# New Economic Stimulus Legislation Provides Important Tax Relief From COD Income

The newly enacted economic stimulus legislation (which was signed into law yesterday by President Obama) provides important temporary tax relief to borrowers that would otherwise have recognized taxable cancellation of debt income ("COD Income") in connection with (1) the amendment of a bank loan, bond or other debt instrument (a "debt instrument"), (2) an exchange offer or (3) the repurchase of a debt instrument at a discount by the borrower or certain persons related to the borrower (such as a majority shareholder). The upfront tax cost of COD Income often prevented such transactions from proceeding (or required the terms of such transactions to be modified so as to avoid COD Income). In many cases, the new legislation eliminates this potential roadblock (or significantly reduces its impact) by allowing a borrower to defer completely the recognition of COD Income for four or five years, and, thereafter, to recognize such income ratably over the following five years. In situations where there has been no reduction in the stated principal amount of the borrower's outstanding debt (such as the typical amendment, or a par-for-par debt-for-debt exchange), the new legislation will, in most cases, eliminate entirely the adverse effect of COD Income.

## I. When Does COD Income Arise?

COD Income generally arises when a borrower repurchases an outstanding debt instrument at a discount to the "adjusted issue price" of the debt instrument. For example, if a borrower repurchases for $70 a debt instrument that was originally issued at $100, $30 of COD Income will result. While this result is not surprising, borrowers and lenders are often surprised to discover that COD Income can also arise in the following situations even though, in some cases, there has been no reduction in the stated principal amount of the borrower's outstanding debt:

***Amendments.*** If there is a "significant modification" of a debt instrument (*e.g.*, a significant change in yield resulting from a change in the stated interest rate and/or the payment of an amendment or consent fee), the borrower will be treated as having repurchased its existing debt instrument for a deemed new debt instrument. If either debt instrument is considered "publicly traded" for tax purposes, the borrower generally will recognize COD Income to the extent that the fair market value of the deemed new debt instrument at the time of the exchange is less than the adjusted issue price of the existing debt instrument (even if there is no reduction in stated principal amount).[1]

***Debt-for-Debt Exchange Offers.*** If the new debt instrument differs significantly from the existing debt instrument and either debt instrument is considered publicly traded for tax purposes, COD Income will result to the extent that the fair market value of the new debt instrument at the time of the exchange is less than the adjusted issue price of the existing debt instrument (even if there is no reduction in the stated principal amount of the borrower's outstanding debt).

***Debt-for-Equity Exchange Offers.*** COD Income will result if the fair market value of equity (stock, partnership interests or limited liability company membership interests) issued in an exchange offer is less than the adjusted issue price of the existing debt instrument (even if the equity has a liquidation preference equal to the stated principal amount of the existing debt instrument).

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1 This point was discussed in more detail in our memorandum "Certain Important Tax Consequences of Amending Debt Instruments," dated January 20, 2009, available at http://www.cahill.com/news/memoranda/000146.

***Purchases of Debt Instruments by Persons Related to the Borrower.*** A purchase of a debt instrument at a discount by certain persons related to the borrower (*e.g.*, a majority shareholder) generally will result in COD Income to the same extent as if the debt instrument were repurchased by the borrower (even if the debt instrument remains outstanding after the purchase).

## II. How Was COD Income Treated Before the New Legislation?

Prior to the enactment of the new legislation, COD Income realized by a U.S. borrower (or a foreign borrower that is a U.S. taxpayer[2]) was currently taxable as ordinary income unless one of the limited exceptions applied (such as where the borrower was a debtor in a bankruptcy proceeding, or to the extent the borrower was insolvent). Where COD Income arose in connection with an amendment, a debt-for-debt exchange offer or the purchase of a debt instrument by a person related to the borrower, and the stated principal amount of the new debt instrument (or deemed new debt instrument) was not less than the stated principal amount of the existing debt instrument, the new debt instrument generally was treated as having been issued with original issue discount ("OID") approximately equal to the amount of the COD Income recognized.[3] This OID generally was deductible over the term of the new debt instrument except to the extent that such deductions were limited by the "AHYDO" rules.[4] Nevertheless, unless a U.S. borrower had sufficient current year tax losses or net operating loss carryovers ("NOLs") to offset the upfront COD Income,[5] the COD Income had a potentially significant cash tax impact in the current taxable year that, at best, was offset over time by subsequent OID deductions. To the extent that the stated principal amount of a borrower's outstanding debt was reduced (such as in a debt-for-equity exchange or a cash repurchase by the borrower), there was simply a permanent upfront tax cost.

## III. How Does the New Legislation Help?

The new legislation allows a borrower that realizes COD Income in 2009 or 2010 to defer the recognition of such income: (1) COD Income realized in calendar year 2009 may be deferred completely for five taxable years, and, thereafter, may be recognized ratably over the next five taxable years (years six through ten) and (2) COD Income realized in calendar year 2010 may be deferred completely for four taxable years and, thereafter, may be recognized ratably over the next five taxable years (years five through nine). Thus, for borrowers who are

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[2] COD Income should not be an impediment to a foreign borrower that is not a U.S. taxpayer unless the tax law of the relevant foreign jurisdiction(s) treats the borrower as recognizing COD Income.

[3] This assumes that the new debt instrument (or deemed new debt instrument) would be respected as debt for U.S. federal income tax purposes. As a technical matter, the Internal Revenue Service (the "IRS") might successfully argue that a new debt instrument in this context should be characterized as equity for tax purposes where the instrument is trading at a significant discount at the time of issuance. While the technical merits of such an argument are uncertain, we believe that the practical risk of the IRS asserting such an argument should be low in this context where the commercial terms of the new debt instrument support debt treatment (and the only factor arguing in favor of equity treatment is the low issue price/high yield of the new debt instrument), except possibly in extreme cases such as where a new debt instrument is trading at distressed levels and it appears likely that the lenders/holders will become stockholders in the near future. If a new debt instrument were treated as equity for U.S. federal income tax purposes, interest payments and OID on such instrument would not be deductible.

[4] Sections 163(e)(5) and 163(i) of the Internal Revenue Code.

[5] A U.S. borrower with NOLs may nevertheless incur some current alternative minimum tax ("AMT") because of limitations on deducting NOLs for AMT purposes.

calendar year taxpayers, COD Income realized in 2009 or 2010 may be recognized ratably from 2014 through 2018.[6]

The new legislation is fairly broad. It generally applies to bank loans, bonds and any other instruments or contractual arrangements constituting indebtedness for U.S. federal income tax purposes. It applies to any debt instrument issued by a "C corporation" or "any other person in connection with the conduct of a trade or business by such person" (such as a partnership or S corporation). It covers COD Income arising from acquisitions of debt by the borrower or certain related persons (1) for cash, (2) in a debt-for-debt exchange (including a deemed debt-for-debt exchange resulting from a significant amendment of an existing debt instrument), (3) in a debt-for-equity exchange or (4) pursuant to a capital contribution.

A borrower that defers COD Income will be required to recognize the COD Income immediately upon the occurrence of certain events, including the borrower's liquidation, the sale of substantially all of the borrower's assets, the cessation of the borrower's business or "similar circumstances."[7] Where any of the foregoing events occurs in a bankruptcy proceeding, the COD Income must be taken into income as of the day immediately before the bankruptcy petition is filed. Any COD Income deferred under the new legislation will be ineligible (in the taxable year in which the COD Income arises and all subsequent taxable years) for the COD exceptions for bankruptcy, insolvency, qualified farm indebtedness and qualified real property business indebtedness.

The new legislation is elective and the election is to be made on an "instrument-by-instrument basis." It is unclear whether the Treasury Department will construe this language as requiring an election to be made on a tranche-by-tranche basis or whether an election will be available with respect to a portion of a tranche. An election is to be made on the borrower's U.S. federal income tax return for the taxable year in which the COD Income arises. Thus, a borrower will have some time after the COD Income arises to assess whether to make the election. Once made, an election is irrevocable.

There are situations where a borrower will prefer not to make the deferral election. For example, a borrower may prefer immediate recognition of COD Income if the borrower has NOLs that are currently available to offset the COD Income but may not be available in future taxable years because the borrower is about to undergo an ownership change[8] or the NOLs are about to expire. In some cases, effecting a transaction through a pre-packaged bankruptcy proceeding may be preferable to making the deferral election.

The relief provided by the new legislation is temporary. Unless extended by subsequent legislation, the new legislation applies only to COD Income arising in 2009 or 2010.

The degree of relief provided by the new legislation will vary from case to case. In situations where there has been no reduction in the stated principal amount of the borrower's outstanding debt (such as the typical amendment, or a par-for-par debt-for-debt exchange), the new legislation will, in many cases, eliminate entirely the adverse effect of COD Income by eliminating entirely the unfavorable timing mismatch between what would

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6 The COD Income provisions of the new legislation generally have no tax effect on lenders/holders of debt instruments.

7 Where COD Income is deferred by a partnership, S corporation or other pass-through entity, a sale, exchange or redemption of an equity interest in such entity shall be treated as an income acceleration event with respect to the owner disposing of such equity interest.

8 Section 382 of the Internal Revenue Code limits a corporation that undergoes an ownership change in using its pre-change NOLs and certain other tax attributes to offset the corporation's taxable income in post-change taxable years.

otherwise have been upfront COD Income and offsetting future OID deductions.[9] In other cases (*e.g.*, where the future OID deductions are deferred until maturity or permanently disallowed under the AHYDO rules),[10] the new legislation will provide a benefit by deferring the tax on the COD Income but will not completely eliminate the adverse tax effect of the COD income. The new legislation also provides relief from the application of the AHYDO rules where a new debt instrument (or deemed new debt instrument) is issued in exchange for an existing debt instrument that was not an AHYDO -- however, this relief applies only to new debt instruments issued between September 1, 2008 and December 31, 2009 (unless the Treasury Department determines that continued application of this AHYDO relief "is appropriate in light of distressed conditions in the debt capital markets") and does not apply to debt instruments issued (or deemed issued) to a person related to the borrower.[11] Thus, this targeted AHYDO relief will not apply where COD Income results from the purchase of a debt instrument by a person related to the borrower.

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If you have any questions about the issues addressed in this memorandum, please do not hesitate to contact the authors or your regular Cahill contacts.



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9 To ensure that borrowers do not enjoy an unfair timing mismatch (*i.e.*, OID deductions on the new debt instrument (or deemed new debt instrument) beginning in year one and no COD Income until year five or six), the new legislation generally defers a borrower's corresponding OID deductions in the first five years until the deferred COD Income becomes taxable.

10 Where the holder of the debt instrument is related to the borrower (*e.g.*, where a person related to the borrower purchase a debt instrument at a discount), the OID deductions may also potentially be deferred or permanently disallowed (in whole or in part) under the "earnings stripping" provisions of Section 163(j) of the Internal Revenue Code or Section 267(a)(3) of the Internal Revenue Code (which may prevent a U.S. taxpayer that pays interest to a related foreign person from deducting such interest until paid in cash).

11 The new legislation also provides that, beginning in 2010, the Treasury Department may, on a temporary basis, determine AHYDO status by reference to an interest rate higher than the "applicable federal rate" if such higher rate is appropriate "in light of distressed conditions in the debt capital markets."