



TAX PRACTICE CORNER

Deferring COD Income: Burden May Outweigh Benefit

The election provided in the American Recovery and Reinvestment Act of 2009 (ARRA) to defer until 2014 and spread over five years cancellation of debt income (CODI) has been touted as an attractive relief option for taxpayers struggling with cash flow problems. However, partnerships and S corporations and their owners should weigh against that potential tax benefit complex recordkeeping and reporting requirements that can arise, especially in the case of partial elections and the provision's interaction with exclusions for bankruptcy and insolvency.

The election is available for CODI resulting from the reacquisition in 2009 and 2010 tax years of applicable debt instruments. An applicable debt instrument is one issued by a C corporation or any other person in connection with a trade or business conducted by that person (IRC § 108(i)(3)). For prior *JofA* coverage, see "Tax Consequences of Mortgage Discharge," Nov. 2009, page 54.

SOLOMONIC WISDOM REQUIRED

The bankruptcy or insolvency exclusion is determined at the partner or shareholder level (section 108(d)(6)), whereas the deferral election is made at the partnership or S corporation level (section 108(i)(5)(B)(iii)). An example of a simple partnership containing only two limited partners, one of whom is bankrupt and one of whom is solvent, illustrates the potential conflict. The insolvent or bankrupt partner would want to rely on the exclusion, whereas the solvent partner would want to rely on the new election to effectuate the deferral. Since the deferral trumps the exclusion, the partners would be placed in an adversarial position, and the general or tax matters partner of that partnership would be faced with a task requiring the wisdom of Solomon.

This and other points are addressed in the statute and guidance, including temporary and proposed regulations issued Aug. 11, 2010 (TD 9498 and REG-144762-09; see "Tax Matters: COD Income Deferral Regs Issued," page 66). The electing

partnership must first allocate all of the CODI to partners in the partnership immediately before the debt cancellation in the manner in which the income would be included in their distributive shares without regard to section 108(i). The partnership may elect a full or partial deferral of CODI under section 108(i). The partnership may then determine by any manner how much of each partner's allocable share of the CODI represents a portion of the deferred amount and how much is taken into account for the tax year of the debt reacquisition. In other words, for each qualifying debt reacquisition, each partner may be allotted a portion of deferred income up to the amount of that partner's share of CODI and the partnership's aggregate section 108(i) deferral for that reacquisition. See Temp. Treas. Reg. § 1.108(i)-2T.

In the simple example above, the partnership could elect to defer 50% of the CODI and report as income the other 50%. The deferred amount could be allocated to the solvent partner, allowing that partner to defer the income until 2014 and recognize it ratably over the next five years, while currently recognized income could be allocated to the insolvent partner, who may rely on the bankruptcy or insolvency exclusion.

ISSUES OF SCALE

The further problem is that not all partnerships are as small and as simple as the above example. Consider a large national partnership with diverse partners who are strangers to each other, and whose financial conditions are not readily known. In addition to the complexity of determining each partner's preferences for allocating a partial deferral, voluminous disclosures and statements must be distributed to them with Schedule K-1 and attached to their returns. See sections 4.05 and 4.07 of Revenue Procedure 2009-37 (2009-36 IRB 309) for the lengthy list of required disclosures.

Moreover, these disclosures must be made every year, from the year of the election through the final recognition year of 2018. Partners are also required to report the basis of their partnership interest in order for the general partner to properly compute the deferred section 752 amount (increase or decrease in partner's share of liabilities).

Before making a section 108(i) election, the partnership must make reasonable efforts to obtain a written statement signed under penalty of perjury from each partner with a deferred amount for which it does not have the information necessary to compute the partner's basis in its partnership interest (and its deferred section 752 amount as described in the revenue procedure). Within 30 days of the date of request by the partnership, each partner with a deferred amount must provide this written statement to the partnership. Many partners may lack sufficient information and may be hesitant to comply. A partner's failure to comply with this reporting requirement does not automatically invalidate the partnership's

election, provided the partnership makes reasonable efforts before making the section 108(i) election to obtain the written statement from the partner and otherwise complies with the requirements of the revenue procedure. If an error is made, revisions will be necessary.

The requirements for S corporations are less onerous, requiring only that a list of shareholders at the time of the election be disclosed and that the allocation of the deferral be made in accordance with their ownership interests immediately before the debt reacquisition. Such disclosure is also required through the final date of income recognition (2018). The revenue procedure also allows for protective elections in the event that taxpayers are not clear whether a transaction has resulted in CODI. Such a protective election is made with the original federal income tax return for the year in which the recognition transaction occurs, and again for each subsequent year for the entire deferral period. The statement must be labeled as a "section 108(i) protective election," and provide the information required by the revenue procedure, including, but not limited to, the name and tax identification number of the debt issuer, a description of the debt, the taxpayer's trade or business, and a description of the reacquisition transaction.

Another layer of complication ensues if an electing partnership or S corporation (or partner or shareholder) then experiences an "acceleration event" of section 108(i)(5)(D)(ii), including the sale, exchange or redemption of an interest in a partnership or S corporation, causing immediate recognition of any remaining deferred CODI (see also TD 9497 and REG-142800-09).

The ARRA deferral shows how a seemingly straightforward benefit may be entirely offset by the complex interaction of onerous reporting requirements and other tax provisions. General partners and tax matters partners may be subject to increased personal liability and the threat of litigation due to the conflicting interests of the partners and the reporting requirements. Whether they make the election or not, partnerships may find the rules problematic and burdensome.

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