Cancellation of indebtedness and the ramifications under Section 108(i)

January 25, 2010 - Financial Digest

When debt is forgiven, ordinary income to the debtor is generally created in the amount equal to the difference between the amount of the liability that was due and the amount paid for the debt's discharge. Code Section 108(a)(1)(B) provides that the gross income does not include any amount which would be included in gross income because of the discharge of the debt (COD) if the discharge occurs when the taxpayer is insolvent. Section 108 also provides for other exclusions such as when the discharge occurs in a title 11 case, where the debt was qualified farm indebtedness or where the debt was qualified principal residence indebtedness which will be discharged before January 1, 2013. Also, for taxpayers other than C corporations, if the debt is qualified real property business indebtedness, the exclusion applies. However, taxpayers that are able to exclude COD income under the various exceptions mentioned above are required to reduce certain tax benefits, such as carryovers of net operating losses, capital losses, general business credits, minimum tax credits, and/or tax basis of depreciable real property.

If none of the above exceptions apply, then the taxpayer would generally be required to include the cancellation of indebtedness income in full in the year that the debt was discharged. New legislation under the American Recovery and Reinvestment Act of 2009 added Code Section 108(i). This section allows an election to defer the cancellation of indebtedness income in the circumstance where there is a reacquisition of an applicable debt instrument after December 31, 2008 and before January 1, 2011. The deferred income would be included in gross income equally over a five-year period beginning with the fifth taxable year after the repurchase for 2009 repurchases, and beginning with the fourth taxable for 2010 repurchases. For calendar year taxpayers, this would correspond to the year 2014 for repurchases in either 2009 or 2010. Hence, the income would be recognized 20% per year from 2014 to 2018.

The election is made on an instrument by instrument basis. The taxpayer is required to make the election with its tax return for the taxable year when the reacquisition occurred. The election statement must clearly identify the debt instrument as well as the amount of deferred income under Section 108(i). The election is irrevocable.

It is important to define the terms applicable debt instrument and reacquisition. Applicable debt instrument refers to any debt instrument which is issued by a C corporation or any other person in connection of the conduct of a trade or business. A debt instrument includes any bond, debenture, note, certificate or other instrument or contract which constitutes indebtedness under Code Section 1275(a)(1). Reacquisition is defined as any acquisition of an applicable debt instrument by the debtor that issued the original debt instrument or any person related to the debtor. The related party test is met under Section 267(b) or 707(b)(1). This includes ancestors, lineal descendents, siblings corporations in a controlled group and partnerships with 50% or more common ownership. The term

acquisition is defined as any of the following: acquisition of debt for cash, exchange of one debt instrument for another debt instrument, exchange of a corporation's stock or an interest in a partnership for debt, contributing the debt instrument to the capital of the issuer, and the complete forgiveness of the debt by the holder of the debt instrument.

As with the trade-offs under Section 108(a), a business making the election under Section 108(i) will lose some other tax benefits. In this case, those benefits are the exclusions under Section 108(a) for bankruptcy, insolvency, qualified farm indebtedness, and qualified real property business indebtedness. In other words, the taxpayer must choose either to exclude the cancellation income completely, which results in reducing the benefits of the net operating loss, capital loss, credit carryovers, basis, etc. or simply to defer the income for 5 years and then recognizing it into income. The situation for every taxpayer is likely to be very different, so an analysis of both projected income and the related tax ramifications should warrant a discussion with your accounting and tax professionals. This is particularly important since the election is irrevocable.

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