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Top 10 Tax Issues in the COVID-19 Downturn

Companies considering transactions relating to their existing debt or equity in the current market environment should be mindful that these transactions can result in current tax liabilities or affect the amount of net operating losses ("NOLs") or other tax attributes that would otherwise be available to shelter taxable income in the future. In addition, companies raising new financing (whether debt or equity) should be mindful of tax implications. Finally, companies should consider the tax impact on them of the recently enacted Coronavirus Aid, Relief, and Economic Security Act (the "CARES Act"). Top tax considerations to keep in mind during the COVID-19 downturn are as follows (with embedded hyperlinks for additional detail):

1. Transactions involving a company's debt obligations can give rise to taxable cancellation of debt income ("CODI"). In particular, companies should be aware that CODI can arise in unintuitive circumstances, including debt-for-debt exchanges, debt amendments, debt-for-equity exchanges and debt repurchases by affiliates.

2. CODI may be excluded from income if the borrower (or, a partner if the borrower is a partnership) is in bankruptcy or insolvent, but the borrower must "pay a price" for this benefit by reducing tax attributes (*e.g.*, NOLs, and potentially even asset basis).

3. Tax rules alleviate the impact of CODI triggered by a debt-for-debt exchange or a debt amendment by creating deductible "original issue discount" on the new or amended debt instrument, but in some cases deductions of such original issue discount may be deferred or even disallowed.

4. Private equity funds acquiring debt obligations of their portfolio companies should be aware that the acquired debt may not be fungible with the remainder of the issue.

5. Lenders to U.S. companies might request credit support from the borrower's foreign operations (*e.g.*, foreign subsidiary guarantees or pledges of more than 66.66% of foreign subsidiary stock). Despite favorable recent IRS regulations, this credit support still can potentially give rise to a tax liability for the U.S. borrower.

6. Companies issuing debt that is not "plain vanilla" should consider the impact of any contingencies or "pay-in-kind" ("PIK") features on the timing and amount of interest deductions and, in the case of convertible debt, potential withholding on "deemed" dividends and treatment of related hedges.

7. Changes in a corporation's equity ownership—including accumulation by new or existing owners and equity issuances or buybacks—can result in limitations on the corporation's ability to use its NOLs against future income. The rules are highly fact-specific. Corporations with significant NOLs frequently confront two critical questions: (1) whether a transaction involving the corporation's stock will trigger an "ownership change" giving rise to NOL limitations and (2) if so, what is the resulting annual limitation (and what would the amount and timing of NOL utilization be in the absence of the limitation).

8. Because acquisitions and dispositions of a public corporation's stock by "5% shareholders" may trigger an ownership change, some public corporations with significant NOLs have implemented or considered implementing "NOL pills." An NOL pill has many implications, which may or may not make it an appropriate mechanism, depending on a corporation's particular circumstances. In most cases, the CARES Act changes are not likely to affect the desirability of an NOL pill.

9. A holder of stock that does not participate in corporate growth may be required to include amounts in income as a dividend even if no cash dividend is paid (so-called "phantom" income). If the holder is not a U.S. person, the issuer may have a related withholding obligation.

10. Companies should consider whether they can boost their liquidity position by taking advantage of favorable changes relating to NOL utilization in the CARES Act.

Debt and equity transactions undertaken in the context of the COVID-19 downturn raise tax issues that may be subtle or unexpected. Tax advisors should be involved early in the process. For a more detailed discussion of our "top 10" list, please see the appendix below.

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Appendix

DEBT TRANSACTIONS

• Cancellation of Debt Income and Attribute Reduction. In the current downturn, a company might consider buying back debt, refinancing, amending existing debt terms, or engaging in a debt-for-debt exchange or stock-for-debt exchange. Each of these transactions can result in CODI. If a taxpayer repays (or repurchases) debt for less than the amount it borrowed, the taxpayer generally recognizes taxable income equal to the difference. For example, if a taxpayer borrows $100 and later repays the debt for $60, the taxpayer is generally taxed on the difference, the CODI, of $40. Thus, buying back debt can give rise to CODI.

Further, CODI can arise in circumstances that one might not expect. For example, if debt is trading at a discount, the borrower exchanges new debt for the old debt or otherwise amends the old debt, and the new or amended debt reflects changes in terms that are economically significant (*e.g.*, significant changes to the interest rate or term to maturity), then the borrower generally recognizes CODI equal to the difference between the face amount of the old debt and the trading price of the new or amended debt at the time of the exchange. Indeed, the same result can arise if debt is trading at a discount and the borrower issues equity, with a value equal to the debt, in exchange for the debt. And, in yet another variation, CODI can be triggered if an affiliate of the borrower repurchases the debt, even if the debt remains outstanding. If the borrower is a partnership for U.S. tax purposes, any CODI arising from a transaction in partnership debt is includible in income at the partner level.

The tax rules alleviate the result if CODI arises in a Title 11 bankruptcy case or if the taxpayer is insolvent (as specially determined under tax principles). In those cases, the borrower is entitled to exclude CODI from income (in the case of the insolvency exception, up to the amount of the insolvency) but is required to reduce tax "attributes," such as NOLs and, potentially, asset basis. In effect, in these circumstances, the rules defer taxation by excluding CODI that would otherwise be taxable currently (a benefit to the borrower) but reducing attributes that would otherwise reduce future taxes (a detriment to the borrower). If the taxpayer runs out of tax attributes to reduce, *i.e.*, CODI exceeds the amount of attributes (such excess often referred to as "black hole CODI"), there is no further consequence. The taxpayer benefits from the exclusion of the black hole CODI without any corresponding detriment. If the borrower is a partnership for U.S. tax purposes, exclusions of CODI under the bankruptcy or insolvency exception are applied at the partner level, depending upon each partner's characteristics.

Issuers or their affiliates engaging in transactions relating to historic debt should consider whether they will incur CODI; and, if so, whether it will be excludible and to what extent tax attributes will be reduced; or, if not excludible, whether the taxpayer has NOLs to absorb the CODI.

• Potential Deferral—or Disallowance—of Interest and OID Deductions. In the context of a debt-for-debt exchange or debt amendment, the tax rules generally alleviate the CODI sting by treating the new or amended debt as having been issued with "original issue discount" ("OID") equal to the difference between the face amount of the new or amended debt and the trading price of the new or amended debt at the time of the exchange or amendment. Such OID is generally deductible as interest over the remaining term of the new or amended debt, but this deduction may be deferred until the OID is paid in cash (if the yield to maturity equals or exceeds the applicable federal rate plus 5%) or disallowed (to the extent the yield to maturity exceeds the applicable federal rate plus 6%). Disallowance of interest and OID deductions is particularly inefficient in that those deductions would otherwise offset the CODI on the debt-for-debt exchange or debt amendment (albeit in later years). Notably, however, the above deferral or disallowance limitations do not apply if the new or amended high-yield debt has a term of five years or less.

• Lack of Fungibility. Instead of the issuer buying back its debt, companies sometimes consider having a party related to the issuer buy a portion of the issuer's debt. For example, a private equity fund might consider buying debt of its portfolio company. Such related party acquisitions may give rise to CODI, just like acquisitions by the issuer of its own debt. In addition, where such purchase involves less than all of the debt in a particular issue, the debt held by the related party may no longer be "fungible" with the debt held by third parties (as the transaction may cause the debt held by the related party to have different tax characteristics from the debt held by unrelated parties), potentially affecting trading. In such circumstances, companies should consider whether the debt could instead be purchased by a party that is unrelated, for tax purposes, to the issuer.

• Foreign Credit Support. U.S. companies raising new debt or amending existing debt might face requests from lenders for enhanced credit support in the form of guarantees or asset pledges by foreign subsidiaries, or pledges of more than 66.66% of foreign subsidiary stock. Internal Revenue Code Section 956 historically impeded such arrangements by giving rise to a "deemed" dividend from the relevant foreign subsidiary, taxable to the U.S. borrower. Recent IRS regulations took most of the teeth out of this provision by generally allowing the U.S. borrower to deduct 100% of the amount of the dividend, but exceptions

remain. See our prior memo. In addition to holding period requirements and exceptions for "hybrid dividends," a deduction may not be available for deemed dividends from a foreign subsidiary that has positive "earnings and profits" (as determined under U.S. tax principles) in a current year, but accumulated deficits due to prior year losses. Borrowers considering guarantees by loss-making foreign subsidiaries should consider the possibility and impact of a "springing" Section 956 dividend if and when the foreign subsidiary turns a profit.

• New Debt Issuances. A company issuing a debt instrument with unusual features should consider the tax implications. For example, any contingencies relating to interest or principal payments (*e.g.*, an increase to the interest rate upon the occurrence of certain events), the likelihood of which is not "remote," may cause a corporate bond to be treated as a "contingent payment debt instrument." In such case, the timing and amount of the issuer's interest deductions (and the holder's interest inclusions, as well as the character of any gain) may be affected. PIK features can also have an unexpected impact: if the yield on a debt instrument exceeds certain thresholds (see above), a PIK option could result in deferral of OID deductions until paid in cash or even disallowance. These deferral and disallowance rules generally do not apply, however, if a significant portion of the interest is paid in cash by the fifth anniversary of issuance. Finally, issuers of convertible notes should be aware that certain adjustments to the conversion ratio—notably including adjustments on account of cash dividends paid on common stock—may give rise to a "deemed" dividend on the note, and, if the holder is not a U.S. person, a related withholding obligation to the issuer. Convertible debt issuers should also consider any related derivatives (*e.g.*, a call on the issuer's stock held by the issuer of the debt or a warrant on the issuer's stock issued by the issuer of the debt), including the implications of integrating the convertible note with the derivative for tax purposes. Finally, interest deductions on convertible subordinated debt issued to fund an acquisition can be disallowed.

STOCK TRANSACTIONS

A corporation might consider buying back stock, issuing new stock (for cash or as part of an acquisition of a target company), exchanging stock for debt or being acquired. As well, new or existing stockholders may increase their holdings. These transactions all implicate a potential limitation under Internal Revenue Code Section 382 on the corporation's ability to use NOLs and other tax attributes after the transaction. Whether the limitation applies, and whether the limitation, if it does apply, imposes a constraint on the use of NOLs, is highly fact-dependent.

• Limitation on NOL Carryforwards. Congress has long been concerned about "trafficking" in losses, such as scenarios where an acquiror acquires a corporation with NOLs in order to apply the target's NOLs from a pre-acquisition year against the acquiror's income. Internal Revenue Code Section 382 impedes trafficking in losses, but also sweeps much more broadly, as it does not require an acquisition in a single transaction. Under Section 382, if a corporation undergoes an "ownership change" (generally, a greater than 50 percentage point increase in ownership over a three-year period by holders or "public groups" that each own at least 5%), then the corporation may not carryforward its pre-ownership change NOLs to offset future taxable income in excess of a specified annual threshold.

Thus, corporations with NOLs confront two critical questions: (1) whether a transaction triggers an ownership change and (2) if so, what is the resulting limitation on annual NOL utilization and what amount of NOLs would be utilized, and when, in the absence of the limitation.

As to the 50% test for an ownership change, the calculation cumulates changes in ownership generally over the past three years. Thus, although a particular transaction might involve far less than 50% of the corporation's stock, when taken together with other transactions during the testing period, the transaction might cause the corporation to undergo an ownership change. And even if it does not, it is worth understanding how close a corporation is to the 50% threshold in order to be prepared for subsequent transactions. For example, suppose a public corporation has three large shareholders each of whom owned no stock two years ago and now owns 16%, with the public owning the remaining 52%. If the corporation buys back 5% of its shares from the public, an ownership change would occur (as the aggregate ownership of the three large shareholders would have increased from zero to 50.5% (*i.e.*, 48/95) during the testing period).

If an ownership change occurs, the baseline annual limit on NOL utilization is the product of the corporation's equity value immediately before the ownership change and the applicable "long-term tax-exempt rate" (1.47% for ownership changes occurring in May 2020). The annual NOL limitation may be increased during the five-year period following an ownership change if a corporation sells "built-in gain" assets during that period. Indeed, a 2003 IRS Notice further ameliorated the impact of an ownership change by providing that an actual sale of "built-in gain" assets was not required for the limitation to be increased. Rather, the mere ownership of such assets could suffice. Recently proposed IRS regulations would override the 2003 Notice for ownership changes occurring after the regulations are finalized, significantly limiting the potential increase in the annual NOL limitation above the baseline limit. See our prior memo.

• NOL Pills. In light of the possibility that acquisitions and dispositions of stock by 5% shareholders of publicly traded corporations may trigger an ownership change, public corporations with significant NOLs or other tax attributes sometimes consider implementing an "NOL pill" to deter acquisitions of stock that would result in, or increase the ownership by, 5% shareholders. As of the date of this memo, 12 companies have adopted NOL pills since the COVID-19 outbreak began. An NOL pill has many implications, which may or may not make it an appropriate mechanism, depending on a corporation's particular circumstances. In most cases, the tax law changes in the CARES Act are not likely to affect the desirability of an NOL pill because, as discussed below, the CARES Act has little impact on NOL carryforwards to 2021 and subsequent years.

• "Phantom" Income on Non-Participating Stock. A holder of stock that does not participate in corporate growth ("Tax Preferred Stock") may be required to include amounts in income as a dividend even if no cash dividend is paid (so-called "phantom" income). By the same token, an issuer of Tax Preferred Stock may be required to withhold tax on phantom income of a foreign holder. Stock that is entitled to receive dividends along with the common stock on an as-converted basis and to receive assets on liquidation no less than what it would receive on an as-converted basis is generally not considered Tax Preferred Stock. In a quirk, the tax rules do not take account of a conversion right itself in determining whether stock is Tax Preferred Stock. In the case of a new issuance of stock that is preferred stock for state law purposes, consideration should be given to whether the stock will give rise to phantom income.

POTENTIAL LIQUIDITY FROM CARES ACT CHANGES

The CARES Act was intended to enhance taxpayers' near-term liquidity by temporarily liberalizing rules enacted in 2017 relating to NOLs, interest expense deductions and alternative minimum tax credits. See our prior memo. Companies would be well-served to analyze whether they are entitled to claim a refund of prior years' taxes and whether near-term tax obligations will be reduced as a result of the CARES Act.

• NOL Carrybacks Permitted. The CARES Act permits NOLs incurred by corporations in 2018, 2019 and 2020 to be carried back five years. Prior to enactment of the CARES Act, NOLs generally could only be carried forward, not back. The new five-year carryback period could be especially valuable for corporations with capacity to carry back losses to 2017 (or a prior year), as such losses would reduce taxable income that was generally taxed at a 35% corporate rate (rather than the current 21% rate).

• Suspension of 80% Limitation. The CARES Act permits NOLs arising in tax years beginning after December 31, 2017 to eliminate 100% of taxable income in tax years beginning before January 1, 2021, rather than only 80% of taxable income under pre-CARES Act law.

• Change in Calculation of 80% Limitation. The 80% limitation on NOL carryforwards that will apply again beginning with carryforwards to 2021 will be calculated in an improved manner in that taxable income will be determined without regard to deductions under Internal Revenue Code Section 250 (deductions taken by multinationals and exporters) or Section 199A (deductions taken by owners of certain businesses held in partnerships or other pass-through entities).

• Increased Limit on Interest Expense Deductions. Prior to enactment of the CARES Act, interest expense deductions were limited to 30% of "adjusted taxable income." The CARES Act changes the limit to 50% for 2019 and 2020 (with special rules for partnerships for 2019). Furthermore, under the CARES Act, taxpayers may use 2019 adjusted taxable income to calculate the limit for 2020.

• Alternative Minimum Tax Refunds. The CARES Act accelerates the ability to claim refunds of corporate alternative minimum tax credits that became refundable following the repeal of the corporate alternative minimum tax in 2017.