



Deferral Under the 2009 Recovery Act

The 2009 Recovery Act grants taxpayers an election to defer 2008 and 2009 cancellation of indebtedness income until 2014 and then to report it over five years.

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The current economic downturn has presented both lenders and borrowers with the opportunity to restructure loans so that borrowers may keep current on their payments. However, as a result of the adverse income tax consequences to the borrower in the form of cancellation of indebtedness income ("COD income"), many borrowers have not taken advantage of the opportunity. To facilitate debt modifications and restructurings, the American Recovery and Reinvestment Act of 2009 (the "Act") made two significant — but temporary — pro-taxpayer changes. First, it created a new election to defer COD income arising from debt restructuring and workouts occurring during 2009 and 2010. Second, it suspended the application of the "applicable high-yield discount obligation" ("AHYDO") rules for certain debt instruments issued in a restructuring during the period from September 2008 through December 2009.

COD Income Generally

Subject to certain exclusions, a debtor may recognize COD income when debt is forgiven, reduced or acquired by a related party for less than the amount due or contributed to the capital of a corporation or partnership or exchanged for another debt instrument of the debtor or by a significant modification of the debt instrument. Statutory exclusions to the taxation of COD income are provided for debtors in Title 11 bankruptcy proceedings, insolvent debtors, certain student loans, some farm indebtedness, a number of real estate business loans and certain qualified principal residence indebtedness. Where one of the exclusions applies, the taxpayer is required to reduce its tax attributes by the amount of the excluded COD income, including its net operating loss (NOL) carryovers, general business tax credit carryovers and the tax basis of its property. In the case of a C corporation the exclusions are determined at the corporate level, while in the case of a partnership the exclusions are determined at the partner level.

Deferral of COD Income Under the Act

The Act granted taxpayers an election to defer COD income recognized from the "reacquisition" of an "applicable debt instrument" that takes place in either 2009 or 2010. Taxpayers making the election do not have to include the COD income until 2014 and then it is ratably included over the next five years. An "applicable debt instrument" is any debt instrument issued by a C corporation or by any other taxpayer in connection with the conduct of a trade or business by such taxpayer. A "reacquisition" includes the acquisition of an applicable debt instrument by the debtor that issued the debt instrument or by a person related to the debtor. An acquisition includes an acquisition of the debt for cash, an exchange of the debt instrument for another debt (including a modification resulting in a deemed exchange), an exchange of the debt instrument for an equity interest of the debtor, a

contribution of the debt to the capital of the debtor or a complete forgiveness of the debt. The transfer to the lender of pledged collateral in satisfaction of recourse debt is not one of the specifically listed transactions, but may constitute a reacquisition under the legislative history which suggests that the enumerated re-acquisitions may not be all inclusive. The Treasury has confirmed that the list of exchanges is not meant to be exclusive.

The Deferral Election

The election is made on an instrument by instrument basis and once made is irrevocable. A taxpayer makes the election on its tax return for the year in which the reacquisition occurs by identifying the debt instrument and the amount of COD income for which the election is being made. In the case of pass through entities the election is made at the entity level. Further, the specific statutory exclusions from the recognition of COD income will not apply if the debtor makes the election to defer COD income.

Acceleration of Deferred COD Income Under Certain Events

Deferred COD income is accelerated into income: upon the death of the debtor, the liquidation or sale of substantially all of the assets of the debtor (including a Title 11 or similar case) or the cessation of business or similar circumstance. The deferred COD income will be includible in income for the taxable year in which such event occurs. With respect to a pass through entity, the sale or exchange or redemption of an interest in the entity by the holder of such interest will accelerate the inclusion of the deferred COD income allocated to such holder.

OID Deferral Under the Act

There is a similar deferral rule for OID (original issue discount) that arises from the modification of the original debt instrument or an actual or deemed debt for debt exchange. This rule requires otherwise deductible OID accruing prior to the first year in which the deferred COD income is required to be included in the taxpayer's income to be to be deferred and deducted ratably over the same five year period in which the deferred COD income is includible. To the extent the OID exceeds the amount of deferred COD income, such excess is not subject to the deferral. Any deferred OID deductions will be accelerated as a result of the occurrence of the same events that cause the deferred CODI to be accelerated. These OID deferral rules do not affect the holder's timing of recognition of OID on such debt instrument.

Special Partnership Rules

There are special rules that apply to partnerships and other pass through entities. The deferral election is made at the entity level and the sale, exchange or redemption of an interest in the entity will cause the acceleration of the COD income allocated to the holder of such interest. Where the borrower is a partnership, the COD income that is subject to the deferral election is allocated in accordance with Section 704 to the partners who were in the partnership immediately before the reacquisition that triggered the COD income. To the extent a decrease in a partner's share of partnership liabilities as a result of the reacquisition would cause a partner to recognize gain under Section 731, such decrease will be deferred until the deferred COD income is included in income and only to the extent of the amount of the deferred COD income.

Suspension of AHYDO Rules

The Act also amended the AHYDO rules to suspend the interest deferral and interest disallowance for AHYDO debt issued on or after September 1, 2008 and before January 1, 2010 for previously outstanding non-AHYDO debt. The rules suspended are that interest on AHYDO debt is deductible only when paid in cash and if the yield on the AHYDO debt exceeds the applicable federal rate plus five percentage points, the OID attributable to such excess yield is nondeductible by the issuer. The Treasury has the authority to extend the suspension, if necessary.

Conclusion

Whether a debtor elects the deferral of COD income may depend upon the tax attributes of the debtor. The exclusions under the Code require the reduction of the tax attributes of the debtor and therefore, may be more attractive to a debtor without tax attributes. The deferral election may however be more attractive to a debtor who has tax attributes that would be reduced under one of the statutory exclusions.

About the Author

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