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CANCELLATION OF DEBT: TAX EFFECTS

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A CLE Presentation

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Section 61 of Internal Revenue Code

(a) Except as otherwise provided in this subtitle, gross income means all income from whatever source derived, including (but not limited to) the following items:

- (12) Income from discharge of indebtedness

Section 108 of Internal Revenue Code

(a) Exclusion from gross income—

(1) In general. Gross income does not include any amount which (but for this subsection) would be includible in gross income by reason of the discharge (in whole or in part) of indebtedness of the taxpayer if—

- (A) the discharge occurs in a title 11 case,
- (B) the discharge occurs when the taxpayer is insolvent,
- (C) the indebtedness discharged is qualified farm indebtedness, or
- (D) in the case of a taxpayer other than a C corporation, the indebtedness discharge is qualified real property business indebtedness...

(b) Reduction of tax attributes—

(1) In general. The amount excluded from gross income under subparagraph (A), (B), or (C) of subsection (a)(1) shall be applied to reduce the tax attributes of the taxpayer as provided in paragraph (2).

(2) Tax attributes affected; order of reduction. Except as provided in paragraph (5), the reduction referred to in paragraph (1) shall be made in the following tax attributes in the following order:

- (A) NOL. Any net operating loss for the taxable year of the discharge, and any net operating loss carryover to such taxable year.
- (B) General business credit. Any carryover to or from the taxable year of a discharge of an amount for purposes for determining the amount allowable as a credit under section 38 (relating to general business credit).
- (C) Minimum tax credit. The amount of the minimum tax credit available under section 53(b) as of the beginning of the taxable year immediately following the taxable year of the discharge.
- (D) Capital loss carryovers. Any net capital loss for the taxable year of the discharge, and any capital loss carryover to such taxable year under section 1212.
- (E) Basis reduction.

- (i) In general. The basis of the property of the taxpayer.
 - (ii) Cross reference. For provisions for making the reduction described in clause (i), see section 1017.
- (F) Passive activity loss and credit carryovers. Any passive activity loss or credit carryover of the taxpayer under section 469(b) from the taxable year of the discharge.
- (G) Foreign tax credit carryovers. Any carryover to or from the taxable year of the discharge for purposes of determining the amount of the credit allowable under section 27.

Introduction

Under the general principles of income recognition, the borrowing of money is not a taxable event, because the borrower has assumed an obligation to repay the debt in full at a later date. However, when that debt is cancelled or discharged, then section 61(a)(12) of the Internal Revenue Code (IRC) will apply. Gross income is defined as “all income whatever sources derived,” and section 61(a) lists items that are considered gross income. Section 61(a)(12) states that “income from discharge of indebtedness” is included in gross income. 26 U.S.C. § 61(a)(12).

Whenever a taxpayer, who had incurred a financial obligation, is relieved of liability, in whole or in part, the discharge of indebtedness income doctrine is applicable. At this point, the taxpayer recognizes income “equal to the difference between the initial obligation and the amount, if any, paid to discharge that obligation.” *Smith v. Commissioner*. 198 F.3d 515, at 530 (5th Cir. 1999).

The cancellation of indebtedness may include situations where a debtor performs a service for a creditor, who in turn cancels the debt, then the debtor realizes as gross income the amount of the debt as compensation for the services. 26 CFR 1.161-12(a). In addition, income may be realized by the payment or purchase of obligations at less than their face value. 26 CFR 1.161-12(a).

There are two rationales for the discharge of indebtedness rule, these were stated in *Preslar v. Commissioner*, 167 F.3d 1323, 1330 (10th Cir. 1999). The first rationale is that the rule is “based on the premise that the taxpayer has an increase in wealth due to the reduction in valid claims against the taxpayer's assets.” *Id.*, at 1327. Another rationale that has been suggested is that “taxation is appropriate because the consideration received by a taxpayer in exchange for [his] indebtedness is not included in income when received because of the obligation to repay and the cancellation of that obligation removes the reason for the original exclusion.” *Id.*

There are ways for a taxpayer to reduce this discharge of indebtedness income, such as purchase price adjustment discussed below. In addition, section 108(a)(1) of the IRC lists four exceptions, where discharge of indebtedness income may be excluded from gross income, and any income received from a discharge of liability would not be subject to income taxation.

Debts Forgiven

In order for discharge of indebtedness income to occur, the taxpayer, who had incurred a financial obligation, must be discharged from liability, whether in whole or in part, or has compromised or settled the debt for less than the face amount, or amount due. "Indebtedness" is defined as, "an obligation, absolute and not contingent, to pay on demand or within a given time, in cash or another medium, a fixed amount." *Preslar*, at 1330.

A debt is viewed as being discharged, for the purposes of section 61(a)(12) of the IRC, "when it becomes clear that the debt will never have to be paid." *Friedman v. Commissioner*, 216 F.3d 537, 546 (6th Cir. 2000). The test that the court used in *Friedman* to determine whether a debt was discharged, was also used in *Brountas v. Commissioner* 74 T.C. 1062 (1980). Whether it is "absolutely impossible" for a debt to be repaid is based on the practical worthlessness of a debt, it is not necessarily the point at which a creditor could deduct for a bad debt. *Brountas* at 1074. The test for when a debt is viewed as being discharged is "when only an incorrigible optimist would expect repayment." *Id.* In addition, in *Cozzi v. Commissioner*, 88 T.C. 435 (1987), the court held that whether a debt has been discharged, "is dependent on the substance of the transactions. Mere formalisms arranged by the parties are not binding in the application of the tax laws." *Cozzi* at 445. Further, "[a]ny 'identifiable event' which fixes the loss with certainty may be taken into consideration." *Id.* at 445.

Contested Liability/Disputed Debt Exception

The contested liability exception to discharge of indebtedness income, or COD income, is based on the premise that "if a taxpayer disputes the *original amount* of a debt in good faith, a subsequent settlement of that dispute is 'treated as the amount of debt cognizable for tax purposes.'" *Preslar* at 1327. If this exception is applicable, then "the 'excess of the original debt over the amount determined to have been due' may be disregarded in calculating gross income." *Id.* According to the *Preslar* court, "[t]he few decisions that have interpreted this doctrine have generated considerable controversy." *Id.*

For example, the Third Circuit in *Zarin v. Commissioner*, 916 F.2d 110 (3d Cir. 1990), held that Zarin had no COD income because his transaction arose from a contested liability. The *Preslar* court criticized *Zarin* because the Third Circuit failed to distinguish between liquidated and unliquidated debts, instead treating them alike. *Preslar* at 1328. In addition, the court in *Zarin* did

not recognize the difference between disputes about the amount of debt, and the enforceability of a claim for a certain sum.

The court in *Preslar* states that the “mere fact that a taxpayer challenges the enforceability of a debt in good faith does not necessarily mean he or she is shielded from discharge-of-indebtedness income upon resolution of the dispute.” *Id.* Further, the court held that in order to utilize this contested liability doctrine, the original amount of the debt must be unliquidated. *Id.*

There might be a situation, as found in *Exchange Sec. Bank v. United States*, 345 F. Supp. 486 (N.D. Ala. 1972), in which a debtor may actually owe the debt, and the creditor, knowing that debtor will deny liability, wants to settle, to save time and expense of litigation, and will accept a smaller payment than actually owed. In addition, if there are real problems of proof or collectibility, the creditor might even dismiss the suit without any payment. In these types of situations, the debtor would realize discharge of indebtedness income, “subject to the ‘insolvency’ and ‘gift’ exceptions.” *Id.* at 491. Essentially, the settlement of a contested liability or disputed debt “may or may not result in cancellation-type income.” *Id.*

Purchase Price Adjustment Exception

In addition to the contested liability exception, section 108(e)(5) carves out another way for a taxpayer to avoid discharge of indebtedness income. Basically this rule allows the taxpayer to “reflect their debt reduction by adjusting the basis of their property rather than recognizing an immediate gain as cancellation of indebtedness.” *Preslar*, at 1331. There is a purchase-money debt reduction for a solvent debtor treated as a price reduction if “the debt of a purchaser of property to the seller of such property which arose out of the purchase of such property is reduced, such reduction does not occur—in a title 11 case, or when the purchaser is insolvent, and but for this paragraph, such reduction would be treated as income to the purchaser from the discharge of indebtedness, then such reduction shall be treated as a purchase price adjustment.” 26 U.S.C. § 108(e)(5). The court in *Preslar* noted that this section only applies “to direct agreements between a purchaser and seller.” *Preslar* at 1331.

In limited circumstances, the purchase price adjustment is available in a situation besides the direct seller-purchaser transaction. This is the “infirmary exception,” which allows a taxpayer to “treat debt reductions negotiated with third parties as purchase price adjustments ‘to the extent that the debt reduction by the third-party lender is based on an infirmity that clearly relates back to the original sale (e.g., the seller’s inducement of a higher purchase price by misrepresentation of material fact or by fraud).” *Id.* at 1333.

Section 108(a)(1) Exceptions

Bankruptcy

According to section 108(a)(1)(A) of the IRC, income is not realized by a taxpayer who receives a discharge of indebtedness under a title 11 case. Section 108(d)(2) of the IRC, a “title 11 case” is as “a case under title 11 of the United States Code (relating to bankruptcy), but only if the taxpayer is under the jurisdiction of the court in such case and the discharge of indebtedness is granted by the court or is pursuant to a plan approved by the court.” 26 U.S.C. § 108(d)(2).

In any case under chapter 7 or 11 of title 11 of the United States Code, to which section 1398 of the IRC applies, for purposes of section 108(b)(1) of the IRC, the estate (not the individual) shall be treated as the taxpayer. 26 U.S.C. § 108(d)(8). This refers to the reduction of tax attributes in title 11 cases of individuals to be made by the estate.

Insolvency

There is an insolvency exception to the general rule of taxability of a discharge of indebtedness. It applies when the borrower is insolvent, both before and after the forgiveness of debt. As a result, the debtor will not recognize income under section 61(a)(12). However, if the discharge makes the debtor solvent, the debtor must recognize income to the extent that the debtor is solvent after the debt reduction.

The term “insolvent” is defined in section 108(d)(3) of the IRC, as “the excess of liabilities over the fair market value of assets. With respect to any discharge, whether or not the taxpayer is insolvent, and the amount by which the taxpayer is insolvent, shall be determined on the basis of the taxpayer’s assets and liabilities immediately before the discharge.” The term “liabilities” is not defined in the IRC, and section 108(d)(3) does not state how likely the occurrence of a contingency must be in order for the obligation to count as a liability. According to Black’s Law Dictionary, “liability” is broadly defined, “including almost every character of hazard or responsibility, absolute, contingent, or likely.” *Black’s Law Dictionary* 914 (6th ed. 1990).

Now the question is just how remote of a contingency should be taken into consideration in determining insolvency. According to the Ninth Circuit in *Merkel v. Commissioner*, 192 F.3d 844 (9th Cir. 1999), if all contingent liabilities were included in the calculation of insolvency, no matter how remote, this “could lead to the absurd result of the insolvency exception swallowing the general rule that discharge of indebtedness income be included in gross income.” *Id.* at 848. The court in *Merkel* held that a taxpayer claiming to be insolvent under section 108(a)(1)(B) of the IRC, must “prove by a preponderance of the evidence that he or she will be called upon to pay an obligation claimed to be a liability and that the total amount of liabilities so proved exceed the fair market value of his or her assets.” *Id.* at 850.

If a taxpayer is allowed to exclude discharge of indebtedness income because of the insolvency exception, any tax attributes that the taxpayer has in relation to the debt must be reduced by the amount of the exclusion.

Qualified Farm Indebtedness

There are special rules for the discharge of qualified farm indebtedness. See *26 U.S.C. § 108(g)*. First, in order for section 108(a)(1)(C) to apply, the discharge must be by a qualified person. A “qualified person” is defined as “any person which is actively and regularly engaged in the business of lending money and which is not-- (I) a related person with respect to the taxpayer, (II) a person from which the taxpayer acquired the property (or a related person to such person), or (III) a person who receives a fee with respect to the taxpayer's investment in the property (or a related person to such person).” *26 U.S.C. 49(a)(1)(D)(iv)*. According to section 108(g)(1)(B), the term “qualified person” includes “any Federal, State, or local government or agency or instrumentality thereof.” *26 U.S.C. § 108(g)(1)(B)*.

The indebtedness of a taxpayer is treated as “qualified farm indebtedness” if, “(A) such indebtedness was incurred directly in connection with the operation by the taxpayer of the trade or business of farming, and (B) 50 percent or more of the aggregate gross receipts of the taxpayer for the 3 taxable years preceding the taxable year in which the discharge of such indebtedness occurs is attributable to the trade or business of farming.” *26 U.S.C. § 108(g)(2)*.

In general, the amount excluded under section 108(a)(1)(C), shall not exceed the sum of, “(i) the adjusted tax attributes of the taxpayer, and (ii) the aggregate adjusted bases of qualified property held by the taxpayer as of the beginning of the taxable year following the taxable year in which the discharge occurs.” *26 U.S.C. § 108(g)(3)*.

Qualified Real Property Business Indebtedness

According to section 108(c)(3), “qualified real property business indebtedness” means indebtedness that “was incurred or assumed by the taxpayer in connection with real property used in a trade or business and is secured by such real property, was incurred or assumed before January 1, 1993, or if incurred or assumed on or after such date, is qualified acquisition indebtedness, and with respect to which such taxpayer makes an election to have this paragraph apply.” *26 U.S.C. § 108(c)(3)*. This does not include qualified farm indebtedness, however.

If there is a discharge of qualified real property business indebtedness, then the amount excluded under section 108(a)(1)(D) “shall be applied to reduce the basis of the depreciable real property of the taxpayer.” *26 U.S.C. § 108(c)(1)*. There are limitations, however, for indebtedness in excess of value. The amount excluded in section 108(a)(1)(D) shall not exceed the excess of, “the outstanding principal amount of such indebtedness (immediately before the discharge), over the fair market value of [real property used in trade or business], reduced by the

outstanding principal amount of any other qualified real property business indebtedness secured by such property..." 26 U.S.C. § 108(c)(2)(A). In addition, the amount excluded shall not exceed the aggregate adjusted bases of depreciable real property held by the taxpayer right before the discharge. 26 U.S.C. § 108(c)(2)(B). One important note is that section 108(b)(1) is not applicable to the qualified real property business indebtedness. Section 108(b)(1) states that the amount excluded from gross income shall be applied to reduce the tax attributes of the taxpayer. Section 108(b)(1) only applies to the first three exceptions listed in section 108(a)(1).