

Client Alert

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AN OPPORTUNE TIME TO REACQUIRE OR RESTRUCTURE BUSINESS DEBT

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Under new Section 108(i) of the Internal Revenue Code, 2009 and 2010 would appear to be an ideal time for taxpayers to reacquire or restructure their debt, much of which may have been heavily discounted.

Background

A borrower is not required to include the proceeds of a loan made to it as gross income, because the borrower is required to repay the loan. When a debt instrument is discharged for less than its principal amount (i.e., at a discount), such discharge generally gives rise to cancellation of indebtedness income (COD) in an amount equal to the discount, which income is taxable as ordinary income. Although bankrupt and insolvent taxpayers are not required to recognize COD as such, certain tax attributes of these taxpayers, such as net operating losses, are reduced dollar-for-dollar by the amount of the COD.

Section 108(i)

Section 108(i) of the Internal Revenue Code, as added by the American Recovery and Reinvestment Tax Act of 2009, provides beneficial tax treatment for the reacquisition by an issuer of its business debt at a discount. It applies to debt instruments of corporations and other entities, as well as to individuals, provided that in each case the debt was initially incurred in the conduct of the taxpayer's trade or business.

Under Section 108(i), a taxpayer may elect to defer the recognition of COD to the fifth tax year after the reacquisition of the debt giving rise to the COD (if reacquired in 2009) or to the fourth tax year after reacquisition (if reacquired in 2010). The COD would then be recognized by the taxpayer ratably over the succeeding five-year period. The election may be made on an instrument-by instrument basis. This beneficial tax treatment only applies to debt reacquired in 2009 and 2010.

Debt Instruments Defined

A debt instrument is broadly defined as any instrument or contractual arrangement constituting indebtedness. The term "reacquisition" is also broadly defined to include:

- a debt-for-debt exchange (including a significant modification of debt, which is generally deemed to be an exchange of such debt for newly issued debt)
- a complete forgiveness of debt
- an acquisition of debt by certain related persons

To the extent that a debt-for-debt exchange gives rise to original issue discount, the deduction of the accrued discount by the issuer of the debt is deferred to the year in which the COD is recognized and is then deducted ratably over the same five-year period that the COD is recognized.

Acceleration on Sale

The recognition of all deferred COD income is accelerated upon the sale of the assets of a business entity, the assets of a sole proprietorship, the death of a sole proprietor or the liquidation of the business entity.