

## Debt-Relief Provisions of the Stimulus Act

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In the current economic climate, many borrowers and lenders are seeking to restructure outstanding loans. Restructuring transactions are often made more difficult, and sometimes become impossible, because of tax rules that cause borrowers to realize taxable income upon forgiveness or reduction of debt. The American Recovery and Reinvestment Tax Act of 2009 (the “Act”), Division B of P.L. 111-5, the Stimulus Act, contains debt-relief provisions intended to mitigate the affect of those rules.

### Background

Federal income tax law does not consider the proceeds of borrowings to be income, primarily because of the existence of the borrower’s obligation to repay the borrowed funds. However, when that obligation is eliminated or reduced (e.g., by forgiveness, satisfaction at less than face or repurchase at a discount), assets of the borrower are “freed up” from the claims of creditors and the borrower generally realizes “cancellation of indebtedness” income. Consistent with the “freeing of assets” theory, no cancellation of indebtedness income is realized if the borrower remains insolvent after the cancellation or is in bankruptcy. Congress has added other exceptions over the years; for example, a taxpayer may elect to exclude cancellation of indebtedness income arising with respect to qualified real property business indebtedness, but the taxpayer must then reduce the tax basis of depreciable real property by the amount so excluded.

Cancellation of indebtedness income can arise when a borrower satisfies outstanding indebtedness for cash, by the issuance of new debt or through the issuance of its own stock (if the borrower is a corporation) or capital or profits interests (if a partnership) or when a corporate shareholder contributes the corporation’s debt to capital. Acquisition of outstanding debt by certain parties related

to the borrower from a holder not so related is treated as acquisition of the debt by the borrower. In addition, a “significant modification” of a debt instrument is treated as a constructive exchange of the original, “old” debt instrument for the modified, “new” debt instrument. The rules for what constitutes a significant modification are complex and contain many exceptions but, in general, a material change in yield, term or security will usually constitute a significant modification.

The amount of cancellation of indebtedness income is equal to any excess of the “adjusted issue price” of the debt being cancelled over any amount treated as paid by the borrower to effect the cancellation. Adjusted issue price is generally the amount initially borrowed adjusted to reflect repayments of principal and the accrual over time of any discount or premium. In a debt-for-debt exchange, the borrower is treated as having paid an amount equal to the “issue price” of the new debt. Where outstanding debt of a corporation is exchanged for stock of the corporation, the amount treated as paid by the corporate borrower is the fair market value of that stock; where debt is contributed to a corporation’s capital, the corporate borrower is treated as having paid an amount equal to the former holder’s adjusted tax basis for the debt.

When debt is issued for cash its issue price is the cash amount (for public issuances the initial offering price at which a substantial amount of the debt is sold and for private issuances the price paid by the first buyer excluding intermediaries). When newly issued debt is “publicly traded” its issue price is its fair market value as established by the public trading. If the newly issued debt is not publicly traded but is issued in exchange for property (including outstanding debt) that is publicly traded, the newly issued debt’s issue price is the fair market value of that publicly traded property. “Publicly traded” is a term of art and can include property appearing on a system of general circulation (including a computer listing disseminated to subscribing brokers, dealers or traders) that provides a reasonable basis to determine fair market value by disseminating either recent price quotations or actual prices of recent sales transactions.

For debt issued at a discount (technically, with an issue price less than its stated redemption price at maturity), the original issue discount rules generally

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require a holder to accrue that discount as interest income over the term of the debt using a “constant yield” method, but also provide the issuer an interest deduction for that accruing discount. However, special rules apply to “applicable high yield discount obligations,” debt obligations having a yield greater than the “applicable federal rate” (a series of rates determined monthly by the Internal Revenue Service based on the yields on U.S. Treasuries) plus five percentage points if, at any time after five years, more than one-year’s worth of accrued discount is unpaid. For corporate issuers of an applicable high yield discount obligation, the interest deduction for accrued original issue discount is deferred until that discount is actually paid in cash and is disallowed entirely to the extent the yield on the applicable high yield discount obligation exceeds the applicable federal rate plus six percentage points. The accrued discount for which the interest deduction is disallowed is treated by corporate holders, solely for purposes of the dividends-received deduction, as if it were a distribution with respect to the debtor corporation’s stock.

## Act Changes

### *Cancellation of Indebtedness Income*

**B**orrowers that qualify under the Act may now elect to defer cancellation of indebtedness income on debt reacquired by the borrower or a related person in 2009 or 2010. The amount deferred is then included in income ratably over five years beginning in the fifth taxable year (fourth taxable year if the reacquisition occurs in 2010) following the taxable year of the reacquisition; for calendar-year borrowers, the income inclusion period will begin in 2014 for debt reacquired in either 2009 or 2010. Deferral is explicitly available for cancellation of indebtedness income arising from (i) a debt-for-debt exchange (including a deemed exchange arising from a significant modification), (ii) a debt-for-equity exchange, (iii) contribution of debt to the capital of a corporation, (iv) cash repurchases and (v) forgiveness. Deferral for cancellation of indebtedness income arising from an exchange of debt for other property (e.g., the exchange of a recourse loan for real property in the case of foreclosure or a deed in lieu of foreclosure) is not explicitly mentioned, but the legislative history suggests it should be available.

*Example.* X Corporation, a calendar-year taxpayer, and holders of its notes (\$1 million face amount outstanding) agree to a significant modification of the notes at a time during 2009 when there are a few trades of the notes at \$650 per \$1,000 face amount

listed on Bloomberg during the week including the modification date. If the reporting on Bloomberg provides a reasonable basis to determine fair market value in light of the trading frequency, the notes are treated as publicly traded and X Corporation is deemed to have exchanged \$1 million of “old” notes for “new” notes having an aggregate issue price of only \$650,000. X Corporation has \$350,000 of cancellation of indebtedness income and, under the Act, it can elect to defer that income to the period 2014-2018 (\$70,000 per year).

The election to defer cancellation of indebtedness income is made on an instrument-by-instrument basis and, once made, is irrevocable. An eligible taxpayer makes the election by including with its return for the taxable year of a debt instrument’s reacquisition a statement clearly identifying the debt instrument and including the amount of deferred cancellation of indebtedness income and any other information required by the Internal Revenue Service. No other cancellation of indebtedness exclusions (e.g., insolvency or bankruptcy) are available for debt instruments for which the election is made.

The Act’s deferral provisions apply to any C corporation and to other taxpayers that issued reacquired debt in connection with the conduct of a trade or business. In the case of a partnership, S corporation or other pass-through entity, the election to defer cancellation of indebtedness income is made at the entity level. This entity-level rule distinguishes the new deferral rules from the existing owner-level rules for excluding cancellation of indebtedness income in the case of bankruptcy, insolvency or qualified real property business indebtedness. A partnership’s election to defer cancellation of indebtedness income might actually disadvantage some partners (e.g., partners who would otherwise be able to exclude the cancellation of indebtedness income under the bankruptcy or insolvency exception). Regulations are to be issued to clarify the application of the deferral rules to partnerships, S corporations and other pass-through entities. But the Act does explicitly provide for a corresponding deferral of the tax consequences of a decrease in a partner’s share of partnership liabilities where that decrease results from a transaction giving rise to cancellation of indebtedness income deferred under the Act.

Deferred cancellation of indebtedness income is accelerated to the taxable year that the taxpayer (i) dies, (ii) liquidates or sells substantially all of its assets, (iii) ceases to do business or (iv) is in similar circumstances. Acceleration also occurs with respect

to a partner, shareholder or owner of an interest in a partnership, S corporation or other pass-through entity that has elected to defer cancellation of indebtedness income, upon the sale, exchange or redemption of such owner's interest in the partnership, S corporation or other pass-through entity. Although the mere filing of a bankruptcy case doesn't trigger acceleration of deferred cancellation of indebtedness income, if one of the foregoing triggering events occurs while a taxpayer is in bankruptcy, that deferred income is accelerated and taken into income on the day before the filing of the bankruptcy case.

#### *Original Issue Discount*

**N**ew debt in an actual or deemed debt-for-debt exchange (*i.e.*, arising from a significant modification) will have original issue discount if its stated redemption price at maturity exceeds its issue price. Prior to the Act and subject to the applicable high yield discount obligation rules, the issuer of the new debt would generally be entitled to interest deductions for that discount as it accrued using a constant yield method. The Act provides that if an actual or deemed debt-for-debt exchange gives rise to cancellation of indebtedness income and the borrower elects under the Act to defer that income, then any interest deductions for discount on the new debt accruing during the deferral period (up to the amount of deferred cancellation of indebtedness income) are also deferred and deducted ratably over the same five-year period that the deferred cancellation of indebtedness income is taken into income. This deferral of interest deductions for accrued discount also applies where new debt is sold for cash, that cash is used directly or indirectly to reacquire outstanding debt and the borrower elects to defer cancellation of indebtedness income arising from that reacquisition.

*Example.* In the example above, X Corporation has \$350,000 of cancellation of indebtedness income, but the new debt is treated as issued with \$350,000 of original issue discount (\$1 million stated redemption price at maturity less \$650,000 issue price). If X Corporation elects to defer the cancellation of indebtedness income, it must also defer any interest deductions for discount on the new debt accruing prior to 2014 and instead deduct the discount accrued during that deferral period ratably in 2014-2018.

#### *Applicable High Yield Discount Obligations*

**T**he Act suspends the applicable high yield discount obligation rules for new debt issued in a debt-for-debt exchange (including a deemed debt-for-debt exchange resulting from a significant modification) occurring after August 31, 2008 and before January 1, 2010. The suspension does not apply (i) if the new debt is issued for cash (or other property), (ii) the old debt was subject to the applicable high yield discount obligation rules, (iii) the obligor on the new debt is not the same as the obligor on the old debt, (iv) the new debt bears contingent interest or (v) the new debt is held by a party related to the borrower. The Act gives the Treasury the power to extend the suspension of the applicable high yield discount obligation rules beyond December 31, 2009 and to designate a rate higher than the applicable federal rate for debt issued after that date to reflect market distress.

#### **Illustrative Example**

**S**uppose that Corporation Y, a calendar-year borrower, has outstanding \$80 million of debt with a three percent coupon originally issued for \$80 million in cash (*i.e.*, without premium or discount). Suppose also that Corporation Y exchanges \$60 million of new debt with an eight percent coupon and a ten-year maturity for the \$80 million in outstanding debt. Assume, for simplicity, that the applicable federal rate at all times is four percent, that at the time of the exchange the old debt is trading at 50 percent of face, that the volume of those trades is sufficient to provide a reasonable basis to determine fair market value and that the new debt doesn't trade (or doesn't trade in sufficient volume to be treated as publicly traded).

The issue price of the new debt is \$40 million, the fair market value of the old debt (50 percent of \$80 million) for which it is exchanged. Corporation Y has \$40 million of cancellation of indebtedness income (\$80 million face amount of old debt less \$40 million issue price of new debt) and the new debt is issued with \$20 million of original issue discount (\$60 million payable at maturity less \$40 million issue price). The following table shows the accrual of the \$20 million of original issue discount on the new debt over the 20 semi-annual periods until maturity and verifies that the yield on the new debt is roughly 14.388 percent.

Semi-Annual Period	Beginning Adjusted Issue Price	14.388% Accrual	Interest Payment	Original Issue Discount	Principal Payment	Ending Adjusted Issue Price
1	40,000,000	2,877,616	2,400,000	477,616		40,477,616
2	40,477,616	2,911,976	2,400,000	511,976		40,989,592
3	40,989,592	2,948,808	2,400,000	548,808		41,538,399
4	41,538,399	2,988,289	2,400,000	588,289		42,126,688
5	42,126,688	3,030,611	2,400,000	630,611		42,757,299
6	42,757,299	3,075,977	2,400,000	675,977		43,433,276
7	43,433,276	3,124,607	2,400,000	724,607		44,157,883
8	44,157,883	3,176,736	2,400,000	776,736		44,934,619
9	44,934,619	3,232,614	2,400,000	832,614		45,767,234
10	45,767,234	3,292,513	2,400,000	892,513		46,659,747
11	46,659,747	3,356,721	2,400,000	956,721		47,616,467
12	47,616,467	3,425,548	2,400,000	1,025,548		48,642,015
13	48,642,015	3,499,326	2,400,000	1,099,326		49,741,341
14	49,741,341	3,578,412	2,400,000	1,178,412		50,919,753
15	50,919,753	3,663,187	2,400,000	1,263,187		52,182,940
16	52,182,940	3,754,062	2,400,000	1,354,062		53,537,002
17	53,537,002	3,851,473	2,400,000	1,451,473		54,988,475
18	54,988,475	3,955,893	2,400,000	1,555,893		56,544,368
19	56,544,368	4,067,824	2,400,000	1,667,824		58,212,192
20	58,212,192	4,187,808	2,400,000	1,787,808	60,000,000	0
		<i>Totals</i>	48,000,000	20,000,000		

*August 15, 2008 Exchange*

If the exchange described above occurs on August 15, 2008, none of the Act's debt-relief provisions applies; Corporation Y takes the \$40 million of cancellation of indebtedness income into income on that date. The yield on the new debt of approximately 14.388 percent is in excess of nine percent, the applicable federal rate plus five percentage points, and none of the original issue discount on the new debt is paid until maturity in ten years; the new debt is accordingly an applicable high yield debt obligation. The portion of the \$20 million of original issue discount for which interest deductions are disallowed is the full \$20 million, the lesser of (i) the \$20 million of original issue discount and (ii) \$20.7+ million, the amount that bears the same ratio to the total return of \$68 million (\$20 million of original issue discount plus \$48 million of semiannual interest) as 4.388 percent (the yield in excess of ten percent, the applicable federal rate plus six percentage points) bears to the total yield of 14.388 percent.

*December 15, 2008 Exchange*

If the exchange occurs on December 15, 2008, Corporation Y takes the \$40 million of cancellation of indebtedness income into income on that date. However, because the new debt is issued after August 30, 2008, the applicable high yield discount rules do not apply. Corporation Y can deduct the \$20 million of original issue discount on the new debt as it accrues.

*January 15, 2009 Exchange*

If the exchange occurs on January 15, 2009, Corporation Y can achieve the same results as the December 15, 2008 exchange—cancellation of indebtedness income taken into income on the date of the exchange and deduction of the original issue discount as it accrues. Alternatively, Corporation Y can elect under the Act to defer the \$40 million of cancellation of indebtedness income and take it into account in 2014-2018 (\$8 million per year). If Corporation Y

makes that election, the interest deduction for the original issue discount on the new debt accruing through December 31, 2013 is also deferred with the amounts so deferred deducted ratably in 2014-2018.

#### Material Available On-Line

The following legislative material is available with the indicated file sizes:

- [P.L. 111-5, Division B, Title I, Subtitle C, Part IV, §§ 1231, 1232](#), the debt-relief provisions of the American Recovery and Reinvestment Tax Act of 2009 [36K].
- [H.Rpt. 111-16, pp. 561-568](#), the Conference Committee's explanation of the debt-relief provisions of the Act [87K].

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