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Stimulus Bill Allows Deferral of COD Income Realized from Repurchases of Debt at a Discount

The current debt market environment may offer opportunities for borrowers to purchase their debt at a discount. Historically, such purchases by a borrower or a related party were often not consummated because a solvent, non-bankrupt borrower would usually realize current cancellation of debt ("COD") taxable income equal to the discount and incur a tax liability. However, the recently enacted American Recovery and Reinvestment Tax Act of 2009 (the "Act") contains a provision which allows borrowers or related parties (e.g., fund sponsors of portfolio companies), to purchase the borrower's outstanding debt obligations in either 2009 or 2010 without recognizing COD taxable income on such purchase until 2014, at which time the borrower will include the deferred COD income on its tax returns ratably over a five-year period. When the COD income is recognized between 2014-2018 as ordinary income to the borrower, such COD would thus potentially be subject to any increases in the ordinary income tax rate. A sale of all of the assets of the borrower, a liquidation of the borrower, or the cessation of the borrower's business would accelerate the recognition of the deferred COD.

In addition to purchases of debt obligations, the Act applies to defer the recognition of COD income realized upon (i) the exchange of the debt instrument for another debt instrument (including an exchange resulting from a modification of the debt instrument), (ii) the exchange of the debt instrument for corporate stock or a partnership interest, (iii) the contribution of the debt instrument to capital and (iv) the complete forgiveness by the holder of the debt instrument. Additionally, the deferral election is made on a debt instrument by debt instrument basis, and therefore, the borrower can elect to defer COD income on some but not all eligible debt instruments, if so desired.

One cost for a borrower electing to defer the recognition of COD income resulting from the purchase of its debt by a related party at a discount is that any original issue discount ("OID") deductions that would otherwise be available to the borrower are also deferred. If a related party purchases a borrower's debt at a discount, the debt is treated as issued with OID equal to the difference between the face amount of the debt and its purchase price. Without the deferral election, the OID can be deducted by the borrower ratably over the term of the debt instrument, subject to the limitations imposed by the "AHYDO" rules, the "earnings stripping rules" and the other restrictions generally applicable to deductions of interest expense. Under the Act, if the borrower elects to defer the recognition of COD, the related OID deductions are also deferred until 2014, at which time the deferred OID can be deducted ratably over a five-year period. A sale of all of the assets of the borrower or other events that would result in the acceleration in the recognition of the deferred COD income would also accelerate the deferred OID interest deductions.

If a related party purchases a borrower's debt obligation at a discount, it will generally recognize the resulting OID as taxable income over the remaining term of the debt obligation. The aggregate amount of the OID income should be equal to the amount of COD income that was deferred, assuming that the related party holds the debt obligation to maturity. Although the OID deductions of the borrower are deferred under the Act, the related party's corresponding OID income inclusions are not. Such OID income would, therefore, need to be ratably included in the related party's taxable income, unless perhaps such party is a tax-exempt or foreign investor. If the related party sells the debt obligation before maturity, any gain should generally be capital gain income.

In the case of a borrower that is a partnership, any COD income that is deferred under the Act is allocated to the partners who were in the partnership immediately before the discharge of indebtedness occurred, as if the COD had been recognized at such time. In addition to the other COD income acceleration provisions discussed above, if a partner sells, exchanges or

redeems such partner's partnership interest, any amount of COD income that was previously allocated to such partner under the preceding sentence will be recognized as taxable income of such partner upon the sale, exchange or redemption of such partner's partnership interest. Additionally, any decrease in a partner's share of partnership liabilities as a result of the debt being discharged is generally not taken into account until such time as the COD income is no longer deferred, and then only to the same extent of the amount of COD income that is recognized into taxable income. Although the effects of the election to defer COD income are borne by the partners of a partnership, the election to defer is made by the partnership and is therefore applicable to all partners.

As yet unclear is whether the election to defer COD income also affects the timing of income for a corporate borrower in computing its earnings and profits. The Treasury Department has promised guidance.

For further information regarding planning opportunities related to the COD deferral election or other provisions in the Act please contact:

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