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## Stimulus Bill Provides Tax Relief to Encourage Deleveraging

On February 13, 2009, Congress approved the American Recovery and Reinvestment Tax Act of 2009, and the President signed the legislation into law on February 17, 2009. Included in the economic stimulus legislation are tax provisions that modify existing law by providing tax relief to companies that repurchase, exchange or significantly modify their existing debt during 2009 or 2010 by allowing those companies, under certain circumstances, to elect to defer recognizing income arising from those transactions generally until 2014. The deferred income would then be recognized ratably over a five year period. The legislation, however, also includes a corresponding deferral of deductions for original issue discount (OID) accrued with respect to a debt instrument that is issued for the debt instrument being acquired. In addition, the legislation temporarily suspends the limitations on the deduction of OID currently applicable to certain "applicable high yield debt obligations" (AHYDO) if those obligations are issued in certain debt-for-debt exchanges or debt modifications. These new provisions may provide benefits to a variety of taxpayers, including portfolio companies of private equity funds that may be able to deleverage their balance sheets in a more tax efficient manner given the current economic environment. The following briefly summarizes certain provisions of the new rules.

In light of the current and ongoing economic crisis and distress in the debt capital markets, the debt of many companies (including those acquired by private equity funds and other similar investment vehicles) is selling at prices much lower than their adjusted issue prices. These discounts, together with the general desire (if not pressing need) in the current economic climate to deleverage, have presented an attractive opportunity for companies to repurchase, exchange or modify their existing debt at the current discounted levels. As discussed further below, prior tax rules presented obstacles for those looking to capitalize on those opportunities in the past.

### Deferral of COD Income

Prior Law. Under prior law, a company that retired its debt at a discount by engaging in one of the transactions referenced above generally would have been required to recognize the difference between the adjusted issue price of that debt and the price being paid to satisfy the debt as cancellation-of-debt (COD) income for the taxable year in which that debt was retired. Subject to certain exceptions (as in the cases of bankruptcy or insolvency), this recognition of COD income for the taxable year in which the debt was retired generally would have had the effect of creating an immediate tax liability for the issuer, and therefore was an impediment to companies looking to restructure their debt. For example, under prior law, a company with debt

having an adjusted issue price of \$10 million that retired that debt at a cost of \$7.5 million generally would have been required to recognize COD income in the amount of \$2.5 million for the taxable year in which the debt was retired.

New Rules. The new legislation provides generally that a company may elect to defer COD income from the discharge of indebtedness in connection with the “reacquisition” of an “applicable debt instrument” after December 31, 2008 and before January 1, 2011. If deferred, the COD income would be recognized ratably over a five year period starting (i) in the fifth year after the taxable year of the reacquisition for reacquisitions made during 2009, and (ii) in the fourth year after the taxable year of the reacquisition for reacquisitions made during 2010. Using the example above, if the company is a calendar year taxpayer that retired its debt now and elected to defer recognition of the COD income, instead of recognizing \$2.5 million of COD income for the 2009 taxable year, it would be able to recognize that income ratably over a five year period starting in the 2014 taxable year (i.e., \$500,000 for each of years 2014–2018).

In the case of a partnership (including a limited liability company or other entity treated as a partnership for United States federal income tax purposes) that has elected to defer COD income pursuant to the new legislation, the deferred COD income generally will be allocated to the partners in the partnership immediately before the debt reacquisition in the manner in which the partners would have shared such COD income had it not been deferred. Any decrease in a partner’s share of partnership liabilities resulting from the reacquisition will not be taken into account at the time of the reacquisition to the extent it would cause the partner to recognize gain, but will be deferred and taken into account by such partner at the same time, and to the extent remaining in the same amount, as the deferred COD income.

For purposes of the election, an “applicable debt instrument” is defined broadly to include any bond, debenture, note, certificate or any other instrument or contractual arrangement constituting indebtedness issued by a C corporation or any other person (including partnerships, S corporations and other pass-thru entities) in connection with a trade or business of that person.

A “reacquisition” eligible for the election would be an acquisition of an applicable debt instrument by the debtor that issued (or is otherwise the obligor under) the instrument or by a person related to that debtor (such as the debtor’s private equity sponsor), and would include acquisitions of the debt instrument:

- For cash;
- In a debt-for-debt exchange;
- In a deemed exchange arising from a “significant modification” of the existing debt instrument;
- In an exchange for corporate stock or partnership interests;
- By contribution of the debt instrument to capital; or
- By complete forgiveness of the debt.

OID Matters in Debt-for-Debt Exchanges. If a company were to retire its existing debt through a debt-for-debt exchange (including a “significant modification” to existing debt that results in a deemed exchange) or through the use of proceeds from the issuance of new debt, and elected under the new COD provision to defer recognition of the COD income, any OID deductions otherwise allowable on the newly issued debt that are attributable to OID accrued prior to the first taxable year in which the deferred COD income is recognized and that do not exceed the deferred COD income would also be deferred until the time the COD income is recognized, and the aggregate amount of those deferred deductions would be allowed ratably over the same five year period that the related COD income would be recognized.

Acceleration of Recognition for Deferred COD Income and OID Deductions. The recognition of any deferred COD income and related OID deductions would be accelerated and generally taken into account in the taxable year in which the taxpayer (i) dies (as the rules apply to individuals as well), (ii) liquidates or sells substantially all of its assets, (iii) ceases to do business, or (iv) is in similar circumstances. With respect to pass-thru entities, acceleration would also be triggered upon the sale, exchange, or redemption of an ownership interest in the entity by the holder of that interest.

Potential Adverse Effect of COD Income Deferral. Under the new rules, an election to defer COD income is irrevocable and can have significant tax consequences. A company that is

insolvent or in bankruptcy proceedings may exclude COD income (and reduce tax attributes) under the existing tax rules, but if that company elects to defer COD income under the new rules, it will not be able to also exclude COD income. Likewise, if a company makes a deferral election under the new rules, it may not later exclude the deferred COD income under the exclusions generally available in the cases of bankruptcy or insolvency, or for qualified real property business indebtedness or qualified farm indebtedness.

### Temporary Suspension of AHYDO Rules Disallowing Certain Interest Deductions

**Prior Law.** Under prior law, companies that retired their debt through a debt-for-debt exchange (including a “significant modification” to debt that would have resulted in a deemed exchange) where an AHYDO was issued, or deemed to be issued, would have been subject under certain circumstances to the so-called AHYDO rules. Application of these rules would have generally had the effect of deferring and/or disallowing any OID deductions on the AHYDO issued in exchange for the debt that would have otherwise been available, and therefore would have posed another possible impediment to companies looking to restructure their debt. A debt instrument is generally treated as an AHYDO if (i) the maturity date is more than five years from the issue date, (ii) the yield to maturity is greater than the applicable federal rate plus five percentage points, and (iii) the instrument has “significant” OID.

**New Rules.** The new legislation generally suspends the application of the AHYDO rules for AHYDOs issued in a debt-for-debt exchange (including a “significant modification” that results in a deemed exchange) during the period beginning on September 1, 2008 and ending on December 31, 2009, so long as the issuer of the new AHYDO is the same as the issuer of the original debt. The practical effect of the suspension is that the AHYDO rules no longer defer or disallow OID

deductions on new AHYDOs issued in connection with certain debt-for-debt exchanges or debt modifications occurring during the suspension period. The suspension, however, would generally not apply to (i) a new AHYDO issued in exchange for an existing AHYDO, (ii) an AHYDO issued to a related person, or (iii) certain contingent debt. The new legislation includes a clarification that any AHYDO issued during the suspension period and to which the suspension applies would not be treated as an existing AHYDO for purposes of precluding the application of the suspension to newly issued AHYDOs issued in exchange.

**Additional Authority.** The new legislation provides authority for the Treasury Secretary, for periods after December 31, 2009, to extend the suspension of the AHYDO rules and to permit the temporary use of a rate higher than the applicable federal rate for purposes of determining whether a debt instrument is an AHYDO if, in both cases, the Secretary determines it is appropriate in light of distressed conditions in the debt capital markets.

### Purpose

Among the goals of the new legislation is to allow companies to defer the recognition of COD income and claim OID deductions previously unavailable under the AHYDO rules in order to encourage companies to restructure their existing debt and take advantage of the unprecedented discounts at which their debt is trading or selling. As companies restructure their debt, the deleveraging and increased liquidity should make companies better situated to weather the current economic storm, and assist in facilitating a broader economic recovery.

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We will continue to monitor and report on developments in this area. If you have any questions, please call on the Sidley Austin lawyer with whom you have regular contact.

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