



presents

Cancellation of Indebtedness Income: Mastering Latest Guidance Capitalizing on Recent Deferral Rules to Minimize Corporate Income Tax

A Live 110-Minute Teleconference/Webinar with Interactive Q&A

Today's panel features:

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Wednesday, December 9, 2009

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Cancellation Of Indebtedness Income: Mastering Latest Guidance Webinar

Dec. 9, 2009

Overview Of Recent Federal Guidance

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Recent Federal Guidance Related To Cancellation Of Debt (COD) Income

- Revenue Procedure 2009-37: Related to new Sect. 108(i) and the election to defer COD income arising from certain discharges of indebtedness
- Treasury Decision 9461: Related to COD information reporting under Sect. 6050P



Cancellation Of Debt Takeaway Points

When COD arises

Exclusion and attribute reduction on the one hand
Deferral and ratable inclusion on the other hand
... and sometimes, both at the same time

Federal and state income tax law differences



COD Basics

- Incurring indebtedness is not income, because the debt is balanced by an obligation to repay
- When the offsetting obligation to repay is terminated, COD income results

Primary Exceptions To COD

- Some COD exclusion provisions in § 108(a)(1)(A) – (D)
 - Bankruptcy
 - Insolvency
 - Qualified farm indebtedness
 - Qualified real property business indebtedness (“QRPBI”)
- Each may be available, depending on the specific facts and circumstances, subject to priority between the exclusions. § 108(a)(2)
- Generally speaking, a taxpayer must pay a price for using any exclusion: attribute reduction
 - § 108(b)(1)
 - § 108(c)(1)

Primary Exceptions To COD (Cont.) Special Partnership Issues

- For “partners” of entities taxed as “partnerships,” the 108(a)(1) exclusions are applied at the partner level. § 108(d)(6)
- For example, in evaluating whether a partner in a partnership that realizes COD may avail itself of an exception to COD under 108(a)(1), the bankruptcy or insolvency of the partnership “entity” is irrelevant
- Generally speaking, a partner’s ability to use a § 108(a)(1) exception is particular to its own particular facts and circumstances
- For S corporations, availability of the 108(a)(1) exclusions are applied at the entity level. § 108(d)(7)(A)

New Sect. 108(i)

- Added by the American Recovery and Reinvestment Tax Act of 2009
- Provisions: Limited to COD income arising from
 - Reacquisitions
 - After Dec. 31, 2008 and before Jan. 1, 2011
 - Applicable debt instrument
 - Issued by a C corporation, or by
 - Any other person “in connection with the conduct of a trade or business by that person”
- Deferral is four or five years, depending on when the reacquisition occurs
- Beginning in the fifth year following the reacquisition, gross income is ratably included over a five-year period.
- For calendar-year taxpayers, for COD realized in connection with a reacquisition in 2009 or 2010, income is deferred to 2014 and then included ratably for the following five years



New Sect. 108(i) – A Brief Reminder

- Sect. 108(i) is federal law
- It is not necessarily the case that state income tax law automatically follows federal income tax law
- Many states are “coupled” to federal law as it exists on a certain date. For example, California incorporates the Internal Revenue Code as it was enacted on Jan. 1, 2005
- For states that incorporate pre-ARRA Federal law, Sect. 108(i) will not apply. Similarly, for states that have wholly self-contained income tax law, Sect. 108(i) will not apply
- Where state and federal law diverge, federal and state treatment of the same items will diverge

Sect. 108(i) – Selected Issues

- There are many issues raised by Sect. 108(i). For example:
- Is an exchange of debt for property, such as foreclosure on a recourse debt, a “reacquisition” under the statute?
 - The statute provides a list of “included” acquisition transactions that do not include foreclosure. § 108(i)(4)(B)
 - The legislative history says the “includes” language is “without limitation.” H.R. Conf. Rep. No. 111-16 at 564 (2009). It is hard to see a policy reason for not including foreclosure transactions under 108(i)
- For non-C corporation taxpayers, the trade or business requirement could be an issue
 - There is no “active” requirement, but it is not clear what the dividing line between an “investment” and a trade or business might be
 - How about a partnership engaged wholly in “investment activities” but made up of C corporation partners?

Sect. 108(i) – Selected Issues (Cont.)

- The election is irrevocable. § 108(i)(5)(B)(ii). Because the length of time over which 108(i) operates, the effects of making the election will need to be lived with for many years to come
- The election is exclusive. Once the election is made and 108(i) applies to an applicable debt instrument, sections 108(a)(1)(A) through (D) cannot apply for the taxable year of the election or any subsequent taxable year. § 108(i)(5)(c).
 - The taxpayer cannot use another exception at a later time, even if in hindsight that decision might have been better
- ***For a partnership, S Corporation or other pass-through entity, the Sect. 108(i) election must be made by the entity rather than the partners or shareholders.*** § 108(i)(5)(B)(iii).

Sect. 108(i) – Selected Issues (Cont.)

- For pass-through entities, the 108(i) election is made at the entity level. § 108(i)(5)(B)(iii). This aspect has been subject to much criticism by partnership practitioners
- The § 108(a)(1) exclusions are applied at the partner level. § 108(d)(6).
- Partner-level elections are generally more favorable, where different partners have desire different treatment for COD income
- For example, one partner may have filed for bankruptcy protection, another may be a C corporation with expiring NOLs, and yet another may be an individual – not insolvent or bankrupt – that wants to defer the income under 108(i)
- Does a partnership-level election to use 108(i) preclude the other partners from using another exclusion?

Recent Guidance – T.D. 9461 – Final Regulations Under Sect. 6050P

- Sect. 108(i) is debtor-centric in that its focus is on COD to the borrower. For example, the conflicts raised in the preceding slide are between partners on the debtor side who might prefer to treat their share of the relevant COD differently
- Similar issues can arise between debtors, who generally want to put-off or entirely avoid recognizing COD, and lenders who prefer to accelerate any deduction that is available
- Generally speaking, Sect. 6050P requires certain entities which discharge the indebtedness of any person during any calendar year to make a return to the IRS and to provide a written statement to the person whose name is furnished in the return
- T.D. 9461 relates to information reporting for cancellation of indebtedness by a subset of the entities listed under 6050P

Recent Guidance – T.D. 9461 (Cont.)

- The entities covered under T.D. 9561 are specified under §§ 6050P(c)(1) and (c)(2)(D)
 - Executive, judicial and legislative agencies; and
 - Any organization for which a significant trade or business is lending money
- As a matter of background, §§ 6050P(c)(1) and (c)(2)(D) were added in 1996 and 1999, respectively, to expand the scope of § 6050P, which previously had applied to a more limited range of entities
- Regulations issued in 1996 created a “36-month rule” - a rebuttable presumption that non-payment at any time during a roughly 36-month testing period in conjunction with no *bona fide* collection activity by the lender - would trigger a reporting requirement to the entities listed under § 6050P

Recent Guidance – T.D. 9461 (Cont.)

- The 1996 and 1999 changes to Sect. 6050P potentially applied the 36-month rule to those newly added entities, even though they had not been part of the statute when the 1996 regulation was enacted
- Under the 36-month rule, an entity may be required to file an information statement, even when the entity had not legally or practically discharged the debt. In 2008, temporary regulations provided a carve-out to limit application of the 36-month rule to the more limited entities to which § 6050P had originally applied
- Under T.D. 9461, the final regulations maintain the rule contained in the temporary regulations

Recent Guidance – T.D. 9461 (Cont.)

- Although finalization of the temporary regulation does not significantly change the prior rule under the temporary regulations, the issue of the 36-month rule highlights a number of points. For example:
 - A lender and a debtor may take inconsistent positions (sometimes driven by reporting requirements) on when and whether a discharge occurs
 - The 36-month rule may require a report be made to the IRS, even though the reporting entity “has not legally or practically discharged the debt.” See T.D. 9430, Bulletin 2008-48 at 1206, Dec. 1, 2008 (amending the regulations under 6050P).



Recent Guidance – Revenue Procedure 2009-37: General Overview

- The revenue procedure resolves some, but by no means all, of the substantive tax and administrative issues raised by Sect. 108(i)
- The revenue procedure provides the exclusive procedures for taxpayers to make an election to defer recognizing COD under 108(i)
- The heart of the revenue procedure is contained in sections 4 (election procedures) and 5 (required information statements)
- For entities taxed as partnerships, the revenue procedure provides a great deal of flexibility within the constraints imposed by the statute
- In the future, the IRS and the Treasury Department may issue additional guidance that could be retroactive and could modify the guidance contained in the revenue procedure



Revenue Procedure 2009-37: Selected Election Procedures

- Sect. 4.01 says a taxpayer makes the 108(i) election by:
 - (a) Attaching a statement meeting the requirements of Sect. 4.05 of the revenue procedure to the taxpayer's timely filed (including extensions) original federal income tax return ..., and
 - (b) Satisfying the additional requirements of sections 4.07 through 4.10 of the revenue procedure
 - 4.07 applies to partnerships that are not "nonfiling foreign partnerships"
 - 4.08 applies to S corporations
 - 4.09 applies to certain foreign corporations, and
 - 4.10 applies to non-filing foreign partnerships



Revenue Procedure 2009-37: Selected Election Procedures (Contents)

Generally speaking, the required contents of the election statement are straightforward. See Section 4.05. The contents include:

- A label stating “Section 108(i) Election” across the top of the statement and the name and taxpayer identification numbers, if any, if the issuer or issuers of the applicable debt instrument
- A general description of the applicable debt instrument and, in the case of any person other than a C corporation, a general description of the person’s trade or business to which the applicable debt instrument is connected
- A general description of the reacquisition transaction or transactions generating the COD income, including dates
- The total amount of the COD income resulting from the reacquisition and a general description of how it is calculated
- The total amount of COD income for the applicable debt instrument that the taxpayer is electing to defer

Revenue Procedure 2009-37: Selected Election Procedures (Aggregation)

- The 108(i) election is a debt-by-debt election, but there is an aggregation rule
- Sect. 4.03 provides an aggregation rule allowing a taxpayer to treat two or more applicable debt instruments that are part of the same issue and that are reacquired during the same taxable year as one applicable debt instrument for purposes of the revenue procedure.
 - The election and reporting procedures for the revenue procedure are extensive, so aggregation could be simplifying
- For pass-through entities, the revenue procedure appropriately only allows aggregation where the owners and their ownership interests in the pass-through entity immediately prior to the reacquisition of each applicable debt instrument are identical

Revenue Procedure 2009-37: Selected Election Procedures (Partial Elections)

- Sect. 4.04 allows partial elections - perhaps the most important aspect of the revenue procedure. “A taxpayer ... may make an election for any portion of COD income realized from the reacquisition of any applicable debt instrument.”
- For example, a taxpayer realizing \$100 of COD income that may be subject to 108(i) could elect to defer \$40 under 108(i). With respect to the \$60 of COD remaining, the taxpayer could not elect to defer, and could instead apply other exclusions to the extent available
- Also, for a taxpayer with multiple applicable debt instruments, the taxpayer does not need to elect the same portion of COD income arising from each applicable debt instrument that it reacquires. For example, a taxpayer realizing \$100 of COD income each from two instruments may elect to defer \$40 of income from the former instrument and \$0 of income from the latter instrument

Revenue Procedure 2009-37: Selected Election Procedures (Partial Elections)

- A similar rule is provided for partnerships, thus providing a practical solution to the divergent partner-level/partnership-level election procedures for 108(i) and 108 in general. This will be discussed in further detail later in the presentation. For now, suffice it to say that a partnership and its partners may “vertically” and “horizontally” slice COD under the revenue procedure in a manner that practically addresses the potential disjunction between sections 108(d)(6) and 108(i)(5)(B)(iii). See Sect. 4.04(3).
- Similar flexibility extends to tiered partnerships. See Sect. 4.12(3).
- The Sect. 108(i) election is still made at the partnership level. It is critical for a partnership that recognizes COD income that is subject to Sect. 108(i) to effectively communicate with its partners and determine what portion of the COD income they wish to defer

Revenue Procedure 2009-37: Selected Election Procedures (Partial Elections)

- In the case of a partnership, the revenue procedure introduces new terms relating to partnerships. These terms are reflective of the revenue procedure's flexibility related to the ability of partners to choose how to treat (or not) COD under 108(i). Some terms are:
 - Each partner's "COD income amount"
 - Such partner's "deferred amount," and
 - Such partner's "included amount" of COD income
- For partnerships, the election statement must include a list of partners that have a deferred amount, their identifying information and each partner's deferred amount. Sect. 4.05(2)(f).
- For partnerships, additional election procedures apply depending on whether the partnership is a "non-filing foreign partnership." See sections 4.07 and 4.10.

Revenue Procedure 2009-37: Selected Election Procedures (Partial Elections), Cont.)

- The rules for S corporations are similar to those for partnerships. See Sect. 4.08 for additional S corporation election procedures
- A critical distinction is that S corporations, unlike partnerships, which can make special allocations, must allocate income – such as COD income – *pro rata* to its shareholders
- An S corporation still may elect to defer a portion of its COD income arising from each applicable debt instrument under the general rule provided in Sect. 4.04
- Note that the flexibility afforded partnerships to allocate different amounts for each applicable debt instrument to each partner is not present for S corporations. Query how an S corporation with multiple shareholders is to coordinate amounts subject to 108(i)?

Revenue Procedure 2009-37: Supplemental Information

- Issue: What if the IRS determines that the taxpayer understated the amount of COD income arising from an applicable debt instrument?
- Sect. 4.06 refers to this as the “additional COD income” and allows the taxpayer to specify that all or a portion of such income should be subject to § 108(i)
- Also, for a partnership, the partnership must specify each partner’s share of the partnership’s additional COD income that would be deferred (the partner’s “additional deferred amount”), which the partnership may describe as either the partner’s entire share of the partnership’s additional COD income or as a percentage of the partner’s share of the partnership’s additional COD income. The same rule applies to S corporations and their shareholders



Revenue Procedure 2009-37: Protective Elections

- Issue: What happens if the taxpayer concludes there is no COD from a particular transaction but wants to make a § 108(i) election that would otherwise be permissible if the conclusion were incorrect?
- Sect. 4.11 of the revenue procedure provides for protective elections and specifies the information that must be reported. Generally speaking, this includes:

Revenue Procedure 2009-37: Protective Elections (Cont.)

- A label stating “Section 108(i) Protective Election” across the top and the name and taxpayer identification numbers, if any, if the issuer or issuers of the applicable debt instrument
- A general description of the applicable debt instrument
- A general description of the reacquisition transaction or transactions generating the COD income, including dates
- The total amount of the COD income resulting from the reacquisition and a general description of how it is calculated
- The total amount of COD income for the applicable debt instrument that the taxpayer is electing to defer

Revenue Procedure 2009-37: Protective Elections (Cont.)

- The revenue procedure takes the position that a protective election is irrevocable at any time the IRS determines the taxpayer's conclusion, that the particular transaction does not result in the realization of COD income, is incorrect
- The IRS, "may require the taxpayer to report COD income deferred pursuant to the valid and irrevocable protective election, even if the statute of limitations has expired for the year in which the COD income was realized and the protective election was made"
- Taxpayers will need to carefully weigh the benefit of deferral vs. the detriment of potentially extending the relevant statute of limitations by making a protective election



Revenue Procedure 2009-37: Required Annual Information Statements

- For many taxpayers, the ongoing reporting burden associated with making the 108(i) election could be substantial. See generally Sect. 5 of the revenue procedure.
- A taxpayer that makes an election under § 108(i) must attach a statement as provided in the revenue procedure for each taxable year beginning with the taxable year following the year for which the election is made and ending with the first taxable year in which all items deferred under § 108(i) have been recognized
- Because of the complex rules surrounding pass-through entities, the information required for partnerships and S corporations is extensive
- The ongoing reporting requirements do not apply to protective elections. Sect. 5.01.

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Specific Issues With Entity Formation And Debt Modification

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Difficult Economic Times: Debt Forgiven Or Modified

- Supreme Court determined that forgiveness of debt represented an accretion to wealth and was therefore Income
- Various statutory exceptions can be found in IRC § 108
- Due to large amounts of debt that needed modification as a result of the recession (including Nevada casino debt restructuring), a deferral of recognition of income was passed

§108(i) Election To Defer Certain COD Income

- Eligible taxpayer may elect to defer COD income with respect to:
- “Reacquisition” of “applicable debt instrument” (“ADI”) during the period after 2008 and before 2011 (i.e., during 2009 and 2010)
- Inclusion is ratable over the five-year period beginning:
 - 2009 reacquisition – Fifth tax year following
 - 2010 reacquisition – Fourth tax year following

§108(i)(3) ADI Defined

- Any debt instrument issued by:
 - C corporation
 - Other person in connection with conduct of “trade or business” of such person
- Debt instrument broadly defined
 - Any bond, debenture, note, certificate or other instrument or contractual arrangement constituting indebtedness within meaning of §1275(a)(1)
- Trade or business not defined
 - Presumably includes depreciable rental real estate (triple net lease?)
 - Unclear if rental of undeveloped land will qualify

Reacquisition

- Acquisition of an ADI includes, without limitation, the following:
 - Acquisition of debt for cash
 - Exchange of debt instrument for another (including deemed exchange resulting from modification of a debt instrument)
 - Issuance of corporate stock or partnership interest for debt instrument
 - Contribution of debt instrument to capital, or
 - Complete or partial forgiveness of debt instrument

Obvious Cases Where COD Could Be Triggered

- Reduction of the amount of principal to be repaid
 - Reduction in interest below AFR may impute reduction of principal to be repaid
- Elimination of the need to repay
- Contribution to capital or exchange for equity
 - Have to determine what was received and FMV, basis or deemed FMV; and
 - Also have to look at whether debt was recourse or non-recourse

Contribution Or Debt-for-Equity

- Contribution of debt to capital
 - For corporation (including S), only COD to the extent the amount of debt exceeds the basis of the debt
 - For partnerships (“PS”), COD to the extent the amount of debt exceeds the FMV of the interest received (or deemed received)
 - If PS uses properly maintained capital accounts (Treas. Reg. §1.704-1(b)(2)(iv)) to control liquidation, parties treat FMV of debt as equal to liquidation value of the interest for purposes of determining tax consequences of exchange. If the debt-for-equity is arms length and not part of a plan of avoidance of COD, and the debt is not publicly traded, FMV can be determined based on capital account credit

Modification Of Debt Instrument Is Area Of Complexity, And Sometimes Surprise

- Almost anything that alters a debt instrument is a modification (“hair-trigger”)
- Three exceptions
 - Alteration occurring by terms of instrument is generally okay
 - Exception to exception
 - If substitution of a new obligor; addition or deletion of a co-obligor; change in recourse nature of instrument
 - Exercise of option must be unilateral, and if by holder not result in deferral or reduction of scheduled payment of interest or principal

Modification Of Debt Instrument Is Area Of Complexity, And Sometimes Surprise (Cont)

- Three exceptions (Cont.)
 - Issuer's failure to perform (confusing area)
 - Agreement of holder not to exercise remedies is modification under Treas. Reg. §1.1001-3(c)(1)
 - Absent written or oral agreement to alter terms of debt instrument, agreement to stay collection or temporarily waive an acceleration clause or similar default right is not a modification, unless and until forbearance remains in effect for period exceeding two years following initial failure to perform or pay, plus any additional period in which parties conduct good faith negotiations or the issuer is in bankruptcy

Modification Of Debt Instrument Is Area Of Complexity, And Sometimes Surprise (Cont.)

- Three exceptions (Cont.)
 - Party has option to change debt instrument but determines not to do so
 - Example: An option to increase interest rate if rating falls below a level. Not doing so is not a modification
 - Compare to an automatic increase if rating falls. The affirmative modification of the instrument not to increase interest generates COD

Modification Of Debt Instrument Is Area Of Complexity, And Sometimes Surprise (Cont.)

- Regulations provide guidance as to whether modification is “significant”
- If “significant modification,” must retest:
 - Debt vs. equity, and
 - Whether the issue price of new debt equals the face amount of the old debt

Potential Surprise Reacquisitions

- Significant modifications of a debt instrument creates a deemed exchange of debt instruments
- Under Treas. Reg. §1.1001-3(e), there are 11 bright-line tests and safe harbors as well as a general rule if bright lines do not apply

Potential Surprise Reacquisitions (Cont.)

- Modification
 - Deletion or addition, in whole or in part, of legal rights or obligations of issuer or holder
 - Evidenced by express agreement (oral or written), conduct of the parties or otherwise
- Significant
 - Based on facts and circumstances, the legal rights and obligations are altered and the degree is economically significant (general rule)

Potential Surprise Reacquisitions (Cont.)

- Change in yield by more than greater of (i) 25 basis points or (ii) 5% of the annual yield of the unmodified instrument
 - Change in principal amount will often result in significant modification
 - Change in interest rate by itself will often result in significant modification
 - Not apply with respect to contingent payment instruments; those are under general rule

Potential Surprise Reacquisitions (Cont.)

- Changes in timing of payments is material modification if it results in a material deferral of scheduled payments
 - Extension of final maturity date
 - Deferral of payments prior to maturity
- Safe harbor exception
 - Deferred payments unconditionally payable no later than end of safe harbor period
 - Applies to scheduled interest and principal payments
 - Applies to payments due at the maturity of debt instrument
 - Safe harbor period begins on original due date of first payment deferred and extends for lesser of:
 - Five years, or
 - 50% of original term of instrument
 - If payments deferred for less than full safe harbor, unused portion is available for another modification

Potential Surprise Reacquisitions (Cont.)

- Change in obligor
 - On a non-recourse debt instrument, is not a significant modification
 - On a recourse debt instrument, is unless:
 - New obligor is an acquiring corp. (IRC §381)
 - New obligor acquires substantially all assets of original obligor
 - Change in obligor is result of §338 election or bankruptcy filing, or
 - Special rule for tax-exempt bonds

Potential Surprise Reacquisitions (Cont.)

- The §381, or acquisition of substantially all assets, exception must not result in a “change in payment expectations”
 - A substantial enhancement of likelihood of payment results in deemed exchange (speculative to adequate), and
 - A substantial impairment of likelihood of payment (adequate to speculative)
 - It is strange that tax consequences of a debt assumption would depend on the nature of the other assets of the debtor

Potential Surprise Reacquisitions (Cont.)

- **Addition or deletion of a co-obligor** can be a significant modification if it changes payment expectations
- **Change in security or credit enhancement**
 - Recourse debt: Is there a change in payment expectations?
 - Non-recourse debt: Generally significant modification without regard to change in payment expectations, unless collateral is fungible

Potential Surprise Reacquisitions (Cont.)

- **Change in priority of debt:**
Significant modification if it results in change in payment expectations
- **Change from debt to equity:**
Significant modification. Deterioration in financial condition of obligor without modification of instrument, or change in obligor or addition or deletion of co-obligor, does not count

Potential Surprise Reacquisitions (Cont.)

- Change in recourse/non-recourse nature
- Generally a change from recourse (or substantially so) to non-recourse (or substantially so) is significant modification
Where not substantially all recourse or non-recourse, requires consideration of instrument before and after modification as to likelihood of payment

Potential Surprise Reacquisitions (Cont.)

- Change in Covenants
 - Addition, deletion or alternation of customary accounting or financial covenants is not a significant modification
 - Impact of change to other covenants determined using facts-and-circumstances test
- Special rules for tax-exempt bonds

Simply Because There Has Been A Significant Modification Does Not Automatically Mean COD

- If there is a significant modification and therefore a deemed exchange of debt instruments, you must determine the issue price of the new debt and compare it to the face amount of the old debt
- Under §108(e)(10), debtor is treated as having satisfied old debt with amount of money equal to issue price of new debt
- Issue price is determined under §§1273 and 1274

Simply Because There Has Been A Significant Modification Does Not Automatically Mean COD (Cont.)

- Generally, the new debt will be treated as having an issue price less than the face amount of the old debt, if the interest rate on the new debt is less than the AFR
- If debt is publicly traded (traded on an established market), its issue price will be the price at which the debt trades on the day the new debt is deemed to be issued
 - On larger debt issuances, does almost “normal” bank trading constitute “publicly traded”?

When Does The Modification Take Place?

- Agreement to change a term of a debt instrument is a modification at the time the issuer and holder agree, even if change is not immediately effective. *Treas. Reg. §1.1001-3(c)(6)*
- If change of a term of a debt instrument is conditioned on reasonable closing conditions, the modification occurs on closing date
- If change occurs in bankruptcy, modification occurs only if the bankruptcy plan becomes effective

When Does The Modification Take Place? (Cont.)

- Importance of timing
 - Tax year
 - Reporting
 - §108(i) election potential
 - Quarterly payments
 - AFR that will be applied (changes monthly), and
 - Who is a partner or S shareholder at the time

Danger

- §108(i) election is irrevocable
- If election applies to COD, the normal exceptions to recognition will not apply
- No non-C corporation entity is likely to have a specific procedure in place for making the §108(i) election(s)
 - Because of potential consequences and timeframes, recommend developing and following specific governance procedure

Election: Conflicts And Fiduciary Duty

- Not a lot of issues if a C corporation is corporation affected
- If S corporation is involved, insolvency and bankruptcy exceptions are tested at entity level, while COD income flows to shareholders in accordance with stock ownership to pay tax
 - May have different benefits/detriments to specific shareholders

Election: Conflicts And Fiduciary Duty (Cont.)

- Unincorporated associations taxable as partnerships have most potential for conflict
 - COD flows to partners/members
 - Insolvency tested at partner/member level
 - §108(i) election at PS level but binds partners/members, and
 - Rev. Proc. 2009-37 relief

Rev. Proc. 2009-37 Is Extraordinarily Helpful For Partnerships

- Election by ADI
- Permits election as to part of COD generated by particular ADI
- Allows allocation of COD (elected and unelected) to specific partners
- If implemented properly, each partner chooses for himself whether to have the election apply to such partner and how much COD for such partner
- No such flexibility for S corporations

Need Procedure And Process If Decision Makers Are To Be Protected From Liability

- With respect to pass-through entities, the TMP or the management of the S corporation needs protection
 - Remember, the deferral of the recognition of COD for a party that later becomes insolvent means no exception to tax; and
 - Trustee in bankruptcy or other creditors may take issue with decision

The Partners/Members And S Shareholders Need Disclosure, Process

- First step in protecting management or TMP is to inform the partners and S shareholders
 - COD likely
 - Estimated amount (not as easy as one would think)
 - Election possibility, and
 - Consequences of election

S Corporation

- The S corporation must elect or not elect. Election will impact all shareholders, no special allocations. All or nothing on election
 - No special allocation possible
 - Election is made or not made and binds all shareholders
- Consider:
 - Informing shareholders of pending circumstances that may give rise to COD
 - Amend by-laws for process to determine to elect COD deferral
 - Attempt to quantify COD amount, and
 - Procedure for protective election (in whole or in part and amount)

S Corporation (Cont.)

- In addition to by-laws containing process and procedure to determine whether to make the election to defer COD include:
 - Indemnification of directors and officers if procedure substantially followed, and
 - Ability to charge distributions of shareholder challenging decision to elect or not to elect
- By-laws should be amended to require shareholders to provide information that the corporation may request in order to comply with IRS reporting requirements, as ongoing obligations for years if elected

Remainder Of Presentation Focuses On Entities Taxable As Partnerships

- The remainder of the presentation focuses on partnerships (LLCs and other unincorporated entities taxable as partnerships)
- Consult Rev Proc 2009-37 for very specific election procedures (particularly for non-partnerships) and stay tuned for future developments on election mechanics

§108(i) Potential Election: PS Procedures

- If a partnership/LLC, suggest the following:
 - Amend PSA or OPA to provide procedures
 - Partner-by-partner input as to whether to elect and amount. ADI by ADI
 - Include default ramifications (partner does not respond)
 - Require each partner to timely provide information requested for tax compliance and, if appropriate, under penalties of perjury
 - Make sure TMP, directors, managers and officers are held harmless and indemnified
 - If substantial COD is being generated, it is possible that the partnership will not have funds to provide meaningful indemnity
 - Consider charging provision to challenging partner or member for indemnity costs. May even want the ability to sell interest to satisfy indemnity expenses

§108(i) Potential Election: PS Procedures (Cont.)

- Direct partner-to-partner discussion with written materials and request written instructions and provide for what happens if no written instructions by specific time period
 - Recommend partner/member consult personal tax advisor, and
 - CPAs need to be involved and run tax pro formas for partner. If matter is big enough, recommend that each partner/member obtain valuations to determine insolvency or degree of insolvency of partner
 - Debt-by-debt approach where COD may be generated
- Start early with the communications and modification to the PSA and OPA
- Deal with protective election in case COD expected amount is wrong

§108(i) Potential Election: PS Procedures (Cont.)

- Written record, preferably with signatures of the partners/members, is highly recommended. Litigation may be several years down the road and may involve a bankruptcy trustee or other third party
 - Election by ADI
 - Protective election by ADI, or
 - Default election and default protective election

Rev. Proc. Is Extraordinarily Helpful For Partnerships

- Election is by applicable debt instrument (ADI)
 - Election made with respect to one or more instruments, and
 - The amount of the deferral may be different for each instrument (i.e., not pro rata)
- Election may be for all or a portion of the COD of each applicable debt instrument “reacquired” after Dec. 31, 2008 and before Jan. 1, 2011

Rev. Proc. Is Extraordinarily Helpful For Partnerships (Cont.)

- The amount deferred and the amount not deferred may be allocated among the partners as the partnership desires
 - Start with partners to determine the portion to elect and not elect
 - Elect portion and allocate to partners seeking deferral, and
 - Portion not elected allocated to partners who do not want deferral
- Deal with protective election aspect (sometimes hard to tell exactly how much, if any, COD may be generated!)
 - Want partners to direct how much, if any, of protective amount

Conclusions

- Debt exchange can sneak up on you
- Consider exemptions to COD first before §108(i)
- If §108(i) seems possible, develop procedures for determining whether to implement or not implement and hold management harmless and indemnify
- Particularly for PS, Rev. Proc. 2009-37 offers great flexibility

Cancellation Of Indebtedness Income: Mastering Latest Guidance Webinar

Dec. 9, 2009

*Partnership COD Income Allocation And Related
Issues*

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IRC § 108(i) – Revenue Procedure 2009-37: Select COD Income Deferral Election And Partnership Issues

- Exceptions to cancellation of indebtedness (COD) income
 - Bankruptcy: Title 11 case (chapters 7, 11, 12 and 13)
 - Insolvency: To the extent of the debtor's insolvency immediately before the COD event (tested by fair market value of assets/liabilities)
 - Qualified real property business indebtedness (QRPBI) of non-C corps
 - Debt incurred to acquire, construct or substantially improve real property
 - Realty must secure the discharged liability
 - Elective method/exclusion limited by complex formula
 - Utility to non-C corp. outside insolvency or bankruptcy
 - Qualified farm indebtedness (QFI)
- COD exceptions applied to partnerships (P/S) at partner level




IRC § 108(i) Election – Revenue Procedure 2009-37: Select COD Income Deferral And Partnership Issues (Cont.)

- COD exception rules of priority
 - Bankruptcy pre-empts all other exceptions
 - Insolvency pre-empts QFI and QRPBI, to extent of insolvency
 - QFI and QRPBI can be used after insolvency to COD income balance
- COD income exception attribute reduction – Order of priority
 - NOLs for year of COD and then prior year NOLS
 - Tax credits (general business and minimum tax)
 - Capital loss carryovers
 - Basis of taxpayer property – Reduction not below
 - Passive activity loss (PAL) and credit carryovers
 - Foreign tax credit (FTC) carryovers
- Reduction of NOLs, capital losses, PALs and asset basis is \$-for-\$
- Credit reduction is 33.33 cents per dollar of COD exclusion



IRC § 108(i) Election – Revenue Procedure 2009-37: Select COD Income Deferral And Partnership Issues (Cont.)

- Partner-Level Basis Reduction – P/S interest is treated as “depreciable” to extent of pro rata share of P/S depreciable property
- Form 982 Election To First Reduce Asset Basis –
 - Valuable tool to preserve current utility of NOLs
 - Regular basis reduction absent Form 982 election is limited to excess of aggregate basis of properties over aggregate liabilities
 - Form 982 election permits basis reduction to zero – no floor (compare QRPBI)
- Attribute Reduction // Timing –
 - Occurs after determination of tax for Tax Year of COD income event
 - Taxpayer can use tax attributes such as NOLs to offset non-COD Income or COD Income not eligible for COD Income Exclusion




IRC § 108(i) Election – Revenue Procedure 2009-37: Select COD Income Deferral And Partnership Issues (Cont.)

- Partnership COD income and IRC §108(i) elections – COD Income Exclusions, offsets, partial elections and allocation planning
 - Conflict of COD income exclusions and IRC §108(i) election
 - COD income exclusions apply at the partner level, e.g. bankruptcy or insolvency
 - IRC §108(i) election made by P/S
 - Tension: Partner-level considerations determine optimum strategy and will differ among partners
 - Compare: S corporation availability of the COD exclusions is determined at entity level
 - Rev. Proc. 2009-37 provides two very liberal rules
 - Partial election concept – Flexible utilization of COD exclusions in conjunction with IRC §108(i) neither reflected in statute nor envisioned by legislative history




IRC § 108(i) Election – Revenue Procedure 2009-37: Select COD Income Deferral And Partnership Issues (Cont.)

- Allows P/S to “allocate” to each partner a COD “deferred income” amount and tailor partner-level treatment to suit their needs/objectives
- Partnership allocation process – Deferral mechanics
 - Deferred COD Income may be recognized in disproportionate amounts relative to allocable share of COD income
 - Sounds like a “special allocation” of income but not truly; rather, in effect it is a partner-level partial IRC §108(i) election relative to regular COD Income allocations
 - E.g., partner with 5% profits interest does not defer recognition of any allocable share of the COD income, while partner with 50% interest may defer a portion of the COD income allocable to it (e.g., 1/5) and currently realize the balance (or 4/5) of its COD income allocation




IRC § 108(i) Election – Revenue Procedure 2009-37: Select COD Income Deferral And Partnership Issues (Cont.)

- P/S must (i) compile all the requested IRC §108(i) election preferences from each partner and (ii) determine the aggregate or effective deferral percentage – this becomes the P/S-level election percentage (per applicable Debt Instrument)
 - P/S mechanism and process are important
 - Indemnity issues and concerns vis-à-vis general partner or manager



IRC § 108(i) Election – Revenue Procedure 2009-37: Select COD Income Deferral And Partnership Issues (Cont.)

- “Partial election” and partner-level allocation via Rev. Proc. 2009-37 allow P/S to select different percentages of deferred COD income to suit partners, based on respective consideration of following factors:
 - Utility of their own separate NOLs or credit position (from this or other ventures)
 - Effective tax rate position
 - OID deductions available on debt-for-debt exchanges, including modifications resulting in “deemed” exchanges
 - Time value of the deferral of income – Five- or six-year pure deferral plus five-year ratable inclusion
 - Compare present value of future tax cost of IRC §108(i) election
 - Vs. cost of lost tax attribute under IRC §108 COD exclusion



IRC § 108(i) Election – Revenue Procedure 2009-37: Select COD Income Deferral And Partnership Issues (Cont.)

- Statutory mechanics – Related tax items of partners with deferred COD income
 - Liability reduction – Tax basis reduction for cancelled partnership liabilities is also deferred
 - Decrease is taken into account as deferred income is recognized
 - Suspends application of IRC §752, which treats as constructive cash distributions reduction of share of liabilities. Thus, electing partner tax basis will concurrently rise by the inclusion of deferred income amount and equally decline under IRC §752
 - OID deductions – Share of OID attributable to new debt will not be amortizable before 2014; deductions are matched to recognition of deferred COD income



IRC § 108(i) Election – Revenue Procedure 2009-37: Select COD Income Deferral And Partnership Issues

- Acceleration of IRC 108(i) deferred amount – Upon certain events
 - Death
 - Liquidation or sale of substantially all of the taxpayer's assets
 - Cessation of business
 - Sale or exchange and redemption of a P/S interest – A purchaser of an interest does not realize as taxable income the transferor's COD deferred amount (though it would be reflected in transferee's capital account)
- Procedure – Election statement must include the following information:
 - Partner respective current year and deferred amount, OID deduction and IRC §752 amounts
 - Tiered partnerships – A P/S that receives a K-1 with an IRC §108(i) election must report shares to its partners
 - Protection IRC § 08(i) election – P/S must attach to K-1s a statement that (i) contains the name and TIN of the issuer of the applicable debt instrument, (ii) describes the debt instrument and the partnership's trade or business to which it relates, and (iii) describes the reacquisition transaction(s) generating the debt-discharge income



Case Study 1 – Revenue Procedure 2009-37: Partnership Partial Election

- Example: ABC LLP has 4 partners, each with 25% interest in profits, and has COD income from debt exchange of 1,000 that is fully secured by real estate
 - Partner A, an S corp., is insolvent by \$250 and has \$500 NOL – decides to recognize all COD income
 - Partner B, a C corp., is solvent and has no NOLs – elects to defer 100% of his allocation of COD income of \$250
 - Partner C, an individual, is solvent and elects to apply COD exclusion for QRPBI to 50% of COD income (that will reduce the basis of its P/S interest and share of realty basis) and will defer 50% via P/S Sect. 108(i)
 - Partner D, an exempt entity, will not defer any COD income
 - P/S will file an IRC Sect. 108(i) election
 - Total COD Income allocation to each partner is unaffected by election -- i.e., 25% each
 - P/S will make partial election of 37.5% and effectively allocate COD deferred amount on 2:1 basis between partners B and C



Case Study 2 – Revenue Procedure 2009-37: Related Party Repurchase Of Debt/Debtor Deemed Modification

- Example 2A: ABC LLP is a private equity fund that owns 80% of a portfolio company XYZ Co. ABC LLP purchases \$10M of bank loans owed by XYZ Co. for \$6M that mature at the end of 2015. XYZ Co. has a \$1M NOL and is insolvent in FMV terms by only \$1M (as it holds valuable IP and real estate)
- Under COD-related party rules, the purchase is treated as a discounted repurchase by XYZ Co. ABC LLP's purchase would constitute a "reacquisition of debt" by XYZ Co. and a deemed reissuance of debt from XYZ Co. to ABC LLP in an exchange that generates \$4M of potential COD Income and is eligible for the Sect. 108(i) election
 - Although the new debt would carry \$4M of OID, none of it would be deductible until the ratable deferred income inclusion period starting 2014 begins
 - XYZ Co. would elect to defer 50% of the total \$4M COD income; as to the 50% balance, use the insolvency exclusion to exclude \$1M and its \$1M NOL (that would not be subject to attribute reduction) to offset the remaining currently included COD income

**Cancellation Of Indebtedness
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Dec. 9, 2009

Financial And International Implications

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Sect. 108(i) Election And Foreign Corporations: Who Makes The Election?

- The “controlling domestic shareholder” of (i) a controlled foreign corporation (CFC) or (ii) a non-controlled Sect. 902 corporation, which are not otherwise required to file U.S. federal income tax returns, may make the Sect. 108(i) election on behalf of a foreign corporation
 - A CFC generally defined as a foreign corporation that is more than 50% owned (directly, indirectly or constructively) by 10% U.S. shareholders
- Need to satisfy requirements of Sect. 1.964-1(c)(3)
 - Controlling domestic shareholders of CFC defined as those U.S. shareholders who, in the aggregate, own more than 50% of the voting power of the CFC and who undertake to act on its behalf
 - Controlling domestic shareholders of non-controlled Sect. 902 corporation that is not a CFC are its majority domestic shareholders

Sect. 108(i) Election And Foreign Partnerships: Who Makes the Election?

- A foreign partnership that is not otherwise required to file a U.S. federal income tax return (a “non-filing foreign partnership”) is the person required to make the Sect. 108(i) election
- The information required to be filed by the non-filing foreign partnership when making the Sect. 108(i) election, in addition to the requirements set forth in Rev. Proc. 2009-37, need only include the name and address of the partnership making the election and must clearly identify the election being made
- Therefore, this election statement does not constitute a partnership tax return (see *Sect. 1.6031(a)-1(b)(5)*)
 - A foreign partnership typically is not required to file a U.S. federal income tax return so long as (i) it has no gross income that is (or treated as) effectively connected to a U.S. trade or business, and (ii) does not have gross income (including gains) derived from U.S. sources

Sect. 108(i) Election And Foreign Partnerships: Who Makes The Election? (Cont.)

- In the information that the non-filing foreign partnership is required to file with the IRS, it must include the aggregate amounts for all partners as well as the aggregate amounts for all U.S. persons and CFCs that are partners with deferred amounts in the non-filing foreign partnership (“affected partners”)
- Election needs to be made by the general filing date for partnerships, even though non-filing foreign partnership is not otherwise required to file tax return
- For each affected partner, the partnership is required to file with the IRS a Schedule K-1 that sets forth the information required by Rev. Proc. 2009-37

Treatment Of Deferred COD Income To CFCs

- U.S. shareholders of CFCs typically are only taxed on “subpart F” income generated by CFC
 - Subpart F income is limited to the CFC’s earnings and profits (E&P)
- Subpart F income includes most forms of passive income such as dividends, interest, rents, royalties, capital gains, etc., as well as income from certain related-party sales and service transactions
- The IRS has ruled that COD income generally does not give rise to subpart F income (*See PLR 9729011*)
- In Rev. Proc. 2009-37, IRS provided that COD income deferred as a result of Sect. 108(i) election will generate E&P in the year the COD income is realized, not the year it is actually included in gross income
- Therefore, U.S. shareholders of CFCs need to be aware that deferred COD income may increase current year’s E&P of a CFC and therefore may increase the amount of Subpart F income that is taxable to the U.S. shareholders

Sect. 108(i): Taxation Of Foreign Persons, In General

- Unlike U.S. persons who are subject to U.S. federal income tax on their worldwide income, foreign persons generally are subject to U.S. taxation on two categories of income:
 - Certain passive types of U.S. source income (e.g. interest, dividends, rents, annuities and other types of “fixed or determinable annual or periodical income,” collectively known as FDAP)
 - FDAP income is subject to a 30% withholding tax that is imposed on a foreign person’s gross income (subject to reduction or elimination by an applicable income tax treaty)
 - Income that is effectively connected to a U.S. trade or business (ECI)
 - ECI is subject to tax on a net basis at the graduated tax rates generally applicable to U.S. persons

Sect. 108(i) Triggering Events: How Does Provision Apply When Debtor Is Foreign?

- All deferred amounts (COD income and OID deductions) will be taken into account in the taxable year (or in the case of a Title 11 case, the day before the petition is filed) in which the following events occur:
 - In the case of the death of the taxpayer
 - The liquidation or sale of substantially all the assets of the taxpayer (including in a Title 11 or similar case)
 - The cessation of business by the taxpayer, or
 - “Similar circumstances”
 - The sale or exchange or redemption of an interest in a partnership, S corporation or other pass-through entity by a partner, shareholder or other person holding an ownership interest in such entity also will trigger an acceleration of all deferred amounts

Sect. 108(i) Triggering Events: How Does Provision Apply When Debtor Is Foreign? (Cont.)

- What if foreign person that has U.S.-source COD income that is treated as ECI elects to defer the income inclusion under Sect. 108(i), but when inclusion period begins five years later, the foreign person is no longer engaged in a U.S. trade or business?
 - Will the cessation of the foreign person’s U.S. trade or business be treated as “the cessation of business of the taxpayer,” for acceleration purposes?
 - Will the cessation of the foreign person’s U.S. trade or business fall under the “similar circumstances” catch-all, for acceleration purposes?
 - Will sections 864(c)(6) or (c)(7) apply to treat COD income as arising in year when foreign person was engaged in U.S. trade or business?

Sect. 108(i) Triggering Events: How Does Provision Apply When Debtor Is Foreign? (Cont.)

- What if foreign person with U.S.-source COD income treated as FDAP income subject to withholding elects to defer the income inclusion under Sect. 108(i), but when inclusion period begins five years later, the withholding agent no longer has custody of, or control over, property of the borrower?
- Or, what happens if, when the inclusion period begins, foreign person is now a resident in the jurisdiction whose income tax treaty with the U.S. excludes the COD income under the “other income” provision of the treaty?
- Would either of these situations fall under the “similar circumstances” catch-all of the acceleration provision?

Sect. 108(i) Triggering Events: How Does Provision Apply When Debtor Is Foreign? (Cont.)

- What are the U.S. withholding tax consequences when a foreign partner sells its interest in a U.S. partnership that has elected to defer the recognition of COD income under Sect. 108(i)?
- A sale of the partnership interest by the partner would trigger acceleration of the COD income
- Does the partnership have to withhold on the foreign partner's share of the accelerated COD income, or does the purchaser of the partnership interest have to withhold?
 - It would seem that, based on Sect. 108(i)(6), the partnership would be required to withhold under Sect. 1446 on the foreign partner's share of the COD income. However, from where does the cash come?
 - Purchaser is required to withhold on acquisition of partnership interest only if FIRPTA is implicated (*Sect. 1.1445-11T; Rev. Rul. 91-32, 1991-1 C.B. 107*)

Sect. 108(i): Timing Of OID Deductions

- Deferral of OID deductions
 - Similar to the general five-year deferral provided to a debtor who realizes COD income, if a new instrument issued in a debt-for-debt exchange has OID, the issuer's OID deductions will be deferred until the inclusion period of the COD income begins
 - OID deferral rule does not apply if the amount of the OID is less than a *de minimis* amount (*i.e.*, less than 0.25% of the stated redemption price at maturity)
 - Similar to rule for COD income, a corporation's E&P will generally be decreased in the taxable year or years in which the deduction would otherwise be allowed, without regard to Sect. 108(i)

Sect. 108(i): OID Deferral Rule And Pass-Through Entities

- The OID deferral rule applies at the entity level for a pass-through entity
- Therefore, a partnership (and its partners) may not currently deduct the OID that is deferred as a result of Sect. 108(i) election

Timing Consequences Resulting From A Sect. 108(i) Election: COD Income

- When loan is discharged, creditor typically recognizes loss currently under Sect. 165 or possibly Sect. 166 (bad debt deduction)
 - Taxpayers can obtain ordinary loss treatment under Sect. 166 on loans that are capital assets, so long as the loans are not “securities” under Sect. 165(g)(2)(C) (and, for non-corporate taxpayers, the loan is a business debt)
 - If a loan that is a capital asset is a security under Sect. 165(g)(2)(C), any loss attributable to the worthlessness of the loan generally will be a capital loss under Sect. 165(g)
- Exception is provided for loss recognized from the sale or exchange of debt instrument between related parties (loss may be deferred or disallowed, depending on relationship). See Sect. 267
- Therefore, assuming loss is recognized currently by creditor, timing mismatch results as a result of Sect. 108(i) election if debtor does not need to currently recognize COD income

Timing Consequences Resulting From A Sect. 108(i) Election: OID Deductions

- Similar timing mismatches may occur as a result of the deferral of OID deductions under Sect. 108(i)(2)
 - Holder of debt instrument with OID typically includes ratably daily portion of OID in income under Sect. 1272
 - IRS argues that even if there is “doubtful collectability” of interest, accrual of OID is still required (see *TAM 9538007*)
 - This should be contrasted with accrual of non-OID interest by taxpayers on the accrual method of accounting where the “doubtful collectability” allows for non-accrual of income (see *Rev. Rul. 80-361*)

Background – IRS Rev. Proc. 2009-37

<http://www.irs.gov/pub/irs-drop/rp-09-37.pdf>