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Skadden

Oil Price War and Challenging Debt Markets

Coronavirus/COVID-19 Update

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Oil Price War and Challenging Debt Markets: Tax Risks and Strategies for Upstream and Midstream Companies

Introduction

Many upstream and midstream companies are grappling with the prospect of severe liquidity constraints due to the rapid deterioration of both the commodity markets and the debt capital markets. While upstream companies have borne the most immediate effects of the deterioration in these two markets, we have begun to see midstream companies reevaluate their capital structures in anticipation of declines in throughput volumes due to massive reductions in drilling activities and potential shut-ins of producing wells.

While the 2008 crisis is still fresh in the minds of a number of a market participants, tax law developments during the post-crisis years will require participants to think differently about capital structure modifications, particularly developments involving the modification of outstanding debt. In some cases, participants will be able to take advantage of strategies that did not exist during the 2008 crisis, while in other cases strategies that were effective in dealing with the 2008 crisis either are no longer available or do not function in the same way.

This mailer summarizes some of the key tax issues facing upstream and midstream companies that are reevaluating their capital structures and provides insight into how certain post-2008 developments in the tax law can be expected to affect their approaches to capital structure management.

Debt Modifications and Workouts

- Any time the terms of an outstanding debt instrument undergo modification, the tax treatment of the modification must be carefully analyzed. Most upstream and midstream assets are operated at one level or another in "pass-through" form — *i.e.*, as a partnership or disregarded entity (DRE) for tax purposes. These entities include wholly owned special purpose vehicles formed by a corporation or fund to hold assets, as well as joint ventures. Among other things, the ownership of assets and the incurrence of debt in pass-through entities results in the owners of those entities, rather than the entities themselves, bearing any tax burden attributable to a debt modification. Because debt modifications can produce unexpected tax results, borrowers should bear in mind the following critical considerations: If the principal amount of a debt is written down in connection with a modification, the borrower must report ordinary cancellation of debt income (CODI) even in situations where the debt is nonrecourse

or the interest rate on the modified debt is set at a high enough level to compensate the holder for the loss of principal.

- Surprisingly, under post-crisis regulations addressing the issue price of "traded" instruments, modifications of discounted or distressed debt instruments can result in the recognition of ordinary CODI, even where the principal amount of the debt is unchanged. These rules apply to, among other things, debt instruments for which broker quotations are readily available. The debt of a substantial number of upstream and midstream companies is trading at a significant discount to par in the secondary market. These entities must approach any debt modification with extreme caution, as the phantom CODI recognized in connection with a debt modification can produce an immediate tax liability that results in significant liquidity concerns at the owner level.
- The recognition of phantom CODI in connection with a debt modification might be more understandable if the CODI could be fully offset by net operating loss (NOL) carryforwards or future interest deductions in situations where the modified debt is repaid at par. Under the 2017 Tax Cuts and Jobs Act (TCJA), however, a borrower's ability to use NOLs and interest deductions to reduce taxable income is extremely limited. In addition, certain other provisions can deny altogether interest deductions on certain traded debt instruments that have been modified. The result here — phantom income at the time of a debt modification coupled with the denial of offsetting deductions — is particularly difficult for owners of distressed companies to accept. Draft legislation released by the Senate on March 19, 2020, would alleviate the NOL usage issue for NOLs arising in the 2018, 2019 and 2020 taxable years and mitigate to a certain extent the interest deductibility issue. Although these two proposals, if enacted, would take some of the sting out of recognizing phantom CODI as a result of a debt modification that leaves the principal amount of the debt unchanged, borrowers would need to run tax models to determine the extent of any net tax cost to such a modification.
- Borrowers that recognize CODI are allowed to exclude the CODI from income if certain requirements are satisfied. For example, if a borrower is insolvent or in bankruptcy, the CODI is potentially eligible for exclusion. In the case of a pass-through borrower, however, the CODI exclusions apply at the owner level. If the owner of the borrower is itself a pass-through entity, then the CODI exclusion provisions apply up the chain to a person or entity (*e.g.*, an individual, S-corporation, or C-corporation) that is treated as a taxpayer for this purpose. As a result, a solvent and nonbankrupt owner of an insolvent or bankrupt pass-through borrower must recognize and pay immediate tax on CODI if the borrower's debts are written down or deemed to have been written down as the result of a debt modification. This rule can pose significant challenges to funds and master limited partnerships (MLPs), whose owners are typically averse to the recognition of significant amounts of phantom income. Borrowers in this situation can consider converting from pass-through to corporate status in order to isolate CODI at the corporate level. A few midstream companies utilized this strategy during the last business cycle. Converting into a taxable corporation can itself trigger a tax liability for investors, though potentially a smaller liability than if the investors recognize CODI. Careful tax modeling is critical.
- A borrower wishing to modify its debt without triggering CODI can do so through a modification that satisfies one of the safe harbors set out in the regulations. These safe harbors include, among other options, modifications of financial covenants, forbearance agreements and modifications that do not change the yield of the instrument by more than 25 basis points. If these routes are unavailable, borrowers can consider one or more of the strategies outlined below.

Strategies for Midstream Companies

Depending on their circumstances, certain midstream companies may be in a unique position to raise capital through sale/leaseback transactions.

For this type of transaction in particular, real estate investment trust (REIT) investors may prove to be a potent source of capital in light of post-crisis regulations that confirm that midstream assets such as pipelines and storage tanks qualify as real estate that can be owned by a REIT. REITs are popular among both public and private yield-seeking investors. A key feature of the REIT regime is that a REIT is not subject to tax on income distributed to shareholders, while shareholders such as tax-exempt organizations and sovereign wealth funds are eligible to receive REIT dividends on a tax-free basis. These features generally result in REITs enjoying a lower cost of capital in comparison to other investment vehicles, a feature that can provide a pricing benefit to a midstream company that transfers assets to a REIT in a sale/leaseback transaction.

In situations where a midstream company does not want to fully relinquish control of its assets in a sale/leaseback, the parties can use a JV/leaseback structure or JV/opco structure whereby the midstream company would contribute assets to a joint venture while a REIT or another capital provider would contribute cash in order to address capital needs. The assets could be leased back to the midstream company or operated within the JV structure. In either case, the midstream company would be eligible for

roll-over treatment on its contribution and could control the joint venture through a general partner or managing member interest. This approach works best with assets that have built-in gain (*i.e.*, are not underwater).

Strategies for Upstream Companies

Upstream companies can contribute leveraged assets to joint venture structures just as midstream companies can. Putting upstream assets inside a REIT vehicle, however, is challenging, which may negatively influence the number of interested investors and/or the prices they are willing to pay for the assets.

Alternatively, certain upstream companies may consider raising capital through sales of volumetric production payments (VPPs) to REIT investors. If properly structured, a VPP is treated as a real estate mortgage, which is an eligible asset for a REIT. Careful structuring of the VPP should be used in order to prevent the underlying cashflows from being included in the bankruptcy estate of the VPP issuer. This strategy can prove helpful in situations where the sale of a VPP provides sufficient liquidity to obviate the need for a debt modification or workout.

Conclusion

The ideas outlined above provide a thumbnail sketch of the tax issues faced by distressed companies and the strategies they can use to manage those issues. As with everything in the tax law, the devil is in the details, and some of these strategies will work better than others depending on each borrower's situation.

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