

Private Equity and Hedge Fund Corner

By *Thomas C. Lenz and Joseph Bergthold*

Do Private Equity Fund Loans to Troubled Portfolio Companies Really Require Matching of Interest Income and Expense?



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Recent volatility in the credit markets and the downturn in the economy have both lenders and borrowers questioning the tax treatment of interest accruals on troubled debt. In this column, we will discuss when interest income is recognized by the lender, the deductibility of interest expense by the borrower, and the tax treatment of interest accruals when a related-party relationship exists.

Let's set the scenario for discussion throughout the column (see figure 1):

Private Equity Fund A, LP (the "Fund") owns a capital and profits interest in Portfolio Company, LLC (the "LLC"). The Fund also makes a subordinated loan to the LLC. The downturn in the economy has greatly impacted the business of the LLC. As a result, the LLC is in financial distress

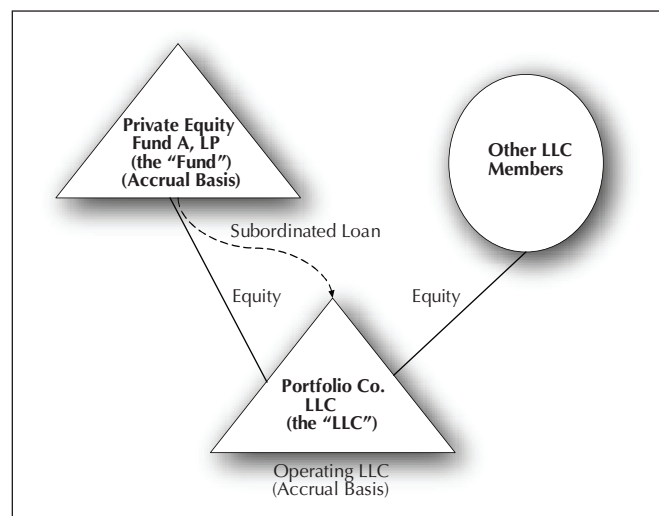


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Figure 1. Baseline Scenario



and ceases to make interest or principal payments on the debt. As the financial condition of the LLC continues to worsen, its ability to ever pay the interest becomes increasingly doubtful. The financial condition of the LLC may also worsen to the point of insolvency or bankruptcy. Let's also assume a related-party relationship exists between the Fund and the LLC.

General Rules for Permissible Methods of Accounting

The accrual and cash methods of accounting are authorized as permissible methods of accounting. Taxpayers may use different methods of accounting for different trades or businesses²; however, the cash method of accounting is prohibited for any partnership whereby more than thirty-five percent of the losses are allocable to limited partners or limited entrepreneurs.³ It is for this reason that most private equity funds use the accrual method of accounting.

Under the accrual method of accounting, the timing of the recognition of an item of income or expense generally coincides with the economic activity that triggers the event, rather than simply the related cash transfer. This method was created to enable taxpayers to organize their books and prepare their returns according to, "scientific accounting principles, by charging against income earned during the tax period, the expenses incurred in and properly attributable to the process of earning income during that period," as referenced in *P.C. Anderson*.⁴ Reg. §1.451-1 states that under the accrual method, income is includable in gross income when all the events have occurred which fix the right to receive such income, and the amount thereof can be determined with reasonable accuracy. The regulations further state that a deduction may be taken in a tax year when all the events have occurred that establish the fact of the liability, the amount of the liability can be determined with reasonable accuracy, and economic performance has occurred with respect to the liability.

A taxpayer who elects to use the cash method of accounting will recognize income upon receipt or constructive receipt, and deduct expenses as they

are paid.⁵ This method recognizes only the tangible flow of currency.

The general rule under Reg. §1.446-2 states that interest expense will be accounted for under the taxpayer's method of accounting. Under the accrual method, a deduction for interest expense is appropriate in the year in which the interest expense is accrued. Conversely, a taxpayer using the cash method is permitted an interest expense deduction in the tax year the interest expense is paid.⁶

Discussion of the Taxability of Interest Income on Nonperforming Debt

As previously discussed, an accrual method taxpayer, pursuant to Reg. §1.451-1, includes an income item in gross income when all of the events have occurred which fix the right to receive such income and the amount thereof can be determined with reasonable accuracy. In other words, an accrual method taxpayer recognizes interest income as it is earned over the life of a loan.

So what happens when the borrower becomes financially distressed and begins to fall behind on the interest payments? What if its financial condition worsens to the point whereby payment on the unpaid accrued interest becomes increasingly doubtful? What happens if the borrower enters into bankruptcy? How is the interest income accrual treated in each of these scenarios? All of these questions are quite common, given today's downturn in the market. Several cases address these issues and provide taxpayers and practitioners guidance on how to address these questions.

In *Corn Exchange Bank*,⁷ loans were made to the Brooklyn Rapid Transit Corporation, and the interest income on the loans was accrued under the accrual method of accounting. Brooklyn Rapid Transit Corporation went into receivership on December 31, 1918, and notified the lender of this fact at the close of business that day. The lender argued it was improper to accrue interest income for the year, based on the reasoning that the obligation of the corporation was in the receiver's control and they did not expect

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to receive the interest payments on the obligation. Agreeing with the lender that under these conditions it is unlikely the lender would receive the payment of the interest income, the court introduced the concept of “reasonable expectancy:”

When a tax is lawfully imposed on income not actually received, it is upon the basis of a reasonable expectancy of its receipt, but a taxpayer should not be required to pay a tax when it is reasonably certain that such alleged accrued income will not be received and when, in point of fact, it never was received. A taxpayer, even though keeping his books upon an accrual basis, should not be required to pay a tax on an accrued income unless it is good and collectable, and, where it is of doubtful collectability or it is reasonably certain it will not be collected, it would be an injustice to the taxpayer to insist upon taxation.

In a later case, *Jones Lumber Co.*,⁸ citing *Corn Exchange Bank*, the court required the accrual method taxpayer to include accrued interest income into gross income, reasoning that the taxpayer failed to prove a reasonable doubt as to the collectability of the notes. The court stated there must be a definite showing that the insolvency of the debtor makes the receipt improbable.

Building further on the “definite showing” concept from *Jones Lumber Co.*, *Koehring Co.*⁹ stated the lender must provide evidence relating to permanent uncollectibility to demonstrate “definite showing.” In this case, the court held that the accrual method taxpayer should continue to accrue interest income despite the financial condition of the borrower, because evidence was lacking to suggest permanent uncollectibility. The court reasoned the taxpayer believed the financial condition of the borrower to be only temporary; therefore, the borrower eventually would have means to make payment.

The “no reasonable expectancy of payment” exception to the fundamental rules of income accrual was applied in *European Am. Bank & Trust Co.*¹⁰ In this case, the court stated, “For accrual of income to be prevented, uncertainty as to collection must be substantial.”

The IRS later asserted its position on the issue in Rev. Rul. 80-361.¹¹ The IRS noted that the lender should accrue interest up to the point where it became clear the lender is unlikely to be paid, and could cease accruing interest from that point on. The

IRS also stated that if the interest accrued becomes subsequently uncollectible because of the borrower’s financial condition, the lender would be entitled to a bad debt deduction. This reasoning by the IRS is supported in cases: *Spring City Foundry Co.*¹² and *Atlantic Coast Line R.R. Co.*¹³

In summary, IRS guidance and case law provide a framework, which suggests that in order to treat an item as nonaccrual because of doubtful collectability, evidence as to the financial instability or insolvency of the borrower must be substantial and permanent in nature. As shown in the cases, temporary financial difficulty by the borrower will not support a position for the nonaccrual status of interest income. The IRS states that a taxpayer must continue to accrue interest income up to the point where it is clear payment will not be received, and for the period prior to this point, for the unpaid accrued interest that lender deems uncollectible, the lender is entitled to a bad debt deduction.

Discussion of the Deductibility of Interest Expense by the Borrower

When can a borrower deduct interest accrued or paid? As stated earlier, general rules allow a borrower to deduct interest accrued or paid under Code Sec. 163(a) and such interest is deductible for an accrual-method taxpayer in the year in which all events have occurred which establish the fact of a liability, the amount can be determined with reasonable accuracy, and economic performance has occurred.¹⁴ Economic performance generally occurs with the passage of time with regards to interest expense.¹⁵ But what happens when the borrower is in financial distress and cannot make the interest payments to the lender? Is the borrower permitted to accrue and deduct the interest expense?

Rev. Rul. 70-367 permits the accrual and corresponding deduction of interest expense despite the financial condition of the borrower and the fact that there is no reasonable expectancy the borrower will pay the accrued interest in full.¹⁶

The Eighth Circuit Court of Appeals, in *Zimmerman Steel Co.*,¹⁷ allowed an accrual method taxpayer a deduction on the accrual of interest on debt for stated interest even though there was no reasonable expectation that the accrued interest would actually be paid.

In contrast to Rev. Rul. 70-367 and the *Zimmerman* decision, the courts denied deductions in *Continental Vending Machine Corp.*¹⁸ and *West Texas Marketing.*¹⁹ The courts determined in these cases that the taxpayer, who was in bankruptcy, was not permitted an interest expense deduction for post-petition debt that had accrued after the taxpayer had entered into bankruptcy when the taxpayer did not have sufficient assets to pay the interest payments on the debt. The courts reasoned the departure from Rev. Rul. 70-367 was due to the manner in which the liability for post-petition interest accrues under bankruptcy laws, and that the liability was not fixed until there was a confirmed plan of liquidation and sufficient assets to distribute under that plan.

In *Dow Corning Corp.*,²⁰ the court allowed Dow Corning, in bankruptcy, to take deductions attributable to post-petition interest expense on its pre-petition bank debt and capital loans. The court also commented on *Continental Vending* and *West Texas Marketing* and determined these cases were wrongly decided.

The IRS affirmed its position with the release of CCA 200801039.²¹ The IRS concluded in the CCA that the taxpayer, a corporation, may treat a pre-petition liability for interest expense on contractual borrowings to a subsidiary as incurred and deductible until the resolution of the bankruptcy proceeding, in this case, through confirmation of the plan of reorganization.

Based upon the IRS guidance and case law, it appears that an insolvent or even bankrupt borrower is permitted a deduction despite the uncertainty that it actually will be able to pay the amounts.

How Does the Existence of a Related-Party Relationship Affect the Tax Treatment to the Fund and the LLC?

How should the interest accrual by the lender and borrower be accounted for when a related-party relationship exists? There is a rule, otherwise known as the “matching rule,” which generally requires the deduction of an expense item to follow the income recognition in the same tax year. A related-party relationship exists if the parties have a relationship described in Code Sec. 267(b). In the case of an LLC owned by a partnership (such as the Fund), a related-party relationship exists for purposes of the matching rule.²² The section further

states that a deduction shall be allowable in the tax year when the item is includible in the gross income of the recipient.²³ Accordingly, an accrual method taxpayer is not allowed a deduction for transactions involving outlays to a related-party cash method taxpayer until the payment is made. The purpose for the matching rules under Code Sec. 267 is to prevent a taxpayer from exploiting the difference between accounting methods of the payor and the payee and, therefore, receiving unwarranted tax benefits.

The regulations provide additional guidance with respect to the treatment of unpaid expenses and interest by parties who are deemed to be related. The regulations state that an accrual method taxpayer would not be permitted a deduction for interest expense, which would otherwise be deductible under Code Sec. 163, if the payee is on the cash method of accounting and would not be required to include the interest in income until actual receipt of the interest payment from the payor.²⁴ Presumably, if both the payee and payor were on the same method of accounting, the limitation under Code Sec. 267 would not apply.

Application of Rules to Base Scenario

In evaluating the fact pattern mentioned at the beginning of the column, the Fund, assuming it has elected to be an accrual method taxpayer, would be required to accrue interest income under the general rules of the accrual method of accounting; however, if the LLC becomes financially distressed and the circumstances should suggest the dire financial condition of the LLC to be permanent in nature, one could then argue for nonaccrual status of the interest income. Additionally, with respect to the unpaid accrued interest income on the books of the Fund, which it deems uncollectible, the Fund may be entitled to a bad debt deduction.

Assuming that the LLC elected to be treated as an accrual method taxpayer, it would be permitted an interest expense deduction under the general rules. In the event the LLC becomes financially distressed, case law and IRS guidance support the ability of the LLC to accrue and deduct the interest expense despite its financial condition.

Now assume that a related party relationship exists between the Fund and the LLC. If the Fund uses the cash basis method of accounting, the applica-

tion of the matching rule is clear: the Fund would recognize the interest income as payments are received or constructively received as provided for under the regulations. The LLC, however, would be required to forestall its interest expense deduction until the interest income is required to be included into gross income by the Fund, thus forcing the LLC to a cash basis method of accounting with respect to the interest expense accrual. But what happens when the Fund is on the accrual method? Upon a closer reading of the statute, the application of the matching rule is not as evident as may appear when distressed debt is involved and both payor and payee are accrual method taxpayers. The statute provides:

by reason of the method of accounting of the person to whom the payment is to be made, the amount thereof is not includible, unless paid, in the gross income of such person...

So how does the matching rule work when distressed debt is involved? When the Fund puts the loan on non-accrual status, the question is: Is the Fund not recording the interest income “by reason of their method of accounting” or in other words, because they are on the cash method of accounting? It would appear the answer is no. The Fund is not recording the interest income because it put the loan on non-accrual status, not because it is on the cash basis. Accordingly, it would appear there may be a basis for the LLC to continue to accrue the interest expense, and need not apply the matching rule. As a result, the Fund may be able to indirectly deduct its share of the interest expense accrued by the LLC, yet exclude the interest income on the same loan. This treatment may result in unintended tax consequences, and guidance from the IRS in this area would be helpful. In addition, Funds will need to work closely with their portfolio companies to ensure proper accounting for this interest.

ENDNOTES

- ¹ Additional assistance was provided by Kristen Slusarczyk and Erin Ferman.
- ² Code Sec. 446(d).
- ³ Code Secs. 448(a)(3), 461(i)(3)(B) and 1256(e)(3)(B).
- ⁴ *P.C. Anderson (Yale & Towne Mfg. Co.)*, SCt, 1 ustr ¶ 155, 269 US 422, 46 SCt 131 (1926).
- ⁵ Reg. §1.451-1 and §1.461-1.
- ⁶ Reg. §1.461-1 and Code Sec. 163(a).
- ⁷ *Corn Exchange Bank*, CA-2, 2 ustr ¶ 455, 37 F2d 34.
- ⁸ *Jones Lumber Co.*, CA-6, 69-1 ustr ¶ 9113, 404 F2d 764.
- ⁹ *Koehring Co.*, CtCls, 70-1 ustr ¶ 9242, 190 CtCls 898, 421 F2d 715.
- ¹⁰ *European American Bank and Trust Co.*, ClsCt, 90-2 ustr ¶ 50,333, 20 ClsCt 594 at 605.
- ¹¹ Rev. Rul. 80-361, 1980-2 CB 164.
- ¹² *Spring City Foundry Co.*, SCt, 4 ustr ¶ 1276, 292 US 182, 54 SCt 644 (1934).
- ¹³ *Atlantic Coast Line R.R. Co.*, BTA, 31 BTA 730, 751 (1934) acq. XIV-2 CB 2 (1935).
- ¹⁴ Reg. §1.461-(a)(2).
- ¹⁵ Reg. §1.461-4(e).
- ¹⁶ Rev. Rul. 70-367, 1970-2 CB 37.
- ¹⁷ *Zimmerman Steel Co.*, CA-8, 42-2 ustr ¶ 9697, 130 F2d 1011.
- ¹⁸ *Continental Vending Machine Corp.*, DC N.Y., 77-1 ustr ¶ 9121 (1976).
- ¹⁹ *West Texas Marketing Corp.*, CA-5, 95-1 ustr ¶ 50,296, 54 F3d 1194.
- ²⁰ *Dow Corning Corp.*, BC-DC Mich., 2002-1 ustr ¶ 50,155, 270 BR 393.
- ²¹ CCA 200801039, September 24, 2007.
- ²² Code Sec. 267(e)(1)(b).
- ²³ Code Sec. 267(a)(2).
- ²⁴ Reg. §1.267(a)-1.

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