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Karl Fryzel is Co-Chair of the Firm's Tax Department and a member of the Private Equity & Venture Capital Group. His practice includes all aspects of tax planning for corporations, partnerships, limited liability companies and individuals engaged in business and investment activities. Karl handles the tax aspects of venture capital and private equity financings, corporate and partnership restructurings, mergers and acquisitions, general advice in acquiring, holding and disposing of real estate, the formation of investment funds, executive compensation and preparation of tax disclosure materials in private and public offerings of partnership and corporate securities, including investment partnerships and real estate investment trusts.

Tax Planning When Investing in Distressed Assets

Editor's Note: This is one in a continuing series of Q&As with Locke Lord lawyers on key legal issues confronting companies engaged in industries that have national and global impact.

Can private equity firms unwittingly trigger a tax when they invest in distressed assets?

A: All taxpayers, including private equity firms, can trigger a tax when investing in distressed assets. This can occur when a taxpayer acquires distressed debt and also owns some equity in the debtor, or is considered a related party of the debtor under tax law rules, even if these relationships do not exist on the date the distressed debt is acquired. A tax can be triggered in other situations, such as when the debt acquired is subsequently restructured which under tax law rules can be considered a constructive sale of the acquired debt instrument. There are several other collateral tax consequences to a borrower as well when a private equity firm acquires distressed assets that may trigger adverse tax consequences by triggering limitations on the borrower's use of its own favorable tax assets, for example, NOLs.

The IRS recently issued proposed regulations addressing master limited partnership (MLP) qualifying income under Section 7704(d)(1)(E) of the Internal Revenue Code. How could these proposed regulations affect investment in the oil and gas industry?

A: These proposed regulations have had a mixed reaction so far in the market. The stock prices of some MLPs have dropped by 25%. Some MLPs have indicated that they may have to end their business operations if the proposed regulations are finalized in their current form, for example, MLPs engaged in producing ethylene from natural gas. The National Association of Publicly Traded Partnerships has indicated that the vast majority of the MLPs in the oil and gas industry are not adversely affected. In any event, there is a 10-year transition period for MLPs adversely affected if they had received a prior private letter ruling from the IRS or have taken a reasonable position under applicable law that they qualified for tax-free MLP status.

Why is tax planning important when an investment firm is looking to do deals in a distressed environment?

A: Tax planning is always important in making investments in a distressed industry environment. The tax laws governing equity and debt investments vary depending on whether the investment is made in a corporation or a partnership or limited liability company. The tax law rules vary also depending on whether a debt or equity restructuring takes place in the context of a bankruptcy plan of reorganization or whether the restructuring of the debt occurs outside of any bankruptcy proceeding. Further, the tax results to the creditor and debtor change if a foreclosure occurs. Thus, as is normally the case in any business transaction, the tax laws are complex when debt and equity restructurings occur, especially when the business is having financial difficulties. Timely tax planning can avoid or mitigate any potential adverse tax consequences. Lastly, any management incentive plans need to be evaluated to be sure that they still can provide an incentive to reverse the company's financial performance without triggering any tax on the revised incentive arrangements.