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FINAL REGULATIONS UNDER SECTION 108(I) DO NOT SOLVE THE PROBLEMS

The final Regulations are largely unchanged from the Temporary Regulations issued three years ago. The complexity and compliance burdens remain, along with some questions about the application of Section 108(i).

***120** Treasury and the IRS have issued final Regulations (TD 9622 and TD 9623, 7/3/13) under Section 108(i), which permits taxpayers to defer the recognition of cancellation of debt (COD) income that otherwise would have been recognized as a result of the reacquisition of an applicable debt instrument in 2009 or 2010. A previous in-depth analysis revealed that Section 108(i) is the kind of mystifying and ironic tax policy that—unfortunately—we have come to expect from Washington. [1] Layer on the fact that the section applies only for two long-gone years, 2009 and 2010, and the issuance of the final Regulations feels quite anti-climactic. Nevertheless, the Regulations are timely for a taxpayer subject to recapture commencing in 2014.

The final Regulations are largely unchanged from the Proposed and Temporary Regulations issued in 2010 relating to the application of Section 108(i), which have been previously discussed extensively. [2] Reg. 1.108(i)-1 concerns the application of Section 108(i) to C corporations; Reg. 1.108(i)-2 addresses partnerships and S corporations; and Reg. 1.108(i)-3 covers OID deductions. This article will focus on the changes (or lack thereof) in the final Regulations. The complexity and compliance burdens remain, however, and some questions about the application of Section 108(i) still linger.

BACKGROUND

The American Recovery and Reinvestment Act of 2009 (P.L. 111-5, 2/7/09) added a new twist to the COD income provisions. Under Section 108(i)(1), an eligible taxpayer may elect that COD income with respect to the ‘reacquisition‘ of an ‘applicable debt instrument‘ during ***121** 2009 and 2010 be included ratably over a five-tax-year period starting in 2014.

For purposes of applying these rules, an ‘applicable debt instrument‘ is defined in Section 108(i)(3) as any debt instrument issued by a C corporation or by any other person in connection with the conduct of a trade or business by such person. A debt instrument is broadly defined to include any bond, debenture, note, certificate, or any other instrument or contractual arrangement constituting indebtedness within the meaning of Section 1275(a)(1).

****2** A ‘reacquisition‘ also is broadly defined, in Section 108(i)(4), and includes any ‘acquisition‘ of an applicable debt instrument by either the debtor that issued (or is otherwise the obligor under) the instrument or a person related to that debtor (determined using the rules under Section 108(e)(4)).

According to Section 108(i)(4)(B) an 'acquisition' of an applicable debt instrument includes, without limitation, the following:

1 An acquisition of the debt instrument for cash.

2 The exchange of the debt instrument for another debt instrument (including the deemed exchange resulting from the modification of a debt instrument).

3 The issuance of corporate stock or a partnership interest in exchange for the debt instrument.

4 The contribution of a debt instrument to capital.

5 The complete forgiveness of a debt instrument by a holder of such instrument.

Although the partial forgiveness of a debt instrument does not appear at first blush to be directly covered by this provision, in fact such a partial forgiveness would be treated as a significant modification of the debt instrument, and hence a reacquisition.

There are a series of important special rules. First, Section 108(i)(6) provides special rules for partnerships:

• Any income deferred under Section 108(i) must be allocated to the partners in the partnership immediately before the discharge in the same manner such amounts would have been included in the distributive shares of such partners under Section 704 if such income were recognized.

• Any decrease in a partner's share of partnership liabilities as a result of such discharge is not taken into account for purposes of Section 752 at the time of the discharge to the extent it would cause the partner to recognize gain under Section 731 .

• Any decrease in a partner's share of partnership liabilities deferred by this rule is taken into account at the same time as income deferred is recognized.

Second, the election to defer COD income is made on an instrument-by-instrument basis and is irrevocable.[3] If a taxpayer makes the election provided in Section 108(i) to defer income, then the exclusions from COD income provided in Sections 108(a)(1)(A), (B), (C), and (D) do not apply to any COD income from the debt instrument for the year in which the taxpayer makes the election or any subsequent year.

A reacquisition of a debt instrument includes a debt-for-debt exchange, which can occur if there is a significant modification of a debt instrument or the acquisition of a debt instrument by a related party. There are special rules to match deferral of COD income and any OID deductions in Section 108(i)(2).

Section 108(i)(5)(D) provides acceleration provisions in the case of certain occurrences. COD income that is deferred under Section 108(i)(1), as well as any related OID deduction that is deferred under Section 108(i)(2)(A), generally is accelerated and taken into income in the tax year in which the taxpayer (1) dies, (2) liquidates or sells substantially all of its assets (including in a Title 11 bankruptcy or similar case), (3) ceases to do business, or (4) is in similar circumstances. For a partnership or other pass-through entity, this acceleration rule also applies to the sale, exchange, or redemption of an interest in the entity by a holder of such interest.

**3 Congress authorized such Regulations as may be necessary or appropriate for purposes of applying Section 108(i), including rules (1) extending the acceleration provisions where appropriate, (2) requiring reporting of the election and such other information as required, including on subsequent returns, and (3) for the application of this provision to partnerships, S corporations, and other pass-through entities, including the allocation of deferred deductions.

In Rev. Proc. 2009-37, 2009-36 IRB 309, the Service provided taxpayers with the exclusive procedures to make the election under Section 108(i). Noteworthy aspects with respect to partnerships were extensively discussed in a prior article.[4] Section 4.04 expressly allows partial elections to defer COD income with respect to each debt instrument. Specifically, a taxpayer may elect to defer all or any portion of the COD ***122** income with respect to a debt instrument, or the taxpayer may elect to defer different portions of the COD income with respect to different debt instruments.

The usefulness of a partial election is greatly supplemented by a special rule for partnerships in section 4.04(3) of the Procedure. Under this provision, a partnership that elects to defer less than all of the COD income realized from the reacquisition of an applicable debt instrument may determine, in any manner, the portion, if any, of a partner's COD income amount that is the partner's deferred amount and the portion, if any, of a partner's COD income that is the partner's included amount.

For example, one partner's deferred amount may be zero while another partner's deferred amount may equal that partner's COD income amount (or any portion thereof). A partner may exclude from income the partner's included amount under Section 108(a)(1)(A), (B), (C), or (D), if applicable. In contrast, an S corporation is required to allocate the COD income that is deferred under Section 108(i) pro rata only among those shareholders who were shareholders of the S corporation immediately before the reacquisition transaction.

The practical effect of this rule is that the election to defer a portion of the COD income under section 4.04 can be specially allocated to one or more partners, in whole or in part. This type of special allocation would, in substance, allow the partnership to allocate the COD deferral so as to minimize the partners' aggregate tax liability. Although this special rule appears at first blush to be contrary to the ‘substantiality‘ requirement in Reg. 1.704-1(b)(2)(iii) , section 4.04(3) clarifies that this special rule is applicable only for purposes of applying Section 108(i) and is not intended as an interpretation of or a change to existing law under Section 704. These provisions were meant to address the situation where different partnershad divergent economic interests, and the general partner was ‘damned if he did, damned if he didn't‘ in terms of making an election that helped some partners but hurt others.

SUMMARY OF THE TEMPORARY REGULATIONS

****4** The issues addressed by the Temporary Regulations included the determination of whether a trade or business exists, the amount of deferred OID deductions, the interaction of Section 108(i) with the at-risk rules, and specific issues relevant to partnerships and corporations.

Trade or Business

Temp. Reg. 1.108(i)-2T(d)(1) provided that the determination whether a debt instrument issued by a partnership or an S corporation is treated as a debt instrument issued in connection with the conduct of a trade or business is based on all the facts and circumstances. A debt instrument issued by a partnership or an S corporation is automatically treated as an applicable debt instrument for purposes of Section 108(i) if any one of the five following tests is met:

- The gross FMV of the trade or business assets of the partnership or S corporation that issued the debt instrument represented at least 80% of the gross FMV of that partnership's or S corporation's total assets on the date of issuance.

- The trade or business expenditures of the partnership or S corporation that issued the debt instrument represented at least 80% of the partnership's or S corporation's total expenditures for the tax year of issuance.

- At least 95% of the proceeds from the debt instrument issued by the partnership or S corporation was allocated to one or more trade or business expenditures under Temp. Reg. 1.163-8T for the tax year of issuance.

• At least 95% of the proceeds from the debt instrument issued by the partnership or S corporation was used by the partnership or S corporation to acquire one or more trades or businesses within six months from the date of issuance.

• The partnership or S corporation issued the debt instrument to a seller of a trade or business to acquire the trade or business.

The foregoing rules provided assurance to a partnership having both trade or business assets and investment assets that a debt instrument will be treated as an applicable debt instrument notwithstanding its investment assets. They also contain a general facts and circumstances rule, but did not address the more difficult issue as to whether the *activities* of a partnership rise to the level of a trade or business for purposes of applying these rules.

Deferred OID

The second general issue addressed by the Temporary Regulations concerned the determination of the amount of deferred OID deductions ***123** with respect to a debt instrument. These deferred OID deductions arise most frequently when an applicable debt instrument is acquired by a related party; the COD income that would have been recognized under Section 108(e)(4) is deferred, but the taxpayer also is not permitted to claim the OID deductions that otherwise would have resulted from the deemed issuance of a new debt instrument.

Temp. Reg. 1.108(i)-2T(d)(2)(i) provided that for each tax year during the deferral period, an issuing entity's deferred OID deduction for that year is the lesser of the following:

****5** 1 The OID that actually accrues in the current year with respect to the debt instrument (less any of such OID that is allowed as a deduction in the current year as a result of an acceleration event, described below), or

2 The excess, if any, of the entity's deferred COD income (less the aggregate amount of such deferred COD income that has been included in income in the current year and any previous tax year during the deferral period) over the aggregate amount of OID that accrued in previous years with respect to the debt instrument (less the aggregate amount of such OID that has been allowed as a deduction in the current year and any previous tax year during the deferral period).

As a result of an acceleration event during a tax year in the deferral period, an issuing entity's aggregate deferred OID deductions for previous tax years with respect to a debt instrument may exceed the amount of the electing entity's deferred COD income. Under Temp. Reg. 1.108(i)-2T(d)(2)(ii), after taking into account amounts that had been deducted or included in income, such excess deferred OID deductions are allowed as a deduction in the tax year in which the acceleration event occurs.

At-Risk Rules

When Congress enacted Section 108(i), it failed to consider that the cancellation of a portion of a debt instrument would not only generate COD income but also might decrease a taxpayer's at-risk amount under Section 465. The deferral of COD income would not provide any benefit to partners in a partnership, or to the shareholders of an S corporation, if the partners or shareholders would recognize income in any event due to a decrease in their at-risk amount.

To address this issue, Temp. Reg. 1.108(i)-2T(d)(3) provided that to the extent that a decrease in a partner's or a shareholder's amount at risk in an activity would result in income where such income otherwise had been deferred as a result of a reacquisition of an applicable debt instrument under Section 108(i), the decrease in the at-risk amount is not taken into account for purposes of determining the partner's or shareholder's amount at risk as of the close of the tax year. The partner's or shareholder's amount at risk is taken into account only when the partner or shareholder, as the case may be, recognizes the deferred COD income.

Partnerships

Temp. Reg. 1.108(i)-2T(b)(1) provided that an electing partnership that defers any portion of the COD income realized from a reacquisition of an applicable debt instrument under Section 108(i) must allocate all of the COD income with respect to the applicable debt instrument to its direct partners that are partners in the electing partnership immediately before the reacquisition in the manner in which the income would be included in the distributed shares of the partners under Section 704(b), without regard to Section 108(i). Consistent with Rev. Proc. 2009-37, the electing partnershipmay determine, in any manner, the portion, if any, of a partner's COD income amount with respect to an applicable debt instrument that is deferred and the portion that is currently included in income.

****6** Nevertheless, no partner's deferred amount with respect to an applicable debt instrument may exceed the amount of COD income allocated to that partner. In addition, the aggregate amount of the partners' included and deferred COD income with respect to an applicable debt instrument must equal the electing partnership's total COD income.

Assuming that a partnership has elected to defer a portion of its COD income allocable to a specific partner, the adjusted basis of a partner's interest in a partnership is neither increased under Section 705(a)(1) nor decreased under Section 705(a)(2) by the partner's deferred amount in the tax year of the reacquisition of the debt instrument. [5] Instead, the adjusted basis of a partner's interest in a partnership is adjusted under Section 705(a) by the electing partnership's deferred items for the tax year in which the partner takes such deferred items into account.

Under Temp. Reg. 1.108(i)-2T(b)(2)(ii), however, the capital account of a partner maintained under Reg. 1.704-1(b)(2)(iv) is adjusted for a partner's share of an electing partnership's deferred items as if no election under Section 108(i) had been made. Thus, the partner's capital account is increased to take into account the economic benefit from the reacquisition of a debt instrument at a discount, but basis is not adjusted at that time.

The Temporary Regulations also provided extensive guidance concerning the events that are treated as accelerating—or not accelerating—a partner's deferred amount under Section 108(i). The provisions of the Temporary Regulations that concerned the application of Section 108(i) to S corporations were generally similar to the rules applicable to partnerships, taking into account the differences between these entities.

Corporations

The Temporary Regulations provided that an electing corporation that has deferred COD income will accelerate such income if the electing corporation does any of the following:

***124** 1 Changes its tax status (e.g., elects to be taxable as a partnership or trust).

2 Ceases its corporate existence in a transaction to which Section 381 does not apply.

3 Engages in a transaction that impairs its ability to pay the tax liability associated with deferred COD income under the ‘net value acceleration‘ rule in Temp. Reg. 1.108(i)-1T(b)(2)(iii).

These three rules are the only events that accelerate an electing corporation's deferred COD income (although a corporation still could recognize COD income from a partnership in which it is a partner).

The corporate acceleration events are different from those applicable to partnerships. For example, a partnership is required to recognize deferred COD income on the sale of all or substantially all of its assets; no such rule applies to corporations.

Under the net value acceleration rule, an electing corporation generally is required to accelerate deferred COD income if it engages in an 'impairment transaction' and, immediately after the transaction, the value of its assets fails to satisfy the 'minimum threshold.' An impairment transaction is any transaction, however effected, that impairs an electing corporation's ability to pay the federal income tax liability on its deferred COD income.

**7 For consolidated groups, Temp. Reg. 1.108(i)-1T(b)(2)(iii)(F) provided that the determination of whether an electing corporation that is a member of a consolidated group ('an electing member') has engaged in an impairment transaction is made on a group-wide basis. Thus, an electing member is treated as engaging in an impairment transaction if any member's transaction impairs the group's ability to pay the tax liability associated with the group's deferred COD income. As a result, intercompany transactions are not impairment transactions, and the net value acceleration rule takes into account the gross asset value and liabilities of all members, as well as the tax liability on all members' deferred items.

THE FINAL REGULATIONS

Treasury and the IRS responded to multiple comments on the operation of the Temporary Regulations, in most cases making no changes.

Acceleration rules for an electing corporation in bankruptcy proceedings. The Temporary Regulations did not provide any special acceleration rules for an electing corporation in a Title 11 or similar case with regard to either (1) acceleration events or (2) the time of inclusion of deferred COD income resulting from the occurrence of any acceleration event. One commenter requested clarification of the acceleration rules applicable to a C corporation in bankruptcy proceedings.

Treasury and the IRS believed, however, that the rules provided in the Temporary Regulations were sufficient to address the underlying purpose of Section 108(i)(5)(D), which is to ensure that the government's ability to collect the tax liability associated with the deferred COD income is not impaired. This is essentially the golden rule of Section 108(i): COD income may be deferred, but the fisc shall not be harmed.

The Temporary Regulations provided for accelerated inclusion of deferred COD income in all circumstances (including a Title 11 or similar case at the time a mandatory acceleration event occurs) in which a C corporation has impaired its ability to pay the latent tax liability:

- Change of tax status,
- Termination of corporate existence in a transaction to which Section 381(a) does not apply, or
- A transaction that otherwise impairs the ability to pay the tax liability associated with its deferred COD income (the net value acceleration rule).

Thus, the final Regulations do not provide any special acceleration rules for a corporation in bankruptcy proceedings.

Guidance on built-in items. The limitation on NOL carryforwards and certain built-in losses following an ownership change provided in Section 382 contains special modifications and rules for built-in gains. Treasury and the IRS demurred on requests for guidance with respect to the treatment of built-in items under Section 382 and their interaction with Section 108(i), explaining that it would be better addressed in more general guidance regarding the treatment of built-in items under Section 382.

Adjustments to E&P. The Temporary Regulations generally provided that deferred COD income generally increases E&P in the tax year in which it is realized (reflecting the recognition of economic income and its effect on dividend-paying capacity), and deferred OID deductions generally decrease E&P in the tax year or years in which the deductions would be allowed without regard to the deferral rules of Section 108(i) (reflecting the economic cost).

****8** Treasury and the IRS noted that a question was raised concerning why the Temporary Regulations did not provide a rule similar to Section 301(e) (which was aimed at certain thought-to-be-manipulative transactions) in conjunction with the general rule above. Treasury and the IRS stated that such a rule was not necessary to achieve the purposes of Section 108(i). Moreover, they recognized that adjustments to E&P for the relevant years already have been made and a change at this point would be overly burdensome.

Partnership-level election. The election under Section 108(i) is required to be made by the partnership, S corporation, or other entity involved. [6] One commenter suggested that the final Regulations permit a partner in a partnership to make a Section 108(i) election if the partnership does not make the election.

The commenter reasoned that a partner-level election rule would align Section 108(i) with ***125** Section 108(d)(6), which generally applies the rules under Section 108 at the partner level. Additionally, the commenter noted that a partner-level election would be beneficial when the partners who control the partnership have no interest in making a Section 108(i) election, but a noncontrolling partner does.

Treasury and the IRS did not adopt the commenter's suggestion in the final Regulations because Section 108(i)(5)(B)(iii) unambiguously permits only a partnership to make the election.

Applicable debt instrument safe harbors. One commenter recommended that the final Regulations add an additional trade or business safe harbor providing that a debt instrument issued by a partnership to acquire or improve real property held for rental purposes is treated as issued in connection with a trade or business for purposes of Section 108(i) if at least 30% of the total tax basis (without reduction for depreciation deductions) of the partnership's property is allocable to depreciable property.

Treasury and the IRS, citing Section 167(a), did not adopt the commenter's suggestion in the final Regulations, because depreciable property does not necessarily mean that there is a trade or business. That section provides depreciation deductions for property used in a trade or business *or for property held for the production of income.*

Treasury and the IRS, however, added that no inference should be drawn from the decision not to adopt the comments as to whether a partnership described in the comments is or is not engaged in a trade or business.

The same commenter also requested that, because many partnerships own interests in lower-tier partnerships, the final Regulations should permit an upper-tier electing partnership to take into account its proportionate share of assets held through lower-tier partnerships in which the upper-tier electing partnership holds a significant percentage of the interests (for example, at least 20%) as part of its trade or business assets. Treasury and the IRS also demurred on this comment, citing undue complexity.

****9** At the least, it is interesting to find the threshold at which Treasury and the IRS draw the line at excessive complexity and that our national disease of hyperlexis is alive and well. [7] Instead of wanting more and more guidance, tax practitioners should take comfort in the flexibility provided by a facts and circumstances test. The safe harbors already provide sufficient guideposts in this determination. Why ask for permission to look-through a lower-tier partnership when it appears that this would likely be reasonable and justifiable under a facts and circumstances test?

Deferred Section 752 amount rules. Section 108(i)(6) provides that any decrease in a partner's share of partnership liabilities as a result of the discharge is not to be taken into account for purposes of Section 752 at the time of the discharge to the extent it would cause the partner to recognize gain under Section 731 (‘ Section 108(i)(6) deferral‘). The decrease in a partner's share of a partnership liability under Section 752(b) resulting from the reacquisition of an applicable debt instrument that is not treated as a current distribution of money to the partner under Section 752(b) by reason of the Section 108(i)(6) deferral is referred to as a partner's ‘deferred Section 752 amount.‘

Under the Temporary Regulations, a partner's deferred Section 752 amount could not exceed the partner's share of deferred COD income. The partner's deferred Section 752 amount is treated as a distribution of money to the partner under Section 752(b) at the same time and, to the extent remaining, in the same amount as the partner recognizes the deferred COD income (see the last sentence of Section 108(i)(6)).

An example in the Temporary Regulations concerns a 50/50 partnership between A and B, each with an outside basis of $50. AB had two outstanding liabilities of $300 (debt one) and $200 (debt two). Both of these debts were cancelled and the partnership makes elections to defer (1) $225 of the $300 of COD income ($150 of which is A's deferred amount, and $75 of which is B's deferred amount), and (2) $125 of the $200 of COD income ($100 of which is A's deferred amount, and $25 of which is B's deferred amount). A has no included amount and B has an included amount of $75 for each debt.

The amount of gain that A would recognize under Section 731 is $200. Since this is less than A's aggregate deferred amounts, this amount becomes A's deferred Section 752 amount ($120 for debt one and $80 for debt two). The amount of gain that B would recognize under Section 731 is $50. Since this is less than B's aggregate deferred amounts, this amount becomes B's deferred Section 752 amount ($37.50 for debt one and $12.50 for debt two).

Some commenters questioned how the last sentence of Section 108(i)(6) would work when a partner's deferred Section 752 amount is less than the partner's deferred COD income. The final Regulations add an example to illustrate that the deferred Section 752 amount is treated as a deemed distribution under Section 752(b) in a tax year of the inclusion period to the extent that the deferred Section 752 amount (less any deferred Section 752 amount that has already been treated as a deemed distribution under Section 752(b) in a prior tax year of the inclusion period) is equal to or less than the partner's deferred COD income that is recognized in that tax year.

**10 To continue with the above example (assuming there are no acceleration events), A has $250 of deferred COD income and a $200 deferred Section 752 amount. A will recognize $50 of deferred COD income ($30 for debt one and $20 for debt two) in each of the five tax years of the inclusion period. A will be treated as receiving a $50 deemed distribution in each of the first, second, third, and fourth tax years of the *126 inclusion period. In the fifth tax year of the inclusion period, A will not have any remaining deferred section 752 amounts and thus no deemed distribution, but A will recognize $50 of deferred COD income.

B has $100 of deferred COD income and a $50 deferred Section 752 amount. B will recognize $20 of deferred COD income ($15 for debt one and $5 for debt two) in each of the five tax years of the inclusion period. B will be treated as receiving a $20 deemed distribution in each of the first and second tax years of the inclusion period, and a $10 deemed distribution in the third tax year of the inclusion period. In the fourth and fifth tax years of the inclusion period, B will not have any remaining deferred Section 752 amounts and thus no deemed distribution, but B will recognize $20 of deferred COD income.

In other words, the deemed distributions do not occur ratably over the inclusion period, but are front-loaded to the extent that COD income is recognized.

Acceleration events. Some commenters questioned when exactly the acceleration rule applies in the case of the filing of a petition in Title 11 or a similar case. The filing acceleration rule applies to partnerships and S corporations that make an election under Section 108(i) before filing a petition in a Title 11 or similar case. The filing acceleration rule does not apply, however, to partnerships and S corporations that file a petition in a Title 11 or similar case before making an election under Section 108(i).

A commenter also suggested that the final Regulations permit partnerships and S corporations that have made an election under Section 108(i) after filing bankruptcy to reorganize, recapitalize, or liquidate in bankruptcy without triggering acceleration of the deferred items under Section 108(i). The commenter explained that a bankruptcy reorganization will in many cases cause an acceleration of the deferred items under Section 108(i) because the bankrupt partnerships or S corporations may sell, exchange or transfer substantially all of their assets or liquidate as part of the reorganization.

Treasury and the IRS did not adopt this comment because the same acceleration events that apply to partnerships and S corporations that do not file bankruptcy should apply to partnerships and S corporations that make an election under Section 108(i) after filing bankruptcy.

Calculation of ‘substantially all‘ of the assets. The Temporary Regulations provide that a sale, exchange, transfer, or gift of ‘substantially all‘ of the assets of an electing partnership or S corporation triggers an acceleration of the deferred Section 108(i) items.

**11 One commenter advocated for a facts and circumstances test rather than the 90/70 test in determining whether a partnership or S corporation transfers substantially all of its assets for purposes of accelerating the deferred items under Section 108(i). Treasury and the IRS considered the comment but decided to retain the rule in the Temporary Regulations, because the 90/70 test provides electing partnerships and S corporations clear guidance on when a sale, exchange, transfer, or gift of their assets accelerates their deferred items.

Exceptions for certain distributions and Section 381 transactions. The Temporary Regulations provided that when a direct or indirect partner of an electing partnership sells, exchanges, transfers (including contributions and distributions), or makes a gift of all or a portion of its ‘separate interest‘ (a direct interest in an electing partnership or in a partnership or S corporation that is a direct or indirect partner of an electing partnership), its deferred items with respect to the separate interest are accelerated and must be taken into account.

The Temporary Regulations provided an exception to this acceleration rule for certain distributions of separate interests and for Section 381 transactions. Since the publication of the Temporary Regulations, Treasury and the IRS considered whether these exceptions in Reg. 1.108(i)-2(b)(6)(iii)(E) and Reg. 1.108(i)-2(b)(6)(iii)(F) should apply when the electing partnership terminates under Section 708(b)(1)(A). In that situation, the electing partnership no longer exists and cannot report any deferred items to its partners. Therefore, the final Regulations clarify that these exceptions to acceleration for distributions of entire separateinterests do not apply if the electing partnership terminates under Section 708(b)(1)(A).

REITs. Section 2.01 of Rev. Proc. 2009-37 provides that for purposes of Section 108(i), REITs are not pass-through entities. One commenter recommended that, for purposes of clarity, the final Regulations should reiterate that statement. Treasury and the IRS did not believe it was necessary to add a rule in the final Regulations to that effect.

CONCLUSION

Our hopes have been dashed—in finalizing the Temporary Regulations Treasury and the IRS did nothing to address the complexity and compliance burdens of regulatory guidance with respect to a statutory provision that was intended to relieve the burden of taxpayers struggling in the Great Recession. Any taxpayers involved in acquisitive transactions must now look out for deferred COD income lurking in the shadows, and the final Regulations will be relevant in avoiding its acceleration. One thought remains, especially now that we have some (fairly) ironed out regulatory guidance that required a lot of effort to assemble. Although tough times were prevalent for many taxpayers in 2009 and 2010, whenever a taxpayer is experiencing financial difficulties, it is a ‘tough time‘! An expanded and improved statutory deferral for COD income could be wise policy for all years.

**12 The Temporary Regulations provided assurance to a partnership having both trade or business assets and investment assets that a debt instrument will be treated as an applicable debt instrument notwithstanding its investment assets.

As a result of an acceleration event during a tax year in the deferral period, an issuing entity's aggregate deferred OID deductions for previous tax years with respect to a debt instrument may exceed the amount of the electing entity's deferred COD income.

A partnership is required to recognize deferred COD income on the sale of all or substantially all of its assets. No such rule applies to corporations.

This is essentially the golden rule of Section 108(i): COD income may be deferred, but the government's ability to collect the tax liability associated with the deferred COD income shall not be impaired.

Why ask for permission to look-through a lower-tier partnership when it appears that this would likely be reasonable and justifiable under a facts and circumstances test?

Footnotes

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1 See Lipton, 'Recovery Act Allows Deferral of COD Income—To Elect or Not?,' 110 JTAX 260 (May 2009).

2 See Lipton, 'Temporary Regulations on COD Income Deferral Affect Most Types of Business Entities,' 114 JTAX 4 (January 2011).

3 Section 108(i)(5).

4 See Lipton, 'Deferral of COD Income: IRS Provides Exclusive Procedures for the Section 108(i) Election,' 111 JTAX 260 (November 2009).

5 Temp. Reg. 1.108(i)-2T(b)(2)(i).

6 Section 108(i)(5)(B)(iii).

7 See Manning, 'Hyperlexis: Our National Disease,' 71 Northwestern U.L. Rev. 767 (1977); Lipton, 'We Have Met the Enemy and He Is Us: More Thoughts on Hyperlexis,' 47 Tax Lawyer 1 (Fall 1993).

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