Discharge of Indebtedness Keyed To Interest, Crnkovich Says

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Under section 108(i), a person can defer discharge of indebtedness income only if it issues debt in connection with the conduct of a trade or business by that person. But recently released regulations do not explicitly require that the debt be used in a trade or business conducted by the borrower, said Bob Crnkovich, senior counsel in Treasury's Office of Tax Policy.

Treasury drafted the language the way it did to deal with common business transactions, said Crnkovich, speaking September 27 at a Passthroughs and Real Estate Committee meeting of the District of Columbia Bar Taxation Section. "Our view was that as long as the interest on that debt is treated as trade or business interest, then effectively that is trade or business indebtedness, and as a result, that debt ought to qualify."

The section 108(i) election enables taxpayers to defer cancellation of debt (COD) income arising in 2009 or 2010 from the reacquisition of an applicable debt instrument. The income is ratably included over a five-year period unless an acceleration event triggers current recognition. (For prior coverage, see *Tax Notes*, Sept. 27, 2010, p. 1326, *Doc 2010-20551*, or *2010 TNT 182-1*. For T.D. 9498, see *Doc 2010-17905* or *2010 TNT 155-7*. For T.D. 9497, see *Doc 2010-17907* or *2010 TNT 155-8*.)

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Redemptions and Mergers

Redemption of an interest in a partnership is an acceleration event under the statute, but the guidance identifies only complete redemptions as a trigger. Crnkovich said the redemption must be complete to cause a trigger because "it was extraordinarily complex" to come up with a rule that would have appropriately triggered a partial acceleration in proportion to a partial redemption.

GENERATION-SKIPPING TRANSFER TAX MORE TROUBLESOME IN 2010 THAN ESTATE TAX

The generation-skipping transfer tax presents even larger planning problems during the 2010 repeal year than the estate tax, according to practitioners at a District of Columbia Bar Taxation Section luncheon in Washington on September 29. The questions surrounding the GSTT are "infinitely more complicated," said Beth Shapiro Kaufman of Caplin & Drysdale.

Kaufman, who previously served as associate legislative tax counsel in Treasury's Office of Tax Policy, said the 2010 GSTT law is helpful for only two scenarios: a direct transfer to a skip person, and a distribution or termination of a trust in existence before 2010, which would not be exempt from the GSTT. "Everything else is not clear," she said.

One open question is what effect the GSTT has on a nonexempt trust created in 2010. In 2009 the trust would have been subject to GSTT at creation, but its distributions would have been exempt. In 2010 it cannot be subject to GSTT, and the GSTT effects of distributions made in subsequent years are unknown.

Kaufman said there is "a large risk" that the distributions will be subject to GSTT. The design of the Economic Growth and Tax Relief Reconciliation Act of 2001 implies that its tax advantages are intended to extend only through 2010, so lasting benefits may not be permitted, she said. As a result, practitioners are looking for ways to make generation-skipping transfers that don't involve trusts. However, Kaufman noted that Treasury regulations treat many arrangements as trusts for tax purposes, including Uniform Gifts to Minors Act accounts. A limited liability company could hold the assets, but state laws may prevent minor beneficiaries from owning them, Kaufman said.

Regarding the estate tax, the biggest problem practitioners face is surviving spouses who might die in 2010, said Mary Ann Mancini of Bryan Cave LLP. The 2010 regime includes carryover basis with an allowance for step-up in basis available only to assets that are both owned by and acquired from the decedent. According to Mancini, most property that would have been included in the estate as a result of sections 2036, 2037, or 2038 does not qualify for the step-up in basis.

That leaves practitioners deciding whether to leave assets in a qualified terminable interest property trust or to distribute them outright. The latter allows a surviving spouse to use the step-up, which otherwise would be lost upon death in 2010, but it also risks uses of the property that the decedent may not have wanted. ■

— Sam Young

Audience member Monte Jackel, a managing director in the partnership group at PricewaterhouseCoopers LLP, questioned whether this rule opens the door for taxpayers to defer $1 billion of COD income, for example, with a $1 partnership interest. But Crnkovich said if the interest is so small as to be de minimis, the partner's position would likely be rejected through application of judicial doctrines.

Megan Stoner and Joseph Worst, both attorneys with the IRS Office of Associate Chief Counsel (Passthroughs and Special Industries), were the principal authors of T.D. 9498. Worst pointed out that if a partner's interest in a limited liability company is completely redeemed, only the redeemed partner's share of the COD income subject to the election would be accelerated without detrimental effect on the other partners.

However, the merger of two partnerships is not treated as an acceleration event even though the deferral is in the hands of a different taxpayer. ''If a 721 contribution is a deferral, then a merger ought to be, assuming there's no boot received, because it's simply a continuation of the ownership of the assets to which the 108(i) item relates in an alternative form — that is, a lower-tier partnership,'' Crnkovich said. ''We don't explicitly say this, but if you view the 108(i) item as a quasi-704(c) item, the transfer of everything down to a lower tier allows you to continue to allocate things up through the chain to the party who had the COD income.''

Technical Terminations

Matthew Lay, a director in the passthroughs group of Deloitte Tax LLP's Washington National Tax Office and moderator of the panel, asked whether a technical termination resulting in two short tax years during the calendar year of the termination would advance the five-year inclusion period and reduce the deferral benefit under the election.

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''We didn't specifically address this in the guidance,'' Stoner said. But because a tax year is just that under the rules, ''if you have two tax years, then it definitely could be considered to shorten up the deferral period,'' she added.

Bankruptcy Filing

Jeremy Babener, a 2010-2011 New York University Tax Policy Fellow at Treasury's Office of Tax Policy, said that if the taxpayer generates COD income and then files for chapter 11 bankruptcy, the filing triggers an acceleration of the deferred income. ''What the regulations actually do is regardless of sale of substantially all of the assets, they are going to treat the taxpayer as taking into account that COD income the day before filing,'' he said.

If the taxpayer is in bankruptcy when it generates COD income, it is not precluded from making an election under section 108(i) to defer the income, Crnkovich said. But a partnership in bankruptcy is subject to the section 108(a)(1)(A) and (B) insolvency and bankruptcy provisions at the partner level, ''so the mere bankruptcy of the partnership is not going to allow you to escape taxation,'' he said.■