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Recent Tax Law Changes Provide Relief When Restructuring Debt Obligations

Recognizing that the current economic crisis has necessitated the restructuring of many debt instruments, Congress took steps in the recently enacted American Recovery and Reinvestment Act of 2009 (the "Act") to provide some relief for debtors who might otherwise suffer adverse tax consequences from such restructurings. This relief includes allowing debtors to defer the recognition of cancellation of indebtedness ("COI") income on certain debt restructurings and avoid the potential loss or limitation of their interest deductions under the applicable high yield discount obligation ("AHYDO") rules. In addition, the Act provides more liberal rules for the carryback of certain net operating losses, although the scope of this change was severely limited as the legislation wound its way to passage. Thus, the Act provides more flexibility in restructuring debt than existed under prior law and may provide certain companies with the ability to use their operating losses to generate cash to be used in the business.

COI Income Resulting From Certain Reacquisitions of Indebtedness

The Act added new section 108(i) to the Internal Revenue Code of 1986, as amended (the "Code"), which allows certain taxpayers to defer recognizing COI income for a specified period and, after the deferral period expires, to take any deferred COI income into account ratably over a five year period. This election is available to any C corporation and any other person who issued debt in connection with that person's trade or business when, through a reacquisition (either directly or through a "related" person) of its debt instrument, the C corporation or other person recognizes COI income. This election applies for reacquisitions occurring after December 31, 2008 and before January 1, 2011. A reacquisition, for this purpose, includes (i) an acquisition of existing debt for cash, stock, a partnership interest or another debt instrument (including a deemed exchange resulting from a significant modification of an existing debt instrument), (ii) the contribution of a debt instrument to capital or (iii) the complete forgiveness of the debt by the holder.

If made, the election allows the taxpayer to defer recognition of COI income for five tax years (if the reacquisition occurs in 2009) or four tax years (if the reacquisition occurs in 2010) and then, after the conclusion of the applicable deferral period, to include the deferred COI income ratably over the five succeeding tax years. A taxpayer's election to apply Code section 108(i) is made by filing a statement with the tax return for the tax year in which the reacquisition occurs and can be made on an instrument-by-instrument basis. Once the election is made, it is irrevocable. In addition, upon making the election, certain interest deductions relating to original issue discount ("OID") on debt that is issued (or modified) in connection with the reacquisition is deferred. Essentially, any deduction for OID on such instruments that accrues before the end of the applicable deferral period is deferred to the

extent of the deferred COI income. Once the applicable deferral period ends, these deferred OID deductions are taken ratably over the same five year period for which any COI income is ratably included.

If a Code section 108(i) election is made, the debtor is not required to reduce any of its tax attributes (e.g., net operating losses, tax credit carryovers, or the basis in its assets). However, the Code provisions allowing a debtor to exclude COI income from its gross income (e.g., because the discharge occurs while the debtor is in bankruptcy or insolvent) will not apply to income from the discharge of a particular debt instrument to which the election relates for the year in which the election is made *or any subsequent taxable year*.

Other notable items relating to the election include: (i) the immediate recognition of any deferred COI income if the debtor liquidates, sells substantially all of its assets, or ceases its business, among other things; and (ii) special rules for determining how any deferred COI income and deferred deductions for OID are allocated among partners if the debtor is a partnership.

Suspension of the AHYDO Rules

The Act also added new Code section 163(e)(5)(F), which exempts certain debt instruments from the AHYDO rules. Under the AHYDO rules, all or a portion of a C corporation's interest deductions are deferred or permanently disallowed if the deductions stem from certain applicable high yield discount obligations[1] that produce significant OID. New Code section 163(e)(5)(F) effectively suspends the application of the AHYDO rules for debt instruments issued between September 1, 2008 and December 31, 2009 by the issuer (or obligor) in exchange for a debt instrument of the same issuer (or obligor) that was not subject to the AHYDO rules. For these purposes, an exchange can include a deemed exchange resulting from a significant modification of an existing debt instrument.

However, this suspension does not apply to certain contingent debt instruments or instruments issued to certain related persons. For these purposes, a person or entity may be considered related to the issuer if certain relationships exist between the person or entity and the issuer. For example, a corporate issuer may be considered related to a partnership if the same persons own (directly or indirectly) more than 50 percent of the value of the outstanding stock of the corporate issuer and more than 50 percent of the capital or profits interests in the partnership. Similarly, two corporations may be considered related if they are members of the same "controlled group" (e.g., certain parent-subsidiary or brother-sister relationships exist), and two partnerships may be considered related if the same persons own, directly or indirectly, more than 50 percent of their capital or profits interests. Consequently, these related party rules should be carefully examined before any debt restructuring is undertaken.[2]

This new Code section also provides the Secretary of the Treasury with the authority to extend this relief to debt instruments issued after December 31, 2009, if the Secretary determines that the suspension is appropriate in light of the conditions of the debt capital markets.

Additional Carryback of NOLs

The Act also increased the number of years that certain small businesses may carryback net operating losses ("NOLs") arising in tax years that either end or begin in 2008 ("2008 NOLs"). Under current law, taxpayers generally can carryback NOLs to the two preceding tax years. However, the Act amended the period for which an eligible small business (i.e., a business with average annual gross receipts of no more than $15,000,000 for a specified period) can carryback 2008 NOLs. Under the Act's amendments, these taxpayers may elect to carryback a 2008 NOL up

to five years. Even though these rules apply only to eligible small businesses, they are worth noting because when they were originally introduced into Congress they had a much broader application. There has been recent talk of revising these rules to broaden their scope beyond eligible small businesses.

Conclusion

The new provisions of the Act can mean significant tax savings when a debt restructuring occurs. Although section 108(i) provides for only the deferral of COI income, the present value of this deferral may be significant given the length of time for which the COI income is deferred. Care must be taken, however, to ensure the particular debt is eligible for the relief provided by these Code sections, and that all the tax consequences are considered before making the permitted election. Finally, the change regarding NOL carrybacks provides certain taxpayers with an immediate tax benefit. Hopefully, these NOL carryback rules will be expanded to provide significant tax benefits to more taxpayers.

If you have any questions or comments, please call your Vedder Price contact attorney, the Co-Chairs of our Tax Group, **Dan Sherlock** (312-609-7551) or **Tim O'Donnell** (312-609-7683), or the head of our Finance & Transactions Group, **Michael Nemeroff** (312-609-7858).

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[1] A debt instrument is not considered an applicable high yield discount obligation for these purposes unless (among other things) it has a term of more than five years and its yield to maturity equals or exceeds the relevant applicable federal interest rate plus five percentage points.

[2] These same related party rules apply for purposes of Code section 108(i) (discussed above).

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