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New Provision Offers Relief to Troubled Debtor Taxpayers

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In today's economic climate, an increasing number of taxpayers are struggling to repay loans, and seek concessions from their lenders. These concessions often involve a reduction in the principal balance of a debt, which typically generates taxable income from the discharge of indebtedness ("COD income"). With the aid of ameliorating tax code provisions, taxpayers have been able to avoid the recognition of COD income in certain cases. Now, thanks to a new Internal Revenue Code provision added by Congress, taxpayers can elect to defer certain COD income.

Internal Revenue Code Section 108(i), added by Congress earlier this year, provides welcome relief for many taxpayers, allowing the deferral of COD income generated in 2009 or 2010 in connection with certain debt transactions. For a taxpayer who takes advantage of this provision, COD income will not be included in gross income until 2014, and even then, included only ratably over a five-year period. Revenue Procedure 2009-37, issued by Treasury this past August, contains helpful guidance, clarifying some issues left open by section 108(i), and providing the election procedures.

Background

If a lender cancels all or a portion of a borrower's indebtedness, the borrower generally will have taxable income equal to the amount of the discharge. Section 108 provides various exceptions (i.e., bankruptcy, insolvency) to the general rule that COD income must be included in gross income in the year of the discharge. Generally the price of this exclusion is a reduction in basis or other tax attributes of the taxpayer.

Section 108(i), added by Congress as part of the American Recovery and Reinvestment Act of 2009, provides a new election under which a taxpayer can defer COD income. Under this provision, a taxpayer who has COD income generated in 2009 or 2010 from the "reacquisition of an applicable debt instrument" can elect to defer such income until 2014, and then recognize such COD income ratably over the five-year period beginning in 2014.

Under the statute, an "applicable" debt instrument is defined as a debt instrument issued by either (1) a C corporation, or (2) any other person (including a partnership) "in connection with the conduct of a trade or business by such person." The "reacquisition" of such a debt instrument is defined as an "acquisition" of the debt by either the debtor which issued the debt (or is otherwise the obligor under the debt), or a person related to the debtor. "Acquisition" of the debt includes: (1) acquiring the debt for cash or property, (2) exchanging equity for the debt, (3) exchanging new debt for the debt, (4) debt contributed to capital, or (5) complete forgiveness of the debt by the holder.

Rules for Partnerships

In the case of partnerships and S corporations, section 108(i) requires that the election to defer COD income be made at the *entity* level. This initially caused a great deal of concern, as partners in a partnership often have conflicting interests regarding whether to defer COD income or apply a different exclusion under section 108. Luckily, Revenue Procedure 2009-37 resolves this problem favorably by giving a taxpayer the ability to make a "partial" election. Under the Revenue Procedure, a taxpayer can elect to defer all, part, or none of its eligible COD income. In the case of a partnership, the partnership must first allocate to each partner its distributive share of COD income under the partnership agreement. The partnership can then decide, on a partner-by-partner basis, how much, if any, of each partner's distributive share of COD income will be deferred under the partnership's election. Although section 108(i) states that no other exceptions under section 108 (i.e., bankruptcy, insolvency) are applicable for COD income deferred under the election, the Revenue Procedure clarifies that a taxpayer *can* apply another section 108 exception to any COD income that is not deferred and would otherwise be included in income. Thus each partner can effectively decide whether it will (1) defer its share of COD income, (2) take advantage of a

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different exclusion, or (3) recognize COD income in the current year (and perhaps apply expiring net operating losses). For example, in the case of a partnership with one partner who is an individual and another partner who is a C corporation, the individual may prefer to reduce his basis in depreciable property under the "qualified real property business indebtedness" exclusion (section 108(a)(1)(D)), while the C corporation, to which such exclusion is not available, may prefer to defer its share of COD income.

There is more good news for partnerships. Generally, when a partner's share of partnership liabilities is reduced, there is a decrease in the partner's basis in his partnership interest, which could result in the recognition of gain. However, section 108(i) provides a helpful exception to this rule. In the case of a partnership that has made an election under section 108(i) and has chosen to defer a particular partner's share of COD income, the decrease in such partner's share of partnership liabilities will not be taken into account at the time of the discharge, to the extent it would cause the partner to recognize gain. The deferred decrease in the partner's share of liabilities must be taken into account by the partner at the same time as the related deferred COD income is ultimately included in such partner's income. As a result, at the time a partner takes into account any decrease in its liability share due to a debt discharge, the partner will generally have enough basis to absorb the decrease in basis resulting from the deemed distribution.

Acceleration Events

Although deferred COD income, which is treated as ordinary income, generally will not be included in an electing taxpayer's gross income until 2014, certain events will trigger earlier inclusion. Under section 108(i), all deferred COD income of a taxpayer is accelerated at the time of: (1) the death of the taxpayer, (2) liquidation or sale of substantially all the assets of the taxpayer, (3) cessation of business by the taxpayer, or (4) in the case of a partnership or S corporation, the sale, exchange or redemption by a partner or shareholder of its interest in the partnership or S corporation. For those taxpayers considering an election, it is important to evaluate any potential acceleration transactions that might occur in the foreseeable future.

Election Procedures

Revenue Procedure 2009-37 specifies the procedures for making the section 108(i) election. An election statement must be filed by the taxpayer and attached to the tax return for the year the COD income is generated, and must include certain details abut the COD income reacquisition transaction. The Revenue Procedure grants an automatic one year extension to this deadline. There are also annual filings required by the taxpayer for each year beginning the year following the deferral, through the year all deferred COD income is recognized. Partnerships and S corporations have additional filing and record keeping requirements, including attaching certain statements to K-1's issued to their owners.

Additional Guidance Needed

Section 108(i) provides relief to troubled debtor taxpayers and favorable rules for partnerships. Unfortunately, even with the release of Revenue Procedure 2009-37, some of the crucial terms found in section 108(i) remain undefined, making it difficult for some taxpayers to determine whether they qualify for the election and which actions will trigger acceleration. For example, there is no definition provided for the term "issued in connection with the conduct of a trade or business." If a partnership engaged in a trade or business issues debt in order to make distributions to its partners, is that debt considered to be "issued in connection with a trade or business?" Will a partnership's trade or business be imputed to one of its partners in the case where the partner borrows money in order to buy a partnership interest or make a contribution to the partnership?

Similarly, certain acceleration events, such as "sale of substantially all of the assets of the taxpayer" and "cessation of business by the taxpayer" need clarification. For example: a taxpayer in the real estate business has made an election to defer COD income. One year later the taxpayer sells a large portion of its real estate portfolio and immediately purchases a new real estate portfolio, continuing to operate a real estate business. Has there been a "sale of substantially all the assets of the taxpayer" or a "cessation of business by the taxpayer?" Should there be an exception in this case to prevent acceleration? The current guidance leaves these and other related issues unresolved.

We hope that further guidance from Treasury will be forthcoming to aid the growing number of troubled borrowers wishing to take advantage of section 108(i).