(b) Effective Date.—The amendments made by this section shall apply to individuals who begin work for the employer after December 31, 2008.

PART IV—RULES RELATING TO DEBT INSTRUMENTS

SEC. 1231. DEFERRAL AND RATABLE INCLUSION OF INCOME ARISING FROM BUSINESS INDEBTEDNESS DISCHARGED BY THE REACQUISITION OF A DEBT INSTRUMENT.

26 USC 108.

(a) In General.—Section 108 (relating to income from discharge of indebtedness) is amended by adding at the end the following new subsection:

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(i) Deferral and Ratable Inclusion of Income Arising From Business Indebtedness Discharged by the Reacquisition of a Debt Instrument.—
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Time periods.

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(1) In General.—At the election of the taxpayer, income from the discharge of indebtedness in connection with the reacquisition after December 31, 2008, and before January 1, 2011, of an applicable debt instrument shall be includible in gross income ratably over the 5-taxable-year period beginning with—

(A) in the case of a reacquisition occurring in 2009, the fifth taxable year following the taxable year in which the reacquisition occurs, and

(B) in the case of a reacquisition occurring in 2010, the fourth taxable year following the taxable year in which the reacquisition occurs.

(2) Deferral of Deduction for Original Issue Discount in Debt for Debt Exchanges.—
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(A) In General.—If, as part of a reacquisition to which paragraph (1) applies, any debt instrument is issued for the applicable debt instrument being reacquired (or is treated as so issued under subsection (e)(4) and the regulations thereunder) and there is any original issue discount determined under subpart A of part V of subchapter P of this chapter with respect to the debt instrument so issued—

(i) except as provided in clause (ii), no deduction otherwise allowable under this chapter shall be allowed to the issuer of such debt instrument with respect to the portion of such original issue discount which—

(I) accrues before the 1st taxable year in the 5-taxable-year period in which income from the discharge of indebtedness attributable to the reacquisition of the debt instrument is includible under paragraph (1), and

(II) does not exceed the income from the discharge of indebtedness with respect to the applicable debt
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If the amount of the original issue discount accruing before such 1st taxable year exceeds the income from the discharge of indebtedness with respect to the applicable debt
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instrument being reacquired, the deductions shall be disallowed in the order in which the original issue discount is accrued.

“(B) DEEMED DEBT FOR DEBT EXCHANGES.—For purposes of subparagraph (A), if any debt instrument is issued by an issuer and the proceeds of such debt instrument are used directly or indirectly by the issuer to reacquire an applicable debt instrument of the issuer, the debt instrument so issued shall be treated as issued for the debt instrument being reacquired. If only a portion of the proceeds from a debt instrument are so used, the rules of subparagraph (A) shall apply to the portion of any original issue discount on the newly issued debt instrument which is equal to the portion of the proceeds from such instrument used to reacquire the outstanding instrument.

“(3) APPLICABLE DEBT INSTRUMENT.—For purposes of this subsection—

“(A) APPLICABLE DEBT INSTRUMENT.—The term ‘applicable debt instrument’ means any debt instrument which was issued by—

“(i) a C corporation, or

“(ii) any other person in connection with the conduct of a trade or business by such person.

“(B) DEBT INSTRUMENT.—The term ‘debt instrument’ means a bond, debenture, note, certificate, or any other instrument or contractual arrangement constituting indebtedness (within the meaning of section 1275(a)(1)).

“(4) REACQUISITION.—For purposes of this subsection—

“(A) IN GENERAL.—The term ‘reacquisition’ means, with respect to any applicable debt instrument, any acquisition of the debt instrument by—

“(i) the debtor which issued (or is otherwise the obligor under) the debt instrument, or

“(ii) a related person to such debtor.

“(B) ACQUISITION.—The term ‘acquisition’ shall, with respect to any applicable debt instrument, include an acquisition of the debt instrument for cash, the exchange of the debt instrument for another debt instrument (including an exchange resulting from a modification of the debt instrument), the exchange of the debt instrument for corporate stock or a partnership interest, and the contribution of the debt instrument to capital. Such term shall also include the complete forgiveness of the indebtedness by the holder of the debt instrument.

“(5) OTHER DEFINITIONS AND RULES.—For purposes of this subsection—

“(A) RELATED PERSON.—The determination of whether a person is related to another person shall be made in the same manner as under subsection (e)(4).

“(B) ELECTION.—

“(i) IN GENERAL.—An election under this subsection with respect to any applicable debt instrument shall be made by including with the return of tax imposed by chapter 1 for the taxable year in which the reacquisition of the debt instrument occurs a statement which—

“(I) clearly identifies such instrument, and
“(II) includes the amount of income to which paragraph (1) applies and such other information as the Secretary may prescribe.
“(ii) ELECTION IRREVOCABLE.—Such election, once made, is irrevocable.
“(iii) PASS-THRU ENTITIES.—In the case of a partnership, S corporation, or other pass-thru entity, the election under this subsection shall be made by the partnership, the S corporation, or other entity involved.
“(C) COORDINATION WITH OTHER EXCLUSIONS.—If a taxpayer elects to have this subsection apply to an applicable debt instrument, subparagraphs (A), (B), (C), and (D) of subsection (a)(1) shall not apply to the income from the discharge of such indebtedness for the taxable year of the election or any subsequent taxable year.
“(D) ACCELERATION OF DEFERRED ITEMS.—
“(i) IN GENERAL.—In the case of the death of the taxpayer, the liquidation or sale of substantially all the assets of the taxpayer (including in a title 11 or similar case), the cessation of business by the taxpayer, or similar circumstances, any item of income or deduction which is deferred under this subsection (and has not previously been taken into account) shall be taken into account in the taxable year in which such event occurs (or in the case of a title 11 or similar case, the day before the petition is filed).
“(ii) SPECIAL RULE FOR PASS-THRU ENTITIES.—The rule of clause (i) shall also apply in the case of the sale or exchange or redemption of an interest in a partnership, S corporation, or other pass-thru entity by a partner, shareholder, or other person holding an ownership interest in such entity.
“(6) SPECIAL RULE FOR PARTNERSHIPS.—In the case of a partnership, any income deferred under this subsection shall be allocated to the partners in the partnership immediately before the discharge in the manner such amounts would have been included in the distributive shares of such partners under section 704 if such income were recognized at such time. Any decrease in a partner’s share of partnership liabilities as a result of such discharge shall not 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. Any decrease in partnership liabilities deferred under the preceding sentence shall be taken into account by such partner at the same time, and to the extent remaining in the same amount, as income deferred under this subsection is recognized.
“(7) SECRETARIAL AUTHORITY.—The Secretary may prescribe such regulations, rules, or other guidance as may be necessary or appropriate for purposes of applying this subsection, including—
“(A) extending the application of the rules of paragraph (5)(D) to other circumstances where appropriate,
“(B) requiring reporting of the election (and such other information as the Secretary may require) on returns of tax for subsequent taxable years, and
“(C) rules for the application of this subsection to partnerships, S corporations, and other pass-thru entities, including for the allocation of deferred deductions.”.

(b) Effective Date.—The amendments made by this section shall apply to discharges in taxable years ending after December 31, 2008.

SEC. 1232. MODIFICATIONS OF RULES FOR ORIGINAL ISSUE DISCOUNT ON CERTAIN HIGH YIELD OBLIGATIONS.

(a) Suspension of Special Rules.—Section 163(e)(5) (relating to special rules for original issue discount on certain high yield obligations) is amended by redesignating subparagraph (F) as subparagraph (G) and by inserting after subparagraph (E) the following new subparagraph:

“(F) Suspension of application of paragraph.—

“(i) Temporary suspension.—This paragraph shall not apply to any applicable high yield discount obligation issued during the period beginning on September 1, 2008, and ending on December 31, 2009, in exchange (including an exchange resulting from a modification of the debt instrument) for an obligation which is not an applicable high yield discount obligation and the issuer (or obligor) of which is the same as the issuer (or obligor) of such applicable high yield discount obligation. The preceding sentence shall not apply to any obligation the interest on which is interest described in section 871(h)(4) (without regard to subparagraph (D) thereof) or to any obligation issued to a related person (within the meaning of section 108(e)(4)).

“(ii) Successive application.—Any obligation to which clause (i) applies shall not be treated as an applicable high yield discount obligation for purposes of applying this subparagraph to any other obligation issued in exchange for such obligation.

“(iii) Secretarial authority to suspend application.—The Secretary may apply this paragraph with respect to debt instruments issued in periods following the period described in clause (i) if the Secretary determines that such application is appropriate in light of distressed conditions in the debt capital markets.”.

(b) Interest Rate Used in Determining High Yield Obligations.—The last sentence of section 163(i)(1) is amended—

(1) by inserting “(i)” after “regulation”, and

(2) by inserting “, or (ii) permit, on a temporary basis, a rate to be used with respect to any debt instrument which is higher than the applicable Federal rate if the Secretary determines that such rate is appropriate in light of distressed conditions in the debt capital markets” before the period at the end.

(c) Effective Date.—

(1) Suspension.—The amendments made by subsection (a) shall apply to obligations issued after August 31, 2008, and taxable years ending after such date.

(2) Interest Rate Authority.—The amendments made by subsection (b) shall apply to obligations issued after December 31, 2009, and taxable years ending after such date.