

DEFERRAL OR ELIMINATION OF TAXABLE INCOME FOR DEBT DISCHARGES MAY BE AVAILABLE FOR TAX YEARS 2009 AND 2010

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Typically, if you have a debt that is forgiven by a lender, the amount of the debt discharge is generally taxable income in the year the discharge occurred. This law has recently changed, however, providing additional exclusions and deferrals.

There are several exclusions. This means that you will never have to include the amounts into income. These exclusions include:

- Discharge of income that occurs in bankruptcy
- Discharges of income that occur when the taxpayer is insolvent
- Discharges of qualified farm indebtedness
- Discharges of qualified real property indebtedness if you are not a C corporation
- Discharges of certain principal residence debt up to \$2 million dollars

There is also new legislation that allows a business taxpayer to elect to defer debt discharge income under certain circumstances. A business taxpayer would typically have taxable income from the discharge of indebtedness if they:

- Purchase their own debt back at a discount
- Issue a new debt instrument in satisfaction of an old debt at a lower issue price, or
- Has debt acquired by a related party

The new legislation would allow that income to be includable into gross income ratably over a period of five years as long as it was in connection with the conduct of a trade or business. The income recognition will begin in 2014 and will be spread ratably over a period of five years.

The taxpayer must jump through a few hoops to get this deferral. First, they must elect to apply this provision on their tax return for the year of the debt discharge. They must make the election for each debt they wish to defer; it is not a global election. Once the election is made, it is irrevocable. If the election is made, the taxpayer cannot use any other debt relief provisions, including the exclusions discussed above.

This deferral gets complicated if you are using it for a partnership or LLC because insolvency for these entities is determined at the partner level, not the entity level. The law allows for a partial election that is allocable to specific partners. The deferral also gets complicated if a partner or shareholder dies or there is a liquidation or sale of the business during those interim years.

Taxpayers may also lose the benefit of certain tax attributes if they make this election. I recommend you consult your tax advisor before making a decision with respect to making this election.