Debt restructuring

In this episode, we take a close look at debt in the current economic landscape. Deloitte's Steve Harrison and Ken Gerstel break down the challenges companies are facing in the markets, including debt modifications and negotiations, and what tax departments can do to be prepared.

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IAN: Ken, Steve, thanks for coming on the podcast. Great to talk to you again. Looking forward to today's conversation. Thanks for being here.

KEN: Yes, thank you.

STEVE: Thanks for having us.

IAN: So, Ken, in the current economic landscape, there's obviously a significant amount of debt tranches that are experiencing declines in market value across a great percentage of debt issuers. What are some of the impacts of those declines?

KEN: Ian, thanks for the question. I think that there really are a couple of things that that are going on from a macroeconomic environment. And like you said, some of it is that the existing indicative values of debt out on debt markets are declining relative to their face value. In addition, just because of the current circumstances, we're seeing an exponential increase in borrowings under existing credit facilities and a lot of our clients and a lot of taxpayers entering new borrowing.

And sometimes, this is even for clients that aren't traditionally distressed, so that we're seeing a lot of companies have debt trading or debt-indicative pricing in the markets at a discount, even for businesses that are financially sound.

And the issue that often precedes anything more severe, like a balance sheet restructuring, and in the current COVID-19 environment, is when a debt issuer has an instrument that's outstanding, it's greater than $100 million, and might be looking to extend their maturity date, reach some form of a consent, because they're doing other borrowings, possibly go into some sort of a forbearance or temporary stay on interest or principal payments, possibly relaxed covenants—say, for example, certain financial ratios that are going to be hard to achieve in 2020—and for some issuers, just obtain some level of runway, get some extension of time on maturities.

All those things can create a potential tax event if not carefully managed. And that tax event could be considered a significant modification under the tax rules, which are very distinguishable from financial accounting rules. And the words "significant modification" for tax definitely means something, and it can be significant if debt is trading at a discount.

STEVE: Yeah, and that's what we're seeing and talking about with a number of companies, right, Ken? I mean, it's … You're running into companies who are … It's a rush for cash, right? And with the debt markets being in flux, there's all of the new borrowing the government's issuing from a Treasury perspective. And so, as investors are putting their money there, it's really … There's more of a risk to quality, and so those debts that maybe were good corporate bonds, but aren't quite the same as treasuries are, they're losing some of their investment groups.

And as a result, it's really putting pressure on really all of the stacks and types of tranches of debt that's out there, really pushing the pricing down, which can really create some real issues for companies to the extent they're looking at some of these modification points around there. And while all changes to debt instruments are modifications, not all modifications are created equal.

IAN: So, Ken, when it comes to debt modification and negotiations, what should tax departments be thinking about there?

KEN: Yeah, I think what the tax departments probably need to start with is just a real education process as to what is a significant modification. The issue here is that a significant modification, if it arises, causes a debt instrument to be deemed satisfied and reissued for its fair market value.

So you could have … Your organization could have a $200 million issuance, for example. If your organization had a significant modification of that $200 million instrument, and it just so happened that it was trading at 80 cents on the dollar indicatively in the credit markets, that 20 percent differential could create $40 million of phantom cancellation of debt income. And that recovery of that income really comes on the back side through interest expense. So you could have a very unfavorable timing item, and that unfavorable timing item could be a little insult to injury on that to the extent the company in 2020 happens to have a net operating loss, because that income might be an offset to that net operating loss that otherwise could be carried back five years and recovered at higher tax rates.

So the implications of a significant modification really is the first thing to triage. And I think, oftentimes, tax is last to know when there's a negotiation with lenders. And what we're really encouraging our clients to do is to be connected to the finance and treasury teams for any discussions that relate to debt modifications or negotiations, even if it's a fairly perceived, minor issue with respect to debt, and even if debt is not being reduced because of these unpleasant surprises—things that, if they're in front of you, you can avoid.

STEVE: I think a lot of what we would say to tax departments is that these conversations generally don't often include tax departments. So as a result, they're not always thinking about tax. And so what I think is critical from a tax department perspective, if they have to go upstream a little bit to really make sure they're educating and saying, "Hey, look, I know we've got some risk around some of our ratios, or we're struggling with the ratios; maybe we've got cash crunch, or there's debt that's coming due in one year or two years," something along those lines, and say there can be some really negative consequences from a tax perspective if we have an inadvertent trip and create a significant modification out of something that's going on.

So we need to know what's going on from a tax department perspective. We need to understand if we're looking at potential changes to the interest rate. Things like that can create these significant modification issues and create this unintended tax consequence that Ken was describing.

KEN: And I think the other point there is, fees become a big issue in these negotiations, and sometimes a minor change with a fee can have the implication that a very small outlay to banks creates a very big exposure for the borrowing organization, and just education on that is key. The other thing I'd say is, tax departments really in this time need a broader connection to treasury and finance also with borrowings. The interest rates are going up for those subindustries or subsectors that are most impacted by the current economic environment. And those interest rates are effectively double.

And when you have an increased interest rate, there's a substantial increase in the level of diligence you need to do to make sure you don't run afoul of those rules and somehow be in the unfortunate position of having a future obligation to pay interest that doesn't create a tax deduction for the organization. And then getting involved in the borrowing itself can help mitigate those issues and also identify any opportunities as it relates to flight alterations of the transaction to achieve the desired tax result.

IAN: And finally, I just want to ask about the connection between debt modification and debt restructuring. Is there potentially a connection there, Ken? And if so, what does that mean for tax?

KEN: Yes, great question. I think, from a tax point of view, we view the issues as similar in terms of their exposure. But we definitely distinguish what is a modification and the resulting tax consequences and the debt restructuring. When we think of a debt restructuring, oftentimes debt modification comes first—there's some sort of a runway being negotiated. But when we think about a broader debt restructuring, what we're talking about is a debt workout.

And that would be a restructuring of the balance sheet, something that is more extensive, exploring various options like equitization of some of the debt, some sort of alteration of the various stakeholders of the organization, whether it's in a court proceeding to work out the balance sheet indebtedness, or out of court, both of those. Steve and I and many of our colleagues have worked through a whole bunch of these transactions.

And that ends up being a highly visible moment for the tax function, both in terms of opportunity and risk. And typically, creditor groups, shareholders, equity holders, and management are all going to have representation that is going to scrutinize the whole framework for the tax implications of the debt restructuring. Requires a lot of information, requires a lot of modeling, and it actually requires looking down the field quite a bit.

STEVE: I guess the one thing to just remind folks is, not every debt modification results in the greater debt restructuring, but it is not uncommon for the debt modification to be the precursor to a debt restructuring more broadly. And so the one thing I would say—to just kind of add on to everything that you were just describing—is that when understanding these debt modification questions and issues as they arise, part of the reason of getting in front of these is because, if you have a debt modification that turns into a significant modification event, and they create this taxable income, that you just don't have the shield or the capacity to cover.

And so that's really, I think, one of the main pieces to also be mindful of: that you've just got to be included. You've got to be involved. You've got to understand that tax can be critical to these analyses. And really, there can be some real negative unintended consequences if folks aren't watching, paying attention to it.

KEN: And I think that's a great point. And then if you are dealing with the broader debt restructuring, there are a number of helpful provisions that can mitigate some of the downside effects from a tax perspective. And that kind of evaluation of all those provisions, both from an attribute planning perspective and from a taxable income perspective, become very important.

STEVE: That's going to happen then, if that's ultimately the path that you're heading towards, having the debt model that you want to avoid the debt modification until you get to the broader restructuring, because maybe what otherwise would have been taxable income is available to be excluded and not actually subject to tax, which can help you manage the tax consequences in and around the transaction. It doesn't come without a cost, but it at least can potentially avoid some cash payments today.

IAN: Ken, Steve, thanks again for coming on. Always great to have you on the podcast.

STEVE: Thanks so much.

KEN: Thanks.