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November 24, 2009

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Re: Temporary Suspension of AHYDO Rules*

Dear Sir and Madam:

This letter addresses the issue of whether the Treasury Department should exercise its authority under Section 163(e)(5)(F)(iii) to extend the temporary suspension of the applicable high yield discount ("AHYDO") rules under Section 163(e)(5)(F)(i) with respect to certain debt-for-debt exchanges.¹ Section 163(e)(5)(F)(iii) authorizes the Secretary to extend the temporary suspension of the AHYDO rules with respect to debt

* This letter may be cited as New York State Bar Association Tax Section, *Temporary Suspension of AHYDO Rules* (Report No. 1196, Nov. 24, 2009). The principal drafter of this letter is Lisa Levy.

¹ Section 163(e)(5) limits the deductibility of original issue discount ("OID") on a debt instrument if the debt instrument is treated as an AHYDO. Under Section 163(i), a debt instrument is treated as an AHYDO if it (i) has a term exceeding five years, (ii) has a yield to maturity that equals or exceeds the applicable federal rate ("AFR") for the calendar month of issuance plus 5% and (ii) (in general) defers the payment of more than one year of interest at any time after the first five years. In the case of a corporate issuer of an AHYDO (or a corporate partner of a partnership that issues an AHYDO), (1) OID on an AHYDO is deductible only when it is actually paid and (2) if the yield to maturity on the AHYDO exceeds AFR plus 6%, the OID in excess of that amount is permanently disallowed (even when paid).

All section references herein are to the Internal Revenue Code of 1986, as amended (the "Code"), and the Treasury Regulations promulgated thereunder.

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instruments issued in periods following December 31, 2009 if the Secretary determines that such application is appropriate in light of distressed conditions in the debt capital markets. For the reasons discussed below, we suggest that the temporary suspension of the AHYDO rules be extended until December 31, 2010.

We have submitted two reports earlier this year commenting on the potential for tax rules to interfere with the ability of taxpayers to restructure their debt under distressed market conditions.² Very generally, the principal tax rules at issue are the cancellation of indebtedness (“COD”) rules, which can give rise to current income inclusions as a result of a debt-for-debt exchange or debt modification, and the AHYDO rules, which can defer or deny deductions for the corresponding original issue discount (“OID”) created by the exchange or modification. That is, a debt modification or debt-for-debt exchange can give rise to tax costs to the issuer of the debt as a result of both (i) timing differences between the inclusion of COD income and the deduction of the corresponding OID deductions and (ii) the permanent disallowance of a portion of the issuer’s OID deductions. These tax costs can be relatively severe for a troubled company that must restructure its debt in a distressed and illiquid debt market. While we express no view in this letter on the appropriateness of these results under normal market conditions, as we have previously written, we believe that the normal rules should not be applied to distressed market restructurings.³

The American Recovery and Reinvestment Act of 2009, Pub. L. No. 111-5 (the “Stimulus Bill”) temporarily alleviates these problems through two related provisions. Section 108(i), enacted as part of the Stimulus Bill, allows a taxpayer to elect to defer until 2014 COD income arising from (among other things) an exchange of a debt instrument for another debt instrument (including an exchange resulting from a modification of a debt instrument) by the taxpayer (or a person related to the taxpayer) that occurs in 2009 or 2010, with the taxpayer being required to include in taxable income the deferred COD income ratably over a five-year period from 2014 through 2018. An electing taxpayer’s deductions for OID that accrue on the new or modified debt instrument during the COD deferral period (*i.e.*, prior to 2014) will be similarly deferred and will be deductible ratably from 2014 through 2018.

Section 163(e)(5)(F)(i), also enacted by the Stimulus Bill, provides that, subject to certain exceptions, the deferral and disallowance of OID deductions under the AHYDO rules do not apply to any AHYDO issued during the period beginning on September 1, 2008 and ending on December 31, 2009, in exchange (including an exchange resulting from a modification of a

² New York State Bar Association Tax Section, *Report on the Cancellation of Indebtedness and AHYDO Rules of Sections 108(i) and 163(e)(F)(5)* (Report No. 1182, April 27, 2009) (the “April 2009 Report”), and New York State Bar Association Tax Section, *Report on Revenue Procedure 2008-51* (Report No. 1175, January 16, 2009), available at www.nysba.org (Tax Section/Tax Section Reports).

³ In our April 2009 Report we described how the existing rules relating to the taxation of debt exchanges and debt modifications are in many cases difficult to apply and can lead to tax consequences that are both severe and counterintuitive. April 2009 Report at pp. 18-19. We accordingly recommended that the IRS and Treasury consider whether existing rules relating to debt modifications and exchanges should be revised so as to better align the timing of the resulting COD income and OID deductions (among other objectives). *Id.* at 96-99.

debt instrument) for an obligation that is not an AHYDO and has an issuer (or obligor) that is the same as the issuer (or obligor) of such AHYDO. In this regard, Section 108(i) and Section 163(e)(5)(F)(i) function synergistically to improve the alignment between a taxpayer's COD income and the OID deductions resulting from a restructuring or exchange of the taxpayer's debt, thereby ameliorating "whipsaw" resulting from taxpayers having to include COD income but not being able to deduct offsetting OID.⁴

By way of example, assume that on January 1, 2010, Corp (a calendar year taxpayer) significantly modifies a debt instrument that has a \$1,000 principal amount and adjusted issue price and a 7% coupon and that was not an AHYDO when it was originally issued. The term of the debt instrument is extended to end on January 1, 2019. The debt instrument is publicly-traded for purposes of the OID rules⁵ and has a fair market value of \$700 such that it has a semi-annual yield to maturity of approximately 12.7%. Corp realizes \$300 of COD income. Corp elects to defer the COD income under Section 108(i) and thus will recognize \$60 of COD income in each of the years 2014 through 2019. Assume that the modified debt instrument is an AHYDO. If the suspension of the AHYDO rules continues in 2010, Corp's OID deductions of approximately \$94 attributable to the period prior to 2014 will be deductible ratably in 2014-2018, along with the OID deductions accruing in those years. If suspension of the AHYDO rules is not extended to 2010, then Corp's OID deductions attributable to the yield in excess of AFR plus 6% will be permanently disallowed and its remaining OID deductions will be deferred until the OID is paid in cash in 2019.

Earlier this year, we wrote that we believed that the enactment of Section 108(i) and Section 163(e)(5)(F)(i) was likely to serve an important role as taxpayers seek to reduce their debt loads and modify their debt in light of the then current market conditions.⁶ That has in fact been our experience. The fact that Section 108(i) applies to debt exchanges occurring in 2010 reflects Congress' recognition that the distressed conditions in the debt markets could continue until 2010. We believe that, if these conditions in fact continue into 2010, an extension of the temporary suspension of the AHYDO rules would be appropriate, because it would serve Congress' purpose for enacting these provisions in the Stimulus Bill to continue the improved alignment of taxpayers' COD income and OID deductions arising from distressed debt restructurings.

We are not economists and are not in a position to predict economic conditions and the condition of the debt markets generally in 2010, although we observe that normal market conditions have not yet resumed. We believe, however, based on the major bankruptcy and debt

⁴ As indicated in the April 2009 Report, the OID deferral rule contained in Section 108(i) is somewhat inexact; assuming a Section 108(i) election is made, a significant modification of a debt instrument that is publicly traded for purposes of the OID rules may put an issuing taxpayer in a better position or worse position, as compared with no deemed exchange, depending upon the remaining term of the debt instrument and the amount of pre-existing OID (if any). April 2009 Report at 22-23.

⁵ See Treas. Reg. section 1.1273-2(f).

⁶ April 2009 Report at 2.

restructuring matters with which we are currently involved and that market participants believe are likely to arise in the relatively near future, that significant bankruptcy and debt restructurings are likely to continue for some period of time. These types of transactions often involve an extended period of time during which the parties negotiate the terms and conditions of the restructured debt of the debtor or a debt-for-debt exchange. Therefore, we expect that many of these ongoing transactions will not close until 2010, and we think it is reasonable to believe that there will be many new transactions of this kind next year. Accordingly, based on our current experience, we believe that extension of the temporary suspension of the AHYDO rules is appropriate if Treasury concludes that the debt capital markets will continue to be “distressed.”

We appreciate your consideration of our comments. Please let us know if you would like to discuss these matters or if we can assist you in any other way.

Respectfully submitted,

A handwritten signature in black ink, appearing to read "Erika Nijenhuis", with a long horizontal flourish extending to the right.

Erika W. Nijenhuis
Chair