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Debt Discharge Income and Foreign Subs

Weathering the Economic Storm

In these uncertain economic times businesses everywhere are reworking their business plans, shoring up credit resources, and attempting whatever it may take to weather the current economic storm. Taxpayers and tax advisers alike are faced with having to acquaint themselves with areas of the Internal Revenue Code and the regulations that were less applicable during strong economic times, i.e. net operating loss carry back rules, capital loss carry forward rules, theft loss, etc.

Discharge of indebtedness income (and related tax rules) is one such area whose application has become more significant. As one might imagine in these challenging economic times, businesses are faced with the dual dilemma of rising debt service costs and less access to debt facilitation ordinarily available on the open market. As such, through debt workouts, refinancing, defaults, and foreclosures, tax rules relating to debt discharge income continue to be of interest.

What if the company whose debt was discharged is a U.S.-owned foreign corporation? How will discharge of indebtedness income (in whatever



form it takes) be treated for U.S. federal income tax purposes when generated in a U.S.-controlled foreign corporation? This article will briefly introduce and explain the tax rules, and address their tax implications to controlled foreign corporations.

Discharge of Indebtedness Income Recognition

As a general rule, a cancellation of indebtedness creates income to the debtor in an amount equal to the difference between the amount due under the obligation (the face amount) and the amount paid for its discharge.

Generally, under the relevant tax rules, cancellation of indebtedness can occur under the following circumstances: debt forgiveness, debt for cash, debt for debt exchange, debt exchanged for equity, debt contributed to capital,

debt purchased by a person related to the debtor, substantial modification of debt, etc.

As an example: On Sept. 1, 2008, M Corporation issued bonds with a face value of \$1,000,000. Assume the adjusted issue price of the debt on that date was also \$1,000,000 (taking into account discount or premium issue adjustments). If M were to repurchase the bonds on Oct. 1, 2008 for \$900,000, M would realize \$100,000 of debt discharge income.

Whether debt discharge income will be treated as gain from the sale or exchange of property or as "cancellation of indebtedness" income (a separate and distinct item of income as described in Section 61(a) (12) of the Code) will depend on various factors, including whether the debt itself qualifies as recourse or nonrecourse debt and whether the debt is secured by property of the corporation.

Generally, if the debt discharged is unsecured, the tax treatment of the income generated will be "cancellation

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of indebtedness” income, regardless of whether the debt is classified as either nonrecourse or recourse debt.

Broadly, if the debt discharged was secured by property of the corporation, we must determine and compare the debtor corporation’s basis in the property, the fair market value of the property, and the adjusted issuance price of the debt. In addition, whether the debt is characterized as recourse or nonrecourse becomes critical in this scenario because discharge of nonrecourse debt secured by property will result in income treated as gain from the sale or exchange of property, rather than “cancellation of indebtedness” income. [See *Commissioner v. Tufts*, 461 U.S. 300 (1983)]

For example, let’s suppose a corporate taxpayer has a recourse debt obligation with an adjusted issue price of \$1,000,000 and an adjusted basis of \$550,000, which is secured by property having a fair market value of \$750,000. Upon discharge of the debt, the corporation will generate debt discharge income subject to a bifurcated analysis.

The corporation will have “cancellation of indebtedness” income equal to \$250,000, the difference between the adjusted issue price of the debt and the fair market value of the property. The corporation will also have gain from the sale or exchange of property equal to \$200,000, the excess of the property’s fair market value over the corporation’s basis in the property.

In the case of nonrecourse debt, “cancellation of indebtedness” income is removed as a possible result. Using the same facts as above, the debt

discharge income will be treated as gain from the sale or exchange of property equal to \$450,000, the difference between the corporation’s basis in the property and the face value of the nonrecourse debt.

New Deferral Provision

Under a new provision of law, provided in The American Recovery and Reinvestment Act of 2009, issuers of debt may elect to defer the inclusion of “cancellation of indebtedness” income realized in 2009 and 2010. If an election under this provision is made, “cancellation of indebtedness” income realized in calendar year 2009 or 2010 will be includable ratably over the five year period beginning in 2014 and ending in 2018, inclusive. [See *Section 108(i)*]

As the deferral is available only with respect to “cancellation of indebtedness” income, the new provision will not apply to debt discharge income treated as gain from the sale or exchange of property, i.e., income from the discharge of nonrecourse debt secured by an asset of the debtor.

Consider the result if the corporation were a controlled foreign corporation. Should any of the income generated from the discharge of indebtedness be considered Subpart F income subject to a current inclusion in taxable income? The answer is, as is often the case in tax matters, “it depends.”

International Tax Matters: Corporate Debt Discharge Income

Subpart F Income.

Generally, a controlled foreign corporation (“CFC”) is a foreign corporation where more than 50% of

the vote or value of its shares lies in the hands of U.S. persons who each own at least 10% of the voting power of all classes of stock entitled to vote. Certain types of income of a CFC are includible in the taxable income of its U.S. shareholders in the year it is generated. This current inclusion is required even though, in general, U.S. shareholders are not required to include in their taxable income their allocable portion of a corporation’s income until the period in which the earnings of the corporation are distributed to the shareholders or the shareholder disposes of the shares at a gain. This type of “bad” CFC income is commonly referred to as Subpart F income.

There are five categories of Subpart F income; however, the category relevant to our topic of discussion is foreign personal holding company income (“FPHCI”). Generally, FPHCI includes dividends, interest, rent, royalties, and net gains from the sale or exchange of certain property, etc. In the following paragraphs, we examine whether debt discharge income should be considered FPHCI and, thereby, Subpart F income.

Debt Discharge Income: Gain vs. COI. As we illustrated above, debt discharge income will generally result in either income treated as gain from the sale or exchange of property or “cancellation of indebtedness” income. In certain circumstances, gain from the sale or exchange of property is considered FPHCI and, thereby, Subpart F income subject to taxation in the year in which the CFC realizes such income. Whether debt discharge income resulting in income treated as gain from the sale or exchange of property is considered FPHCI will depend on

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the use or purpose of the property securing the debt.

Generally, gain from the sale or exchange of property used in the active conduct of a trade or business is not considered FPHCI. Thus, if the property securing the debt was used in the active conduct of a trade or business of the corporation, the gain will qualify for an exception to the foreign personal holding company rules and will not be considered Subpart F income. On the other hand, if the property was a capital asset, the gain is likely included in the definition of FPHCI and, arguably, should be considered Subpart F income. *[FPHCI includes net gains from the sale of, among others, property which gives rise to FPHCI-type income, e.g., interest, rents, royalties, etc., or does not give rise to any income.]*

Generally, debt discharge income treated as “cancellation of indebtedness” income (either unsecured debt or recourse debt with an adjusted issue price in excess of the property’s fair market value) should not be treated as Subpart F income.

In PLR 9729011 *[CCH IRS Letter Rulings Report No. 1064, 07-23-97. Note that letter rulings may not be used or cited as precedent for*

establishing a tax position], Internal Revenue Service officials addressed that question directly and determined that “cancellation of indebtedness income” was not included in the definition of foreign personal holding company income. The Service implied that since “cancellation of indebtedness” income was not expressly included in any category of Subpart F income, it should not be read into the definition. The Service cited the fact that the gross income of a controlled foreign corporation should be determined by treating the CFC as a domestic corporation, and the gross income of a domestic corporation specifically includes “cancellation of indebtedness” income as a separate and distinct type of income.

However, the Service stated that if a deduction for accrued but unpaid interest payable on the debt had reduced the Subpart F income of the CFC, the CFC would have been treated as earning Subpart F income in the year of the cancellation in an amount equal to any Subpart F income previously reduced by the interest deduction.

Applying the new “cancellation of indebtedness” deferral provision discussed above to a CFC, the U.S. shareholders of the CFC may elect on

behalf of the foreign corporation to defer the “cancellation of indebtedness” income to the future periods allowed under the provision. *[Treas. Reg. §§ 1.952-2(a) and 1.964-1(c)(1)(iv)].*

Though the income itself will not be treated as Subpart F income, the decision to elect or not will affect the timing and amount of the accumulation of earnings and profits of the foreign corporation. The decision might also affect the tax impact of any distributions treated as a dividend and the creditability of associated foreign taxes.

Cancelling the debt of a foreign subsidiary can give rise to a U.S. tax liability. The availability of an election to defer “cancellation of indebtedness” income presents planning opportunities. It is not necessarily always better to defer. Whether it is advantageous to make the deferral election will depend on the particular tax attributes of the U.S. shareholder and the CFC which realizes the “cancellation of indebtedness” income.

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