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M&A Tax Talk: Private equity insights

Navigating the tax consequences of COVID-19

KEY TAKEAWAY

When evaluating and executing transactions to mitigate economic downside or pursuing opportunities caused by the COVID-19 pandemic, avoid unintended tax consequences by first considering relevant tax rules.

Opportunities and pitfalls

The current economic disruption triggered by the COVID-19 pandemic is causing private equity sponsors (PEIs) to urgently focus on their portfolio companies (PortCos). In particular, many PEIs and their PortCos are considering (amongst other transactions) (i) negotiating with lenders to potentially modify PortCo debt, (ii) the purchase by PEI of PortCo debt at a discount, and (iii) certain strategic business restructurings such as taxable spin-offs or asset transfers.

While these transactions can have material financial benefits, including the potential for significant cash tax savings and refunds, PEIs and their PortCos should also be aware of the overall tax consequences of each transaction.

Further, as a direct result of the COVID-19 pandemic, there are newly enacted tax legislative provisions (and IRS guidance) that should be considered, as well as proposed new legislation and guidance that should be closely monitored.

Opportunities to address capital structure

A distressed environment may present opportunities (or in some cases, the necessity) to readdress a PortCo's capital structure to align with its near and longer-term cash needs. For example, PortCos can obtain additional liquidity by modifying the terms of their current indebtedness (such as bank debt). Also, PEIs may see an opportunity to acquire a PortCo's debt on the open market that they believe is trading below its intrinsic value. These transactions can enhance a PortCo's financial performance and the PEI's internal rate of return (IRR); however, these transactions can also trigger material unintended tax consequences if not properly addressed.

Modification of indebtedness and potential deemed exchange

A "significant modification" of a debt instrument will be treated as a taxable "deemed exchange" of such debt instrument and may trigger taxable cancellation of indebtedness income (CODI) to the PortCo. The rules governing when a modification of outstanding debt is a "significant modification" are complex, but generally include, among other things (i) changes in yield above a threshold, (ii) material deferral of scheduled payments, (iii) changes in obligor (with exceptions), (iv) certain changes in collateral or guarantee, and (v) changes in the nature of the debt from recourse to nonrecourse. A significant modification can also result in CODI when the debt is considered to be "publicly traded" for tax purposes and has a trading price that is less than par.

Example 1: Significant modification of PortCo debt

On January 1, 2015, PortCo issued a $100M face value debt at par with an original maturity of 10 years and a 10 percent annual interest rate. On December 31, 2019, PortCo and the debt holder agree to reduce the interest rate on the debt to 9 percent. At the time of the exchange, the debt is trading at a discount to its par value and is determined to be publicly traded under the tax rules.

PortCo will recognize taxable CODI in connection with this debt modification, as it should be considered a "significant modification" and, therefore, a taxable deemed exchange of debt. (Note that for tax purposes, "publicly traded" debt is deemed reissued at fair market value (FMV) and not its par value; "publicly traded" is interpreted very broadly with a bias to treat many debt instruments as such with mere indicative quotes.)

A significant modification can occur if the yield on the "new" instrument varies from the yield on the "old" instrument by more than the greater of (i) 25 basis points or (ii) 5 percent of the yield of the "old" instrument (.05 * old yield).

The 100-basis-point reduction in the yield is a "significant modification," as it is greater than both (i) 25 basis points and (ii) 5 percent of the "old" yield of 10 percent (50 basis points).

Acquisition of indebtedness by a related party

A PEI and its PortCos are treated as "related parties" for US tax purposes if the PEI owns (directly, indirectly, or through application of complex attribution rules) more than 50 percent of the PortCo's equity. Assuming requisite ownership, if a PEI were to acquire its PortCo's existing debt on the open market at a discount, the US tax rules would generally treat the acquisition as if the PortCo itself were buying back its own debt. While this transaction may seem innocuous, it will generally trigger taxable CODI and potential adverse tax consequences to a PEI's LPs.

Example 2: Acquisition of PortCo debt at a discount by PEI

PEI owns 95 percent of the single class of stock of PortCo. PortCo has $100M of debt outstanding, which matures on December 31, 2022. On January 1, 2020, PEI determines that the debt is trading at a 10 percent discount relative to its par value and purchases PortCo's debt in the open market from lender for $90M. PortCo repays the full $100M indebtedness at maturity.

On January 1, 2020, PortCo realizes $10M of CODI (the $10M difference between the redemption price at maturity ($100M) and the new issue price ($90M)).

This $10M difference also represents original issue discount (OID) and is amortized over the term of the indebtedness and treated as interest income to PEI. Income of this character could have adverse implications for PEI LPs:

- Potential "phantom" income to US taxable LPs (taxable ordinary income with no corresponding cash distribution)
- Potential withholding tax leakage to non-US LPs
- Potential unrelated business taxable income (UBTI) to tax-exempt LPs.

The OID, in turn, is treated as interest expense by PortCo and generally deductible, although potentially subject to limitation (for example, Section 163(j) or the AHYDO rules of Section 163(e)(5)). Further consideration should also be given to whether the interest expense deductions result in application of the base erosion and anti-abuse tax (BEAT).

Mitigating CODI

There are several circumstances where the immediate cash tax impact of CODI may be limited, including:

NOLs: If a PortCo has net operating losses (NOLs), those NOLs may be available to offset any CODI. However, the ability to completely offset any CODI with NOLs may be limited. For example, NOL usage may be dependent on (i) the tax years to which the NOLs relate (pre-2018 vs. post-2017), and (ii) if PortCo has a current limitation that restricts usage of NOLs under Section 382. Importantly, PEIs and PortCos should analyze whether utilizing NOLs to offset CODI at the current US federal income tax rate of 21 percent is more beneficial than carrying back NOLs to tax years prior to 2018 (pursuant to recently enacted tax legislation—see below) to shield taxable income at the prior 35 percent US federal income tax rate.

Chapter 11 bankruptcy: A PortCo in the process of bankruptcy can exclude any CODI from taxable income (however, there is a requirement to reduce tax attributes).

Insolvency: To the extent a PortCo is insolvent (liabilities greater than FMV of assets), CODI can be excluded from taxable income (however, there is a requirement to reduce tax attributes).

Structuring: In the past, some PEIs have implemented structures to mitigate the impacts of CODI with respect to purchases of PortCo debt at a discount. Given changes in US and non-US tax laws in recent years, these structures should be reevaluated.

Opportunities for strategic restructurings

When the FMV of a PortCo declines, PEIs may consider whether it is advantageous to undertake corporate restructurings to achieve financial, operational, and/or tax efficiencies. While these transactions may be available in an appreciating market, a depressed market decreases equity and asset valuations, which can reduce or eliminate the cash tax cost of such transactions that may have otherwise resulted in material tax leakage. Some of these transactions may include:

Spin-off transactions: PEIs looking to create value among their PortCos may consider separating certain business divisions of a single company through a spin-off. While spin-offs can be achieved in a tax-free transaction, the requirements for such transactions are numerous and complex. In a distressed environment, it may be efficient to engage in a "taxable" spin-off to separate two business divisions at a reduced tax cost.

Value chain transformations: Depressed asset values can create the opportunity for a PortCo to better align its supply chain and intellectual property ownership to suit its operational footprint and to achieve tax efficiency going forward. This realignment can sometimes be done in a tax-free manner, but such transactions can be complex and have an operational impact. If actual cash tax costs are reduced or eliminated because of depressed asset values, these realignments can be done with more efficient techniques while producing similar long-term benefits.

Other tax planning: PEIs and PortCos should consider other steps that can be done with minimal or no cash tax costs, including (i) cash repatriation and foreign tax credit planning, (ii) planning to maximize US tax rate benefits on certain non-US sourced income (such as GILTI and FDII), and (iii) monetization of certain tax attributes.

Recent legislative developments

Distressed environments and "black swan" events with economic repercussions often push governments to create new fiscal policies to help stimulate economic activity. Over the past few months, the US government has enacted new legislation, including the Coronavirus Aid, Relief, and Economic Security Act (CARES Act).

The CARES Act contains several significant business tax provisions that may be applicable to companies across various industries. The following provisions, in particular, may be impactful to PEIs evaluating new investment opportunities, as well as those seeking to optimize the cash tax profile of their existing PortCos:

Interest expense limitation: Prior to the CARES Act, the tax law generally limited the deduction for business interest expense to business interest income plus a threshold equivalent to 30 percent of "adjusted taxable income." For 2019 and 2020, the CARES Act would increase the percentage of adjusted taxable income to 50 percent. The provision would also permit PortCos to use their taxable income from 2019 in tax year 2020 (rather than their likely lower 2020 income) for purposes of applying the 50 percent limitation.

NOLs: PortCos would generally be permitted to carry back NOLs incurred in 2018, 2019, and 2020 to the five prior tax years. Under the new legislation, NOLs incurred in these years could offset 100 percent of prior-year taxable income and may result in a cash refund, which for tax years prior to 2018 would be computed based on the prior 35 percent US federal income tax rate (versus the current 21 percent US federal income tax rate effective for tax years beginning after 2017). This would represent a relaxation of current law, which generally eliminates all NOL carrybacks and provides that the NOLs arising in tax years beginning after December 31, 2017, are able to offset up to 80 percent of taxable income.

Our approach

The material presented in this article is an overview, and the tax planning considerations are nuanced and complex. If you are looking to evaluate or execute a new investment, readdress a PortCo's capital structure, understand how recent and proposed legislation can affect your business, or undertake a strategic restructuring, Deloitte can help you analyze and mitigate the potentially adverse US tax implications of your desired transaction(s).

Let's talk

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