

# Capital Markets

## TREASURY TAX REVIEW

Treasury groups are facing unprecedented challenges from volatile market conditions. Uncertain interest rates, volatile credit markets, currency fluctuations, and strained commodity markets have all been affecting financing, investing, and cash management and have caused treasurers to re-evaluate how and when to hedge various risks. These activities will generally have significant tax consequences and the need for tax departments to be involved in these decisions has never been greater. Companies should evaluate all of the treasury activities from a tax perspective on a regular basis. A few areas of focus are highlighted below:

- ▶ Tax Considerations of Debt Refinancing Transactions
- ▶ Tax Hedging Identification and Documentation Processes
- ▶ Cash Pooling
- ▶ Branch Foreign Currency Gains and Losses (see International Tax section of this guide)

## TAX CONSIDERATIONS OF DEBT REFINANCING TRANSACTIONS

Over the past year, many companies have refinanced their existing debt to secure current interest rates, with the potential for rates to decrease in the future. Refinancing transactions that result in a “*significant modification*” of the debt under applicable regulations can have disparate tax consequences depending on the specific circumstances. Although the regulations provide relatively clear rules for determining when a modification is “*significant*,” the application of these rules is highly fact-dependent and frequently requires relatively complex calculations.

Companies should review their debt modification transactions undertaken during the year to confirm their tax impact. Companies that are considering changes to existing credit facilities in the coming year should likewise assess whether the proposed change would amount to a significant modification and, if so, determine the tax implications of the modification.

### Tax Treatment of Debt Modifications

The U.S. federal income tax treatment of debt refinancing transactions is highly fact-specific and requires careful analysis. Certain refinancing transactions may be treated as a taxable retirement of the existing (refinanced) debt, which may give rise to the ability to write-off any unamortized debt issuance costs and original issue discount, the latter as “*repurchase premium*.” However, in certain situations a refinancing transaction may also give rise to taxable ordinary income in the form of “*cancellation of indebtedness income*.”

The tax consequences of a debt refinancing transaction hinge in part on whether the transaction results in a “*significant modification*” of the debt under rules set out in Treas. Reg. §1.1001-3, which results in a deemed retirement of the existing debt in exchange for a newly issued debt instrument.



## When Is a Modification Significant?

As a threshold matter, a modification includes not only a change to the terms of an existing debt instrument but would also include an exchange of an old debt instrument for a new one or the retirement of an existing debt instrument using the proceeds of a new debt instrument. Stated differently — it is the substance, not the form, that governs whether debt has been modified for federal income tax purposes.

Whether a modification of a debt instrument constitutes a significant modification depends on the materiality of the changes. The regulations provide a general “*economic significance*” rule and several specific rules for testing whether a modification is significant. In practice, most debt modifications are covered by two specific rules governing changes in the yield to maturity of a debt instrument (the change in yield test) and deferrals of scheduled payments (the deferral test).

Under the change in yield test, a modification is significant if the new yield of the modified debt instrument differs from the old yield of the unmodified debt instrument by more than 25 basis points (i.e., 1/4 of 1%) or 5% of the unmodified yield. Various changes, such as adjusting the interest rate, altering payment schedules, or paying modification fees, can impact the yield. It is not uncommon for a modification with only a minor (or no) change to the stated interest rate to result in a significant modification due to changes in the yield to maturity that result from the payment of modification fees or changes to the due dates for certain payments. This issue is often overlooked.

Under the deferral test, a modification is significant if it causes a material deferral of payments. While the test does not define “*material deferral*,” it offers a safe harbor: a deferral is not significant if all payments are unconditionally made within the safe harbor period. This safe harbor period starts on the first deferred payment date and lasts for the lesser of five years or 50% of the original term (e.g., the deferral safe harbor for a five-year debt instrument would be two-and-a-half years).

In applying both the change in yield test and the deferral test, taxpayers are required to consider the cumulative effect of the current modification with any prior modifications (or, in the case of a change in yield, modifications occurring in the past five years). This cumulative rule is particularly noteworthy for taxpayers who routinely modify their debt (and often incur modification fees in connection with the modification), as the results of certain modifications may not be significant when viewed in isolation but may be significant when combined with prior modifications.



## Tax Implications of Significant Debt Modifications

A significant modification results in the deemed retirement of the existing debt instrument in exchange for a newly issued debt instrument. The existing debt instrument will be deemed retired for an amount equal to the “*issue price*” of the newly issued debt instrument, together with any additional consideration paid to the lenders as consideration for the modification.

The issue price of a debt instrument depends on whether the debt instrument was issued for cash or property. If a significant amount (generally 10%) of the debt was issued for money, the issue price will be the cash purchase price. Otherwise, assuming the debt instrument is in excess of \$100 million, the issue price will be its fair market value (or the fair market value of the property for which it was issued) if it is “*publicly traded*.” In all other cases, the issue price of the debt instrument will generally be its stated principal amount.

If the issue price of the modified debt instrument (i.e., the repurchase price) is less than the tax adjusted issue price of the old debt instrument, a borrower will incur cancellation of indebtedness income, which is generally taxed as ordinary income in the current tax year. If instead the repurchase price exceeds the adjusted issue price (this may occur when the old debt instrument had unamortized original issue discount or where the debt is publicly traded and has a fair market value in excess of its face amount), the borrower will incur a “*repurchase premium*.” Repurchase premium is deductible as interest expense. Special rules apply to determine whether such repurchase premium is currently deductible or is instead amortized over the term of the newly issued debt instrument.

The retirement of an existing debt instrument may also give rise to the ability to deduct any unamortized debt issuance costs. As a general matter, the determination of whether any unamortized debt issuance costs should be written off or carried over and amortized over the term of the new debt instrument generally follows the same analysis as repurchase premium. Notably, debt issuance costs are deducted as ordinary business expenses under Section 162, and therefore are not subject to the limitation on business interest expense deductions under Section 163(j).

Finally, a significant modification may give rise to a number of additional tax implications that companies should consider, including the potential for foreign currency gain or loss and the need to “*mark-to-market*” existing tax hedging transactions.

## Potential Benefits of Using Hedges in Debt Refinancing

When refinancing existing debt, taxpayers might want to consider the potential benefits of integrating the newly issued debt instrument with a hedge under Treas. Reg. §1.1275-6. In times of market volatility, hedging helps reduce exposure to significant market fluctuations related to the financing transaction, offering an additional layer of protection in unpredictable conditions. Additionally, this integration can serve as a valuable planning tool by impacting the calculation of the business interest expense deductibility limitation under Section 163(j), a benefit that is often overlooked.

The passage of the Tax Cuts and Jobs Act (*TCJA*) broadened the scope of Section 163(j)'s deductibility limit and provided a formulaic approach to determine the maximum deduction allowed for a company's business interest. In general, Section 163(j) limits the deduction of business interest to the sum of the taxpayer's business interest income, 30% of the taxpayer's adjusted taxable income (*ATI*), and any floor plan financing interest for the tax year. Disallowed interest can be carried forward to future years, subject to certain limitations.

Treasury Reg. §1.1275-6 allows taxpayers to integrate a qualifying debt instrument (*QDI*) with a hedge (or combination of hedges) when their combined cash flows resemble those of a fixed or variable rate debt instrument. This integration ensures more accurate timing and character of income, deductions, gains, or losses. The combination of cash flows creates a synthetic debt instrument, which is governed by the rules of Treas. Reg. §1.1275-6, rather than the separate rules that would apply to each component. Because the synthetic debt instrument is governed under the integration rules, any net payments made or received with regards to the synthetic debt instrument are characterized as interest (interest income or interest expense). In contrast, without integration, the debt instrument and hedge would be treated separately, and any gain from the hedge would be considered ordinary income rather than interest, providing no impact on the Section 163(j) business interest limitation.

The following example highlights the differences in treatment between integration and non-integration, illustrating the impact (if any) on the Section 163(j) business interest limitation calculation.

**Facts:** Corporation X borrows \$100 million at a fixed rate of 8% from an unrelated party. Based on current market predictions, Corporation X enters into an interest rate swap (swap) with an unrelated bank. Under the terms of the swap, Corporation X receives fixed payments at 8% and pays a floating rate tied to SOFR (Secured Overnight Financing Rate). The floating rate is below 8%, resulting in a gain for Corporation X at the end of the year. Corporation X would like to deduct all of its interest expense; however, it is subject to the Section 163(j) limitation. Corporation X wants to increase the amount of interest it is permitted to deduct under Section 163(j).

**Situation 1 - No Integration.** Corporation X does not integrate the QDI with the interest rate swap. While Corporation X benefits economically from receiving more fixed payments than it pays under the floating rate, the gain from the swap is not treated as interest for tax purposes. Instead, the gain is considered ordinary income and thus not included in the Section 163(j) calculation, and Corporation X is unable to increase the amount of interest it is allowed to deduct.

**Situation 2 - Integration under Treas. Reg. §1.1275-6.** Corporation X chooses to integrate the QDI and the interest rate swap under Treas. Reg. §1.1275-6, creating a synthetic debt instrument. As a result, Corporation X is deemed to incur interest expense on the synthetic instrument as an integrated transaction. Such interest expense is essentially the interest expense on the debt netted with the gain on the swap and therefore produces the benefit for Section 163(j).



## REVIEW TAX HEDGING IDENTIFICATION AND DOCUMENTATION PROCESSES

Most companies enter into hedging transactions to manage risk that arises in their business, such as interest rate, currency, and commodity price risk. These transactions are subject to tax hedging rules, and failure to follow the requirements under those rules could result in negative tax consequences. The tax hedging rules impose a same-day identification requirement with timing and character whipsaw rules that may apply if such transactions are not timely identified.

As part of year-end reviews and planning for next year, companies should review these rules and the sufficiency of their hedging identification and documentation processes to ensure that they meet the requirements.

### Tax Hedge Qualification & Character

To qualify as a tax hedge, the transaction must occur within the normal course of business and be used to manage interest rate, currency, or commodity price risk with respect to ordinary property or ordinary obligations (incurred or to be incurred) by the taxpayer. For this purpose, property is ordinary if a sale or exchange of the property could not produce capital gain or loss under any circumstances. Taxpayers may manage risk on a transaction-by-transaction basis or, alternatively, may manage aggregate risk (i.e., they may enter into one or more foreign currency contracts to manage aggregate foreign currency risk).

Gain or loss on a tax hedging transaction will be ordinary income or loss if the transaction is properly identified and documented in a timely manner.

### Same-Day Identification Requirement

The tax hedging rules require that each tax hedging transaction be identified as such no later than the close of the day on which the hedge was entered into. The hedged item must be identified substantially contemporaneous with the tax hedging transaction, but in no case more than 35 days after the hedging transaction was entered into.

An identification must identify the item, items, or aggregate risk being hedged. Identification of an item being hedged involves identifying a transaction that creates risk and the type of risk that the transaction creates. This identification is made in (and retained as part of) the company's tax files and is not sent to the IRS. A GAAP (or IFRS) hedge identification will not satisfy the tax hedge identification requirement unless the taxpayer's books and records make clear that such identification is also being made for tax purposes. Additional regulatory guidance is provided for certain categories of hedging transactions, including hedges of debt issued (or to be issued) by the taxpayer, inventory hedges, and hedges of aggregate risk.

Taxpayers are given significant flexibility regarding the form of such identification. For companies that enter into tax hedging transactions infrequently, a same-day identification may be prepared and saved in the company's tax files. However, this approach is often challenging for taxpayers that enter into hedging transactions routinely (often on a daily basis). For taxpayers who enter into hedging transactions more frequently, the same-day identification requirement can be satisfied through a tax hedging policy. A tax hedging policy will identify the types of transactions entered into to manage risk and the risk managed (and how such risk is managed) and will identify all transactions described in the policy as tax hedging transactions. If properly prepared, the tax hedging policy will serve as identification (for tax hedging purposes) of any transactions described in the policy.

### Hedge Timing Rules

Treasury regulations provide special tax accounting rules for tax hedging transactions known as the "hedge timing rules." The hedge timing rules provide a general requirement that the method of accounting used to account for hedging transactions must clearly reflect income by matching the recognition of income, deduction, gain, or loss on the hedging transaction to the recognition of income, deduction, gain, or loss on the hedged item. Special rules are provided for specific types of hedging transactions.



### Failure to Identify - Timing & Character Whipsaws

Failure to properly identify a hedging transaction generally establishes that the transaction is not a tax hedging transaction. As a result, gain or loss on the hedging transaction is determined under general principles. However, the regulations provide a broad anti-abuse rule that will frequently treat any gains as ordinary, which may result in a character whipsaw in which losses are capital and any gains are ordinary income. An inadvertent-error exception is provided in the regulations, which, if applicable, may allow taxpayers to treat losses in some circumstances as ordinary.

A proper and timely hedge identification also prevents the application of certain loss deferral rules. One example is the tax “straddle” rules, which may defer losses (but not gains) on certain unidentified hedging transactions.

### Planning Considerations

Given the volatility of commodity prices, interest rates, and foreign currency exchange rates, businesses are increasingly incentivized to rely on hedging activities to manage risk and reduce exposure to dramatic market movements. To prevent the character and timing mismatches previously discussed and ensure proper reporting of gains and losses from these hedging transactions, companies should carefully review their tax hedge identification policies or establish them if none exist. These are important planning considerations, and while the identification and documentation requirements are complex, failure to comply with these rules may result in significant adverse tax consequences.

## CASH POOLING

Cash pooling is a banking tool that provides enhanced cash management for companies that choose to implement such a structure. The benefits include increased interest income, lower banking fees, lower cost of borrowing, and potentially cash centralization. There are several tax and non-tax considerations when implementing a cash pooling structure that require careful analysis.

### Cash Pooling

Cash pooling is a cash management system administered by a third-party bank and generally involves the consolidation of participants' cash accounts and the assignment of a pool leader or "header." The benefits of cash pooling include an increase in interest income, potentially lower bank fees, cash centralization (zero balancing, described below), and a lower cost of borrowing for those participants that need cash.

### Physical Pooling (Zero Balancing)

Physical pooling involves the sweeping of cash from the participants' accounts to the pool leader and therefore creates the ability to centralize the organization's cash. The goal of physical pooling is to create a series of intercompany loans from both a U.S. and non-U.S. perspective.

### Notional Pooling

Notional pooling, on the other hand, does not involve the sweeping or physical movement of cash. The bank consolidates the participants' accounts for purposes of calculating the total interest income that is credited to the pool leader. Each participant maintains their own third-party banking relationship and may or may not be credited a share of the pool benefit depending upon how the pooling arrangement is structured.

### Pooling Considerations

There are many tax-related and non-tax considerations that must be evaluated upon the implementation of a cash pooling structure. The type of pooling arrangement (physical vs. notional) depends largely upon the cash management goals of the company. One important determination is the location of the pool leader. The additional interest/pooling benefit will likely be taxable in the jurisdiction of the pool leader; therefore, choosing a country where such income is not highly taxed is important. Further, a jurisdiction with a robust banking network is important as well.

With respect to physical pooling, a strong treaty network between the pool leader and the participants is important to reduce withholding tax as much as possible. Other tax considerations include transfer pricing with respect to the appropriate interest rate, foreign currency exposure and potential hedging, Subpart F and GILTI considerations, foreign tax credits, etc.

Notional pooling often reduces or eliminates foreign currency and withholding tax exposure as the participants are transacting with the third-party bank. The choice of location for the pool leader is equally important for notional pooling as it is for physical pooling. The determination of whether the pooling benefit is allocated to the participants and the characterization of such benefit should be conducted including a transfer pricing analysis.

Depending upon the corporate structure and the location of participants with excess cash and those that have funding requirements, companies may want to entertain a physical pool in some regions and a notional arrangement in others. For example, most Asian countries do not have a significant treaty network, which would make notional pooling more attractive. Europe has a fairly thorough treaty network, and thus physical pooling tends to be very effective in those countries.



### Planning Considerations

Cash pooling has been a popular cash management tool for several years. For the companies that have a cash pooling structure in place, it is important to have a pooling agreement between the third-party bank and the participants, including the pool leader. The agreement should be clear regarding the type of pooling arrangement that is in place in order to reduce any risk of recharacterization regarding the entities that are borrowing and lending. Such agreement should be reviewed, as well as the accounting for the cash pooling, to ensure that the agreement is being followed by accounting and tax. This type of year-end review could help alleviate the risk of potential recharacterization, which could lead to a whole host of issues, including withholding tax, Subpart F issues, foreign currency issues, etc.