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# Could Future COVID-19 Relief Allow COD Income Deferral?

The Coronavirus Aid, Relief and Economic Security Act (CARES Act) (P.L. 116-136),[1] signed into law March 27, contained numerous business relief provisions, one of which was a repeat from the 2008-2009 financial crisis.[2] While the current crisis was not precipitated by an extreme disruption to the credit markets, companies are facing a liquidity crunch, and highly leveraged companies—of which there are many—are particularly susceptible.

In a recent article in *The New York Times* entitled "Coronavirus May Light Fuse on 'Unexploded Bomb' of Corporate Debt," Peter S. Goodman writes that "[c]ompanies facing grave debt burdens may be forced to cut costs, laying off workers and scrapping investments, as they seek to avoid default."[3] But what if a lender is willing to forgive or modify a borrower's debt, so that the borrower can spend its limited cash on salaries rather than debt service? One provision that could prove helpful was introduced in 2009 and would give such debtors additional time to pay the tax due on phantom income they have as a result of debt forgiveness/modification, even in cases where the debt workout is facilitated by a related party.

We understand that resurrecting Section 108(i) is coming up on calls between companies and policy advocates. We would not be surprised if these discussions coalesce in an effort to include the provision in a future relief package for businesses struggling with the COVID-19 outbreak.

## Deferring Debt-Discharge Income

As this crisis causes the number of financially troubled companies to surge, debt workouts (either cancellation or modification) will become an increasingly important recovery strategy, including for public companies and private firms with public debt. However, under the general tax rules, a taxpayer must include the amount of any debt discharge in its gross income[4] and pay tax on it unless it qualifies for an exception (for example, if the indebtedness is discharged when the taxpayer is insolvent, there is an exclusion[5]).

If the terms of debt are significantly modified (e.g., an extension of the maturity date), Internal Revenue Code (IRC) Section 1001 treats the old debt instrument as having been exchanged for a new debt instrument. If the debt is publicly traded and the debtor does not qualify for an exclusion, the debtor will have taxable COD income equal to the difference between the issue

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[1] The CARES Act is available here: https://www.congress.gov/116/bills/hr748/BILLS-116hr748enr.pdf
[2] For example, allowing a corporation to carry back losses to the five preceding tax years.
[3] Peter S. Goodman, *Coronavirus May Light Fuse on 'Unexploded Bomb' of Corporate Debt*, N.Y. Times, March 11, 2020 (https://www.nytimes.com/2020/03/11/business/coronavirus-corporate-debt.html).
[4] IRC §61(a)(11).
[5] Note that the amount of discharged indebtedness that is excluded from taxable income pursuant to the insolvency exclusion is limited to the amount of the insolvency (IRC §108(a)(3)).

price of the new debt (tied to its fair market value, not its face amount) and the adjusted issue price of the old debt. This means that a debtor could have a tax hit even if the principal amount of the debt is the same.

Tax relief for debt workouts could play a critical role in facilitating our economic recovery. Lenders to related and heavily leveraged companies may be especially interested in this.

In the American Recovery and Reinvestment Act (ARRA) of 2009,[6] lawmakers added a temporary provision to the COD income rules. Section 108(i) allowed certain taxpayers to elect to defer COD income on the acquisition of an applicable debt instrument (ADI,[7] such as certain bonds or notes) reacquired in 2009 or 2010. An acquisition for this purpose occurred not only when a borrower (or an entity related to the borrower) repurchased for cash its outstanding bonds for a discounted price, but also when the lender forgave the debt entirely or when the debt instrument was modified (resulting in a deemed exchange of the old debt for new debt).

Rather than forcing borrowers that were not eligible for the insolvency exclusion to have to include and pay tax on the COD income triggered by such forgiveness/modification, Section 108(i) provided that the borrower could completely defer the income inclusion for the first five years (or four years if the reacquisition was in 2010 instead of 2009) and then ultimately spread the income recognition out ratably over the next five-year period.[8]

This relief also applied in situations where the bond was acquired by a related entity, in which case the borrower was still deemed to have COD income, but such income was eligible for deferral.[9] After 2010, reacquisitions of ADIs were no longer eligible for this relief, and if an acceleration event occurred (such as the sale of substantially all of the entity's assets), current recognition would be required.

## History of the Provision

Section 108(i) came about during a time when highly leveraged companies could use their interest deductions to completely offset their taxable income, without limitations. That is not the case today. As a result of the 2017 Tax Cuts and Jobs Act (TCJA), the business interest deduction was limited by IRC Section 163(j), capping a company's allowable interest deductions to 30 percent of its "adjusted taxable income." Although the CARES Act increased the Section 163(j) limit to 50 percent for 2019 and 2020, many companies were hoping that lawmakers would go farther, temporarily doing away with the limit on the deductibility of debt service payments rather than simply increasing it.

Turning back on Section 108(i) during this crisis could help. The lawmaker who pushed for this relief during the last downturn was Sen. John Ensign (R-Nev.), who argued that giving firms the

[6] Pub. L. No. 111-5 (https://www.govinfo.gov/content/pkg/PLAW-111publ5/pdf/PLAW-111publ5.pdf).
[7] An ADI must be issued in connection with the conduct of a trade or business by the issuer.
[8] IRC § 108(i)(1).
[9] JCX-10-09 (https://www.jct.gov/publications.html?func=download&id=1239&chk=1239&no_html=1) and IRC § 108(e)(4).

ability to buy back their debt at a discount to deleverage and avoid default would "help small and large businesses across the United States."[10] Note that the loans being forgiven or restructured were often entered into to help a business pay its employees' salaries or rent—exactly the types of expenses that Congress is now trying to bolster with the various lending (and, in some cases, forgiveness) programs in the CARES Act (including the small business Paycheck Protection Program, or PPP, loans in Section 1102). As Congress looks to increase funding for the PPP lending facility and expand relief available to businesses of all sizes, discussions have begun about turning back on Section 108(i). It is a natural option to consider, given that it provides necessary liquidity, there are already detailed rules in place to facilitate its administration and the tax relief is temporary (the COD income ends up being subject to tax, just on a delayed basis).

## Implications for Borrowers

Companies are certainly feeling the squeeze, and turning Section 108(i) back on could help increase cash flow to businesses able to negotiate debt restructurings. But to what extent did publicly traded companies take advantage of this deferral provision during the last downturn? A review of securities filings sheds some light on the use of Section 108(i) to defer COD income:

- A television broadcasting company deferred nearly $650 million.
- A business technology provider deferred nearly $400 million.
- A mortgage real estate investment trust (REIT) deferred over $300 million.
- A media and entertainment company deferred over $100 million.
- A sports apparel company deferred about $80 million.
- A hotel/retail REIT deferred over $60 million.

Turning back on Section 108(i) to provide COD income deferral would ease the tax impact of a debt workout for borrowers—a natural and simple relief provision that could spur debt restructurings and help reduce corporate leverage. Perceived as a very successful program during the last financial crisis, Section 108(i) should be carefully considered as an important tool to help businesses during this difficult time. Because Section 108(i) could not only provide relief for large, public companies but also small businesses including partnerships and sole proprietors with trade or business indebtedness, the appeal of such relief would be widespread.

*One or more authors may have positions in stocks referred to in this article. Akin Gump may represent individuals or entities that may have positions in stocks referred to in this article.*

[10] 155 Cong. Rec. S1396 (daily edition. Feb. 3, 2009).

**Akin Gump Strauss Hauer & Feld LLP has a full tax team closely following developments in this area. Please feel free to contact any of them with any questions.**

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