



Tax Consequences of a Debt Workout

by Patrick J. Downey

During this recession, many businesses have seen their revenues drastically decrease and are having difficulty meeting all their obligations. Chapter 11 bankruptcy is one option for a business that wants to try to make a go of it. Unfortunately, the control exerted by the bankruptcy judge and trustee over a business in Chapter 11 can make it difficult for it to successfully emerge from bankruptcy. In a Chapter 11 bankruptcy, the business will have a portion of its debt cancelled. Although a business is generally taxed on its cancellation of indebtedness income (COI), COI that results from a bankruptcy is generally excluded from income.

For a business that wants to obtain relief while honoring its obligations, another option is to privately negotiate a workout with its creditors. A workout likely will involve the business reacquiring some of its existing debt, which could result in it realizing COI. COI generally is taxed in the tax year of the cancellation. Paying tax on COI always is difficult because a business does not receive any cash that it could use to pay the tax. Consequently, although a workout can reduce a business's cost of servicing its debt, the tax consequences reduce its chances of surviving.

Congress actually realized that fact. It recently enacted a law that allows C corporations and other businesses to elect to defer paying tax on COI from the reacquisition of their debt occurring after December 31, 2008 and before January 1, 2011. Once made, the election cannot be revoked. A business that elects to defer COI from the reacquisition of debt will report

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it ratably over five taxable years. Payment of the tax will begin in the fifth taxable year following the taxable year in which the reacquisition occurred, if it occurred in 2009, and beginning in the fourth taxable year following the taxable year of the reacquisition, if it occurred in 2010.

Most of the debt that a business acquires in the course of its operations would be covered by the new law. For example, a business's exchange of a new promissory note for its existing debt is a reacquisition under the statute. The business would realize COI from this transaction if the adjusted issue price of the old debt exceeds the issue price of the new note. Similarly, a business's exchange of a capital interest in the business for its existing debt is also a reacquisition of debt and COI results if the adjusted issue price of the existing debt exceeds the fair market value of the capital interest. A contribution of existing debt held by a shareholder to a corporation is not treated as a tax-free contribution to capital. It is a reacquisition of debt that results in COI if the adjusted issue price of the debt exceeds the holder's basis in the debt.

The election to defer the recognition of COI from the reacquisition of debt is made by attaching a statement to the income tax return for the tax year in which the reacquisition occurred. The statement must clearly identify the debt instrument(s), list the amount(s) of the deferred income and provide the other information the Secretary of Treasury requires.

A business that realizes COI when it is insolvent can exclude it from gross income to the extent it is insolvent at the time the debt is discharged. So, assuming a business has a negative net worth of \$100 and receives COI of \$120, it would pay tax only on \$20 of COI income. Similarly, a business that realizes COI from the cancellation of certain farm indebtedness or certain business real property indebtedness also can exclude part or all of the COI from income. Also, the COI arising under these circumstances possibly could qualify as COI from the reacquisition of debt. However, a business cannot exclude COI arising from the reacquisition of debt from income if it elects to defer the COI under this new law. As a result, a business that reacquires its debt may have an opportunity to elect to either defer COI or exclude it from income. Other tax consequences can result from the election to exclude COI from income. A business should carefully review its options if it reacquires its debt to ensure that it obtains the most favorable tax results. Eastman & Smith Ltd. will be happy to assist in analyzing those options.



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