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Stimulus Legislation Includes Debt Cancellation Tax Relief

We had previously reported to you that the Senate version of the financial stimulus legislation that was working its way through Congress included relief from recognition of cancellation of indebtedness income ("COD") for 2009 and 2010. Although no such provision was included in the House bill, and other tax relief measures dropped away or were cut back (including the five year NOL carryback), an improved version of the COD provision was adopted in Conference, and is part of the American Recovery and Reinvestment Tax Act of 2009 that was approved today by Congress and is expected to be signed into law by the President.

Key provisions of the legislation are as follows:

- COD realized in 2009 or 2010 will generally be deferred until 2014, and then will be recognized ratably over a five-year period.
- The provision applies not only to issuer or related party cash purchases of debt, but also to debt for debt exchanges (including deemed exchanges resulting from a "significant modification" of debt) and debt for equity exchanges.
- Application of the provision is elective, on a debt by debt basis, so, for example, taxpayers with expiring NOLs (or taxpayers that expect that their NOLs may be limited by an "ownership change" in the near future) may choose to forego the benefit of the deferral in order to permanently eliminate the COD income. Also, if a taxpayer believes that an "ownership change" is likely before 2014, and that this occurrence would result in NOL utilization limitations that preclude full offset of the deferred COD income, an election to forego deferral might enable current use of an NOL to fully offset COD income.
- Issuers electing the five year deferral for a particular debt instrument forego access to other COD relief provisions (exclusion of income and reduction of tax attributes in Chapter 11, to the extent that the issuer is insolvent, or with

respect to certain real estate debt), but only with respect to the debt instrument for which the election is made.

- Any deferred COD income must be taken into account upon a liquidation of the issuer, the sale of substantially all of its assets (including in a Chapter 11 proceeding), cessation of business or similar circumstances.

Note that the combination of the two rules described above means that companies considering bankruptcy might continue to find it more advantageous to wait until they are in Chapter 11 to trigger COD.

- Deductions for original issue discount ("OID") resulting from debt for debt exchanges are deferred along with the corresponding COD. Ordinarily such deductions represent a delayed offsetting tax benefit for issuers recognizing COD. This provision ensures that the timing of income and deductions is properly aligned, avoiding an unintended extra advantage for taxpayers.
- A new provision not included in either the original Senate or House bills also substantially mitigates the impact of the AHYDO (Applicable High-yield Discount Obligation) rules, which generally limit the deductibility of OID above a designated yield threshold and longer than five year term. Under the relief provision, OID resulting from actual or deemed debt for debt exchanges after August 31, 2008 and before January 1, 2010 will not be subject to the AHYDO limitations. This prevents a mismatching of COD income with non-deductible interest expense.

As noted above, the five year NOL carryback provision was substantially cut back, applying only to businesses with less than $15 million in annual revenues. The provision was cut back as part of the negotiations to limit the overall cost of the legislation. But we understand that an expanded version of this rule may appear in future legislation.

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We have been following these issues closely and have spoken with many of you about debt buybacks, debt exchanges and other strategies available given the current state of the markets and the economy in general. This memorandum is not intended to provide legal advice, and no legal or business decision should be based on its content. If you have any questions, or would like to pursue any of these strategies further, please feel free to call any of the Paul, Weiss Tax Partners:

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