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American Recovery and Reinvestment Act of 2009: COD, AHYDO and Other Tax Provisions

Earlier today, President Obama signed into law the American Recovery and Reinvestment Act of 2009 (the "Act"). Included in the Act's many intended stimulus provisions are two provisions expected to provide tax relief for certain borrowers. Under the Act, a borrower may elect to defer income from cancellation of indebtedness ("COD Income") arising from repurchases, exchanges (including deemed exchanges resulting from debt modifications), or cancellations of its debt that occur in 2009 or 2010 (including any such transactions that occurred in 2009 prior to the signing of the Act), with the maximum deferral being ten years. The Act also suspends application of the "applicable high yield discount obligation" ("AHYDO") rules to certain debt instruments issued in debt-for-debt exchanges (including deemed debt-for-debt exchanges) after August 31, 2008, and before January 1, 2010. Of note, the final provisions of the Act, as modified by the Conference Agreement, are broader and more favorable than the provisions passed by the Senate.

Background

As background, under Sections 61 and 108 of the Internal Revenue Code of 1986, as amended (the "Code"), a borrower generally includes currently in its income any COD Income arising from the borrower's repurchase or other acquisition of its debt at a discount, or the cancellation of its debt. These rules apply to actual debt-for-debt exchanges, as well as deemed debt-for-debt exchanges resulting from "significant" modifications of a debt instrument, where the "issue price" of the new debt instrument is lower than the "adjusted issue price" of the old debt instrument. For this purpose, issue price is as determined for tax purposes and, if the debt instrument is considered to be publicly traded (as specially defined), the issue price of the new debt instrument will be the trading price, which may, under current market conditions, result in a material amount of COD Income for a borrower. Code Section 108 also applies when a person "related" to a borrower purchases the borrower's debt at a discount. Although Code Section 108 contains limited exclusions of COD Income from a borrower's income, such as in the case of a bankruptcy, to the extent of the borrower's insolvency, or in connection with certain mortgage debt, the consequences to a borrower of being subject to Code Section 108 are often materially adverse from a tax

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and financial perspective. In addition, under the AHYDO rules, a borrower's deductions for original issue discount ("OID") on a new debt instrument issued in an exchange, deemed exchange, or "related" person's acquisition may be deferred, and also may be subject to partial disallowance.

COD Deferral

The Act amends Code Section 108 to allow a borrower to elect to defer COD Income arising from an "acquisition" of an "applicable debt instrument" by the borrower or a person "related" to the borrower that occurs in either 2009 or 2010. An "applicable debt instrument" is, generally speaking, any debt instrument issued by (x) a "C corporation" or (y) any other person in connection with the conduct of a trade or business (*e.g.*, a partnership or limited liability company with an operating business). An "acquisition" of an applicable debt instrument includes (i) a repurchase of the debt instrument for cash, (ii) an exchange of the debt instrument for another debt instrument (including a deemed exchange), (iii) an exchange of the debt instrument for equity, (iv) a contribution of the debt instrument to the capital of the borrower, and (v) a complete cancellation of the debt by the holder of the debt instrument. "Related" is as defined currently, and includes complex attribution rules, the application of which can vary significantly based on the particular facts and circumstances.

An electing borrower will defer until 2014 any COD income resulting from an acquisition of an applicable debt instrument by the borrower or a related person in 2009 or 2010. The election is made on an instrument-by-instrument basis, and the electing borrower will include the deferred COD Income in its income ratably over a five-year period from 2014 through 2018 (*i.e.*, 20% of the COD Income will be included in the borrower's income in each year during 2014-2018). The election to defer the COD Income cannot be combined with applicable pre-existing exclusions under Code Section 108, such as the insolvency exception or mortgage debt exception and, consequently, the election may not be the best strategy for all taxpayers. The election is made by the borrower with the filing of its tax return for the year of the acquisition of the applicable debt instrument and, once made, cannot be revoked (note that, in the case of partnerships, S corporations or other pass-through entities which make this election, each of the partners, shareholders or members will be bound by the consequences of the election).

Related OID Consequences

Under applicable tax rules, in the case of a debt-for-debt exchange (including a deemed exchange) or a related person's acquisition of a debt instrument, a new debt instrument is (or is deemed to be) issued by the borrower in exchange for the acquired debt instrument. If a borrower elects to defer COD Income arising from such a debt-for-debt exchange or acquisition by a related person, the borrower's deductions for OID that accrue on the new debt instrument during the COD deferral period (*i.e.*, prior to 2014) will be similarly deferred. The deferred OID will be deductible ratably from 2014 through 2018 so as, generally speaking, to match the timing of the COD Income inclusions during that period. This OID limitation does not apply to the portion of any such OID accruing before 2014 which exceeds the total COD Income, although a statutory ordering rule may nonetheless effectively result in deferral of the excess portion of the OID deductions. Under an anti-abuse provision, this OID deferral rule applies to a new debt

instrument issued for cash to the extent of the portion of the cash proceeds that the borrower uses (directly or indirectly) to repurchase another debt instrument issued by the borrower.

Under the Act, a borrower's inclusion of deferred COD Income (and deduction of any related deferred OID) will be accelerated in certain cases to the extent not previously taken into account, including upon the borrower's liquidation, sale of substantially all of its assets, or cessation of business. Inclusion of deferred COD Income (and deduction of any related deferred OID) will be similarly accelerated if an owner of an equity interest in a borrower that is a partnership, S corporation or other pass-through entity disposes of its equity interest in the entity. In the case of an entity treated as a partnership for tax purposes, there are specific rules that specially allocate the COD Income on a partner-by-partner basis.

AHYDO

Under the AHYDO rules, a borrower's OID deductions on a debt instrument that is an AHYDO are deferred until the OID is paid in cash, and a portion of the borrower's OID deductions may be permanently disallowed. Under the Act, the AHYDO rules will not apply to a debt instrument issued by a borrower after August 31, 2008, and before January 1, 2010, in exchange (including a deemed exchange resulting from a "significant" modification of a debt instrument) for another debt instrument issued by the same borrower that is not an AHYDO. This relief from the AHYDO rules does not apply to any debt instrument that has a contingent interest coupon or that is issued to a person related to the borrower. Accordingly, of significant note, it appears that this provision does not provide relief from the AHYDO rules for debt-for-debt exchanges between the borrower and a person related to the borrower (including a deemed exchange resulting from a "significant" modification of a debt instrument held by a person related to the borrower or a purchase of the borrower's debt by such a related person). The Act also gives the Secretary of the Treasury authority to suspend the AHYDO rules in periods subsequent to 2009 if the Secretary determines such relief is appropriate in light of distressed conditions that may then exist in the debt capital markets.

Other

In addition to the relief for COD Income and accompanying AHYDO consequences, several other business tax relief provisions were adopted in the Act. These provisions include (i) an extension of the carryback for net operating losses for taxable years beginning or ending in 2008 from two to five years, but, unlike many earlier proposals, this provision is available only to small businesses with revenue of up to $15 million, (ii) an extension through 2009 for expensing the cost of certain property in the year of purchase, (iii) an extension through 2009 and 2010 of the ability to take an additional depreciation deduction of 50% of the cost of certain qualifying property, (iv) a reduction of the recognition period for S corporations for dispositions of property subject to the net unrealized built-in gains tax from ten years to seven years, applicable to sales of such property in 2009 and 2010, (v) an increased exclusion from income of 75% of the gain (up to a specified amount) from the sale of qualified small business stock acquired after the signing of the Act and before January 1, 2011, and (vi) an exclusion from the limitations on net operating loss carryforwards and net unrecognized built-in loss where there is an ownership

change pursuant to certain restructuring plans which are required by the Treasury Department. Also of note, the Act prospectively reverses the guidance provided by the Treasury Department last year allowing certain NOL limitations to be suspended in bank mergers. The Act also addresses a number of non-tax provisions, as well as tax-related provisions directed at individuals.

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If you have any questions regarding this client memorandum, please contact any member of the Fried Frank tax department.

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