



CLIENT MEMORANDUM

American Recovery and Reinvestment Tax Act of 2009 Temporarily Defers Cancellation of Indebtedness Income for Debt Repurchases, Exchanges, Cancellations and Modifications

February 13, 2009

INTRODUCTION

Under current law, if a company (or a related party) repurchases its debt at a discount, the company would generally recognize cancellation of debt ("COD") income in the amount of the discount under Section 108 of the Internal Revenue Code of 1986, as amended (the "Code").¹ The same result could occur in certain situations if a company exchanged outstanding debt for new debt (including through a "deemed exchange" resulting from significant modifications of such outstanding debt).

On February 13, 2009, The House of Representatives approved the economic stimulus package, the American Recovery and Reinvestment Tax Act of 2009 (the "Act"), which contains a provision intended to mitigate the adverse tax consequences to borrowers that incur COD income as a result of debt repurchases and restructurings. The Act is expected to be approved by the senate and President Obama. Under the Act, an electing taxpayer may defer COD income that would

otherwise result from certain debt repurchases, exchanges, cancellations and modifications during 2009 and 2010. The provision also permits a taxpayer to defer COD income arising from the acquisition of its debt by a related party at a discount.

A. GENERAL RULE: ELECTION TO DEFER RECOGNITION OF CANCELLATION OF DEBT ("COD") INCOME

The Act amends Section 108 by adding subsection (i), which permits electing taxpayers to defer COD income arising in connection with the reacquisition of an applicable debt instrument by the borrower or related party in 2009 or 2010. If the reacquisition of the taxpayer's debt occurs in 2009, an electing taxpayer recognizes the resulting COD income ratably over the five taxable years beginning with the fifth taxable year following the taxable year in which the reacquisition occurs. If the

¹ All section references herein are to the Code.

reacquisition occurs in 2010, an electing taxpayer recognizes the resulting COD income ratably over the five taxable years beginning with the fourth taxable year following the taxable year in which the reacquisition occurs.

B. DEBT INSTRUMENTS COVERED BY THE PROVISION

Debt instruments covered by the provision include bonds, debentures, notes, certificates and any other instrument or contractual arrangement constituting indebtedness. The debt instrument must have been issued by either a C corporation or any other person in connection with the conduct of a trade or business by such person.

C. DEFINITION OF REACQUISITION

For purposes of this provision, a "reacquisition" is defined as any acquisition of debt by the debtor or a purchaser related to the debtor. The reacquisition may take various forms, including a cash acquisition of the debt instrument, a debt-for-debt exchange (including a deemed exchange resulting from a modification to the debt instrument or purchase by a related party), an exchange of the debt for corporate stock or a partnership interest, the contribution of the debt to capital or the complete forgiveness of the debt by the holder of the debt instrument.

D. DEFERRAL OF OID DEDUCTIONS RESULTING FROM DEBT-FOR-DEBT EXCHANGES

In debt-for-debt exchanges and deemed debt exchanges resulting from debt modifications or related party debt purchases, the new debt will be deemed to be issued with OID if the issue price of the new debt is less than the adjusted issue price of the old debt. Under the Act, a borrower's OID deductions resulting from an actual or deemed debt-for-debt exchange are deferred if the borrower elects to defer the related COD income under Section 108(i). For these purposes, if a new OID debt instrument is issued for cash and the proceeds of such issuance are used to retire an applicable debt instrument, the new debt is treated as if it were exchanged for the old

debt in a debt-for-debt exchange. Under the OID deferral rule, the issuer may not deduct any OID that (1) accrues before the five-year COD income inclusion period and (2) does not exceed the COD income resulting from the reacquired debt instrument. The deduction so disallowed will be allowed as a deduction ratably over the same five-year COD income inclusion period. It is important to note that the Act does not change the tax treatment of the holder with respect to any OID that is created as a result of a debt-for-debt exchange or deemed debt exchange (i.e., the requirement that the issuer defer its deduction attributable to the OID does not result in a deferred income inclusion for the holder with respect to the OID.)

E. SPECIAL RULE FOR PARTNERSHIPS

For partnerships, any COD income deferred under Section 108(i) will be allocated to the persons that are partners in the partnership immediately before the applicable debt discharge. The deferred items will be allocated to such persons in the manner the items would have been allocated if the COD income was recognized immediately before the discharge. If the debt discharge decreases a partner's share of partnership liabilities, such decrease will not be taken into account to the extent it would cause the partner to recognize gain. Such decreases will be taken into account by the partner when it recognizes the deferred income.

F. ACCELERATION OF DEFERRED ITEMS

In the case of a taxpayer's death, liquidation or sale of substantially all of its assets (including in a title 11 or similar case), the cessation of business by the taxpayer or similar circumstances, any items of COD income or OID deduction deferred under Section 108(i) will be taken into account in the taxable year in which such event occurs (in the case of a title 11 case, the day before the petition is filed), to the extent such items have not already been taken into account. This acceleration rule also applies to sales or exchanges or redemptions of interests in a partnership, S corporation or other pass through entity by a partner, shareholder or other person holding an ownership interest in such entity.

G. MAKING THE ELECTION

A taxpayer makes an election under Section 108(i) by including a statement with its tax return for the tax year in which the debt reacquisition occurs. This statement must clearly identify the reacquired debt instrument and include the amount of income to which the election applies, as well as include any other information the Secretary of the Treasury may require. In the case of a partnership, S corporation or other pass through entity, the election shall be made by the partnership, the S corporation or other entity. An election under Section 108(i) is irrevocable.

H. IMPACT ON OTHER PROVISIONS OF SECTION 108

Section 108(a)(1) of the Code provides certain exceptions to the general rule that COD income must be included in a taxpayer's gross income. These exceptions include COD income that arises in a title 11 case or that occurs when the taxpayer is insolvent. Section 108(i) provides that if a taxpayer elects to have the deferral rules apply to an applicable debt instrument, the Section 108(a)(1) exceptions to inclusion of COD income will not apply to COD income for the tax year of the election or any subsequent tax year.

I. TEMPORARY SUSPENSION OF INTEREST DEDUCTION LIMITATION UNDER AHYDO RULES

The Act provides additional relief for taxpayers by suspending the limitation on interest deductions under Section 163(e)(5) of the Code for certain applicable high yield discount obligations ("AHYDO"). Under this provision, the AHYDO interest deduction limitations do not apply to AHYDO debt issued between September 1, 2008 and December 31, 2009 in an exchange (or deemed exchange) for non-AHYDO debt issued by the same issuer. The AHYDO rules will continue to apply, however, to obligations issued to persons related to the borrower and to certain contingent interest obligations.

J. EFFECTIVE DATES

Section 108(i) applies to debt discharges occurring in tax years ending after December 31, 2008. The temporary suspension of the limitation on interest deductions for AHYDOs applies to obligations issued after August 31, 2008 and in taxable years ending after August 31, 2008.

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