Introduction to Original Issue Discount

Virginia Leggett Stevenson (Charlotte)
Erica Messimer (Charlotte)
Abigail Williams (Charlotte)

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TIME VALUE OF MONEY

I will gladly pay you next Tuesday for a hamburger today.

– J. Wellington Wimpy

TIME VALUE OF MONEY

For securities that are treated as debt for U.S. federal income tax purposes:

- the repayment of principal is tax free
- **interest is very taxable**
  - Code § 61(a)(4)

TIME VALUE OF MONEY

Which sort of securities are treated as debt for U.S. federal income tax purposes?

- "A bond, debenture, note or certificate or other evidence of indebtedness." Code § 1275(a)(1)(A).
- Read the offering document
  - It should say whether something "will be treated as debt for tax purposes"
  - When in doubt, what does/will the tax opinion say?
- REMIC regular interests. Code §860B(a).
- Corporate debt (even if convertible, non-vanilla, etc.)

TIME VALUE OF MONEY

What is interest?

- It is a charge for the **use** or **forbearance** of **money**. Deputy v. Du Pont, 308 U.S. 488 (1940).

- E.g., $100 bond x 10 years @ 5% interest; $100 price
  - The 5% interest is taxable to the recipient
    - If a cash basis taxpayer: when received
    - If an accrual basis taxpayer: when accrued
      - These are tax accounting concepts that govern **timing** of income and not whether it is income. Timing can be a very big deal.

TIME VALUE OF MONEY

Interest is not just very **taxable**, it is also very **deductible**.

Gaming the system:

payers want to **deduct** interest **expenses** ASAP

recipients prefer to **defer** taxable **income** (there is a time value of money, so there is value in deferring taxable income)

TIME VALUE OF MONEY

What about $100 bond x 2 years @ 0% interest?

- Think:
  - How much would you pay for this bond?
  - Say, if prevailing interest rates are 10%?
  - Maybe about $82?
  - At the end of year 2, you get $100.
  - How do you treat the $100?
    - The $82 component?
    - The $18 component?
  - And what about timing?

ORIGINAL ISSUE DISCOUNT

- Treas. Reg. § 1.61-7(c) states:
  - When notes, bonds, or other certificates of indebtedness are issued by a corporation or the Government at a discount and are later redeemed by the debtor at the face amount, the original discount is interest.

- "Original Issue Discount" = **unstated interest**

- The daily portions of OID are taxable to the holder **as it accrues**. (Code § 1272(a)(1))
  - Yikes! A holder has to pay taxes on $ that hasn't been received yet.
  - This is true even for cash method taxpayers (e.g., you).

ORIGINAL ISSUE DISCOUNT – DEFINITION

- Colloquially, OID occurs when a debt instrument is issued for less than its face amount.
  - E.g., our bond was issued for $82 but its face amount is $100.
- But it's more complicated:
  - OID = the excess (if any) of (A) the stated redemption price at maturity (SRPM), over (B) the issue price (IP). Code § 1273(a)(1).
    - Simplified: OID = SPRM - IP

ORIGINAL ISSUE DISCOUNT

- Some practical considerations
  - Offering documents, especially “base” documents, discuss OID
  - Often, the particular need is to identify which bonds have OID
  - Accounting for OID is often tasked to the trustee (read PSA, trust agreement, or indenture for who sends out the tax forms; this would include sending out 1099s to reflect payments of interest and accruals of OID)

ORIGINAL ISSUE DISCOUNT

- Related issues NOT part of this CLE (but please call tax counsel for help if you seem to encounter these)
  - gift loans often used in estate planning / high net worth families
  - loans in the employment context
  - installment sales (i.e., payments of purchase price made in >1 year)
  - secondary purchases (which have “market discount”) or ones other than at *initial* issuance
  - other loans with below-market interest (i.e., Code section 7872)

ORIGINAL ISSUE DISCOUNT

- Related issues NOT part of this CLE (but please call tax counsel for help if you seem to encounter these)
  - The situations on the previous slide are similar in that they involve hidden interest that may be a substitute for a taxable gift or employment income
  - Payments and their characterization may need to be untangled from the concepts of tax basis and capital gains, as well as principal and interest

ORIGINAL ISSUE DISCOUNT

- Finally, the rule requiring that OID be currently included in income does not apply to:
  - Tax-exempt obligations
  - U.S. savings bonds
  - Debt with a maturity of less than one year (Code §1272(a)(2)(C))
    - Think: deferral isn't a problem for these bonds
  - Some loans b/w actual people
  - See Code§1272(a)(2).

OID – BACK TO THE DEFINITION

- OID = the excess (if any) of (A) the stated redemption price at maturity (SRPM) (usually: the stated principal or face amount), over (B) the issue price (IP). Code§1273(a)(1).

  - **OID = SRPM - IP**

OID – UNPACKING THE DEFINITION: SPRM, QSI

- OID = SRPM – IP
  - SRPM = all $ payable other than qualified stated interest (Code§1273(a)(2))
    - Not just the final payment: all $ payable over the life of the bond other than QSI
    - QSI = stated fixed-rate interest that is payable in cash/property unconditionally at fixed periods of <= 1 year (Code § 1273(a)(2))
    - $100 bond @ 5% per annum interest = ?
    - $100 bond @ 0% per annum interest = ?
    - $100 bond @ 5% per annum interest that is added to the principal of the bond = ?
      - AKA an Accrual Class or Z bond
    - If VRDI, see Treas. Reg. § 1.1275-5(e) (treat as fixed)

OID-MANDATORY BONDS – FAILING THE QSI TEST

- OID = SRPM – IP
  - SRPM = all $ payable other than qualified stated interest (Code§1273(a)(2))
    - QSI = stated fixed-rate interest that is payable in cash/property unconditionally at fixed periods of <= 1 year (Code § 1273(a)(2))
    - Observe: this definition renders three types of bonds **OID-mandatory** because they ordinarily can't meet the QSI rule:
      - **PO bonds** (no stated interest; stated interest @ 0%)
      - **Z bonds** (interest is not payable annually – watch for short duration bonds though)
      - Ascending rate or descending rate bonds (**ARB**s) – interest is fixed at one rate and then jumps up or down to another rate
        - (note, though, that ARBs are complex and that there can be exceptions)

OID-MANDATORY BONDS – INTEREST ONLY CLASSES

- OID = SRPM – IP
  - What about IO classes (i.e., classes with a notional or nominal principal amount where there is an interest entitlement but no or nominal principal entitlement; AKA “stripped coupons”)?
  - It’s complicated, in terms of theoretical tax rationales and IRS silence
  - The prevailing theory is that given their structure, the interest payments can be considered part of SPRM, in which case, SRPM generally always > IP → OID by math (but watch for negative OID)
  - Treat IOs as **OID-mandatory**

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OID – UNPACKING THE DEFINITION: ISSUE PRICE

- OID = SRPM – IP
  - IP = if publicly issued, the initial offering price to the public at which price a substantial amount of the debt issuance was sold (Code § 1273(b)(1))
    - What is a substantial amount?
      - The Code and Regs are silent; ~10% is market
    - Prices letters give you the price in decimal format
      - Some traders use the old Spanish pieces of 8 system, so you may need to convert stated prices to decimals (e.g., 5-16 = 5 and 16/32 = 5.5%)
      - Are prices stated to include accrued interest?
        - Many prices letters expressly exclude accrued interest – read the document!
    - How do you write disclosures in an offering document when the offering will occur in the future?
      - Based in part on (a) the level of LIBOR on the date of this Supplement and (b) information provided by the Underwriter regarding the initial prices at which it would have expected to sell or will sell substantial portions of the Regular Classes, we expect to report income to the Internal Revenue Service and to Holders of the Regular Classes assuming they are issued as follows: [OID classes; de minimis OID classes; premium classes]

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ORIGINAL ISSUE DISCOUNT – DE MINIMIS OID

- For non-OID-mandatory bonds, this is usually the next inquiry:
- When making a determination about whether a bond has OID, there is a **¼ of 1% de minimis rule**:
  - If SRPM – IP < [1/4 * 1%]*[number of complete years to maturity], then OID is treated as 0. (Code § 1273(a)(3)).
  - There is a lot to unpack here.
  - Easy: ¼ * 1% = .0025 → .25% if you are dealing with percentages
    - **25% or ¼ if you treat SRPM as 100 (recommended)**
  - Harder: years to maturity (Treas. Reg. § 1.1273-1(e)(3))
    - Corporate debt: maturity is maturity
    - REMIC/GT/Mortgage-backed securities (esp. where underlying collateral is prepayable): start with: decrement table column for the pricing prepayment assumption (PSA% or CPR% -- will be in tax §)
      - NOT Final Payment Date – that is likely to be highly distortive!
      - Ignore the first entry on the table and sum the rest of the figures; then divide by 100: this is the best figure to use for "weighted average tax life" or "WATL"
      - Quick & dirty: weighted average life ("WAL") per table - .5 = WATL
        - Conservative quick & dirty: WAL per table - .6 = WATL
        - WAL = weighted average life
        - WATL = weighted average tax life = what we use for OID "years to maturity" concept

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ORIGINAL ISSUE DISCOUNT – DE MINIMIS OID

- De minimis OID is generally treated as “no OID” and these bonds are not generally listed as carrying OID

- In Freddie Mac deals, de minimis OID bonds are listed separately (the other buckets are OID and premium)

- SRPM – IP < [(WAL - .5) / 4] → de minimis OID → no OID
- Treat SRPM as 100: 100 – IP < [(WAL - .5) / 4]
- Move IP to other side of equation: 100 =?= IP + [(WAL - .5) / 4]
  - **USE THIS**!
- Think of it as “**is IP + [(WAL - .5) / 4] at least 100?**”
  - If so, bond only has de minimis OID; if not, bond has OID

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ORIGINAL ISSUE DISCOUNT – DE MINIMIS OID

- Example:
  - Class BC: $1,184,049; 3% fixed rate; price = 95
  - QSI?
  - What is the WAL? WATL?
  - What is the PSA% for the pricing prepayment speed?
    - WAL = 22 years at 201% PSA; price is 95%
    - WATL = 21.5 (easy); 21.52 (hard)
  - Math: IF SRPM – IP < .0025 * WATL → de minimis
  - OR: **100 <= IP + WATL/4**
    - 100 < 95 + 21.52/4 = 95 + 5.38 = de minimis OID

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OID - IP: ACCRUED INTEREST/SHORT PERIOD?

- No comprende
- This something we mainly see on mortgage-backed securities (but it is not limited to them)
- Two things to remember:
  - Economically, bonds are stated to be sold with the economically accrued interest appropriate to their type
  - If there is a short first accrual period, you must follow the OID rules for this
- First: whether the bonds are sold with economically accrued interest
  - **FIX & DLY bonds are sold with economically accrued interest**
  - **FLT & INV bonds are sold with no economically accrued interest**
  - This is not a tax concept! It is an economic concept with a tax spillover effect.
  - This seems simple, but is a huge deal to investors
- Second: whether there is a short first period; if so, follow short period rule
- Look at the days your bond did accrue interest:
  - Cut-off day for the trust is 1st of January; deal closes on January 30th; bonds first pay on the 20th day of February (all in book or offering document)
  - First payment date is 20th of the next month.
    - So you get a full month of interest even though you didn't hold the bond for 30 days (in fact, it didn't exist for 30 days) → short period rule applies

OID – WHAT ABOUT ACCRUED INTEREST?

- Second: **short initial interest period** – first payment is 2/20. Holder buys bond 1/30, but gets interest for 30 days.
  - If there is a short initial period, first interest payment is QSI if it is pro-rated; otherwise, it is SRPM. Treas. Reg. §1.1273-1(c)(1)(iii)(B).
  - Treat as: interest in excess of pro-rated interest is SRPM
    - FIX/DLY:
      - 28 days of accrued interest (based on calendar month accrual period) → add to IP
      - 9 days [30 days of interest – time held (= 2 days in January + 19 days in February)] of interest in excess of pro-rated interest → add to SRPM
      - Net the days to add 19 days interest @ coupon rate to IP (= rate *19/360)
    - WAC/FLT/INV:
      - 9 days of accrued interest (based on accrual period starting 1/20) → add to IP
      - 9 days [30 days of interest – time held (= 2 days in January + 19 days in February)] of interest in excess of pro-rated interest → add to SRPM
      - Net the days to get 0 – no adjustments to either IP or SRPM

OID – WHAT ABOUT ACCRUED INTEREST?

- Short-hand for prior slide (use these):
  - FIX/DLY:
    - **Add (payment date – 1) days interest @ coupon rate to IP**
      - The thinking is that investor pays value for this
      - May have slight adjustments based on closing date, etc.
      - Call Virginia if you have questions
    - One important thing to note: this rule is why a fixed rate mortgage-backed security sold at par technically has a premium
      - Important on Freddie Mac deals
      - And why you might want to adjust your ordering to do this before the de minimis calculation
  - WAC/FLT/INV:
    - **No adjustments to either IP or SRPM on account of accrued interest (unless noted to be a DLY class)!**

OID – WHAT ABOUT ACCRUED INTEREST?

- What about accrued interest?
  - Class BC: $1,184,049; 3% fixed rate; WAL = 22 years at 201% PSA;
  - Price is 95% →
    - 1. Test for QSI
    - 2. Add accrued interest to IP: 95% + (3%*19/360)= 95.15833333% → still <100%
      - This helps show why this calculation is less important at lower prices and <u>very</u> important at prices close to 100%
    - 3. WATL = 22 - .5 = 21.5 years
    - 4. De minimis analysis: 99.158333333 + (21.5/4) = 95.158333333 + 5.375 > 100 = de minimis OID

RECAP FOR OID ANALYSIS IN OFFERING DOCUMENTS

- Identify OID-mandatory bonds: PO, Z, IO classes and other bonds with no QSI (ARBs)

- For FIX/DLY bonds @ 100%: know that these have premium (only really relevant in Freddie Mac REMICs)

- For other bonds: Quick math using prices and WALs to determine which bonds may have de minimis OID

- For FIX/DLY bonds (but only if they may have de minimis OID): add accrued interest to the issue price to make sure bond is correctly disclosed as either premium (rare) or de minimis OID (usual)

A FINAL WORD ABOUT OFFERING DOCUMENTS

- Mistakes about OID in an offering document are governed by a materiality standard
  - OID is considered negative and you never want to omit a negative: that is material
  - It is considered material if a bond has OID and that fact is not stated or is stated erroneously.
    - Remedy by “stickering” the book: issuing a supplemental statement to delete the incorrect information and state the correct information.
  - If a bond is claimed to have OID and that isn’t the case, this is a beneficial change to the holder and usually thought not to require a sticker.

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CORPORATE LAWYERS: WHY DOES THIS MATTER?

- This slide is a gift from Jared Mobley
- AHYDO: "Applicable High Yield Debt Obligation"
  - Debt issued by a C corporation or partnership / LLC with corporate partners
  - Term > 5 years
  - Yield to maturity >= Applicable federal rate ("AFR") + 5%
  - And debt is issued with "significant OID" (i.e., issuer is not required to pay all of the accrued interest in cash or non-PIK property within the first accrual period ending after 5 years from issuance and each accrual period thereafter)
- If AHYDO applies to debt
  - No interest deduction is allowed for the "disqualified portion" of the OID on the debt; other interest is deductible only when paid
    - Disqualified portion = lesser of 1) OID on the debt and 2) portion of the yield to maturity that exceeds AFR + 6%
  - Holder accrues all OID as income as it accrues
- Call for help and analysis if you are issuing debt, especially if it is issued with any stock, warrants or other equity

FINANCE LAWYERS: WHY DOES THIS MATTER?

- We are now seeing term loans that carry adequate stated interest (that would be QSI for tax puposes)
  - E.g., 100M loan for 5-7 years at a LIBOR-based interest rate
- How can the lender increase its return?
  - Have the stated loan amount be for $100M (SRPM)
  - And yet only loan $98-99M to the borrower (IP)
- The discount of 1-2% is additional profit to the lender
- It is also designed to be a secured claim against the borrower in a bankruptcy case
- Is this OID?
  - Here, look at the amount of the discount and the term
  - Be aware of OID and try to spot issues.

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INVESTMENT MANAGEMENT LAWYERS: WHY DOES THIS MATTER?

- Consider that a bond with OID means that its holder has taxable income without receiving any funds to pay the associated taxes
- Mutual funds also have to distribute income (regardless of whether it comes from OID) to their investors
- Because OID bonds generate taxable income without an associated amount of cash, we have a *situation*
- If a mutual fund holds a bond with OID, it will pass through the income to its investors on a 1099
  - And yet: the cash passed through from the related bond will be less than that (or zero)
  - Cash passed through to investors will have to come from other sources
    - Forces mutual fund to sell assets under time pressure, perhaps at less-than-ideal prices, and incur gain/loss on those transactions
    - Failure subjects mutual fund to excise taxes, possible loss of status

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INVESTMENT MANAGEMENT LAWYERS: WHY DOES THIS MATTER?

- Some funds may be prohibited from buying debt that has OID.
  - This eliminates the associated taxable income > cash problem
- Other funds carefully disclose that they buy bonds with OID:
  - Certain of the Fund's investments will require the Fund to recognize taxable income in a tax year in excess of the cash generated on those investments during that year. In particular, the Fund expects to invest in loans and other debt obligations that will be treated as having "market discount" and/or original issue discount ("OID") for U.S. federal income tax purposes. Because the Fund may be required to recognize income in respect of these investments before, or without receiving, cash representing such income, the Fund may have difficulty satisfying the annual distribution requirements applicable to RICs and avoiding Fund-level U.S. federal income and/or excise taxes. Accordingly, the Fund may be required to sell assets, including at potentially disadvantageous times or prices, raise additional debt or equity capital, make taxable distributions of Fund Shares or debt securities, or reduce new investments, to obtain the cash needed to make these income distributions. If the Fund liquidates assets to raise cash, the Fund may realize gain or loss on such liquidations. In the event the Fund realizes net capital gains from such liquidation transactions, the Company and, ultimately, Shareholders, may receive larger capital gain distributions than it or they would in the absence of such transactions.

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