



WEALTH PRESERVATION AND TAX PLANNING ALERT

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**Current Issues Regarding New Election to Defer COD Income:
Does Election Apply to Foreclosure and Deed in Lieu of Foreclosure Transactions?**

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Congress recently passed and President Obama signed into law the American Recovery and Reinvestment Act of 2009 which included provisions modifying Section 108 of the Internal Revenue Code of 1986, as amended ("Code"), with respect to the cancellation of indebtedness ("COD") income. Specifically, new Code Section 108(i) was added which allows a taxpayer under certain circumstances, who would otherwise recognize COD income, to file an election with the IRS to defer the recognition of the COD income in 2009 or 2010 over a stated period of time.

General Overview of New Law

New Code Section 108(i) provides that an eligible taxpayer may elect to defer COD income with respect to the "reacquisition" of an "applicable debt instrument" during 2009 or 2010 in which case the COD income is included in income ratably over a 5-year period beginning in 2014. The term "applicable debt instrument" means any debt instrument (i.e., bond, debenture, note, certificate or any other instrument constituting indebtedness) issued by a C corporation or any other person in connection with the conduct of a trade or business by such person and the term "reacquisition" with respect to any applicable debt

instrument means an "acquisition" of the debt instrument by the debtor that issued (or is otherwise the obligor under) the debt instrument or a related party to such debtor.

The term "acquisition" of a debt instrument includes (i) an acquisition for cash, (ii) the exchange of the debt instrument for another debt instrument, (iii) the contribution of the debt instrument to capital or (iv) the complete forgiveness of the indebtedness by the holder of the debt instrument. It is interesting to note that the term "acquisition" of a debt instrument does not expressly state that it includes a foreclosure or deed in lieu of foreclosure transaction.

The election to defer COD income under Code Section 108(i) is elective (not mandatory) and is irrevocable once made. This election is made on the tax return for the year in which the reacquisition of the debt instrument occurs and is made on a debt instrument-by-debt instrument basis meaning that an election may be made with respect to one or more debt instruments but not with respect to other debt instruments. In addition, with respect to a partnership, LLC, S corporation or other "pass thru" entity, the election to defer COD

income shall be made at the entity level (i.e., by the partnership, LLC, S corporation, etc.) and not at the partner/member or shareholder level.

Code Section 108(i) provides for the acceleration of deferred COD income in certain circumstances. For example, in the event of the death of the taxpayer, the liquidation or sale of substantially all the assets of the taxpayer (including in a title 11 or similar case), the cessation of business by the taxpayer or similar circumstances, any COD income which is deferred as a result of this Code Section 108(i) election shall be accelerated and taken into account in the taxable year in which such "acceleration" event occurs (or in the case of a title 11 or similar case, the day before the petition is filed). With respect to partnerships, LLCs, S corporations and other "pass-thru" entities, these "acceleration" events also include the sale, exchange or redemption of an interest in the "pass-thru" entity by the holder of such interest.

While the election to defer COD income under Code Section 108(i) would seem to be a significant benefit to the debtor, there is a significant "toll charge" that must be taken into account when making this election. Code Section 108

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generally provides certain exceptions to the recognition of COD income for insolvency, bankruptcy, qualified farm indebtedness or qualified real property business indebtedness. However, if an election to defer COD income is made by the taxpayer, these general exceptions to the recognition of COD income will not apply to any COD income for the tax year of the election or any subsequent tax year.

Does Election to Defer COD Income Apply to Foreclosure and Deed in Lieu of Foreclosure Transactions?

As previously noted, Code Section 108(i) in defining the term “acquisition” of a debt instrument does not expressly state that this term includes a foreclosure or deed in lieu of foreclosure transaction, even though common sense would dictate that the election to defer COD income should apply to foreclosure and deed in lieu of foreclosure transactions in which COD income is generated.

In a foreclosure or deed in lieu of foreclosure transaction involving recourse indebtedness in which the encumbered property is transferred to the lender and the lender agrees to release/discharge the resulting deficiency (i.e., the amount by

which the recourse debt discharged exceeds the then fair market value of the property), there are essentially two separate transactions for federal income tax purposes: (i) the first transaction is a taxable gain (or loss) on the disposition of the encumbered property equal to the difference between the fair market value of the property and its adjusted tax basis; and (ii) the second transaction is COD income equal to the total amount of the outstanding indebtedness encumbering the property less the fair market value of that property.

The election to defer COD income under Code Section 108(i) should apply with respect to the second transaction, i.e., the COD income portion of the transaction, since Code Section 108(i) while not expressly stating that the term “acquisition” of a debt instrument includes a foreclosure or deed in lieu of foreclosure transaction, it does state that the term includes “the complete forgiveness of the indebtedness by the holder of the debt instrument” which would seemingly include a foreclosure or deed in lieu of foreclosure transaction in which the lender releases or forgives the debtor from the deficiency amount, thus resulting in COD income.

Last month, at the May 9th meeting of the American Bar Association Section of Taxation, Lee Kelley, Deputy Associate Chief Counsel (Corporate), Office of Chief Counsel, publicly acknowledged that COD income as a result of a foreclosure or a debt-for-property exchange (like a deed in lieu of foreclosure transaction) should be a transaction covered under new Code Section 108(i) and “if that needs to be clarified, then that’s something [the IRS] will do.” This clarification would be welcome given the current uncertainty regarding this issue.

Summary

The election to defer income under Code Section 108(i) should be available to defer COD income resulting from a foreclosure or deed in lieu of foreclosure transaction, although this may necessitate clarification from the IRS. ■

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