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PIK Toggles Are Back: Uncertainty for AHYDO Savings and Catch-Up

Tax Update

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Issuers and their advisors need to be aware of the potential pitfalls and uncertainties of the applicable high-yield discount obligation rules, which can have the effect of permanently disallowing a portion of interest deductions.

Though the issuance of PIK toggle high-yield debt bottomed out following the credit crisis, its issuance has resumed and increased over the last several years, beginning in 2012 and increasing in 2013 and 2014. With more of this debt entering the market, issuers and their advisors need to be aware of the potential pitfalls and uncertainties of the applicable high-yield discount obligation (AHYDO) rules, which can have the effect of permanently disallowing a portion of interest deductions.

A "PIK toggle" debt instrument is one that permits the issuer to decide annually whether to pay interest in cash or accrue it for payment later, commonly known as "paying in kind" or "PIK." Because interest is not mandatorily payable on at least an annual basis, the debt instrument has original issue discount (OID),[1] and if the AHYDO rules are met, the deductibility of the OID may be deferred or denied. As described below, there is a mechanism to preclude the denial of the deduction, but its application is subject to considerable interpretative uncertainties.

When Is Debt Subject to AHYDO?

Debt with OID may be subject to the negative effects of the AHYDO rules if it (1) is issued by a corporation,[2] (2) has a term of more than five years, (3) has a yield to maturity (YTM) greater than 5 percent plus the applicable federal rate (AFR) for the month of the debt's issuance,[3] and (4) the instrument's OID is "significant." OID is "significant" if, under the terms of the debt, the amount of accrued but unpaid OID at the end of an accrual period that occurs more than five years after the issuance of the debt could be greater than one year's worth of yield, calculated based on the YTM of the debt (referred to herein as the one-year yield or OYY).

The most significant downside for an issuer subject to the AHYDO rules is the possibility of the suspension of, or permanent disallowance of, interest deductions. For all OID on AHYDO debt, the issuer will not receive an interest deduction until the OID is actually paid (which, in many cases, will be at maturity).[4] The "disqualified portion" of the OID interest, which is never deductible, is generally the OID attributable to the amount by which the total YTM of the debt exceeds 6 percent (not the 5 percent as above) plus the AFR.

Self-Help to Avoid AHYDO

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Typically, issuers attempt to prevent debt from being treated as AHYDO debt by adding what is referred to as an "AHYDO savings clause" or "AHYDO catch-up clause" to the terms of the debt. These provisions alter the terms of the debt such that, notwithstanding any other term of the debt,[5] when the accrued but unpaid OID could exceed the OYY at the end of any accrual period occurring more than five years after the date of the debt's issuance, the issuer will make a cash payment to the holder (before the end of that post-five-year accrual period) in an amount sufficient to decrease the accrued but unpaid OID to less than the OYY. It is often in the interest of both issuers and holders to include an AHYDO catch-up clause because it allows issuers to avoid AHYDO treatment while not paying any more than they would otherwise pay and it accelerates cash payments to holders.[6]

For example, in the case of straight PIK debt issued in January 2012 with a $100 issue price, 10-year term, semi-annual accrual period, and 10 percent YTM (all of which is attributable to OID), prior to the end of the accrual period five years and six months from the issuance of the debt (July 2017, and for each accrual period thereafter) a cash payment would be made to the holder such that the accrued but unpaid OID did not exceed $10.

Special Problems with PIK Toggle Debt

The amount of an AHYDO catch-up payment likely can be calculated with relative certainty in the case of PIK debt that does not have a "toggle" feature (whereby the issuer can elect to pay in cash or in kind). However, in the case of PIK toggle debt, the elective nature of the PIK payment raises significant questions because the calculation of the amount of the catch-up payment is not addressed in the applicable sections of the Internal Revenue Code of 1986, as amended (Code), or Treasury Regulations.

PIK toggle debt generally only provides for the option to pay in kind during the earlier years of the debt, and typically an election to pay in kind results in a higher interest rate for the issuer. Under the OID regulations, because the cash payment option produces a lower yield, the issuer generally is assumed to pay in cash for purposes of calculating the YTM at the time of issuance. This assumption is, however, in conflict with certain of the AHYDO rules.[7] Further, under the general OID rules, when, contrary to the "low yield payment assumption" in the OID regulations, an issuer elects to pay interest in kind, the debt is deemed (solely for tax purposes) to be retired and reissued at an amount equal to the issue price at that time. This reissuance generally has the effect of changing the YTM of the debt and creating a new issue price for the remainder of the term of the debt.

Determining the OYY is a critical component of determining the amount of an AHYDO catch-up payment. There is, however, no clear guidance on how to make that determination. When the YTM and the issue price of debt change during its term, it is not clear under the AHYDO rules whether it is (1) the issue price of the debt on day one or (2) the issue price at a later date (closer to the time of the catch-up payment) as a result of an election to PIK that should be used in calculating the OYY. Similarly, the YTM of PIK toggle debt also may change during the term of the instrument. In this case, it is unclear whether the YTM would be (1) the initial YTM calculated under the general OID rules, (2) the YTM determined under the AHYDO assumption that interest eligible to be paid in kind is paid in kind, or (3) the actual YTM based on the facts that occur prior to the end of the first accrual period after the debt's fifth year outstanding.

The uncertainty as to the appropriate determination of the YTM and issue price affects other aspects of determining the amount of a catch-up payment as well. For example, to determine amount of the catch-up payment, the accrued but unpaid OID at the end of the relevant post-five-year accrual period must be calculated.

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This requires a determination of the applicable YTM and issue price.

Pepper Perspective

In each of the cases above, issuers are left with the difficult decision of choosing to interpret the provisions of the Code and Treasury Regulations in a reasonable way such that they produce (1) a conservative (larger) catch-up payment (*e.g.*, by choosing interpretations that reduce the OYY amount) or (2) a smaller catch-up payment.

As a result of the significant negative consequences of an instrument becoming subject to the AHYDO rules, it may be appealing for an issuer to simply select a larger payment (as, assuming sufficient cash, this may allow them to pay off a portion of high-yield debt earlier). However, a larger payment may run afoul of certain provisions of the debt (perhaps a redemption premium on any amount exceeding the appropriate amount). Aside from living with the tax uncertainty, holders may prefer to be paid earlier and, thus, would object to what they believe to be an inadequate catch-up payment. Accordingly, issuers and their advisors must balance these considerations and model the impact of these rules based on their specific situation because many of the issues associated with these rules are not addressed by the Code and Treasury Regulations.

Endnotes

1 Generally, OID is the difference between the total amount of payments received under a debt instrument (whether in the form of principal or characterized as a payment of interest) that are not interest payments made on at least an annual basis. OID is typically accrued into the income of the holder on a yield-to-maturity basis, regardless of whether payments are actually received by the holder (a corresponding interest deduction for the issuer is typically available at the same time). “Yield to maturity” (YTM) is not defined in the AHYDO rules, but, under the general OID rules, it is the discount rate at which the present value of all payments under a debt instrument equals its issue price. OID accounts for the fact that, for example, a two-year debt instrument that is issued in exchange for $100 and pays $121 at maturity (without annual interest payments) is the economic equivalent of debt that makes annual interest payments at a 10 percent annual percentage yield.

2 Although, in some cases, debt issued by a partnership with corporate shareholders can be subject to the AHYDO rules with respect to such corporate shareholders.

3 AHYDO debt would use either the mid-term (if its term was less than nine years) or long-term AFR (if it has a greater than nine-year term). For October 2016, the mid-and long-term AFRs were 1.29 percent and 1.94 percent, respectively. As discussed below, if the YTM is greater than 6 percent plus the AFR, the most draconian effect of the AHYDO rules (permanent disallowance of interest deductions) may apply.

4 Compare this to the general OID rules, where issuers are typically permitted to claim an interest deduction in the year that the holder takes the OID into income.

5 Including potential restrictions imposed by intercreditor agreements in the case of debt that is not first lien. Documents other than the debt instrument may need to be updated to account for this.

6 Holders may be less enthused when they would prefer compounding at the high rate of interest on the

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capitalized PIK interest, but this consideration is typically outweighed by the negative effects of the AHYDO rules on the issuer.

7 When determining if debt is subject to the AHYDO rules, if the terms of the debt permit an optional payment of interest in kind, such payment is assumed to be made in kind, even if that would have the effect of increasing the yield.

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