

AMERICAN RECOVERY AND REINVESTMENT ACT - IMPACT OUTSIDE OF ROAD WORK

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I'm sure that everyone has seen or experienced the effects of the American Recovery and Reinvestment Act through the road and bridge construction on seemingly every major highway in New Hampshire. However, the American Recovery and Reinvestment Act of 2009 ("ARRA"), more commonly referred to as the Stimulus Package, encompasses more than just the funding of "shovel ready" projects. ARRA revised certain sections of the Internal Revenue Code in an attempt to lessen the impact of the current economic crisis on individuals and businesses. In particular, and the focus of the following discussion, ARRA provides some additional flexibility and planning options relating to cancellation of indebtedness income arising from a "reacquisition" of "an applicable debt instrument" occurring within the next two (2) years.

Overview of the Amendments

In general, discharge of indebtedness results in income to the debtor generally equal to the difference between the outstanding amount of the debt immediately prior to discharge and any amount paid to satisfy the debt. Under the pre-ARRA rules, gross income generally includes income realized by a debtor from the discharge of indebtedness recognized in the year of the discharge. Fortunately a number of exceptions for discharge of indebtedness are allowed, including: (1) bankruptcy cases; (2) insolvency; (3) "qualified farm indebtedness"; (4) certain qualified real property business indebtedness; or (5) certain qualified indebtedness for the taxpayer's primary residence. I.R.C. § 108.

ARRA amended I.R.C. Section 108 by adding a new subsection (i) which allows a taxpayer to elect to defer cancellation of indebtedness income arising from the "reacquisition" of "an applicable debt instrument" that occurs after December 31, 2008,

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and before January 1, 2010. The deferred income resulting from this election is then included in income ratably over a five (5) or four (4) year period beginning in 2014 (depending on whether the “reacquisition” is made in 2009 or 2010).

The term “applicable debt instrument” is defined to mean any debt instrument that was issued by (1) a C corporation or (2) any other person in connection with the conduct of a trade or business by that person. For purposes of applying this provision, the term “debt instrument” is defined broadly to include, a bond, debenture, note, certificate, or any other instrument or contractual arrangement constituting indebtedness within the meaning of I.R.C. Section 1275(a)(1). The term “reacquisition” means any acquisition of the debt instrument by (1) the debtor which issued (or is otherwise the obligor under) the debt instrument, or (2) a related person to such debtor (as defined in Section 108(e)(4)).

In the case of a partnership, any deferred debt discharge income shall be allocated to the partners immediately before the discharge in the manner those amounts would have been included in the distributive shares of the partners under I.R.C. Section 704 if the income or deduction were recognized at that time. Any decrease in a partner’s share of partnership liabilities as a result of the discharge is not taken into account for purposes of I.R.C. Section 752 partnership liability rules to the extent it would cause the partner to recognize gain under I.R.C. Section 731. Therefore, the deemed distribution under I.R.C. Section 752 is deferred for a partner to the extent it exceeds the partner’s basis. Also, the provision states “Any decrease in partnership liabilities that is deferred under this rule will be taken into account by the partner at the same time, and to the same extent, as the deferred income is recognized.”

Practical Application

In general, this amendment may provide companies with an additional planning tool and added flexibility in dealing with restructuring company debt. Being able to buy back troubled debt at a discount without an immediate income tax hit may make the difference in a plan to restructure a balance sheet and work with lenders to avoid bankruptcy. Although all of the deferred debt discharge income will eventually be recognized, the taxpayer benefits from having the tax deferred to later years.

A taxpayer may choose not to make the deferral election if, for example, it has a net operating loss carryover that it can use to offset the debt discharge income and that otherwise would expire unused. The exclusion provisions should also be reviewed carefully to determine if the exclusions are applicable, and if

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so, whether the exclusions and the correlating reduction in tax attributes are more beneficial than the deferral. Like many tax planning options, the decision will depend on an analysis of the timing of the deferral or exclusion, a company's cash flow and the availability of net operating losses.

The election to defer discharge of indebtedness income under these provisions is made on an instrument-by-instrument basis and once made, the election is irrevocable. The election is made by including a statement in the income tax return for the tax year in which the debt instrument was reacquired. The election must clearly identify the instrument and the amount of deferred income. Also, once the election is made, the deferred income will be accelerated and included in income in the case of the death of the taxpayer, liquidation or sale of substantially all of the assets of the taxpayer, the cessation of business of the taxpayer or similar circumstances.

Because the State of New Hampshire has not adopted the ARRA amendments into the Business Profits Tax, a deferral election made for federal purposes will not be effective to defer income for New Hampshire tax purposes.

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