

New Legislation Will Permit Deferral of Cancellation of Debt Income

By **Kenneth E. Werner**

Among the tax provisions contained in the American Recovery and Reinvestment Act of 2009 (the “2009 Act”) are amendments to the Internal Revenue Code that will allow companies to defer income they would otherwise recognize from repurchasing their debt at a discount.

In general, taxable income includes income recognized by a debtor from repurchasing its indebtedness at a discount (or otherwise satisfying its indebtedness for an amount less than the adjusted issue price), including repurchases by certain persons related to the debtor. Exceptions apply to this general rule, *e.g.*, in the case of bankruptcy or insolvency, in which case the debtor must reduce certain tax attributes. In the current environment, many companies are finding there are attractive opportunities to reacquire their outstanding debt at substantial discounts, however the benefit of doing this is partly offset by the tax cost incurred.¹

Pursuant to the 2009 Act, taxpayers that would otherwise recognize income from reacquisition of debt occurring in tax years ending after December 31, 2008, may elect to defer such recognition of income for debt instruments reacquired after December 31, 2008 and prior to January 1, 2011, by having such income incurred ratably over a 5 year period, beginning with the fifth tax year after the reacquisition for debt instruments reacquired during 2009, and beginning with the fourth tax year after the reacquisition for debt instruments reacquired in 2010.

For example, if a company reacquires its debt instruments with an adjusted issue price of \$10 million in 2009 for \$5 million, instead of recognizing \$5 million of income in 2009, it

could elect to recognize \$1 million of income in each of years 2014-2018.

If such a deferral election is made, special rules apply to defer deductions on original issue discount on debt issued by a taxpayer to reacquire its existing debt at a discount, and to accelerate recognition of the deferred income when the company sells substantially all of its assets or otherwise ceases to do business.

While these new provisions only defer recognition of taxable income from repurchase of debt at a discount, rather than avoid it, they still make it more attractive for companies (or related persons) to reacquire their debt.

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If you have any questions regarding the matters discussed in this memorandum, please call your usual contact at Richards Kibbe & Orbe LLP or the person listed below.

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Memorandum

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¹ See, *e.g.*, “Equity Kickers: Extra Point for Lenders” available on our website at www.rkollp.com.

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