

Relief From Project Debt (At Least For Now)

Thanks to February's stimulus bill, project owners working with their lenders can minimize or eliminate tax liabilities when they restructure project debt.

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Special-purpose companies created to develop, finance and operate large power and infrastructure projects have not been immune to the growing credit crisis. Owners of these project companies are often surprised to learn that they face significant tax consequences as they attempt to renegotiate the terms of the project debt.

These tax consequences result from broad application of a rule that requires a borrower to pay taxes when its debt is canceled. A borrower may also trigger a tax when the debt is merely restructured.

This rule applies so broadly that it has consequences for nearly all project debt workouts, even those in which only minor changes are made to the project debt. It also affects debt-for-equity swaps and comes into play when project owners buy out the project debt.

The stimulus bill passed in February offers some temporary relief from these tax penalties. Project owners that restructure or cancel project debt this year or in 2010 can make a special election to defer their tax bill for up to five years.

Project owners working in close cooperation with their lenders can now minimize and even eliminate tax liabilities entirely when they restructure project debt. The key to accomplishing this is to identify

the issues early in the restructuring phase and work closely with all project stakeholders.

A typical project is owned by one or a small number of project owners who actively manage the project's assets. The project is financed through equity contributions by the sponsor and large amounts of project debt held by banks and other financial investors. The project debt is usually concentrated with a small group of lenders but can be held more widely and managed by an agent chosen by the lenders.

Some projects were still in the development or construction phases when credit conditions rapidly tightened. The lenders to these projects have begun to advance funds more slowly and demand more security from the project sponsors.

Other projects are well into the operating stage and are finding their operating margins squeezed due to a nonperforming off-taker or increased costs to operate the project. In either case, the lenders and the project owners have begun to search for ways to reduce or restructure the debt to keep the project afloat. The tax structure common to project finance debt is what creates some of the pitfalls as well as the opportunities.

In most cases, the project owners are responsible for the project

company's tax liability. This is because projects are usually held in a special-purpose entity that is either disregarded for tax purposes (as if the projects are held directly by the project owners) or is a tax partnership among a small number of project owners.

The project debt is usually non-recourse to the owners of the project; it is secured only by the assets and the contracts of the project. The project assets are frequently written off, or depreciated, for tax purposes fairly quickly so that the tax basis of these assets are often lower than the outstanding balance of the project debt.

When debt is canceled

Anyone whose debts are canceled by a lender must pay taxes on the canceled debt. This rule applies to a wide range of possible transactions. In its simplest application, the project owners are taxed if the project debt is canceled or paid off by the borrower at less than face value. The borrower owes taxes on the difference between the face value of the note and the value given to pay off the note.

Even when the project debt is not formally canceled or reduced, project owners can be penalized if they renegotiate the terms of their project debt or convert the project debt

into an equity stake in the project company.

When project debt is changed in a significant way, the tax rules create the false impression that the old project debt has been canceled in exchange for new and restructured project debt. This idea is maintained whether or not the old debt instrument is formally canceled and whether or not a new debt instrument is actually delivered. The act of changing the terms of the loan is what triggers this result. If the new restructured debt is valued at less than the face amount of the old debt, the project owners can get stuck with a tax bill for the shortfall.

The recently enacted stimulus bill offers some relief to those who restructure or cancel debt, as long as it is completed during the next two years. Under the new law, project owners can elect to defer the taxes they owe for up to five years after they restructure or cancel project debt.

After the five-year deferral period is over, the project owners pay the taxes in equal installments over the next five years. If the project company liquidates or ceases business, or a partner in the company sells its interest, all the deferred tax is due immediately. This election can be made separately for each tranche of project debt, but the election is irrevocable once it is made.

Project owners that modify project debt create extra tax deductions if the principal balance of the debt exceeds its value or issue price. Project owners must also defer these tax deductions if they elect to defer the taxes they owe under the special rule in the stimulus bill.

Complete exemptions

Project owners considering a restructuring of their debt should analyze whether electing to defer the taxes under the special rule in the stimulus bill is more desirable than other alternatives available to certain taxpayers.

By making the election, project companies forfeit the opportunity to take advantage of three exceptions –

insolvency, bankruptcy and real estate – that each allow for a complete exemption from paying taxes when project debt is restructured.

The bankruptcy exception allows the project owners to avoid taxes if the restructuring happens during a Chapter 11 proceeding and the project debt is discharged by the bankruptcy court.

The insolvency exception lets the project owners escape taxes if the restructuring occurs when the project owners are insolvent. The real estate exception applies where the project owners have used loans to buy real estate and can be helpful to a project that is comprised of a significant amount of real estate.

Using any of these exceptions, however, does not come free to the project owners. Project owners who avoid taxes under these exceptions must reduce their tax assets up to the amount of debt that was canceled. These tax assets include net operating loss carry-forwards, existing tax basis in project assets and unused tax credits.

Trading tax assets to avoid a current tax liability is usually advantageous, but electing to defer the taxes under the special rule in the stimulus bill often will provide greater benefits.

In the former case, trading tax assets acts as a deferral of current taxes, because the tax assets are used to reduce current taxes instead of future ones. Nevertheless, in the latter case, the project company defers current taxes and retains its tax assets for use in alleviating future tax liabilities.

The election under the special rule in the stimulus bill does not require the project company to reduce its tax assets. Even project owners who anticipate ceasing business or filing for bankruptcy protection in the near future, therefore, may find the deferral option offered under the stimulus bill to be the more attractive option.

Debt-for-debt exchanges

The Internal Revenue Service (IRS) has regulations that describe

when a modification to project debt is significant enough to be considered an exchange of one debt instrument for another.

These regulations give no weight to whether or not one note is physically exchanged for another, or whether the old note is formally canceled and a new note issued. Regardless of the form the parties use to document the change to the terms of the project debt, the change will be considered an exchange of one note for another if the cumulative changes are a significant modification under these rules.

The regulations spell out specific changes that are considered significant and also provide a general rule for types of changes that are not covered in the specific categories. The IRS has set a low threshold for changes to project debt that will result in a significant change. As a result, many project loan workouts will be considered a debt-for-debt exchange.

If the yield on the debt changes by an amount greater than 25 basis points per year, or 5% of the annual yield of the original project debt, the change is significant. There is an important exception to this rule for yield changes that are triggered by operation of the original loan agreement.

Deferral of a scheduled loan payment is significant if the deferral period is longer than the lesser of five years or 50% of the original term of the loan. Scheduled payments may be deferred by extending the maturity date of the loan or by simply deferring one or more payments due before the loan matures. A deferral of even a small payment all the way to the maturity date may be significant if the maturity date is more than five years away.

Unsurprisingly, a change in the obligor under a non-recourse project debt is not significant. The identity of the obligor is of little importance where the project lender must look solely to the project assets to recover its loan. Conversely, a change in the collateral or other forms of credit

enhancement that secure the project debt is significant, subject to a few limited exceptions.

Requiring a project sponsor (or other creditworthy entity) to guarantee the project debt is usually significant, unless the guarantee does not change the project lender's expectation of receiving payment under the loan.

Additionally, a significant modification occurs if the project debt is reclassified for tax purposes as an equity interest. Some factors that might indicate the project debt is – for tax purposes – an equity interest, include no fixed maturity date, relaxed default rights, the project company's debt-to-equity ratio, and conversion or participation rights in the project.

Aside from these specific categories, a change to project debt can be significant if the nature and degree of the change is economically significant based on all the facts and circumstances. Successive changes are tested on a cumulative basis. For example, if the yield on project debt is changed first by 15 basis points a year, and is later changed by another 15 basis points, then the cumulative change of 30 basis points may be significant under these rules.

When a debt workout is a debt-for-debt exchange under these rules, the project owners will owe taxes on the difference between the principal balance of the old debt (before it is restructured) and the amount paid to cancel the old debt. The payment to cancel the old debt is the new restructured debt delivered to the lender. The value of the new debt is its issue price.

While the issue price of the new debt is generally equal to its principal balance, there are at least three situations where this is not the case. First, if the old debt is publicly traded for tax purposes, then the issue price of the new debt is the fair value of the old debt. Second, if the new debt is publicly traded, then the issue price of the new debt is the fair value of the new debt and not its principal balance. Third, even

if both the old debt and the new debt are not publicly traded, the issue price of the new debt might be less than its principal balance if the new debt has an interest rate below the lowest applicable federal rate (currently around 4%) in effect in the three months preceding the restructuring.

The tax definition of publicly traded sets a far lower threshold than the commonly understood meaning of this term. Debt is publicly traded not only if it is listed on a national securities exchange, but also if it is traded on an informal market consisting of a group of banks (or other financial service companies) holding themselves out as being willing to purchase, sell or otherwise enter into certain transactions.

Debt is also publicly traded if price quotes are readily available from brokers, traders or dealers. It may be possible to obtain a quote on virtually any debt paper in the market, increasing the risk that project finance debt can fall within this category.

The following example illustrates how the project company should compute the amount of tax it owes when it restructures its debt in a significant way and causes a debt-for-debt exchange. A project company has \$1 million of debt outstanding that pays interest at 10% annually. As part of a workout with its lender, the interest rate is increased to 12% annually in exchange for the lender's agreeing to lower the required debt service coverage ratios. The outstanding principal balance remains at \$1 million. The change to the interest rate is a significant modification, because it exceeds 25 basis points.

Therefore, the tax rules consider the project company to have issued new debt to pay off the old debt. Assume the project lender then sells 50% of the debt for \$0.80 on the dollar. If the new debt is publicly traded, then the project company will owe tax on \$200,000 of canceled debt.

The new debt is valued at \$800,000, even though the prin-

cipal balance is \$1 million. The project company has paid off a \$1 million debt by paying \$800,000. If the new debt is not publicly traded, then the project company owes no taxes, and a more sensible result is reached. It paid off debt of \$1 million with a new note with a face value of \$1 million.

As is obvious from this example, borrowers with publicly traded debt are significantly disadvantaged by this rule. Indeed, the project company is economically worse off after the restructuring – it owes the same \$1 million – except now, it must repay the debt at a higher rate of interest. The tax result adds insult to injury, as the project company now owes tax on \$200,000 of canceled debt.

The tax rules allow the project owners to amortize the \$200,000 as a tax deduction over the life of the note. The project owners, however, lose the time value of money as they pay current taxes in exchange for a deferred tax deduction.

Debt-for-equity swaps

Prior to 2004, a project lender might have been able to convert its project debt into an equity stake in the project company without causing any tax consequences to the project company. This technique was often used to avoid the possible unfavorable tax results of modifying project debt.

Congress changed this rule in 2004. Since then, if a project company converts its debt into an equity stake, the project company will owe taxes if the value of the equity stake is less than the principal balance of the loan.

Allowing the project to value the lender's equity stake at liquidation value is usually advantageous. Without this approach, the project company might be forced to reduce the value assigned to the lender's equity stake by a minority or illiquidity discount.

A project company can take advantage of the liquidation value approach only if it follows a number of rules. First, the project company

must maintain capital accounts in accordance with the tax regulations. Second, all parties to the exchange must use the same valuation number for all tax purposes. Third, the exchange must be done at arm's length. Lastly, the project company cannot plan to redeem or buy the lender's interest and avoid tax on canceled debt.

While these proposed regulations are generally favorable to the project company, they create some tax

difficulties to the lender. In a debt workout, the lender is most concerned with getting an immediate tax loss for the decline in value of its investment.

The proposed regulations do not allow the lender to take the tax write-off when it exchanges its debt interest for an equity stake in the project; it must defer the tax loss until it sells the equity stake. This result may make it more difficult to get lenders to agree to debt-

for-equity swaps in project debt workouts. **SNP**

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