

Part 1. Computing Federal Income Tax

Vol. 1A Gross Income & Exclusions

CHAPTER 1A:8 Discharge of Indebtedness **

§ 1A:8.14 Miscellaneous Exclusions from the Inclusions of Cancellation of Indebtedness in Gross Income

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[5] Debt Instruments reacquired by Taxpayers in 2009 or 2010

As part of the American Recovery and Reinvestment Act of 2009, a new section, [IRC § 108\(i\)](#), was added to the Internal Revenue Code. This section provides certain taxpayers the election to defer cancellation of indebtedness income for a period of five years. Generally, a discharge of indebtedness results in income to the debtor equal to the difference between the debt instrument's adjusted issue price and the price at which the debt is satisfied. Before 2009, when a taxpayer repurchased its debt for less than the adjusted issue price, the taxpayer generally recognized cancellation of indebtedness income under [IRC § 108](#), unless another exception applied, in the year of the repurchase. Under the new [IRC § 108\(i\)](#), a taxpayer that reacquires a debt instrument after December 31, 2008, and before January 1, 2011, for less than the adjusted price may defer the cancellation of indebtedness income for either 4 or 5 years depending on the year of the reacquisition of the debt. For debt instruments reacquired in 2009, the cancellation of indebtedness begins to be recognized in the fifth year after the reacquisition, or 2014. For debt instruments reacquired in 2010, the cancellation of indebtedness begins to be recognized in the fourth year after the reacquisition, which also is 2014.

The deferral applies to the reacquisition of an "applicable debt instrument", which is defined in [IRC § 108\(i\)\(3\)\(A\)](#) as any debt instrument that was issued by either a C Corporation or by another other person in connection with the conduct of a trade or business by such person. Therefore, the deferral is available to taxpayers upon the reacquisition of debt instruments issued in connection with a trade or business, but not for debt instruments issued for personal purposes. The types of debt instruments that are covered by the rules are any debt instrument under the meaning provided in [IRC § 1275\(a\)\(1\)](#), which includes

bonds, debentures, notes, certificates, or any other instrument or contractual arrangement constituting indebtedness.

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In [Rev. Proc. 2009-37, 2009-36 IRB 309](#), the IRS has provided guidance on the procedures surrounding the making of an election under [IRC § 108\(i\)](#).

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For taxpayers that are partnerships, [Rev. Proc. 2009-37](#) advises that the election is to be made at the entity level rather than at the partner level. Beyond the clarity of this instruction, there are numerous complex issues that are raised when the taxpayer making the election under IRC § 108(i) is a partnership. For example, the interaction of election to defer the COD income and the partner allocation rules of [IRC § 704\(b\)](#) seemingly raises more questions. This is because the electing partnership has the right to defer less than all of the COD income. In such a situation, there is the potential for disparate treatment among the different partners potentially on the partners' own personal tax position... Furthermore, the interplay with the partnership liability rules of [IRC § 752](#) poses other potential pitfalls for taxpayers.

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[S]everal questions... are not addressed...:

- The definition of "in connection with a trade or business" of an issuer other than a subchapter C corporation;
- The recapture rules in the statute at both the entity level and at the partner or subchapter S corporation shareholder level; and
- Various related issues for partnerships, such as the effect of deferred COD on the partners' capital accounts.