KIRKLAND**PEN**

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KIRKLAND & ELLIS LLP

Private Equity Newsletter

# Economic Stimulus Legislation Provides Deferral of Debt Cancellation Income and Temporary Relief from AHYDO Interest-Deduction Disallowance Rules

## PENpoints

Economic stimulus legislation to be signed today allows taxpayers to defer most CODI over a 5-year period and temporarily suspends the application of AHYDO rules for new debt issued in exchange for existing debt.



The economic stimulus legislation passed by Congress last Friday and expected to be signed by the President today contains important relief for a company seeking to restructure debt in the current economic crisis. In particular, the legislation:

- allows a taxpayer to elect to defer most cancellation of debt income (CODI) that would otherwise be recognized in a 2009 or 2010 transaction (including a debt modification), so that such CODI is taken into income over the 5-year period from 2014 through 2018, and
- temporarily suspends application of the applicable high yield discount obligation (AHYDO) rules (deferring or disallowing OID interest deductions) for new debt issued in exchange for existing debt (or deemed issued in a debt modification) from 9/1/08 through 12/31/09, where certain conditions are met.

These two provisions will provide substantial relief to many companies seeking to repurchase debt at a discount, engage in a debt-for-debt or an equity-for-debt exchange or modify an outstanding debt instrument. Companies eligible for existing rules that exclude CODI from taxable income (and substitute tax attribute reduction) because they are bankrupt or insolvent can elect between the old exclusion-and-attribute-reduction rules or the new CODI-deferral rules, a decision that will depend on each company's individual situation and forecasts.

**Background**

A company generally recognizes taxable CODI to the extent that its debt is forgiven or repurchased or otherwise satisfied for less than the debt's adjusted issue price (generally its face amount for debt issued without original issue discount). A company may also recognize taxable CODI when it (i) exchanges new equity for existing debt, (ii) exchanges new debt for existing debt or (iii) modifies the terms of existing debt, especially (in the case of (ii) and (iii)) if such debt is "traded on an established market" (a concept significantly broader than the usual meaning of publicly traded). CODI may also arise where a related person (e.g., a debtor company's private equity sponsor) acquires a company's debt at a discount.

Current tax rules allow (i) a company in bankruptcy to exclude CODI from taxable income and (ii) a company that is insolvent to exclude CODI from taxable income but only to the extent of its insolvency. In each case, the company must reduce its tax attributes (e.g., net operating losses (NOLs) and asset tax basis), generally by the amount of excluded CODI.

Due to the economic crisis, the debt of many companies is selling at unprecedented discounts. As a result, companies may face recognition of large amounts of taxable CODI if they engage in debt repurchases, debt-for-debt exchanges, debt modifications and equity-for-debt exchanges. Where a company is not in bankruptcy and is not sufficiently insolvent, such a transaction may trigger a large tax liability, inhibiting the ability to restructure debt.

**Elective CODI Deferral**

The new legislation allows taxpayers to elect to defer CODI taxation on "applicable debt instruments" that would otherwise be recognized in a covered transaction from 1/1/09 through 12/31/10. An applicable debt instrument includes any debt issued by a C corporation or debt issued by an individual or flow-through entity (such as a partnership, LLC or S corporation) in connection with a trade or business.

The new legislation covers CODI that would be recognized in the following types of transactions, whether engaged in by the issuer/obligor of the debt instrument or by a related person:

- acquisition of a debt instrument for cash,
- exchange of a debt instrument for another debt instrument,
- deemed exchange of a debt instrument for another debt instrument arising from modification of the debt instrument's terms,
- exchange of a debt instrument for corporate stock or for a partnership or LLC interest,
- contribution of a debt instrument to capital, or
- complete forgiveness of a debt instrument.

Where the taxpayer so elects, CODI that would otherwise be recognized in a transaction occurring from 1/1/09 through 12/31/10 is deferred (subject to acceleration rules described below) and instead taken into income over the 5-year period from 2014 through 2018.[1] **A taxpayer electing to defer CODI may not exclude the deferred CODI from income in any year on grounds of bankruptcy or insolvency.**

A taxpayer who defers CODI is also required to defer "related" deductions for original issue discount (OID) that would otherwise accrue prior to 2014, taking such deductions into account over the same 5-year period from 2014 through 2018 when deferred CODI is taken into income.[2] OID is generally "related" for this purpose if it accrues on (i) new debt issued in a debt-for-debt exchange (or deemed exchange) that caused the deferred CODI or (ii) new debt issued for cash where the new debt proceeds are used to repurchase existing debt at a discount creating deferred CODI.

Where the taxpayer is a partnership or LLC, any deferred CODI is allocated to those persons who were partners or LLC members immediately before the transaction that generated the deferred CODI.[3] Deferred OID deductions are not literally covered by this special allocation rule. However, the IRS has authority to issue regulations dealing with application of the new rules to partnerships, S corporations and other flow-through entities and thus could provide by regulation for matching deferred income and deduction.

Deferred CODI and deferred OID deductions are accelerated into income immediately if:

- the taxpayer liquidates (or in the case of an individual, dies),
- the taxpayer sells substantially all of its assets,
- the taxpayer ceases business, or
- similar circumstances occur (with IRS authority to elaborate).

It is not clear whether a change of control of a corporation might be treated as "similar circumstances" that would cause acceleration.

Where CODI is deferred by a flow-through entity (generally a partnership, LLC or S corporation), acceleration is required if an equity owner sells its interest. Presumably such acceleration is limited to the CODI and OID deferred on behalf of the selling equity owner and does not affect the CODI and OID deferred by other equity owners.

A taxpayer wishing to elect to defer CODI under the new provisions must make such election on its tax return for the year that includes the

1 For simplicity, we assume that a taxpayer uses the calendar year for tax reporting. The deferral period is slightly different for a taxpayer using a fiscal year other than the calendar year.

2 There is no similar deferral of OID income for a holder of such a debt instrument.

3 The statute does not provide a similar rule for CODI recognized by an S corporation.

transaction creating the CODI (i.e., its 2009 or 2010 federal income tax return). The election may be made on an instrument-by-instrument basis. Thus, a taxpayer may elect deferred CODI treatment for some but not all debt instruments in a tranche. The election must be made at the entity level for debt issued by a flow-though entity.

The election must also indicate the amount of CODI subject to deferral and other information required by the IRS. This requirement may create complexities where the amount of CODI or the fact of CODI is uncertain, for example, in a debt-for-debt exchange where it is not entirely clear whether the old debt or new debt is "traded on an established market" or where the FMV of stock issued in an equity-for-debt exchange is unclear.

**Examples of CODI Deferral**

***Example 1***

On 4/1/09, Corporation X repurchases $100 million of its outstanding debt for $60 million in cash. X is not bankrupt or insolvent. In the absence of the new deferral rules, X would recognize $40 million of taxable CODI on its 2009 tax return. Under the economic stimulus legislation, X may elect to defer recognition of such $40 million of taxable CODI, taking $8 million into income in each of the 5 years from 2014 through 2018.

***Example 2***

Same as Example 1, except that X issues stock with an FMV of $60 million to retire $100 million of its existing debt. Same result as Example 1.

***Example 3***

Same as Example 1, except that X issues new debt instruments with a face amount and issue price of $60 million to retire $100 million of its existing debt. Same result as Example 1.

***Example 4***

Same as Example 1, except that X's majority shareholder (Fund) purchases $100 million of X's outstanding debt for $60 million. For tax purposes, X is treated as issuing a new debt instrument to Fund having a face amount of $100 million and an issue price of $60 million and as repurchasing $100 million of old debt for $60 million. Same result as Example 1. Fund will be required to accrue the $40 million of OID on the deemed new debt over the remaining term of the debt. X's OID deductions will be deferred to match the timing of its CODI inclusions and the OID deductions may also be deferred and partially disallowed under the AHYDO rules. Because Fund is related to X, the AHYDO relief discussed below will not apply.

***Example 5***

Same as Example 1, except that X is in bankruptcy on 4/1/09. Under current tax rules, because it is in bankruptcy, X is entitled to exclude the $40 million of CODI from its taxable income (at the cost of reducing certain tax attributes such as NOLs, generally by $40 million). Under the economic stimulus legislation, X may alternatively elect to defer recognition of such $40 million of taxable CODI, taking $8 million into income in each of the 5 years from 2014 through 2018 (where it may not be excluded from income under the bankruptcy or insolvency exclusion), in which case the attribute reduction rules do not apply.

## AHYDO Interest Disallowance Relief

A debt instrument issued by a corporation is generally an AHYDO if it has (i) a term greater than 5 years, (ii) a yield greater than the IRS's applicable federal rate (AFR) plus 500 basis points and (iii) "significant" accrued but unpaid OID on any accrual date after the fifth anniversary of issuance. Under current law, a company may not deduct OID on an AHYDO until paid in cash. In addition, if the AHYDO has a yield in excess of the AFR plus 600 basis points, a portion of the deduction for OID is permanently disallowed.

Where a company engages in a debt-for-debt exchange or a debt modification, the new debt issued in the exchange or deemed exchange may have OID, particularly if either the new debt or the old debt is considered "traded on an established market" so that the new debt has a tax issue price equal to FMV. A similar deemed exchange creating CODI and OID can occur when a related person acquires a company's debt at a discount.

The company's deduction of such OID over the life of the new debt instrument partially offsets the tax cost of recognizing CODI. However, in many situations, the amount of the OID may be large enough to cause the new debt to be an AHYDO, limiting the ability of the company to claim OID deductions.

Under the new legislation, the AHYDO rules do not apply to defer or disallow OID deductions on debt issued in a debt-for-debt exchange (including a deemed exchange caused by modification of an existing debt instrument) that occurs from 9/1/08 through 12/31/09 so long as (i) the old debt (or the debt prior to modification in the case of a deemed exchange) was not an AHYDO, (ii) the new debt and the old debt have the same issuer/obligor, (iii) the new debt does not have certain contingent interest features and (iv) the new debt is not issued to a related person within the meaning of Code Section 108(e)(4).

AHYDO relief is independent of CODI deferral relief. Where the requirements are met, AHYDO relief is available regardless of whether the company makes an election to defer CODI as described above. As drafted, AHYDO relief covers only exchanges (or deemed exchanges) occurring on or before 12/31/09. In contrast, the CODI deferral rules apply to transactions occurring on or before 12/31/10. However, the IRS is given authority to extend AHYDO relief to additional periods if "such application is appropriate in light of distressed conditions in the debt capital markets."

AFR is calculated based on yields of U.S. Treasury instruments with similar maturities. Given the decline in interest rates on U.S. Treasury instruments coupled with the rise in interest rates on corporate debt, it is currently difficult to avoid AHYDO status by keeping the interest rate of a debt instrument below the yield threshold of the AHYDO definition (generally AFR plus 500 basis points). The legislation gives the IRS authority to use an interest rate higher than the AFR on a temporary basis in determining whether a debt instrument is an AHYDO (and the consequences of AHYDO status) for debt issued after 12/31/09 if "such rate is appropriate in light of distressed conditions in the debt capital markets." Where the IRS authorizes use of a higher interest rate, it will apply to all debt instruments, not merely those issued in certain exchanges and deemed exchanges. If market conditions remain distressed and the IRS uses this authority to allow use of a higher interest rate in testing for AHYDO status, fewer AHYDOs may be created.

Given current market conditions, it is curious that Congress has limited the potential use of a higher interest rate in testing for AHYDOs to debt issued after 12/31/09.

**Examples of AHYDO Interest Disallowance Relief and Interaction with CODI Deferral**

***Example 1***

On 4/1/09, Corporation Y issues a new debt instrument with OID in exchange for $100 million of its existing debt. The issue price of the new debt instrument is $100 million, so Y does not recognize any CODI as a result of the exchange. Under the economic stimulus legislation, the new debt will not be an AHYDO as long as (i) the old debt was not an AHYDO, (ii) the new debt does not have contingent interest and (iii) the new debt is not issued to a related person.

***Example 2***

On 4/1/09, Corporation Y exchanges $100 million (face amount) of new debt instruments for $100 million (face amount) of its existing debt instruments. The new debt instruments bear interest at a higher rate and have more favorable financial covenants. Y's new debt instruments are considered "traded on an established market" and trade at 60% of face when issued, so that the new debt instruments have a $60 million aggregate issue price. Y is not bankrupt or insolvent.

In the absence of the new deferral rules, Y would recognize $40 million of taxable CODI on its 2009 tax return (i.e., $100 million face amount of existing debt less $60 million issue price of new debt). Under the economic stimulus legislation, Y may elect to defer recognition of such $40 million of taxable CODI, taking $8 million into income in each of the 5 years from 2014 through 2018.

Y will also have $40 million of OID on the new debt issued to retire its existing debt (i.e., the new debt's $100 million face amount less its $60 million issue price). Under the economic stimulus legislation, the new debt will not be an AHYDO as long as (i) the old debt was not an AHYDO, (ii) the new debt does not have contingent interest and (iii) the new debt is not issued to a related person. However, if Y elects to defer its CODI, any OID deductions that Y would have accrued on the new debt from 2009 through 2013 will be deferred and deducted ratably over the 5-year period from 2014 through 2018, though the holders of the new debt will be required to accrue the OID into income on a constant yield basis over the life of the new debt under the normal OID inclusion rules.

***Example 3***

On 4/1/09, Corporation Y agrees with its lenders to amend the terms of $100 million (face amount) of its existing debt instruments. The amended debt instruments bear interest at a higher rate and have more favorable financial covenants. Y is deemed to exchange a "new" debt instrument (with the post-amendment terms) for the existing debt instrument (with pre-amendment terms). Y's "new" debt instruments are considered "traded on an established market" and trade at 60% of face after the amendment. The "new" debt instruments thus have an aggregate issue price of $60 million. Y is not bankrupt or insolvent.

In the absence of the new deferral rules, Y would recognize $40 million of taxable CODI income on its 2009 tax return (i.e., $100 million face amount of existing debt less $60 million issue price of "new" debt). Under the economic stimulus legislation, Y may elect to defer recognition of such $40 million of taxable CODI, taking $8 million into income in each of the 5 years from 2014 through 2018.

Y will also have $40 million of OID on the "new" debt deemed issued in exchange for its existing debt (i.e., the "new" debt's $100 million face amount less its $60 million issue price). Under the economic stimulus legislation, the "new" debt will not be an AHYDO as long as (i) the existing debt was not an AHYDO, (ii) the "new" debt does not have contingent interest and (iii) the "new" debt is not issued to a related person. However, if Y elects to defer its taxable CODI, any OID deductions that Y would have accrued from 2009 through 2013 on the "new" debt will be deferred and deducted ratably over the 5-year period from 2014 through 2018, though the debt holders will be required to accrue the OID into income on a constant yield basis over the remaining term of the debt under the normal OID inclusion rules.

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# PENnotes

**“Real Estate Joint Ventures”**
**Chicago, Illinois**
**February 19 - 20, 2009**

Kirkland partner Gary E. Axelrod will speak on “Governance, Risk Management and Allocation of Liability in Real Estate Joint Ventures” at this two-day conference, which will provide a comprehensive examination of the issues that often arise in the formation and operation of real estate joint ventures and an in-depth discussion of the key economic and business terms found in joint venture agreements. The seminar will be held at the University of Chicago’s Gleacher Center.

**Beecken Petty O’Keefe & Company Private Equity Conference**
**Chicago, Illinois**
**February 20, 2009**

This event is designed to give students and friends of The University of Chicago Booth School of Business an opportunity to hear from successful professionals and alumni in the private equity industry. Keynote speakers include Peter Kagan, managing director at Warburg Pincus, and Raymond Svider, a co-chairman of BC Partners. Kirkland partner Jack S. Levin, P.C., will moderate a panel on debt restructuring, and partners Sanford E. Perl, P.C., and Linda K. Myers, P.C., will participate as panelists.

**Institutional Investor’s 7th Annual Distressed Investing Forum**
**New York, New York**
**February 23 - 25, 2009**

Institutional Investor will hold its 7th Annual Distressed Investing Forum from February 23 - 25, 2009, at the Union League Club in New York City. The program will examine the current environment of distressed investing. Kirkland partner James H.M. Sprayregen, P.C., will deliver the keynote address entitled “Essential Industry Update: Examining the Current Investing Landscape.”

**PLI’s “Drafting Corporate Agreements 2009”**
**Chicago, Illinois**
**February 27, 2009**

This program will discuss and explain how to identify issues, how to find effective and creative drafting solutions to address those issues, how the provisions of an agreement are connected and where the tough issues usually arise. In addition, litigators will discuss how to draft contracts with enforcement in mind. Kirkland partner Gerald T. Nowak will chair this event and speak on credit and indenture agreements and ethical issues in drafting corporate agreements. Kirkland partner Keith S. Crow, P.C., will speak on acquisition agreements.

**Infrastructure Investment World Americas 2009**
**Bridgewaters, New York**
**April 27 - 30, 2009**

Infrastructure Investment World Americas 2009 has been designed by the infrastructure community to uncover the possibilities and address the challenges that this crucial asset class poses in this time of uncertainty. The conference will bring together the key players in the infrastructure community including government, infrastructure funds, financiers and end investors. Kirkland partner Bruce L. Gelman, P.C., will speak at this event.

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## Kirkland & Ellis LLP's Private Equity Practice

Kirkland & Ellis LLP's private equity attorneys handle leveraged buyouts, growth equity transactions, recapitalizations, going-private transactions and the formation of private equity, venture capital and hedge funds on behalf of more than 200 private equity firms in every major market around the world.

Kirkland has been widely recognized for its preeminent private equity practice. In 2008, Mergermarket ranked Kirkland first by volume for Global and North American Buyouts in its "League Tables of Legal Advisers to Global M&A for Full Year 2007." Also in 2008, Kirkland received prestigious first-tier rankings in both private equity and fund formation from Chambers & Partners.

*The Lawyer* magazine recently recognized Kirkland as one of the firms in "The Transatlantic Elite," noting that the firm is "leading the transatlantic market for the provision of top-end transactional services ... on the basis of a stellar client base, regular roles on top deals, market-leading finances and the cream of the legal market talent." In addition, Kirkland's London office was recently named the 2008 "Banking Team of the Year" at the Dow Jones *Private Equity News* Awards for Excellence in Advisory Services.

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