

**Client Alert**

February 17, 2009

**2009 Economic Stimulus Package: Certain Debt Repurchases by Businesses Granted Relief from Tax on Cancellation of Indebtedness Income****Areas of Interest****Tax Transactions****Corporate and Securities****Private Equity****United States**

The economic stimulus package, signed into law on February 17, 2009, grants corporations and businesses that repurchase their debt at a discount a right, under certain circumstances, to elect to defer the recognition of their cancellation of indebtedness (COD) income for up to five years. The provision is intended to help businesses deleverage and restructure their balance sheets. It is also expected to help reduce the amount of distressed and discounted debt held by financial institutions.

Generally, when taxpayers (or certain related parties) repurchase their debt at a discount, they are required to recognize COD income in an amount equal to the difference between the purchase price paid and the debt's principal amount (or in the case of debt issued with original issue discount (OID), its adjusted issue price). Similarly, when a debtor satisfies an outstanding debt by issuing new debt, the debtor will realize COD income to the extent the adjusted issue price of the original debt instrument exceeds the issue price of the "new" debt instrument. Historically, the tax cost of COD income could only be avoided if the taxpayer qualified for an exclusion (e.g., bankruptcy or insolvency) or if the taxpayer had sufficient net operating losses or other losses to offset the COD income.

The stimulus package added Section 108(i) to the Internal Revenue Code, which allows taxpayers to elect to defer COD income for "applicable debt instruments" repurchased in 2009 and 2010 by the taxpayer or a related party. Subject to certain limitations and qualifications, an election will defer COD income for a period of five years for debt instruments repurchased in 2009 and four years for debt instruments repurchased in 2010. Partnerships must allocate the deferred income to the partners when the debt is repurchased; however, the partners are permitted to defer any income or gain from the COD for the four or five year deferral period, as applicable. The term "applicable debt instruments" includes most bonds, debentures, notes or other forms of indebtedness issued by C corporations or other trades or businesses. The repurchase of indebtedness may be effectuated through a repurchase for cash, debt, or stock; a contribution of the debt to capital; or even the complete forgiveness of the debt by the holder.

After the deferral period, the COD income is taken into taxable income ratably over a five year period. However, liquidation, cessation of business, sale of substantially all of the business assets, or bankruptcy will cause an acceleration of the deferred income to the taxable year in which such event occurs. This acceleration rule is expanded for pass-thru entities to include the sale, exchange, or redemption of an ownership interest in the pass-thru entity by an interest holder.

The new provision also limits deductions of OID on debt instruments used to repurchase debt. This OID can arise not only when a debt instrument is issued at a discount to produce the cash proceeds to repurchase the debt, but also when debt is repurchased by the issuance of new debt, is repurchased by a related party, or has its terms significantly modified. To the extent the new debt is, or is deemed to be,

reissued at an amount less than the face value, such instrument may be recharacterized as a debt instrument issued with OID. Generally, the debtors accrue a deduction for OID as interest expense over the life of the instrument. Under the new law, a debtor who makes a Section 108(i) election must defer some or all of such OID deductions for the years in which the COD income is deferred and, then, such deductions will be taken ratably over the following five years, subject to certain limitations. The deductions, however, will be accelerated in the same cases that COD income is accelerated, as discussed above.

An election to apply this new Section 108(i) eliminates the availability of certain other exceptions to the rules requiring the inclusion of COD income. For example, bankrupt or insolvent debtors are allowed to exclude COD income from their taxable income and never take it into account. Therefore, debtors who are at risk of becoming insolvent, filing for bankruptcy, or are otherwise entitled to another exclusion for COD income should consider whether the benefit of the deferral is preferable to the exclusion.

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