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Provisions of the American Recovery and Reinvestment Act of 2009 Relating to Deferral of Cancellation of Debt Income

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I. BACKGROUND.

In recent months, many issuers of outstanding debt now valued at substantially less than its par amount have considered restructuring or tendering for their debt. Transactions of that kind often give rise to "cancellation of debt" income ("COD income") for U.S. federal income tax purposes. COD income is treated as ordinary taxable income of the issuer. In the absence of sufficient net operating losses ("NOLs"), tax credits or similar tax attributes, transactions that generate COD income may produce a current cash tax liability for the issuer. In the present liquidity-constrained environment, the incurrence of additional cash tax costs may well impede commercially desirable transactions to reduce leverage.

The American Recovery and Reinvestment Act of 2009 (the "Act") signed into law on February 17, 2009, amends section 108 of the Internal Revenue Code[1] to provide generally for an elective deferral of COD income realized by certain issuers as a result of transactions that occur in 2009 or 2010. Any such COD income generally will be deferred through 2013 and subsequently recognized ratably over the following five taxable years. We expect that the ability to defer or in some cases avoid paying cash taxes attributable to COD may greatly facilitate liability management transactions for the next two years.

However, the COD income deferral election reduces or eliminates certain favorable provisions of current law for issuers who make the election. Accordingly, issuers will need to consider carefully whether making the election is on balance advantageous to them.

The new COD income deferral election will be relevant for issuers who engage in a number of different types of transactions that generate COD income:

[1] Section 1231 of the Act; section 108(i). Unless indicated otherwise, all section references are to the Internal Revenue Code of 1986, as amended, or to Treasury regulations promulgated thereunder.

- Cash tender offers. The repurchase of debt by the issuer for cash in an amount less than the debt's adjusted issue price, such as a cash tender offer.
    - The COD income in a tender offer is the difference between the adjusted issue price of the debt (in simple cases, par plus accrued interest) and the cash repurchase price.
- Exchange offers. The exchange by the issuer of new debt for old debt, where either the new or old debt is "publicly traded,"[2] or where there is a reduction in the principal amount of the outstanding debt.
    - For publicly traded debt, the COD income generally is the difference between the adjusted issue price of the old debt and the trading price of the new debt. Engaging in an exchange offer for debt that is trading at a significant discount may give rise to significant COD income, even though from the issuer's perspective the debt burden has not changed.
- Consent solicitations. For tax purposes, a modification of the terms of the debt also may be treated as a deemed exchange of new debt for old debt. For example, extending the maturity, reducing the interest rate, or modifying other payment terms may give rise to a deemed exchange of this kind, with the same tax consequences to the issuer as for an actual exchange offer.
- Related party transactions. An issuer will realize COD income when a person related to the issuer acquires issuer debt at a discount from an unrelated person. These rules may apply for example to a private equity fund that buys in debt of a portfolio company, or a parent buying in debt of a subsidiary.
    - The COD income is the difference between the adjusted issue price of the new debt and the price paid by the related person (or in some circumstances, the fair market value of the debt). As a result, the acquisition by a related person of debt that is trading at a deep discount will generally give rise to significant COD income.

[2] The term "publicly traded" is a tax term of art; in practice all but the most illiquid bonds or loans may be treated as publicly traded.

- Debt forgiveness. Having debt forgiven, whether in or out of bankruptcy.
    - The COD income generally equals the amount of debt forgiven.
- Debt-for-equity swaps. The exchange by the issuer of its stock or a partnership interest (as relevant) for debt.
    - The COD income is the difference between the adjusted issue price of the debt and the fair market value of the equity issued.
- Foreclosure and similar transactions. Transferring property to a creditor in satisfaction of a recourse liability, whether pursuant to a foreclosure or in lieu of foreclosure. (Different rules apply to non-recourse debt and generally gain on transfer of collateral in satisfaction of non-recourse debt will not be eligible for the new deferral provision).

II. PRINCIPAL IMPLICATIONS OF THE NEW COD DEFERRAL PROVISION.

- ***In general***

New section 108(i) provides that an issuer may irrevocably elect to defer COD income realized on the reacquisition of its own debt after December 31, 2008 and before January 1, 2011, and to recognize such COD income ratably over a five-taxable-year period that will begin in 2014 and end in 2018 for most issuers (the "inclusion period"). An issuer that uses a fiscal rather than calendar taxable year, or that has one or more short taxable years during the deferral or inclusion periods, may be required to start recognizing the COD income sooner, or to take it into account more quickly.

Electing issuers that carry out exchange offers or otherwise are treated as issuing new debt with original issue discount ("OID") in exchange for old debt generally must defer any OID deductions up to the amount of the deferred COD income and deduct them ratably over the five-taxable-year inclusion period. In some cases this will result in the effective elimination of the COD income. In other cases, issuers may be required to pay tax on non-economic income on a permanent (not merely timing) basis, if limitations or changes in circumstances give rise to a situation where they cannot deduct the OID in full. For example, OID arising from purchases of debt by related parties may be disallowed in part under the "applicable high yield discount obligation" ("AHYDO") rules. Some issuances of new debt for cash are treated as if they were debt-for-debt exchanges, if the issuer uses the proceeds to redeem outstanding debt held by different investors.[3]

All of the deferred COD income and deferred OID not yet recognized is accelerated and taken into account in the taxable year in which the issuer dies, liquidates, sells substantially all of the assets of its business (including in bankruptcy), ceases its business, or in which similar circumstances occur. In a bankruptcy case, any deferred items are taken into account on the day before the day the bankruptcy petition was filed, which may give rise to certain anomalies in view of the fact that a bankruptcy case may take years to resolve.

The COD income deferral election is made on an instrument by instrument basis, which may allow flexibility to issuers to take advantage of the election on a limited basis. It is only available for debt of C corporations or business debt of other issuers.

The election also provides special allocation rules for deferred COD income realized by partnerships and special rules for reflecting the reduction in partnership debt in the outside basis of partners in the partnership. The election is made at the partnership level, which may give rise to conflicts between the interests of different partners.

The primary benefit of the election for most issuers is in the postponement of a cash tax obligation and the time value of the deferral and spreading of tax that may result from a liability management transaction. In addition, the issuer generally will be able to offset future COD income inclusions by operating losses, including those incurred in the years *after* the repurchase and including those generated as a result of deductible OID on new debt issued in a debt-for-debt (or deemed debt-for-debt) exchange.

- ***Making the election***

  - ***Time for making the election.*** The election is made on the issuer's tax return for the taxable year in which the reacquisition occurred, which ordinarily would be filed in the next taxable year. As a result, issuers will be able to "look back" at their debt acquisitions in 2009 and 2010 to decide whether to make the election. It would be prudent to interpret this rule as applying to elections made with timely filed (including applicable extensions) income tax returns.

[3] The provision does not appear to recharacterize a transaction in which a party *related* to the issuer issues new debt and the proceeds are directly or indirectly used to purchase applicable debt of the issuer as a deemed debt-for-debt exchange. It is unclear whether this is a technical glitch or the result of a deliberate choice to apply the special recharacterization rule only to transactions in which outstanding debt of an issuer is retired for new debt of the same legal entity.

- ***Identification of debt instrument subject to election.*** To make the election, the issuer must clearly identify the applicable debt instrument and disclose the amount of the deferred COD income in a statement filed with the issuer's income tax return for the taxable year of the discharge and include such other information as the Treasury may prescribe. The election is irrevocable.

- ***No consistency is required.*** The election is made on an instrument by instrument basis, without any apparent requirement for consistency. While not entirely clear, a debt "instrument" could be interpreted to mean a single bond (rather than, for example, a bond issue). Under such interpretation, assuming the individual bonds could be clearly identified, an issuer could tailor its election so as to maximize the use of available NOLs and defer only excess COD income.

- ***Tender offers, debt forgiveness, debt-for-equity swaps***

For many issuers that engage in debt reacquisitions where no new debt is issued or deemed issued, it will be clearly beneficial to make the COD income deferral election. Issuers that could otherwise take advantage of existing favorable rules for excluding COD income will need to decide, however, whether it is preferable to retain the benefit of those rules or to make the election.

- ***Net operating losses.*** Taxpayers that have current NOLs or NOL carryforwards may prefer not to make the election, if they can offset any COD income from a debt acquisition with those NOLs. A taxpayer might be better off using NOLs today, rather than in the future, for a variety of reasons. For example, the NOLs might expire prior to the inclusion period, or might become subject to limitations under section 382,[4] or might simply have had a valuation allowance placed against them for accounting purposes so that a financial accounting benefit is realized from their use.

- ***Bankruptcy or insolvency.*** Under current law there are already a number of provisions that exclude COD income from gross income, including if the debt discharge occurs in bankruptcy or when the issuer is insolvent, or (for certain

[4] Under section 382, if a corporation has a "net unrealized built-in gain," built-in pre-change gain or income items that are recognized during the five-year period beginning on the change date will increase the section 382 limitation for the taxable year in which such items are recognized. Presumably pre-change deferred COD income would be such a built-in income item. An issuer that experiences a section 382 change of ownership after the discharge may not, however, be able to take full advantage of the built-in gain rules to have the deferred COD income increase its section 382 limitation, if it does not have "net unrealized built-in gain" as of the change date or the "inclusion period" for the COD income is outside the five-year section 382 recognition period.

non-corporate issuers under certain conditions) if the discharged debt was incurred in connection with business real estate. If COD income is excluded under these provisions, the issuer generally must reduce available tax attributes (*e.g.*, NOLs, tax credits, tax basis) to the extent of the excluded COD income, with the result that over time the issuer may generate increased taxable income.

- *Exclusion rules do not apply*. Unlike these exclusions, the new COD deferral election does *not* require any reduction in tax attributes, presumably because the election provides only for a deferral of taxable income and not a complete exclusion. However, an issuer that makes the election cannot also take advantage of the special rules for bankruptcy or insolvency with respect to the deferred COD income. As a result, a taxpayer that is insolvent or in bankruptcy needs to determine whether it would prefer to recognize the COD income on a deferred basis, but keep its tax attributes, or exclude the COD income permanently and reduce its tax attributes.

- ***Liquidation or sale.*** As noted above, there are a variety of events that may cause acceleration of deferred items of COD income and OID deductions. An issuer anticipating any of these events in the near future may not fully benefit from making the election.

- ***Exchange offers and consent solicitations***

Issuers that engage in a transaction in which a new debt instrument is issued or deemed issued for tax purposes, including some consent solicitations in which the modified debt is treated for tax purposes as newly issued debt, will need to take into account the above considerations and also perform a more complex analysis to determine the benefits of the election. That is because the new debt will be treated as issued with OID if its fair market value is significantly less than its par amount, and the debt is treated as publicly traded.

- ***Deferral of OID deductions.*** OID will accrue on new debt issued in a debt-for-debt exchange on a constant yield basis over such debt's term. Under the OID rules, over time the new debt generally will produce cumulative interest expense attributable to the OID equal to the amount of the COD income. In order to ensure that an issuer does not deduct the OID in advance of the inclusion of the related COD income, an issuer that makes the new COD income deferral election must also defer the deductions for OID on the new debt. The amount of OID deductions deferred under this provision will be capped at the amount of the deferred COD income. Any such deferred OID will then be taken into account ratably during the five-year inclusion period (potentially subject to any other applicable interest expense deferral or disallowance provisions). The requirement to defer OID deductions generally will not apply to deductions for periodic interest coupons, which will remain deductible under the normal tax rules.

- *Total amount of OID.* While the *total* amount of OID on the new debt generally will be no less than the deferred COD income on the old debt, the amount of OID that would have accrued and been deducted before the start of the inclusion period (generally, through 2013) does *not* necessarily equal the deferred COD amount.

- *Debt maturing before the inclusion period.* As a practical matter, the OID deductions will be no less than the COD income in each year of the inclusion period if the new debt matures before the inclusion period (*i.e.*, generally, before 2014). In that case, recognition of any COD income will be effectively avoided.

- *Debt maturing after the start of the inclusion period.* For new debt with a maturity after 2013, however, the COD income recognized in some or all of the taxable years of the inclusion period may exceed the OID expense deductible in that year. As a result there may be cash income taxes due during some of the years. Even then, the matching of taxable COD income inclusions and of OID deductions will generally be more beneficial than that without the election. An analysis will often need to be run to determine whether any cash income taxes may become due in any year.

- *Liquidation or sale of the issuer.* If an acceleration event occurs, both the remaining deferred COD income and the remaining deferred OID deductions are accelerated. However, if the issuer redeems or restructures the new debt, there is no acceleration of either the COD income or the OID deductions.

- ***Temporary suspension of the high yield debt obligation ("AHYDO") rules under the Act.*** In the current interest rate environment, many issuers that restructure debt trading at a deep discount may inadvertently fall under the AHYDO rules on the new debt with a term of more than five years, even if the old debt was not an AHYDO. If the AHYDO rules apply, then the issuer generally cannot deduct any OID in excess of the applicable federal rate ("AFR") plus six percentage points (*i.e.*, currently, in excess of approximately nine percent) and must defer any remaining OID until paid. As a result, an issuer may be required to pay tax on phantom income, because its aggregate OID deductions will be less than its COD income.

- *AHYDO rules suspended for some periods.* The Act generally suspends the application of AHYDO rules for debt issued in exchange for a non-AHYDO debt between September 1, 2008 and December 31, 2009. The Treasury Department is authorized to suspend the AHYDO rules or to permit temporary use of a rate higher than the AFR after 2009.

- *AHYDO rules may apply for exchanges after 2009.* There is no guarantee that the Treasury will exercise its authority to extend the suspension or permit a temporary use of a higher rate after 2009. Without any action by the Treasury, the AHYDO rules will be in effect for debt issued in debt-for-debt exchanges starting in 2010 and will supersede the OID deferral rules under the new COD deferral provision.

- ***PIK toggle debt, contingent interest convertibles, "call spread" convertible bond transactions and other debt subject to special rules.*** Debt that is issued or deemed issued in a transaction for which the issuer makes a COD income deferral election and that provides for deferrable interest payments, or that is treated as a "contingent payment debt instrument," or that is part of an integrated transaction such as a convertible bond and bond hedge may be required to defer the deduction of all or part of its stated interest coupons even if paid on a timely basis. Similar rules will apply to other debt that pays a coupon but is treated as issued with no "qualified stated interest." Generally deductions will be deferred for coupons paid until the total amount of deferred OID (including the coupons) is equal to the amount of the deferred COD income.

- ***Related party acquisitions***

  - If a related party such as a majority shareholder, private equity sponsor or other affiliate acquires debt of an issuer, the transaction is treated as if the issuer had retired the debt in exchange for the issuance of new debt to the related party for an amount equal to the purchase price paid by the related party. A deemed exchange of this kind is subject to the same rules described above, including the requirement to defer OID deductions on the "new" debt instrument.

    - *AHYDO rules apply.* The suspension of the AHYDO rules described above does not apply to related party debt. As a result, in related party repurchases of debt trading at a deep discount, the issuer may not be able to deduct a portion of the excess OID and may have to defer all of the remaining OID until paid, instead of applying the more favorable OID deferral rule under the new COD income deferral provision. Congress's decision not to waive the application of the AHYDO rules to related party debt acquisitions may reduce the attractiveness of such transactions despite the new COD income deferral election.

- ***Debt of partnerships and other pass-through entities***

The COD income deferral election is available for debt issued by a pass-through entity such as a partnership or S corporation engaged in a trade or business. Thus, issuers such as oil and gas partnerships, real estate partnerships, and other operating partnerships may be able to benefit from the election. However, special rules apply for pass-through entities that may render the election considerably less attractive than for corporate issuers, or may make the election unavailable.

- ***Election is made at an entity level.*** The COD income deferral election is made at the level of the partnership or similar entity. The COD income of a partnership is determined for certain purposes, however, at the partner level. For example, the bankruptcy and insolvency exclusions described above depend on whether the partner — not the partnership — is bankrupt or insolvent. In addition, whether individual partners are eligible to exclude COD income on the discharge of debt incurred in connection with business real estate or whether partners have NOLs or other tax attributes available to offset COD income depends on the partners' individual circumstances. Consequently, partners could easily have conflicting interests as to whether or not a COD income deferral election should be made and an election that benefits some partners may be to the disadvantage of others.

- ***Partnership allocations of deferred COD income.*** In the case of a partnership, any deferred COD income is allocated to the partners immediately before the discharge in the same manner as if it would be included in partners' distributive shares had such COD income been recognized at the time of the discharge.[5] In other words, a person that acquires a partnership interest after the discharge will not be allocated deferred COD income, although that person potentially could be

[5] Because there is no actual COD income recognized until the inclusion period (or an earlier acceleration), this will be a "phantom" allocation that generally should not currently affect the partner's basis or capital account. It is unclear whether this deemed allocation should take into account special partnership allocation rules such as minimum gain chargebacks, qualified income offsets, or curative allocations. If so, presumably the allocation of the deferred COD income amounts would satisfy the regulatory allocation requirements notwithstanding the deferral (*e.g.*, if the deferred COD income is allocated to a partner as a result of a minimum gain chargeback provision, the minimum gain chargeback should now be satisfied). Similarly, it is unclear to what extent the deferred COD income allocation would be relevant for purposes of substantial economic effect determinations, section 752 allocations of non-recourse liabilities related to allocations of profits, and other partnership allocations.

allocated deferred OID deductions.[6] There is no similar rule for S corporations or other pass-throughs and so new equity owners might be allocated a share of the deferred COD income (assuming that the acquisition of the interest does not trigger acceleration of all deferred items, as discussed below).

- ***Effect of the decrease of partner's share of partnership liabilities.*** Under the partnership tax rules, a decrease in a partner's share of liabilities generally is treated as a deemed cash distribution, which decreases a partner's adjusted basis in the partnership interest and may result in a taxable gain to the extent it exceeds the basis. A discharge of debt subject to the COD income deferral election generally is treated in the same manner, except that the amount of the deemed distribution is limited to the partner's adjusted basis in the partnership interest (and thus does not cause immediate gain recognition); the remainder is deferred and taken into account at the same time and (to the extent remaining) in the same amount as the deferred COD income.[7]

    - *Timing and character mismatches may occur*. Partners may not benefit from the new COD income deferral provision to the same extent as a C corporation would, and in fact may suffer a detriment. These rules may produce timing and/or character mismatches, because a partner's basis is in fact reduced (although not below zero) as a result of the reduction in partnership debt before the deferred COD income is recognized. As a result, distributions (including deemed distributions from liability shifts or discharges) may give rise to gain, and unrelated losses in subsequent years may be suspended. (If the COD income were not deferred, the allocation of COD income would have increased the partner's basis and avoided these results.) Subsequent inclusions of deferred COD income will be taxed as ordinary income, and although the basis attributable to the COD income may ultimately create an economically offsetting capital loss, this may occur far in the future and with a character mismatch.

[6] The new provision does not currently have any special rules relating to allocation of OID deductions, aside from a grant of regulatory authority to the Treasury. It is certainly possible that guidance limiting the flexibility to allocate deferred OID will be issued (*e.g.*, under section 706 or the substantial economic effect regulations).

[7] While it is clear that the deferred COD income is allocated among the partners at the time of discharge, the new provision is not clear as to whether the limitation on the deemed distribution under section 752 is determined at the time of the discharge, or at the end of the taxable year after all items of income, gain, loss and deduction have been allocated among the partners and other actual or deemed cash contributions or distributions have been made. We expect that guidance will clarify that the limitation is determined as of the end of the year.

- ***Disposition of an interest in a pass-through entity.*** One significant difference between the application of the COD income deferral election to debt of a partnership, S corporation, or another pass-through entity as compared to debt of a C corporation is that deferred COD income and OID deductions of a pass-through entity are accelerated upon a sale, exchange or redemption of an interest by an owner holding an equity interest in the pass-through. It is unclear whether *all* of the deferred items of a partnership are to be accelerated if a *single* partner sells or redeems its interest at any time during the deferral and inclusion periods, or whether the acceleration applies on a partner by partner (or interest by interest) basis. We hope that Treasury guidance will clarify that only that partner's share (or proportionate share) of the COD income would be accelerated.

  It is also not clear whether this acceleration applies to *any* disposition of interests, including tax-free dispositions (*e.g.*, under sections 721, 731, or 351). We also expect that rules will have to be developed to cover dispositions of interests in upper-tier pass-through entities and allocation of deferred COD income and OID deductions to upper-tier partners. Until such rules are issued it will not be clear whether any such disposition would trigger an acceleration and how the COD income or OID deductions would be allocated by the upper-tier entity.

- ***Requirement that debt be issued in connection with a trade or business.*** The new COD income deferral election applies solely to discharge of an "applicable debt instrument." All debt issued by C corporations will qualify, but debt issued by partnerships, S corporations, individuals or other persons needs to be issued in connection with the conduct of a trade or business. This requirement is ambiguous in certain respects.

  - *Standard is unclear.* The phrase "in connection with the conduct of a trade or business" is not defined and it is not clear what standard would apply. Presumably it would not include an individual or pass-through entity that is merely "investing" in securities or real estate.[8]

  - *Allocation of debt among several business and nonbusiness activities.* There may also be questions of allocation — for example, if a partnership issuer has an active operating business but also has foreign C corporation

8 Although it would be an unusual circumstance, finance companies that are organized as partnerships might be treated as not engaged in "the conduct of a trade or business" (*i.e.*, because their activities consist entirely of lending to, or making equity investments in, related persons) and therefore ineligible for the benefits of the new COD income deferral election.

subsidiaries, it is not clear whether those subsidiaries might be treated as "investments" or how debt would be allocated between the subsidiaries and the actively conducted business.

- *Debt issued before trade or business is commenced.* Certain debt may have been issued in contemplation of the future conduct of a trade or business, but before any actual trade or business has begun (*e.g.*, a defaulted construction loan before property has been placed into service). It is unclear whether such debt would be eligible for the benefits of the new COD income deferral election.

- *Treatment of disregarded entities.* We presume that a disregarded entity (*e.g.*, a wholly owned special purpose LLC in a mezzanine financing) would be aggregated with its owner for purposes of determining whether the issuer is a C corporation or for purposes of determining if the issuer is engaged in a conduct of a trade or business. Since the statutory language does not similarly look to the partners of a partnership for these purposes, the availability of the new COD income deferral election may depend on whether the issuer is a disregarded entity or a partnership for tax purposes.

- ***Treasury guidance***

The Treasury has authority under the new provision to issue regulations, including regulations that may extend the rules requiring acceleration of deferred items in certain situations, may require certain reporting related to the election on subsequent year tax returns, and may implement the rules relating to pass-through entities. Because of the short time during which the benefits of the election are expected to be available, prompt Treasury guidance may be expected with respect to at least some aspects of the new COD income deferral election.

III. OTHER TECHNICAL OBSERVATIONS ON THE PROVISION.

- ***Deferral applies only to COD income — not all transactions involving debt generate COD income.*** The deferral provision applies only to income that is technically characterized as COD income. There are a number of transactions that may involve debt obligations but that give rise to income other than COD income. For example:

  - ***Foreclosure of non-recourse debt.*** A foreclosure, or transfer of collateral in lieu of a foreclosure, in respect of non-recourse debt is treated as a taxable disposition of the collateral for an amount equal to the amount of the debt. As a result, in many cases, the issuer will derive income from the foreclosure but it will be treated as gain from the sale of property rather than COD income. (A transfer of collateral in full satisfaction of recourse debt is treated as a taxable disposition of the collateral for its fair market value, and COD income would be generated equal to the difference between the amount of the debt and the value of the collateral.)

  - ***Foreign currency denominated debt.*** Under the foreign currency rules, any gain realized on a repurchase of a foreign currency denominated borrowing will be attributed first to foreign currency gain, and only the balance will be treated as COD income eligible for deferral.

- ***Acceleration of deferred items.*** As noted above, the new provision requires an accelerated recognition of deferred COD income and deferred OID deductions upon the occurrence of certain listed events, or under a more general catch-all ("similar circumstances") provision. Treasury has also been granted authority to extend the scope of this acceleration provision. There are some uncertainties as to how the acceleration provision will be applied:

  - ***Application to tax-free transactions.*** Given the fact that the acceleration provision uses the term "sale" (rather than the broader "sale or exchange"), it appears it may not apply to tax-free asset dispositions. This is not clear however. A similar question arises as to whether "liquidation" encompasses both taxable liquidations and tax-free liquidations.

  - ***Deconsolidation.*** It is unclear what would happen to the deferred items if an issuer subsidiary leaves a consolidated group. It seems likely to us that future guidance will treat deconsolidation as a triggering event for accelerating the deferred items, although possibly the COD income and OID deductions would remain deferred and recognized by the issuer on a separate member basis.

  - ***Divisive reorganization of the issuer.*** It is unclear how the deferred items would be treated where the issuer subsequently undergoes a spin off or a split off. Would any such transaction involving substantially all of the assets of the issuer trigger an acceleration? Can the deferred items be allocated between the portions of the business? Similar questions may arise in a partnership division.

  - ***Section 338(g) or 338(h)(10) election.*** Although the new provision does not clearly specify that a deemed asset sale will trigger acceleration, it seems likely that a deemed sale would be treated like an actual sale for this purpose.

  - ***Foreign entities engaged in a U.S. trade or business.*** If a foreign entity defers COD income on repurchase of its debt related to its U.S. trade or business and subsequently ceases its activities in the United States, that may qualify as "similar circumstances" that warrant acceleration of deferred items.

- ***Quantum of business required.*** It is not clear whether there is any minimum amount of business activity required to avoid triggering acceleration. The provision does not appear to look to the particular business in connection with which the discharged debt was issued.

- ***Liquidation or sale of substantially all assets in bankruptcy.*** If the liquidation or sale of substantially all the assets of the issuer occurs in bankruptcy, then the deferred items are to be taken into account the day before the bankruptcy petition is filed. For a bankruptcy case that spans several taxable years, this may mean that an asset sale or liquidation that occurs in one year may trigger acceleration for a prior year. It is unclear how this should be reflected if the tax return for the prior year has already been filed. Note that the mere filing of a bankruptcy petition or the termination of the bankruptcy case should not itself be treated as an acceleration event.

- ***Miscellaneous issues.***

  - ***Short taxable years***. If the issuer has one or more short taxable years after the qualified reacquisition, the recognition of the deferred COD income and deferred OID deductions may be accelerated. We expect that "ratable" recognition of deferred items would mean one fifth of the deferred amount, regardless of the duration of the short taxable year.

  - ***Statute of limitations.*** The IRS will not be able to commence an audit with respect to the first year of the inclusion period until after the expiration of the normally applicable statute of limitations with respect to the year of the repurchase. It is therefore possible that the IRS would assert its right to examine the issuer's returns for the taxable year of the repurchase notwithstanding the expiration of the statute of limitations. It is unclear whether any special statute of limitations rules could also be applied to each of the five years during the inclusion period.

  - ***State laws.*** COD income generally would be deferred for state income tax purposes in those states that use federal taxable income as a base for calculating state tax liabilities (assuming the states do not "de-link" themselves from the federal base with respect to the treatment of COD income). In other states, issuers may be required to recognize COD income for state income tax purposes in the year of discharge even though such income will be deferred for U.S. federal income tax purposes.

- ***Due diligence and contractual protection.*** Deferral of COD income and the possibility of deferral or disallowance of all or a portion of OID deductions with respect to debt issued during the next two years may create a material deferred tax liability. Potential acquirors should conduct full due diligence with respect to any debt repurchase and contemporaneous debt issuances by a target company and consider requiring protective representations and covenants regarding the treatment of COD income and any OID deductions.

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Questions regarding the deferral of COD income provision may be directed, in New York (212-225-2000), to Leslie B. Samuels, James M. Peaslee, Yaron Z. Reich, James A. Duncan, Erika W. Nijenhuis, William L. McRae, Jason R. Factor, Kristofer W. Hess, S. Douglas Borisky or Elena V. Romanova, or in London (20-7614-2200), to Sheldon H. Alster. Please also feel free to get in touch with any of your regular contacts at the firm.

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