

**AMERICAN RECOVERY AND REINVESTMENT ACT OF 2009 PROVIDES
SIGNIFICANT TAX RELIEF IN DEBT RESTRUCTURINGS**

In the current economic climate, many companies may be considering a repurchase or restructuring of their outstanding debt instruments. Significant discounts in the trading value of debt may make it attractive for companies with available cash to repurchase such debt. At the same time, other companies may be having difficulty meeting financial covenants and other terms of their debt obligations and may be seeking to modify or refinance such debt. In either case, companies may be deterred from engaging in repurchase or restructuring transactions because of (i) the cancellation of indebtedness (“COD”) income that may be incurred if the debt is trading at a significant discount and/or (ii) concern that a debt exchange or modification may give rise to significant original issue discount (“OID”) on the new debt that is effectively nondeductible due to the high-yield discount obligation (“HYDO”) rules.

On Tuesday, February 17, 2009, President Obama signed into law the American Recovery and Reinvestment Act of 2009 (the “Act”), which includes two changes to current law that provide significant tax relief over the next two years to companies that are considering a repurchase or restructuring of their debt. One provision allows companies that incur COD income in 2009 and 2010 to include that income ratably over a five-year period beginning in 2014. The other provision makes inapplicable the rules that defer or deny deductions on debt that is treated as a HYDO if the debt is issued during the period from September 1, 2008 through the end of 2009 in an exchange (including a deemed exchange) for another debt obligation. The combined effect of these provisions creates a unique window period during 2009 in which companies will be able to modify or exchange their debt free of the onerous tax consequences that attended these transactions prior to the Act.

Background

Debt Repurchases. If a company repurchases its debt at a discount to the debt’s issue price, the company generally recognizes COD income equal to the difference. If a person who is treated as a “related party” to the company for tax purposes repurchases the debt, COD income is also recognized by the company to the same extent. In a “related party” repurchase, the debt is treated as being reissued for an amount equal to the purchase price, with the difference between the purchase price and the adjusted issue price (generally, the face amount) of the original debt being treated as original issue discount (OID). OID is includable by the holder of the debt and deductible by the issuer on a constant yield basis over the remaining life of the debt. Because the gross amount of OID is equal to the COD income, the OID deductions generally offset the COD income, ignoring the time value of money. However, if the remaining term of the debt in such situations is greater than five years, the HYDO rules may apply to defer or deny tax deductions attributable to the OID.

Debt Modifications. If a debt instrument is “publicly traded” and a “significant modification” is made to the debt instrument, the debt is deemed to be satisfied and reissued at its trading price at the time of the modification. If the debt is trading at a discount, these deemed exchanges will have the same COD income and OID effects as described above. Significant modifications include changes in yield of more than the greater of 25 basis points or 5% of the yield before the amendment, a material deferral of scheduled payments, a change in obligor, and other changes that collectively are deemed to be “economically significant.”

Generally, debt is treated as “publicly traded” if it is listed on a major exchange or interdealer quotation system, if certain specified information is available on a system of general circulation (e.g., Bloomberg), or, in certain circumstances, where the instrument is “readily quotable.” Many debt instruments will clearly meet this definition and many other debt instruments will at least arguably be publicly traded under this definition. In addition, the public trading test is technically applied by taking into account the 30-day period after a debt modification or exchange is effective, in many cases making a definitive determination regarding the existence of public trading extremely difficult at the time of the transaction. This will be the case especially if the issue is one of some size, so that trading activity could be expected to arise subsequent to closing the transaction. The status of debt as publicly traded is significant because if it is not, a deemed exchange generally does not result in COD income or OID.

HYDO Rules. Generally, a HYDO is a debt instrument (i) issued by a corporation (ii) with a maturity greater than five years (iii) that has a yield to maturity greater than or equal to 5% plus the applicable federal rate (AFR) in effect for the month in which the debt is issued and (iv) that has “significant OID.” AFRs, which are published monthly by the IRS, currently range from 0.81% to 3.51%, depending on the term of the debt instrument and how often interest compounds. Generally, a debt instrument has significant OID if it has OID outstanding at the end of the fifth year after issuance that is at least equal to the first twelve months’ yield on the debt. Interest and OID deductions on a HYDO are generally deferred until paid and are also permanently disallowed to the extent the yield exceeds the applicable federal rate plus 6%. The unprecedented yield gap between U.S. government securities (which form the basis for the AFRs) and corporate obligations, plus the depressed trading values of the debt of even high-quality corporate issuers, often leads to large amounts of OID on new debt that results from a modification or debt exchange. The fact that the OID is often nondeductible to a significant extent under the HYDO rules leads to a pernicious asymmetry because taxable COD is triggered by the transaction, but the equivalent OID is largely nondeductible under the HYDO rules. This asymmetry often leads issuers to decline to consider transactions in corporate debt that were otherwise compelling from a commercial standpoint.

Tax Relief Under the Act

COD Income Relief. Under the Act, companies that incur COD income in 2009 and 2010 in connection with any “acquisition” of a debt instrument may elect to include that income ratably over a five-year period beginning in 2014. An “acquisition” for this purpose includes a cash repurchase by the company or a related party, an exchange of debt for another debt instrument, a

deemed exchange as a result of a significant modification to a debt instrument, a debt-for-equity exchange, a contribution of debt to capital and a complete forgiveness of debt by the holder of the debt instrument. The provision applies to any debt instrument issued by a C-corporation or any other person in connection with the conduct of a trade or business by such person (e.g., a partnership, an S-corporation or a limited liability company engaged in the conduct of a trade or business). The Act also defers any OID deductions that accrue prior to 2014 that are attributable to a debt-for-debt exchange or deemed exchange of debt to which the COD income applies; such OID deductions are then taken into account ratably over the same five-year period as the COD income.

HYDO Relief. Importantly, the Act also provides that the HYDO rules do not apply to any debt instrument that is issued in exchange for a debt instrument (or deemed issued as a result of a significant modification of a debt instrument) during the period from September 1, 2008 through December 31, 2009, as long as the HYDO rules did not apply to the pre-existing debt. This relief is more limited than the COD income relief both in time (it does not apply to exchanges or deemed exchanges of debt in 2010) and in scope (it does not apply to debt issued for cash or property other than non-HYDO debt or to related party repurchases). If the Treasury Secretary deems it appropriate to do so given the distressed conditions in the debt capital markets, the Act permits the Treasury Secretary to (i) extend the effect of this provision beyond December 31, 2009 and (ii) use a rate higher than the applicable federal rate for purposes of determining whether a debt instrument is a HYDO.

Significance of the Relief

It seems likely that the tax relief provided by the Act will significantly increase the number of companies that execute debt repurchases and restructuring transactions. Deferral of COD income for five years with a five-year spreading of its inclusion thereafter materially reduces the net present value tax cost of such transactions. In addition, the suspension of the HYDO rules during the balance of 2009 will generally permit OID deductions corresponding to the reduction in issue price resulting from the restructuring to offset the COD income triggered by the exchange. (Note, however, that the offset will not be complete if the new or modified debt has a term in excess of ten years, and for debt instruments with a maturity of ten years or less there may be certain years in which the COD income inclusion exceeds the OID deduction.) For debt-for-debt exchanges and restructurings in 2010, the HYDO rules may again operate to limit significantly an issuer's ability to deduct most of the OID resulting from the exchange, again making these transactions noneconomic as a practical matter.

* * * * *

If you have any questions regarding the foregoing or would like additional information, please contact Richard L. Reinhold (212-728-8292, rreinhold@willkie.com), Christopher J. Peters (212-728-8868, cpeters@willkie.com) or the Willkie attorney with whom you regularly work.

Willkie Farr & Gallagher LLP is headquartered at 787 Seventh Avenue, New York, NY 10019-6099. Our telephone number is (212) 728-8000 and our facsimile number is (212) 728-8111. Our website is located at www.willkie.com.

February 20, 2009

IRS Circular 230 disclosure:

To ensure compliance with requirements imposed by the Internal Revenue Service, we inform you that any U.S. tax advice contained in this communication (including any attachments) is not intended or written to be used, and cannot be used, for the purpose of (i) avoiding penalties under the Internal Revenue Code or (ii) promoting, marketing or recommending to another party any transaction or matter addressed herein.

Copyright © 2009 by Willkie Farr & Gallagher LLP.

All Rights Reserved. This memorandum may not be reproduced or disseminated in any form without the express permission of Willkie Farr & Gallagher LLP. This memorandum is provided for news and information purposes only and does not constitute legal advice or an invitation to an attorney-client relationship. While every effort has been made to ensure the accuracy of the information contained herein, Willkie Farr & Gallagher LLP does not guarantee such accuracy and cannot be held liable for any errors in or any reliance upon this information. Under New York's Code of Professional Responsibility, this material may constitute attorney advertising. Prior results do not guarantee a similar outcome.