

**INTERNAL REVENUE SERVICE ISSUES PROCEDURAL GUIDANCE ON TAX  
RELIEF IN DEBT RESTRUCTURINGS**

On August 17, 2009, the Internal Revenue Service (the “IRS” or the “Service”) issued much-anticipated guidance under section 108(i) of the Internal Revenue Code (“Section 108(i)”) in the form of Revenue Procedure 2009-37 (the “Revenue Procedure”). Under Section 108(i), enacted as part of the American Recovery and Reinvestment Act of 2009, certain taxpayers that incur cancellation of indebtedness (“COD”) income in 2009 or 2010 in connection with the “reacquisition” of an “applicable debt instrument” may elect to include that income ratably over a five-year period beginning in 2014. A “reacquisition” for this purpose includes a repurchase by a taxpayer or a related party for cash or other property, an exchange of debt for another debt instrument, a deemed exchange as a result of a significant modification to a debt instrument, a debt-for-equity exchange, a contribution of debt to capital and a complete forgiveness of debt by the holder of the debt instrument. The provision applies to any debt instrument issued by a C-corporation or any other person in connection with the conduct of a trade or business by such person (e.g., a partnership, an S-corporation or a limited liability company engaged in the conduct of a trade or business). The provision also defers any original issue discount (“OID”) deductions that accrue prior to 2014 that are attributable to a debt-for-debt exchange or deemed exchange of debt to which the COD income applies; such OID deductions are then taken into account ratably over the same five-year period as the COD income.

The Revenue Procedure provides the exclusive procedure for taxpayers to make the election to defer COD income. Generally, a taxpayer makes the election to defer COD income by providing a statement clearly identifying the applicable debt instrument (and, in the case of a partnership or other person other than a C-corporation, a general description of the trade or business to which the applicable debt instrument is connected), specifying the total amount of COD income realized as well as the general manner in which such amount was calculated, and stating the amount of income to be deferred under Section 108(i). The statement must be attached to and filed with the tax return for the year in which the COD income is realized, and, once made, cannot be modified or revoked, although an election made on a return filed on or before September 16, 2009 can be modified by filing an amended return on or before November 16, 2009.

Highlights of the Revenue Procedure include:

*Partial Election.* The Revenue Procedure allows a taxpayer to make a partial election for any portion of COD income realized from the reacquisition of an applicable debt instrument. Thus, for example, the Revenue Procedure states that if a taxpayer realizes \$100 of COD income in a transaction to which the rules apply, the taxpayer can elect to defer only \$40 of that income. A partnership that elects to defer less than all of the COD income realized from the reacquisition of a debt instrument may determine in any manner how much, if any, of each partner’s allocable share of the COD income is deferred. Thus, the partnership could elect to defer different amounts of COD income for partners with otherwise equal shares of income, loss and capital.

*Pass-Thru Allocation Rules.* If a partnership elects to defer all or a portion of the COD income realized, the deferred income will be allocated to the partners in the partnership immediately before the reacquisition of the debt instrument. Similarly, an S-corporation's deferred COD income is shared pro rata only among those shareholders that are shareholders of the S-corporation immediately before the reacquisition.

*Effect on Earnings and Profits.* The Revenue Procedure generally requires that earnings and profits be adjusted at the time of the reacquisition. Significantly, however, the Revenue Procedure announced the intention to promulgate regulations permitting real estate investment trusts ("REITs") and regulated investment companies ("RICs") to adjust their earnings and profits in the year in which the deferred COD income is includible in income. Such a rule will allow REITs and RICs to satisfy distribution requirements and therefore seems both appropriate and welcome.

*Protective Election.* The Revenue Procedure adopts the suggestion of some commentators that taxpayers be permitted to make a protective election under the rules. If a taxpayer concludes that a transaction does not result in the realization of COD income but makes a protective election with respect to the transaction, the election will cause the deferral of any COD income if the IRS subsequently determines that COD income was realized. Unfortunately, it is not clear whether the protective election is available where the amount of COD income is uncertain, due, for example, to difficulty in valuing bonds issued in a debt-for-debt exchange. It is hoped that clarification on this subject will be forthcoming.

*Further Clarifications.* Revenue Procedure 2009-37 offers clarity on some questions not answered by the statute. While the statute provides that the deferral election applies only to an acquisition of a debt instrument "for cash," the Revenue Procedure clarifies that the election applies to acquisitions of debt for cash "or other property." In addition, the Revenue Procedure clarifies that deemed acquisitions, for example deemed acquisitions of debt under section 108(e)(4) of the Internal Revenue Code, are "acquisitions" for purposes of Section 108(i).

*Additional Information Required for Partnerships.* In the case of a partnership (other than certain foreign partnerships not otherwise required to file returns), the partnership must provide additional detailed information on the Schedule K-1 filed with the Service and must provide certain additional information to the partners in an information statement attached to the K-1 sent to the partners. This required information includes a statement of each partner's "deferred §752 amount," defined as the distribution of cash that would be treated as made to the partner as a result of the COD income but for the application of Section 108(i), but not to exceed the gain that would be recognized by the partner as a result of such distribution exceeding the partner's tax basis in his or her partnership interest. To make this determination, the partnership must either have information necessary to determine the partner's tax basis or must make reasonable efforts to obtain the information from the partner, under penalties of perjury. Significantly, the election will be invalid unless the partnership has the information or uses reasonable efforts to obtain the information from each partner for whom COD income will be deferred prior to making the election. Possibly a partnership might determine that unless partners provide the information described in preceding paragraph, the partnership will not elect to defer COD income with respect to that partner.

Although the Revenue Procedure offers some long-awaited clarity on mainly procedural matters, further guidance on substantive matters is needed. For example, the Revenue Procedure offers no insight on the question of when a debt instrument issued by a person other than a C-corporation will be treated as issued in connection with the conduct of a trade or business by that person such that the debt instrument would qualify as an “applicable debt instrument” under the rules.

For further information on the scope and operation of Section 108(i), please see our memorandum entitled “American Recovery and Reinvestment Act of 2009 Provides Significant Tax Relief in Debt Restructurings,” dated February 20, 2009.

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