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IRS Rules Covering Recession Are Music to Accountant Ears: Taxes

By Lydia Beyoud - Jul 18, 2013

For some companies that got a temporary reprieve from the IRS in the height of the recession, the payback isn't going to be as bad as they expected.

Congress let some firms that are organized as partnerships defer income from forgiven debts in 2009 and 2010, and the final rules just came out for paying those taxes starting next year, Bloomberg BNA reported. The tax amounts stay the same and the accounting isn't going to be as complicated as previously anticipated, lawyers said.

The rules "should prove to be music to a tax accountant's ear, without any atonality or dissonance," said Michael Grace, counsel at Whiteford, Taylor & Preston LLP.

With 3.2 million partnerships in the U.S., including many private equity managers, hedge funds and real estate investors, the rules may have a big impact. Companies have been waiting on the Internal Revenue Service to finalize the accounting because taxpayers will start including the income after these deferrals next calendar year for their 2015 taxes.

Businesses set up as partnerships don't pay taxes at the corporate level and instead pass their income through to their owners' individual tax returns.

The deferrals saved a lot of pain during the recession because standard practice would have forced partners to report a higher on-paper "income" from the cancellation of debt on their taxes, and then pay taxes on that "income" when they didn't have the real cash or assets to pay the taxes.

Cancellation of debt covers debt that has been forgiven by the lender. The IRS considers forgiven debt to be taxable income to the borrower. A forgiven $1 million debt would normally be taxed the same as if a company were paid $1 million. The rule meant the tax could be paid in installments as if the company received $200,000 a year over five years.

Partnership Boom

Partnerships and other pass-through entities have become a popular way to organize businesses in the past 30 years, because of tax-rate reductions for individuals, a double tax on corporate profits and interaction with state legal structures.

Some large businesses are organized as partnerships, including global accounting firms such as Ernst & Young LLP. In 2010, 48 percent of partnerships were in the real estate, rental and leasing industries, according to the IRS.

Under current tax law, partnerships can split tax benefits and income among partners in myriad ways. For example, in many real estate partnerships, depreciation deductions can be given only to some partners who want to use those breaks to offset other income. The differences in tax benefits made the deferral rules even more complicated.

New Complexity

These final rules, known for their tax code Section 108(i), clarify the accounting that needs to take place for the deferral and how it interacts with other rules about accounting for partnerships.

"In the partnership context, the Section 108(i) rules necessarily took complexity to a whole new level," Steven Schneider, a partner at Goulston & Storrs, told BNA.

Early on, the IRS let people opt out of a partnership's Section 108(i) election, so not everyone would be forced into a tax decision if it would hurt them, he said.

The rules still contain some areas that may catch some taxpayers off-guard, practitioners told BNA.

In addition to the Section 108(i) piece, some of the changes are covered in a different slice of the code, Section 752. In some cases, the way the two sections talk to each other means that the final rules required the deferrals to be front-loaded -- which may be a substantial change from the tax plan they'd been expecting, Schneider said.

Easily Confused

Some taxpayers may have been counting on the ability to use a pro rata or back-end approach, he said. Therefore, they may not have gotten as good a deal under Section 108(i) as they had originally expected, Schneider said.

This timing difference, together with confusion about concepts including capital accounting for partnerships, may present challenges for some practitioners, Grace said.

"It would be very easy for someone to get confused about when the different categories of these amounts should be adjusted," he said.

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