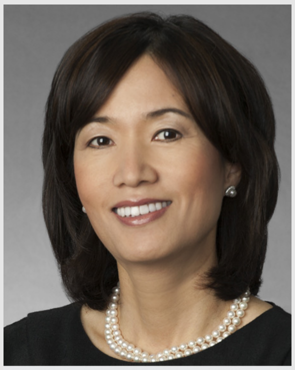
Tax Issues in Committed Debt Financing in a Distressed Market

by Jiyeon Lee-Lim



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In this report, Lee-Lim analyzes federal income tax issues that may arise in common committed debt financing structures in a distressed market. An earlier version of this report was presented at the New York Tax Forum on April 6.

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I. Introduction

COVID-19 is causing unprecedented havoc in numerous ways. While perhaps not nearly as drastic as in some other areas, it could have a material negative effect on debt financing on a scale not seen since the 2008 financial crisis. This report analyzes the federal income tax issues that can arise in common committed debt financing structures in a distressed market.

For various reasons, a borrower often seeks a firm commitment from banks regarding its future financing transaction long before actual funding. For example, a private equity fund or a strategic investor planning to buy a target may need to know the cost of its borrowing before bidding for the acquisition of the target. Similarly, a company that anticipates refinancing its outstanding debt in the near future may want to set terms for the new financing when the market interest rate is favorable.

Unless it is a direct lender, a bank making a firm commitment would ideally have a chance to discuss the terms with potential investors and even obtain a soft commitment from them. However, the commitment by banks is often made without a corresponding commitment from investors. And if the financing does not close for a significant period, there will be no assurance that market conditions will not deteriorate after a bank makes its commitment.[1] If a bank makes a firm commitment and cannot syndicate the debt without incurring a loss, there are various tax issues to consider from the borrower's perspective, as well as the bank's.

To reduce syndication risks, many committed financings include a market flex provision. A market flex provision allows specified changes to the terms of the debt to the extent needed to achieve successful syndication. Although a

[1] For example, if the borrower needs the financing for acquisition of a target that is not planned to close for many months and does not want to borrow in advance, it would be difficult for the lead banks to syndicate the loan when they make the financing commitment. One alternative to avoid a delayed syndication is to sell the commitment to investors when the commitment is made and pay them ticking fees. However, ticking fees would increase the cost of financing for the borrower.

market flex usually must be exercised before the financing closes, some transactions allow its exercise after the closing. Invoking a market flex provision after the financing closes raises concerns about a potential deemed exchange and cancellation of debt (COD) income.

Another common structure is the use of a securities demand in bridge financing. The securities demand provision, which is incorporated into a fee letter (or an equivalent document), facilitates the take-out of the bridge by giving the arranger or the administrative agent a right to request that the borrower issue permanent debt to repay the bridge loan. If a securities demand is made when the fair market value of the permanent debt is significantly below par, however, it also raises potential deemed exchange and COD income issues.

This report explores various federal income tax issues concerning the financing scenarios described above: (1) a firm commitment underwriting when the underwriter is unable to sell the debt at or above the price at which it buys (taking into account the underwriting fee); (2) a market flex; and (3) a securities demand.

II. Firm Commitment Underwriting

If an underwriter commits to buying bonds at a specified price, purchases them at that price, but ends up selling below that price (taking into account the underwriting fee), there are several issues that need to be considered from the perspectives of both the issuer and the underwriter.

A. Consequences to the Issuer

From the issuer's perspective, the concern is that there is no clear rule governing the consequences of receiving net proceeds (taking into account the underwriting fee) that exceed the issue price of the debt. Consider the following example:

Example 1: In connection with Company X's entering into an agreement to acquire Target, Bank A makes a firm commitment to Company X to underwrite $200 million of bonds at par with a 5 percent coupon payable annually in cash. Company X is obligated to pay Bank A an underwriting fee of $6 million (3 percent of the face amount). The acquisition is expected to close in a few months. The interest rate of 5 percent is a market rate when the commitment is entered into. However, immediately after the commitment is signed, market conditions deteriorate significantly, and Bank A ends up purchasing the bonds at par (with the 3 percent underwriting fee) but selling them to third-party investors at 95 percent of their face amount. At closing, Bank A wires $194 million to Company X and receives net sale proceeds of $190 million from the investors. Bank A suffers a net loss of $4 million, equal to 2 percent of the face amount of the bonds. It is assumed that Company X incurred no other expenses in connection with the financing.

In general, the issue price of a debt instrument issued for money is the first price at which a substantial amount of the debt instruments in the issue are sold for money.[2] The issue date of a debt instrument issued for money is the first settlement date or closing date, as may be applicable, on which a substantial amount of the debt instruments in the issue are sold for money.[3] Reg. section 1.1273-2(e) (the underwriter rule) provides that "for purposes of determining the issue price and issue date of a debt instrument under this section, sales to bond houses, brokers, or similar persons or organizations acting in the capacity of underwriters, placement agents, or wholesalers are ignored." Applying this rule, the issue price of the bonds in Example 1 would be 95 percent of the face amount.

When an issuer issues a debt instrument, the net proceeds to the issuer after the underwriting fee usually are, and should be, lower than the issue price of the debt instrument. If they are, the underwriting fee incurred by the issuer is generally amortized over the term of the debt instrument as if the issuer adjusted the yield (in a manner similar to original issue discount) on the debt instrument.[4]

In Example 1, however, instead of suffering a reduction in the net proceeds reflecting the underwriting fee, Company X earns a "premium"

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[2] Reg. section 1.1273-2(a)(1).

[3] Reg. section 1.1273-2(a)(2).

[4] Reg. section 1.446-5(b)(1) ("Solely for purposes of determining the amount of debt issuance costs that may be deducted in any period, these costs are treated as if they adjusted the yield on the debt. To effect this, the issuer treats the costs as if they decreased the issue price of the debt.").

in connection with the issuance of the bonds, in that it receives net proceeds of $194 million — $4 million above the $190 million issue price of the bonds. What is the proper treatment of the $4 million? Is it current income to Company X?

There is no direct authority governing the treatment of the issuer's receipt of net proceeds exceeding the issue price of a newly issued debt instrument.[5] That excess should not be COD income, because there is no outstanding debt that is being cancelled in that case. Even though there is no clear authority, the most reasonable approach would be to treat those excess proceeds as an adjustment to the deduction of interest and OID over the term of the debt instrument. In fact, that treatment would be the only sensible answer. Treating the excess proceeds as immediate income would be inconsistent with the clear reflection of income principle underlying section 446 and with the treatment of comparable items in analogous situations. Although not directly on point, the following authorities should provide ample support for that treatment.

First and foremost, an issuer does not recognize any gain or loss upon the issuance of a debt instrument.[6]

Second, reg. section 1.163-13 requires the issuer to adjust its interest deduction by taking into account the bond issuance premium. The bond issuance premium is generally defined as "the excess, if any, of the issue price of a debt instrument over its stated redemption price at maturity."[7] Under those rules, the issuer would generally determine its interest deduction by offsetting the interest allocable to an accrual period with the bond issuance premium allocable to that period based on a constant yield.[8] The excess proceeds received by the issuer in Example 1 do not meet this definition because the issue price of the bonds will not exceed their stated redemption price at maturity. However, they are conceptually very similar, and it would be logical to apply the same treatment for both.

Third, in dealing with a qualified reopening, the regulations provide that if a holder pays more or less than the adjusted issue price of the original debt instruments for additional debt instruments issued in a qualified reopening (meaning that the issuer receives net proceeds that are more or less than the adjusted issue price of the original debt instruments for additional debt instruments issued in that qualified reopening), the issuer must treat this difference as an adjustment to the issuer's interest expense for the original and additional debt instruments.[9] Although this rule deals with qualified reopenings, it would be reasonable to apply the same logic to proceeds that exceed the issue price at original issue.

Fourth, looking at the matter from the clear reflection of income principle under section 446, as is the case with debt issuance costs, adjusting the yield by the amount of the excess proceeds should most clearly reflect income and deductions for the issuer.[10]

Lastly, from the perspective of the general income tax principles, it is difficult to see any accretion to wealth in this instance because the net proceeds to the issuer will in any case be less than the amount owed under the debt instrument. And with no accretion to wealth, the issuer should not be treated as having income when there is no authority addressing this specific fact pattern.

The treatment of an issuer that receives excess proceeds above the issue price of a newly issued debt instrument is a fundamental question that is relevant not only to a simple firm commitment underwriting that hits a market downturn, but far beyond.[11] Until we have clear guidance, however, it appears that the above authorities should provide ample support for amortizing the excess proceeds over the term of the debt as an adjustment to the deduction of interest or OID on the debt using a constant yield method.

[5] This is different from a bond issuance premium, discussed later.

[6] Reg. section 1.61-12(c)(1) ("An issuer does not realize gain or loss upon the issuance of a debt instrument. For rules relating to an issuer's interest deduction for a debt instrument issued with bond issuance premium, see [reg.] section 1.163-13.").

[7] Reg. section 1.163-13(c).

[8] Reg. section 1.163-13(a). The regulation explains that "the use of a constant yield to amortize bond issuance premium is intended to generally conform the treatment of debt instruments having bond issuance premium with those having original issue discount."

[9] Reg. section 1.163-7(e)(1).

[10] *See supra* note 4. *See also* Rev. Rul. 83-84, 1983-2 C.B. 97 (ruling that an interest deduction exceeding the economic accrual of interest for the current year is not allowed).

[11] As discussed later, this issue is also relevant in analyzing the consequences of a securities demand. *See infra* Section IV.

B. Fungibility

Example 2: The facts are the same as Example 1, except that Bank A is able to sell only 20 percent of the bonds at 98 percent of the face amount at closing. Bank A ends up holding the rest of the bonds, which it bought at the face amount minus the underwriting fee of 3 percent (net 97 percent). After the closing, Bank A sells the bonds to investors over several months at varying prices. Are the bonds fungible for federal income tax purposes?

On its face, the underwriter rule appears absolute and allows no leeway. A sale to any person acting in the capacity of an underwriter, placement agent, or wholesaler is ignored in determining the issue price and the issue date. Does this mean that when debt instruments are issued and outstanding but are held by an underwriter that is unintentionally stuck holding them, the portion retained by the underwriter is not treated as issued, even though for nontax purposes the entire debt is issued as a single tranche under the same governing document at the same time for cash and accrues the same interest?[12]

Strict application of the underwriter rule could create unnecessary hardship for underwriters in a firm commitment underwriting (a so-called bought deal) that are caught in a failed syndication. When the rule is applied strictly, fungibility may arguably be achievable only if all the debt in the same tranche is treated as a single issue, which requires a sale to investors (who are not underwriters or acting in similar capacity) within a 12-day period,[13] or if the sale meets the qualified reopening requirement.[14] Alternatively, if the underwriter holds onto the debt long enough, that debt should at some point cease to be considered held by an underwriter in its status as such (essentially cleansing the status as debt that was purchased by an underwriter).[15] Unfortunately, however, a bank caught up in a failed syndication in a bought deal might not be able to sell the entire tranche within 12 days, and once the 12-day period passes, the bank would want to sell all the remaining portion as soon as possible, at whatever price it could get without having to meet the qualified reopening requirement.

This raises the next question: At what point does an underwriter that, contrary to the parties' expectations, is stuck holding a debt instrument it cannot sell cease to be viewed as holding the debt as an underwriter? Some practitioners treat 30 days as an appropriate length of time for that purpose.[16] However, there appears to be no compelling reason for using a flat 30-day period as the seasoning period for an underwriter converting to something other than an underwriter in all cases. Rather, in the absence of guidance, it would be sensible to interpret the term "underwriter" in the way it is intended to be used by the parties. That is, an underwriter refers to a person that sells debt instruments on behalf of an issuer (which is its customer and client) and earns fees by doing so. If, based on the relevant facts of the transaction, an underwriter is holding the debt instrument beyond the expected underwriting period, it should be reasonable to treat the underwriter as not acting as an underwriter after that period.[17] Within the framework of the applicable regulations, as a general rule, it seems logical and appropriate to use 12 days[18] as the underwriting period and to treat any portion held by the underwriter beyond

[12] *See* New York State Bar Association Report, "Report on Tax Fungibility of Debt Instruments," No. 1425 (Nov. 5, 2019). The report discusses the fungibility problem raised in firm commitment underwritings and recommends that the definition of the issue date be amended to be the date on which a debt instrument is treated as issued under general federal income tax principles (without applying the underwriter rule), subject to an antiabuse rule.

[13] *See* reg. section 1.1275-1(f)(1)(iii).

[14] *See* reg. section 1.1275-2(k)(3) for the definition of a qualified reopening. To be considered a qualified reopening, additional debt instruments must, among other things, satisfy the 110 percent yield test if they are issued within six months of the original issue.

[15] If this happens, however, it is unclear whether the debt should be deemed to have been held by an "investor" retroactively from the first day the underwriter held the debt, or only from the date on which the underwriter ceases to be considered an underwriter. Although not clear, the former approach seems more logical.

[16] *See* David C. Garlock, *Federal Income Taxation of Debt Instruments*, para. 203.01, n.43 ("The most sensible and administrative rule is to treat debt instruments retained by a bond house, broker, etc., for 30 days or more as having been purchased to hold, regardless of the original intention.").

[17] It has been suggested that treating an underwriter as the principal may be sensible under some circumstances. NYSBA, "Report on Revenue Procedure 2008-51," No. 1175 (Jan. 20, 2009).

[18] *See* reg. section 1.1275-1(f)(1)(iii)..

that period as no longer held in that person's capacity as underwriter.[19] However, the period should be longer in cases in which the parties explicitly contemplate that the underwriter could continue to syndicate for more than 12 days.[20]

C. AHYDO

If the issue price of a debt is so far below its principal amount that it creates a "significant original issue discount" within the meaning of section 163(i), the rules governing applicable high-yield discount obligations (AHYDOs) may be implicated, even if the issuer might receive cash proceeds (ignoring the underwriting fee) equal to or close to the principal amount. If a debt instrument is considered an AHYDO, the deduction of accrued OID would generally be deferred until paid in cash, and a portion of the OID deduction may be permanently disallowed. Facts similar to those in Example 1 may raise AHYDO concerns because the issue price as determined under the underwriter rule may drop significantly below the principal amount of the debt instrument, even though the issuer would receive proceeds exceeding that issue price. Had the proceeds received by the issuer been compared against the principal amount, the debt instrument would probably have avoided AHYDO treatment.

During the last economic downturn, the IRS issued Rev. Proc. 2008-51, 2008-2 C.B. 562, which provided temporary relief from the AHYDO rules for debt obligations meeting specified conditions. One category of debt instruments eligible for the relief was those issued to unrelated parties for cash under a financing commitment in situations in which the debt instrument would not have been an AHYDO if its issue price had been determined based on the net cash proceeds to the issuer.[21] To be eligible, a debt instrument had to be issued before January 1, 2009.[22]

Suspending the AHYDO rules for debt that meets the conditions listed in Rev. Proc. 2008-51 seems reasonable at all times, and the IRS should consider adopting the relief permanently.

III. Market Flex

A. What Is Market Flex?

A market flex is a provision that allows arrangers in debt financing to change some key terms of the debt until the debt is successfully syndicated. This provision is generally included in a fee letter or its equivalent. The scope of market flex provisions varies greatly and is often heavily negotiated. One of the most common flex provisions involves pricing flex, which deals with the interest rate or a one-time fee (that is, the arrangers are permitted to increase the interest rate (or margin) or offer a one-time fee if doing so is necessary for successful syndication), subject to an overall cumulative cap. Other market flex provisions may cover covenants and debt structure (for example, the split between a senior tranche and a junior tranche).

B. Post-Closing Market Flex

A market flex may be available from the date the financing is committed or the financing mandate is obtained until the close of the primary syndication, subject to a backstop date. When a market flex provision is used *after* the issuance of the debt instrument, a question arises as to whether the changes triggered as a result of the market flex provision can cause a deemed exchange of the instrument under section 1001. That is, if a debt is funded at closing but its terms are later modified in accordance with a market flex provision, should the debt be treated as outstanding before the modifications with pre-flex terms? The modifications triggered by the market flex provision should be analyzed to determine if they constitute significant modifications for federal income tax purposes

[19] *See* Jeffrey D. Hochberg and Michael Orchowski, "What Looks the Same May Not Be the Same: The Tax Treatment of Securities Reopenings," 67 *Tax Law.* 143, 150-151 (Jan. 2014) ("Although sales to underwriters are ignored for purposes of determining the issue price of a note, notes that are issued to underwriters are nevertheless treated as issued and in existence for tax purposes, notwithstanding that the underwriter may hold the notes in inventory. Thus, notes that are sold by an underwriter (other than an underwriter that is part of the same tax consolidated group as the issuer) after the expiration of the 13-day period would not be treated as issued in a reopening, and such sales would be treated no differently than any other sale of notes in the secondary market.").

[20] *See infra* Section III.B.1.

[21] Rev. Proc. 2008-51, section 4.01.

[22] *Id.*

under the rules that govern debt modifications (that is, reg. section 1.1001-3).

If there is a significant modification of the terms of the debt instrument and the issue price of the deemed reissued debt is lower than the adjusted issue price of the existing debt, the issuer will recognize COD income. The issue price of a debt instrument that is issued (or deemed reissued) in exchange for another debt instrument is generally equal to its FMV as of the issue date (or deemed reissue date), as long as the debt instrument is treated as publicly traded.[23] For this purpose, subject to some exceptions (including the exception for a small debt issue with the principal amount of $100 million or less), a debt instrument is treated as publicly traded if there are any quotes (including indicative quotes) available within 31 days starting on the 15th day before the issue date (or deemed reissue date).[24] The COD income risk is a major concern, particularly in the context of a post-funding market flex. Because the market flex concept is fundamentally to aid syndication when the market conditions are worse than expected and the arranger is unable to sell the debt with the negotiated terms, in situations in which a market flex provision is triggered, the FMV of the deemed new debt instrument — and thus its deemed new issue price — might well be below par when the flex provision is implemented.

But should changes under a market flex provision be treated as modifications of the instrument's terms? There are good arguments that they should not. And even if the changes under a market flex provision constitute modifications, those changes, similar to purchase price adjustments, should not be treated as a stand-alone taxable event.

1.The underwriter rule.

As discussed earlier, the underwriter rule provides that in determining the issue price and issue date of a debt instrument under section 1273, sales to bond houses; brokers; or similar persons or organizations acting in the capacity of underwriters, placement agents, or wholesalers are ignored.[25] Although this rule states that it applies "for purposes of determining the issue price and the issue date of a debt instrument," for the following reasons, it should also apply in determining COD income when a market flex is exercised.

If there is a significant modification of an outstanding debt instrument, section 108(e)(10)(A) and reg. section 1.61-12(c)(2)(ii) provide that COD income to the issuer resulting from that modification generally is equal to the difference between the adjusted issue price of the unmodified debt and the issue price of the deemed new debt. For this purpose, the adjusted issue price of the unmodified debt is determined under reg. section 1.1275-1(b), and the issue price of the new debt is then determined under sections 1273 and 1274.[26] This means that COD income turns to the OID regulations and principles in determining the issue price and adjusted issue price. The underwriter rule is clearly part of the OID regulations and provides that in determining the issue price and the issue date, sales to an underwriter or anyone acting in similar capacity are ignored. Accordingly, if an arranger is holding the loan in the process of actively syndicating it as contemplated by the parties with a market flex backup, the issue date and the issue price of the debt instrument should be decided at the earlier of when the debt instrument is sold to investors and when the market flex provision terminates.

The fact pattern involving a market flex provision should be distinguished from a bought deal discussed earlier.[27] In a bought deal in which the underwriter is unexpectedly left holding a debt instrument, that holding is not expected by the parties. In that case, the status as an underwriter for the issuance essentially ends when the debt is issued and the issuer gets the cash. By comparison, when there is a market flex provision, parties clearly contemplate the existence of the market flex provision as part of the syndication process, and the flex provision

[23] Reg. section 1.1273-2(c)(1).

[24] Reg. section 1.1273-2(f).

[25] Reg. section 1.1273-2(e).

[26] Section 108(e)(10)(B); reg. section 1.61-12(c)(2)(ii).

[27] *See supra* Section II.B.

typically goes away upon a successful syndication.

If the underwriter rule is applied in a manner consistent with its purpose, the price paid by an underwriter, placement agent, or wholesaler when the terms are subject to a market flex should indeed be ignored as being temporary and contingent, and the determination of the issue price should wait until the market flex goes away. While the terms are subject to a market flex, the arranger is still clearly acting as an underwriter, placement agent, or wholesaler in accordance with the parties' intent. Under the underwriter rule and consistent with the logic behind it, a debt instrument in that case should not be treated as issued until the market flex provision is settled or terminated.

2. Unilateral option.

Under reg. section 1.1001-3(c)(1)(ii), an alteration of a legal right or obligation that occurs by operation of the terms of a debt instrument is generally not a modification. An alteration that occurs by operation of the terms may occur as a result of the exercise of an option provided to an issuer or a holder to change a term of a debt instrument.[28] On its face, a market flex provision is such an option provided to arrangers.

However, reg. section 1.1001-3(c)(2)(iii)(A) provides that an alteration that results from the exercise of such an option is a modification unless the option is unilateral.[29] Reg. section 1.1001-3(c)(3)(i) then provides that an option is unilateral only if, among other things, "there does not exist at the time the option is exercised, or as a result of the exercise, a right of the other party to alter or terminate the instrument or put the instrument to a person who is related . . . to the issuer."[30] Thus, for a market flex provision to be treated as a unilateral option, an issuer cannot have a right to alter or terminate the instrument when it is used or as a result of its use. This is where the unilateral option argument may fail. A market flex is normally granted in connection with a bank financing, and the borrower customarily has a call option or optional redemption, even though exercising the call option may require the borrower to pay a premium. As a result, unless the issuer's call option is suspended during the relevant period, it would be difficult to argue that a market flex provision qualifies as a unilateral option.

3. Purchase price adjustment.

Purchase price adjustment is a concept frequently used in an acquisition. For example, if there is any post-closing earnout adjustment or indemnity payment in connection with an asset purchase agreement, that adjustment or payment is generally treated as an adjustment to the purchase price for federal income tax purposes.

The concept underlying that treatment is one of the bedrock principles of federal income tax law. Under *Arrowsmith*[31] and its progeny, a subsequent adjustment to a payment made in connection with a previously closed transaction has been held as relating back to the original transaction and is not treated as a separate transaction or a taxable event. Applying the same logic, a strong argument can be made that the modification of a debt instrument in accordance with a market flex provision is a purchase price adjustment and not a separate taxable event.

In *Arrowsmith*, two individual shareholders liquidated their corporation and divided the proceeds equally, reporting the resulting gain as capital gain. Four years later, a judgment was rendered against the liquidated corporation. The shareholders each paid half of the judgment and deducted their payments as ordinary loss. The Supreme Court did not view the payments of the judgment as separate from the liquidation proceedings. It reasoned that the payments of the judgment essentially reduced the amount of capital gains the taxpayers realized upon the liquidation. Thus, the Court held that the judgment payments resulted in a capital loss, relating back to the treatment of liquidation proceeds as capital gain.

[28] Reg. section 1.1001-3(c)(1)(ii).

[29] For an option exercisable by a holder, the exercise of the option also cannot result in a deferral of, or a reduction in, any scheduled payment of interest or principal. Reg. section 1.1001-3(c)(2)(iii)(B). As an option exercisable by arrangers, a market flex provision satisfies this requirement because it normally increases, rather than decreases, scheduled payments of interests.

[30] A market flex provision satisfies the other two requirements for an option to be unilateral because arrangers may exercise it without other parties' consent and its exercise does not require consideration. *See* reg. section 1.1001-3(c)(3)(ii)-(iii).

[31] *Arrowsmith v. Commissioner*, 344 U.S. 6 (1952).

Courts frequently cite *Arrowsmith* for the principle that two transactions — one occurring after the other and each integrally related — should be treated as parts of the same transaction, so that the later event relates back and is given the treatment as part of the prior event.[32] For example, in *Wener*,[33] a renegotiation of a prior sale was related back to the original transaction. The taxpayers were partners in a partnership and conveyed their partnership interests to other partners, receiving a cash down payment and the remainder of the purchase price over three installments. In the year following the sale, because of a pressing need for funds, the taxpayers negotiated a settlement of the installments for an immediate cash payment that was less than the amount remaining under the installment agreement. The court declined to treat the price difference as ordinary loss, and it treated the sale and the settlement as a single transaction. It reasoned that there was a renegotiation, adjustment, or revamping of the sale itself both as to price and the terms of payment, and there was a renegotiation and revision of the unexecuted provisions of the sales contract itself and the substitution of new provisions therefor.

What happens when a market flex provision as exercised is analogous to a purchase price adjustment. Even if there is a modification of the original debt instrument, it is essentially the same as what happened in *Wener* — a renegotiation and adjustment of the terms as the result of changes in the circumstances and the parties' needs. Under the principle of *Arrowsmith*, the change of terms in accordance with a market flex provision should relate back to the original debt instrument and be treated together as a single transaction. As a result, the exercise of a market flex provision, like a purchase price adjustment, should not be subject to any stand-alone tax treatment separate from that of the original debt instrument.[34]

Another point that may be made to reinforce the analogy between the exercise of a market flex provision and a purchase price adjustment is the application of the purpose and intent test in rebates. In *Pittsburgh Milk*,[35] a milk producer paid allowances to some purchasers of its milk to circumvent the state law regulating the minimum price of milk. In determining whether the allowances were adjustments to the purchase price or ordinary and necessary business expenses, the court focused on the facts and circumstances of the transaction, what the parties intended, and the purpose or consideration for which the allowance was made. It concluded that the allowances were purchase price adjustments because the purpose and intent of the parties was to reach an agreed net selling price. Similarly, the purpose and intent of the issuer and arrangers in exercising a market flex provision is to reach finally agreed terms for the debt.

C. Variations

Although there are strong arguments that the exercise of a market flex provision for a funded debt instrument should not be viewed as a modification of the terms of the instrument or treated as a taxable event, if the parties have concerns, there are ways to mitigate an adverse effect of a market flex provision. The following are some examples.

1. One-time exercise.

Some market flex provisions require that the market flex be exercised all at once. By limiting the exercise of the market flex to one time for the entire debt instrument, the parties may avoid having multiple deemed exchanges.[36]

[32] TAM 200427023.

[33] *Wener v. Commissioner*, 24 T.C. 529 (1955), *aff'd*, 242 F.2d 938 (9th Cir. 1957).

[34] Reg. section 1.305-1(c) applies the same logic in a different context, which specifically provides an exception from deemed dividend treatment under section 305 for a purchase price adjustment: "A transfer of stock (or rights to acquire stock) or an increase or decrease in the conversion ratio or redemption price of stock which represents an adjustment of the price to be paid by the distributing corporation in acquiring property . . . is not within the purview of section 305 because it is not a distribution with respect to its stock."

[35] *Pittsburgh Milk Co. v. Commissioner*, 26 T.C. 707 (1956).

[36] A sample provision reads as follows: "Any syndication of the Term Loan Facility that involves an invocation of the modifications described above after the Closing Date shall take place in a single closing with respect to all portions of such facility that are being syndicated."

2. Issuer's option to trigger partial or full exercise immediately before closing.

Financing commitments are frequently entered into long before actual funding and closing. A market flex provision is even more relevant in those cases because arrangers and issuers are unable to predict future market conditions. Some market flex provisions thus build in a relief provision stating that if the issuer, as it gets closer to the closing and given the market conditions at that time, reasonably determines after consulting with the arranger that the market flex provision is almost certain to be exercised and could trigger a significant risk of COD income, it may, at its option, require the arranger to exercise some or all of the market flex provisions immediately before funding. By causing the changes to the terms to occur before the closing and funding, the parties would reduce the risk of a deemed exchange.[37]

3. Closing the loan with fully flexed terms, coupled with reverse flex.

If there is no successful syndication by the time the financing closes and the market flex provision remains exercisable after closing, the parties could choose to close the financing with terms that reflect the maximum flex allowed under the market flex provisions (including maximum OID) and add a reverse flex provision. Under a reverse flex provision, the arranger would be required to make issuer-friendly changes if, when it goes out to market and syndicate, it can actually syndicate the loan with terms that are more favorable to the issuer (for example, a lower margin or lesser OID).

Under this approach, by funding the loan at the maximum OID and coupon, any reverse flex will occur only when investors demand *less* OID or lower coupon.[38] If the syndication is very difficult, the value of the loan may well be far below par, but the terms will generally not change any further (thereby avoiding modification) because they have already been fully flexed to provide the maximum yield. Although the terms could change if the market calls for a *lower* yield, the FMV of the loan under those circumstances would then likely be at or above the original issue price (the price at which the banks funded the loan, ignoring fees paid for their services).[39]

4. General cooperation clause.

Many market precedents simply include a general cooperation clause among the parties that require that the market flex provision be exercised in a manner to reduce or eliminate adverse tax consequences to the issuer (including any COD income) resulting from the exercise. Although the language looks harmless, this provision is too vague and general to have any meaning.[40] Accordingly, if the parties are seriously concerned about the effect of a market flex provision, they should include a more concrete provision.

5. AHYDO savings clause.

The parties may also add an AHYDO savings clause so that if the exercise of a market flex provision creates deemed new debt with a significant OID, that new debt is not treated as an AHYDO.

[37] The following is a sample provision:
Notwithstanding the foregoing, if a [Successful Syndication] has not been achieved by the [Closing Date], the [Borrower] may, in its sole discretion (but after consultation with the [Lead Arrangers]), require the [Lead Arrangers] to exercise some or all of the [Flex Provisions] immediately prior to the funding of loans under the [Facilities] on the [Closing Date] if the exercise of the [Flex Provisions] after the [Closing Date] could cause adverse tax consequences (as determined by the [Borrower] in good faith); provided that any such partial exercise shall not limit the [Lead Arranger]'s right to exercise its other flex rights that were not so exercised.

[38] When a loan is fully flexed, it includes maximum OID permitted under the original market flex terms. However, in that case, banks may still want to retain flexibility to convert all or a portion of the OID to coupon. Although OID and coupon are normally treated as interchangeable, depending on market conditions, investors may prefer one over the other. In general, a change from OID to corresponding coupon under a market flex provision is unlikely to trigger a significant modification under the change-in-yield test in reg. section 1.1001-3(e)(2).

[39] A reduction in coupon or OID could cause a deemed exchange if the yield is reduced by more than the threshold under reg. section 1.1001-3(e)(2). However, that reduction would take place only if the market demanded less yield, meaning that the FMV of the debt would be par or close to par.

[40] The following is a sample provision:
If a [Successful Syndication] in respect of the [Term Facility] has not been achieved on or prior to the [Closing Date], the [Lead Arrangers] shall cooperate with the [Borrower] in good faith to exercise any flex rights in a manner to avoid and/or minimize adverse tax consequences to the [Borrower], including the tax consequences of any cancellation of debt income, as a result of the exercise of any flex rights by the [Lead Arrangers].

IV. Securities Demand

A. What Is a Securities Demand?

A securities demand is a provision under which the borrower refinances a funded bridge loan with the proceeds of a marketed offering of notes. It is typically included in a fee letter entered into as part of a set of commitment papers. In a usual securities demand provision, the administrative agent or the arranger for the bridge loan will have the right, within a set period (often 12 months) following the closing of a bridge loan, to send a notice to the issuer requiring it to issue a new security (a so-called demand security) with terms that meet specified conditions (including a cap on the yield), the proceeds of which will be used to repay the bridge loan. One of those conditions is that the aggregate amount of the proceeds from the sale of a demand security not be less than the amount needed to pay off the related bridge loan. A securities demand provides assurance for the bridge lenders that there will be a mechanism to encourage the issuer to issue permanent debt to take out their bridge loan in a relatively short time.

When the market is good and the issuer's financial conditions are healthy as expected, a demand security will be issued at par or at a slight discount, and the bridge will be taken out at par. However, if market conditions are bad and the demand security cannot be sold at par to unrelated investors, the bridge lenders or their affiliates might be the only investors that would be willing to step in to purchase the demand security at par.

It is not clear how to analyze such distressed market issuance of a demand security for federal income tax purposes. As discussed later, depending on the characterization, there are potentially significant COD income and AHYDO issues arising from a securities demand. For this reason, at the height of the last economic crisis, many borrowers refused to go along with a securities demand, which resulted in an astronomical amount of "hung bridges."[41]

Commentators discussed the hardships resulting from potential deemed exchange treatment and asked for guidance from the government.[42] Although the IRS has not clarified the treatment of a securities demand, there were piecemeal remedies available for a limited time. First, Congress adopted section 108(i) to allow an election to spread out the inclusion of COD income over four to five years under some circumstances. Separately, the IRS addressed the AHYDO concerns arising from a debt-for-debt exchange in Rev. Proc. 2008-51 (turning off the AHYDO treatment for some debt instruments issued in accordance with a financing commitment).[43] However, all those relief measures were available only during a very limited window.[44]

During the 10-plus years of the economic boom that followed, these issues have been almost forgotten, even though a securities demand provision still appeared in bridge papers. If we face another economic downturn, as is almost certain, most of the issues we faced last time will become relevant again. Moreover, the potential impact could be significantly worse as the result of changes in the interim. The discussion below takes a fresh and detailed look at alternative ways to characterize securities demand transactions and then explains developments in market practice since the last financial crisis.

B. Potential Income Issue

Assuming that a demand security is issued in a distressed market and the bridge lenders or their affiliates acquire it pro rata, there are at least four

[41] One argument that borrowers made to reject the demand was that because of the potential COD income and resulting income tax liability, the effective yield on the demand security would exceed its pre-negotiated cap.

[42] Charles Morgan, "Bridge Loans — Confronting Tax Issues Triggered by the Recent Economic Downturn," 7 *J. Tax'n Fin. Prod*. 35 (Jan. 2009); and NYSBA, *supra* note 17.

[43] In general, for new debt issued in exchange for old debt to qualify for the exclusion from AHYDO treatment, Rev. Proc. 2008-51 required that (1) the new debt be issued directly or indirectly in exchange (including a deemed exchange within the meaning of reg. section 1.1001-3) for old debt issued by a corporation for money before January 1, 2009; (2) the new debt be issued within 15 months of the old debt; (3) the new debt would not be an AHYDO if its issue price had been equal to the net cash proceeds actually received by the issuer for the old debt; (4) the maturity date of the new debt be no more than one year later than the maturity date of the old debt; and (5) the stated redemption price at maturity of the new debt be no greater than that of the old debt.

[44] Section 108(i) applies to COD income resulting from reacquisition of debt occurring in 2009 or 2010. Rev. Proc. 2008-51 applies only if the old debt was issued on or before January 1, 2009.

alternative ways to characterize the issuance of a demand security and the repayment of the related bridge for federal income tax purposes.

1. Respecting the form and treating the banks as underwriters.

If we follow the form, a demand security will be treated as issued at par (or a slight discount), and the bridge is repaid at par. If that form is respected, there should be no COD income because the bridge loan will be fully repaid. Under this construct, it would be reasonable to treat the bridge lenders taking the demand security as underwriters and to treat the issuance of a demand security as an issuance under a firm commitment underwriting. If we apply the underwriter rule, the issue price of the demand security would be determined when the demand security is sold to an investor that is not acting as an underwriter or in a similar capacity. In a distressed market, such a sale might well be at a steep discount and, if so, the issue price of the demand security could be significantly lower than the cash proceeds to the issuer. Should the issuer in that case recognize as current income the difference between the net cash proceeds it receives (or is deemed to receive) from the sale of the demand security and its issue price? For the reasons discussed earlier,[45] it should be reasonable not to treat that difference — the excess net cash proceeds to the issuer above the issue price of the demand security — as current income to the issuer. Instead, that excess should be amortized over the term of the demand security as an adjustment to the deduction of interest or OID.

2. Respecting the form and treating the banks as investors.

Assuming we respect the form of the transaction and treat the bridge loan as being repaid in full, another alternative would be to treat the bridge lenders purchasing a demand security as acting as investors rather than as underwriters or someone acting in similar capacity. These bridge lenders' purchase of the demand security would not be something that was initially contemplated by the parties, and although the arranger or the administrative agent may be viewed as acting as an underwriter, it would be inconsistent with the parties' intent to treat the bridge lenders (or their affiliates) as underwriters acting for the issuer in proportion to their bridge loan. Rather, it would be logical to treat them as investors purchasing the demand security for cash, in accordance with the form, and determine the issue price based on the cash price paid by the bridge lenders (or their affiliates).[46]

Although these two alternatives are consistent with the form of the transaction, one problem in treating a securities demand this way would be that in distressed situations, the money used for the bridge loan repayment would likely be sourced from the banks holding the bridge loan or their affiliates, almost always pro rata. As such, the repayment at par and the circular cash flow may be considered a meaningless gesture.

3. Ignoring the bridge loan.

Another alternative is to combine a bridge loan and the related demand securities and treat them together as a firm commitment financing, particularly if the securities demand is exercised soon after the closing. Under this alternative, in accordance with the underwriter rule, the bridge loan would be ignored as transitory and its issuance would not be respected for federal income tax purposes. A debt obligation will be deemed to exist only when the demand security is issued, and only then will its issue price and issue date be determined based on the sale to third-party investors. Under this alternative, the issuer may not have any COD income because the bridge loan does not exist in the first place, and the only potential income to the issuer would be the receipt of proceeds exceeding the issue price, as addressed earlier.[47]

Although arguments can be made that the bridge lenders taking a demand security shortly after the funding of the bridge are substantively acting as underwriters of the demand security, it is difficult to ignore the existence of a bridge loan altogether simply because of the potential repayment with a demand security within a short period. A bridge loan by nature is supposed to exist for a short duration and serves an important

[45] *See supra* Section II.A.

[46] NYSBA, *supra* note 17.

[47] *See supra* Section II.A.

function in financing. Further, as explained later, a securities demand does not provide the bridge lenders an unfettered right to a demand security; in fact, as discussed later, securities demand provisions these days normally permit the issuers not to go along with the demand for various reasons or for no reason at all.

Any of the three alternatives above would avoid the creation of COD income in connection with a securities demand. However, as discussed, each alternative has its own flaw.

4. Debt-for-debt exchange.

If we ignore the circular cash flow (treating a bridge lender and its respective affiliates as one), and if the existence of a bridge loan before a demand security cannot be ignored, the issuance of a demand security and the repayment of the bridge loan may be treated as a debt-for-debt exchange, when the exercise of a securities demand is treated as a redemption of the funded bridge loan with the demand security. In that case, if the demand security has terms that are significantly different from the terms of the bridge loan, the redemption would be treated as a deemed exchange governed by section 1001, and the borrower would recognize COD income in an amount equal to the difference between the issue price of the demand security and the adjusted issue price of the bridge loan.[48] That COD income could be significant if the deemed issue price of the demand security, which will most likely be equal to its FMV (assuming any quote or trading value for the demand security is available), is below par.[49] Although the newly issued demand security with OID would generally give rise to OID (or additional OID) deductions corresponding to that COD income, the OID deductions would accrue over the life of the note, resulting in a significant timing difference between the inclusion of COD income and the deduction of the corresponding OID to the borrower. Moreover, depending on the amount of OID arising from that exchange and the term of the demand security, the borrower's OID deductions may be deferred or partially disallowed under the AHYDO rules.[50]

Further, compared with the last economic downturn, the consequences of COD income resulting from such a deemed exchange would be a lot worse now because of changes introduced under the Tax Cuts and Jobs Act. Among other things, section 163(j) after the enactment of the TCJA generally limits interest deduction to 30 percent of adjusted taxable income, subject to a temporary increase in the limitation (unless the taxpayer elects out) to 50 percent of ATI for any tax year beginning in 2019 or 2020 under the Coronavirus Aid, Relief, and Economic Security (CARES) Act (P.L. 116-136).

Any excess interest deduction becomes carryforwards, which can be used subject to the 30 percent of ATI limitation for future years. However, it is likely that many companies that incur COD income will have little room under this limitation to take any additional interest or OID deduction for future years, such that future OID accrual just keeps being added to the excess interest carryforwards. Combining that with the narrowed definition of ATI under section 163(j) after 2021,[51] using interest deduction carryforwards in years beyond 2021 would be extremely difficult, if not impossible.

C. Current Market Practice

There have been some changes in securities demand provisions since the last economic downturn. The following discusses a few of them.

1. AHYDO savings clause.

Many securities demand provisions now require that a customary AHYDO savings clause be included in the demand security, to the extent relevant or at the option of the issuer. Given all the uncertainty surrounding the treatment of a

[48] *See supra* Section III.B.

[49] *See* reg. section 1.1273-2(c)(1).

[50] A possible argument to improve the effect of what would otherwise be current COD income is that a securities demand, if it is a separate legal right from the rights in the bridge loan, is a hedge against the risks of interest rate increases. If this argument is successful, the hedge accounting rules would spread the COD income over the life of the demand security and thereby limit or eliminate the difference in timing of recognition of the COD income and the accrual of OID deductions. To argue for the application of the hedge accounting rules, it would be important to keep the securities demand as a legal right separate from the rights under the bridge loan.

[51] After 2021, the definition of ATI will take into account depreciation, amortization, or depletion. *See* section 163(j)(8).

securities demand, this is a great practice to follow, because there is no assurance that the IRS would issue relief similar to that provided under Rev. Proc. 2008-51 and, if so, when it would do so.

2. Requirement to sell a majority to bona fide investors.

One puzzling market practice that has developed and is becoming almost standard is a clause in a securities demand provision tied to material adverse tax consequences. It essentially provides that, if needed to avoid material adverse tax consequences, a majority (sometimes more, sometimes less) of the demand security must be sold to bona fide investors unrelated to the arrangers (or the administrative agent). In some cases, this requirement applies for 30, 45, 60, or 90 days from the closing date of the bridge financing, while in other cases there is no such time limit. The origin of this provision (and similar ones) is unclear, but for whatever reason, once it started appearing shortly after the last economic downturn, it became standard in virtually all forms of securities demands.

Although the sale-to-bona-fide-investor requirement is almost always tied to avoiding material adverse tax consequences, it is unclear if this is really a tax point. Selling a majority of a demand security to bona fide investors would certainly help to establish the true FMV of the demand security, but how that would help avoid material adverse tax consequences to the issuer is unclear.[52] Also, why would establishing that FMV be important only for 30, 45, 60, or 90 days after the closing of the bridge loan (as opposed to the demand security)?

Because this requirement generally applies when a demand security is issued shortly after the funding of the bridge loan, the concern was that the banks making the bridge, if soon taken out with the proceeds of a demand security, might be treated as underwriters (or as someone acting in a similar capacity). Once 30 to 90 days pass, the bridge lenders may be treated as having held the security long enough that they are no longer underwriters.[53] However, if the bridge lenders are considered to be acting as underwriters or in a similar capacity, it is unclear why selling the demand security to bona fide investors would mitigate any material tax issues. If the bridge lenders are indeed so considered, the only potential adverse consequence to the issuer would be if the receipt of the amount representing the excess over the issue price (the price at which investors buy) constituted current income,[54] and selling a majority to bona fide investors would not help avoid that problem. On the contrary, if the bridge lenders were to hold onto the demand security long enough to be considered investors, and if they still did not sell the security to any investors, there would be strong arguments that the issue price of the demand security is what the bridge lenders paid for it (that is, par or a slight discount). Also note that under the antiabuse rules in the regulations governing OID, temporary restrictions on trading to avoid the characterization of the property as being publicly traded, as well as artificial pricing information for a principal purpose of establishing public trading, would both be ignored.[55]

There is a strong possibility that this bona fide investor requirement is not really a tax point but instead a commercial point disguised as a tax point.[56] No matter what the reason is, and although no one seems to know the exact logic behind this provision, the provision took on a life of its own and keeps appearing in all securities demand provisions. To date, however, I am unaware of any actual transaction in which the issuer made the material adverse tax consequence argument to force sales to bona fide investors under such a provision.

[52] Note that this requirement to sell to bona fide investors is not tied to the requirement that the net proceeds of a demand security be sufficient to pay off the related bridge loan. Thus, even if a sale to bona fide investors is at a deep discount, as long as the arranger or the banks "top up" the difference so that the net proceeds to the issuer are at par, the conditions for the demand security are met.

[53] *See* Garlock, *supra* note 16, at para. 203.01 n.43.

[54] *See supra* Section II.A.

[55] Reg. section 1.1273-2(f)(7).

[56] In the meantime, not understanding exactly what this provision means, some banks have been adding clarification that this sale-to-bona-fide-investor requirement does not prevent the acquisition of demand securities by the bridge lenders or their affiliates in connection with ordinary course market-making activities (*e.g.*, by adding "provided that, for avoidance of doubt, the foregoing shall not prevent the acquisition of [the demand security] by the initial lenders or their affiliates in connection with ordinary course market-making activities").

D. Demand Failure

Almost all recent securities demand provisions these days incorporate the concept of a demand failure. A demand failure generally means that the issuer, upon receiving a demand notice, decides not to go along with the issuance of a demand security. The issuer can inform the arranger of its decision to reject the demand by giving a notice, but even without a notice, there is automatically a demand failure if a demand security is not issued within a specified time. Despite the term "failure," a demand failure typically can be given for any reason, including tax reasons, and it does not on its own constitute a default or an event of default. When there is a demand failure, however, the interest rate is increased to the maximum rate, and some other features (such as the call protection) automatically kick in. Moreover, a pre-negotiated conversion fee may be payable to the bridge lenders.

Although it is not entirely clear how these automatic changes that take place as part of a demand failure should be analyzed for federal income tax purposes, it should be reasonable to treat a demand failure as a unilateral option of the issuer within the meaning of reg. section 1.1001-3(c)(2)(iii)(A), and thus as an alteration occurring by operation of the terms of the debt instrument, which is not a modification, according to reg. section 1.1001-3(c)(1)(ii).[57]

One question is whether the amendments resulting from a demand failure can be considered to occur as a result of the exercise of an option of the issuer when the option to trigger a demand failure arises only if an arranger or administrative agent first makes a securities demand. In this regard, it is important to note that neither reg. section 1.1001-3(c)(2) nor (3) requires that the option be unconditional. Thus, it would be reasonable to interpret that an option could be a conditional option, which becomes exercisable when specified conditions are met. In this case, the issuer's option to trigger a demand failure would become available and unconditional once the issuer is served with a securities demand.

For an option to be considered unilateral, reg. section 1.1001-3(c)(3) further provides that each of the following conditions must be met:

- both at the time of the exercise and as a result of the exercise, the other party has no right to alter or terminate the instrument or to put the instrument to a person related to the issuer;
- the exercise of the option does not require the consent or approval of the other party, a person who is related to the other party, or a court or arbitrator; and
- the exercise of the securities demand does not require consideration, excluding incidental costs, unless on the issue date the consideration is a de minimis amount, a specified amount, or an amount that is based on a formula that uses objective financial information (as defined in reg. section 1.446-3(c)(4)(ii)).[58]

The condition that there be no termination or put right in the hands of the bridge lenders should be met in almost all securities demands. Even though a securities demand itself could be viewed as a potential put, it would be incorrect to view it as a put right if the issuer is free not to go along with the demand.

Regarding no consent or approval required from the bridge lenders, there could be some concerns about whether the fact that the arranger or administrative agent must first serve a securities demand could be viewed as a consent or approval of the bridge lenders. However, the arranger or administrative agent should not be viewed as acting on behalf of the bridge lenders. Although an arranger or administrative agent could hold a portion of the bridge loan, the role of the arranger or administrative agent is distinguished from that of bridge lenders. More importantly, even if the arranger or administrative agent were viewed as acting on

[57] As discussed earlier, under reg. section 1.1001-3(c)(1)(ii), an alteration of a legal right or obligation that occurs by operation of the terms of a debt instrument is generally not a modification. An alteration that occurs by operation of the terms may occur as a result of the exercise of an option provided to an issuer or a holder to change a term of a debt instrument.

[58] If an option is with a holder, for the exercise of the option to avoid being a modification, there is an additional requirement that the exercise of the option not result in a deferral of, or a reduction in, any scheduled payment of interest or principal. However, because a demand failure must be viewed as an issuer option, this additional requirement should not be relevant.

behalf of the bridge lenders in making a securities demand, that demand is not a consent or approval of a demand failure; rather, it is a mere request that the issuer issue a new demand security and take out the bridge. Once a securities demand is made, the issuer's exercise of a demand failure will not be subject to a consent or approval, and the bridge lenders will have no say on the outcome.

The third condition concerning no consideration is a factual question to be answered on a case-by-case basis. However, in ordinary situations, any fees that are payable on a demand failure should meet one of the exceptions as either a specified amount or as an amount determined under an objective formula.

V. Conclusion

Committed debt financing in a distressed market raises several questions about its proper federal income tax treatment. For some of those questions, even though there is no direct authority, reasonable answers may be found in existing authorities in analogous areas or if we look at the substance more closely.

Specifically, based on analogous authorities, it should be reasonable to allow the issuer selling debt under a firm commitment underwriting and receiving proceeds exceeding the issue price of the debt to amortize the excess as an offset against interest or OID deduction on the debt over its term. In the absence of any guidance, it should be reasonable to interpret the meaning of underwriter in a flexible manner in accordance with the parties' intent. Based on the facts and applicable rules, there are several strong arguments for avoiding any deemed exchange when the terms of a debt instrument are changed under a market flex. A demand failure triggered by a securities demand should be treated as a unilateral option of the issuer that does not result in a modification for federal income tax purposes. ■