Bloomberg BNA

Daily Tax Report®

Non-Fungible Fungibilities: Maximizing Liquidity of Loans Through Tax Fungibility

BY JOSHUA THOMPSON, CRAIG GIBIAN AND DANIEL DUVAL

In order to maximize the ability to sell (that is, to maximize the liquidity of), and to reduce the all-in effective yield at issuance for, add-on or incremental syndicated bank loans, the add-on or incremental loans should be ''tax fungible'' with the original loans.

For agents and lenders, lack of ''tax fungibility'' may result in different trading prices (and potential losses on the sale of a less liquid debt tranche) of loans that otherwise have the same terms, as well as the following increased risks:

- lack of liquidity may constrain an exit from troubled credits due to thin trading conditions;
- limited trading activity or different price points could create unexpected mark-to-market impacts on investors; and
- collateralized loan obligation (CLO) and other securitized investment vehicles may be constrained in investing in such loans as their fund documentation may restrict purchases of tranche sizes below certain thresholds.

It is important for borrowers and financial sponsors to hurdle the challenge of tax fungibility to efficiently execute on subsequent debt deals. Practitioners should therefore keep issues of tax fungibility in mind when structuring subsequent debt issuances.

The term ''fungibility'' has several meanings in the context of the U.S. loan market. One meaning is defined by U.S. tax laws (so-called tax fungibility). Another meaning is ascribed to loans that have identical terms as set forth in the credit documentation (so-called documentation fungibility). Finally, a third meaning is ascribed to syndicated loans that are bought and sold on an equal basis (i.e., trade interchangeably, so-called trading fungibility). Only one of these meanings, however, should be used for the purpose of establishing the fungibility of subsequent loan issuances: fungibility as defined by U.S. tax laws.

This article will examine each of the three meanings of fungibility and how they relate to the determination of fungibility of add-on or incremental loans for tax purposes with an eye to identifying relevant issues for practitioners.

Joshua Thompson is a New York-based finance partner and Craig Gibian is a Washington, D.C.-based tax partner at Shearman & Sterling LLP, and Daniel Duval is general counsel at Jefferies Finance LLC. *The authors would like to thank Iain Scoon, a London-based tax partner at Shearman & Sterling LLP, for his contributions to the article.*

Tax Fungibility

The determination of whether loans are ''tax fungible'' is made solely by reference to U.S. tax laws. Accordingly, a working knowledge of these laws is necessary to ensure that add-on or incremental loans will be fungible with the original loans from a tax perspective.

The determination of whether loans are ''tax fungible'' is made solely by reference to U.S. tax laws.

The driving force behind the concept of tax fungibility is original issue discount (OID). In particular, when a loan is issued with more than a de minimis amount of OID (i.e., OID of at least 25 basis points per full year to maturity of a term loan), lenders are required to accrue such OID on a constant yield to maturity basis.

Accordingly, if an original loan and an additional loan have identical terms, but are issued for different prices that result in differing accruals of OID (or one loan having OID and the other not), the loans will generally not be fungible from a tax perspective, subject to the exceptions discussed below. On the other hand, if neither the original loan nor the additional loan is issued with more than de minimis OID, such loans will generally be fungible for tax purposes.

Where loans have identical terms but are issued for different prices, the U.S. Treasury regulations provide limited relief allowing for tax fungibility even if the amount of OID would otherwise differ. If the additional loans are issued within 13 days of the original loans, the additional loans will be treated as part of the original issuance for tax purposes, thus allowing for tax fungibility.

However, even if the additional loans are not issued within 13 days of the original loan, the U.S. Treasury regulations provide limited relief for such additional loans; this limited relief is generally given under the so-called ''qualified reopening'' rules. If the additional loans qualify under these rules, such loans will be treated as having the same issue price and issue date as the original loans.

The qualified reopening rules have recently been revised and expanded. The revised rules add a third category to the two long-standing categories describing situations where additional debt instruments may be issued in a qualified reopening. The requirements for each of these three categories are discussed below.

Further, the rules have been simplified for cash issuances. In particular, the prior qualified reopening rules required the outstanding debt instruments to be ''publicly traded'' for U.S. tax purposes. Not only do the revised rules do away with this requirement for cash issuances, the new rules have simplified the determination of when debt instruments are considered to be publicly traded (which will be helpful if the additional loans are issued for property, e.g., in a debt-for-debt exchange). For the sake of simplicity, the discussion below assumes that any additional loans are issued for cash.

Category 1: Reopenings Within Six Months

An additional issuance of loans will constitute a qualified reopening if:

- the additional loans are issued no more than six months after the issue date for the original loans; and

- the yield of the additional loans, based on the cash issue price, is not more than 110 percent of the yield of the original loans on their issue date (or if the original loans were issued with no more than a de minimis amount of OID, the stated coupon rate).

Example 1. On June 1, 2012, Company X issues a loan at par with a coupon of 6 percent per annum. The loan is due on June 1, 2020. Assume that on Oct. 1, 2012, the original loan is trading for a price of 97.5 percent (producing a yield of 6.42 percent) and Company X would like to issue an additional loan with terms identical to those of the original loan for a price of 97.5 percent. Without the benefit of the qualified reopening rules, any additional loan issued for the trading price would have more than de minimis OID, and would not be fungible with the original loan (which has no OID) for U.S. tax purposes. Under the qualified reopening rules, however, because the additional loan would be issued within six months of the issuance of the original loan, and the yield on the additional loan is within 110 percent of the yield on the original loan (i.e., not more than 6.6 percent), the additional loan would be treated as issued without OID and would be fungible with the original loan for U.S. tax purposes.

Category 2: Reopenings With De Minimis OID

Regardless of whether the additional loans are issued within six months of the original loans, the qualified reopening rules provide that loans will be treated as tax fungible provided that the loans are issued with no more than a de minimis amount of OID.

Subject to the discussion of the new third category of qualified reopenings below, the reopening rules outside of six months are thus generally more restrictive, by looking to whether the additional loans are issued with OID, as opposed to simply comparing the yield on the additional loans to the yield on the original loans (which, as illustrated in Example 1 above, could allow for tax fungibility even where the additional loans are issued with more than de minimis OID).

Example 2. On Feb. 1, 2012, Company Y issues loans for 97 percent of par with a coupon of 5 percent per annum. The loans are due on Feb. 1, 2018. Accordingly, the original loans are issued with more than a de minimis amount of OID and have a yield of 5.60 percent. On Feb. 1, 2013, the loans have traded up to 99 percent, producing a yield of 5.23 percent. If Company Y issues additional loans at such time for 99 percent, these loans would be fungible with the original loans for U.S. federal income tax purposes even though the additional loans are issued more than six months after the original loans because the additional loans are issued with no more than a de minimis amount of OID (i.e., they are issued for more than 98.75 percent).

Category 3: Reopenings at the Same Or Lower Yield

Under this new category, an issuance of additional loans will be a qualified reopening if the yield of the additional loans (ignoring the application of the qualified reopening rules) is not more than 100 percent of the original yield of the original loans (regardless of whether the original loans have more than de minimis OID). Accordingly, this provision will permit taxpayers to issue additional fungible loans with OID outside of six months, as long as the yield of the original loans as of the reopening date is 100 percent or less of the original yield.

Example 3. Assume the same facts as in Example 2, except that the original loans are trading for 98 percent instead of 99 percent. Accordingly, the additional loans are sold for 98 percent, producing a yield of 5.46 percent. Under the prior qualified reopening regulations, Company Y's issuance of the additional loans on Feb. 1, 2013 would not be a qualified reopening because the additional loans would have more than de minimis OID, notwithstanding that the yield of the original loans had actually decreased as of the reopening date. Under the new category, because the yield of the additional loans on the reopening date (5.46 percent) is less than the original yield on the loans (5.60 percent), the additional loans will be treated as issued in a qualified reopening even if the reopening occurs more than six months after the original issue date.

From a practitioner's perspective, we have considered two issues that are potentially relevant for one or more of the above categories.

First, the question will often arise whether anticipated discount on additional syndicated loans can be documented as an arrangement or structuring fee for the agent so that the agent is willing to initially fund the loans at par; in due course, a portion or all of this fee would then be used to subsidize discount loan sales by the agent in the secondary market following such initial loan issuance. In situations where the issuer is trying to avoid having more than de minimis OID or trying to keep the yield at least equal to the yield on the original loans, such a strategy may be of limited utility, and the success of such a strategy will depend in part on whether the agent is acting as a principal for some pe-

   ISSN 0092-6884

riod of time and whether the original loans are trading for a price that is below such threshold (which would provide evidence that the ''fee'' is really discount on the loans). As discussed below, penalties could apply to the borrower where loans are incorrectly treated as tax fungible.

Second, as stated above, where neither the original loans nor the additional loans have more than a de minimis amount of OID, such loans should generally be tax fungible regardless of the qualified reopening rules. Application of the qualified reopening rules, however, may be critical to obtain tax fungibility if the original loans are grandfathered obligations that are exempt from U.S. withholding tax under the Foreign Account Tax Compliance Act (FATCA) regime and the additional loans do not benefit from the grandfathering exemption.

U.S. Treasury regulations (T.D. 9610) released Jan. 17 provide that obligations outstanding on Jan. 1, 2014, are grandfathered from the FATCA withholding tax rules. For this purpose, obligations will be considered to be outstanding on Jan. 1, 2014, if they have an ''issue date'' prior to such date.

U.S. Treasury regulations (T.D. 9610) released Jan. 17 provide that obligations outstanding on Jan. 1, 2014, are grandfathered from the FATCA withholding tax rules.

The regulations confirm that in the case of a qualified reopening, the issue date for the additional obligations will relate back to the issue date of the original obligations. Accordingly, if loans are issued in 2013 and additional loans are issued in 2014, the additional loans will be treated as grandfathered obligations for purposes of the FATCA rules if the additional loans are issued in a qualified reopening (and thus will be tax fungible with the original loans, notwithstanding that the actual date of issuance is after the expiration of the grandfathering period).

In contrast, the qualified reopening rules are not available if the terms of the additional loans are not identical to the terms of the original loans for an initial period of time (e.g., because of an escrow arrangement), but will be identical following such initial period. In such case, the FATCA rules may preclude tax fungibility following the initial period even if neither the original loan nor the additional loans have OID, depending on the date of the relevant issuances.

Misleading Definitions: Non-Fungible Fungibilities

Even though fungibility from a tax perspective is defined solely by reference to U.S. tax laws, two other commonly used definitions of fungibility can mislead many practitioners: documentation fungibility and trading fungibility.

Documentation Fungibility

This is the most confusing and unhelpful meaning. Documentation fungibility does not always correlate with tax fungibility even though it may appear to at first glance.

For instance, if the credit documentation permits the incurrence of incremental or add-on term loans that have identical terms to the term loans initially issued at the closing of the financing (e.g., identical as to tenor, applicable margin, interest rate floor (if any), and other provisions set forth in the credit documentation), it is easy to mistakenly assume that the loans are fungible for tax purposes (i.e., the first meaning) and should trade on a fungible basis (i.e., the third meaning). This is not a safe assumption. As discussed above, careful scrutiny of the issue price and potential OID attributable to the incremental or add-on term loans is required to determine whether tax fungibility exists.

If tax fungibility does not exist, then it may be quite confusing that the credit documentation permits equivalency of the incremental or add-on term loans. Practitioners should work to ensure that incremental or add-on term loans are separately identified in the credit documentation as a new tranche or sub-tranche if such loans are not tax fungible with the original loans (e.g., if the original loan is a ''Tranche B Term Loan'' and the incremental or add-on term loan is not tax fungible, such incremental or add-on term loan should be separately sub-tranched and, for instance, identified as a ''Tranche B-1 Term Loan'').

Trading Fungibility

The buying and selling of syndicated bank loans in the United States is a private market conducted over-the-counter between and among sophisticated investors through intermediaries, which are commonly financial institutions acting as administrative agent under the credit documentation and which commonly structure and arrange the loan transaction in an alternative capacity as lead arrangers.

Such loans are considered a category of general debt instruments covered by Committee on Uniform Security Identification Procedures (CUSIP) numbers, identification numbers which have facilitated trading of loans and securities by improving transaction speed and transparency. However, CUSIP Global Services (CGS), which oversees the creation and delivery of CUSIP numbers in the United States, is not a governmental body and so its standards for trading fungibility can differ from the standards for tax fungibility. As a result, a CUSIP number may be mistakenly obtained from CGS that erroneously implies a proposed new debt issuance is tax fungible with a prior debt issuance.

For the avoidance of doubt, CGS does not guarantee the tax status of the debt instrument, and obtaining a CUSIP number does not determine the tax status of the debt instrument.

For purposes of this hypothetical, let us assume that the CUSIP number for a term loan at closing is, erroneously, also assigned to a non-fungible (from a tax perspective) subsequent incremental or add-on term loan facility. At that point, the third meaning of fungibility comes into play. Buyers and sellers of the subsequent incremental or add-on term loan facility will, given that the CUSIP number is identical to the initial term loan, as a practical matter often (mistakenly) assume that the subsequent incremental or add-on term loan facility is

fungible from a tax perspective and start, erroneously, trading both the initial and incremental (or add-on) loans on a fungible basis.

In such case, the borrower or another party responsible for filing tax returns or otherwise providing tax information could be subject to penalties. This situation could occur if the original loans do not have OID and the issuer incorrectly treats an add-on loan as not having OID under the qualified reopening rules. In practice, this could occur if the issuer improperly treats ''fees'' paid to the lender as a separate payment instead of discount on the issuance of the additional loan (in an attempt to create tax fungibility). In such case, the penalties could be as high as $3 million in total for failure to provide the appropriate information to the U.S. Internal Revenue Service and to the lenders ($100 per form, assuming no intentional disregard of the rules), as well as a one-time penalty of $50,000 for failure to provide certain information to the U.S. Internal Revenue Service regarding the OID.

On a pre-trade basis, as documentation for a syndicated loan (or other covered) transaction is being finalized, a CUSIP number will be requested by the administrative agent or its counsel. Prior to this point in time it is critical that practitioners give careful consideration to tax fungibility. Where a subsequent debt issuance is occurring (e.g., the proposed incurrence of an incremental or add-on debt facility), it is important that the transaction parties determine whether or not there is tax fungibility between the original debt and the proposed new debt.

A failure to make the correct determination of tax fungibility and to establish documentation that respects the fungibility distinctions required by U.S. tax laws creates risks to agents and lenders that have been identified above. From a business perspective, as a further material risk for lead arrangers when underwriting a subsequent debt issuance and ''pricing the deal'' for a borrower, there may be an assumption of fungibility that proves, upon further examination, to be incorrect. Bottom line: The failure to price non-fungibility into a deal may lead to losses or adverse reputational impact on the lead arranger.

Which Tax Fungibility?

Finally, it is important to consider which tax laws are relevant when determining whether debt is fungible. For purposes of the discussion above, the determination as to whether debt is ''tax fungible'' is made solely by reference to U.S. tax laws.

By way of contrast with the U.S. tax rules, the tax code in the United Kingdom, for example, has no concept of ''tax fungibility.'' The approach that the U.K. tax code takes to the taxation of corporate debt is, generally, to give deductions and to require income to be recognized in accordance with the statutory accounting treatment of the relevant counterparty. There are of course numerous exceptions to this general rule, especially where counterparties are connected. Nevertheless, because the U.K. tax treatment is generally driven off of the accounts, and given that the accounting treatment that may be applied by a borrower may be very different from that applied by a lender, it should become apparent relatively quickly that fungibility for U.K., as opposed to U.S., tax purposes is not an issue that has any particular significance.

Consequently, any issues of fungibility that arise in a U.K. context would typically not relate to U.K. tax issues, but instead to commercial issues that fall under the heading of documentation fungibility or trading fungibility, i.e., to issues that do not affect (U.S. tax) fungibility. As a result, where tax fungibility is important (generally where the borrower or other applicable obligor on the debt, or one or more of the lenders, has a relevant U.S. tax nexus), it is necessary to ensure that the analysis is undertaken under the appropriate (U.S.) tax laws.

Conclusion

When structuring or arranging a subsequent debt issuance, keep in mind that tax non-fungibility will impair liquidity and therefore, potentially, increase the all-in effective cost to the borrower. Consequently, it is prudent that the administrative agent makes or has made, and follows, the tax fungibility analysis when updating the CUSIP registration; otherwise, non-fungible (from a tax perspective) syndicated loans may mistakenly be treated as fungible from a trading (and inferentially tax) perspective.

   ISSN 0092-6884