



Financing Incentives

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Three Provisions of the Bill

- **Bill Section 1231** - Deferral and ratable inclusion of income arising from business indebtedness discharged by the reacquisition of a debt investment.
- **Bill Section 1501** - *De minimis* safe harbor exception for tax-exempt interest expense of financial institutions.
- **Bill Section 1503** - Temporary modification of AMT limitations on tax-exempt bonds.

Section 1231 - Deferral of Taxable Income From Certain Debt Workouts

General Rules -

- The satisfaction of a debt by the issuer/borrower for less than the amount owed generally results in taxable income to the issuer/borrower equal to the amount of the debt that the issuer/borrower is relieved from paying.
- The resulting taxable income generally is referred to as cancellation of indebtedness (“COD”) income.
- Code Section 108 generally allows taxpayers to exclude COD income from gross income where the cancellation of debt occurs during a title 11 case or to the extent that a taxpayer is insolvent.
 - However, there is a corresponding reduction of the taxpayer’s tax attributes.

Section 1231 - Deferral of Taxable Income From Certain Debt Workouts

New Code Section 108(i) -

- Code Section 108(i) was added to the Code pursuant to the Recovery Act and provides some relief to taxpayers for COD income resulting from certain debt acquisitions, modifications and forgiveness.

- Generally, C corporations, or other taxpayers that have issued debt in connection with the conduct of a trade or business, may elect to defer COD income arising from an “acquisition” of a debt during the calendar years 2009 and 2010.
 - Acquisitions in 2009 – 5 year deferral followed by 5 year ratable inclusion in gross income.
 - Acquisitions in 2010 – 4 year deferral followed by 5 year ratable inclusion in gross income.

Section 1231 - Deferral of Taxable Income From Certain Debt Workouts

- Issuer or Related Party - An election under Section 108(i) can be made with respect to acquisitions of debt by the issuer or a party that is “related” to the issuer under Code Section 267(b) or 707(b).
- Acquisition/Reacquisition - An “acquisition” for purposes of Code Section 108(i) includes:
 - The acquisition of the debt for cash;
 - The acquisition of the debt in exchange for new debt (including a deemed exchange resulting from a debt modification under Treas. Reg. Section 1.1001-3);
 - The acquisition of the debt in exchange for corporate stock or a partnership interest of the issuer/borrower;
 - The contribution of the debt to capital by the holder/creditor; and
 - The complete forgiveness of the debt by the holder/creditor.

Section 1231 - Deferral of Taxable Income From Certain Debt Workouts

Irrevocable Election –

- An election under Code Section 108(i) is irrevocable.
- Such an election is made on an instrument by instrument basis.
- For partnerships, S corporations or other pass-thru entities, the election is made by the entity.
- There is no corresponding reduction of tax attributes.
- If an election is made, any other exclusion that is otherwise available under Code Section 108 shall not apply to COD income for which an election is made.
- If an election is made, assuming the taxable year is the calendar year, the COD income resulting from the acquisition of such debt is deferred until 2014 and beginning in 2014, the deferred COD income must be included in gross income ratably over 5 years.

Section 1231 - Deferral of Taxable Income From Certain Debt Workouts

Irrevocable Election and Debt for Debt Exchange -

- In cases where debt is exchanged for new debt with OID, the issuer's OID interest deduction is deferred until 2014 to match such deduction with the COD income inclusion (except to the extent the OID interest deduction exceeds the COD income). Beginning in 2014, the deferred OID interest deduction is taken ratably over five years.
- The deferral of the OID deduction also applies to “deemed” debt-for-debt exchanges, where the proceeds of one debt instrument are “used directly or indirectly” to acquire another debt instrument, and proportionally, where part of the proceeds of an OID debt instrument are used to acquire another debt instrument.

Section 1231 - Deferral of Taxable Income From Certain Debt Workouts

Acceleration -

- COD income and any related deduction for OID that is deferred by an electing taxpayer (and not previously taken into account) is accelerated and taken into income in the taxable year in which the taxpayer:
 - Dies;
 - Liquidates or sells substantially of its assets (including in a Title 11 case);
 - Ceases conducting its business; or
 - In a similar circumstances.

Section 1231 - Deferral of Taxable Income From Certain Debt Workouts

Observations-Potential Issues -

- An election provides a 4 or 5 year deferral followed by ratable inclusion over 5 years and no reduction of tax attributes like other Code Section 108 exclusions.
- Corporations with NOLs and concerns about their expiration or limitations resulting from an ownership change should consider not making an election under Section 108(i) so that any COD income generated may be recognized and offset by such NOLs before they expire or become limited under Code Section 382.
 - If multiple debt instruments are reacquired, it may make sense to make the election with respect to some of the debt instruments.
- There is uncertainty as to whether COD income that is realized but deferred under Section 108(i) must be taken into account in the year realized for E&P purposes. See Code Section 312(l); *but see* Treas. Reg. Sec.1.312-6.
 - For example, this could potentially create or exacerbate Code Section 956 issues where a controlled foreign corporations that has an investment in U.S. property realizes COD income.

Bill Sections 1501 and 1503

- **Bill Section 1501** - *De minimis* safe harbor exception for tax-exempt interest expense of financial institutions.
- **Bill Section 1503** - Temporary modification of AMT limitations on tax-exempt bonds.

Overview -

- Amendments to facilitate the issuance of tax-exempt bonds.
- Utilities issue tax-exempt private activities bonds.
 - For example, solid waste disposal bonds.
- These amendments are generally expected to create greater market interest for tax-exempt bonds and, therefore, permit them to be issued with a reduced rate of interest.

Section 1501 - De Minimis Safe Harbor Exception for Tax-Exempt Interest Expense of Financial Institutions

General Rules -

- Generally, interest on debt incurred or continued to purchase or carry tax-exempt bonds is not deductible under Code Section 265. However, it generally is presumed that debt is not incurred or continued to purchase or carry tax-exempt bonds where the adjusted basis of a corporation's tax-exempt bonds is 2% or less than the adjusted basis of the corporation's trade or business assets.
- This 2% de minimis safe harbor exception does not apply to financial institutions; rather, Code Section 265(b) generally disallows the portion of a financial institution's interest expense that is allocable to tax-exempt bonds that are not issued by certain "qualified small issuers."
- The Recovery Act has modified the law to allow for an increase in bond purchasers to the market including financial institutions.

Section 1501 - De Minimis Safe Harbor Exception for Tax-Exempt Interest Expense of Financial Institutions

New Code Section 265(b)(7)-

- The Recovery act amends Code Section 265(b) by providing that tax-exempt bonds issued in 2009 and 2010 and held by a financial institution, in an amount not to exceed 20% of the adjusted basis of the financial institution's assets, are not taken into account in determining the portion of the interest expense deduction of a financial institution that is disallowed.
 - For this purposes, a refunding bond (i.e., a bond issued to pay the principal or interest on another bond) is treated as issued on the issue date of the refunded bond, or in the case of a series of refundings, the original bond.
 - This means that the exception will not apply to a refunding bond unless the bond it refunds is issued in 2009 or 2010 but that the exception will apply to refunding bonds issued after 2010 if the refunded bond is issued in 2009 and 2010.
- The portion of any tax-exempt bonds not taken into account under the 2% de minimus safe harbor exception above will be treated as a financial institution preference item under Code Section 291 such that the resulting deduction is reduced by 20%.

Section 1503 - Modification of Alternative Minimum Tax Limitation on Tax-Exempt Bonds

General Rules -

- Private Activity Bonds, which are state and local bonds issued to provide financing for private transactions, are exempt from tax if they are “qualified bonds” and meet certain other requirements.
- However, the exemption generally does not apply for purposes of the alternative minimum tax (“AMT”) such that a portion of a corporation’s tax exempt interest income generally is taken into account for purposes of calculating a corporation’s AMT liability.
 - These rules generally limit the marketability of these bonds and, therefore, force state and local governments to issue these bonds at greater interest rates.

Section 1503 - Modification of Alternative Minimum Tax Limitation on Tax-Exempt Bonds

Amendments to Code Section 56(g)(4)(B) and 57(a)(5)(C) -

- The Recovery Act provides amendments such that interest on private activity bonds that are issued in 2009 and 2010 are not taken into account for purposes of calculating a corporation's AMT liability.
- A refunding bond is treated as issued on the date that the refunded bond was issued, and in the case of multiple refundings, on the date the original bond was issued; however, this issue date rule does not apply to bonds issued during 2004 through 2008.
 - As a result of this rule, tax-exempt interest on a refunding bond issued after 2010 will be exempt from AMT if the bond it refunds is issued in 2009 or 2010.
 - Further, this rule allows AMT relief for bonds issued after 2003 that are refunded in 2009 and 2010.