New IRS Revenue Procedure Provides Some Relief From AHYDO Rules Where AHYDO Status Would Otherwise Result From Adverse Market Conditions

On August 8, 2008, the Internal Revenue Service ("IRS") released Revenue Procedure 2008-51, which provides some relief from the applicable high yield discount obligation ("AHYDO") rules where AHYDO status would otherwise result from certain adverse market conditions. The Revenue Procedure addresses one tax-related impediment to achieving a later syndication/resale of debt instruments that could not be successfully syndicated at the time of funding, but does not address another significant tax issue that often arises in this context -- the possible recognition by the issuer of cancellation of indebtedness income ("COD Income").

I. Background

In general, an AHYDO is any corporate debt instrument (including a term loan or revolving loan, a bridge loan or a bond) that (i) has a term of more than 5 years, (ii) has a yield to maturity (including original issue discount ("OID")) that equals or exceeds the sum of the applicable federal rate ("AFR")[1] plus 5 percentage points (500 basis points), and (iii) may, under the terms of the debt instrument, have "significant OID" (*i.e.*, unpaid OID on any testing date after the fifth anniversary of the issue date that exceeds the product of the issue price multiplied by the yield to maturity). Deductions for OID on an AHYDO are deferred until the OID is paid, and are permanently disallowed to the extent that the overall yield exceeds the sum of the AFR plus 6 percentage points (600 basis points). For debt issued in August 2008 with semi-annual interest periods, the AFR is 4.53% if the term exceeds 9 years or 3.52% if the term exceeds 3 years but not 9 years.

OID generally excludes any stated interest that is unconditionally payable in cash at least annually throughout the term of a debt instrument ("qualified stated interest"), but includes any stated interest other than qualified stated interest (such as stated interest that accretes or is payable in kind automatically or at the option of the issuer). Thus, discount notes and "PIK toggle" notes are frequently classified as AHYDOs, whereas an instrument that provides for only qualified stated interest, such as a "cash-pay" note or a typical bank loan (a "cash-pay debt instrument"), generally will not be an AHYDO (because a cash-pay debt instrument will not have "significant OID") unless the "issue price" of such a debt instrument is substantially below its stated principal amount.

The recent difficulties in the credit markets have unexpectedly caused some cash-pay debt instruments that were funded at par (or at a *de minimis* discount) to be considered AHYDOs. This is because the "issue price" of debt instruments issued for cash is the first price at which a substantial amount of the debt is sold,[2] excluding sales to bond houses, brokers or similar organizations acting as underwriters, placement agents or wholesalers.[3] Where market conditions deteriorate between the date on which an issuer obtains a binding financing commitment from a syndicating bank or underwriter and the issue date of the debt, the issue price may be significantly lower than the cash proceeds received by the issuer pursuant to the financing commitment. The IRS has determined that AHYDO treatment should not apply in such cases or in certain cases where a debt funded at par or with *de*

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1 The AFR is an interest rate determined each month pursuant to Section 1274(d) of the Internal Revenue Code of 1986, as amended.

2 Treas. Reg. §1.1273-2(a)(1).

3 Treas. Reg. § 1.1273-2(e).

minimis OID (such as a bridge loan) is later exchanged for a new or modified debt instrument with the same stated principal amount but an issue price significantly less than par.

II. Discussion of Revenue Procedure 2008-51

Revenue Procedure 2008-51 applies to three categories of debt instruments:

(1) Debt instruments issued for cash, pursuant to a binding financing commitment, that would not be AHYDOs if the issue price were the net cash proceeds actually received by the issuer from the syndicating bank or underwriter (a "Cash Funded Debt Instrument") -- for example, a cash-pay senior note that is purchased by the underwriter (pursuant to a pre-existing commitment) for par of $100 and immediately resold to third-party investors for $80. [4]

(2) Debt instruments issued in exchange for Cash Funded Debt Instruments ("Exchange Debt Instruments"), including "deemed" exchanges resulting from a significant modification of the terms of a Cash Funded Debt Instrument[5] -- for example, a bridge loan funded at par by a syndicating bank is later exchanged for high-yield bonds with an "issue price" significantly lower than the stated principal amount of the bonds (because, at the time of the exchange, the bonds are considered to be publicly traded and are trading significantly below par). An Exchange Debt Instrument will qualify for this exception if the Exchange Debt Instrument is (or was) issued within 15 months of the related Cash Funded Debt Instrument, and the Exchange Debt Instrument would not have been an AHYDO if its issue price were the net cash proceeds actually received by the issuer for the related Cash Funded Debt Instrument. In addition, for Exchange Debt Instruments issued on or after August 8, 2008, the maturity date cannot be more than one year after the maturity date of the related Cash Funded Debt Instrument, and the stated redemption price at maturity cannot exceed that of the related Cash Funded Debt Instrument. The Revenue Procedure does not elaborate on what the "maturity date" of a bridge loan is, but, based on an informal conversation with a representative of the IRS, it appears that the maturity date of a bridge loan should be interpreted as the ultimate maturity date that would apply if the bridge loan became permanent (even if the bridge documentation refers to the end of the bridge period as the "maturity date").

(3) Debt Instruments issued in exchange for Exchange Debt Instruments (("Re-Exchange Debt Instruments") -- for example, a bridge loan funded at par by a syndicating bank is later significantly modified (*e.g.*, its interest rate is significantly increased) and, thereafter, exchanged for new high-yield bonds with an issue price significantly lower than the stated principal amount of the bonds. A Re-Exchange Debt Instrument will qualify for this exception if the Re-Exchange Debt Instrument is (or was) issued within 15 months of the related Cash Funded Debt Instrument, and the Re-Exchange Debt Instrument would not have been an AHYDO if its issue price were the net cash proceeds actually received by the issuer for the related Cash Funded Debt Instrument. In addition, for Re-Exchange Debt Instruments issued on or after August 8, 2008, the maturity date

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4 Because the Cash Funded Debt Instrument must be one purchased under a binding financing commitment, it does not appear that the Revenue Procedure was intended to apply to high-yield bonds sold pursuant to a typical "securities demand" right.

5 A deemed exchange of debt instruments will occur if there is a "significant" modification of an existing debt instrument (even if the modified debt instrument is treated as a continuation of the existing debt instrument for commercial purposes). Treas. Reg. § 1.1001-3 contains rules for determining whether a modification of a debt instrument is significant.

cannot be more than one year after the maturity date of the related Cash Funded Debt Instrument, and the stated redemption price at maturity cannot exceed that of the related Cash Funded Debt Instrument.

The Revenue Procedure is effective on August 8, 2008, for both existing and future Cash Funded Debt Instruments, Exchange Debt Instruments, and Re-Exchange Debt Instruments, but applies only where the relevant Cash Funded Debt Instruments are issued on terms consistent with the general terms of a binding financing commitment obtained by a corporate issuer from an unrelated party before January 1, 2009.

As noted above, the Revenue Procedure provides relief only from the AHYDO rules. It does not address the possible recognition of COD income by an issuer or the appropriate tax treatment of any financing proceeds received by an issuer in excess of a debt instrument's issue price.

The IRS has invited public comment related to the Revenue Procedure to be submitted no later than November 15, 2008.

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If you have any questions about the issues addressed in this memorandum or if you would like a copy of any of the materials mentioned, please do not hesitate to call or email Howard Adams at 212.701.3162 or hadams@cahill.com; or Craig Horowitz at 212.701.3856 or chorowitz@cahill.com.

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