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IRS Temporarily Suspends AHYDO Rules in Certain Financing Transactions

In Revenue Procedure 2008-51, released on August 8, 2008, the IRS offered temporary relief from the rules that defer, and in some cases deny, interest deductions for original issue discount ("OID") accrued on an Applicable High Yield Discount Obligation ("AHYDO"). Debt instruments issued with OID may include debt issued with pay-in-kind ("PIK") interest and other interest that is not required to be paid in cash at least annually. As described below, the Revenue Procedure temporarily suspends the application of the AHYDO rules for lending transactions where corporate borrowers obtain financing commitments before January 1, 2009, and where circumstances beyond the borrower's control (including, for example, market conditions affecting the market value of the debt) might otherwise cause the debt instrument inadvertently to become an AHYDO instrument.

OID Rules

U.S. tax law generally allows the issuer of a debt instrument with OID to take an interest deduction for a ratable portion of the OID accruing over the term of the debt instrument. OID exists if there is more than a *de minimis* difference between the issue price of a debt instrument and its stated redemption price at maturity. In most cases, issue price is the first price at which a substantial amount of the debt instrument is sold for money, ignoring sales to underwriters or similar persons acting in their capacity as underwriters or brokers.[1] Taxable exchanges of debt instruments by the issuer, including deemed exchanges arising from significant modifications of existing debt instruments, can result in a new issue price lower than issue price of the original debt instrument. Stated redemption price at maturity is the amount to be paid at maturity, excluding the last payment of qualified stated interest (essentially the "face" amount due). Given recent market conditions for debt, there is a greater potential for significant increases in amounts treated as OID as a result of a drop in issue price when debt is sold or modified debt is resold.

The AHYDO Rules

The AHYDO rules limit the normally allowable deductions for OID where the amount of OID is determined to be significant compared to cash payments of interest that are required to be made under the terms of the debt instrument.

[1] According to Treasury Regulation § 1.1273-2(e), in determining issue price "sales to bond houses, brokers, or similar persons or organizations acting in the capacity of underwriters, placement agents, or wholesalers are ignored" and the issue price is based on the price paid by those who purchase from the underwriter or broker.

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Under the AHYDO rules, deductions for OID are suspended until paid in cash if three conditions are met:

1. the maturity date of the debt instrument is more than five years from the date of issue;

2. the yield to maturity of the debt instrument exceeds the applicable Federal rate for the calendar month in which the debt instrument is issued plus five percentage points; and

3. the debt instrument has significant OID as determined under the AHYDO rules.

There is an important exception for instruments that require cash payment of all but one year's worth of yield at the fifth anniversary of the loan (a "clean-out" provision). If the yield to maturity on a debt instrument exceeds the sum of the applicable Federal rate for the calendar month in which the debt instrument is issued plus six percentage points, no deduction is permitted for a portion of the OID called the "disqualified portion" and the amount is instead, for certain limited purposes, treated as a dividend.

Revenue Procedure 2008-51

The revenue procedure notes that unanticipated market conditions have resulted in borrowers obtaining temporary financing pursuant to a financing commitment that lenders cannot sell to third party investors without significant changes in terms. Similarly, borrowers have been forced to revise the terms of bridge loans in order to make the bridge loans permanent and marketable to third parties because the proposed terms of the originally anticipated permanent financing pursuant to a financing commitment can no longer be obtained. In each case, the changes in terms raise the possibility that the issue price of the revised debt instrument may be substantially lower, OID greater, and therefore require application of the AHYDO rules.

In response to these market conditions, the revenue procedure suspends the application of the AHYDO rules in three circumstances described below. If the revenue procedure applies, deductions for OID will not be deferred or denied under the AHYDO rules. The revenue procedure does not call off any other tax consequences of an exchange or deemed exchange of debt instruments. In other words, issuers may still recognize cancellation of debt income and holders may still recognize a loss as a result of any exchange treated as a recognition event for tax purposes.

The circumstances in which the revenue procedure is likely to benefit taxpayers include cases where bridge financing is converted into debt that trades at an unanticipated discount on an established market and situations where the original lender, in the capacity of an underwriter or broker, sells the debt at a substantial discount from face. The revenue procedure provides a limited opportunity to increase the interest rate on a debt instrument (or defer interest payments), but only to the extent that these kinds of changes would not increase the yield to the point where the AHYDO rules would apply if the issue price of the revised debt instrument were the net cash proceeds actually received by the issuer.

The revenue procedure applies to three categories of debt instruments issued by a corporation.

First Category: Debt issued for money

1. A debt instrument issued for money and the terms of the debt instrument are consistent with the general terms of a binding financing commitment obtained by the corporation from an unrelated party before January 1, 2009; and

2. The debt instrument would not have been an AHYDO, if the issue price of the debt instrument had been the net cash proceeds actually received by the corporation when the loan was made.

Second Category: Category One debt exchanged for new debt

1. The new debt instrument is issued in exchange (including a deemed exchange caused by debt modifications) for a debt instrument ("Old Debt Instrument A") issued by the corporation and described in the first category;

2. The new debt instrument is issued within 15 months following the issuance of Old Debt Instrument A;

3. The new debt instrument would not have been an AHYDO, if the issue price of the debt instrument had been the net cash proceeds actually received by the corporation when the loan was made under Old Debt Instrument A;

4. The maturity date of the new debt instrument is not more than one year later than the maturity date of Old Debt Instrument A; and

5. The stated redemption price at maturity of the new debt instrument is not greater than the stated redemption price at maturity of Old Debt Instrument A.

Third Category: Category Two debt exchanged for new debt

1. The new debt instrument is issued in exchange (including a deemed exchange caused by debt modifications) for a debt instrument ("Old Debt Instrument B") issued by the corporation and described in the second category;

2. The new debt instrument is issued within 15 months following the issuance of Old Debt Instrument A;

3. The new debt instrument would not have been an AHYDO, if the issue price of the debt instrument had been the net cash proceeds actually received by the corporation when the loan was made under Old Debt Instrument A;

4. The maturity date of the new debt instrument is not more than one year later than the maturity date of Old Debt Instrument A; and

5. The stated redemption price at maturity of the new debt instrument is not greater than the stated redemption price at maturity of Old Debt Instrument A.

The maturity and redemption price requirements under points 4 and 5 for second and third category loans are waived for instruments issued before August 8, 2008. The January 1, 2009, sunset date for loan commitments eligible for relief under the revenue procedure should also be kept in mind.

The application of the AHYDO rules and the tax rules regarding debt exchanges and modifications are highly technical. Tax review is strongly advised before undertaking such transactions.

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