

IRS Issues Favorable Guidance on Election to Defer Cancellation of Debt Income

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On August 17, 2009, the Internal Revenue Service (“IRS”) issued Revenue Procedure 2009-37 (the “Revenue Procedure”) to provide important guidance on the ability of taxpayers to defer cancellation of debt (“COD”) income arising on the reacquisition of their own debt. The right to defer COD income on reacquired debt — added by the American Recovery and Reinvestment Tax Act of 2009 (the “2009 Act”) — can yield significant tax and related cash flow benefits to taxpayers who are restructuring or negotiating settlements of their indebtedness.

The 2009 Act enacted new Section 108(i) of the Internal Revenue Code to allow C corporations and other taxpayers that conduct a trade or business to elect to delay recognition of COD income arising from their or a related party acquisition of its own debt in 2009 or 2010 (the “Section 108(i) Election”). COD income subject to the election is deferred until 2014 and then included in income ratably over 5 years.

A reacquisition of debt that is eligible for the Section 108(i) Election includes a (i) purchase for either cash or property, (ii) recapitalization of old debt in exchange for new debt or equity, (iii) contribution to capital, and (iv) forgiveness or cancellation of indebtedness by the holder. The election applies to COD income from the taxpayer’s bonds, debentures, notes, certificates, or any other instrument or contractual arrangement constituting indebtedness for income tax purposes (referred to as “an applicable debt instrument”).

For a discussion of the COD income deferral election, see our Briefing Note entitled *The American Recovery Act of 2009: an Update on Tax Provisions* dated February 26, 2009.

REVENUE PROCEDURE 2009-37

The Revenue Procedure provides administrative guidance including the timing and manner for making the election as well as specific procedures for partnerships, S corporations, tiered-passthrough entities and foreign entities.

The most significant feature of the Revenue Procedure is the “partial” deferral concept – i.e., a taxpayer may elect the portion of the total COD income it wishes to defer with respect to each acquired applicable debt instrument. This flexibility permits deferral elections for different portions of COD income with regard to each debt instrument (whether or not part of the same issue). As a result, taxpayers may utilize available exclusions from COD income (e.g., insolvency, bankruptcy) or an expiring tax net operating loss (“NOL”) to offset dollar-for-dollar an equal amount of COD income that is not deferred under an election. Without the partial election, the COD income inclusion versus deferral reporting decision would have to be made on an all or nothing basis.

For example, a taxpayer (insolvent by \$60) who realizes \$100 of COD income from the reacquisition of an applicable debt instrument may elect to defer only \$40 of COD income and rely on the insolvency exception to exclude \$60 from income. Similarly, a solvent taxpayer with an expiring \$60 NOL may elect to defer \$40 of the \$100 of COD income and use the expiring NOL to offset \$60 of COD income. Without an election to defer only a portion of COD income, in these two scenarios a deferral election would cause the taxpayer to lose the full benefit of the \$60 COD income exclusion (or available \$60 NOL) that could be utilized only if no election were made. However, in such case if no deferral election were made so that the COD income exclusion or NOL could be utilized, \$40 of COD income (representing the excess of the COD income over the available exclusion or offset) would be immediately taxed.

The Revenue Procedure also provides important flexibility for partnerships (including limited liability companies taxed as partnerships) by allowing them to determine for each partner the portion of COD income amount that is deferred and the portion that is included as income currently. Each partner may then utilize any applicable exclusions from inclusion in gross income of COD income available under Section 108(a) rather than defer such income. For example, one partner may defer none of his share of the amount of COD income while another partner defers his entire share of COD income. This flexibility essentially permits treatment that is tailored to the optimum tax reporting position for each partner, rather than requiring a uniform deferral approach that would not necessarily suit all partners. In contrast, S corporations must allocate a single amount of deferred COD income realized at the S corporation level on a pro rata basis among the shareholders.

The Section 108(i) Election is made at the entity level for partnerships, S corporations and other passthrough entities. In the case of a consolidated group, the common parent corporation makes the Section 108(i) Election on behalf of all members of the group. In all cases, once made, the election is irrevocable.

The Section 108(i) Election is made with a timely filed income tax return (including extensions) for the year of the debt “reacquisition.” A statement must be attached to the tax return and contain a general description of the debt instrument subject to partial or complete cancellation, the taxpayer’s trade or business, and the reacquisition transaction. It also must recite the amount of COD income from the reacquisition and the amount subject to the deferral election. Partnerships must list those partners with deferred COD income and each partner’s deferred amount. S

corporations must list the shareholders and their pro rata share of the aggregate amount of deferred COD income. In the case of an exchange of new debt for old debt, the statement must include a schedule of the original issue discount in the new instrument that the issuer will be required to defer by reason of the Section 108 Election each taxable year.

Lastly, the Revenue Procedure contains special provisions pertaining to protective elections, late elections, and defective elections.

Taxpayers can make a "protective" election with regard to cancellation or exchange transactions reported as not generating any COD income. In the event the IRS were to disagree and find that a particular transaction subject to the protective election does in fact result in COD income, the taxpayer's protective election is treated as a valid, irrevocable election and COD income deferral will apply. As a result, the taxpayer may be required to report COD income subject to the protective election in tax years after the statute of limitations expired with respect to the tax year in which the debt cancellation occurred. A protective election is made generally by attaching a statement to the Federal income tax return and attaching a copy to each Federal income tax return through the 2018 tax year.

The Revenue Procedure permits an automatic 12-month extension from the regular due date for making the election (i.e., beyond the regular return filing deadline). This would benefit taxpayers that need additional time to analyze whether or not to make the election.

A taxpayer that has already filed an election not compliant with the requirements of the Revenue Procedure must file an amended return with a compliant election by November 16, 2009. A taxpayer that files a compliant election by September 16, 2009 may modify the election by filing an amended return no later than November 16, 2009. In either case, the taxpayer is permitted to change the amount of COD income deferred by the election. This provides taxpayers with an opportunity to consider with the benefit of hindsight which position permitted by the Revenue Procedure is the most advantageous.

SUMMARY

The IRS has provided much needed guidance to taxpayers with regard to the procedures for electing to defer COD income under Section 108(i).

The Revenue Procedure offers considerable flexibility to taxpayers in determining whether to elect to defer COD income and how much by permitting partial elections, debt-by-debt elections, an automatic 12-month extension for late elections, protective elections and amended elections. The guidance also mitigates partner-level conflicts by enabling partnerships to, in effect, elect in a manner that satisfies partner preferences for COD income recognition or deferral.

We encourage companies that have outstanding debt instruments and private equity and venture sponsors that wish to repurchase such debt at a discount to consult with counsel to evaluate the strategic options under this election.