

February 25, 2009

WEATHERING THE STORM

Purchasing a Company's Own Debt – The Tax Consequences May Surprise You

Recently, we have been approached by a number of companies that have expressed an interest in purchasing their own outstanding debt that, in many cases, is trading at a significant discount. While a debt acquisition (redemption) transaction may save cash for a company, unless one of the statutory exceptions is applicable, this type of transaction generally will result in the company immediately recognizing ordinary income. The purpose of this Alert is to provide a summary of the material federal income tax consequences associated with a company's purchase of its own debt.

General Rule

As a general rule, if a company purchases its own debt for an amount that is less than the outstanding principal amount due, the company will recognize cancellation of debt income ("COD income") in an amount equal to the difference between the debt's principal balance and its purchase price. Also, if an affiliate of the company (*i.e.*, a person who is treated as being related to the company for tax purposes) purchases the debt, the company will still be treated as if it purchased the debt. COD income resulting from this type of transaction is taxable at ordinary income rates.

By way of illustration, assume ABC Co. issued 1 million bonds several years ago to raise additional cash, each bond having an initial issue price of \$10. However, with an ailing economy, the value of each bond has declined to \$8. Seeing an opportunity to save \$2 million, ABC Co. agrees to redeem all of these bonds for \$8 million in 2009. As a result of this repurchase, ABC Co. will be required to recognize COD income of \$2 million (absent the application of certain limited exceptions that are discussed below) in 2009 just as if a lender had forgiven \$2 million of debt. Although ABC Co. saved \$2 million when it repurchased the bonds at a discount, the actual savings only amounts to \$1.3 million after taking into account income taxes that must be paid.

Assume instead that XYZ Co., a company that is wholly-owned by the same individual that owns ABC Co., acquires all of ABC Co.'s outstanding bonds for \$8 million. Under this example, ABC Co. still must recognize \$2 million of COD income.

Exceptions for Companies that are Insolvent or Bankrupt

There are several exceptions to the general rule that requires the recognition of COD income relating to a debt repurchase. Two notable exceptions are the insolvency exception and bankruptcy exception. Pursuant to the insolvency exception, a company may exclude COD income to the extent that the company is insolvent immediately before the debt repurchase (*i.e.*, the amount by which the value of the company's liabilities exceed the fair market value of its assets). In addition, pursuant to the bankruptcy exception, a taxpayer may exclude COD income realized by it if the COD income is realized in a Title 11 bankruptcy case. Therefore, in the example above, if ABC Co. redeemed its bonds while in bankruptcy proceedings or while it was insolvent, ABC Co. would be able to exclude the COD income from its gross income (in the case of insolvency, only to the extent of the insolvency).

To the extent COD income is excluded from the company's income under one of the exceptions noted above, certain of the company's tax attributes (e.g., net operating losses, tax basis in the company's assets, certain tax credits, etc.) must be reduced in the manner required by the applicable tax law.

Benefits of the Stimulus Package

Last week, the American Recovery and Reinvestment Act of 2009 (the "Stimulus Bill") became law. The Stimulus Bill provides a further benefit to companies that purchase or restructure their debt obligations. The Stimulus Bill allows taxpayers that reacquire trade or business debt in 2009 or 2010 to elect to completely defer the recognition of any resulting COD income for the first four or five years (depending on whether the debt is purchased in 2010 or 2009) following the taxable year in which the discharge occurs and then recognize the COD income ratably over the succeeding five taxable years. This election will not result in any reduction of a company's tax attributes. However, a company that elects to defer COD income pursuant to this provision may not rely on the insolvency or bankruptcy exceptions noted above to avoid recognizing such COD income recognized in subsequent years.

In the examples above, ABC Co. is required to recognize \$2 million of COD income in 2009. However, as a result of the Stimulus Bill, instead of immediately recognizing \$2 million of COD income in 2009, ABC Co. may elect to defer that COD income until 2014 and recognize \$400,000 of COD income in each year from 2014 through 2018.

Planning Opportunities and Other Issues

Although a company generally is required to recognize COD income when it purchases its own debt at a discount, there are some tax planning opportunities available in this area. In limited circumstances, a company may be able to use an "affiliate" to reacquire the company's debt without triggering the recognition of COD income.

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