Talking Asset Management with KPMG

Distressed Debt and Credit Funds

Below is a transcript of *Talking Asset Management with KPMG*. In this episode, **Patrick Brooks**, Credit Tax practice leader, is joined by **Scott Woods**, Credit Tax practice leader, and **Peter Ritter**, Washington National Tax Principal focused on Financial Institutions and Products, to discuss the lifecycle of distressed debt from the perspective of a credit fund.

Pat Brooks:

Well hello everyone. This is Pat Brooks and we really appreciate you all joining us again for Talking Asset Management with KPMG.

The last five or six of these we really focused on credit and credit funds and credit structures and credit issues. We've done the YA global podcast and BDC podcast. In talking with our clients and really given the current economic environment we actually thought today's podcast would be really relevant, talking about distressed debt, and joining me today to dive into this little bit more are two my partners – Scott Woods, who also has led a number of these podcasts, and Pete Ritter, who is a Washington National Tax partner who focuses on financial statements and products. So guys, I think we should just dive right into it and Scott I'm going to put you on the hot seat first, so what's going on out there, what are you seeing, what are you hearing from your clients regarding distressed?

Scott Woods:

All right, thanks Pat. It's good to be here and talk about this because it's definitely timely, obviously, with everything that's going on in the world between you know the disruption that's caused by the Russian invasion in Ukraine, inflation here, and then the potential recession and the timing of that, there's definitely a lot of interest around the distressed debt space. Obviously credit as a whole, you know we've seen just huge growth in that overall fund practice and, you know, we continue to see that and distressed is right along in that, but just seeing the things that are going on in the world, you know, we're definitely seeing the volume of distressed start to pick up and interest in creating funds around that space is definitely increasing.

Pat Brooks:

Yeah, we're seeing quite a bit of that. I don't know Pete, what are you seeing from a Washington perspective?

Peter Ritter:

Yeah, same, same, seeing increased activity here, and you know, a common scenario we'll see is an investment fund client that maybe acquires that distressed debt at a discount from face or par and in a secondary market transaction it might then, you know, restructure or work out that debt to get it current and then try to maximize or realize value of this. Hopefully the economy might recover, you know, through a sale or maybe just holding that debt to maturity and certainly foreclosure is a possibility too if needed, and the other scenario I'm seeing is simply new lending, you know. we have borrowers that are desperately in need of cash or liquidity that need funds now, so we're seeing other clients that are making loans. You know, albeit it's expensive money but new loans and certainly the issues there are, you know, debt versus equity and for non-U.S. investors, you know, could you have a lending business here in the U.S. But I think the focus today is more on the on the former scenario.

© 2022 KPMG LLP, a Delaware limited liability partnership and a member firm of the KPMG global organization of independent member firms affiliated with KPMG International Limited, a private English company limited by guarantee. All rights reserved. NDP302978-2A

Pat Brooks:

That is correct and you must have taken a look at my agenda, as you pretty much took all the items we're going to talk about. We are not going to get into the lending business aspects today, but since you hit there, I was thinking let's talk sort of about the life cycle Pete, the life cycle of acquiring the secondary market and sort of what are the issues regarding acquiring and then while you're holding and then disposing before we get into some of the work out issues.

Peter Ritter:

Exactly yeah, you hit it right there, you know, when you buy a loan, you know, at a discount from par, there are some issues we should talk about and holding it as well. And certainly, the issues that come up are, you know, timing and character. Perhaps starting with, you know, the purchase, you know, when you buy a loan at a discount from par you can have a scenario where what you think might be a long term capital gain can be converted into interest income taxable at ordinary income rates on account of these so called market discount rules which can catch some off guard so that's something to consider.

Pat Brooks:

Well that's, just cutting you off for a second – Scott, how many conversations do you have about regarding that every day?

Scott Woods:

Quite a few, quite a few. Definitely everybody, you know, thinks that, you know, they should get capital gains on the sale, that instrument, after it appreciated some because the company was doing a little bit better and lo and behold, you got to request some of that income on their K-1 and then explain to them what the market discount rules are so it's definitely good thing to talk about here.

Pat Brooks:

Yeah there's hurdles there. So Pete, why don't you just talk about that for a second?

Peter Ritter:

Yeah, yeah, absolutely. You know the way these rules work is, you know, if you buy a loan at a discount from par or face you have so called this market discount and that amount kind of accrues in the background. It's not like OID in the sense you don't have to pick it up currently, but it does accrue and it's triggered when you have a principal payment or when you sell the loan later at maturity, and you can certainly get some really weird results here with highly distressed debt. You know, happy to give you a simple example that kind of really highlights the point.

You know, let's say you have a loan that was originally issued and had a $3 million principal amount and let's say investment fund acquires it for $2 million, so you've got a million market discount, and let's say the loan has two more years to go to maturity, so you'd have half a million of market discount that would accrue each of those years. And so, you know, if the fund sold the loan at the end of year one for $2.5 million, you'd have quite literally $500,000 of gain that would be characterized as ordinary interest income under the market discount rules, and you know, client or fund might say hey, wait a second, that feels like economic gain, doesn't feel like interest income. You know, another example might be if there's a partial principal payment made of half a million at the end of year one, you'd have the same result. So again, some counterintuitive maybe results that might surprise folks.

Pat Brooks:

I mean, we know that there's people who buy stuff in the secondary market and a lot of you all are familiar with some of these things, but at the same time, there can be some frustration. The rules were written at a time that maybe there wasn't as much distress going on, so it's a little bit different. So Pete, there's three different types of accruals that I look at. You sort of have your stated interest, you have OID and you have accrued market discount.

Peter Ritter:

Right.

Pat Brooks:

These are things. So I think when we talk about stoppage of accrual, and we're not going to get into all the different nuances here, but what we are going to say is there is the ability to stop the accrual of stated interest, right?

Peter Ritter:

Yes. Yeah, no, it's a great point. Yeah, with market discount, unfortunately, you know, the rules are quite murky. There's no specific exemption for stopping the accrual market discount. The one scenario where we know many get comfortable is where the loan is in default, let's say, with an acceleration clause or past the maturity date at the time of purchase. There, you know, the loan looks kind of like a demand note, and maybe, you know, you don't need to accrue market discount, because, quite literally, there's no period over which to accrue it. But, you know, with stated interest, you know, yes, there's some law here that is quite favorable – the so-called doubtful collectability doctrine – which can stop interest accruals where it applies. And you know the case law basically says hey, if the interest here is of doubtful collectability and not reasonably certain to be collected, then you can stop the interest accruals under the accrual method of accounting, and the idea here is, you know, you shouldn't have to pick up interest income that you'll never, you know, realize or receive. You know, it just wouldn't be fair.

Pat Brooks:

What do people do on OID side?

© 2022 KPMG LLP, a Delaware limited liability partnership and a member firm of the KPMG global organization of independent member firms affiliated with KPMG International Limited, a private English company limited by guarantee. All rights reserved. NDP302978-2A

Peter Ritter:

Yeah, it's a great point. You know, on the OID side there is some IRS guidance out there that seems to suggest that this doubtful collectability doctrine doesn't apply in the OID context, but I think many think that guidance is just flat out wrong and don't follow it.

You know, it's worth mentioning that the bar here is pretty high for the doubtful collectability doctrine to apply the case law that says, you know, there should be some type of identifiable, you know, event, you know, insolvency, bankruptcy would certainly be good, and it's not enough that you know, the borrower's just going through some temporary financial difficulty or, you know, just postponed an interest payment or two, you know, there has to be pretty good high event here.

Another interesting issue that comes up – let's say you've stopped accruing interest and then lo and behold, you know, you do get an interest payment later on, to your surprise, and there's some concern that you might have to apply a portion of that payment that you might think is principal to interest. There is a payment ordering rule in the regs, and quite literally applied, would suggest that you have to report some interest in here in that scenario. So another surprise to many investment funds and clients.

Pat Brooks:

Yeah, so what we're just trying to lay out here is that there's a lot of different facts that have to be taken in consideration to stop the accruals or stop the recognition of ordinary income versus a capital gain and the like. So we're just noting that to all the listeners here, is that there's a lot that goes on there. There are definitely positions that people take, and so that's what we just want to make sure you're aware of those items.

Now let's get into work outs. So there's a lot going on here in workouts, and I'm going to actually change something here. I'm going to actually pick on Scott for a second. So I've already picked on you once, but Scott, when you start thinking about workouts you have some sort of modification going on, right?

Scott Woods:

Right, for sure.

Pat Brooks:

But then, you have a different, what's like the thought process you have? Okay, it's a modification, but then what are your other thought processes?

Scott Woods:

Well, you know, how much, you know, is it going to be an immediately taxable event, you know, and how much of a modification was there? Those rules are, you know, pretty specific and those, you know, what like the market discount rules and others kind of, you know, definitely can surprise folks, you know, especially if, you know, they bought distressed debt at a pretty low amount, and it has a pretty high face and they do a work out or, you know, they issue new debt for that same face, they're going to get really surprised, you know, that that new face, that that transaction is treated as a taxable transaction and the amount realized is that new face amount. So definitely catches folks off guard.

Pat Brooks:

That's probably, I don't know Pete how you feel, but that seems to be like the one that really catches people by surprise.

Peter Ritter:

Absolutely, Scott's right. I mean the idea here is if you're modifying, you know, your existing old debt, in a way you're changing the material economic terms. It says if you've swapped that old loan for a new loan in a taxable transaction and, as Scott alluded to, there's some detailed regulations that apply here for so called significant modifications. And yes, the amount realized on that taxable exchange can catch folks off guard. You know, what those rules say is that the amount realized is equal to the issue price of the new modified debt, so it's as if you're selling the old loan for an amount equal to the issue price of the new debt, and the way the issue price rules work is if you have publicly traded debt, you know, the issue price is the fair market value and here there are some pretty broad rules as to what's publicly traded. You know, in some cases, if you have an indicative quote on Bloomberg that might be enough, especially if the debt here is over 100 million, but as Scott was suggesting, in many cases the debt is not publicly traded and there your amount realized will be your face or stated principal amount, and that's where surprises happen, where you could trigger tax gain and not have any economic gain and clients will say hey, you're crazy, that doesn't make sense. It's just the way the rules work here.

Pat Brooks:

We understand that. But there's also though situations where something can be considered recapitalization, right?

Scott Woods:

Right. The first thing when you realize you may have had that significant modification is is it possible to treat that original instrument as a security, so it might fall under those rules as opposed to the significant modification rules.

Peter Ritter:

That's right. Especially there you need to have a, you know, corporate borrower or corporate issuer and the old loan has to be a security, the new one has to be a security as well, and you know, in some cases that saves the day.

© 2022 KPMG LLP, a Delaware limited liability partnership and a member firm of the KPMG global organization of independent member firms affiliated with KPMG International Limited, a private English company limited by guarantee. All rights reserved. NDP302978-2A

But, you know, to have a security we generally will look to the term of the loan and want to see something more than five years, but for highly distressed debt, maybe there's some scenarios where we can get comfortable. Even debt with a shorter term might qualify.

Pat Brooks:

Yeah. So when you have a modification that, number one, that doesn't mean there's automatically a trigger, has to be a significant modification, and even if it's a significant modification which could create a unfavorable result, you do have the recapitalization rules that might be able to allow you to avoid some of the negative consequences.

Now, the last thing I want to hit on here was on, okay, you're holding a debt instrument, you're doing a work out and you're taking over an asset of some sort and I sort of looked at this as being three assets – corporate stock, passthrough entities, real estate. So I'll throw it over to you Pete for the time-being on the corporate stock side, what does a fund really need to be concerned about?

Peter Ritter:

Not much. I mean if you're holding stock, I mean, I think where you're headed is, you know, there could be some issues for tax sensitive investors, you know. It's non-U.S. investors they need to worry about – U.S. trader business issues, ECI or FDAP withholding on maybe dividends on the stock. And certainly U.S. tax exempts have to worry about UBTI and stock is pretty simple I would think, and you've got to worry about FIRPTA possibly, if it's a U.S. real property holding company.

I think the thornier issues are the other two scenarios that you just talked about where maybe you may hold equity in a partnership that is engaged in a trader business, or certainly if you hold the underlying collateral real estate, you're going to have U.S. trader business issues and UBTI in those scenarios.

Scott Woods:

The thing that always comes to mind here is, you know, one of the things to work out obviously if you're going to need to put the instrument into an entity that's going to block some of those negative tax consequences, so put it in a blocker, one of the things that really needs to be done to make sure everything is copacetic is to get evaluation of that because a lot of times they just kind of put it in there to get it out of the out of the way and then don't think much of it because it's still kind of within, you know, perhaps a control group so to speak. But, you know, you really need to have a good valuation done on that distressed debt or the trip distressed property as it comes in, so you know how to treat that going forward because I've seen some weird consequences where people haven't necessarily valued it correctly and had some weird tax results down the road as they do work that out inside of corporate vehicle.

Pat Brooks:

That's a great point. Well, look, I thank you both for your time. This has been great and I just wanted to say thank you to all you people who are joining us. This series has really been going really well. We hope you found this very interesting, and we look forward to you joining us again on another Talking Asset Management with KPMG. Take care, all. Thank you.

Scott Woods:

Thank you.

Questions? Contact:

Patrick Brooks
Credit Tax Practice Leader
E: pbrooks@kpmg.com

Scott Woods
Credit Tax Practice Leader
E: scottwoods@kpmg.com

Peter Ritter
Principal, Washington National Tax – Financial Institutions and Products
E: kpeterritter@kpmg.com

Some or all of the services described herein may not be permissible for KPMG audit clients and their affiliates or related entities.

kpmg.com/socialmedia

KPMG LLP does not provide legal services.

The information contained herein is of a general nature and is not intended to address the circumstances of any particular individual or entity. Although we endeavor to provide accurate and timely information, there can be no guarantee that such information is accurate as of the date it is received or that it will continue to be accurate in the future. No one should act upon such information without appropriate professional advice after a thorough examination of the particular situation.

© 2022 KPMG LLP, a Delaware limited liability partnership and a member firm of the KPMG global organization of independent member firms affiliated with KPMG International Limited, a private English company limited by guarantee. All rights reserved. The KPMG name and logo are trademarks used under license by the independent member firms of the KPMG global organization.
NDP384600