

Premium Debt Swaps: The Best of Both Worlds?

Andrew Kalotay and Leslie Abreo

Andrew J. Kalotay is President and Leslie A. Abreo is Senior Financial Analyst at Andrew Kalotay Associates.

In a recent transaction, a corporation offered to exchange an outstanding issue selling at a premium for a new issue of somewhat longer maturity and slightly higher market value. Why would an issuer offer such a deal? This paper examines the transaction and explains its motivation, which is based on accounting and tax considerations. In addition, the paper provides an historical perspective on debt exchanges and describes the sequence of innovations and the resulting legislative responses that led up to this transaction.

■ January 1998 saw the introduction of a new type of debt-for-debt exchange—par-for-par swaps involving bonds selling at a substantial premium. Using this approach, two major transactions took place: the \$700 million United Parcel Service 8 3/8's of 2020 and the \$200 million Freddie Mac 8 1/4's of 2016. Then, in February, Banc One made an exchange offer for its 9 7/8's of 2009, a \$200 million issue. These transactions represent a new trend in debt management.

The challenge of effective corporate debt management lies in the complex interaction of cash flow and accounting considerations. It is often the case that when a transaction is desirable from an accounting perspective, the tax treatment tends to be unfavorable. On the other hand, when the cash flows are attractive, the accounting may be unpalatable. The retirement of outstanding debt stands as a case in point.

During periods of low interest rates, the repurchase of debt selling at a premium tends to have a positive net present value. However, the premium paid over face value must be recognized as an immediate loss for accounting purposes. The accounting impact can be substantial—repurchasing \$100 million face value of bonds at a price of 105, for instance, results in a \$5 million reduction in pretax earnings. Bearing in mind that the compensation of top management is often tied to the corporation's earnings, it is not hard to

understand why high-coupon bonds callable at a premium are sometimes left outstanding far beyond when they should be redeemed.

On the other hand, when interest rates are relatively high, the repurchase of discounted debt prior to maturity may seem attractive, but only until one realizes that the associated gain is taxable. For example, if the corporation's marginal tax rate is 40%, the after-tax cost of repurchasing a bond at a price of 60 turns out to be 76.

So, the debt-refunding challenge is two-pronged. If the cash flows are desirable, how should the transaction be structured so that its accounting is acceptable? Or, if the accounting is desirable, how should the tax burden be alleviated?

In major investment banks where innovation is the driving force behind business development, debt management has been fertile ground for new ideas in the last several decades. Teams of financial analysts, tax attorneys, and accountants spend long hours working on such problems. Although the novel financial structures and transactions emanating from such efforts cannot be patented, the payoff in fees and prestige is often substantial.

Not surprisingly, the Financial Accounting Standards Board and, more so, the Internal Revenue Service tend to be on the opposing side of these creatively

structured transactions. Consequently, innovation by investment banks is often followed in quick succession by changes in accounting practices or tax regulations.

I. A Brief History of Debt Swaps

Although the type of debt exchange under discussion involves bonds selling at a premium, it is important to appreciate that the events leading up to it involved discount, rather than premium, bonds. During periods of high interest rates, as was the case in 1981 when long Treasuries hovered around 15%, the issuers naturally considered repurchasing/extinguishing obligations at deep discounts. But, as mentioned earlier, even if such repurchases would boost earnings, the immediate taxation of the resulting gain would make them prohibitively expensive.

On the other hand, if taxation of the gain could be avoided, extinguishing discounted debt would be desirable from both a cash flow and an accounting perspective (see Kalotay, 1978). In 1981, this was accomplished in large volumes through equity-for-debt swaps. Equity-for-debt swaps were treated as nontaxable recapitalizations, until the Tax Reform Act of 1984 made such exchanges taxable (see Finnerty, 1987).

Par-for-par debt swaps, on the other hand, remained nontaxable until the 1990 Omnibus Budget Reconciliation Act, which was motivated by some sizable swaps earlier that year (see Kalotay and Tuckman, 1992). So, par-for-par swaps no longer make sense for discount debt, but, as we shall see, from a tax angle they are fine for premium debt.

II. The UPS Premium Debt Swap

The UPS exchange, which we will use as an illustrative example in this paper, fits this criterion. It is a par-for-par swap for option-free debt that was selling at a substantial premium. The maturity of the new debentures is somewhat longer than that of the outstanding ones, and, in order to be acceptable to investors, their value is marginally higher.

In January 1998, the estimated value of the UPS 8 3/8's of 2020 was 123.76%. The debentures offered in exchange have a 2030 maturity, their coupon remains 8 3/8% until 2020, and from 2020 until maturity it will step down to 7.62%. Because this "extension coupon" is still above the forward ten-year rate as of 2020, the value of the new bonds at the time of the exchange was about a point higher, or 124.77%.

From the investor's perspective, the transaction is straightforward. The investor receives a new bond whose value is approximately one point higher than the outstanding one. If the investor is a non-taxable institution, such as a pension fund, tax considerations

are not relevant. But some taxable bonds may be held by tax-paying insurance companies. In any case, according to the UPS prospectus, under current tax treatment, a par-for-par debt exchange is not a taxable event for the investor.

The accounting treatment depends on the relevant statutory requirements. If the investor's portfolio is marked to market, it shows a modest gain. Otherwise, the exchange will have no immediate accounting consequences. Given that, it is hard to see why an investor would not participate in the exchange and enjoy an essentially riskless increase in value. Should the marginally longer duration of the new bond be unacceptable, the investor can readily rebalance the portfolio after realizing the gain.

III. The Issuer's Perspective on High-Coupon Debt Repurchase

From the corporation's vantage point, the transaction is considerably more complicated—but the potential benefit is significantly greater. Before turning to the specifics of a par-for-par swap, let us review the pros and cons of a traditional cash redemption or repurchase of debt selling at a premium.

As is probably clear by now, a call at a premium is usually a "good-news/bad-news" event. The good news is that the transaction may lead to significant cash flow savings. The bad news is that the premium over tax basis is immediately reported as an expense. So, an issuer calling bonds of \$100 million face value at 104 would have to report a \$4 million expense.

Public utilities are a special case. In order to mitigate the accounting problem, regulatory commissions allow them to amortize the premium over the stated life of the outstanding issue or the replacement issue. And for utilities, statutory reporting is governed by regulatory reporting.

From a tax perspective, the call/repurchase premium is expensed immediately. While this enhances the economics, the calling of bonds, in essence, is not a tax-driven transaction. In contrast, repurchasing an option-free high-coupon bond, at a fair price, can be beneficial only on an after-tax basis. But, unfortunately, the resulting reduction in earnings would be unacceptable to many companies. For example, if UPS repurchased all \$700 million of its 8 3/8's at a price of 123.76, it would have to report an expense amounting to approximately \$166 million.

IV. The Issuer's Perspective on Par-for-Par Debt Exchanges

This neatly brings us to the UPS debt-for-debt swap. As it turns out, this swap combines the best

Table 1. After-Tax Economics of the UPS Transaction

Base Case: Do Nothing	
(1) After-tax cost of outstanding bond	117.20%
Alternative: Par-for-Par Exchange	
(2) After-tax cost of new bond	123.76%
(3) Less tax savings upon exchange (40% of (124.77 - 100))	<u>9.91%</u>
(4) Net Cost (2) - (3)	113.85%
Net savings on transaction (1) - (4)	3.35%

of two worlds: both the accounting *and* tax treatments are favorable.

From an accounting perspective, there is no loss, because the exchange is for the same principal amount as the outstanding issue. But for tax purposes, the exchange is treated as a repurchase, and the excess of the market value of the new bonds over the tax basis of the old bonds is expensed immediately.

The new bonds are treated, for tax purposes, as original issue premium (OIP) bonds. The initial market premium, in the UPS case 24.77%, is amortized over the life of the issue, and the amortized amount is considered to be taxable income. We should add that as of January 1998, the method of amortization has changed from straight-line to constant yield, consistent with the method used for original issue discounts (OIDs). So, under the current tax treatment, at the time of issuance, the after-tax cost of an OIP issue is very close to its market value.

V. Analysis of the UPS Transaction

Let us look at the economics of the UPS transaction on an after-tax basis, assuming a marginal tax rate of 40%. We used the yield curve on the transaction date, 1/21/98, when the ten-year Treasury yield was 5.54%, and the 30-year Treasury yield was 5.84%. In this rate environment, adjusted for the UPS reoffer spreads over Treasuries, the pre-tax value of each bond was 123.76% of face amount. In order to obtain a value of 124.77% for the replacement bond, the "extension" coupon for the period extending from 4/1/20 to 4/1/30 was set to 7.62%.

The generally accepted method of valuing a fixed income security is to discount its cash flows using the one-period forward rates derived from the prevailing

yield curve (see Kalotay, Williams, and Fabozzi, 1993). After-tax present values are obtained by discounting the after-tax cash flows using after-tax forward rates.

Table 1 compares, on an after-tax basis, the UPS par-for-par exchange against the alternative of not acting. The after-tax cost of the outstanding issue is 117.20% of the face amount. The after-tax cash flows, assuming the bond was originally issued at par, consist of after-tax coupon payments, and principal (which is unaffected by taxes). After-tax coupon payments are calculated by reducing the pre-tax payments by the tax savings. In this case, the pre-tax semiannual coupon is half of 8.375% per 100% face. The after-tax figure is 2.5125% per 100% face.

The after-tax cost of the new bond, 123.76% of face amount, is similarly calculated by discounting the after-tax cash flows using after-tax forward rates. Here, the after-tax cash flows consist of: a) after-tax coupon payments (2.5125% per 100% of face semiannually through 4/1/20; 2.286% per 100% face, thereafter, through 4/1/30), b) 40% of the periodic 'constant-yield' amortization amount, and c) principal. After factoring in the tax savings received upon exchange, the net savings on the transaction are 3.35% of the face amount.

VI. Conclusion

Par-for-par exchanges of premium debt allow borrowers to capture the tax benefit of extinguishing premium debt without actually recording the premium as a loss for accounting purposes. In the current, historically low, rate environment, we are likely to see many more transactions of this type. It remains to be seen how the FASB and the IRS will respond to this innovation. ■

References

- Finnerty, J.D., 1987, "Stock for Debt Swaps," *Financial Management* (Autumn), 5-17.
- Kalotay, A.J., 1978, "On the Advanced Refunding of Discounted Debt," *Financial Management* (Summer), 14-18.
- Kalotay, A.J., and B. Tuckman, 1992, "A Tale of Two Bond Swaps," *Journal of Financial Engineering* (December), 325-343.
- Kalotay, A.J., G.O. Williams, and F.J. Fabozzi, 1993, "A Model for Valuing Bonds and Embedded Options," *Financial Analysts Journal* (May/June), 34-46.