

## **Election to Defer Cancellation of Debt Income Under the American Recovery and Reinvestment Act of 2009**

Last month, President Obama signed into law the American Recovery and Reinvestment Act of 2009 (“the Act”). The Act provides an election for certain taxpayers to defer recognition of income arising from cancellation of indebtedness. This provision may provide relief to any business that is considering acquiring its own debt at a discount, whether for equity, cash or new debt, or significantly modifying the terms of any of its outstanding debt.

### **CURRENT LAW**

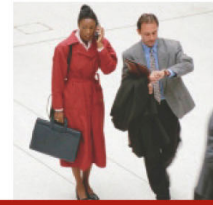
Under current law, a taxpayer must include in gross income any amount realized from the cancellation of its indebtedness (so-called “COD income”), subject to certain exclusions noted below. The amount of COD income is generally equal to the excess of the adjusted issue price of the debt instrument being discharged over the amount the taxpayer pays (or is deemed to pay) to satisfy the debt. Such payment might take the form of cash, the taxpayer’s equity or a newly issued debt instrument. Additionally, COD income can result from the significant modification of the terms of a publicly traded debt instrument. COD income is generally included in income in the year the debt is discharged.

### **NEW DEFERRAL ELECTION**

Under the new provision, a taxpayer may elect to defer COD income realized on a “reacquisition” of a debt instrument if that reacquisition occurs during the two-year period beginning January 1, 2009 and ending December 31, 2010. To be eligible for relief, the debt instrument must have been originally issued by the taxpayer. The following are considered reacquisitions:

- The taxpayer’s acquisition of the debt instrument for cash;
- The exchange of a new debt instrument for the original instrument (including a deemed exchange resulting from a significant modification of the original debt instrument);
- The taxpayer’s exchange of its equity for the debt instrument;
- The taxpayer’s acquisition of its own debt as a contribution to its capital from an equity holder; or
- The creditor’s complete forgiveness of the debt.

If the taxpayer makes the deferral election, the COD income realized in the year of the reacquisition will be deferred until 2014, and then included in income ratably during 2014-2018. Thus, COD income attributable to reacquisitions in 2009 is deferred five years, and COD income attributable to reacquisitions in 2010 is deferred four years. The deferral election applies to debt instruments originally issued by corporations or any other entity engaged in the conduct of a trade or business, including LLCs, partnerships and sole proprietorships.



### **ORIGINAL ISSUE DISCOUNT**

If an electing taxpayer issues new debt in exchange for an existing debt instrument (including a deemed exchange resulting from a significant modification of an existing debt instrument), and the newly issued debt has original issue discount (OID), any otherwise allowable deduction for OID accruing during the deferral period will also be deferred until 2014 and ratably allowed as a deduction during 2014-2018.

### **ACCELERATION OF DEFERRED ITEMS**

Any COD income (and related OID deductions, if any) deferred by an electing taxpayer is accelerated and must be taken into income in the taxable year in which the taxpayer liquidates or sells substantially all of its assets (including in a Title 11 or similar case); ceases to do business; or in the case of an individual, dies.

### **INTERACTION WITH EXCLUSIONS FROM COD INCOME**

Generally, if a debt is cancelled at the time the debtor is insolvent or in a Title 11 bankruptcy, any COD income otherwise resulting from such cancellation is excluded from the debtor's income. However, a taxpayer who acquires its debt and makes the new deferral election forfeits the ability to qualify for any such exclusion from COD income in respect of the reacquired debt either in the year of election or in any subsequent year. A taxpayer should take into consideration the loss of the benefit of these exclusions before deciding to make the new deferral election.

### **SUMMARY**

Many taxpayers may benefit from the new election to defer COD income. It is important to note that the new election is not a permanent exclusion from income and is simply a deferral of the recognition of income. Moreover, taxpayers with current losses or net operating loss carryovers may find it more beneficial to offset COD income with such losses than to make the new deferral election. Taxpayers will need to analyze their specific situation when considering whether to make the new deferral election. Taxpayers should also consider financial accounting implications as well.

### **FOR MORE INFORMATION**

Please contact a member of our **Tax** group for more information.

For our brief analysis of additional tax provisions contained in the Act, please go to <http://www.ThompsonHine.com/publications/publication1711.html>.

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