

PRIVATE INVESTMENT
FUND TAX &
ACCOUNTING FORUM

FRA's Private Investment Fund Tax and Accounting Forum

Tackle Tax Issues of Restructuring Distressed Debt and Business

Steven D. Bortnick, Partner
Steven.Bortnick@troutman.com

Robert Altieri, CPA, Principal
Robert.Altieri@flsv.com

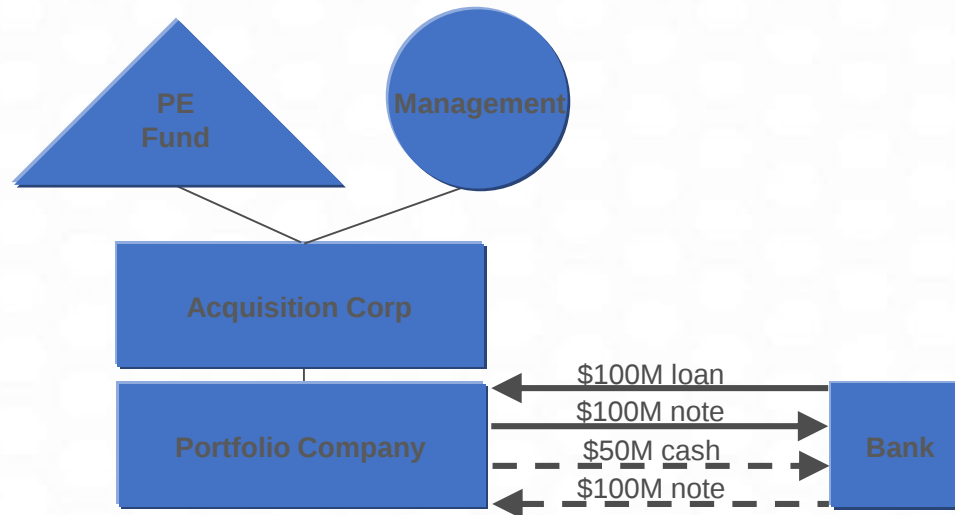
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Tax Issues Related to Distressed Debt Investing

Portfolio Company Purchases its Debt

Structure 1



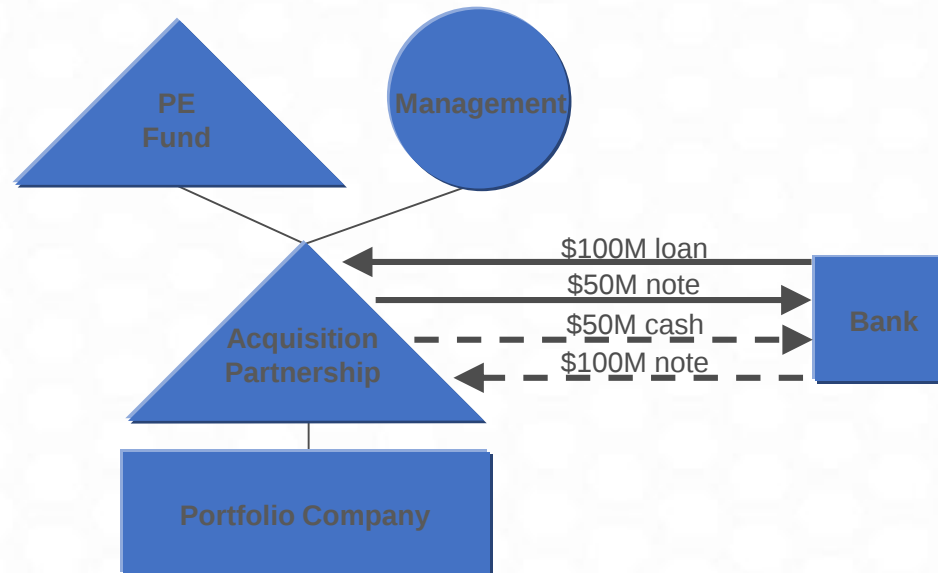
Portfolio Company purchases its note with \$100M face amount from Bank for \$50m cash

Portfolio Company Repurchases Debt

- Income from the Cancellation of Indebtedness (“COD Income”)
- How to measure COD Income
 - Debt issued with original issue discount (“OID”)
 - Debt not issued with OID
- Character of COD Income
- Traditional exceptions to recognition of COD Income
 - Bankruptcy
 - Insolvency

Partnership Acquisition Vehicle Repurchases its Debt

Structure 2



Acquisition partnership purchases its note with \$100M face amount from bank for \$50M cash.

Partnership Acquisition Vehicle Repurchases its Debt

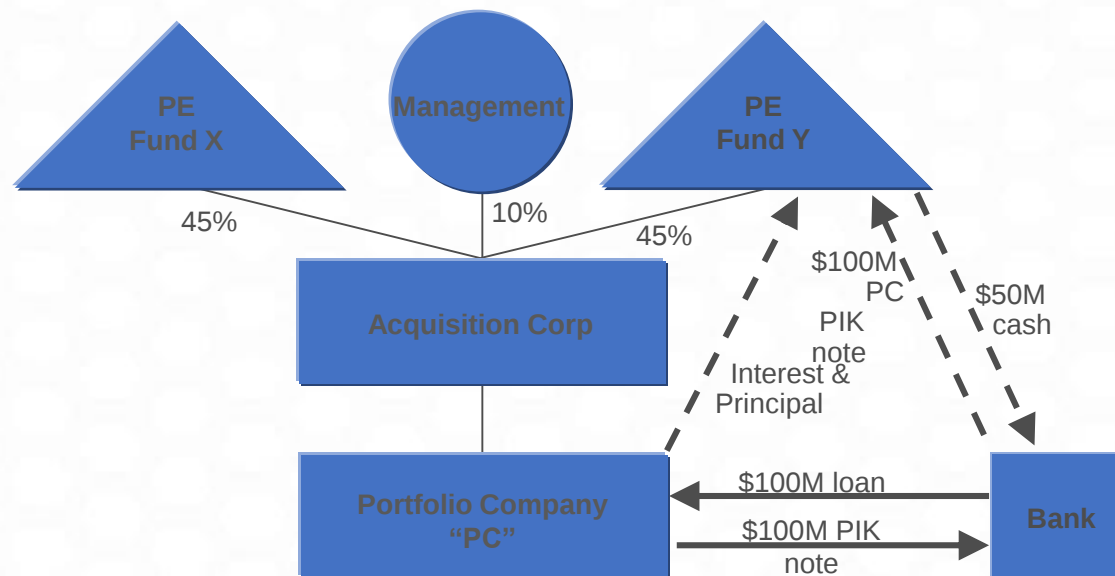
- COD Income
- Phantom / Dry Income
- Where to test bankruptcy / insolvency
- Who gets taxed on COD Income?
 - Special rules
- Technical rules to deal with deemed distributions

Fund Purchases Debt

- Is fund related to issuer of debt?
 - Corporation and partnership related if:
 - Same persons own more than 50% in value of the outstanding stock of the corporation and more than 50% of the capital interest or profits interest in the partnership
 - OR
 - Treated as single employer under Section 414
 - PE fund position on this
 - Constructive ownership rules apply

Unrelated Fund Purchases Debt

Structure 3



PE Fund of purchases \$100M portfolio company PIK note from bank for \$50M. Assume PIK note was issued at \$100M, all interest may be paid in kind and assume PIK interest has accrued to date of purchase.

Unrelated Fund Purchases Debt – A Summary of Investor Tax Issues

- Debt investments tax characteristics:
 - Interest income taxed at ordinary rates (*character*)
 - Accrual accounting requires interest income inclusion before cash receipt (*timing*)
 - Payments made on debt instruments are presumed to be unpaid, accrued interest first (*character*)
 - Realized gains from debt acquired at a discount may be recharacterized as interest income (i.e., market discount), even if held for more than 1 year (*character*)
 - “Bad” debt investments generally result in capital losses, which come with their own deduction limitations (*character and timing*)
- Types of Interest Income and Methods of Accounting:
 - Qualified stated interest (“QSI”) and Original issue discount (“OID”)
 - Timing of interest income inclusions depends on taxpayer’s method of accounting: cash vs accrual
 - Cash method – QSI recognized when cash received, OID recognized with passage of time
 - Accrual method – QSI and OID recognized with passage of time
 - Interest accrued but not collected is “reversed” by way of deduction, not elimination of gross income!

Unrelated Fund Purchases Debt – Distressed Debt Issues

- Tax characteristics applied to Distressed Debt Investments:
 - Despite equity-like risk (i.e., price volatility and uncertain cash flows), the distressed debt instrument is not taxed as equity
 - Accruing QSI that may never be collected (during the tax year)
 - Accruing OID that may never be collected (at maturity)
 - Applying the interest-first payment ordering rule when final payments are less than amounts owed
 - Requiring market discount recharacterization of capital gain
- Example:
 - PE Fund purchased \$100m portfolio company PIK note from bank for \$50m
 - PE Fund accrues PIK interest unless facts and circumstances allow for ceasing of PIK interest (to be discussed)
 - PE Fund tracks accretions of market discount over remaining term of PIK Note. Unless facts and circumstances dictate otherwise, PE Fund recharacterizes payments or capital gains from sale or exchange as interest income under market discount rules

QSI and OID Accruals and The Doubtful Collectability Doctrine (“DCD”)

- General Rule
 - No QSI accrual required if there is no reasonable expectation of payment (Rev. Rul. 80-361)
 - TAM 9538007 and OID accruals
 - IRS has contrary position of Rev. Rul. 80-361 for OID accruals
 - Most practitioners have widely criticized TAM 9538007 and believe the DCD applies equally to OID. The IRS is aware of such criticism.
- Implementing the DCD:
 - Facts and circumstances test that is applied narrowly. Applied on a loan-by-loan (not issuer) basis.
 - The DCD standard is that no reasonable expectation that the interest payment will ever be made. Not the entire principal amount.
 - “Insolvency” is often stated as support of evoking the DCD. Insolvency likely means cash-flow insolvency (vs. balance sheet insolvency). Trading price of debt instrument not dispositive of a DCD determination.
- Practical impact of the DCD:
 - Puts method of accounting of QSI and OID on cash-method. Interest paid still ordinary income!

Allocation of Payments on Distressed Debt Instruments

- General rule:
 - For scheduled payments and unscheduled non-pro-rata payments, presumed to be a payment of accrued but unpaid QSI or OID under Treas. Reg. Sections 1.446-2(e) and 1.1275-2(a) (*i.e.*, “interest first”)
- Application to distressed debt investments:
 - Pre-Treas. Reg. Sections 1.446-2(e) and 1.1275-2(a) authorities leave room for exceptions to these rules when a payment is made in complete satisfaction of the debt instrument for less than the full amount due (*i.e.*, “principal first”)
 - If DCD is evoked and debt instrument is still performing, a payment from debtor or upon sale of debt instrument should result in QSI or OID recognition
 - If debt instrument is bought “flat”, payment received upon sale or redemption is not considered interest (Treas. Reg. Section 1.61-7(c))
- Practical impact of the rule:
 - Avoids a combination of ordinary interest income and capital loss upon settlement or sale of distressed debt instrument

Market Discount and Distressed Debt

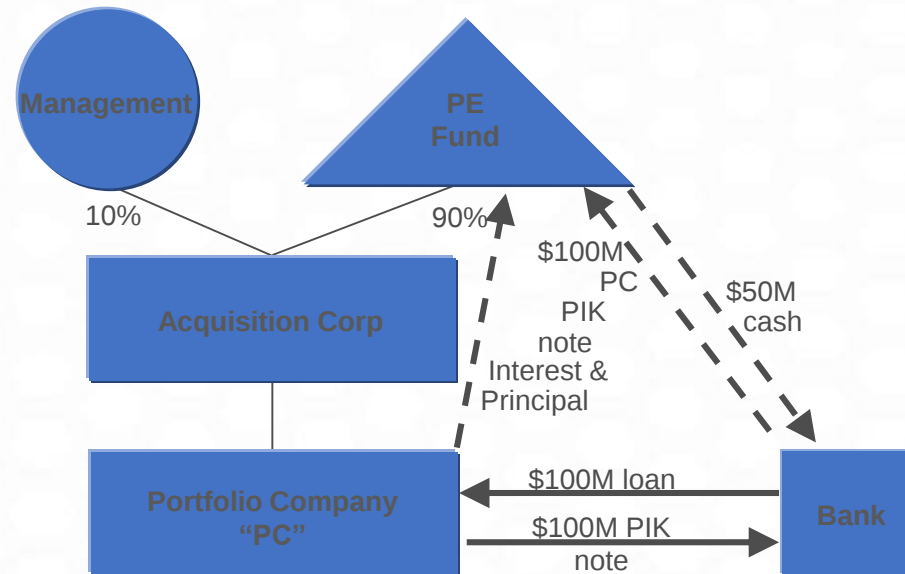
- General Rule:
 - Rules enacted to ensure that secondary market purchasers of debt could not have a character advantage when buying lower-yielding, older debt at a discount vis-à-vis higher-yielding newer debt
 - Two prongs: (i) capital gain recharacterized to interest income upon disposition of debt instrument to the extent market discount accretes, and (ii) partial principal payments trigger ordinary income to the extent of accrued market discount.
 - Applying the market discount rules to distressed debt where punish investors for taking equity-like risk by taxing investment profit as if it was an investment grade debt instrument
- Application to distressed debt:
 - Pre-market discount case law from the 1960s, (*Liftin* and *Underhill*) held that investors who buy speculative investments could treat principal payments as return of basis first. (Rules at time said it was pro-rata ordinary income).
 - 1984 Bluebook: “capital gains treatment should not be afforded to a **largely predictable return** (such as that available on a **typical** market discount bond).
 - Arguments thus have been made that the market discount rules did not specifically address these cases and therefore did not pre-empt such cash law. (*i.e.*, the “pre-emption argument”)

Market Discount and Distressed Debt (cont'd)

- Application to distressed debt:
 - Joint Committee's description of the President Clinton's Fiscal 2000 Budget: "There is authority for the proposition that, in situations where the **amount of realizable discount is uncertain**, the taxpayer may recover his basis in the debt instrument before recognizing any market discount (*i.e.*, open-transaction approach)." (*i.e.*, acknowledging the "pre-emption argument")
 - In situations where the debt instrument has had an event of default, market discount cannot mathematically be computed because the formula to accrete market discount depends on the maturity date of the debt. (the "math argument")
 - Therefore, investors often take the position that if the debt (i) has speculative purchase price (*e.g.*, 50% discount or nominal yield of AFR + 10%), (ii) was acquired when the debt is in default, or (ii) that has an event of default before maturity should be outside the scope of the market discount rules.
 - Testing dates of those facts at least annually?
- Practical Impact of Rule:
 - Normalizes equity-like tax treatment for debt instruments acquired under equity-like risk assumptions

Related Fund Purchases Debt

Structure 4



PE Fund of purchases \$100M portfolio company PIK note from bank for \$50M. Assume PIK note was issued at \$100M, all interest may be paid in kind and \$25M PIK interest has accrued to date of purchase.

Related Fund Purchases Debt

- COD Income
 - How to calculate COD Income
 - Availability of traditional exceptions
- Deemed reissuance of note from original issuer to related party at purchase price
- Converts market discount to OID
 - See discussion above regarding timing and character

Related Fund Purchases Debt – AHYDO Issues

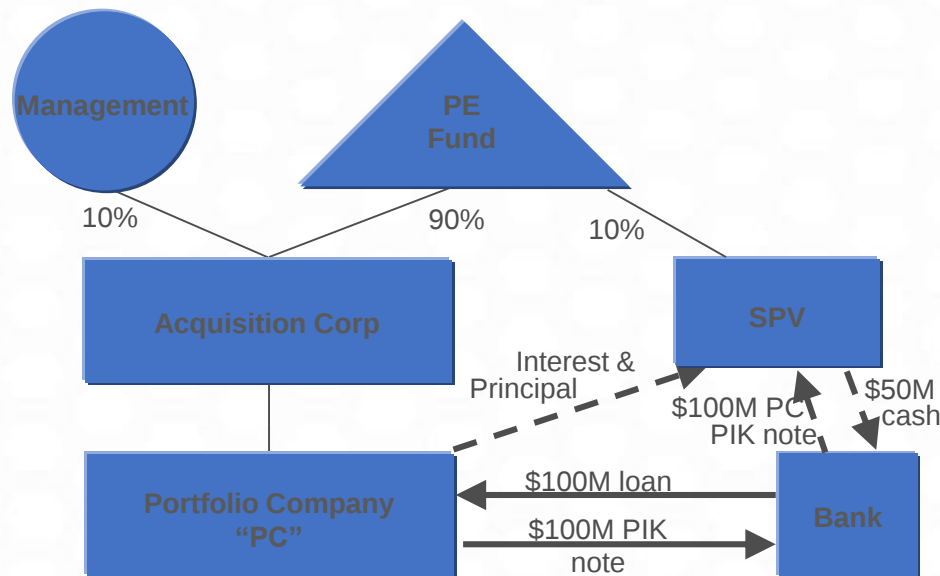
- Applicable High Yield Discount Obligation (“AHYDO”)
 - Defined
 - Maturity date > 5 years
 - Yield to maturity $\geq$ sum of AFR + 500 basis points
 - Significant OID
 - No deduction on “disqualified portion” of OID and remainder of OID deductible only when paid
 - Impact on holder if distressed?

Special Purpose Vehicle Purchases Debt

- Reasons for SPV
 - Combine moneys of different purchasers, which may be different or a smaller group than the shareholders of the portfolio company
 - Avoid COD Income
 - Defer recognition of OID / Accrued Interest (US and foreign laws relevant for foreign investors)
 - Minimize tax in jurisdiction where SPV formed
 - ICAV transactions popular

SPV Purchases Debt

Structure 5



SPV purchases \$100M portfolio company PIK note from bank for \$50M. Assume PIK note was issued at \$100M, and interest may be paid in kind and \$25M PIK interest has accrued to date of purchase.

Portfolio Interest

- Interest (including OID) paid to foreign corporation normally taxed at 30% (or lower treaty rate)
 - Collected by way of withholding
- Portfolio interest paid to foreign corporations not subject to tax
- Portfolio interest doesn't include interest paid to a 10% shareholder
 - 10% voting power of a corporation
 - Stock attribution rules apply

Treaty Rules

- If interest would not be portfolio interest, may form SPV in treaty country
- Treaties may reduce or eliminate withholding tax on interest
- Is treaty available?
 - Limitation on benefits provisions
 - Poland and Hungary – currently no LOB provisions
 - Anti-conduit regulations
- Assuming can get over LOB and anti-conduit issues, must find way to minimize / limit taxation in SPV home country

Is SPV Related to Issuer?

- Two corporations are related if:
 - There is a common parent corporation that owns > 50% (by vote or value) of at least 1 other corporation, and > 50% (by vote or value) is owned by each corporation (*i.e.*, all corporations in one or more chains connected by a common parent are related)
 - 5 or fewer persons who are individuals, estates or trusts own stock possessing more than 50% (by vote or value) of each corporation, taking into account only stock to the extent such stock ownership is identical with respect to each such corporation
 - They are treated as a single employer under Section 414
 - PE fund position on this
 - Constructive stock ownership rules apply

Related SPV Purchases Debt

- COD Income
 - How to calculate COD Income
 - Availability of traditional exceptions
 - Deferral of COD Income
 - “Reacquisition” includes acquisition by related party
- Deemed reissuance of note from original issuer to related party at purchase price
- Converts market discount to OID
 - See discussion above regarding timing and character
 - Still relevant if SPV is CFC or PFIC

Controlled Foreign Corporations

- Controlled Foreign Corporation (“CFC”)
 - US persons (including Delaware partnerships) that own at least 10% (by vote or value) of SPV own in the aggregate more than 50% (vote or value) of SPV
- Interest, OID and capital gain are taxed to 10% shareholders as ordinary income regardless of when distributed
- Interest paid from 1 corporation to a related corporation formed in the same country (which uses a substantial portion of its assets in that country) not subject to deemed dividend rules if interest doesn’t reduce Subpart F income (but may be GILTI)

Passive Foreign Investment Company

- Passive Foreign Investment Company (“PFIC”)
 - 75% or more of gross income is from passive sources or
 - 50% or more of average assets generate passive income or no income
- Interest or OID from a related party not treated as passive for this purpose (if not paid out of passive income)
- US shareholders (regardless of ownership %) of PFIC must either elect to pay tax on ordinary income and net capital gain as derived by the PFIC or “excess distributions” and gains on sale allocated to all periods in holding period, taxed at highest rate of tax in effect in such years and interest rate applies to deemed tax deferral

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Net Operating Losses



NOLs under TCJA

- Background (under TCJA of 2017)
 - NOLs and certain tax credits, if not useable in a tax year, can be carried forward for use against future income.
 - Post-2018 NOLs may not be carried back, but can be carried forward indefinitely, but usability is limited to 80% of taxable income

NOLs under CARES

- The Coronavirus Aid, Relief, and Economic Security Act (“CARES Act”) enacted on March 27, 2020 provides certain changes to NOL usability:
 - NOLs arising in certain tax years may be carried back to 5 prior tax years (but not for REITs), including to years prior to 2018
 - Temporarily removes the 80% limitation for NOL usability

Benefit of NOL Carrybacks under CARES

- NOLs arising in tax years after December 31, 2017 and before January 1, 2021 may be carried back to 5 prior tax years (but not for REITs), including to years prior to 2018:
 - Can create rate benefit for carrybacks to 2013 to 2017 (35% vs. 21%)
 - Companies may consider adopting various timing strategies for expenses
 - Loss companies need to model the impact of a carryback claim for lost deductions (Section 199), international tax issues (GILTI, FDII & BEAT)

NOL Carrybacks Considerations

- 5 year carryback is mandatory (absent an election to waive)
- Procedure 2020-24 allows a loss corporation to waive the carryback on the next tax return filed after March 27, 2020 for 2018 or 2019 NOLs
 - Check Schedule K, box 11 of Form 1120 to see if waived
- Section 382 generally does not apply to limit the loss corporation's ability to carryback its NOL to a tax year prior to an ownership change
 - May need to consider Section 382 on springing credit carryforwards
 - Verify the NOL being carried back is not related to a recognized built-in loss

Alternative Minimum Tax Considerations

- Need to determine impact of alternative minimum tax
 - May 28th IRS FAQs require taxpayers to treat the alternative minimum tax NOL amount arising in a post-2017 year as zero
 - Under CARES, 100% of an AMT credit will be treated as refundable for cash if a special election is made
- Need determine which party is claiming the refund for alternative minimum tax credits if the member left the group
 - Determine how NOLs and AMT credits are allocated between departing members
 - See Prop. Treas. Reg. Section 1.1502-55(h)

M&A Considerations

- Review SPA agreements for acquisitions occurring in '18, '19 and '20 to see who can claim the benefit of pre-acquisition losses
- Negotiate with sellers on carrybacks of post acquisition NOLs
- Review tax sharing agreements for separations and tax-free spin-offs

Example - Pre-Closing NOL of a Target

- Acq. Co (a “C” corporation) acquires Target (a standalone “C” corporation, not part of a consolidated tax group) on June 30, 2018. Target had a loss for the stub period January 1, 2018 – June 30, 2018. (The loss may well have been due to the deduction of transaction expenses). There was a federal stub period income tax return to be filed for Target for the year January 1 – June 30, 2018, because Target joined the consolidated return of Acq. Co.
 - At the time of the deal, federal tax rules did not allow a carry back of the NOL. It could only be carried forward. The amount of the NOL that could be used each year in a carry forward may have been subject to limitations because of the change of control of the Target corporation.

Example – Cares Act Implications

- Under the CARES Act, the NOL as of June 30, 2018 must now be carried back to 2013 – 2017 (earliest year first), with refunds claimed if the Target was a taxpayer in those years, unless Target has waived the carry back.
 - If the SPA allocates tax refunds to the Seller, to preclude the carryback, and take the benefit of the NOLs in future periods, the Target MUST waive the carryback in a timely manner. If the SPA is, however, silent on the benefits of tax refunds, the refunds would inure to the Target (and thus the Buyer), but there may be contractual provisions relating to the filing of amended returns that are required to capture the benefit of the refund.
- Practice Tips –
 - Review acquisition agreements for restrictions on amended returns. Refund Claims.
 - Cooperation and approval clauses related to tax filings and tax positions

Steven D. Bortnick



O: 609.951.4117
M: 609.610.4171
steven.bortnick@troutman.com

- Partner in the Tax Practice Group and Investment Fund Industry Group, resident in the Princeton and New York offices.
- Focuses practice on domestic and international tax and private equity matters.
- Handles a broad range of transactions, including asset, stock, cross-border and domestic acquisitions, tax-free spinoffs, recapitalizations and reorganizations.
- Experienced in the structuring of domestic and international private equity transactions from tax and venture capital operating company standpoints.
- Advises US and foreign funds on tax and VCOC issues in connection with formation of private equity funds.
- An active speaker and author and topics of his presentations include private equity, venture capital, cross-border investing, venture capital operating company issues, and merger and acquisition tax issues.

Robert Altieri, CPA



Principal
Frankel, Loughran, Starr
& Vallone LLP
1475 Franklin Avenue
Garden City, NY 11530
516.874.8871
Cell: 724.516.0864
Robert.Altieri@flsv.com
Website: www.flsv.com

Robert has provided tax and advisory services to professional investors, investment managers, and privately-owned businesses for over a decade. Robert advises his clients on a wide variety of tax issues including transactional planning, fund structuring, distressed investing, and financial instruments.

Prior to re-joining FLSV in 2018, Robert served as a Tax Manager at Centerbridge Partners, L.P., where he focused on Centerbridge's distressed debt and special situation funds dealing with a wide range of tax matters, including U.S. and non-U.S. debt investments, private equity investments, portfolio company restructurings, and international tax issues. Prior to Centerbridge, Robert spent four years at Deloitte Tax, where he advised private equity, venture capital and asset management clients on U.S income tax matters.

Robert received a bachelor's degree in accounting from James Madison University, where he played varsity baseball. He also completed a Master of Science in Taxation degree from SUNY-Old Westbury. He is a member of the New York State Society of Certified Public Accountants (NYSSCPA).

THANK YOU

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