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Stimulus legislation provides new relief from Cancellation of Indebtedness Income for debt restructurings

By Harry D. Shapiro and Seth J. Groman

Generally, when a debtor is relieved of his obligation to pay a debt, he must include the amount of the relief in gross income as cancellation of indebtedness income (“COD income”). Section 108 of the Code¹ provides relief from this inclusion in certain situations. In light of the current economic crisis, the American Recovery and Reinvestment Act of 2009 has expanded the relief from COD income for taxpayers undergoing certain debt restructurings by permitting them to elect to defer the recognition of COD income resulting from such activities.

When a debtor reacquires its own debt for less than the amount of the outstanding debt, COD income must be recognized because the debtor is being relieved of the obligation to pay the amount borrowed. Under newly enacted section 108(i) of the Code, a taxpayer who realizes COD income as a result of reacquiring a previously issued debt instrument between January 1, 2009 and December 31, 2010 may make an election to defer the inclusion of the COD income. For reacquisitions occurring in 2009, the taxpayer must include the COD income ratably over a five-year period beginning in the fifth tax year following the transaction. If the reacquisition occurs in 2010, the taxpayer must include the COD income ratably over a five-year period beginning in the fourth tax year following the transaction.

The benefits of section 108(i) only apply to debt instruments issued by C corporations or by any other person in connection with the conduct of a trade or business. For a reacquisition to occur, the taxpayer must acquire a debt instrument that was issued by the debtor or a related party in exchange for cash, another debt instrument, corporate stock or a partnership interest, or a capital contribution. The complete forgiveness of a debt instrument by the holder of such instrument also serves as a reacquisition.

Section 108(i) differs from the relief provided in other parts of section 108 in that it defers the inclusion of COD income rather than exempting it completely. Section 108(i) specifies that

¹ All section references are to the Internal Revenue Code of 1986, as amended (“the Code”).

taxpayers who take advantage of the provision may not seek relief under other parts of section 108. Though section 108 provides for the exclusion of COD income if the taxpayer is insolvent or the debt cancellation occurs in a Chapter 11 bankruptcy action, the taxpayer must reduce tax attributes. This may seem more beneficial at first blush, but such taxpayers can opt for the new deferral of COD income instead of the other relief provided in section 108. It is important for a taxpayer who qualifies for relief under both section 108(i) and other portions of section 108 to evaluate which provision is more tax effective.

This Alert only provides a broad overview of section 108. The provision itself is complex and contains additional rules affecting a taxpayer depending on its particular circumstance. To determine the best course of action for your business, please contact any of the Saul Ewing tax attorneys listed below.

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