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Debt restructuring considerations for private equity

As a result of the impact of COVID-19 on the global economy and capital markets, many businesses are assessing the need to restructure their debt. The following items represent key related tax considerations for private equity funds and their portfolio companies.

Overview and general considerations

Restructuring options: Debt restructuring can take many forms, including the following:

- "White knight proposals," whereby a company seeks to identify one or more parties willing to advance funds necessary to avoid bankruptcy, e.g., a current debt holder, a white knight suitor, or a merger partner, which involves negotiating alternative funding through the issuance of new debt or equity;
- Out-of-court workout proposals, whereby a company identifies parties that may be willing to restructure existing indebtedness, which involves negotiating with one or more tranches of debt holders seeking to restructure indebtedness in a manner that would allow the company to fund operations and avoid bankruptcy;
- "Pre-pack bankruptcies," whereby a company negotiates a bankruptcy plan of reorganization with its creditors and other stakeholders in advance of filing a bankruptcy petition; and
- Post-filing bankruptcy reorganization negotiation, whereby a company files a petition for bankruptcy protection and negotiates the plan of reorganization with its creditors and other stakeholders as part of the bankruptcy process.

Tax considerations: Each of the above debt restructuring scenarios may trigger some of the following critical tax considerations:

- Need to determine tax consequences of any restructuring on creditors and shareholders;
- Need to determine the amount and impact of cancellation of indebtedness income ("CODI") and corresponding reduction to tax attributes (e.g., NOLs, asset basis);
- Need to determine other tax attributes – e.g., tax basis in subsidiaries, including the existence of any excess loss accounts—and the impact of CODI;
- Need to determine impact of transaction on post-restructuring utilization of NOL carryovers (e.g., impact of IRC section 382), and related tax planning;
- Need to determine ability to effectively create "tax shield" to offset CODI through worthless stock deductions and other planning opportunities;
- Need to consider whether transaction will trigger any withholding taxes;
- Need to determine debt-equity characterization of instruments for tax purposes;
- Need to determine whether a "significant modification" of existing debt has occurred; and
- Need to model post-restructuring taxes.

Cancellation of debt income

CODI generally: Cancellation of indebtedness is generally treated as taxable income to the debtor for U.S. federal income tax purposes. However, a number of exceptions and exclusions can potentially apply, as discussed further below.

Triggering CODI: CODI can be triggered in a number of debt restructuring scenarios, including the following:

- Equity-for-debt exchanges;
- Asset-for-debt exchanges;
- Debt-for-debt exchanges, including certain debt restructurings and modifications; and
- Debt buybacks by a debtor or related party.

Equity-for-debt exchanges: In general, if a debtor issues equity (corporate stock or partnership interests) in satisfaction of a debt, the debtor is treated as satisfying the debt with an amount equal to the value of the equity, and taxed accordingly.

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Asset-for-debt exchanges: In general, if a debtor issues assets in satisfaction of a debt, the debtor is treated as satisfying the debt with an amount equal to the value of the assets, and taxed accordingly, including recognizing gain or loss on the transfer of the assets.

Debt-for-debt exchanges and debt modifications: In general, if a debtor issues debt in satisfaction of a debt, the debtor is treated as satisfying the old debt with an amount equal to the issue price of the new debt. A modification of a debt instrument is generally treated as a debt-for-debt exchange if the modification is a "significant modification," which depends on whether there is a sufficient change in the terms of the debt instrument, including for example a meaningful change in timing of repayment, obligor or collateral, or a change in nature of the debt. Accordingly, any renegotiation, restructuring, or even forbearance of an existing debt instrument may result in a deemed exchange of such instrument for tax purposes. For this purpose, the "issue price" of debt may, depending on the facts, be equal to its fair market value or its stated amount.

Debt buybacks by a debtor or related party: In general, if a debtor repurchases its debt, it will be treated as satisfying its debt in an amount equal to the price paid to repurchase the debt, and taxed accordingly. Similarly, if a party related to the debtor acquires its debt, the acquisition is generally treated as if the debt had been acquired by the debtor itself. This rule can be a trap for the unwary, for example in the case of a private equity sponsor that acquires the debt of one of its portfolio companies at a discount.

Bankruptcy and insolvency exceptions to CODI

General rule: As an exception to the general rule requiring the recognition of CODI, a debtor may exclude CODI that is discharged in a Chapter 11 bankruptcy proceeding (the "bankruptcy exception"), or if the debtor is insolvent, to the extent of its insolvency (the "insolvency exception").

Attribute reduction: As a cost to availing itself of the bankruptcy or insolvency exceptions, a debtor is generally required to reduce its tax attributes, including net operating losses ("NOLs"), tax credits, capital loss carryforward, and asset basis, in an amount equal to the excluded CODI.

CODI considerations for flow-through entities

General rule: Similar rules to those discussed above apply to debtors that operate in flow-through form for U.S. federal income tax purposes. However, while CODI is generally determined at the flow-through entity level, the ability to apply the bankruptcy and insolvency exception is generally determined at the level of the taxable equity holder of the flow-through entity. These rules can be a trap for the unwary, for example in the case of PE-backed portfolio companies operating in flow-through form, which can result in CODI "dry income" to the private equity ("PE") sponsor and its limited partners ("LPs").

Tax planning opportunities for PE

Overview: A number of tax planning opportunities may be available to offset or otherwise mitigate the impact of CODI, including the following:

- Worthless stock deduction planning;
- Bad debt deduction planning;
- Blocker planning for debtors in flow-through form; and
- Tax attribute identification.

Worthless stock deduction planning: Certain common PE holding structures may allow for the efficient triggering of worthless stock deductions, which may partially mitigate and in some cases fully offset otherwise non-excludable CODI (or alternatively may produce additional tax attributes that can offset the attribute reduction mandated when a taxpayer has availed itself of the bankruptcy exception or the insolvency exception). Furthermore, in the case of a worthless stock deduction that is attributable to the federally declared COVID-19 disaster, there may be an opportunity to deduct that loss on a taxpayer's 2019 tax return, and to carry back that loss to pre-2018 tax years, potentially triggering a quick cash tax refund.

Bad debt deduction planning: Depending on the particular debt restructuring, there may be an opportunity to trigger an ordinary bad debt deduction that may partially mitigate and in some cases fully offset otherwise non-excludable CODI.

Blocker planning for flow-through debtors: In the case of debtors operating in flow-through form, there may be an opportunity to introduce a corporate blocker entity into the holding structure, in order to block CODI that would otherwise flow to the PE sponsor and it LPs.

Tax attribute identification: A thorough analysis of a debtor's tax attributes may identify otherwise unutilized tax attributes (e.g., capitalized transaction costs), that can be reduced as a result of excluded CODI, thereby preserving more valuable tax attributes.

Consolidated tax group considerations

Consolidated attribute reduction generally: The tax rules applicable to members of a consolidated group for U.S. federal income tax purposes generally require attribute reductions to be made not only with respect to the debtor but also with respect to the attributes of other members of the consolidated group.

"Black hole" CODI: If the debtor consolidated group's CODI exceeds the amount of attributes of the group, this excess CODI generally is referred to as "black hole CODI." Black hole CODI generally means that the taxpayer can exclude the CODI from taxable income without any corresponding reduction in attributes.

Excess loss accounts ("ELAs"): If a member of the consolidated group has an ELA (effectively negative tax basis in its stock), CODI may result in taxable income notwithstanding the general rules discussed above.

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NOLs and ownership changes

Ownership changes generally: Under section 382, the utilization of NOLs to offset taxable income may be limited if a taxpayer experiences an "ownership change," generally defined as a 50% or greater change in ownership (measured through ownership by "5% holders") over a three-year period (the "section 382 limitation"). In the event of an ownership change, the resulting annual limitation is generally calculated as follows:

- The "base limitation"(the equity value of the company immediately prior to the ownership change multiplied by the IRS-published AFR);
- In certain circumstances, the base limitation may be increased by the "recognized built-in gains" or may limit certain "recognized built-in losses" of the loss corporation during the five-year period after the ownership change.

The rules for determining the section 382 limitation, including the increase / decrease to the limitation related to built-in items and other applicable adjustments, are complex and can have a very significant impact on the base limitation.

Section 382 and bankruptcy: When a creditor exchanges debt for equity in the debtor, the exchange may trigger an ownership change for section 382 purposes. However, an exception applies under which such exchanges are disregarded if (i) the debtor is under the jurisdiction of a court in a Title 11 or similar case, and (ii) the historic shareholders and/or historic creditors own in the aggregate at least 50% of the stock of the company following the restructuring (the "382(l)(5) exception"). This exception comes at two "costs":

- The company must re-compute its taxable income/loss for the tax year of the exchange and the three proceeding tax years, by excluding any interest deductions related to the debt that was exchanged by qualified creditors for stock in the debt for equity exchange.
- If there is another ownership change during the two-year period following the restructuring, the section 382 limitation with respect to that subsequent ownership change will be zero.

Opting out of the 382(l)(5) exception: If a taxpayer in bankruptcy that qualifies for the section 382(l)(5) exception discussed above, it can elect out of the exception (and the resulting costs discussed above), in which case its section 382 limitation will be based on the lesser of the post-emergence equity value or the pre-emergence asset value.

Debt restructuring – tax workstreams

The following is a list of some potentially applicable tax workstreams in debt restructuring transactions:

- Fact-finding and analysis regarding the proposed restructuring transaction;
- Determine the general tax treatment of the proposed restructuring transaction to the debtor and other relevant stakeholders;
- Determine the amount of liabilities subject to compromise, and understand the value of debt, equity, or assets transferred to lenders in the restructuring transaction;
- Calculate the amount of CODI resulting from the transaction;
- Consider various restructuring or other options to reduce CODI or preserve attributes;
- Determine whether, and the extent to which the bankruptcy or insolvency exceptions to CODI recognition apply;
- Determine the tax attributes subject to reduction and calculate attribute reduction;
- For consolidated tax groups, consider separate company tax attributes, including NOLs by entity and tax basis / ELAs in subsidiary stock, and calculate CODI and tax attribute reduction by entity;
- For debt-for-asset exchanges, calculate gain / loss on the transfer of assets;
- For debtors in flow-through tax form, consider ability to mitigate "dry income" through the use of a blocker entity;
- Consider ability to offset taxable income through bad debt or worthless stock deductions;
- Determine withholding tax implications of the restructuring transaction;
- Model post-transaction cash taxes; and
- Consider section 382 implications of the transaction (limiting post-transaction NOL utilization), including the application and ability to elect out of the section 382(l)(5) exception.

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