Amending a Debt Instrument Trading at a Discount: Beware of Tax Consequences

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May 29, 2020

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In light of the current economic uncertainty, many companies are considering amending their credit agreements and other debt instruments either to minimize the likelihood of breaching financial covenants or to rework payment schedules. As companies consider their options, tax consequences might not always be front of mind, as often there are material overriding commercial issues to address. However, amending a debt instrument that is trading at a discount to par in the secondary market can result in cancellation of indebtedness (COD) income that is currently includible for tax purposes without any associated cash (so-called "phantom income") *even in situations where the principal amount of the debt remains unchanged*. This result is not intuitive and even surprising because the existing debt is not technically cancelled, but rather merely amended.

As described below, amendments can result in an existing debt instrument being treated for tax purposes as retired in exchange for another debt instrument with the new amended terms and, where the debt is trading at a discount, that deemed exchange could cause COD income to be recognized. Perhaps even more surprising is that often the discount inherent in the new debt instrument creates deductions for original issue discount (OID), which will generally match the amount of COD income recognized. As a simple example, if debt with a $1 billion face amount is trading at a 30% discount, an amendment may result in $300 million of COD income currently recognized even though $1 billion of principal is still owed on the debt. The amendment would also result in $300 million of OID, but the deductibility of that OID would occur over the remaining term of the debt and, importantly, may be subject to certain limitations as described below.

Amendments Resulting in a Debt Exchange

In the context of an amendment of a debt instrument that is trading at a discount, COD income arises only if the amendment is a "significant modification" that results in a taxable deemed exchange of the existing debt instrument for the "new" amended debt instrument. Relatively modest changes in yield can result in a significant modification, as can extensions in maturity. Although mere changes to, or suspension of, customary financial covenants are generally not, *by themselves*, significant modifications, other changes made in connection therewith or as part of a plan, including *fees paid to debt*

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holders to secure their consent to such changes, are taken into account in determining whether the changes amount to a significant modification.[1]

COD Determination

If an amendment results in a taxable exchange, an issuer generally will recognize COD income if, and to the extent that, the adjusted issue price of the unmodified debt instrument (which is generally its face or principal amount, unless issued with OID) exceeds the issue price of the amended debt instrument. In the case of a debt instrument that is publicly traded for tax purposes, the issue price of the amended debt instrument will equal the fair market value of the debt (as evidenced by the trading price). Any debt for which there is a recent-enough indicative quote from a broker, dealer or pricing service will generally be considered publicly traded for tax purposes. Therefore, it is almost always the case that COD income will result where debt is significantly modified while trading below par.

COD income is currently included in income, resulting in a tax liability without any associated cash unless the taxpayer has NOLs or current-year losses that can be used to offset it.[2]

Deducting OID

A deemed debt exchange that triggers COD income usually also means that the new debt is issued with OID. Even aside from the time value detriment (*i.e.*, the inclusion of COD income upfront followed by OID deductions over the remaining term of the debt), the OID deductions may not offset the COD income entirely due to rules that limit the deductibility of interest in certain scenarios. In particular, the "applicable high yield debt obligation" (AHYDO) rules and recently enacted Section 163(j) rules can defer or even disallow a portion of the OID deductions.

A debt instrument issued by a corporation will be treated as an AHYDO if it has:

- a term exceeding five years,
- "significant original issue discount" (this would be the case if, as of the end of any accrual period ending after the date that is five years from issuance, the accrued but unpaid OID exceeds an amount equal to the first year's yield on the instrument), and
- a yield that exceeds the applicable federal rate (AFR) plus 5%.

The issuer's OID deductions on an AHYDO that relate to the portion of the OID that exceeds AFR plus 6% will be permanently disallowed, and the remaining deductions for OID will be deferred until the OID is actually paid in cash or other property other than debt of the issuer. Although the AFR currently is historically low, potentially implicating the AHYDO rules for a broader set of debt instruments that are significantly modified, the AHYDO rules will not be implicated for any such debt instrument that has five or fewer years remaining until maturity.[3]

OID deductions that are not deferred or disallowed by the AHYDO rules may nevertheless be limited by recently enacted Section 163(j). Section 163(j) sharply limits the ability of businesses to deduct interest payments when calculating their taxable income. Under this regime, a taxpayer's allowable deduction for business interest expense in a particular tax year is generally limited to the sum of its business interest income plus 30%[4] of "adjusted taxable income" (which is intended to approximate a taxpayer's earnings before interest, taxes, depreciation and amortization (EBITDA)), with any excess carried forward to future years. For tax years beginning after 2021, "adjusted taxable income" (and thus, net interest expense capacity under Section 163(j)) would no longer include depreciation, amortization and depletion deductions (effectively moving from EBITDA to EBIT), which would result in an even more significant limitation on interest deductions.

Conclusion

A company considering an amendment of debt at a time when the debt is trading down is often seeking to stabilize its cash flow position and otherwise entrench its financial position. Given that the amendment can result in an upfront cash tax liability due to COD income, it is paramount to incorporate tax planning into the debt modification process. For example, sometimes a significant modification can be avoided altogether with only minor changes to the commercial deal regarding the debt amendment. Also, AHYDO characterization (and, therefore, disallowance and deferral of interest deductions) can be avoided on an amended debt instrument by including mandatory "catch-up" payments to avoid having "significant original issue discount" after five years.

[1] Significant modifications include any amendment, supplement or other alteration that involves (a) a change in the annual yield of the debt by more than the greater of 25 basis points or 5% of the annual yield of the unmodified debt, (b) a change in the stated maturity or a material change in the timing of any payment of the debt, including deferral of an interest payment (however, there is a safe harbor for deferrals that do not extend past the lesser of five years or 50% of the original term of the debt), (c) a change in the obligor on a recourse debt (with certain exceptions), (d) a change in a substantial amount of the collateral or security for a non-recourse debt (with certain exceptions), and (e) the addition or deletion of a guarantor (in the case of a recourse obligation) or a co-obligor that results in a material change in payment expectations with respect to the debt.

[2] COD income generally is excludible from taxable income for taxpayers that are bankrupt or insolvent, but, as a trade-off, tax attributes of the bankrupt or insolvent taxpayer (including NOLs and depreciable asset basis) are subject to reduction or elimination. It's important to note that, for pass-through entities, bankruptcy or insolvency is tested at the owner level. Also, a claim of insolvency for these purposes could potentially carry non-tax considerations, such as triggering defaults on other debt instruments.

[3] More precisely, the AHYDO rules will not apply to any debt instrument that matures by the end of the first accrual period after five years from issuance, because there would be no unpaid OID at the time for determining whether there is "significant original issue discount."

[4] 50% for 2020.