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Tax Considerations for Troubled Debt

The recent stimulus bill included a provision allowing taxpayers to make an irrevocable election to defer recognition of cancellation of debt (“COD”) income arising in 2009 and 2010 from business indebtedness discharged upon the reacquisition of a debt instrument and to recognize it in taxable income ratably over five years beginning in 2014. The election is made for each applicable debt, must clearly identify each debt and must set forth the amount of income being deferred. However, taxpayers who elect this deferral under IRC Section 108(i), will lose the opportunity to use the non-elective COD income exclusions under IRC Section 108(a) that apply to bankruptcy, insolvency, qualified farm indebtedness, qualified real property business indebtedness, and qualified principal residence indebtedness in the year of the election or any subsequent year that the deferred 108(i) income is includable. In other words, taxpayers cannot make the election now to defer the income to a later year and then exclude the income in another year when the exclusion provisions might apply.

Taxpayers who have COD income that falls under both the new deferral rules of 108(i) and the exclusion rules under 108(a) will therefore need to examine the differences and decide whether to make the election under 108(i). The decision to elect or not will vary based upon each taxpayer’s situation and projection of future events.

What transactions cause COD income?

Examples of transactions that cause COD income include:

- > Conveyance of property in satisfaction of recourse debt if the property’s fair market value is less than the amount of the recourse debt.

- > Significant debt modifications which result in the new issue price being worth less than the face amount of the old debt. These rules are discussed in Treasury Regulation 1.1001-3(e). A significant modification could result from a change in any of the following:
 1. yield,
 2. timing of payments,
 3. the obligor,
 4. addition or deletion of a co-obligor,
 5. security or credit enhancement,
 6. priority of debt,
 7. the nature of a debt instrument to something that is not considered debt for federal income tax purposes,
 8. recourse nature to nonrecourse.
- > Acquisition of debt by the obligor or a related party at a discount.
- > Contribution of debt to equity if the fair market value of the equity is worth less than the debt.

Taxpayers who have COD income should determine if the Section 108(a) exclusion rules apply to them. However, before excluding any income, taxpayers must reduce their tax attributes in the following order:

1. Net operating losses,
2. General business credits,
3. Minimum tax credits,
4. Capital loss carryovers,
5. taxpayer,
6. Passive activity loss and credit carryovers, and
7. Foreign tax credit carryovers.

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However, taxpayers other than C corporations can elect to first reduce their basis of depreciable property under # 5 before reducing any other tax attributes under the normal ordering rules. The basis reduction takes effect on the first day of the tax year following the tax year in which the COD takes place. Depreciable property can include property held by the taxpayer or indirectly held through partnership interests to the extent of the partner's proportionate interest in the partnership's depreciable property. Consent must be obtained from the partnership if the taxpayer elects to treat their partnership interest as depreciable property.

The attributes are reduced on a dollar-for-dollar basis, with the exception of credits, which are reduced at a one-third rate. All this becomes even more complicated if the COD income is recognized by a passthrough entity. For corporations, the determination of bankruptcy, insolvency and attribute reduction takes place at the corporate level; these same determinations are not made at the partnership level but rather at the partner level.

Section 108(i) and Electing to Defer

The irrevocable election to defer income must be made on the tax return in the year in which the reacquisition of the debt instrument occurred and is made for each applicable debt instrument reacquired. An applicable debt instrument is defined to include any debt issued by a C corporation or any other person in connection with the conduct of a trade or business by such person. It is expected that additional guidance will be provided with these definitions. The term 'reacquisition' refers to the acquisition of the debt instrument by the debtor which issued or is otherwise the obligor under the debt instrument, or a related person. Acquisition of debt will include all the situations mentioned previously in "What Transactions Cause COD Income". In the case of a pass-through entity, the election

is made by the entity. An entity election would preclude the shareholders and partners from using the exclusion provisions under Section 108 (a). This could create difficult decisions for many S corporation and partnership tax matters persons.

COD income must be allocated to the partners in the same manner as if the income were not deferred. In addition, the deferred income is accelerated and recognized as income in an earlier tax year if the taxpayer dies, sells substantially all of assets (or if a partner or shareholder sells their interest), ceases to do business or enters bankruptcy.

All taxpayers who plan to pay off or restructure debt instruments should generally be aware of the COD rules since successful negotiations could result in "phantom income", i.e., non-cash income that results in a tax liability. The new law under IRC Section 108(i) is clearly taxpayer friendly, but it will create some difficult decisions for many taxpayers, especially partnerships. We believe most taxpayers will conclude that the non-elective provisions under 108(a) are more advantageous, not only for bankrupt and insolvent taxpayers, but also for real estate investors who recognize COD income from qualified real property indebtedness.

Connect with us.

The COD rules can be difficult to navigate, connect with your Baker Tilly advisor to have your questions answered.

In August, the IRS issued Revenue Procedure 2009-37, which provides taxpayer-favorable guidance related to IRC Section 108(i), which was enacted during 2009 as part of the American Recovery and Reinvestment Plan. As discussed here, the Revenue Procedure explains how the election would operate with respect to different entities and the specific procedures to follow in making an election.

Election Mechanics: Taxpayers Have Considerable Leeway in How They Elect to Defer COD Income

The eligible taxpayer must attach a statement to their timely filed tax return in the year the reacquisition occurs providing detailed information about the debt, the amount of cancellation of indebtedness (COD) income realized, and a general description of the taxpayer's trade or business. In addition, the Revenue Procedure allows an automatic twelve-month extension for making the election and permits a protective election for taxpayers who aren't sure whether they have COD income.

It's especially worth noting that the Revenue Procedure provides significant flexibility by allowing taxpayers to elect to defer only a portion of the COD income and/or elect to defer it in connection with one debt and not another.

Impact on Partnerships and Limited Liability Companies

The ability to apply 108(i) in connection with only a portion of the COD income is particularly useful to partnerships, which can then allocate the income to those partners who desire to avail themselves of 108(i).

With an election under 108(i), Schedule K-1 reporting will need to be enhanced to include the deferred IRC Section 752 amount. The Revenue Procedure attempts to assist partners in deferring any gain that might result from the reduction of liabilities under IRC Section 752 until the related deferred gain under 108(i) is recognized. To make this calculation, the partnership must have information to determine each partner's tax basis or must make reasonable efforts to obtain the information from each partner. This will create some administrative and accounting concerns but should eliminate the difficult decision that could have faced tax matters persons when deciding whether to apply 108(i) or 108(a) to the totality of the COD income.

Partnerships and LLC's making the election under 108(i) will have significant current and future reporting requirements beyond the scope of this article, especially since each partner can make numerous different tax decisions.

Impact on S Corporations

The Revenue Procedure requires that any income deferred by reason of 108(i) be allocated only to those shareholders who existed at the time of the event giving rise to the COD income and that it be allocated pro rata based upon their ownership percentages.

Impact on REITs and RICs

The Revenue Procedure indicates that regulations will be issued permitting these entities to adjust their earnings and profits in the year the income is recognized for income tax purposes and not in the year of reacquisition.

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