IRC §1259, enacted in 1997, treats certain enumerated transactions as constructive sales for tax purposes. These include short sales, offsetting notional principal contracts and futures or forward contracts. The call option imbedded in the PHONES is not one of these enumerated transactions.

The IRS may issue regulations that treat other transactions as constructive sales if they have the effect of eliminating substantially all of the taxpayer's risk of loss and opportunity for income and gain in the reference stock. These regulations, when issued, are expected to be prospective, except in cases to prevent abuse.

PHONES eliminate much of the risk of ownership of the stock, but perhaps not “substantially all.”

# Mandatory Exchangeables

# Mandatory Exchangeables - Base Case Example

Issuer C owns 1 million shares of XYZ Corp, an unrelated corporation.  
XYZ stock is currently worth \$25/share.

C issues debt instruments, each with a face amount of \$1000 and a term of 2 years. Interest is payable at a market rate, say 6 percent.

At maturity, the holder of the debt receives the value of

- 40 shares of XYZ stock, if the price is \$25/share or less,
- \$1000, if the stock price is between \$25 and \$31.25,
- 32 shares if the price is above \$31.25.

Same formula as used in VPP forward contracts.

# Mandatory Exchangeables - Basic Tax Issues

Is this instrument -

- A CPDI?
- A financial instrument that is not debt (a variation on the variable prepaid forward contract)?
- A combination of a debt instrument and a forward contract?

Problems with each approach:

- No guaranteed return of principal, so not debt under common law.
- No applicable guidance, especially for the periodic payments.
- Contrary to the law that a single instrument generally is not treated as if it were two and that separate treatment requires legal separability and no economic compulsion to keep the pieces together.

For most issuers, if classified as debt, interest is nondeductible under section 163(I) as expanded in 2004. Dealers, however, got an exception from the expansion in section 163(I)(5).

# Mandatory Exchangeables - Factual Variations

Holder always has the right to the value of 40 shares, but issuer has the right to call the instrument before maturity. Call price is above face, so investor keeps some upside in reference stock, but not unlimited.

Value of holder's downside risk outweighs the upside, so the instrument pays "interest" at an above-market rate. For example, issuer has a right to call at par.

Value of upside outweighs the downside, so the instrument pays interest at a below-market rate. Note that if no downside, the instrument is like PHONES and is taxed as a CPDI.

# Mandatory Exchangeables - Issuer Tax Positions

No one thinks these are CPDIs, because of risk to principal. No one wants this result because holders would lose right to long-term capital gain treatment.

No debt component (2<sup>nd</sup> choice above). Periodic payments taxable to holder in full as accrued or received. Lehman takes this approach.

Combination of debt and forward contract:

- If forward contract has no initial negative value to the investor, which could be inferred if the interest rate is at market, then treatment is easy. Stated interest is treated as interest and investor has gain or loss on the forward contract measured by difference between contract price (\$25) and the amount received when the instrument matures (or when issuer exercises its call right).

# Mandatory Exchangeables - Issuer Tax Positions (cont'd)

If interest rate is above market, implying that the forward contract has an initial negative value, issuers have taken 4 different approaches -

- Deem debt to have been sold at a premium and issuer to have paid investor for having entered into the off-market forward
- Treat "interest" payments as interest only to the extent of market rate. Treat excess as put option premium paid to investors. Not taxable until option resolved.
- Same as preceding, but treat excess as "contract fees," currently taxable to investors
- Treat the entire stated interest amount as interest.

# Mandatory Exchangeables - Issuer Tax Positions (concl.)

If interest rate is below market, choice is essentially whether to

- deem debt to have been issued at a discount, so that holder has to accrue OID income (investment unit model), or
- respect form, so that holder accrues only stated rate (convertible debt model).

Tax disclosures generally take the first approach, which is more conservative for holders.

Issuer tax consequences generally under mark to market rules because issuers are dealers.

# Can the System Be Rationalized?

Mark to market?

Expected value (extend CPDI concepts)?

- To long-term options and prepaid forwards?
- To stock??!

Deconstruction of hybrids (including traditional convertibles)? But how to deal with ambiguities?

- Follow description of product in disclosure to investors?
- Follow market practice of requiring investors to follow tax treatment?
- Rulings or other advance guidance process?

Where to stop?

- Should the risk component of interest be taxed the same as the time value component? What about inflation?