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Debt workout need not result in taxable income

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Struggling businesses that have managed to restructure their debt, may find themselves with a taxable event. Debtors generally realize cancellation of debt income ("CODI") when relieved of the obligation to pay a debt. The Internal Revenue Code, however, contains provisions that allow debtors to escape taxation in certain circumstances. Well known exceptions include those for insolvent or bankrupt debtors. There is a tax cost, however. Tax attributes must be reduced for excluded CODI, including, net operating losses (NOLs), certain tax credits, capital loss and passive loss carryovers, and basis of the debtor's property. The code prescribes the order for attribute reduction. Basis reduction is fifth in the order, but for some debtors it may be advantageous to elect to first reduce basis of depreciable property in order to preserve other attributes, such as NOLs, which may be more valuable. For other insolvent debtors, there are other factors to consider and not making the election to first reduce basis in depreciable property may produce more favorable results.

Solvent taxpayers may be able to exclude CODI under other exceptions. Taxpayers other than C corporations can exclude CODI from the discharge of certain qualified real property business debt, which generally is debt incurred in connection with real property used in a trade or business and secured by the real property. This exclusion also carries a price. The amount excluded must be applied to reduce the basis of the debtor's depreciable real property.

In the American Recovery and Reinvestment Act of 2009, Congress provided additional assistance for debt workouts occurring before the end of 2010. Taxpayers can elect to defer CODI until 2014, at which time CODI must be included ratably in gross income over a 5-year period. The election may be beneficial, for example, to a solvent taxpayer who is not eligible for other relief.

Real estate is generally owned by partnerships and limited liability companies ("LLCs"). Special rules apply to these types of entities. Generally, the partnership (or LLC taxed as a partnership) must allocate CODI to its partners and the availability of the various exceptions is determined at the partner level.

Obviously, careful planning is necessary to determine the best alternative for a debtor with CODI.

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