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Economic Stimulus Act Lowers Tax Barrier to Repurchase or Modification of Discounted Debt

For many businesses, there is a significant tax cost if they repurchase or renegotiate debt at a discount. A one-time, two-year window of opportunity is now available, however, for businesses to remove discounted debt from their balance sheets with much more favorable tax consequences than would otherwise be the case. The recently enacted American Recovery and Reinvestment Act of 2009 (Stimulus Act) generally permits certain businesses to elect to defer paying tax on discharge of indebtedness (DOI) income and to recognize such income over a five-year period that for most taxpayers will begin in 2014.

In general, when a debtor retires debt at a discount, it must include as taxable income the amount of the discount, which is equal to the amount by which the adjusted issue price exceeds the repurchase price. In the absence of the special deferral provided by the Stimulus Act, a solvent taxpayer is generally required to include DOI income as taxable income in the year in which the discharge occurs.

As a result of the Stimulus Act, a debtor can elect to have DOI income resulting from the "reacquisition" of an "applicable debt instrument" taxable ratably over the five-year period beginning (i) in the case of debt reacquired in 2009, the fifth taxable year following the taxable year of reacquisition and (ii) in the case of debt reacquired in 2010, the fourth taxable year following the taxable year of reacquisition. This election applies only to DOI income resulting from a reacquisition during the two-year window beginning after December 31, 2008 and ending before January 1, 2011. For example, if Corporation X, a calendar year taxpayer, repurchases from its lenders in 2010 a significant debt at a discount of US\$100, it will realize that US\$100 discount as DOI income. However, under the Stimulus Act, X may elect to

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defer the inclusion of that US\$100 DOI income, in which case X would include US\$20 of DOI income in its 2014 taxable year and in each of its next four taxable years.

The term "reacquisition" includes cash-for-debt, debt-for-debt and equity-for-debt exchanges of an applicable debt instrument by the issuer of (or obligor under) the debt. It also includes debt modification or forgiveness and the contribution of debt to capital. A qualifying debt-for-debt exchange includes any deemed exchange resulting from the significant modification of a debt instrument. For example, if Corporation Y undergoes a major restructuring of its credit facilities in 2009, it will realize DOI income from a deemed debt-for-debt exchange (assuming that the restructuring significantly modifies the debt). Even though Y is not repurchasing debt, Y can elect to defer DOI income resulting from Y's restructuring of its credit facilities.

A debtor can also elect to defer DOI income resulting from a related person's acquisition of the debtor's debt at a discount. A related person is specially defined for this purpose and generally includes (i) corporations and their subsidiaries, their controlling shareholders and other corporations under common control, (ii) a partnership and a person owning, directly or indirectly, more than a 50-percent interest in the partnership, (iii) two partnerships in which the same person or persons own, directly or indirectly, more than 50 percent of the interests in each partnership and (iv) many of an individual's family members. For example, if Corporation X owns 51 percent of the stock of Corporation Y, Y would realize DOI income if X acquires an applicable debt instrument of Y at a market discount in calendar year 2009. The Stimulus Act permits Y to elect deferral of the DOI income resulting from X's acquisition of Y's debt.

An "applicable debt instrument" is generally any debt instrument, other than an annuity, issued by (i) a C corporation or (ii) any other person in connection with the conduct of a trade or business by such person. For example, a syndicated bank debt or a bond issued by a C corporation is an applicable debt instrument.

A deferral election is filed with the debtor's income tax return for the taxable year in which the reacquisition occurs. Such an election is irrevocable and made on an instrument-by-instrument basis. An election by a partnership, S corporation or other pass-through entity is made at the entity level. A debtor electing DOI income deferral cannot also exclude DOI income from that debt instrument pursuant to the exceptions available under current law for Chapter 11 bankruptcy or insolvency, or on the basis that the debt is farm or real property business indebtedness, either in the year of the election or in any subsequent year. For example, if Corporation X elects to defer DOI income resulting from debt reacquired in 2010 and enters Chapter 11 bankruptcy in 2015, X will not be able to exclude the deferred DOI income from its gross income on the basis of its bankruptcy and, further,

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cannot revoke its deferral election at that time to take advantage of the bankruptcy exclusion. Thus, a debtor can have the benefit of either the deferral provided by the Stimulus Act or the exclusion of DOI income permitted for bankruptcy or insolvency situations under current law, but not both.

Deferred DOI income is accelerated and generally includible in gross income in the year a debtor liquidates or sells substantially all of its assets, ceases business or dies. Deferred DOI income is also accelerated for a person on the sale, exchange or redemption of the person's interest in a partnership, S corporation or other pass-through entity that has elected DOI income deferral.

Finally, the Stimulus Act provides special rules that apply to a partnership electing DOI income deferral and also defers deductions for original issue discount imputed in certain debt-for-debt exchanges.

The contents of this update are not intended to serve as legal advice related to individual situations or as legal opinions concerning such situations. Counsel should be consulted for legal planning and advice.

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