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Deleveraging the Portfolio Company – Stimulus Legislation Provides Tax Relief

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The economic stimulus legislation passed by Congress and signed by the President includes important tax relief that may facilitate the deleveraging of portfolio companies' balance sheets. Where applicable, the legislation would allow a portfolio company to defer the recognition of cancellation of debt ("COD") income and avoid certain limitations on deductions of original issue discount ("OID"). The following is a brief summary of these new rules.

Deferral of COD Income. A portfolio company may elect to defer the inclusion of COD income that results from the occurrence, in 2009 or 2010, of (i) a cash purchase of the portfolio company's debt by the portfolio company or a related person,[1] (ii) a debt-for-debt exchange (including a deemed exchange resulting from the significant modification of outstanding debt),[2] (iii) a debt-for-equity exchange, (iv) a contribution of debt to capital, or (v) a holder's complete forgiveness of debt (each, a "COD Transaction").[3]

Such income would be includible ratably over a 5-year period beginning in the fifth tax year after the tax year in which the COD Transaction occurs (for COD Transactions in 2009) or the fourth tax year after the tax year in which the COD Transaction occurs (for COD Transactions in 2010). Thus, if a calendar year portfolio company effects a COD Transaction in 2009, it could elect to defer the COD income and include it ratably during its 2014 through 2018 tax years.

Corresponding Deferral of OID. A portfolio company that elects to defer its COD income must defer the deduction of any OID attributable to debt that it issues (or is deemed to issue) in the COD Transaction (including debt the proceeds of which are used to repurchase outstanding debt). The deferred deductions generally would not exceed the deferred COD income, and would be taken into account over the same time period as the deferred COD income (*i.e.*, the 5-year period beginning 4 or 5 tax years after the tax year in which the COD Transaction occurs).[4]

Acceleration of Deferred COD Income. The portfolio company would have to include all deferred COD income (and would be allowed to claim its deferred OID deductions) in the tax year in which the portfolio company liquidates or sells substantially all its assets (including in a bankruptcy case) or ceases business and in other similar circumstances.[5] If the portfolio company is a pass-through entity (*e.g.*, a partnership, limited liability company or S corporation), a partner, member or shareholder would have to include its share of the deferred COD income upon a sale, exchange or redemption of its interest in the entity.[6]

Deferral Relief is Elective. The portfolio company must elect to have these rules apply on the tax return for the tax year in which the COD Transaction occurs, and would be irrevocable once made. In the case of pass-through entities, the election would be made by the pass-through entity (and not its owners). If the election is made, the deferral rule would trump the COD exclusion rules (*e.g.*, the bankruptcy and insolvency exceptions). In the case of a pass-through entity, it is possible that different partners might have different perspectives on whether the deferral election is more advantageous than another exclusion.

AHYDO Relief. The new legislation also provides some relief from the AHYDO rules – *i.e.*, rules that, if applicable, defer or disallow OID deductions on certain debt.[7] This relief, although limited, is welcome because, in the context of COD Transactions, the AHYDO rules tend to operate unfairly. To be eligible for such relief, the portfolio company must have issued the debt during the period beginning September 1, 2008 and ending December 31, 2009 in exchange (including a deemed exchange) for outstanding debt that was not subject to the AHYDO limitations. Relief would not be available for debt issued to a related person or that has certain types of contingent interest. Treasury can extend this relief to debt issued after December 31, 2009 if it determines that it is appropriate in light of distressed conditions in the debt capital markets.

If you wish to discuss these new rules or any of the other tax issues arising in connection with restructuring a portfolio company's debt, please call Marc L. Silberberg (212-310-8261), Martin D. Pollack (212-310-8461) or Max A. Goodman (212-310-8173).

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1 Depending on the facts, the purchase by a sponsor of a portfolio company's debt at a discount may be treated for federal income tax purposes as if (i) the portfolio company purchased the debt for the price paid by the sponsor (producing COD income) and (ii) the portfolio company reissued the debt to the sponsor for such price (producing OID).

2 A change in terms of outstanding debt may result in the deemed exchange of the outstanding debt for "new" debt. If the outstanding or "new" debt is treated as "traded on an established market" (as that term is specially defined for tax purposes), the exchange may result in the creation of COD income and OID, even if the principal amount of the debt remains the same.

3 The elective deferral rule is available only for debt issued by (i) C corporations and (ii) any other person in connection with the conduct of a trade or business. Thus, this relief would be expected to be available to the typical portfolio company.

4 The deferral of OID deductions is not intended to precisely match the deduction of OID to the inclusion of deferred COD, so it will not create a "wash" in all cases (e.g., debt with a remaining term of more than 10 years).

5 Special acceleration rules would apply to portfolio companies that file a bankruptcy case.

6 In addition, special rules apply to portfolio companies that are taxable as partnerships. These rules generally coordinate the COD income deferral rule with the normal rules that apply when a partner's share of partnership liabilities is reduced; these rules are intended to limit (but may not have eliminated) the circumstances in which the deferred income might result in a premature increase in a partner's taxable income under a different provision of the tax law.

7 An "applicable high-yield discount obligation" (an "AHYDO") generally is a debt instrument that (i) has a term of more than 5 years, (ii) has a yield that equals or exceeds the applicable federal rate plus 500 basis points, and (iii) in general, after the fifth anniversary of its issuance, has more than a limited amount of OID that has not been paid in cash. The applicable federal rate is a rate published monthly by the IRS that is based on Treasury obligations of comparable maturities. For debt issued after December 31, 2009, the new legislation authorizes Treasury to allow the use of a rate for purposes of the AHYDO rules that is higher than the applicable federal rate if it determines that it is appropriate in light of distressed conditions in the debt capital markets.

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