

THE INCREASED RELEVANCE OF THE CANCELLATION OF INDEBTEDNESS RULES IN TODAY'S ECONOMIC ENVIRONMENT

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I. Introduction.

In today's depressed economic conditions, foreclosures and defaults on loans are becoming more and more commonplace. The U.S. credit and housing markets are in their worst shape in a generation. Real estate values are down and, as a result, the refinancing of existing variable-rate or adjustable rate loans has been curtailed. The fallout is a massive increase in the number of foreclosures and, to an increasing extent, a mortgage workout environment in which mortgage lenders realize they will not fully recoup the loan funds and accrued interest and, therefore, are open to "workouts" in which either principal or interest on existing loans is reduced.

There are tax consequences to borrowers in these situations, tempered somewhat but not entirely by recent Congressional legislation. While the prospects of losing one's home or commercial investment property are frightening to many of our clients, it appears few are cognizant of the potentially adverse tax consequences that could result in connection with forgiven or discharged debt. This paper looks at the tax consequences to borrowers who receive "discharge of indebtedness" income as a result of these voluntary "workouts" and involuntary foreclosures and aims to highlight possible planning opportunities applicable to clients who are facing or are likely to face financial difficulties.

II. General Rules.

A debtor's release from the obligation to repay a loan will generally constitute taxable income to the debtor. U.S. vs. Kirby Lumber 284 U.S. 1 (1931). Indeed, IRC Section 61(a)(12) states that the taxpayer will be required to recognize ordinary income as a result of "discharge of indebtedness" income ("COD Income"). The rationale is that the taxpayer will realize an accession in wealth due to the discharged debt.

This discharge from indebtedness income can result from formal action taken by the creditor (such as a formal discharge or a loan compromise) or by operation of law (such as in bankruptcy discharge or the statute of limitations expiring for enforcement of a loan).

Example: John and 9 other individuals form a partnership to develop a parcel of land. The land purchase is financed with a \$1.98 million loan that is personally guaranteed by the 10 individual partners. When the partnership defaults on the note, the bank purchases the property at foreclosure. The individual partners still owe the bank \$800,000 on the note. The bank sues the partners, and John settles his share of the deficiency for half of his liability, or \$40,000 instead of \$80,000. John has \$40,000 of discharge-of-indebtedness income.

III. Character of Taxable Income and Calculating the Amount of the Debt Discharge Income.

The taxable income recognized by the debtor may be a capital gain, ordinary income or non-taxable income, depending upon the debtor's specific circumstances. When property is foreclosed upon, the taxpayer will be concerned as to whether the foreclosure will generate income from discharge of indebtedness or gain from the sale of that property. This will be very important to the taxpayer if capital gains tax rates are lower than ordinary income rates, or if income from the discharge of indebtedness may be eligible for exclusion from gross income under Section 108.

Different rules apply depending upon whether the property is subject to non-recourse debt or recourse debt.

A. Non-Recourse Debt. In general, debt-discharge income does **not** arise on a transfer of property where non-recourse debt exceeds the fair market value of the property transferred. Instead, the taxpayer must recognize **gain from the sale or exchange** of the property to the extent that the non-recourse indebtedness exceeds the taxpayer's tax basis in the property. Reg. Section 1.1001-2(a)(2). As a result, the taxpayer cannot utilize the exclusions contained in Section 108(a) to avoid income inclusion on account of the transfer of property in satisfaction of a non-recourse debt. See Commissioner v. Tufts, 461 US 300 (1983) and Gershowitz v. Commissioner, 88 TC 984 (1987). So, in the case of a foreclosure of property subject to a non-recourse debt, the entire gain is treated as a gain from the sale or exchange.

B. Recourse Debt. Different rules apply in the case of recourse debt. In the case of recourse debt, where property subject to a recourse debt is disposed of in satisfaction of the debt, and if the amount of the debt exceeds the property's fair market value, then the IRS regulations bifurcate the transaction and provide that:

- (1) gain from the sale or exchange of property arises to the extent that fair market value of the property exceeds his tax basis in the property; and
- (2) debt discharge income arises to the extent of the excess of the debt over the fair market value of the property.

Regs. 1.1001-2(c); Gehl v. Commissioner, 102 TC 784 (1994), affirmed, 75 A.F.T.R. 2d 95,667 (8th Circuit 1995); Frazier v. Commissioner, 111 TC 243 (1998).

This will be a bad result for many taxpayers who dispose of property subject to a recourse mortgage in excess of the fair market value of the property who otherwise would be eligible for relief provisions under Section 108, since they would prefer to have discharge of indebtedness income rather than gain from the sale or exchange of the property.

Example: In 2008, F transfers to a creditor an asset with a fair market value of \$6,000 and a tax basis of \$5,000 in satisfaction of a \$7,500 recourse debt for which F is personally liable. The amount realized on the disposition of the asset is its fair market value of \$6,000, so F realizes a taxable gain on the sale of \$1,000. In addition, F also realizes income from discharge of indebtedness of \$1,500 (\$7,500 - \$6,000). Regs. 1.1001-2(c), Example 8.

Also, under these regulations, debt-discharge income results whether the property is disposed of at a gain or a loss. Thus, in the above example, if F's tax basis in the property is \$7,000 rather than \$5,000, F realizes a loss of \$1,000 on the disposition of the property to the creditor, but still realizes discharge of indebtedness income of \$1,500.

IV. Tax Benefit Approach – Section 108(e)(2).

A. General Rule

Under §108(e)(2), discharge-of-indebtedness income does not arise on a cancellation of debt if payment of the indebtedness would give rise to a deduction, i.e., the indebtedness is with respect to a deductible expense that was not previously deducted. Thus, under §108(e)(2) there is no debt-discharge income where a trade account payable of a cash basis taxpayer is discharged, since payment of the liability would be deductible. On the other hand, the discharge of a trade account payable of an accrual basis debtor does give rise to debt-discharge income since the payable was previously deductible. In this event, §108(e)(2) does not apply, since payment of the liability would not give rise to a deduction (the deduction already having been taken).

Section 108(e)(2) adopts a tax benefit approach to debt cancellation, i.e., recognition of discharge-of-indebtedness income where the indebtedness represents an expense, which has resulted in a tax deduction benefiting the taxpayer. Similarly, the approach of §108(e)(2) provides no cancellation of indebtedness income where the indebtedness represents an expense which has not been deducted, and thus, has not given rise to a tax benefit through a deduction.

What if payment of the debt would give rise to a capital expenditure (as opposed to a deduction) which would give the taxpayer a tax basis in an asset? Although the statutory language is not precisely met (since the payment would not give rise to a deduction), it could be argued under the tax benefit approach that forgiveness of the indebtedness should not result in

discharge-of-indebtedness income, because the debtor receives no tax benefit when the indebtedness is incurred.

B. Exception under §111

An exception to the rule that the discharge of a liability that was previously deducted gives rise to income has been provided in §111 and the regulations promulgated thereunder. Before the Bankruptcy Tax Act, §111 and its regulations provided that income would not be recognized in the case of the recovery of a previously deducted amount (including the discharge of a previously deducted liability) to the extent the deduction did not result in a reduction of the taxpayer's tax. The Bankruptcy Tax Act added subsection (d) to §111 (subsequently redesignated §111(c)), which provides that an increase in a loss carryover that has not yet expired is characterized as a reduction in tax for purposes of §111. Accordingly, taxable income — or attribute reduction in the case of a bankrupt or insolvent individual under §108(a)(1) — results where an amount is deducted in a year, thus creating or increasing an NOL, and the indebtedness is forgiven in a subsequent year, provided that the NOL carryover has not expired at the time the indebtedness is forgiven.

Example: Individual debtor Tom is engaged in a trade or business that is on an accrual basis for tax purposes. In 2008, rental expense of \$2,000 is accrued, but the expense is not paid. Tom has a net operating loss in 2008. Since, under §172(b)(1)(A), any carryover resulting from the 2008 net operating loss can be carried to each of the 20 taxable years following the taxable year of the loss, under §111(c), any discharge of the \$2,000 debt before the conclusion of the 20-year period results in debt-discharge income. Note that if Tom is a cash basis taxpayer, discharge of the \$2,000 liability would not result in debt-discharge income under §108(e)(2) since it would have been deductible.

V. Related Party Rule.

A. In General.

Assume a corporation has indebtedness outstanding that was issued at par, and the fair market value of which has declined below the issue price of the debt because of increases in interest rates. If the debtor corporation were to acquire its own indebtedness for an amount less than its issue price, it would realize discharge-of-indebtedness income, under Kirby Lumber v. U.S. Section 108(e)(4) prevents a debtor corporation from avoiding COD income by having a related party acquire its debt.

Under §108(e)(4)(A), if a related party to the debtor acquires an outstanding debt from an unrelated creditor, the debtor is deemed to have acquired the debt, thereby resulting in COD income.

Example: ABC, Inc., a corporation, owns 100% of the stock of XYZ, Inc., a corporation, and ABC, Inc. has outstanding \$1000 of publicly traded debt. If ABC, Inc. purchases its own debt in the market for \$800, it realizes \$200 of discharge-of-indebtedness income. Assume instead that XYZ, Inc. purchases ABC, Inc.'s debt in the market for \$800. Under §108(e)(4), ABC, Inc. is

treated as having purchased its own debt for \$800, and it realizes the same \$200 of discharge-of-indebtedness income.

For purposes of applying §108(e)(4), the following persons are treated as being related to the debtor:

- A member of the same controlled group of corporations of which the debtor is a member, with control determined by more than 50% vote and value.
- A trade or business under common control with respect to the debtor under §414(b) and (c).
- A partnership controlled by the debtor (or a partner in such a partnership) within the meaning of §707(b)(1).
- A family member of an individual debtor including spouse, children, grandchildren, parents, and any spouse of children or grandchildren. There is no brother-sister family attribution under this rule.

B. Exception to the Related Party Rule.

There is an exception to the related party rule where there is an acquisition of indebtedness with a stated maturity date that is no later than one year after the acquisition date, if the debt is in fact retired on or before its stated maturity date.

Example: P and S are related parties. S purchases P's debt from holder H, an unrelated party. The debt in question will mature seven months after the date it is acquired by S and, in fact, is retired on or before its maturity date. The transaction will not be treated as an acquisition by P of its own debt under §108(e)(4).

C. The Deemed Issuance Rule

Under the regulations, if the debtor realizes discharge-of-indebtedness income under the related party rule: (1) there is a deemed issuance of new debt for the old debt; and (2) the new debt is deemed issued with an issue price equal to the amount used to compute the debtor's discharge-of-indebtedness income, i.e., either the holder's adjusted basis or the fair market value of the indebtedness. Any excess of the stated redemption price of the deemed new debt at maturity over its deemed issue price is original issue discount under §1273(a)(2), which is deductible by the debtor and includible in income by the holder to the extent provided in §§163 and 1272.

Example: Debtor (P) has outstanding indebtedness with a stated redemption price at maturity of \$1,000, an issue price of \$900, and \$25 of original issue discount has accrued on the indebtedness. P's wholly-owned subsidiary (S) acquires P's indebtedness for \$850, paid in cash. S's acquisition of P's indebtedness is a direct acquisition, giving rise to \$75 of discharge-of-indebtedness income to P based on the difference between the adjusted issue price of the debt (\$925) in P's hands and S's adjusted basis in the acquired indebtedness (\$850). P is treated as

issuing new indebtedness with an issue price equal to the S's adjusted basis in the indebtedness (\$850) and a stated redemption price of \$1,000. S will take into income and P will deduct original issue discount of \$150 in accordance with the rules governing original issue discount.

VI. Realization of Income.

Generally, income resulting from the cancellation of indebtedness is realized at the time the debt is satisfied for less than its principal amount. In the absence of an actual repayment or purchase of the debt, the realization of income takes place when it becomes clear that the debt will not be repaid (e.g., a mere bookkeeping entry does not result in income from cancellation of indebtedness), and may be evidenced by an agreement between the debtor and creditor effecting a satisfaction of the debt; on the date of judicial approval of settlement, where required, without regard to the pendency of an appeal; on the date a court determined that the statute of limitations had run as a bar against collection; or other event. For instance, in Marcus Est. v. Comr., T.C. Memo 1975-9, the Tax Court found that the decedent's estate realized income in the year of the decedent's death because the executors did not intend to satisfy certain debts and the creditor's management did not intend to enforce the claims.

Generally, where an indebtedness is forgiven conditioned upon the happening of a future event, income is realized in the year the future event takes place. However, where the taxpayers purchased their indebtedness at a discount from the Farm Home Administration subject to a recapture agreement requiring them to repay the unpaid portion of the debt from the proceeds of selling the property within 10 years, they realized debt discharge income when they purchased the indebtedness, because the possibility of a further payment was highly contingent and within their control. Jelle v. Comr., 116 T.C. 63 (2001).

As discussed below, Section 108(a)(1)(A) excludes discharge of indebtedness from gross income where the discharge occurs in a title 11 case. Section 108(d)(2) defines "title 11 case" as a case under title 11 of the United States Code, but only if the taxpayer is under the jurisdiction of the court and the discharge is granted by the court or pursuant to a plan approved by the court. In Friedman v. Comr., T.C. Memo 1998-156, the Tax Court held that no discharge of indebtedness of an S corporation arose in a liquidating bankruptcy under Chapter 7 of the Bankruptcy Code because the Bankruptcy Court did not grant a discharge either directly or pursuant to a plan. The taxpayer argued that the corporation realized discharge of indebtedness in the bankruptcy proceeding, which increased the basis of taxpayer's stock in the S corporation. Under §727 of the Bankruptcy Code, the bankruptcy court may not grant a discharge to a corporation in a Chapter 7 case.

VII. Distinguishing Sale or Exchange Transactions.

A. General Overview.

The disposition of property subject to recourse or nonrecourse debt raises questions as to whether and to what extent income from the discharge of indebtedness or gain from the sale of property is realized. As mentioned above, the determination of the character of the income is

important if capital gains are taxed at a lower rate than ordinary income, or if income from the discharge of indebtedness is eligible for exclusion from gross income under §108.

B. Non-Recourse Debt.

As a general rule, debt-discharge income does not arise on a transfer of property where nonrecourse debt exceeds the fair market value of the property transferred. Instead, the taxpayer must recognize gain from the sale or exchange of the property to the extent the indebtedness exceeds the taxpayer's basis in the property. This means that the taxpayer cannot utilize the exclusions contained in §108(a) to avoid income inclusion on account of the transfer of the property.

Section 506(a) of the Bankruptcy Code provides generally that the amount of a secured claim is limited to the value of the property that secures the claim, and any excess is treated as an unsecured claim. In PLR 8918016, the taxpayer was in bankruptcy under title 11. The taxpayer owned real property, which was encumbered by a mortgage, and the fair market of the real property was less than the face amount of the mortgage. The IRS ruled that under §506 of the Bankruptcy Code the excess of the mortgage over the property's fair market value became an unsecured claim based on the taxpayer's personal liability, which was discharged in the bankruptcy proceeding. The trustee abandoned the real property, which was foreclosed on by the mortgage holder. The IRS concluded that the taxpayer was required to recognize gain only up to the amount of secured portion of the mortgage determined after applying §506 of the Bankruptcy Code, i.e., only in an amount up to the fair market value of the property. Arguably, the ruling stands for the proposition that in bankruptcy, by virtue of §506 of the Bankruptcy Code, the portion of a nonrecourse mortgage exceeding the value of the mortgaged property will be treated as a recourse mortgage for tax purposes, allowing the taxpayer to exclude the recourse portion of the mortgage from gross income under § 108.

C. Recourse Debt.

Where a taxpayer disposes of property in satisfaction of a recourse debt, the debt is discharged. Upon the discharge, if the amount of the debt exceeds the property's fair market value, the regulations bifurcate the transaction and provide that: (1) gain from the sale or exchange of property arises to the extent the fair market of the property exceeds basis; and (2) debt-discharge income arises to the extent of the excess of the debt over fair market value. Regs. §1.1001-2(c). Debt-discharge income does not arise to the extent the debt does not exceed the fair market value of the property because the debt is satisfied by virtue of the value of the property that transferred.

A taxpayer disposing of property subject to a mortgage in excess of the fair market value of the property and qualifying for the relief provisions of §108 would prefer to have discharge of indebtedness income rather than gain from the sale or exchange of the property. In 2925 Briarpark, Ltd. v. Comr., 163 F.3d 313 (5th Cir. 1999), the taxpayer was unsuccessful in structuring a transaction so as to realize discharge of indebtedness income rather than gain from the sale or exchange of property. The property in question, which was owned by a partnership, was subject to nonrecourse mortgage debt in the approximate amount of \$26 million. The

taxpayer arranged to sell the property to a third party for approximately \$12 million conditioned on the bank releasing its mortgage. The bank agreed to release its mortgage upon the debtor's assignment of the \$12 million sales proceeds to it. The partnership reported discharge of indebtedness income in the amount of the difference between the amount of the mortgage (\$26 million) and the amount paid by the third party buyer (\$12 million). In affirming the Tax Court, the Fifth Circuit held that the partnership did not realize discharge of indebtedness income on account of the bank's release of the mortgage, but rather received only gain from the sale or exchange of property based on the difference between the amount of the mortgage and the taxpayer's basis in the property, stating, “[t]he Tax Court properly found that the partnership's disposition of the property was conditioned upon the relief of its debt and was therefore the functional equivalent of a foreclosure sale.”

Where a recourse mortgage is foreclosed, discharge of indebtedness income is realized only if the mortgage is discharged on account of the foreclosure. In Aizawa v. Comr., 99 T.C. 197 (1992), *aff'd*, 29 F.3d 630 (9th Cir. 1994), the holder of a recourse mortgage foreclosed on the property, which was then purchased by the mortgagor (the taxpayer) at the foreclosure sale. At the time of the sale, the mortgagor's adjusted basis in the property was \$100,091.38, the proceeds of sale were \$72,700, and the mortgagor owed the mortgagee \$133,506.91 (\$90,000 mortgage principal plus unpaid interest and other expenses of \$43,506.91). The mortgagee obtained a deficiency judgment in the amount of \$60,806.91 (\$133,506.91 minus \$72,700 proceeds of sale). The court held that the mortgagor realized a capital loss of \$27,391.38 on the sale (\$100,091.38 adjusted basis minus \$72,700 proceeds of sale). Because the balance of the indebtedness remained outstanding by virtue of the deficiency judgment, the mortgagor did not realize any discharge of indebtedness income.

VIII. Discharge of Debt as a Gift.

Section 102 excludes from the definition of gross income any amount received as a gift or bequest. Accordingly, if the forgiveness of a debt constitutes a gift from the creditor to the debtor (or is in the nature of a bequest), gross income does not result to the debtor, although the holder of the obligation may have gross income if it is an installment obligation. In addition, the holder may have to pay gift tax.

Donative cancellations, like other gifts, are most likely to occur in the family context. Where the debt cancellation takes place in a business or commercial setting, establishing donative intent on the part of the creditor becomes quite difficult.

As one can imagine, the application of the gift exclusion in the case of debt cancellations arising in a business setting has been extremely rare. Nevertheless, it remains at least a possible contention by a debtor seeking to avoid discharge-of-indebtedness income, particularly in view of the Supreme Court's stated willingness in alleged “gift” cases to accept the findings of the triers of fact with respect to the element of donative intent, even as to transactions which occur in the commercial sphere. Comr. v. Duberstein, 363 U.S. 278 (1960). Thus, a jury's finding that the cancellation represented a gift would presumably be conclusive on the issue of donative intent, despite the presence of commercial relations between debtor and creditor.

Section 108 contains no statutory language prohibiting the gift exclusion in the case of debt cancellations. Nevertheless, both the House and the Senate Reports contain the following language: “[I]t is intended that there will not be any gift exception in a commercial context (such as a shareholder-corporation relationship) to the general rule that income is realized on discharge of indebtedness.” H.R. Rep. No. 833, 96th Cong., 2d Sess. 15 (1980); S. Rep. No. 1035, 96th Cong., 2d Sess. 19 (1980).

IX. Discharge of Non-Recourse Debt – No Property Disposition.

As discussed above, where nonrecourse debt is discharged in connection with a disposition of the property which secures the debt, the entire difference between the amount of the debt and the taxpayer's basis in the property is treated as gain from the sale or exchange of property, even if the amount of the debt exceeds the property's fair market value. This section examines the tax consequences of a discharge of nonrecourse debt that is not accompanied by a disposition of the property securing the debt.

Historically, where property was subject to nonrecourse indebtedness, cancellation of the nonrecourse liability for less than its face amount did not result in income to the debtor; instead, the property's basis was reduced by the difference between the face amount and the amount for which the debt was discharged. Hotel Astoria, Inc. v. Comr., 42 B.T.A. 759 (1940). This “no personal liability exception” applied only where the debtor retained the property securing the debt; the exception did not apply where the property was transferred in satisfaction of the debt. In the latter case, the debtor realizes gain from the sale or exchange of the property, rather than debt-discharge income.

In recent cases, the Tax Court has rejected any interpretation that a reduction in the amount of a nonrecourse liability by the holder of the debt (who is not also the seller of the property securing the liability) results in a reduction of the basis in that property, rather than discharge-of-indebtedness income for the year of the reduction. Thus, the Tax Court held in Gershkowitz v. Comr., 88 T.C. 984 (1987), that the settlement of a nonrecourse debt of \$250,000 for a \$40,000 cash payment (rather than surrender of the \$2,500 collateral) resulted in \$210,000 of debt-discharge income. The court held that the discharge from a portion of the liability for an undersecured nonrecourse obligation through a cash settlement must also result in income.

In recent years, the IRS has expressly rejected a “no personal liability exception.” In Rev. Rul. 91-31, the IRS ruled that where a taxpayer is discharged from all or part of nonrecourse liability by a creditor who was not the seller of the secured property, but does not dispose of the property to the creditor, discharge-of-indebtedness income results from the modification of the nonrecourse note.

Example: Assume the taxpayer purchases an office building for \$1 million. In obtaining the purchase funds from a third-party lender, the taxpayer executes a nonrecourse note. When the building's value drops to \$800,000, and the outstanding principal on the note is still \$1 million, the lender agrees to modify the terms of the note's principal amount to \$800,000. The IRS has ruled that, with such modification, the taxpayer realized debt-discharge income of \$200,000.

The debate over the validity of the “no personal liability exception” has lost some of its relevance by the enactment of the exclusion for qualified real property business indebtedness contained in §108(a)(1)(D) and (c). This exclusion gives taxpayers (other than C corporations) that are not in bankruptcy or insolvent the option to reduce the basis of depreciable real property in lieu of recognizing income on account of the discharge of qualified real property business indebtedness. Moreover, even before the enactment of the exclusion for qualified real property business indebtedness, some taxpayers who might have utilized a “no personal liability exception” might also have utilized the “reduction in purchase price exception” of §108(e)(5) discussed below. Thus, in Rev. Rul. 91-31, the IRS specifically noted that the reduction in indebtedness was by a holder who was not the seller of the property, since the “reduction in purchase price exception” presumably applies if the reduction had been by a holder who was the seller.

X. Disputed Debt.

Several cases have held that COD income does not arise when a disputed debt is settled by the debtor and creditor by payment of an amount that is less than the original alleged debt amount, on the rationale that the settlement itself has fixed the amount of the original debt. Sobel v. Comr., 40 B.T.A. 1263 (1939); Zarin v. Comr., 916 F. 2d 110 (3rd Cir. 1990). There is an overlap of the disputed debt exception and the reduction in purchase price exception (discussed below) where the creditor is also the person who sold the property that gave rise to the debt.

The disputed debt exception will not be applied where there is no genuine dispute between the debtor and creditor as to the amount or enforceability of the debt. Marcaccio v. Comr., T.C. Memo 1995-174. In both the Sobel and Zarin cases, the amount of the debt was fixed, but there was a dispute as to the enforceability of the debt. In Sobel, the debt was incurred in exchange for property, and the taxpayer alleged that the seller made misrepresentations in connection with the sale of the property. In Zarin, the debt was a gambling debt, which was not enforceable as a matter of state law. In both instances, the courts held that discharge of indebtedness income did not arise due to the applicability of the disputed debt exception. In Preslar v. Comr., the Tenth Circuit held, in reversing the Tax Court, contrary to Sobel and Zarin, that the disputed debt exception only applies to debts that are not fixed in amount. 167 F.3d 1323 (10th Cir 1999). Since the debt in Preslar was fixed in amount, the court held that the disputed debt exception did not apply.

XI. Reduction in Purchase Price Exception.

A. In General.

Another exception to the general rule of taxation on COD income is the “reduction in purchase price exception”, which has both a judicial and statutory basis.

B. The Judicially Created Exception.

Under the judicially created “reduction in purchase price exception”, the exclusion from taxability only applied to the extent the indebtedness exceeded the value of the acquired property. Helvering v. Killian Co., 128 F.2d 433 (8th Cir. 1942). Accordingly, discharged indebtedness arises to the extent purchase money debt is reduced below the fair market value of the subject property. In addition, the debtor is required to reduce its tax basis in the acquired property, and discharged indebtedness is required to be recognized to the extent basis is not sufficient to absorb the reduction in debt. B.F. Avery & Sons, Inc. v. Comr., 26 B.T.A. 1393.

Example: Tom owns depreciable property encumbered by bank debt of \$100, which was incurred in the acquisition of the property. The fair market value of the property is \$50, and the property has an adjusted basis in Tom's hands of \$30. The bank agrees to reduce its debt to \$50, the fair market value of the property. The “reduction in purchase price exception” applies, since the debt cannot be reduced below the fair market of the property. Nevertheless, Tom's basis is sufficient to absorb only \$30 of the \$50 debt cancellation. Since Tom cannot have a negative basis in the property, Tom realizes \$20 of debt-discharge income in the transaction.

Note that under the exclusion for the discharge of qualified real property indebtedness contained in §108(c) (discussed below), generally the amount excluded cannot exceed the aggregate adjusted bases of all depreciable real property held by the taxpayer immediately before the discharge. In other words, the amount excludible is measured by the aggregate adjusted bases of all depreciable real property owned by the taxpayer, not just the basis of the real property secured by the debt which is discharged as is the case under the judicially created reduction in purchase price exception.

C. The Statutory Exception.

Under §108(e)(5), a reduction in the purchaser's debt to the seller of property is generally treated as a purchase price reduction, as opposed to a debt discharge. Where §108(e)(5) applies, the debtor will not have discharge-of-indebtedness income.

This statutory “reduction in purchase price exception” does not apply when the purchaser is insolvent or in bankruptcy in a title 11 case. §108(e)(5). The Committee Reports state that the reduction in purchase price exception also does not apply if: (1) the seller has assigned the debt (because the reduction is not by the seller of the property); (2) the original debtor has transferred the purchased property (because the debt is not of the purchaser of the property); or (3) a debt is reduced because of factors not involving direct agreements between the buyer and the seller, such as the running of the statute of limitations on enforcement of the obligation. H.R. Rep. No. 833, 96th Cong., 2d Sess., at 13; S. Rep. No. 1035, 96th Cong., 2d Sess., at 16 (1980).

Although the statutory language is silent, it would appear that a basis adjustment to the property is required whenever the statutory reduction in purchase price exception applies. Assuming that a basis adjustment is required where §108(e)(5) applies, a question arises as to whether the debtor is required to recognize income where the amount of the debt reduction

exceeds the debtor's basis in the property. Since the statutory exclusion under §108(e)(5) is not limited by the debtor's basis in the property, it is at least arguable that the debtor is not required to recognize income where the debt reduction exceeds his basis in the property.

In Zarin v. Comr. (discussed above), the Tax Court, with eight judges dissenting, held that gambling chips were not "property" for purposes of §108(e)(5) because what the taxpayer had purchased was the opportunity to gamble, rather than the chips themselves. The taxpayer was, thus, held to realize discharge of indebtedness income upon settlement of a gambling debt for less than the amount owed. On appeal, however, the Tax Court was reversed on the ground that the debt was disputed, so that the amount of the settlement would be treated as the amount of the debt for tax purposes, such that no COD income was realized. 916 F.2d 110 (3d Cir. 1990).

Note that neither the statute nor the legislative history indicates an intention to repeal the judicial exception.

XII. Exclusions from COD Income Where the Debtor Is Insolvent or Is In Bankruptcy.

A. General Overview. The general rule is that a debtor recognizes ordinary income equal to the amount of the debt discharged over the amount of cash and the fair market of any property paid to the creditor. However, there is an important exception to this rule where the debtor is bankrupt or insolvent.

Under Section 108(a)(1), if the debtor is in **bankruptcy**, no debt discharge income is realized. If the debtor is **insolvent**, income **must** be recognized to the extent that the cancelled debt exceeds the amount by which the debtor was insolvent before the discharge. Section 108(a)(3).

Example: Bob has assets worth \$1 Million and debts of \$1.3 Million. So, Bob is "insolvent" to the extent of \$300,000. If Bob's creditors forgive \$400,000 of debt, then Bob must recognize \$100,000 of COD income. However, if Bob was in bankruptcy at the time of the debt forgiveness, Bob would not have any taxable COD income.

Accordingly, there are instances where it may be appropriate to encourage a client to declare bankruptcy, as opposed to relying on the insolvency exception, where there will be a significant amount of discharge of debt.

The taxpayer must be insolvent at the time of the foreclosure, or the foreclosure must occur during bankruptcy to qualify for the exclusions. Thus, if the bankruptcy is filed too late or if the taxpayer has retirement funds or other assets available to satisfy the foreclosure, there can still be enormous and unexpected tax liability arising from the foreclosure.

The application of the bankruptcy and insolvency exclusions is automatic and not elective to the taxpayer. In addition, the exceptions are inapplicable where the income in question, though emanating from the cancellation of debt, is not characterized as income from the discharge of indebtedness. Thus, it has been held that the cancellation of indebtedness in return for the settlement of a damage claim (OKC Corp. v. Comr., 82 T.C. 638 (1984)), for the

surrender of contract rights (Spartan Petroleum Co. v. U.S., 437 F. Supp. 733 (D.S.C. 1977)), or the transfer of property have been held not to give rise to income from the discharge of indebtedness for purposes of §108. Delman Est. v. Comr., 73 T.C. 15 (1979).

If a taxpayer does not realize COD income by virtue of the bankruptcy or insolvency exclusion, the taxpayer must reduce certain tax attributes (such as loss carryforwards and asset basis). Section 108(b); Regs. 1.108-4(a).

B. The Bankruptcy Exception.

Under Section 108(a)(1)(A), gross income does not include discharge-of-indebtedness income if the discharge results in a title 11 case. Section 108(d)(2) provides that the term “title 11 case” means a case under the Bankruptcy Code if: (1) the taxpayer is under the jurisdiction of the court; and (2) the discharge of indebtedness is granted by the court or pursuant to a plan approved by the court. As mentioned above, Section 108(b) specifies that amounts excluded from income under § 108(a)(1)(A) must be applied to reduce certain specified tax attributes.

C. The Insolvency Exception.

Section 108(a)(1)(B) states that gross income does not include amounts otherwise includible in income because of the discharge of indebtedness if the discharge occurs at a time when the taxpayer is insolvent. Under §108(a)(2)(A), the insolvency exclusion does not apply to a discharge that occurs in a bankruptcy case.

Section 108(a)(3) provides that the amount excluded from gross income as a result of the insolvency exclusion cannot exceed the extent of the taxpayer’s insolvency. As mentioned above, the amount excluded must be applied in the reduction of tax attributes under §108(b) similar to the rule for the bankruptcy exclusion. Under Section 108(d)(3), “insolvency” is defined as the excess of the taxpayer’s liabilities over the fair market value of assets, determined on the basis of assets and liabilities immediately before the discharge.

Example: ABC, a debtor corporation, has assets of \$175 and liabilities of \$200. ABC's creditors agree to cancel their indebtedness for ABC's stock worth \$175. ABC has therefore satisfied \$175 of its debt with stock and had \$25 of debt cancelled for no consideration by its creditors. ABC does not realize discharge of indebtedness income because the amount of debt that has been forgiven (\$25) does not exceed the amount by which ABC was insolvent (\$25). If the stock that ABC issued to its creditors were valued at \$150, ABC would realize \$25 of gross income, since the amount of forgiven debt (\$50) exceeds the amount by which it was insolvent (\$25) by \$25.

Section 108(d)(3) does not specify which assets and which liabilities are considered for purposes of determining a taxpayer’s insolvency. Before the enactment of the Bankruptcy Tax Act, the Tax Court held that assets exempt from the claims of creditors are not considered for purposes of determining the debtor's insolvency. Cole v. Comr., 42 B.T.A. 1110 (1940). In Carlson v. Comr., 116 T.C. 87 (2001), the Tax Court held that, under the Bankruptcy Tax Act, **assets exempt from the claims of creditors must be counted** in determining whether the

taxpayer qualifies for the insolvency exception of §108(a)(1)(B). Under the court's reasoning, §108(e)(1) states there is no insolvency exception except as set forth in §108 and thus pre-Bankruptcy Tax Act case law is not controlling. The court also noted that the Bankruptcy Code expressly provides that for purposes of determining whether a debtor in bankruptcy is insolvent, property exempt from the claims of creditors is not taken into account. However, a similar exclusion was not placed in §108(d)(3), which defines insolvency for purposes of §108(a)(1)(B).

In PLR 8920019, the Service ruled that, despite filing a joint return, a spouse's separate assets should not be taken into account in determining whether the other spouse is insolvent for the purpose of §108.

Another factor to consider when evaluating the insolvency exception is whether and to what extent contingent liabilities should be factored in the analysis. In Merkel v. Comr., 192 F.3d 844 (9th Cir. 1999), the Ninth Circuit held that in determining insolvency under §108 a contingent liability should be counted only if the taxpayer proves by a preponderance of the evidence that he or she will be called upon to pay the liability. Thus, the court adopted an all or nothing test.

Another issue to analyze when dealing with the insolvency exception is the extent nonrecourse debt affects the calculation. In Rev. Rul. 92-53, the IRS ruled that the amount by which a nonrecourse debt exceeds the fair market value of the property securing the debt (i.e., excess nonrecourse debt) is factored in to the extent that the excess nonrecourse debt is discharged in determining whether, and to what extent, a taxpayer is insolvent. The ruling also provided that nonrecourse debt is taken into account to the extent of the fair market value of the property securing the debt.

Example (1): Dan borrows \$1 million from Craig and signs a note to repay that amount plus interest at a fixed market rate, payable annually. The note is secured by an office building valued in excess of \$1 million. Dan uses the \$1 million loan proceeds to purchase the building from someone other than Craig. Dan is not personally liable on the note. One year later, when the value of the office building is \$800,000 and the outstanding principal on the note is \$1 million, Craig agrees to modify the terms of the note by reducing the note's principal amount to \$825,000. The modified note bears adequate stated interest within the meaning of §1274(c)(2). At the time of the modification, Dan's only other assets have an aggregate fair market value of \$100,000, and Dan is personally liable to Bob on other indebtedness of \$50,000.

Under these facts, the excess nonrecourse debt is \$200,000. Since \$175,000 of the \$200,000 excess nonrecourse debt is discharged, \$175,000 of the excess nonrecourse debt is taken into account in determining whether Dan is insolvent under §108(d)(3). Dan has liabilities of \$1,025,000, i.e., \$50,000 owed to Bob plus a portion of the nonrecourse debt that is discharged (\$175,000) plus a portion of the nonrecourse debt up to the fair market value of the property securing the debt (\$800,000). Dan's assets total \$900,000. Since Dan's liabilities (\$1,025,000) exceed Dan's assets (\$900,000) by \$125,000 immediately before the indebtedness is discharged, Dan is insolvent to the extent of \$125,000. Thus, Dan must include \$50,000 as income from discharge of indebtedness under §61(a)(12), i.e., the \$175,000 that is discharged less the \$125,000 by which Dan is insolvent.

Example (2): The facts are the same as in Example (1), except that Bob agrees to accept assets from Dan with a fair market value (and basis to Dan) of \$40,000 to settle the \$50,000 recourse debt and that Craig does not reduce Dan's nonrecourse note. Under these facts, the excess nonrecourse debt is not considered in determining whether Dan is insolvent under §108(d)(3). As a result, Dan is solvent immediately before the discharge because Dan's total liabilities — \$800,000 of nonrecourse debt not in excess of the property's fair market value securing the debt plus \$50,000 of recourse debt — do not exceed the \$900,000 fair market value of assets. Accordingly, Dan must include the entire \$10,000 of discharged indebtedness in income under §61(a)(12).

D. Attribute Reduction.

In exchange for the exclusion from gross income where debt is discharged under the bankruptcy or insolvency exceptions, §108(b) requires that the amount excluded from gross income be applied to reduce certain specified tax attributes. With respect to a bankrupt individual, §108(d)(8) provides that the taxpayer is the estate and not the individual debtor for purposes of attribute reduction, except for the purpose of reducing the basis of property transferred by the estate to the debtor.

Attribute reduction is calculated in one of two ways, depending upon whether the taxpayer first elects to reduce the basis of depreciable property under §108(b)(5) (discussed below). If the taxpayer does not first elect to reduce the basis of depreciable property under §108(b)(5), §108(b)(2) provides that the following tax attributes are reduced in the order in which they are listed:

- Any net operating loss for the taxable year of the discharge, and any net operating loss carryover to this taxable year;
- Any carryover to or from the taxable year of the discharge of an amount representing the amount allowable as a general business credit under §38;
- The amount of the minimum tax credit available under §53(b) as of the beginning of the taxable year immediately following the taxable year of the discharge;
- Any net capital loss for the taxable year of the discharge, and any capital loss carryover to such taxable year;
- Basis as provided in §1017;
- Any passive activity loss or credit carryover of the taxpayer under §469(b) from the taxable year of the discharge;
- Any foreign tax credit carryover to or from the taxable year of the discharge.

Section 108(b)(3) provides that the reduction of attributes is made on a dollar-for-dollar basis, except for the reduction of credit carryovers, which is made on the basis of 33 $\frac{1}{3}$ cents for each dollar excluded from income under §108(a). In addition, §108(b)(4)(A) provides that the

reduction in tax attributes is made after the determination of tax for the taxable year of the discharge. Accordingly, tax attributes arising in or carried to the taxable year of the discharge can be used to offset income or tax for the taxable year in which the discharge occurs before they are reduced under §108(b).

Example (1): In a bankruptcy proceeding, there is a discharge in the amount of \$100,000 in the bankruptcy estate's taxable year ending Dec. 31, 2008. Under §108(a)(1)(A), the entire \$100,000 of discharged indebtedness is excluded from the estate's gross income. The estate has taxable income of \$50,000 for 2008 before use of a net operating loss carryover in the amount of \$75,000. Under §108(b)(4)(A), the \$75,000 carryover is first applied to eliminate the estate's taxable income of \$50,000. Under §108(b)(2)(A), the \$100,000 of discharged indebtedness is then applied to eliminate the remaining \$25,000 of the carryover.

Under §108(b)(4)(B), net operating and capital losses are reduced before net operating loss and capital loss carryovers, and carryovers are reduced in the order of the taxable years from which the carryovers arose.

Example (2): In a proceeding under Chapter 11 of the Bankruptcy Code, there is a discharge of \$100,000 in the bankruptcy estate's taxable year ending Dec. 31, 2008. The estate has a net operating loss of \$50,000 for its taxable year ending Dec. 31, 2008, and net operating loss carryovers of \$25,000 and \$50,000 for its taxable years ending Dec. 31, 2006, and Dec. 31, 2007, respectively. Under §108(b)(4)(B), the \$100,000 of discharged indebtedness is first applied against the \$50,000 net operating loss for the estate's taxable year ending Dec. 31, 2008. The remaining \$50,000 of discharged indebtedness is then applied to eliminate the \$25,000 carryover from 2006, and then applied to reduce the \$50,000 carryover from 2007 to \$25,000.

E. Basis Reduction.

(1) In General

Section 1017(a) provides that the amount excluded from gross income under §108(a), which is applied in reduction of basis under §108(b)(2)(E) or (b)(5), is applied in reduction of the basis of any property held by the taxpayer at the beginning of the taxable year following the taxable year of discharge. Under §1017(c), no reduction is made in the basis of property that the debtor treats as exempt property under Bankruptcy Code §522.

The fact that basis reduction will not take place until the taxable year subsequent to the taxable year of the discharge provides significant planning possibilities. The bases of any assets disposed of during the taxable year in which discharge occurs are not subject to reduction under §108(b). In addition, no basis reduction occurs where an asset is sold during the taxable year of the discharge and the proceeds are reinvested after the beginning of the taxable year following the taxable year of the discharge, assuming it is not a sham transaction.

Example: A calendar year corporation (ABC) is in bankruptcy under Chapter 11. In 2008, ABC has debts of \$300, a net operating loss (NOL) carryover of \$100 and property with a basis and fair market value of \$100. In 2008, ABC's plan of reorganization is confirmed, and ABC is discharged from \$200 of indebtedness. After reducing ABC's

NOL to zero, the remaining discharge amount of \$100 is applied to reduce the property's basis to zero on Jan. 1, 2009 if ABC continues to hold the property on this date. On a later sale of the property, ABC realizes taxable gain on account of the reduction in basis, assuming the property has not decreased in value. If ABC sells the property for its fair market value in 2008, however, ABC realizes no gain on the sale of the property because its basis is not reduced on account of the discharge of indebtedness.

With respect to an individual in bankruptcy, the basis reduction takes effect on the first day of the taxable year following the year of discharge. If discharge of debt occurs in the final year of bankruptcy, the basis reduction is made on the bases of any assets transferred to the debtor from the estate. The basis reduction takes place when the property is distributed because in the final year of the bankruptcy estate there would be no taxable year of the bankruptcy estate following the taxable year of the discharge.

Example: In the last year of the bankruptcy estate of an individual in bankruptcy under Chapter 7 or 11 of the Bankruptcy Code, the estate receives a discharge of \$100x and transfers its remaining property with a basis of \$50x to the individual. The estate applies \$60x of the discharged indebtedness to reduce its tax attributes. The individual must apply the remaining \$40x of discharged indebtedness to reduce the basis of the property transferred from the bankruptcy estate to \$10x at the time when the property is transferred.

(2) Ordering Rules

With respect to debt discharged on or after October 22, 1998, the basis reductions under §108(b)(2)(E) are accomplished under ordering rules set forth in Regs. §1.1017-1. A taxpayer must reduce in the following order, to the extent of excluded discharge-of-indebtedness income (but not below zero), the adjusted bases of property held on the first day of the taxable year following the taxable year that the taxpayer excluded discharge-of-indebtedness income from gross income (in proportion to adjusted basis):

- Real property used in a trade or business or held for investment (other than §1221(1) real property, held for sale to customers in the ordinary course of business) that secured the discharged indebtedness immediately before the discharge;
- Personal property used in a trade or business or held for investment, but not inventory, accounts receivable, or notes receivable, that secured the indebtedness immediately before the discharge;
- Remaining property used in a trade or business or held for investment, but not inventory, accounts receivable, notes receivable, or §1221(1) real property, held for sale to customers in the ordinary course of business;
- Inventory, accounts receivable, notes receivable, and §1221(1) real property, held for sale to customers in the ordinary course of business; and
- Property not used in a trade or business nor held for investment.

(3) Recapture Rule

Section 1017(d) provides a “recapture” rule for property whose basis is reduced under §1017. The recapture rule is that, for purposes of §§1245 and 1250, any reduction in basis is treated as a deduction allowed for depreciation, and property that is not §1245 or §1250 property is treated as §1245 property. As such, where any depreciable or nondepreciable property whose basis has been reduced under §1017 is subsequently sold in a transaction that would trigger recapture under §1245 or §1250 (were the property §1245 or §1250 property), any portion of the gain attributable to basis reduction is ordinary income.

Example: Tim owns stock, with a basis of \$100. Pursuant to §108(b)(2)(D), the stock's basis is reduced to \$50. The stock is later sold for \$125. Under §1017(d), the share of stock is treated as §1245 property, and the \$50 basis reduction is treated as a deduction for depreciation. On the sale of the stock, \$50 of the \$75 gain (the amount by which basis was reduced) is ordinary income to Tim under §1017(d). If instead, the stock is sold for \$75, the entire amount of the gain (\$25) is ordinary income under §1017(d).

(4) Election to First Reduce Basis of Depreciable Property

As an alternative to the reduction of attributes in the order specified in §108(b)(2), the taxpayer can elect under §108(b)(5) to reduce the basis of depreciable property before reducing other attributes. The election is made by completing and attaching Form 982 to the tax return for the year in which the discharge occurs. If the election to reduce the basis of depreciable property before other attributes is made, other attributes including the taxpayer's basis in nondepreciable property are reduced in the order specified in § 108(b)(2) after the reduction in basis of depreciable property.

Example: Corporation X, a calendar year corporation, is in bankruptcy under Chapter 11. On the confirmation of its plan on July 31, 2008, Corporation X is discharged from \$1 million of indebtedness. For the year of the discharge, X has a net operating loss of \$500,000 and a net operating loss carryover of \$600,000. X also holds depreciable property as of the beginning of its taxable year following the year of the discharge (Jan. 1, 2009) of \$1.5 million. Corporation X has no other attributes subject to reduction under §108(b). If X does not make the election to first reduce the basis of depreciable property, its net operating loss is eliminated and its net operating loss carryovers reduced to \$100,000 in the order prescribed by §108(b)(4)(B). X's basis in its depreciable property remains intact. On the other hand, if X makes the election to first reduce the basis of depreciable property under §108(b)(5), its net operating loss and net operating loss carryovers are preserved, but its basis in its depreciable property is reduced to \$500,000. Because the election to first reduce the basis of depreciable property applies to property held as of the beginning of the taxable year following the taxable year of the discharge, in the example above the basis of depreciable property disposed of before January 1, 2009, is not reduced.

F. Corporations, Partnerships and LLCs: Who Must Be Insolvent or in Bankruptcy?

Different rules apply depending upon whether the taxpayer is a partnership (including an LLC) or a corporation. If the debtor is a corporation, the cancellation of indebtedness income issue is determined based upon whether the corporation is solvent or insolvent, and the solvency

or insolvency or bankruptcy status of the corporation's shareholders is irrelevant. Section 108(d)(7). In that case, the corporation must reduce its basis in its assets by the amount of the cancelled debt. Section 108(d)(7)(A). Or, in the case of S corporations, the S corporation shareholders may be required to reduce any suspended losses in excess of their tax basis in their S corporation stock. Section 108(d)(7)(B).

A different rule applies where the taxpayer is a partnership or an LLC. Where the taxpayer-debtor is a partnership or LLC, the cancellation of indebtedness income is passed through to the partners and LLC members and the availability of the bankruptcy or insolvency exception is determined at the partner or member level. Section 108(d)(6).

Let's look at some examples:

1. S Corporations. Let's assume Allen and Barry form an S Corporation as a 50/50 S Corporation. The S Corporation files bankruptcy and has COD income. Here, the indebtedness discharged is determined by the corporate bankruptcy at the corporate bankruptcy level. This means that, under IRC §108(d)(7), Allen and Barry do not have any COD income to recognize since their S corporation was insolvent or bankrupt. However, Allen and Barry must reduce their tax attributes by the excluded COD income, such as reducing their basis in S corporation assets or by reducing any suspended loss carryovers to the extent that they have loss carryovers in excess of their available tax basis in their S corporation stock or their loans to the S Corporation.

2. A Bankrupt Disregarded Entity. Let's now assume that Steve is the sole owner of an LLC which is a disregarded entity for federal income tax purposes under Section 301.7701-2(a). Here, the single-member LLC is bankrupt, but Steve is solvent or has not declared bankruptcy himself. Under PLR 200652017, the IRS takes the position that Steve must recognize COD income since he is not bankrupt or insolvent.

3. General Partnership Example. Let's assume that Tom and Bob create an equal 50/50 partnership which files a bankruptcy petition and obtains a discharge of partnership liability. Let's also assume that Tom is bankrupt or insolvent, but that Bob is solvent. In this case, under Section 108(d)(6), qualification for the exclusion of COD income is determined at the partner and not partnership level. Therefore, Tom's COD income is not taxable since he is bankrupt, but Bob's share of taxable income must be recognized as ordinary income unless he can avail himself of another Section 108 exclusion, such as the exclusion for discharge of qualified real property business debt under Section 108(a)(1)(D).

G. Can the Partners Change the Tax Consequences by Allocating COD Income to the Insolvent Partner?

Generally, tax allocations in a Partnership Agreement or an amendment (executed before April 15 of the next tax year) will be respected as long as the tax allocations have "substantial economic effect." So, you may wonder if you can amend a partnership or LLC agreement so as to allocate COD income to the insolvent partner for tax purposes. Unfortunately, the case of Gershowitz vs. Commissioner (88 TC 984 (1987)) and Revenue Ruling 99-43 (1999-2 C.B. 506)

provided that special allocations of COD income to an insolvent partner lack "substantial economic effect" unless the insolvent partner will also be allocated an increase in his right to capital account distributions by the amount of the COD income.

H. When Is An Individual Insolvent?

As indicated above, for individual taxpayers and for partnerships or LLC's, the insolvency exception only applies where the individual is insolvent. Again, the COD income test is applied at the partner or member level for a general partnership or LLC. Therefore, if that partner or member is not bankrupt, we need to determine whether he or she is insolvent for purposes of applying the insolvency exception.

This can be a very tricky analysis. In TAM 199935002, the IRS Chief Counsel stated that exempt assets for bankruptcy purposes should be included as "assets" for insolvency calculation. Therefore, it is quite likely that the IRS will argue that certain assets of the taxpayer which are exempt from creditor claims (such as IRAs, tenants by the entirety real property and 401(k) plan balances) must be included as countable assets for purposes of determining the insolvency exception.

Likewise, in Merkel v. Commissioner, 109 TC 463 (1997), the Tax Court concluded that the contingent liabilities of the taxpayer corporation (under the guaranteed debt and sales taxes) should not be taken into consideration in calculating the taxpayers' insolvency, unless the taxpayers could prove that it was **more likely than not** that the taxpayers would indeed be held liable for the contingent liabilities.

XIII. Making the Election to Reduce a Taxpayer's Basis in Property Instead of Recognizing Debt Discharge Income.

A. General Overview. Under the tax rules, a taxpayer, other than a C corporation, may elect to exclude the discharge of indebtedness income from gross income to the extent that the discharged debt is "qualified real property business indebtedness." Section 108(c)(3). Qualified real property business indebtedness (QRPBI) is indebtedness which:

- (a) was incurred or assumed by the taxpayer in connection with real property used in a trade or business and which debt is secured by such real property;
- (b) was incurred or assumed before January 1, 1993, or if incurred or assumed on or after January 1, 1993, is "qualified acquisition indebtedness"; and
- (c) with respect to which the taxpayer files the required election with the IRS.

Section 108(c)(3).

"Qualified acquisition indebtedness" means indebtedness incurred or assumed to acquire, construct, re-construct or substantially improve the property securing the debt. IRC §108(c)(4). The amount of QRPBI debt that can be excluded from gross income is limited to the excess of

the outstanding principal amount of all QRPBI debt secured by the property (immediately before the discharge) over the fair market value of the property immediately before the discharge. Section 108(c)(2)(A); Regs. 1.108-6(b).

B. Reducing Tax Attributes.

In those cases, where the taxpayer makes an election to exclude the discharged QRPBI from gross income, the taxpayer must reduce its basis in depreciable real property which can include reducing the portion of the taxpayer's basis in his partnership interest attributable to the partnership's depreciable real property and making a corresponding reduction in his share of the partnership's basis in a depreciable real property. Section 1017(b)(3); Regs. 1.1017-1(a) and (g).

The reduction in basis is treated as additional depreciation for purposes of Section 1250. IRC §1017(b). This means that the excluded discharge of indebtedness will be offset by some combination of (1) foregone depreciation deductions, (2) ordinary income on the sale or disposition, and (3) reduced Section 1231 loss treatment on a sale. **Of course, if a taxpayer dies while holding the qualified real property, his heirs will receive an income tax basis step-up on death under Section 1014.**

C. Partnership Treatment.

Unlike the case with individuals or S corporations, in the case of a partnership, the determination as to whether the discharged indebtedness is QRPBI (and the amount by which the principal amount of the QRPBI exceeded the fair market value of the property) would have to be determined at the partnership level. However, the election to exclude QRPBI debt is made by an individual partner. IRC §108(d)(6).

D. Making the Election to Reduce Basis.

In order to make an election to reduce basis, the taxpayer must file with the IRS a completed Form 982 which must be made on a timely-filed income tax return for the taxable year in which the taxpayer has discharge of indebtedness income that is excludable under Section 108(a), including extensions. If the taxpayer fails to make the election on that return, the taxpayer must request the Commissioner's consent to file late election under Reg. §301.9100-1 through -3; Reg. §1.108-5.

XIV. New Tax Relief for Residential Foreclosures

In recent years, with the escalating value of homes, many people have bought more "house" than they could afford and others have sought to refinance their homes in order to "pull out" attractive equity.

On December 20, 2007, the Mortgage Forgiveness Debt Relief Act of 2007 became law. Before this new law, cancellation of debt from foreclosure of homes or from short sales of homes (sale of a home for less than the amount of the debt owed) generally resulted in additional tax liability equal to the difference between what the home was sold for and the amount of the total

debt. Short sales have been particularly troublesome to taxpayers. With a short sale, the homeowner makes arrangements to sell the house for less than the actual mortgage amount.

In these cases, the taxpayer has a terrible credit rating problem and, in addition, the taxpayer is left with a tax bill arising from the COD income by virtue of the short sale or foreclosure.

Under the new Mortgage Forgiveness Debt Relief Act of 2007 (PL 110-142), up to \$2 Million (\$1 Million for married individuals filing separately) of cancellation of indebtedness income is not taxed if the indebtedness is "qualified principal residence" that is discharged in 2007, 2008 or 2009. Section 108(a)(1)(E), added by PL 110-142. Note this relief has been extended through December 31, 2012 by the Emergency Economic Stabilization Act of 2008. This is great news for many homeowners caught in the sub-prime market trap.

The new rules initially provided that relief from debt stemming from foreclosure of a personal residence, to the extent that the debt was incurred to buy or improve a home, will now be excluded from taxable income if the foreclosure occurs between January 1, 2007 and December 31, 2009. The recent passage of the Emergency Economic Stabilization Act of 2008 has extended the exclusion through 2012.

Under Section 108(a)(1)(E), the excluded will reduce the basis of the taxpayer's principal residence.

Note that this exception does not apply to a loan that is discharged because of services performed for the lender or for any other reason not directly related to a decline in the residence's value or to the worsening of the taxpayer's financial condition. §108(h)(3). When a discharged loan is comprised only partially of qualified principal residence indebtedness, the exception only applies to that portion. §108(h)(4). The insolvency exception may not apply in lieu of the qualified principal residence indebtedness exception, unless the taxpayer so elects. §108(a)(2)(C).

XV. Exceptions to New IRC Section 108(a)(1)(E) Rules.

However, there are many exceptions to the new laws.

A. Exclusion Limit. First of all, the limits are \$2 Million for joint taxpayers and \$1 Million for married taxpayers filing separately.

Note, however, that no period of ownership or use is needed to use the principal gain exclusion of debt forgiveness income under Section 108(a)(1)(E), in contrast to the Section 121 rule for gain exclusion on the sale of a principal residence.

Example: Eve purchased her main home in 2006 and has a \$310,000 mortgage debt. Eve is unable to make her mortgage payments and her lender ultimately forecloses in early 2008 when her mortgage debt has been paid down to \$300,000. The lender sells the home for

\$240,000 in satisfaction of the debt later that year. Eve has \$60,000 in income from the discharge of indebtedness. Eve may exclude this \$60,000 under Section 108(a)(1)(E).

Example: The Smiths have a \$2.2 million mortgage taken on a home that was worth \$2.3 million at closing, but now has a fair market value of only \$1.95 million. The mortgagee forecloses and forgives the \$150,000 mortgage amount in excess of the fair market value (at foreclosure, the Smith had already paid the debt down to \$2.1 million). The Smiths may exclude only \$50,000 of the forgiveness amount under the new law. Because the existing mortgage of \$2.1 million is \$100,000 over the \$2 million limit, that \$100,000 cannot be excluded by the qualified residence exclusion.

Example: The Smiths find themselves unable to keep up with their \$4,000 per month mortgage payments on their principal residence. They been paying \$2,200 a month on an adjustable rate mortgage that they had planned to refinance before the higher interest rate kicked in. Unfortunately, their home is now worth less than the remaining mortgage total and thus they cannot refinance. Nevertheless, their current mortgage holder is willing to drop the mortgage amount by \$100,000 (which would reduce payments to \$3,000 per month) rather than face holding a house it cannot sell. If the Smiths had purchased the home for \$400,000 which was their basis in the property, they must reduce their basis by \$100,000, the amount of debt forgiveness income excluded under the principal residence exclusion. Assume further that five years from now, Mrs. Smith, who is now the sole owner because of a divorce settlement, sells the home for \$825,000. With a basis of \$300,000, she will realize \$525,000 in gain, of which \$250,000 is excluded under Section 121.

B. Only Debt to Purchase or Improve a Home Will Qualify For Exclusion.

Second, the new law only provides relief for debt incurred to buy or improve a property or to refinance debt that previously was used to buy or improve a home. So, home equity loans will not be protected from the new relief rules. So, when calculating the amount of forgiven debt that is covered by the new exclusion rules, any debt not used to buy or improve the principal residence will continue to be considered as income to the foreclosed homeowner. This means that forgiven equity lines and many second mortgages will still be subject to the taxable income rules.

C. Second Homes, Vacation Homes and Business and Investment Property Are Not Eligible for the Exclusion. Finally, second homes, vacation homes and business and investment property are not included in the forgiveness rules. Instead, the new rules only apply to debts secured against the **qualified principal residence** of the taxpayer. If a taxpayer has two homes, only the home that is used the majority of the time will qualify for the new forgiveness debt rules.

D. Bankruptcy and Insolvency Exception Still May Be Available. Of course, the bankruptcy and insolvency exceptions to the COD income rules are still available. However, the taxpayer must be insolvent at the time of the foreclosure, or the foreclosure must occur after or during bankruptcy to qualify for the exclusions. Thus, if the bankruptcy is filed too late or if the taxpayer has retirement funds or other assets available to satisfy the foreclosure, there can still be enormous and unexpected tax liability arising from the foreclosure.

XVI. Creditor and Debtor Reporting Requirements.

As discussed below, the creditor will send the homeowner and the IRS a Form 1099-C, Cancellation of Debt Form, to report the amount of the forgiven debt. In order to exclude the COD income from taxable income, the taxpayer-homeowner must file a **Form 982**, Reduction of Tax Attributes Due to Discharge of Indebtedness, with the IRS to claim the exclusion of forgiveness of debt income.

XVII. Reduction of Tax Attributes.

If debt is discharged under new Section 108(a)(1)(E) and the taxpayer keeps his home, the taxpayer must reduce his tax basis in the home by the amount of the released debt. Note, however, this basis reduction does not usually hurt the homeowner at all because any gain realized on the sale of the residence is typically sheltered by the Code Section 121 home sale exclusion of \$250,000 (\$500,000 for joint filers).

XVIII. General Creditor Reporting Requirements .

A. In General.

Except as provided in the applicable Regulations, Section 6050P requires an information return (IRS Form 1099-C) to be filed by an applicable entity, including an applicable financial entity, that discharges indebtedness of any person if the amount discharged is \$600 or more. Section Section 6050P(c)(2) provides that an applicable financial entity includes:

- (1) any financial institution described in §581 or §591(a), and any credit union;
- (2) the FDIC, RTC, NCUA, and any other federal executive agency, and any successor or subunit of such;
- (3) any other corporation which is a direct or indirect subsidiary of such entity but only if, by virtue of being affiliated with the entity, the corporation is subject to supervision and examination by a federal or state agency which regulates such other entities; and
- (4) organizations significantly engaged in the trade or business of lending money.

The report must be made on Form 1099-C on or before February 28 of the year following the year of discharge, or March 31 if filed electronically.

B. Identifiable Events.

The regulations require the reporting of discharge of indebtedness on the occurrence of an “identifiable event” indicating that the debt will never have to be repaid, and provide an

exclusive list of eight identifiable events without which reporting of a discharge of indebtedness is not required. The eight events are as follows:

- (1) Discharges of indebtedness in bankruptcy under the Bankruptcy Code, provided that the creditor knows that the debtor incurred the discharged indebtedness for business or investment purposes (i.e., information reporting is not required in bankruptcy cases where the creditor is not aware of the purpose for the borrowing or where the debt is consumer debt).
- (2) Discharges outside bankruptcy in receivership, foreclosure, or similar proceedings in either federal or state court.
- (3) Expiration of the statute of limitations for collecting the indebtedness, provided that the debtor's affirmative defense that the limitations period has expired is upheld in a final judgment and the time for appeal has expired.
- (4) Cancellation or extinguishment of indebtedness arising from the creditor's election to pursue foreclosure that statutorily extinguishes its right to pursue further collection.
- (5) Cancellation or extinguishment of a debt pursuant to a probate or similar proceeding.
- (6) Discharge for less than full consideration pursuant to an agreement between the creditor and debtor — i.e., an agreement to discharge the debt.
- (7) Discharge pursuant to a decision by the creditor or the application of a defined policy of the creditor to discontinue collection activity and discharge the debt.
- (8) Expiration of a non-payment testing period during which no payment has been made. The testing period is 36 months, increased by the number of months the creditor was precluded from engaging in collection activity by a stay in bankruptcy or a similar bar under local law. This provides a rebuttable presumption that if no payment has been received at any time during the testing period, an identifiable event has occurred. The presumption can be rebutted if the creditor has engaged in significant collection activity (more than just automated mailing or other nominal acts) during the last 12 months of the 36-month period.

XIX. Conclusion.

Most homeowners and debtors generally are in a state of panic when a foreclosure looms on the horizon. As such, it is important to have a tax advisor who understands and is well-versed in the various discharge of indebtedness income rules, as well as the nuances and planning opportunities related to such rules. Hopefully, this paper has provided the reader with some insight into how to more appropriately assist a client navigate through these tumultuous economic times.