Buyer Beware: Key tax issues that arise from private equity investment in distressed debt

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Due to the current state of the credit and bond markets, many market participants are being presented with opportunities to acquire debt obligations from lenders at significant discounts to face amount. These opportunities are increasingly being capitalized upon not only by current borrowers, who are taking advantage of opportunities to redeem their own debt at discounts to face, but also by unrelated investors who are raising funds to acquire third-party distressed debt, often with an eye towards ultimately obtaining ownership of the underlying collateral. These transactions have the potential to create significant investment returns, with lower risk due to the superior capital structure position. However, the tax consequences associated with these types of transactions are very complex and often counter-intuitive. This summary will highlight some of the more significant tax issues that arise in connection with these types of market transactions.

Discounted debt can trigger phantom tax for both the borrower and investor

It is a fairly well-known principal of the tax law that a debtor who repurchases or retires debt for an amount less than the amounts owing will be required to recognize cancellation of indebtedness (“COD”) income for tax purposes. What is perhaps not as well known, however, is that the debtor can be required to pay tax on COD income even in some circumstances where the full amount of the debt remains owing. For example if a purchasing entity which is “related” to the borrower acquires debt from the lender at a discount, then the acquisition will also generally trigger taxable COD income to the borrower in an amount equal to the discount.

The tax law has several possible exceptions which, if applicable, might allow the borrower to either totally exclude this COD income from tax or defer it into future years. These exceptions are fairly limited and very complex, and would require an analysis of the exact facts and circumstances surrounding the transaction to determine the extent to which they apply. In addition, for COD income occurring in 2009 or 2010, newly enacted Section 108(i) of the tax code may, if applicable, allow the borrower to elect to defer the recognition of this COD income until 2014-2018.

The tax code has very detailed rules (including complex and broad “constructive” ownership and attribution rules) which define “related” parties for this purpose. Generally speaking, an entity that purchases the debt will be treated as “related” to the borrowing entity if the purchasing entity owns (or is treated as owning) more than 50 percent of the borrowing entity, or the same persons own (or are treated as owning) more than 50 percent of both the purchasing entity and the borrower.
Also, if a related party purchases debt at a discount under circumstances which trigger COD income to the borrower, the tax law requires the purchaser to include the “discount” into income as interest over the remaining term of the debt (so-called “original issue discount”) thereby creating potential phantom taxable income to the purchaser. In other words, if the debt has a face amount of, say, $10 million, and a related party purchases the debt from the lender for, say, $7 million, the $3 million of “discount” is required to be included in taxable income to the purchaser as “phantom” interest income over the remaining term of the debt, regardless of whether it is actually paid. The borrower receives a concomitant tax deduction for the same amounts.

Additional phantom tax for investors triggered by debt modifications

Perhaps the most surprising tax consequences associated with a purchase of discount debt are those associated with a significant modification of the debt. Under the tax law, if an outstanding debt instrument is “significantly modified,” the note holder is deemed, for tax purposes, to have exchanged the “old” note for a “new” note containing the modified terms. For non-publicly traded notes, this “deemed” exchange will (under the general rules) create taxable gain or loss to the note holder based on the difference between the face amount of the modified note and the note holder’s tax basis in the original note.

To illustrate how these rules would operate, assume that an investment fund purchases a non-publicly traded note with a $15 million face amount for $10 million (i.e., $5 million discount) and then shortly thereafter enters into various modifications of the note with the borrower (perhaps extending the maturity, reducing interest, increase collateral, etc.). If these modifications are deemed to be “significant” then the investment fund will be deemed for tax purposes as having exchanged the original note for a brand new note containing the modified terms. The investment fund would recognize a short-term capital gain equal to $5 million in this example, which is measured by excess of the face amount of the “new” note ($15 million) over the investment fund’s tax basis in the “old” note ($10 million).

This gain is pure phantom taxable income which certainly does not have any basis in economic reality. Depending upon the exact facts and circumstances, there may be one or more possible strategies for mitigating this tax problem for the investor. For debt which has been issued by a “corporation,” the deemed exchange of the “old” note for the “new” note can sometimes qualify as tax-free under the tax rules applicable to corporate recapitalizations. However, for private, non-corporate debt, the tax-free recapitalization rules do not apply and the result is a taxable exchange for the investor. In these cases, the parties may be able to avoid this taxable exchange by entering into the modifications prior to the time the debt is purchased at a discount by the investment fund. This is not always practicable, however, and in cases where the amendments cannot be consummated prior to the purchase, the investment fund might be able to mitigate this phantom tax liability through use of the installment method of reporting tax gains under the tax code (although such method has limitations).

Market discount rules create ordinary income for investors

For investors who purchase discounted debt without making significant modifications, a different set of tax rules come into play. These rules are known as the “market discount” rules.
In general, any purchase of debt in the secondary market at a discount creates what is known in the tax code as “market discount” in an amount equal to the discount. For tax purposes, the market discount will accrue over the remaining term of the debt pursuant to a formula, and then is required to be recognized as ordinary income (rather than capital gain) upon redemption or disposition of the note. (Alternatively, the debt holder is permitted to elect to include the market discount into taxable income over the remaining term of the debt as it accrues (and regardless of whether paid). Thus, for an investor who, for example, purchases a $15 million face amount note in the secondary market for, say, $10 million, and then holds the note to maturity and collects the full $15 million, the $5 million “accrued” market discount will be taxable as ordinary income rather than capital gains. Moreover, partial principal payments which are made prior to maturity can often accelerate the recognition of this ordinary income for the investor.

These market discount rules are very broad and apply to most types of discount debt transactions in the secondary market. However, for distressed debt which perhaps is even in default (and thus immediately due and payable) at the time of the investor’s purchase in the secondary market, there are some arguments that perhaps the market discount rules of the tax code should not apply. Thus, investors in these types of instruments (i.e., distressed, deeply discounted and/or perhaps in default) may have some arguments to support a position that some or all of their gains from such transactions can be reported as capital gains. The strength of this position and/or advisability of taking such a position in any given transaction will depend on the exact facts and circumstances surrounding the investment.

Phantom tax issues to creditor from foreclosures

Many investments in distressed debt are made by the investor with an eye towards obtaining ownership of the collateral securing the loan. These types of “loan to own” transactions can also give rise to phantom tax liabilities. Very generally speaking, the creditor will recognize taxable income to the extent that the fair market value of the property received exceeds the creditor’s tax basis in the debt, and the creditor will recognize a taxable loss to the extent the value of the property received is less than the creditor’s tax basis in the debt. In any event, the creditor will take the property with a tax basis which is equal to the fair market value of the property as of that time. For example, if an investor purchases a $10 million face amount debt for, say, $5 million, and then shortly thereafter obtains ownership of the underlying collateral (either through deed in lieu or foreclosure, etc.) in full satisfaction of the debt at a time when the value of the collateral is, say, $7 million, the creditor will recognize $2 million of taxable income as of that time.

Tax issues for foreign investors

Special tax issues apply in transactions involving non-US investors, including potential withholding taxes and/or US tax return filing requirements for such non-US investors. Investment funds which are taxed as “partnerships” and which have non-US investors as partners need to carefully analyze these rules as these withholding tax obligations and/or reporting obligations can also be imposed upon the investment fund.
Interest income, for example, from a debt issued by a US borrower can be subject to 30 percent withholding taxes to the extent allocable to non-US persons. Certain exemptions are available under the US tax law (most notably the “portfolio” interest exemption) for transactions that qualify and which are otherwise structured properly. In addition, there is some concern under the tax law that an investment fund which purchases distressed debt and restructures such debt may be deemed to be engaged in a “US trade or business” for tax purposes, thereby subjecting any non-US partners in the investment fund to US not only regular income tax obligations and return filing requirements, but also potentially an additional layer of taxation known as the “branch profits” tax (applicable to foreign corporations). Finally, an investment fund which forecloses upon or otherwise takes title to a US real estate asset can also subject non-US investors to these same adverse tax consequences (namely, regular income tax, plus reporting, plus possibly branch profits, etc.). In each case, these obligations of the non-US partner are often also obligations of the US investment fund through mandatory withholding obligations. These are all issues that should be carefully analyzed and managed by any US investment fund with non-US participants.

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