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Dear Client:

As a general rule, the cancellation of a debt creates taxable income to the debtor in an amount equal to the difference between the amount due on the obligation and the amount paid by the debtor. If the debt is discharged without any payment by the debtor, the entire amount of the obligation is treated as taxable gain. The realization of discharge-of-indebtedness income assumes an economic gain to the debtor from the discharge.

I. Transactions That May Be Subject to Discharge of Indebtedness Income

A variety of transactions may produce discharge-of-indebtedness income. A common example is the purchase by a debtor of his own indebtedness at a discount from face value (although relief is provided in 2009 and 2010, as we explain below). In such a transaction, the amount of discharge-of-indebtedness income is determined by reference to the adjusted issue price of the obligation, rather than the face amount, if the debt instrument is issued at a premium or a discount. In addition to purchases by the debtor, certain purchases of indebtedness by a person related to the debtor may result in discharge-of-indebtedness income. Another example might be the discharge of a loan pursuant to the settlement of a business dispute.

A sale of property that is encumbered by liabilities can result in a capital gain or loss, or it may result in discharge-of-indebtedness income. Generally, the amount realized from the sale or disposition of property includes the amount of any liability from which the taxpayer is discharged and depending on the nature of the liability, a portion of the amount realized from the sale may be characterized as discharge-of-indebtedness income, with attendant income tax consequences.
If a debt of an employee to the employer is forgiven in consideration of the performance of services by the employee, the employee realizes compensation income to the extent of the debt forgiveness. A corporation that issues stock in exchange for debt realizes discharge-of-indebtedness income to the extent of the difference between the amount of the obligation and the value of the stock.

Not all debt discharges result in discharge-of-indebtedness income. A debt cancellation that is a gift or a reduction in the purchase price of property does not give rise to discharge-of-indebtedness income.

For cash method taxpayers, the discharge of an obligation that would have been deductible if paid, does not result in discharge-of-indebtedness income. Generally, the discharge of an indebtedness attributable to a previously deducted expense of an accrual method taxpayer will generally give rise to discharge-of-indebtedness income.

The issuance of new debt in exchange for pre-existing debt will result in discharge of indebtedness income to the extent of any difference between the issue price of the old debt and the value of the new debt, again subject to relief in 2009 and 2010.

II. Exclusions of Discharge-of-Indebtedness Income

Taxpayers can exclude discharge-of-indebtedness income if: (1) the discharge occurs in a bankruptcy or insolvency case; (2) the indebtedness is qualified farm indebtedness; (3) the indebtedness is qualified real property business indebtedness; or (4) the discharge is qualified principal residence indebtedness discharged after 2006 and before 2013. In return for the exclusions, taxpayers must reduce specific tax attributes, including the adjusted bases of property, to the extent that the discharged indebtedness is excluded from gross income. The Code provides certain rules regarding the basis reduction required by or elected under these provisions.

When indebtedness of a partnership is discharged, the Code requires that both the exclusions and the reduction of tax attributes associated with the exclusions to be applied at the partner level. Each partner then separately reports his or her distributive share of the income in accordance with the partnership agreement. The partners must include in income their pro rata share of the discharged debt, without a net basis increase that normally accompanies an item of partnership income.

In the case of a discharge of indebtedness of an S corporation, the statutory exclusions and the reduction of attributes are applied at the corporate, rather than the shareholder, level. Due to the limitations imposed on the deduction of losses by S corporation shareholders, however, special attribute reduction rules apply.

III. Deferral of Discharge-of-Indebtedness Income

Responding to the continuing economic crisis in 2009, Congress enacted the American Recovery and Reinvestment Act of 2009 (2009 ARRA). Among the ARRA's provisions is one that allows taxpayers to elect to defer cancellation of indebtedness income arising from a reacquisition of an applicable debt instrument after December 31, 2008, and before January 1, 2011. This irrevocable election is made on an instrument-by-instrument basis. Income deferred pursuant to the election must be included in the gross income of the taxpayer ratably in the five taxable years beginning with (1) for repurchases in 2009, the fifth taxable year following the taxable year in which the repurchase occurs or (2) for repurchases in 2010, the fourth taxable year following the taxable year in which the repurchase occurs.

Please note that there are exceptions and limitations to many of the rules, so we will need to carefully review the specific facts in your case before taking any action. If you have any questions, do not hesitate to contact me.

Very truly yours,

George K Hashem

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