STIMULUS BILL PROVIDES TAX RELIEF FOR COMPANIES THAT DELEVERAGE OR MODIFY OUTSTANDING DEBT

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To Our Clients and Friends:

In recent months, the deep discounts at which bonds and bank debt have been trading and the difficulty of meeting various financial covenants have caused many companies to consider repurchasing, or modifying the terms of, their debt. However, some companies have been deterred by concerns about creating taxable cancellation of debt (COD) income. For example, a typical interest rate bump made in connection with a bank debt covenant waiver could create COD concerns if the debt were to fit the very broad tax definition of "publicly traded" debt.

The tax portion of the Stimulus Bill released today includes provisions which would (if enacted) (i) allow companies that recognize COD income in 2009 and 2010 from the repurchase (or modification) of their outstanding debt to include that income over a five-year period beginning in 2014 and (ii) turn off the so-called "AHYDO" (or "applicable high yield debt obligation") rules in a narrow but important circumstance. As a result, companies will generally be permitted to deleverage (or modify their outstanding publicly traded debt) without triggering immediate taxable income. Under current law, this result generally can be achieved only through filing for bankruptcy or to the extent the company is insolvent (or if the underlying modification is not considered "significant" for tax purposes).

BACKGROUND

Retirement at a Discount. If a company retires its outstanding debt for an amount less than the issue price of the debt, the company generally recognizes COD income equal to the difference. For example, if a company has $100 of debt outstanding and repurchases the debt for $60, the company generally recognizes $40 of COD income at the time of the retirement.

Related Party Purchases. Similarly, if a company has debt outstanding and a person "related" to the company acquires the debt for less than the issue price of the debt, the company is deemed to have COD income equal to the difference between the issue price and purchase price, and the debt is deemed to have been reissued for an amount equal to the purchase price. For example, if a corporation has $100 of debt outstanding and a related person purchases the debt for $60, (i) the corporation has $40 of COD income and (ii) the debt is treated as having been reissued for $60. Since the $60 issue price of the new debt is less than its $100 face amount, the deemed new debt is treated as having $40 of "original issue discount" (OID), which is amortized (as interest deductions for the issuer and interest income for the holder) over the remaining term of the debt. If the remaining term of the debt exceeds five years, the AHYDO rules may severely limit the ability of the corporation to deduct the

OID. In such a case, the corporation is required to recognize the $40 of COD income even though the $40 of corresponding OID deductions are disallowed. If the OID is deductible, the issuer may still have a timing disadvantage: the COD income is includible in the year of the repurchase and may trigger an immediate tax liability, while the benefit of the corresponding amount of OID deductions may be realized only over the course of several years, depending on the remaining term of the debt.

Modifications. If there is a significant modification (*e.g.*, a typical rate increase agreed to in connection with a covenant waiver) of debt that meets the very broad tax definition of "publicly traded" debt (a term of art that can include debt listed on certain quotation media), the debt is deemed to have been satisfied for the trading price and deemed to have been reissued for the same amount. Thus, if a corporation has $100 face amount of publicly traded debt outstanding and a significant modification is made to the debt while it is trading at $60, (i) the corporation has $40 of COD income and (ii) the debt is treated as having been reissued for $60. The same consequences discussed above in "Related Party Purchases" apply. Again, the corporation is required to recognize the $40 of COD income even if the $40 of OID deductions are disallowed.

COD INCOME RELIEF

Under the Stimulus Bill, a company that recognizes COD income in connection with the "reacquisition" of debt after December 31, 2008, and before January 1, 2011, may elect to include the COD income ratably over a five-year period generally beginning in 2014. The term "reacquisition" is defined broadly to include any acquisition of debt by the company or a related person, including an acquisition of the debt for cash, an exchange of the debt for other debt, a deemed exchange of the debt arising from a significant modification of the debt, an exchange of the debt for equity, a contribution of the debt to capital and a forgiveness of debt. Special rules are provided for COD income recognized by a partnership.

AHYDO TURNED OFF IN NARROW CIRCUMSTANCE FOR ONE YEAR

The Stimulus Bill would also generally turn off the AHYDO rules in a narrow but important circumstance. Specifically, the AHYDO rules would not apply to debt issued during the period beginning September 1, 2008 and ending December 31, 2009 in exchange for pre-existing debt (and to debt deemed to have been issued in exchange for pre-existing debt by reason of a "significant modification" of that pre-existing debt) so long as interest deductions on the pre-existing debt are not already limited under the AHYDO rules. However, the AHYDO rules would continue to apply to (i) debt issued for cash or other property (including pre-existing debt the interest on which is already subject to the AHYDO rules), (ii) debt deemed to have been issued by reason of a purchase by a related party, and (iii) certain debt providing for contingent interest.

As noted above, the acquisition of debt by a related person or the modification of publicly-traded debt can result in both COD income to the issuer and the debt being treated as reissued with additional OID. Under the Stimulus Bill, the deduction for any such additional OID is deferred until the five-year period during which the company is required to recognize the COD income. A practical effect of the Stimulus Bill, from the issuer's perspective, of a significant modification of publicly-traded debt is that the COD income will generally be neutralized by offsetting OID deductions, so long as the original debt instrument was not subject to the AHYDO rules and so long as the modification does not reduce the principal amount of the debt. In contrast, the holder of the modified debt will include the OID income as it accrues over the remaining term of the debt even though the issuer is required to defer the corresponding OID deductions.

Please feel free to contact us with any questions.

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