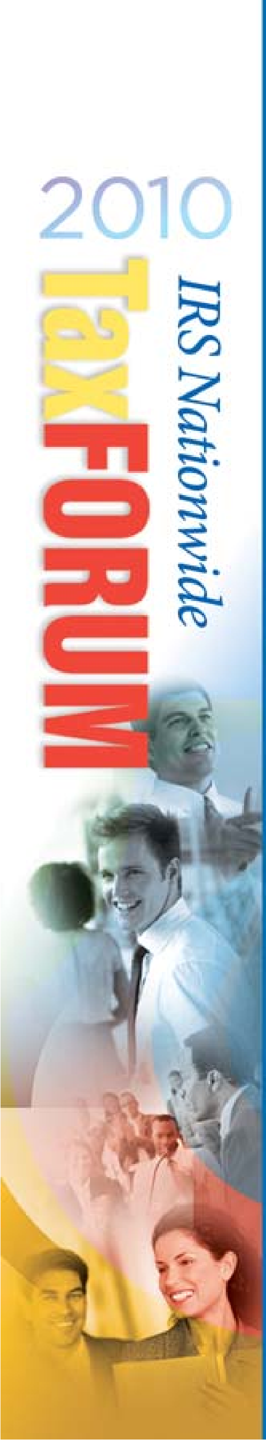


Tax Relief for Businesses in Distress

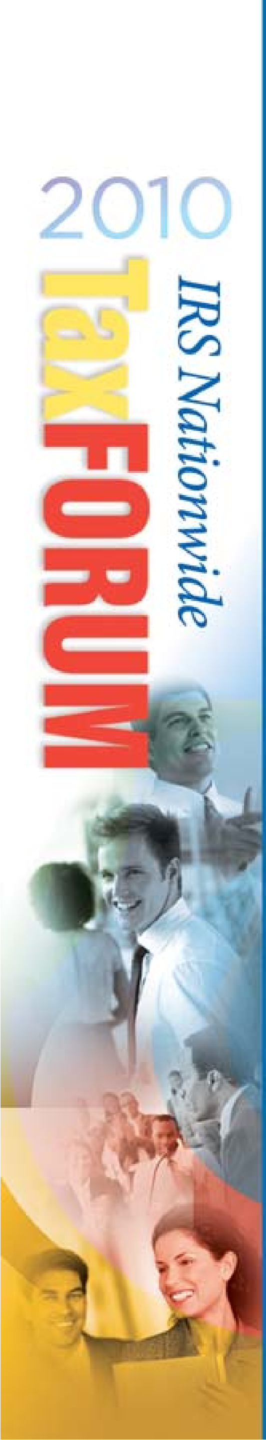
American Bar Association Section of Taxation

5-Year Carryback of 2008 and 2009 Net Operating Losses (NOLs) for Eligible Small Businesses (ESBs)

For 2008 and 2009, you can choose a 3, 4, or 5-year carryback period for the part of your 2008 or 2009 NOL that is an ESB loss. An ESB is a small business as defined in Internal Revenue Code section 172(b)(1)(F)(iii), except that an ESB's 3-year average annual gross receipts can be up to $15 million (instead of $5 million). An ESB loss is the smaller of:

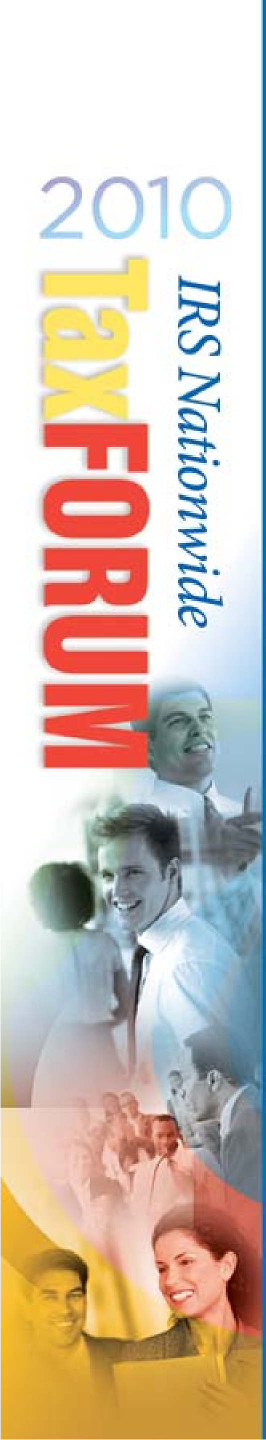
- The amount that would be the 2008 or 2009 NOL if only income, gains, losses, and deductions attributable to ESBs were taken into account, or
- The 2008 or 2009 NOL.

- Irrevocable election applies to all corporations and can be made by attaching an election statement to Form 1139.



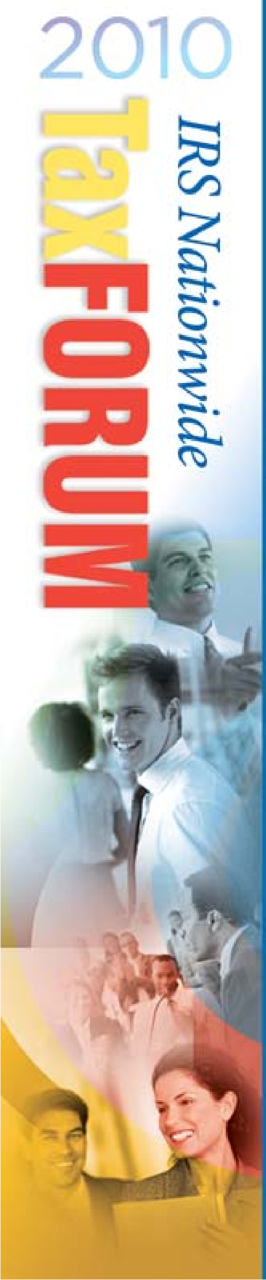
Business Bad Debt

- Generally, is one that comes from operating trade or business. Business deducts its bad debts from gross income when figuring its taxable income. Business bad debts may be deducted in part or in full.



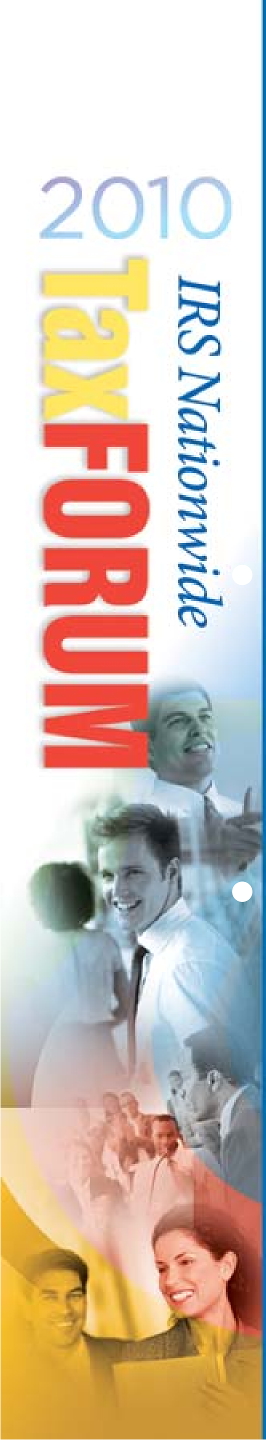
Nonbusiness Bad Debts

- All other bad debts are nonbusiness.
- Nonbusiness bad debts must be totally worthless to be deductible. You cannot deduct a partially worthless nonbusiness bad debt
- Debt becomes worthless when
  - Surrounding facts and circumstances indicate there is no longer any chance the amount owed will be paid.
  - Must establish that you have taken reasonable steps to collect the debt. Not necessary to go to court but must show that a judgment from the court would be uncollectible.
- May take the deduction only in the year the debt becomes worthless. You do not have to wait until a debt is due to determine whether it is worthless.
- Nonbusiness bad debt is reported as a short–term capital loss in Part 1 on Form 1040, Schedule D



Introduction Debt Relief

- Consequences to Debtor
- Four Scenarios
  - Reduce Debt
  - Modify Debt
  - Convey Property for Debt
  - Bankruptcy

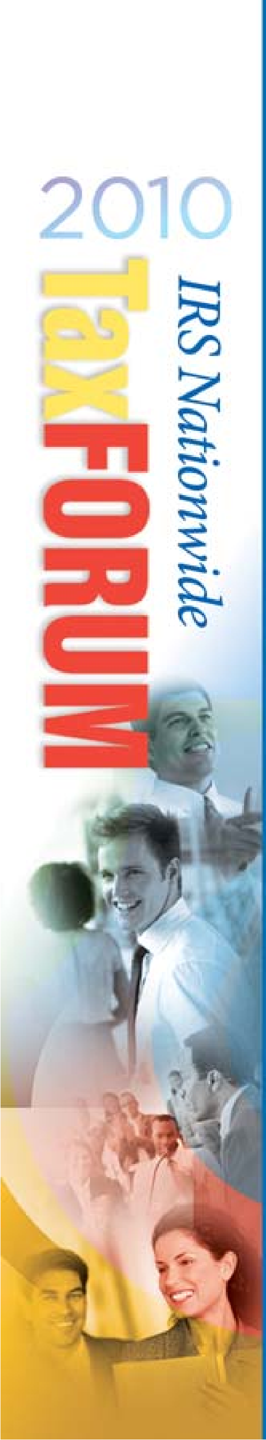


Cancellation of Debt Income ("COD")

General Rule: Taxed as Ordinary Income

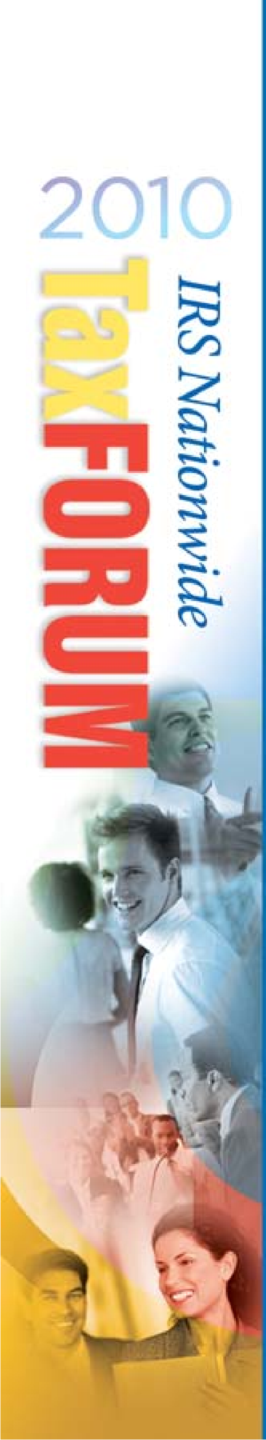
- What it is: "Freeing Up of Assets“; "Accretion of Wealth“

- What it is Not: Medium of Exchange, Settlement of Disputed Claims, Release of Guaranty



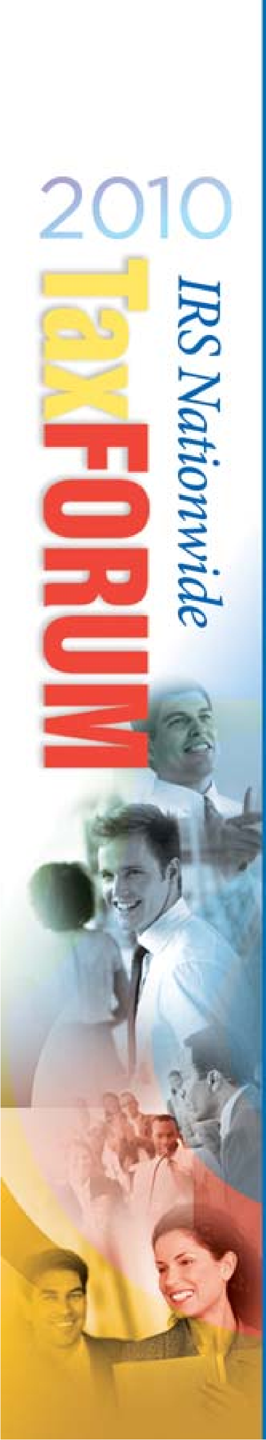
Cancellation of Debt Income ("COD")

- Trap for Unwary: Modification of Debt
- Example: Assume $1MM Note bearing interest of 8% is modified
to provide for 0% interest (principal remains $1MM);
assume that imputed interest
equals $50K
- Result: New “issue price” equals $950K and debtor recognizes COD of $50K
- Related Party Acquisition of Debt



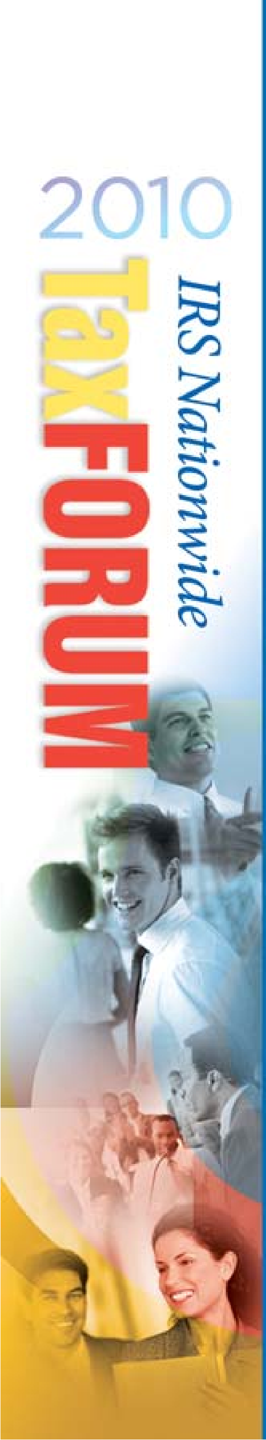
COD vs. Gain from Sale or Exchange

- COD: Ordinary Income
  - Exclusions may apply
- Sale or Exchange (Property Conveyed): §1001 Gain
  - Foreclosure or Deed in Lieu of Foreclosure
  - Not COD
  - Potential Capital Gain (FMV Exceeds Basis)
  - No Exclusions



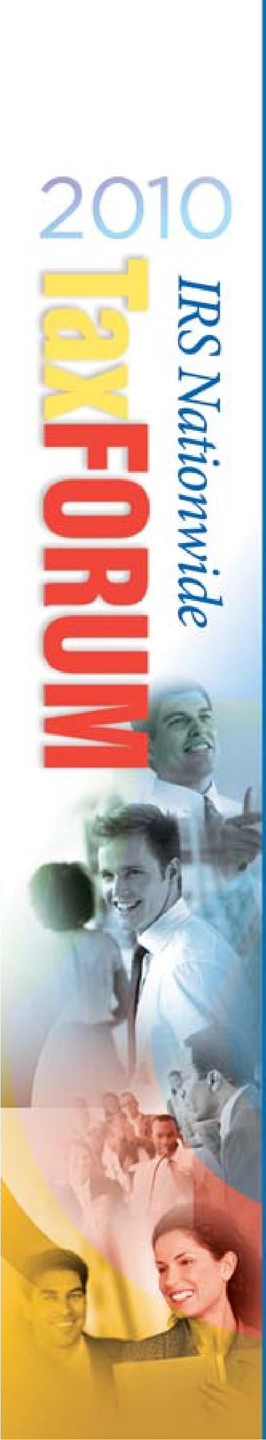
Sale or Exchange

- Non Recourse Debt
  - Sale or Exchange: Debt is amount realized
  - Value irrelevant
  - No COD



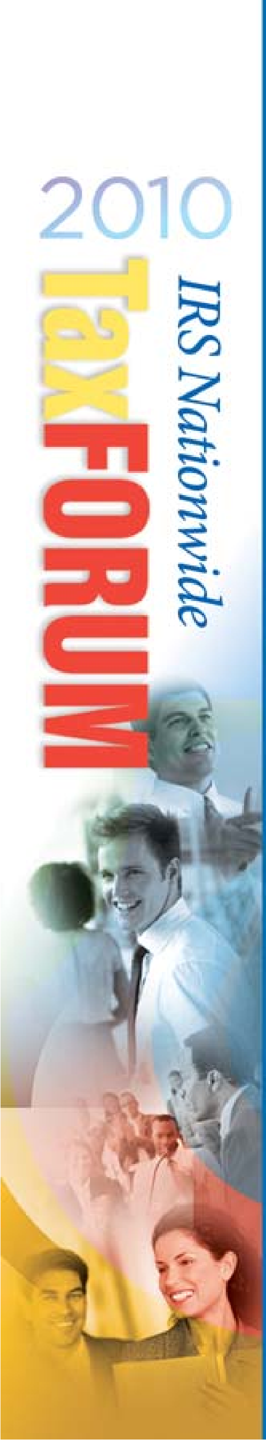
Sale or Exchange

- Recourse Debt: Bifurcate
  - – FMV of Property Reduces Debt: Sale or Exchange
    - Foreclosure: Bid price equals value (presumption)
  - – Deficiency Amount
    - COD if reduced



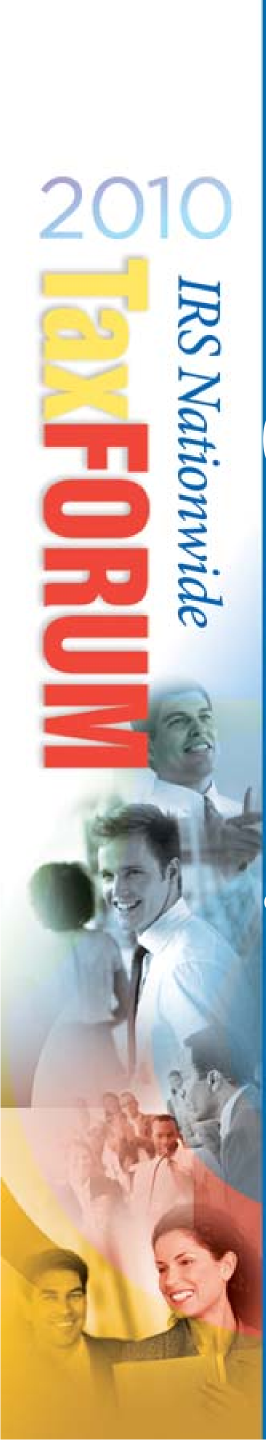
Example:

- Debt $1,000,000
- FMV $800,000
- Basis $700,000
- If Debt is <u>Non-recourse</u>:
  - Amount Realized: $1,000,000
  - Basis: <u>$700,000</u>
  - Gain: $300,000



Example:

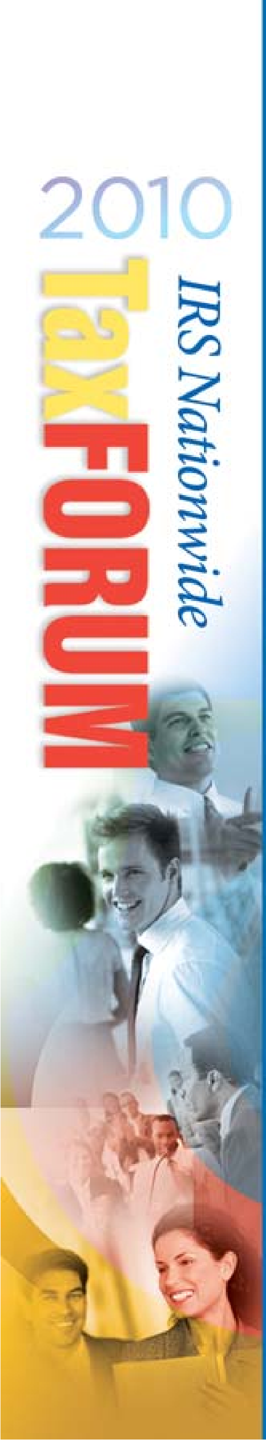
- If Debt is Recourse, and Discharged:
  - Amount Realized (FMV): $800,000
  - Basis: $700,000
  - Gain: $100,000
  - COD Income: $200,000



Exceptions to COD (Not Taxable COD)

(1) Qualified Real Property Indebtedness
- Debt to Acquire or Improve Real Estate
- Secured by Property Used in Trade or Business

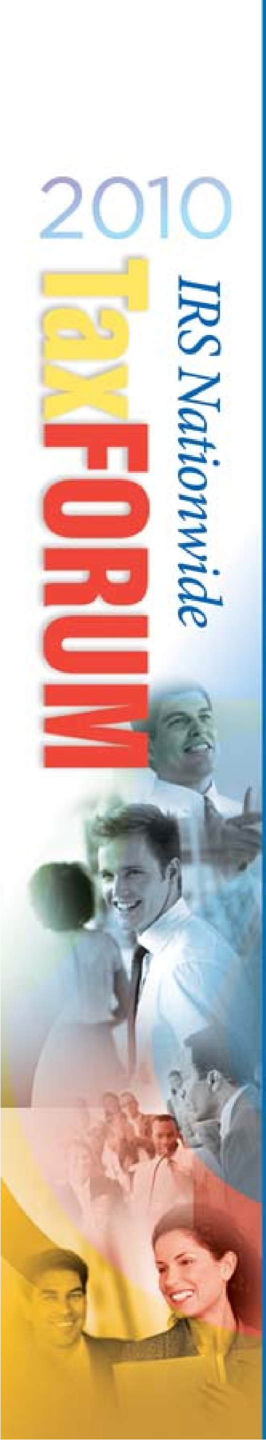
- Reduces Basis of Depreciable Realty



Exceptions to COD (Not Taxable COD)

Limits:

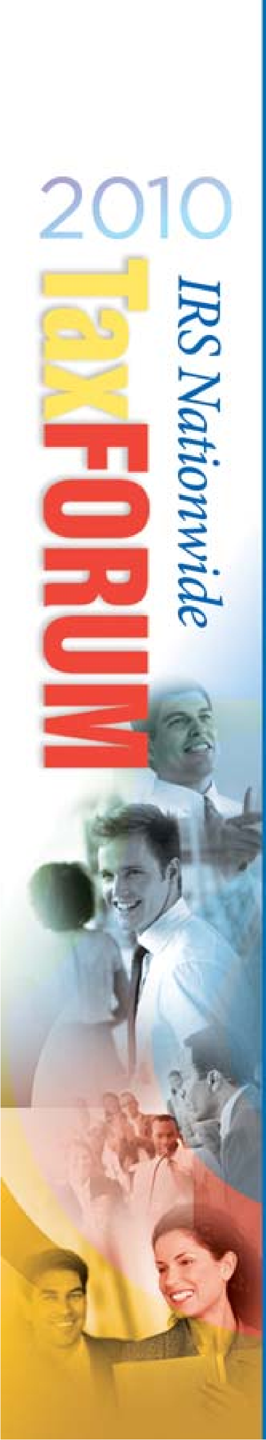
- Only Excess of All Debt on Property Over FMV
- Example: If total debt secured by property equals $1.4MM and FMV of property equals $1MM, only $400K of COD qualifies for exception
- Aggregate Basis of All Depreciable Real Estate
- Not for C Corporations



Exceptions to COD (Not Taxable COD)

(2) Bankruptcy

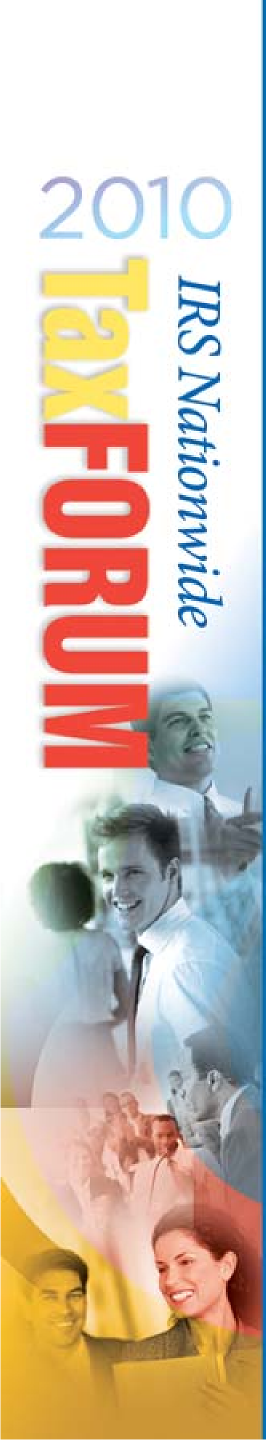
- No limits
- Taxpayer (not partnerships)
- Attribute Reduction
- Timing: 1st day of following year



Exceptions to COD (Not Taxable COD)

(3) Insolvent Taxpayer

- Limited to Excess of Liabilities over FMV of Assets
- Example: If all liabilities equal $1.8MM and FMV of all property equals $1MM, only $800K qualifies for exception
- Attribute Reduction

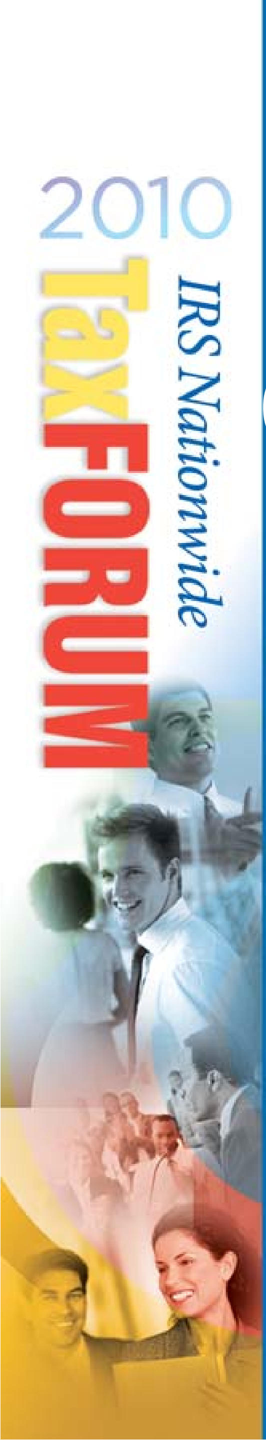


Exceptions to COD (Not Taxable COD)

(4) Seller Financing – Price Reductions (§108(e)(5))

(5) Student Loans

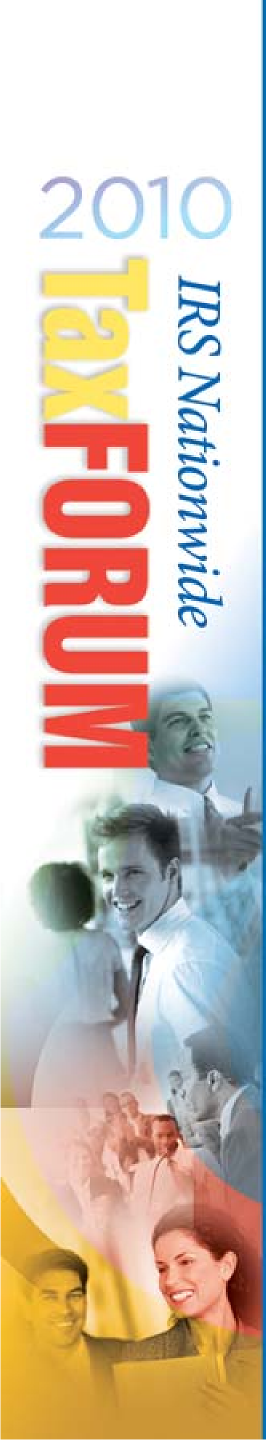
– Loan terms provided for discharge if student works in certain jobs



Exceptions to COD (Not Taxable COD)

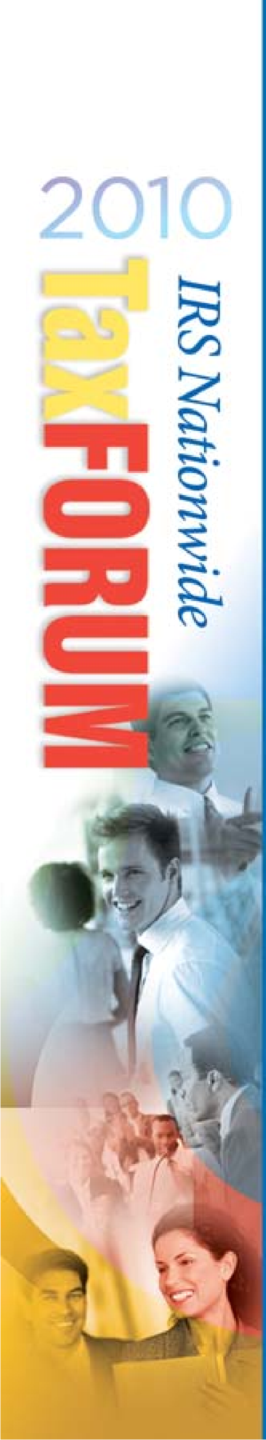
(6) Qualified Farm Indebtedness

- Lender must be "Qualified": Government or Unrelated Institutional Lenders
- Debt: directly incurred in farming business
- 50% or more of taxpayer's gross receipts are from farming



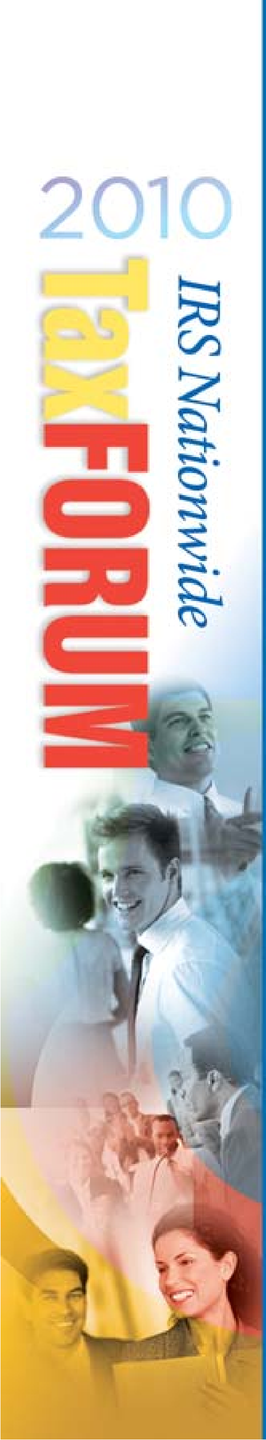
Exceptions to COD (Not Taxable COD)

– Farming Indebtedness Exclusion Limitation: Cannot exceed sum of "adjusted" tax attributes plus basis of "qualified property" (<u>any</u> business or investment property)



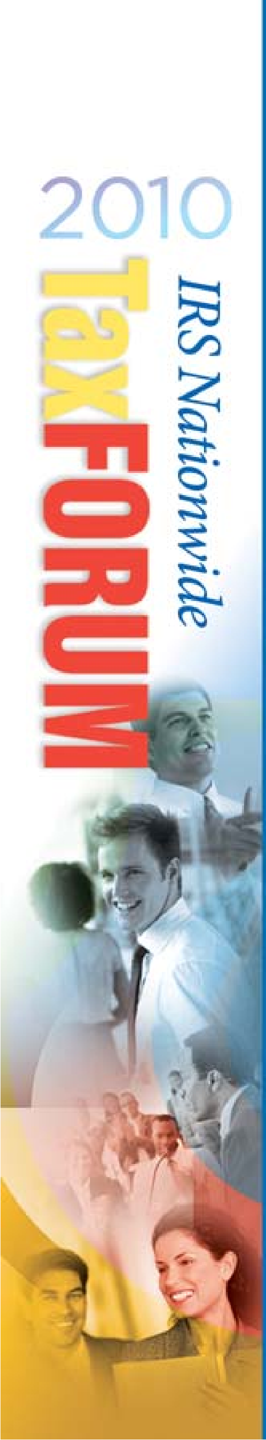
Exceptions to COD (Not Taxable COD)

- (7) Principal Residence Mortgage Loans
  - Only 1 Principal Residence: Primary Residence for any 2 of last 5 years
  - Up to $2MM debt (for Married Taxpayers) to acquire or improve residence, and secured by residence
  - Refinancing of such debt
  - If debt also used for non-qualified purpose or in excess of $2MM,
- discharge is treated as reducing non-qualified portion first



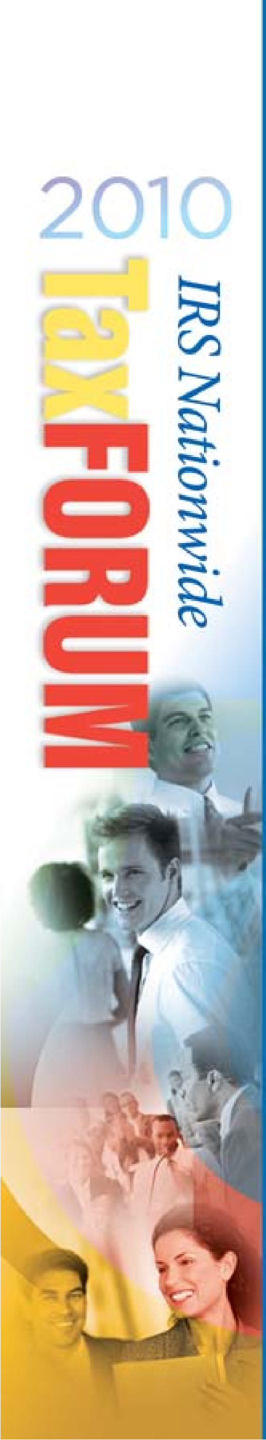
Timing of COD to Debtor

- Agreement
- Court Order
- Statute of Limitations
- See §1.6050P
- Modification of Debt
- Contingent Agreements
  - Conditions Precedent and Conditions Subsequent



2009 Stimulus Act – Provides Election for Deferral of COD

- Applies to debt incurred by a C corporation or any other person in connection with a trade or business
- COD is deferred for 4 or 5 years; then taxed ratably over 5 years
- Acceleration of deferred income in certain circumstances



2009 Stimulus Act – Provides Election for Deferral of COD

- Election: Entity makes election
  - Consequence: No COD exceptions available
  - Conflicts: Partners having differing tax positions

  (e.g. insolvent or bankrupt)