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Section 108(i)—Election to Defer COD Income Recognition

On February 17, 2009, President Obama signed into law the American Recovery and Reinvestment Act of 2009 which added new section 108(i) to the Internal Revenue Code. Section 108(i) allows C corporations and other taxpayers (including pass-thru entities such as partnerships and subchapter S corporations) engaged in the conduct of a trade or business to defer the recognition of income from the discharge of indebtedness ("COD income"). An election may be made for a debtor to defer the recognition of COD income from the purchase, exchange, or forgiveness of a debt instrument of the debtor, as well as a contribution to the capital of the debtor of its debt instrument, and retain its tax attributes for future use. This election to defer the recognition of COD income may also be made with respect to the acquisition of a debt instrument of the debtor by a related person to the debtor. The deferral period is five taxable years (in the case of COD income generated in 2009) or four taxable years (in the case of COD income generated in 2010). Following the end of the deferral period, the COD income will be taken into income ratably over the next five years. However, the entire amount of any COD income deferred pursuant to section 108(i) will be taken into income upon the occurrence of certain acceleration events described below. Section 108(i) will be particularly useful for a taxpayer that (1) realizes COD income when it is not in bankruptcy or insolvent, or (2) has valuable tax attributes that are likely to be used to reduce the taxpayer's tax liability during the deferral period.

Generally, section 61(a)(12) requires debtors to include COD income in the calculation of gross income. A debtor, however, that realizes COD income in a Title 11 bankruptcy proceeding or when the debtor is insolvent may exclude some or all of this COD income from its gross income under section 108(a). The exclusion under section 108(a) is not without cost as the debtor must reduce, on a corresponding basis, valuable tax attributes such as net operating losses, capital losses, various credits, and basis in assets.

Section 108(i) permits a debtor to defer the recognition of COD income from the purchase, exchange, or forgiveness of a debt instrument of the debtor, as well as a contribution to the capital of the debtor of its debt instrument, and retain its tax attributes for future use.^[1] Section 108(i) also permits the deferral of the recognition of COD income with respect to the acquisition of a debt instrument of the debtor by a related person to the debtor. The election may be made with respect to a discharge of debt occurring in 2009 or 2010. At the end of the deferral period, all of the deferred COD income must be taken into account ratably over the next five taxable years without the availability of the exclusionary rules of section 108(a)(1). However, the recognition of any deferred COD income will be accelerated upon: (a) the death of the debtor; (b) the liquidation of the debtor; (c) the sale of substantially all of the assets of the debtor; and (d) the sale or exchange or redemption of an interest in a partnership, S corporation, or other pass-thru entity by a partner, shareholder, or other person holding an ownership interest in such entity in the case of a section 108(i) election made by such partnership, S corporation, or other pass-thru entity. Section 108(i) contains provisions that permit deferral of the recognition of income pursuant to the application of sections 731 and 752 that correspond with the deferral of income pursuant to section 108(i).

The section 108(i) election may be made on a debt instrument by debt instrument basis. Once the section 108(i) election is made for a particular debt instrument, it is irrevocable. The section 108(i) deferral election must be made with the filing of the U.S. federal income tax return for the taxable year in which the COD income is realized. The party responsible for making the election is the taxpayer that realized the COD income.

In the case of a debtor that is a partnership (or a limited liability company taxable as a partnership), the section 108(i) election is made by the partnership and binds all of the partners. This is in stark contrast to the other provisions of section 108 that apply bankruptcy and insolvency exceptions and corresponding tax attribute reduction at the partner level and not to the partnership itself. The decision to make the section 108(i) election by the partnership may produce vastly different results to different partners depending upon the financial condition and tax attributes of the partner. For example, when some partners in a partnership are solvent and not in a Title 11 bankruptcy proceeding and other partners are either in a Title 11 bankruptcy proceeding or insolvent, the first group of partners might derive a substantial benefit from a 108(i) election while the other partners might actually incur increased tax liabilities as a result of the election, particularly if an acceleration event occurs with respect to a partner.

We hope this information is helpful to you. If you have any questions, please contact Jeff Paravano, Bill Toomajian, Ed Ptaszek or John Lehrer.

[1] If a debt instrument is reacquired in exchange for another debt instrument that has original issue discount, section 108(i) provides a similar deferral mechanism for a debtor's deduction relating to the original issue discount.

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