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Reducing the Income Tax Cost of Debt Cancellations

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Over the last eighteen months, the economic recession has resulted in a sharp increase in defaults of both consumer and commercial loans. In response to the defaults, lenders and borrowers are entering into loan modifications and other agreements that lead to the cancellation of debt.

If you have a client who has negotiated a reduction in the amount of debt, your client could be required to report cancellation of indebtedness income (COD income) on a federal income tax return. This increases the client's tax liability for the year in which the cancellation occurred, unless the client qualifies for the relief provisions discussed below.

While taxpayers may recognize the risk of COD income from the complete forgiveness of a debt, many taxpayers do not realize that a loan modification could produce similar results. For tax purposes, a modification of a loan is deemed an exchange of the old debt for a new debt. The modification may occur through an express agreement, the conduct of the parties, or otherwise. Thus, a formal agreement between a lender and borrower is not necessary to effect a modification giving rise to taxable COD income; their conduct can result in a modification if their actions do not match the obligations and duties of the debt instrument.

Code Section 108(a) Exclusions

The Internal Revenue Code (the Code), provides relief through which qualifying taxpayers can exclude COD income from the amount of income reported on

a federal income tax return. Code Section 108(a)(1) provides five categories of exclusions, of which the most commonly applicable are: (i) a discharge occurring in a Title 11 (*i.e.*, bankruptcy) case; or (ii) a discharge occurring when the taxpayer is insolvent (*i.e.*, the taxpayer's outstanding liabilities exceed the fair market value of the taxpayer's assets).

It is important to note that, if the exclusion of COD income results from bankruptcy or insolvency, the taxpayer will be required to reduce certain tax attributes, such as the taxpayer's depreciable tax basis in its assets. I.R.C. § 108(b). As a result, the COD income exclusion and reduction of tax attributes generally has the combined effect of tax deferral, as opposed to a complete reduction of tax. In other words, the exclusion will enable the taxpayer to avoid recognizing COD income immediately, but the taxpayer will generally incur additional taxes in later years as a result of the reduction of the tax attributes.

Code Section 108(i) Deferral Election

Congress recently provided taxpayers with another means of avoiding the immediate recognition of COD income by enacting Code Section 108(i). It provides that a taxpayer who reacquires an "applicable debt instrument" in either 2009 or 2010 can elect to defer the reporting of the COD income resulting from such reacquisition until 2014. The taxpayer can then report a portion the COD income ratably each year from 2014 to 2018.

To take advantage of Code Section 108(i), the following requirements must be satisfied. First, the transaction must involve an "applicable debt instrument," which basically means any debt instru-

ment issued in connection with business activities.

Second, there must be a "reacquisition" of the debt instrument. The definition of a "reacquisition" is exceedingly broad and covers many transactions, such as paying cash in satisfaction of the debt, issuing a new debt instrument in cancellation of the old, a debt modification as described above, or even the complete forgiveness of the debt by the lender.

Third, the debt reacquisition must occur during either 2009 or 2010. Absent further Congressional action, a debt reacquisition occurring after December 31, 2010 will no longer qualify for the deferral election.

Last, the debtor must affirmatively elect to defer COD income by including the requisite statement on the debtor's federal income tax return for the year

in which the reacquisition occurs and each subsequent year until the deferred COD income has been fully reported in income.

As discussed above, the Code provides mechanisms for alleviating the harsh federal income tax effects that generally result from debt cancellations. Determining which mechanism is more favorable for a particular taxpayer will require careful analysis of the Code Section 108 provisions and their potential impact in the taxpayer's particular facts and circumstances. Therefore, a taxpayer who has negotiated a reduction of debt should consult a tax advisor. **HN**

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On Tuesday, October 20, the DBA hosted the first Texas Rule of Law Conference with guest speakers Joe W. "Chip" Pitts, III of Stanford Law School (center), and Dean John Attanasio of SMU Dedman School of Law (not pictured).