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Temporary Deferral of Cancellation-of-Indebtedness Income Under the Recovery and Reinvestment Act of 2009

February 2009

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On February 17, 2009, President Obama signed into law the American Recovery and Reinvestment Act of 2009 (the ***"Act"***). Among its provisions, the Act permits certain taxpayers to elect to defer the taxation of cancellation-of-indebtedness (***"COD"***) income arising from certain repurchases, exchanges or modifications of their outstanding debt that occur during 2009 and 2010.

Current Law

Currently, taxpayers with outstanding debt may be subject to tax on COD income when all or a portion of such debt has been economically cancelled. COD income can arise in a number of circumstances, including forgiveness of debt by the debtholder, the repurchase of debt by the issuer at a discount, the exchange of one debt instrument of the issuer for another, the modification of debt and the exchange of debt for equity of the issuer. Additionally, repurchases or exchanges by persons related to the issuer can create COD income.

Section 108(a) 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. In each case, the COD income is permanently excluded from taxation. As a price for the bankruptcy and insolvency exclusions, the tax attributes of the taxpayer (*e.g.*, its net operating losses, tax credits or adjusted tax basis in property) are correspondingly reduced. Generally, the price for exclusions related to farm, business or principal residence real property is a corresponding reduction in the adjusted tax basis of the relevant property.

In the case of C corporations (including real estate investment trusts and regulated investment companies), COD income is recognized at the corporate level and any exclusions of such income under Section 108(a) apply at that level as well. However, in the case of partnerships (or entities treated as partnerships for federal income tax purposes), while COD income is recognized at the partnership level the exclusions for insolvency, bankruptcy and farm and business real property debt are determined at the partner level.

New Law

The Act adds a new Section 108(i) to the Code. At the election of the taxpayer, Section 108(i) defers the recognition of COD income in connection with certain repurchases, modifications and exchanges, referred to as "reacquisitions", of "applicable debt instruments" after December 31, 2008 and before January 1, 2011. For reacquisitions in 2009, the deferral is five years; for reacquisitions in 2010, the deferral is four years. At the end of the deferral, the taxpayer must include the COD income ratably over the next five years. As discussed in greater detail below, the deferral applies only to the debts of C corporations or, in the case of all other taxpayers, trade or business debts. Original issue discount on certain new debt instruments issued as part of, or in connection with, a reacquisition will not be deductible during the deferral period. The death of, liquidation of or other

similar event with respect to a taxpayer will accelerate deferred COD income. Special rules apply to partnerships and other pass-thru entities. Finally, election of the deferral precludes application of the Section 108(a) exclusions discussed above.

Irrevocable Election. The election is made on the tax return for any applicable debt instrument on the tax return in the taxable year for which the reacquisition occurs. The election is irrevocable. In the case of a pass-thru entity, such as a partnership or S corporation, the election is made by that entity and not by its partners or shareholders.

Applicable Debt Instruments. An applicable debt instrument is any "debt instrument" issued by a C corporation or, in the case of any other person, issued in connection with the conduct of a trade or business. For these purposes, a debt instrument generally includes all forms of indebtedness within the meaning of the Code. However, certain annuity contracts are not included. The provision does not appear to apply to persons, other than C corporations, carrying on investment activities.

Reacquisition. A reacquisition includes:

- an acquisition of a debt instrument for cash,
- an exchange of a debt instrument for another debt instrument (including a deemed exchange resulting from a modification of the debt instrument),
- an exchange of a debt instrument for corporate stock or a partnership interest,
- a contribution of a debt instrument to capital, and
- a complete forgiveness of the indebtedness by the holder of the debt instrument.

Section 108(i) applies when either the issuer or a person related to the issuer (within the meaning of Section 108(e)(4) of the Code) reacquires the debt instrument.

Deferral of OID Deductions. If a debt instrument having original issue discount (***"OID"***) is issued in exchange for an applicable debt instrument, deductions for the OID on the new instrument are disallowed during the deferral period to the extent such OID does not exceed the COD income realized but deferred in the exchange. After the expiration of the deferral period, the deferred OID deductions may be claimed ratably over the five-year period during which the COD income must be included. For these purposes, if the proceeds of a new debt instrument are used directly or indirectly by the issuer to reacquire any of its existing applicable debt instruments (*e.g.*, in a refinancing), the new debt instrument will be treated as though it were exchanged for the reacquired debt instrument.[1] If only a portion of the proceeds from a new debt instrument are used to reacquire an applicable debt instrument, these rules apply to the portion of any OID on the newly issued debt instrument equal to the portion of the proceeds from that instrument used to reacquire the outstanding instrument.

> ***Example:*** Issuer issues a new debt instrument with OID for $1000 of cash and uses the cash to repurchase existing debt with an adjusted issue price of $1100, generating $100 of COD income. Assume Issuer makes an election under Section 108(i) and $200 of OID will accrue on the new debt instrument during the COD deferral period. Under these provisions, $100 of the OID will be deductible during the deferral period. The remaining $100 of OID will be disallowed during the deferral period but will be deducted ratably over the five-year period during which the COD income must be included.

Acceleration of Deferred Items. In the case of a liquidation or sale of substantially all the assets of the taxpayer (including in a Title 11 or similar case), the cessation of business or similar circumstances, any item of income or deduction that had been deferred is required to be included in the taxable year in which such event occurs. A Title 11 case is deemed to occur the day before the petition is filed, such that the accelerated Section 108(i) COD income cannot be discharged in the subsequent bankruptcy case and excluded under Section 108(a)(1)(A) of the Code.

A similar acceleration rule applies to persons holding an ownership interest in a partnership, S corporation or other pass-thru entity in the case of a sale, exchange or redemption of such interest. For example, a partner that sells its interest will trigger the acceleration of the COD income that had been allocated to such partner but that had been deferred under Section 108(i).

Congress has authorized the Treasury Department to prescribe regulations extending application of these acceleration rules to other circumstances where appropriate.

Special Rules for Partnerships. Any income or deduction deferred under Section 108(i) must be allocated to partners in the manner such amounts would have been included in their distributive shares if the income or deduction were recognized immediately before the reacquisition. Any decrease in a partner's share of partnership liabilities is not taken into account under Section 752 to the extent it would cause a partner to recognize gain under Section 731 from the deemed distribution. However, any decrease in partnership liabilities deferred under Section 108(i) is taken into account when the deferred COD income is recognized.

Coordination with Other Section 108 Exclusions. If a taxpayer elects the deferral regime of Section 108(i), none of the Section 108(a) exclusions (*i.e.*, the exclusions for insolvency, bankruptcy and farm or business real property debts) can apply with respect to the applicable debt instrument.

Considerations

Section 108(i) is not an unfettered boon to taxpayers realizing COD income. Because of its complexity and qualifications, taxpayers will have to carefully consider its benefits and burdens prior to making an election. Among other things:

- An election under Section 108(i) can be attractive to a solvent issuer. However, the election precludes the application of the bankruptcy or insolvency exclusions of Section 108(a). Under both of those rules, COD income is permanently excluded from gross income and not merely deferred. Those options may be more attractive to a taxpayer, especially a taxpayer with little or no net operating losses or other tax attributes to be reduced. On the other hand, Section 108(i) does not require the reduction of tax attributes, which may be attractive to taxpayers with net operating losses or other attributes they intend to use. Further, reliance on the insolvency exclusion can prove difficult—COD income is only excluded to the extent of insolvency, which taxpayers have the burden of demonstrating.

- Although the election is irrevocable, it appears to apply to each applicable debt instrument separately, meaning taxpayers may, to some extent, tailor their Section 108 approach to COD income.

- Partnerships will have to weigh potential conflicts among their partners. As discussed above, while the Section 108(a) exclusions for insolvency and bankruptcy are determined at the *partner* level, the Section 108(i) election is made at the *partnership* level. Unless future Treasury regulations provide otherwise, the interests of solvent and insolvent partners will likely diverge at the prospect of Section 108(i) elections.

- Application of Section 108(i) to real estate investment trusts and regulated investment companies (***"REITs & RICs"***) is not entirely clear. REITs & RICs should be considered C corporations for purposes of the section. However, Section 108(i) does not define the term "pass-thru entity," a term that includes REITs & RICs elsewhere in the Code. Although the special rules, including the acceleration rules, applicable to partnerships, S corporations, and "other pass-thru entities" do not appear suited for REITs & RICs, the absence of a clear definition creates some uncertainty. If and when the Treasury Department issues regulations under Section 108(i), such regulations could address this issue.

- Application of Section 108(i) to issuers with debt providing contingent payments may also prove complicated. Relief under Section 108(i) may be available for reacquisitions of indebtedness subject to the "noncontingent bond method" under the contingent payment debt regulations. If available, the extent of any relief will depend on the nature of the reacquisition.

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[1] The Act does not define "directly or indirectly" for these purposes, although any Treasury regulations issued under new Section 108(i) could provide guidance. Other Code provisions, and the regulations thereunder, have addressed similar language. Under one possible standard, the relevant inquiry could be whether the new debt would not have been issued but for the reacquisition of the old debt. Regardless, issuers issuing new debt with OID within close proximity of the

reacquisition of old debt must bear in mind any such issuance should be scrutinized in light of this provision.