

Economic Stimulus Legislation Provides New Deferral Rules for Debt Cancellation Income

The economic stimulus legislation that passed Congress last Friday and which President Obama signed on Tuesday contains important relief for companies seeking to restructure their debt in the current economic crisis. In particular, the legislation allows taxpayers to elect to defer most cancellation of debt income (“CODI”) that would otherwise be recognized in 2009 and 2010 transactions so that it is taken into income over the 5-year period from 2014 through 2018. The new law thus provides an automatic 5-year deferral of any taxable income, and then spreads any remaining tax liability over the next five years.

The new provision will provide substantial relief to many companies seeking to

- (i) repurchase debt at a discount,
- (ii) engage in debt-for-debt or equity-for-debt exchanges, or
- (iii) modify outstanding debt instruments.

Companies eligible for existing rules that exclude CODI from taxable income because they are in bankruptcy or insolvent will need to determine whether the existing CODI rules or the new rules are more advantageous, which will generally depend on each company’s individual tax and economic position.

Background

A company generally recognizes taxable CODI to the extent that its debt is forgiven or the company repurchases or otherwise satisfies such debt for less than the amount owed. A company may also recognize taxable CODI when it (i) exchanges new debt for existing debt, (ii) exchanges new equity for existing debt (whether in bankruptcy or out of bankruptcy), or (iii) modifies the terms of existing debt. CODI may also arise when a related person acquires a company’s debt at a discount.

Current tax rules allow a company in bankruptcy to exclude CODI from taxable income. Companies that are insolvent may also exclude CODI from taxable income, but only to the extent of their insolvency. In each case, the company must reduce its tax attributes (e.g., net operating losses (“NOLs”) and asset tax basis) by an amount up to the amount of excluded CODI. The new rules provide that a debtor in bankruptcy can elect to use the new deferral rules, or use the existing rules that apply to companies in bankruptcy. If a company uses the new rules, it is not required to immediately reduce its NOLs or other tax attributes by the amount of the CODI deferred.

The New Rules — Elective CODI Deferral

The new legislation allows taxpayers to elect to defer taxation of CODI on “applicable debt instruments” that would otherwise be recognized during 2009 and 2010. Applicable debt instruments include any debt issued by

a corporation and debt issued by an individual or flow-through entity (such as a partnership, LLC or S corporation) to the extent that the debt instrument was issued in connection with a trade or business.

The new bill covers CODI that would be recognized in the following types of transactions, whether engaged in by the issuer/obligor of a debt instrument or a related person:

- ♦ the acquisition of a debt instrument for cash,
- ♦ the exchange of a debt instrument for another debt instrument, including a deemed exchange arising from the modification of the terms of a debt instrument,
- ♦ the exchange of a debt instrument for corporate stock or a partnership or LLC interest,
- ♦ the contribution of a debt instrument to capital, and
- ♦ the complete forgiveness of a debt instrument.

When the taxpayer so elects, CODI that would otherwise be recognized in transactions occurring in 2009 or 2010 is deferred (subject to acceleration rules described below) and taken into income over the 5-year period from 2014 through 2018. **Taxpayers electing to defer CODI may not exclude the deferred CODI from income in any year on grounds of bankruptcy or insolvency.**

Whether a company in bankruptcy will want to elect to utilize the new law will depend on the amount of the company's NOLs, whether those NOLs are subject to limitation because of an ownership change, and on whether the company forecasts significant future taxable income. If a company has substantial NOLs which it is permitted to use, and if it expects significant taxable income in the next five years, it is very possible that a company in bankruptcy would prefer to use the new CODI rules rather than the existing bankruptcy exception to CODI. This determination, however, is a complicated calculus involving the interaction of many different factors.

Taxpayers who defer CODI are also required to defer "related" deductions for original issue discount

("OID") that would otherwise accrue prior to 2014, taking them into account over the same 5-year period from 2014 through 2018 when deferred CODI is taken into income. OID is generally "related" for this purpose if it accrues on (i) new debt issued in a debt-for-debt exchange (or deemed exchange) that caused the deferred CODI or (ii) new debt issued for cash where the new debt proceeds are used to repurchase existing debt at a discount creating deferred CODI.

When the taxpayer is a partnership or LLC, any CODI deferred is allocated to those persons who were partners or LLC members immediately before the transaction that generated the deferred CODI.

Deferred CODI (and also deferred OID deductions) are accelerated into income immediately if:

- ♦ the taxpayer liquidates (or in the case of an individual, dies),
- ♦ the taxpayer sells substantially all of its assets,
- ♦ the taxpayer ceases its business, or
- ♦ similar circumstances occur.

Taxpayers wishing to elect to defer CODI under the new provisions must make such election on their tax return for the year which includes the transaction that creates the CODI (i.e., its 2009 or 2010 federal income tax return). The election may be made on an instrument-by-instrument basis. Thus, a taxpayer may elect deferred CODI treatment for some but not all debt instruments in a tranche. The election must be made at the entity level for debt issued by partnerships, LLCs, S corporations and other flow-through entities.

The election must also indicate the amount of CODI subject to deferral and other information required by the IRS. This requirement may create some complexities in using this relief if the amount of CODI or the fact of CODI is uncertain (for example, in a debt-for-debt exchange where it is not entirely clear whether the old debt or new debt is "traded on an established market" or where the FMV of stock issued in a debt-for-equity exchange is unclear).

Examples of CODI Deferral

Example 1. On 4/1/09, Corporation X repurchases \$100 million of its outstanding debt for \$60 million in cash. X is not in bankruptcy or insolvent. In the absence of the new deferral rules, X would recognize \$40 million of CODI income on its 2009 tax return. Under the stimulus bill, X may elect to defer recognition of such \$40 million of CODI, taking \$8 million of it into income in each of the 5 years from 2014 through 2018.

Example 2. Same as Example 1, except that X issues stock with an FMV of \$60 million to retire \$100 million of its existing debt. In the absence of the new deferral rules, X would recognize \$40 million of CODI income on its 2009 tax return. Under the stimulus bill, X may elect to defer recognition of such \$40 million of CODI, taking \$8 million of it into income in each of the 5 years from 2014 through 2018.

Example 3. Same as Example 1, except that X issues new debt instruments with a face amount and issue price of \$60 million to retire \$100 million of its existing debt. In the absence of the new deferral rules, X would recognize \$40 million of CODI income on its 2009 tax return. Under the stimulus bill, X may elect to defer recognition of such \$40 million of CODI, taking \$8 million of it into income in each of the 5 years from 2014 through 2018.

Example 4. Same as Example 1, except that X is in bankruptcy on 4/1/09. Under current tax rules, because it is in bankruptcy, X is entitled to exclude the \$40 million of CODI from its taxable income (at the cost of reducing certain tax attributes such as NOLs, by up to an equal amount). Under the stimulus bill, X may alternatively elect to defer recognition of such \$40 million of CODI, taking \$8 million of it into income in each of the 5 years from 2014 through 2018 (where it may **not** be excluded from income under the bankruptcy or insolvency exclusion). No attribute reduction is required if X elects to use the CODI deferral rules.

Example 5. On 4/1/09, Corporation Y exchanges \$100 million (face amount) of new debt instruments for \$100 million (face amount) of existing debt instruments. The new debt instruments bear interest at a higher rate and have more favorable financial covenants. Y is not in bankruptcy or insolvent. Y's new debt instruments are considered "traded on an established market" and trade at 60% of face when issued. The new debt instruments thus have an aggregate issue price of \$60 million. In the absence of the new deferral rules, Y would recognize \$40 million of CODI income on its 2009 tax return (\$100 million face amount of existing debt less \$60 million issue price of new debt). Under the stimulus bill, Y may elect to defer recognition of such \$40 million of CODI, taking \$8 million of it into income in each of the 5 years from 2014 through 2018.

Should you have any questions about the matters addressed in this Alert, please contact the following Kirkland & Ellis authors or the Kirkland & Ellis attorney you normally contact:

Jack S. Levin, P.C.
Kirkland & Ellis LLP
200 E. Randolph Dr.
Chicago, IL 60601
jlevin@kirkland.com
+1 (312) 861-2004

William R. Welke, P.C.
Kirkland & Ellis LLP
200 E. Randolph Dr.
Chicago, IL 60601
wwelke@kirkland.com
+1 (312) 861-2143

Todd F. Maynes, P.C.
Kirkland & Ellis LLP
200 E. Randolph Dr.
Chicago, IL 60601
tmaynes@kirkland.com
+1 (312) 861-2485

This publication is distributed with the understanding that the author, publisher and distributor of this publication are not rendering legal, accounting, or other professional advice or opinions on specific facts or matters and, accordingly, assume no liability whatsoever in connection with its use. Pursuant to applicable rules of professional conduct, this publication may constitute Attorney Advertising. Prior results do not guarantee a similar outcome.

© 2009 KIRKLAND & ELLIS LLP. All rights reserved.

www.kirkland.com