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Senate Bill Would Temporarily Suspend Cancellation-of-Indebtedness Rules for Debt Buybacks

January 2009

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On January 6, 2009, Sen. John Ensign (R – NV) introduced a bill (the “**Bill**”) that, among other things, would allow corporations and certain partnerships to repurchase at a discount (including through a related party), or modify, their outstanding debt without recognizing cancellation-of-indebtedness (“**COD**”) income. The Bill would apply to debt repurchased or modified during 2009 and 2010.

Currently, taxpayers with outstanding debt are often subject to tax on COD income when all or a portion of such debt has been economically cancelled. For example, taxpayers that repurchase their own debt at a discount generally recognize ordinary income in the amount of the discount. Such taxpayers also recognize income if a related party purchases the debt. Similarly, taxpayers that modify their debt generally recognize income to the extent such modification reduces the principal or, in some cases, otherwise improves the terms, of the debt.

Section 108 of the Internal Revenue Code (the “**Code**”) provides a number of exceptions to the taxation of COD income, including exceptions related to insolvency and bankruptcy, farm and business real property debt and principal residence debt. The Bill would add a new Section 108 exception for “applicable financial indebtedness” discharged in an “applicable discharge”. Generally, “applicable financial indebtedness” would include most debt issued by corporations or partnerships engaged in active businesses. An “applicable discharge” includes a repurchase of the debt by the issuer or a related party and a modification of the debt.

Under the Bill, special rules would apply to account for market discount and certain other issues when the debt remains outstanding, as in the case of a related party purchase or a modification. Under these rules, a related party purchaser would treat any discount from the purchased debt’s adjusted issue price as “market discount”. The Code treats accrued market discount as ordinary income to the extent of gain recognized when the debt is repaid or sold. Such a purchaser also would be restricted in deducting interest on indebtedness used to fund the purchase to the extent attributable to accrued market discount. In the case of foreign purchasers, the Bill further provides that interest income on the debt would be exempt from U.S. withholding tax even though paid to a 10 percent or greater shareholder of, or partner in, the issuer or a controlled foreign corporation (a “**CFC**”) in which the issuer was a 10 percent or greater shareholder. One can imagine such rules, coupled with a relaxation of the Section 956 anti-repatriation rules, would encourage U.S. corporations to use cash “trapped” offshore in CFCs to repurchase debt.

The zeitgeist of the Bill is clear—a Code amendment aimed at helping U.S. companies in the current economic climate. Given market conditions, the outstanding debts of many companies are trading at often steep discounts. The Bill would help improve their balance sheets, allowing them to buy back those debts at a discount without tax. As of the date of this update, the Bill has been placed on the Senate calendar for consideration.