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RELIEF FROM INCOME ON DEBT REPURCHASES AND EXCHANGES AT A DISCOUNT UNDER THE AMERICAN RECOVERY AND REINVESTMENT ACT OF 2009

Today, Tuesday, February 17, President Obama will sign into law the *American Recovery and Reinvestment Act of 2009* (the “Stimulus Act”). The Stimulus Act includes a provision allowing companies to defer tax on certain cancellation of debt income (“CODI”) arising in connection with a repurchase or restructuring of existing debt. The Stimulus Act also includes related tax accounting provisions. This memorandum describes the CODI deferral rule and related tax accounting provisions in more detail.

Background

An issuer recognizes CODI with respect to a debt instrument (the “Existing Debt”) when (i) the issuer or a related party purchases the Existing Debt for an amount less than its “adjusted issue price” (see below), including purchases where the consideration is new debt (“New Debt”), stock and/or other property or (ii) there is a modification of the Existing Debt instrument in a manner significant enough to constitute a deemed exchange of the Existing Debt for New Debt for tax

purposes. CODI can also arise when an equity owner contributes debt to the capital of the issuer.

Generally, an issuer recognizes CODI to the extent that the adjusted issue price of the Existing Debt is greater than the cash, the issue price of the New Debt and/or fair market value of other property it or a related party delivers (or in the case of a deemed exchange, is deemed to deliver) in exchange for the Existing Debt. Where debt is contributed to a corporation by a shareholder, CODI

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equals the excess of the adjusted issue price of the contributed debt over the shareholder's tax basis in that debt. The adjusted issue price of Existing Debt is generally the amount paid by the initial purchaser increased by any accrued original issue discount and decreased by any payments other than qualified stated interest payments (i.e., stated interest that is required to be paid at least annually). The issue price of New Debt issued (or deemed issued) in exchange for Existing Debt is generally the fair market value of the New Debt if the New Debt or Existing Debt is treated as traded on an established market within the meaning of the tax law, or the face amount of the New Debt if neither the New Debt nor the Existing Debt is so traded and the New Debt provides for adequate stated interest.

Prior to enactment of the Stimulus Act, a taxpayer that was neither in bankruptcy nor insolvent at the time it recognized CODI would be required to include CODI in taxable income for the year in which the events giving rise to the CODI occurred. A taxpayer that is in bankruptcy or insolvent at the time it recognizes CODI can exclude the CODI from taxable income (in the case of an insolvent taxpayer, only up to the amount of the taxpayer's insolvency) but must reduce certain tax attributes (including net operating loss carryforwards, general business credit carryforwards and tax basis in assets) by the amount of the CODI that is excluded from income.

Changes under the Stimulus Act

CODI Deferral - Section 1231 of the Stimulus Act generally allows a taxpayer that recognizes CODI in 2009 or 2010 to elect to defer including the CODI in taxable income. The election to defer CODI is made separately for each debt issuance, allowing a taxpayer to make the election for some but not all issuances. CODI deferred pursuant to this election must be included in the gross income of the taxpayer ratably over the five taxable years beginning with the fifth taxable year following the taxable year in which the CODI arises if the CODI event occurs in 2009,

or the fourth taxable year following the taxable year in which the CODI arises if the CODI event occurs in 2010. Any deferred CODI that has not been taken into income is included in taxable income at the time the taxpayer ceases operating, liquidates or sells all of its assets. A taxpayer that elects to apply the Stimulus Act's deferral rules with respect to CODI from a particular debt issue cannot make use of the bankruptcy or insolvency exception with respect to that debt issue.

Example 1: On April 1, 2009, X, a calendar year taxpayer, purchases for \$60 cash its own existing debt with an adjusted issue price of \$100. The \$40 difference between the cancelled debt's adjusted issue price (\$100) and the cash purchase price is CODI for X. If X elects under the Stimulus Act to defer the \$40 of CODI, X will include the CODI in taxable income \$8 per year for each year from 2014 through 2018.

Example 2: Assume the same facts as Example 1 except that instead of purchasing its debt for cash, X issues a new note with a \$75 stated principal amount and 10% interest payable annually in cash, in full satisfaction of its \$100 of existing debt. Further assume that the \$100 of existing debt is traded on an established market within the meaning of the tax law and it has a fair market value of \$60. X recognizes the same \$40 of CODI which it can elect to defer until 2014 and then include in income ratably from 2014 through 2018.

Deferral of OID Deductions - In a debt-for-debt exchange (including a deemed exchange resulting from a modification of existing debt), if the stated redemption price at maturity¹ of the New Debt is greater than its issue price, the difference will be treated as original issue discount (“OID”). The issuer would normally deduct the OID over the life of the debt on a yield to maturity basis. However, the Stimulus Act provides that an issuer electing to defer CODI on retired debt must also defer deductions of OID on New Debt issued for the retired debt up to the amount of the deferred CODI. This deferred OID is deductible over the same five year period during which the deferred CODI is included in income.

Example 3: Assume the same facts as under Example 2 above. The \$15 difference between the new debt’s \$75 stated redemption price at maturity and its \$60 issue price is OID. If X elects under the Stimulus Act to defer including CODI in income, X will also have to defer deductions attributable to the OID for periods from the April 1, 2009 issuance through December 31, 2013. The issuer will then deduct 1/5 of such OID in each year from 2014 through 2018.

AHYDO Suspension - The Stimulus Act also suspends the “applicable high yield discount obligation” (“AHYDO”) rules in certain situations. As a general rule, the issuer of a debt instrument treated as an AHYDO cannot deduct OID attributable to yield in excess of certain thresholds and remaining OID cannot be deducted until paid. Generally, a debt instrument issued by a corporation is treated as an AHYDO if it has a term exceeding

five years, significant original issue discount (as defined in the Internal Revenue Code) and a yield that equals or exceeds the applicable federal rate plus 5%. The Stimulus Act provides that the AHYDO rules will not apply to New Debt issued in exchange for Existing Debt of the same issuer if (1) the Existing Debt is not an AHYDO; (2) the New Debt is treated as issued after August 31, 2008 and prior to January 1, 2010; and (3) the New Debt is not issued to a person “related” to the issuer within the meaning of the tax law. The Stimulus Act also gives the Treasury Department the authority to extend this suspension of the AHYDO rules to instruments issued after 2009 and/or to use a rate that is higher than the applicable rate when determining whether a debt instrument to be treated as an applicable high yield discount obligation.

Effect of the Stimulus Act

The above rules greatly facilitate the repurchase or refinancing of outstanding debt that is trading at a significant discount. While CODI deferral under the Stimulus Act does not eliminate taxation of CODI, it provides a lengthy period for taxpayers to pay the associated taxes. For amendments to debt that cause a deemed exchange, the new rules will effectively eliminate the tax on the CODI other than for instruments with a remaining maturity in excess of ten years. There may also be situations where taxpayers eligible for the bankruptcy or insolvency exceptions to the recognition of CODI are better off electing to defer including CODI in income in lieu of reducing its tax attributes. For example, an insolvent or bankrupt taxpayer that projects it will have taxable income that can be offset by tax attributes that must otherwise be reduced by excluded CODI may benefit from electing instead to defer including CODI thereby preserving the benefit of its tax attributes.

¹ The stated redemption price at maturity of a note equals the face amount of the note as long as the note provides for the unconditional payment of interest (other than payment in the form of debt of the issuer) at least annually.

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