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IRS Issues Favorable Guidance On Election To Defer Cancellation Of Debt Income

The Internal Revenue Service ("IRS") issued Revenue Procedure 2009-37 (the "Revenue Procedure") to provide important guidance on the ability of taxpayers to defer cancellation of debt ("COD") income arising on the reacquisition of their own debt. The right to defer COD income on reacquired debt -- added by the American Recovery and Reinvestment Tax Act of 2009 (the "2009 Act") -- can yield significant tax and related cash flow benefits to taxpayers who are restructuring or negotiating settlements of their indebtedness.

The 2009 Act enacted new Section 108(i) of the Internal Revenue Code to allow C corporations and other taxpayers that conduct a trade or business to elect to delay recognition of COD income arising from their or a related party acquisition of its own debt in 2009 or 2010 (the "Section 108(i) Election"). COD income subject to the election is deferred until 2014 and then included in income ratably over 5 years.

A reacquisition of debt that is eligible for the Section 108(i) Election includes a (i) purchase for either cash or property, (ii) recapitalization of old debt in exchange for new debt or equity, (iii) contribution to capital, and (iv) forgiveness or cancellation of indebtedness by the holder. The election applies to COD income from the taxpayer's bonds, debentures, notes, certificates, or any other instrument or contractual arrangement constituting indebtedness for income tax purposes (referred to as "an applicable debt instrument").