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At Tax Time, Modify Debt With Caution

Shaky economy puts the spotlight on tax consequences of efforts to win debt modification or forgiveness

BY WAYNE R. JOHNSON

The last two years have been trying, to say the least. The dot-com implosion and the events of Sept. 11 wreaked havoc with the American and California economies. Thousands have become unemployed and numerous businesses stand on the brink of disaster. Faced with such unfamiliar and precarious financial straits, many individuals and businesses have begun to approach creditors hoping to either compromise or favorably modify existing debt. Unfortunately, many of these same taxpayers are unaware of the tax consequences that might result from success in their efforts.

This article is the first of a two-part examination of the general tax consequences that might result to an individual taxpayer from forgiveness or modification of his debts. While these same debt forgiveness and modification rules apply generally to all forms of business entities, some subtle and not so subtle differences in their treatment make a general discussion of them beyond the scope of this article. Next month we will explore the tax consequences arising from debt modification.

Tax treatment of debt forgiveness

1. THE GENERAL RULE

In 1931, the United States Supreme Court, in *United States v. Kirby Lumber Co.* (284 US 1 (1931), held that a debtor's satisfaction of debt for less than the amount owed results in income to the debtor in an amount equal to the difference between the amount paid to satisfy the debt and the amount owed at the time of settlement. Thus, satisfaction of a debt for less than the amount owed results in income to the debtor.

Congress codified the rule of *Kirby Lumber* as part of §61(a) — which provides that gross income includes income from cancellation of indebtedness ("CODI") (Code §61(a)(12). All references to the "Code" shall refer to the Internal Revenue Code of 1986, as amended to the date hereof. Cali-fornia has also adopted this rule. See Calif. Rev. & Tax. Code §17071.)

Over time, courts developed several exceptions to the general rule of inclusion; so many in fact, that Congress finally enacted §108 of the Internal Revenue Code to, among other things, take control of the extent and application of these various exceptions. After 1980, §108 stands as the only means by which a taxpayer can exclude CODI from gross income. No judicial exceptions remain. Consequently, unless a taxpayer can fit within one of §108's several exceptions, he must include any CODI realized during the year.

2. STATUTORY EXCEPTIONS TO THE GENERAL RULE

a. Section 108(a) — General Exclusion

Section 108(a) sets forth the primary exceptions to §61(a)(12), and provides that gross income shall not include any amount of CODI if the debtor was bankrupt or insolvent at the time of forgiveness, or the debt discharged was qualified farm indebtedness ("QFI") or qualified real property business indebtedness. ("QRPBI") (Code §108(a)(1). California complies with this treatment. See Calif. Rev. & Tax. Code §17131.) Each of these exceptions is alternative to the others.

Thus, if a taxpayer unsuccessfully claims himself bankrupt, he might nevertheless establish himself to be insolvent. Similarly, if a taxpayer tries unsuccessfully to avail himself of the insolvency exception, he might nevertheless salvage the situation by establishing the debt discharged was QFI or QRPBI.

Section 108 applies whenever a taxpayer falls within an exception described therein. Thus, taxpayers who do not wish to fall within the protections of §108 will need to carefully plan avoidance.

Looking at the several exceptions described in §108(a), one quickly discovers that, unless the debt forgiven is QFI or QRPBI, a solvent taxpayer has no use for §108(a). Moreover, unless debt forgiveness occurs in a manner prescribed in §108(a), it is possible that even bankrupt or insolvent taxpayers could be forced to recognize CODI when reporting income.

Bankruptcy requirement

To exclude CODI under the bankruptcy exception, a taxpayer must be bankrupt. A taxpayer is bankrupt if (1) a bankruptcy petition has been filed concerning him under Title 11 USC, (2) the taxpayer is subject to the bankruptcy court's jurisdiction, and (3) debt discharge is either granted by the bankruptcy court or made pursuant to a court-approved plan of liquidation or reorganization (Code §108(d)(1)). Unless each of these requirements is met, the bankruptcy exception will not apply. In that case, the taxpayer might nevertheless seek exclusion under one of the other exceptions described in §108.

To exclude CODI under the insolvency exception, a taxpayer must establish that he was insolvent at the time of discharge (Code §108(a)(1) (B)). The amount excludible is limited, however, to the amount by which the taxpayer was insolvent prior to discharge (Code §108(a)(2)(B)). Thus, if the taxpayer's creditor forgives a $10,000 debt, but, at the time of forgiveness, the taxpayer is insolvent by only $4,000, only $4,000 is excludible under the insolvency exception. Unless the taxpayer can qualify under one of §108's other exceptions, he would include $6,000 of CODI in income under §61(a)(12).

A taxpayer is insolvent if, immediately before the discharge event, his liabilities exceed the fair market value of his assets (Code §108(d)(3)). For this purpose, both recourse and nonrecourse liabilities are considered (Revenue Ruling 92-53, I.R.B. 1992-27, 7 (June 18, 1992)).

So too are contingent liabilities, such as guarantees, so long as the taxpayer can establish that he will more likely than not be called upon on the contingent debt (*Merkel, et al. v Commissioner,* 192 F.3d 844 (9th Cir., 1999)).

As for which assets the taxpayer must consider, prior to 1999 it was commonly believed that assets exempt from creditors' claims under applicable state law were not considered. IRS took issue with that belief in 1999, however, ruling that all assets of the creditor should be considered when determining a taxpayer's insolvency (Technical Advice Memorandum 199935002 (5/3/1999)).

Which assets count

In 2001 the United States Tax Court agreed with the IRS, finding "that Congress did not intend to exclude assets exempt from the claims of creditors under applicable State law from a taxpayer's assets for purposes of determining whether the taxpayer is insolvent within the meaning of §108(d)(3)." (*Carlson v. Commissioner,* 116 TC 87 (2/23/ 2001)). Though the last word has not likely been heard on this issue, for the time being taxpayers should consider all assets of the taxpayer when conducting an insolvency analysis under §108. To do otherwise could unnecessarily expose the taxpayer to penalties.

To the extent a taxpayer is allowed to exclude CODI under §108(a), he must reduce the value of his tax attributes (Code §108(b)(1)). Unless the taxpayer elects to first reduce the basis of his depreciable property (in which case depreciable property would appear as item number 1 on the ensuing list) (Code §108(b)(5)), the reduction of tax attributes will occur as follows (Code §108(b)(2)):

1. first, against net operating losses created during or carried over to the year of discharge; then

2. general business credits carried over to or from the year of discharge; then

3. minimum tax credits available to the taxpayer on the first day of the tax year immediately following the year of discharge; then

4. capital losses incurred during or carried over to the year of discharge; then

5. the taxpayer's basis in his property; then

6. passive activity losses and credit carryover from the year of discharge; and finally

7. foreign tax credits carried to or from the year of discharge.

Attribute reduction occurs on the first day of the tax year immediately following the year of discharge. Thus, if able to, a taxpayer may utilize his tax attributes durinmg the year of discharge. For that reason, great care should be taken in planning for debt discharge where the taxpayer hopes to preserve or utilize his tax attributes to the greatest extent possible.

In those instances where a taxpayer has tax attributes sufficient to offset the entire amount of CODI excluded under §108(a), §108(b) transforms §108(a) from an income exclusion provision, to an income deferral provision. Thus, the taxpayer is never really offered an opportunity to exclude CODI. Instead, the taxpayer defers recognition until some later date.

b. Section 108(e)(2) — Exception for Deductible Debts

To the extent payment of a discharged liability would give rise to a deduction for the debtor, no income results from discharge of the debt. Thus, for example, if a cash basis taxpayer charges $10,000 on his credit card for business supplies, and later compromises that debt for $5,000, the difference, $5,000, would not constitute CODI.

Instead the amount will be excluded from income under §108(e)(2). Had the taxpayer paid the full amount of the debt, he would have been permitted a deduction. Because he never received that deduction, no tax benefit was captured by him. Accordingly, no CODI results from forgiveness in that circumstance.

If the taxpayer was an accrual basis taxpayer, on the other hand, forgiveness of the debt would give rise to CODI. In that case the taxpayer was able to previously deduct the expense. Not requiring the taxpayer to include the forgiven portion as CODI would allow him to capture a deduction without having ever paid for it.

It should be noted that §108(e)(2) applies to all taxpayers.

c. Section 108(e)(5) — Purchase Money Debt Reduction

Section 108(e)(5), which applies only to solvent taxpayers, provides that no CODI results where the debt of a purchaser of property to the seller of such property is reduced so long as the debt arose in connection with the sale of the property by the seller to the purchaser. In that case, the debt reduction is treated as a purchase price adjustment, not CODI. Thus, no income results under §61(a)(12).

3. RELATED PARTY RULES

No discussion of debt forgiveness would be complete without mention of the related party rules of §108(e)(4). To preserve the integrity of §108, Congress adopted §108(e)(4). Section 108(e)(4) provides that CODI results to a taxpayer if a person related to him acquires the taxpayer's debt from a person unrelated to the taxpayer by paying an amount which is less than that which is owed by the taxpayer. For these purposes, related persons include the taxpayer's spouse, children, grandchildren, the spouses of the taxpayer's children and grandchildren, corporations and partnerships controlled by the taxpayer and certain trusts.

4. CONCLUSION

While the provisions of §61(a)(12) appear simple at first glance, the provisions of §108 make the rule anything but simple. Careful planning must be employed whenever a cancellation of indebtedness event is anticipated. Failure to do so may result in unanticipated income recognition.

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Test
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1. Income resulting from the satisfaction of a debt for less than the amount owed is always excluded from income.

2. Section 61(a)(12) sets forth the general rule concerning the treatment of income from cancellation of indebtedness ("CODI").

3. In addition to the exceptions described in §108, taxpayers may avail themselves of several judicially created exceptions to the rule of §61(a)(12).

4. Section 108(a) does not apply to solvent taxpayers.

5. A taxpayer must satisfy each and every one of the exclusions described in §108(a) in order to exclude CODI from income.

6. A taxpayer may elect to have §108 apply.

7. In some instances, bankrupt and insolvent taxpayers might be excluded from employing §108(a) for the purpose of excluding CODI.

8. For purposes of §108(a), a taxpayer is bankrupt if a bankruptcy petition has been filed concerning him.

9. A taxpayer is insolvent if the amount of his liabilities exceed the basis of his assets.

10. The amount of CODI excludible from income under the insolvency exception of §108(a)(1)(B) may not exceed the amount by which the taxpayer was insolvent immediately before discharge.

11. Contingent liabilities may always be counted as liabilities for purposes of §108(a)(1)(B).

12. Assets exempt from the claims of creditors under state law should nevertheless be considered when conducting an insolvency determination.

13. A taxpayer who excludes CODI under §108(a) must reduce the amount of his tax attributes by the amount of CODI excluded.

14. Debts which are deductible by the taxpayer do not create CODI.

15. Section 108(e)(5) applies to all taxpayers.

16. Debt reduction granted by the seller of property to the purchaser of property may always be excluded from gross income.

17. CODI results if a person related to the taxpayer purchases the taxpayer's debt from a party unrelated to the taxpayer for less than the amount owed.

18. A son-in-law is not a related party for purposes of §108(e)(5).

19. The United States Tax Court and IRS are at odds over how exempt assets should be treated when determining a taxpayer's insolvency.

20. Accrual basis taxpayers are less likely to utilize the exclusion from income set forth in §108(e)(2).

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