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Cancellation of Debt and Related Transactions

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Cancellation of Debt and Related Transactions

DOUGLAS A. KAHN* AND JEFFREY H. KAHN**

Abstract

If a taxpayer borrows money, the borrowed funds are not included in the taxpayer's gross income. That treatment is proper even though the taxpayer has increased his assets by the amount he borrowed because he also has created a corresponding liability to pay back the loan. The taxpayer's net wealth has not increased. The more difficult and interesting questions arise when the taxpayer fails to repay the loan. At first blush, it would appear that upon cancellation of a loan, the taxpayer should have income for the amount that was cancelled. However, the current tax treatment is not that simple. A number of exceptions exist to the straightforward treatment under which the cancellation requires the taxpayer to recognize income. Some of those exceptions reflect an application of normal tax principles while others exist for programmatic purposes. Those exceptions make the tax treatment of cancellation of debt particularly complex.

The goal of this Article is to set out the tax treatment of cancellation of debt, including the many exceptions that apply. It first reviews the history of the cancellation of debt rules, which helps explain how we arrived at the current treatment. It then covers the current statutory treatment of cancellation of debt as well as the many common law rules (such as the transactional approach and the tax benefit rule) that apply.

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I. Introduction

If a taxpayer borrows money, the borrowed funds are not included in the taxpayer's gross income.¹ That treatment is proper even though the taxpayer has increased his assets by the amount he borrowed because he also has created a corresponding liability to pay back the loan. The taxpayer's net wealth has not increased. The more difficult and interesting questions arise when the taxpayer fails to repay the loan. At first blush, it would appear that upon cancellation of a loan, the taxpayer should have income for the amount that was cancelled.² However, the current tax treatment is not that simple. A number

¹This treatment is part of the common law of taxation. While there is no statutory provision for this exclusion, courts have always held that borrowed funds are not included in the taxpayer's income. *See, e.g.,* Commissioner v. Tufts, 461 U.S. 300, 307 (1983). The Internal Revenue Service (Service) has uniformly agreed with this treatment.

²*See Tufts*, 461 U.S. at 312.

of exceptions exist to the straightforward treatment under which the cancellation requires the taxpayer to recognize income. Some of those exceptions reflect an application of normal tax principles while others exist for programmatic purposes. Those exceptions make the tax treatment of cancellation of debt particularly complex.

The goal of this Article is to set out the tax treatment of cancellation of debt, including the many exceptions that apply. In Part II, we review the history of the doctrine, which helps explain how we arrived at the current treatment. In Part III, we describe the current statutory treatment of cancellation of debt and its related issues. In Part IV, we discuss the tax rules that apply when the cancellation constitutes a gift or a contribution to capital from the creditor. In Part V, we briefly review the tax benefit rule and its effect on cancellation of debt. In Part VI, we describe the transactional approach to cancellation of debt and highlight when it is appropriate to use. In Part VII, we review the tax treatment when the debtor has a mixed sale and cancellation of indebtedness. The final part reviews the treatment of a decedent's installment note.

II. Development of the Doctrine

The general rule is that the cancellation of a debt for less than adequate consideration causes the debtor to recognize ordinary income in the amount of debt that was forgiven.³ Section 61(a)(12) provides that gross income includes “[i]ncome from discharge of indebtedness.”⁴ This doctrine is referred to by several terms which are used interchangeably—namely “cancellation of indebtedness or debt,” “discharge of debt,” and “forgiveness of debt.” In this Article, we often refer to it as “cancellation of debt” or by its acronym “COD.”

To understand how the COD doctrine applies, it is useful to go back in time and trace the development of the doctrine.

A. Kerbaugh-Empire *Decision*

In 1926, the Supreme Court decided the *Kerbaugh-Empire* case.⁵ Prior to World War I, the taxpayer in that case had borrowed money from a German bank. The loan was made in marks, and the repayment was to be made in marks. The taxpayer converted the borrowed marks to dollars and invested them in a transaction that resulted in a loss.⁶ The taxpayer repaid the loan after the war. As a result of Germany's defeat, the marks had a much lower dollar value than the value that marks had at the time the loan was made. The Government contended that the repayment with marks of a lesser value

³I.R.C. § 61(a)(12).

⁴§ 61(a)(12).

⁵*Bowers v. Kerbaugh-Empire Co.*, 271 U.S. 170 (1926).

⁶*Id.* at 172.

constituted a cancellation of indebtedness that caused the taxpayer to recognize income.⁷

The Supreme Court held the taxpayer did not recognize income, but the reasoning was not entirely clear. One possible ground for the decision was that a cancellation of a debt does not cause income.⁸ The Supreme Court repudiated that position five years later in *Kirby Lumber*.⁹ Subsequent to the *Kirby Lumber* decision, there was no dispute that cancellation of debt can cause income recognition, but the question of under what circumstances income is recognized proved to be a troubling issue.

A second ground on which *Kerbaugh-Empire* was decided was that the taxpayer did not recognize income because the transaction as a whole resulted in a loss due to the losses incurred when the taxpayer invested the borrowed funds.¹⁰ This use of a “transactional approach” in that context—that is, looking at not only the loan itself but also what happened to the loan proceeds—was rightly repudiated by the Supreme Court five years later in its 1931 decision in *Burnet v. Sanford & Brooks Co.*¹¹

After the two 1931 Supreme Court decisions, it was clear that the *Kerbaugh-Empire* case had been wrongly decided. Why then is the case worth noting? Because the case was wrongly decided, a transactional approach to COD issues was saddled with a bad reputation. To the contrary, as we will see, a transactional approach to COD situations is appropriate and proper. While the manner in which the Court applied a transactional approach in *Kerbaugh-Empire* was wrong, the approach is valid when applied correctly.¹²

B. *The Kirby Lumber Decision and the Rationale for the Rule*

The landmark 1931 case *Kirby Lumber*¹³ established that cancellation of debt can constitute income. Unfortunately, although the result reached in that case was correct, what was taken to be the reasoning of the opinion is flawed. Because of that flawed apparent reasoning, it took subsequent courts many years to reach an analysis that applied the rule accurately. The meandering and sometimes irreconcilable results reached in cases after *Kirby Lumber* are attributable to the courts trying to deal with the application of the

⁷ *Id.* at 173.

⁸ The Court stated that the “transaction here in question did not result in gain from capital and labor . . .” *Id.* at 175. This language refers to the definition of income from earlier Supreme Court cases. See *Eisner v. Macomber*, 252 U.S. 189, 207 (1919). See also *Vukasovich, Inc. v. Commissioner*, 790 F.2d 1409, 1415-16 (9th Cir. 1986) (stating that one of the holdings in *Kerbaugh-Empire* was that cancellation of indebtedness is not income). As noted in the text, the Supreme Court later repudiated this holding in *United States v. Kirby Lumber Co.*, 284 U.S. 1 (1931).

⁹ 284 U.S. 1 (1931).

¹⁰ *Kerbaugh-Empire*, 271 U.S. at 175 (“The result of the whole transaction was a loss.”)

¹¹ 282 U.S. 359, 364-65 (1931). See also *Vukasovich*, 790 F.2d at 1416 (stating the holding of *Kerbaugh-Empire* had been repudiated).

¹² For a discussion of the transactional approach, see *infra* Part VI.

¹³ 284 U.S. 1 (1931).

Supreme Court's deemed rationale to situations where the COD rule should not apply.¹⁴

In *Kirby Lumber*, the taxpayer had sold bonds, which effectively is the borrowing of money.¹⁵ Later that same year, the taxpayer purchased some of those bonds for a price that was significantly less than the price at which it had sold them.¹⁶ The Court upheld the Government's contention that the difference in the amount paid by the taxpayer and the amount it received when it sold its bonds was cancellation of debt income.¹⁷ In its very brief opinion, it appeared that the Court's rationale was based on a net worth approach.¹⁸ The Court noted that, unlike what happened in *Kerbaugh-Empire*, the transaction taken as a whole resulted in a gain for the taxpayer.¹⁹ In effect, the case seemed to say that the taxpayer had income because the reduction of the amount of his liability resulted in an increase in his net worth.

A net worth approach is far too broad. There are numerous situations where a debt is cancelled and the taxpayer's net worth is increased thereby, and yet it would be wrong to treat the reduction of the debt as income to the taxpayer. For example, Jim promises in writing to make a donation of \$20,000 to the Notre Dame University at the end of the next year. Under state law, Jim's promise in writing is enforceable by the charitable donee. In February of the next year, Jim suffers losses in a business venture, and so it would be a hardship for him to satisfy the debt. Jim is solvent, however. Jim asks Notre Dame to accept a payment of \$5,000 in full satisfaction of the debt. Notre Dame agrees, and so \$15,000 of Jim's legal liability is forgiven. Obviously, Jim has an increase in net worth. However, realistically, all that has occurred is that Jim's plan to make a gift of \$20,000 was reduced to a gift of only \$5,000. Jim should not recognize any income thereby.²⁰

One way to analyze the above situation is to say that when the entire transaction is examined, what occurred is that Jim gave \$5,000 to the university

¹⁴ See Boris I. Bittker & Barton H. Thompson, Jr., *Income From the Discharge of Indebtedness: The Progeny of United States v. Kirby Lumber Co.*, 66 CAL. L. REV. 1159, 1165 (1978) ("The tax treatment of debt discharges would have been much simpler if it had been based at the outset on the rationale that borrowed funds are excluded from gross income when received because of the assumption that they will be repaid in full and that a tax adjustment is required when this assumption proves erroneous.").

¹⁵ *Kirby Lumber*, 284 U.S. at 2.

¹⁶ *Id.*

¹⁷ *Id.* at 3.

¹⁸ Many courts and commentators concluded that net worth was the basis of the Court's decision in *Kirby Lumber*. See, e.g., *Zarin v. Commissioner*, 92 T.C. 1084, 1093 (1989), *rev'd on other grounds*, 916 F.2d 110 (3d Cir. 1990). The majority opinion of the Tax Court in *Zarin* acknowledged that a net worth justification for the COD rule is too broad, 92 T.C. 1084 at 109. In *Preslar v. Commissioner*, 167 F.3d 1323, 1327 (10th Cir. 1999), the Tenth Circuit noted that one of the rationales for the *Kirby Lumber* decision is an increase in net worth.

¹⁹ *Kirby Lumber*, 284 U.S. at 2 ("Here there was no shrinkage of assets and the taxpayer made a clear gain.")

²⁰ As early as 1932, the Second Circuit noted that there would be no income in a similar hypothetical situation. See *Commissioner v. Rail Joint Co.*, 61 F.2d 751 (2d Cir. 1932).

instead of the original plan to give it \$20,000. This can be characterized as a transactional approach even though it is very different from the transactional approach taken by the Supreme Court in *Kerbaugh-Empire*.²¹ This transactional approach was adopted in some cases²² but not in others. When adopted, it was sometimes treated as an exception to the general rule that COD income is taxable. As we discuss below, the courts and the Service adopted other exceptions when situations warranted it. As a result, there became a kind of hodgepodge of cases that were difficult to reconcile.

It would not be necessary to create a number of exceptions to the COD rule if the rule were correctly defined.²³ To define the rule, consider a very different rationale for its existence. When someone borrows money, the borrower does not recognize income because it is assumed that the borrower will repay the loan. In effect, the debt prevents the borrower from recognizing income because of the assumption that the loan will be repaid. If any part of the debt is forgiven, it then becomes clear that the assumption of a repayment of that part of the debt was mistaken. So, the forgiveness of the debt removes the obstacle to tax the borrower on the amount of the loan that would have been income when borrowed if there had not then been an obligation to repay. It is not the debtor's increase in net worth that is taxable; rather, it is a tax on the amount that previously was thought to have been borrowed and turned out to have just been an enrichment of the "borrower." Consequently, the forgiveness of a debt should be income only to the extent that the debt had prevented the debtor from recognizing income in a prior period or had provided the debtor with some tax benefit such as a tax deduction or a basis in property. Applying that approach to the Notre Dame situation described above, the \$20,000 debt did not prevent Jim from recognizing income nor did it provide him with a tax benefit.²⁴ Therefore, there is no reason to tax Jim on the cancellation of any of that debt.

While some of the common law exceptions to the COD rule would be superfluous if the rule were correctly described, not all of them would be unnecessary. For example, the exception for insolvency or bankruptcy²⁵ was adopted for a very different reason and would not become redundant if the correct standard were used. It should be noted that, while some courts have

²¹ For more discussion of the transactional approach, see *infra* Part VI.

²² See, e.g., *Bradford v. Commissioner*, 233 F.2d 935 (6th Cir. 1956), *rev'g* 22 T.C. 1057 (1954). See also *Commissioner v. Rail Joint Co.*, 61 F.2d 751 (2d Cir. 1932) (supporting the transactional approach).

²³ This is not to say that the rule would thereby be "simple" to apply. See Lawrence Zelenak, *Cancellation-of-Indebtedness Income and Transactional Accounting*, 29 VA. TAX REV. 277, 280 (2009).

²⁴ A gift to a charity is not deductible until paid even if the donor reports its income on the accrual method. So, Jim did not qualify for a tax deduction when he created a legal obligation for him to make a payment to the school.

²⁵ See *infra* Part III.A.4.

begun to adopt the statement of the COD rule described above, that standard has not been embraced by every court.²⁶

C. *The Pre-1981 and Pre-1987 Statutory Deferral*

Prior to the adoption of the Bankruptcy Tax Act of 1980, the scope and operation of the COD rule was determined exclusively by court decisions (*i.e.*, common law) and by administrative rulings. The only statutory provisions that dealt with COD were sections 108 and 1017 and their antecedents. Those statutory provisions did not describe or limit what constitutes COD. Instead, they provided that in certain circumstances a solvent debtor who had COD income could elect not to recognize that income to the extent that the debtor had basis in property.²⁷ The effect of the election was to prevent income recognition and to reduce the debtor's basis in its property. The provision applied to corporate debtors and to the debts of individuals that were connected to that individual's property that was used in a trade or business.²⁸ The amount of COD income that was excluded could not exceed the basis that the debtor had in its qualified property.²⁹ For pre-1981 years, virtually all of the debtor's property was qualified, and the allocation of the reduction of basis to the debtor's property was subject to an order of priority set forth in the regulation to section 1017. From 1981 through 1986, only depreciable property qualified for the basis reduction.³⁰ If the amount of debt forgiven exceeded the debtor's basis in qualified property, the excess was taxed as income.³¹ As noted below, this elective provision was repealed for years following 1986.³²

Thus, prior to 1980, the determination of what constitutes COD income was not addressed by statutes. The adoption of the Bankruptcy Tax Act of 1980 amended sections 108 and 1017 so as to provide specified exceptions to income recognition.³³ The amended version of those provisions does not define what constitutes COD income; that task is still left to common law and administrative construction. The amended provision establishes a number of exceptions to COD income treatment some of which are codifications

²⁶ See, *e.g.*, *Zarin v. Commissioner*, 916 F.2d 110 (3d Cir. 1990).

²⁷ I.R.C. § 108 (1976) (providing for nonrecognition of COD income in certain circumstances); I.R.C. § 1017 (1976) (limiting nonrecognition to the extent that the debtor had basis in the property).

²⁸ § 108 (1976).

²⁹ § 1017 (1976) ("Where any amount is excluded from gross income (under section 108 (relating to income from discharge of indebtedness) on account of the discharge of indebtedness the whole or a part of the amount so excluded from gross income shall be applied in reduction of the basis of any property held (whether before or after the time of the discharge) by the taxpayer during any portion of the taxable year in which such discharge occurred.").

³⁰ See Bankruptcy Tax Act of 1980, Pub. L. No. 96-589, § 108, 94 Stat. 3411.

³¹ Rev. Rul. 67-200, 1967-1 C.B. 15, as clarified by Rev. Rul. 70-406, 1970-2 C.B. 16.

³² Tax Reform Act of 1986, Pub. L. 99-514, § 143, 100 Stat. 2085 (1986).

³³ See *supra* note 30.

of exceptions previously adopted by the courts.³⁴ The 1980 amendment of the provision retained the election to defer income recognition and reduce the basis of property.

Sections 108 and 1017 were modified subsequent to the Bankruptcy Tax Act of 1980.³⁵ The Tax Reform Act of 1986 made a number of changes. One of the changes made was to eliminate the provision that allowed a debtor to elect not to recognize COD income and instead reduce the basis of property.³⁶ So, the general provision for an election to defer income no longer exists. While there no longer is a provision for a general election of deferral, an election is permitted for the deferral of certain debts such as a “qualified acquisition indebtedness” that constitutes “qualified real property business indebtedness.”³⁷

III. Current Statutory Treatment

A. Sections 108 and 1017

As previously noted, the two principal sections that deal with COD issues are sections 108 and 1017. Section 61(a)(12) provides that gross income includes “[i]ncome from discharge of indebtedness,”³⁸ but it does not provide an explanation of what constitutes COD income or what exceptions apply. Section 108 provides a number of exceptions to the COD rule but does not define what constitutes COD. Section 1017 provides for the reduction of the basis of the debtor’s property when certain exclusions of COD income provided by section 108 are applicable.

The exceptions to COD income that are listed in section 108 are not exclusive. In addition to the statutory exclusions, common law exclusions and the

³⁴ See *supra* note 30.

³⁵ I.R.C. §§ 108, 1017.

³⁶ §§ 108, 1017.

³⁷ § 108(c). If the debt was incurred before 1993, it did not have to be an acquisition indebtedness. § 108(c)(3)(B). The meaning of “qualified real property business indebtedness” is defined in section 108(c)(3) and the meaning of “qualified acquisition indebtedness” is defined in section 108(c)(4). The amount of this exclusion is limited to the amount of basis the debtor had in his depreciable real property that was held immediately before the discharge. § 108(c). Depreciable property is defined in section 1017(b)(3)(B). The election given in section 1017 for a debtor to treat realty held by him for sale to customers in the ordinary course of his trade or business as depreciable property does not apply to the qualified real property business indebtedness exclusion. § 1017(b)(3)(F). The real property business debt exclusion is discussed *infra* Part III.A.6.

Also, the Code provides an election for a deferral over an eight- or nine-year period for the reacquisition of certain debt instruments when the reacquisition took place in the year 2010 or 2011. § 108(i). A reacquisition is defined as any acquisition of an applicable debt instrument by the debtor or a person related to the debtor. § 108(i)(4). An applicable debt instrument is defined as a debt instrument that was issued by a C Corporation or by another person in connection with the conduct of a trade or business by that person. § 108(i)(3). Taxpayers who elected the deferral need to be aware of the numerous circumstances accelerating recognition of deferred income. This Article does not discuss the deferral provision.

³⁸ I.R.C. § 61(a)(12).

common law application of the exclusions that the statute codified continue to be available. However, the statute replaces the common law exception for insolvency, and the exclusion from income for insolvent debtors is determined exclusively by the statutory provisions.³⁹

Let us now consider the operation of sections 108 and 1017. While we will discuss the principal features of those provisions, we will not examine all of their elements.

1. *The Definition of Debt*

Section 108 applies only to the cancellation of an “indebtedness” of a taxpayer.⁴⁰ For purposes of that section, an indebtedness or debt of a taxpayer is defined as an indebtedness for which either the taxpayer is liable or as to which the taxpayer holds property that is encumbered by that debt.⁴¹ In other words, the term debt includes both recourse and nonrecourse debts.

By its terms, the definition of indebtedness in section 108(d)(1) applies only for purposes of that section.⁴² The question then arises as to the definition of indebtedness for purposes of determining the scope of the provision in section 61(a)(12) treating discharge of indebtedness as income. In a divided decision, the Third Circuit held in *Zarin* that the definition of indebtedness in section 108(d)(1) also applies to the meaning of the term in section 61(a)(12).⁴³ This is still an open question because there is only one divided decision of a court of appeals on the issue.

2. *The Exclusions Provided by Section 108*

Section 108(a)(1) lists five discharges of debt that are not included in the debtor’s gross income. One of those five, the discharge of qualified principal residence indebtedness, terminated at the end of the year 2014 and so is no longer applicable.⁴⁴ The other four exclusions are:

- (1) the discharge occurs in a Title 11 case,⁴⁵
- (2) the discharge occurs when the debtor is insolvent (the insolvency exclusion),⁴⁶
- (3) the discharged debt is qualified farm indebtedness,⁴⁷

³⁹ § 108(e)(1).

⁴⁰ § 108(a)(1).

⁴¹ § 108(d)(1)(A)-(B).

⁴² § 108(d)(1).

⁴³ *Zarin v. Commissioner*, 916 F.2d 110, 113 (3d Cir. 1990). For a detailed discussion of the *Zarin* case, see *infra* Part VI.

⁴⁴ For that reason, we will not discuss the section 108(a)(1)(E) exclusion in this article.

⁴⁵ Section 108(d)(2) defines “title 11 case” as a “case under title 11 of the United State 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.”

⁴⁶ Section 108(a)(1)(B).

⁴⁷ The qualified farm indebtedness exclusion applies only if the discharge is made by a qualified person per section 108(g)(1).

(4) The discharged debt is qualified real property business indebtedness.⁴⁸

When these several exclusions overlap, there is an order of priority as to which applies. The bankruptcy or Title 11 exclusion takes precedence over the other three exclusions.⁴⁹ That priority is important because, while the amount of COD that is excludable under the insolvency exclusion is limited to the amount of the debtor's insolvency, there is no limitation on the amount of COD that can be excluded when the debt is cancelled in a bankruptcy case. Note that while a Title 11 case will often involve an insolvent petitioner, there is not a complete overlap with insolvency because a debtor need not be insolvent to file a Chapter 7 voluntary petition in bankruptcy.⁵⁰ The insolvency exclusion takes precedence over the exclusions for qualified farm indebtedness and for qualified real property business indebtedness.⁵¹ That priority is important because the scope of the insolvency exception is more extensive than the reach of the other two provisions. The other two exclusions can apply to the excess of the COD that is not excluded by the insolvency provision.

In addition to those four exclusions, section 108 provides several more exceptions to inclusion of COD income that are discussed later in this paper. Some of those additional items are codifications of common law exclusions. Also, except for the insolvency exclusion, the common law exclusions continue to apply. So, the statutory provisions are not exclusive.

3. *The Common Law Insolvency Exclusion*

The courts initially held that when a debtor had COD at a time when he was insolvent, the debtor did not recognize income.⁵² The courts defined insolvency as the excess of the debtor's liabilities over the fair market value of his assets.⁵³ Those cases initially arose in circumstances where the debtor was insolvent immediately before the COD took place and was still insolvent after the debt was forgiven. Those decisions were based on the fact that, because the debtor was still insolvent, there had been no increase in his net worth. Of course, the debtor's negative net worth was reduced by the forgiveness, but the courts did not deem that a sufficient reason to tax the debtor.

But what is the tax treatment of a debtor who was insolvent before the COD but became solvent as a consequence of the forgiveness of the debt? In that situation, the Board of Tax Appeals (the prior name of what is now called the Tax Court) held that the debtor recognized gross income for the

⁴⁸The exclusion for real property business indebtedness does not apply to a debtor that is a C corporation. § 108(a)(1)(D).

⁴⁹§ 108(a)(2)(A).

⁵⁰2 COLLIER ON BANKRUPTCY ¶ 109.02 (16th ed. 2015).

⁵¹§ 108(a)(2)(B).

⁵²*See, e.g., Dallas Transfer & Terminal Warehouse v. Commissioner*, 70 F.2d 95, 96 (5th Cir. 1934).

⁵³*Id.* That definition of insolvency is codified in section 108(d)(3), and so the same definition is applicable under the statutory treatment of COD.

cancellation of his debt, but only to the extent of the amount by which he became solvent.⁵⁴ In effect, the rule became that a cancellation of a debt of an insolvent debtor was excluded from income to the extent of the amount of the debtor's insolvency immediately prior to the forgiveness. The balance of the forgiveness constituted ordinary income to the debtor unless some other exclusion applied. This same rule was adopted by Congress in its statutory treatment of insolvency and is set forth in section 108(a)(3).⁵⁵

Under the common law insolvency exclusion that existed prior to 1980, the amount excluded from the debtor's income was truly excluded as contrasted to a deferral. There were no adverse tax consequences imposed. The amount of COD that was excluded from gross income did not cause the loss of any favorable tax attributes the debtor possessed. As we will see, that changed when the Code was amended in 1980.⁵⁶

4. *The Statutory Treatment of Insolvency*

a. *The Amount Excluded from Income.* The common law insolvency exclusion was replaced in 1980 by a statutory provision. Section 108(a)(1)(B) excludes from gross income the cancellation of indebtedness of an insolvent debtor, but only to the extent of the amount of the debtor's insolvency immediately before the debt was forgiven.⁵⁷ In other words, the insolvency exclusion will not apply to an amount of the forgiven debt that is equal to the extent that the aggregate fair market value of the debtor's assets exceeds the aggregate of his liabilities immediately after the COD took place. The debtor will be taxed on that amount unless another exclusion is applicable. That aspect of the statutory exclusion is no different from the common law rule.

Illustration 1. As of February 5, Year One, Helen had assets with an aggregate value of \$40,000. Helen had liabilities totaling \$70,000. So Helen was insolvent in the amount of \$30,000. On that date, one of Helen's creditors, to whom she owed \$20,000, offered to accept a payment of \$5,000 in cancellation of that debt. Helen accepted and made the payment. Helen was thereby forgiven \$15,000 of that debt which constituted a cancellation of indebtedness. Because, immediately before the COD occurred, Helen was insolvent by more than the amount of debt that was forgiven, Helen does not recognize any income from the COD. Helen will incur a reduction of favorable tax attributes if she possesses any. Note that after the transaction, Helen has assets of \$35,000 and liabilities of \$50,000, so she is still insolvent.

Illustration 2. As of July 12, Year One, Randolph had assets with an aggregate value of \$115,000, and Randolph had liabilities totaling \$135,000. So, Randolph was insolvent in the amount of \$20,000. On that date, a creditor offered to accept a payment of \$25,000 to cancel a debt of \$60,000, and

⁵⁴ See, e.g., *Lakeland Grocery Co. v. Commissioner*, 36 B.T.A. 289, 292 (1937).

⁵⁵ § 108(a)(3).

⁵⁶ See *infra* Part III.A.4.b.

⁵⁷ § 108(a)(3).

Randolph accepted and made the payment. Randolph had cancellation of a debt of \$35,000, but his insolvency immediately before the transaction was only \$20,000. Consequently, Randolph does not recognize income for \$20,000 of the cancelled debt, but he does recognize income for \$15,000 of the cancelled debt. Randolph will incur a reduction of his favorable tax attributes, if he possesses any, for the \$20,000 that was excluded from income.

b. *The Reduction of Tax Attributes.* As noted above, a major change of the insolvency and bankruptcy exclusions made by the Bankruptcy Act of 1980 is that those exclusions now come with a price. Under section 108(b), the amount that is excluded from the debtor's income because of insolvency (or bankruptcy) reduces specified favorable tax attributes that the debtor possesses.⁵⁸ To the extent that the debtor's tax attributes are reduced, the "exclusion" can be seen as a deferral rather than a pure exclusion from tax consequence of any kind. However, to the extent that the debtor does not have sufficient favorable tax attributes to be reduced, the debtor still does not recognize income for the excluded amount; and so that amount of the exclusion is not a deferral but can be seen as a pure exclusion. Most provisions exempting an item from gross income can be classified in either of these two categories. Either they will constitute a nonrecognition provision in which the income is deferred to a future date, or they will constitute a pure exclusion from income with no deferral of tax consequences. The insolvency exception is somewhat unusual in that it comprises both categories. It will be a nonrecognition provision to the extent that the excluded income causes a reduction of tax attributes, and it will be a pure exclusion to the extent that it does not reduce tax attributes.

The statute provides a list of tax attributes to be reduced and provides an order of priority for their reduction.⁵⁹ Except for the reduction of credits, the reduction is made on a dollar for dollar basis so that each dollar of excluded income reduces a dollar of tax attribute.⁶⁰ Credits are reduced on a one-third basis so that each dollar of excluded income reduces by 33.33 cents of the relevant credit.⁶¹ The order in which tax attributes are reduced is:

(1) Any net operating loss (NOL) for the taxable year and any carryover of a NOL from a prior year are the first items reduced.⁶² Note that carrybacks of NOLs from subsequent years are not reduced. The reduction is made first to the NOL for the current year and then is applied to the carryovers from prior years in the order in which they arose.⁶³

⁵⁸ § 108(b).

⁵⁹ § 108(b)(2).

⁶⁰ § 108(b)(3)(A).

⁶¹ § 108(b)(3)(B).

⁶² § 108(b)(2)(A).

⁶³ § 108(b)(4)(B).

(2) The second item in order to be reduced is the general business credit carryovers that are provided by section 38 from and to the year in which the COD occurred.⁶⁴

(3) The third item in order is the minimum tax credit available at the beginning of the next taxable year under section 53(b).⁶⁵

(4) The fourth item in order is any capital loss in the year in which the COD occurred and any capital loss carryover to that year.⁶⁶ Note that carrybacks of capital losses from subsequent years are not reduced. The reduction is made first to the capital loss for the current year and then is applied to the carryovers of capital losses from prior years in the order in which they arose.⁶⁷

(5) The fifth in order is the basis of property that the debtor owns at the beginning of the next taxable year.⁶⁸ When the COD is excluded by the insolvency provision, all of the debtor's property is subject to having its basis reduced. When the COD is excluded under the bankruptcy provision, no reduction can be made of the basis of property that is exempt from the reach of creditors under the federal bankruptcy rules.⁶⁹ While section 108(d)(10) provides a cross reference to section 1017(c)(1) for the stated proposition that no reduction is made in the basis of exempt property of an individual debtor, the explicit terms of section 1017(c)(1) apply that provision only to an exclusion of COD pursuant to the bankruptcy exclusion.⁷⁰

The order of priority for the reduction of the debtor's basis in his properties is determined by Regulation section 1.1017-1. There is a limitation in section 1017(b)(2) on the amount of the debtor's basis that can be reduced under this provision, and that limitation is discussed later in this Article.⁷¹ The operation of the basis reduction rules for the insolvency and bankruptcy exclusion is determined by section 1017.

(6) The sixth in order is any passive activity loss or credit carryover under section 469(b) from the year in which the COD occurred.⁷²

(7) The last item is the foreign tax credit that is carried over from or to the taxable year in which the COD occurred.⁷³

c. *Election to Change the Order of Tax Attribute Reductions.* Section 108(b)(5) permits a debtor whose tax attributes are to be reduced to elect to

⁶⁴ § 108(b)(2)(B).

⁶⁵ § 108(b)(2)(C).

⁶⁶ § 108(b)(2)(D).

⁶⁷ § 108(b)(4)(B).

⁶⁸ I.R.C. §§ 108(b)(2)(E), 1017(a).

⁶⁹ §§ 108(d)(10), 1017(c)(1).

⁷⁰ *Id.*

⁷¹ See *infra* Part III.A.4.d.

⁷² I.R.C. § 469(b).

⁷³ § 108(b)(2)(G).

reduce the basis of depreciable property before reducing any other tax attributes. If elected, the debtor's basis for his depreciable property will be reduced first. If the amount of reduction to be applied exceeds the debtor's basis in his depreciable property, then the excess will reduce his tax attributes in the normal order. The election is made on the taxable return for the taxable year in which the discharge occurred unless an extension is granted.⁷⁴

Depreciable property has the same meaning in section 108 that it has in section 1017.⁷⁵ Section 1017(b)(3)(B) defines depreciable property as property of a character that is subject to an allowance for depreciation, but only if a reduction of the basis of that item because of an exclusion of COD would reduce the depreciation that otherwise would have been allowable for that item in the next taxable period.

Section 1017(b)(3)(E) grants the debtor an election to expand the scope of what constitutes depreciable property to include real property that the debtor holds for sale to customers in the ordinary course of his trade or business. This election permits the debtor to expand the items that can qualify for the section 108(b)(5) election to advance the reduction of basis of depreciable property ahead of other reductions of tax attributes.

d. *The Limitation on the Amount of Basis Reduction.* One of the tax attributes reduced by the excluded COD of an insolvent or bankrupt debtor is the basis of his property. Congress did not wish the imposition of a tax on the debtor's subsequent disposition of his property to leave that debtor in a position where he may not have enough funds available to pay his debts. If the debtor needed to sell assets to have the cash to pay a debt, a reduction of basis would increase his tax liability on that sale and might leave him with an inadequate amount after taxes to satisfy the debt. To prevent that from occurring, Congress set a ceiling on the amount of basis of the taxpayer's property that can be reduced under sections 108(b)(2)(E) and 1017.⁷⁶

Section 1017(b)(2) limits the reduction of basis to be made because of an insolvency or bankruptcy exclusion from income.⁷⁷ The amount of reduction cannot exceed the aggregate of the debtor's basis in his assets immediately after the discharge over the aggregate of the debtor's liabilities immediately after the discharge. For this purpose, cash is treated as basis.

Illustration. As of March 12, Year One, Sylvia had \$23,000 of cash and an acre of unimproved land with a fair market value of \$12,000. Sylvia had no other assets. Sylvia's basis in the land was \$28,000. Sylvia's only liability was a \$60,000 recourse debt that she owed to the Friendly Bank. So, Sylvia was insolvent in the amount of \$25,000. The Bank offered to cancel \$50,000 of Sylvia's liability in exchange for her payment to the Bank of \$20,000 cash. Sylvia accepted and made the payment. By this transaction, the Bank forgave

⁷⁴ § 108(d)(9)(A).

⁷⁵ § 108(d)(5).

⁷⁶ I.R.C. §§ 108(b)(2)(E), 1017.

⁷⁷ § 1017(b)(2).

\$30,000 of Sylvia's debt. Because Sylvia was insolvent before the COD in the amount of \$25,000, she excludes that amount of her COD and is taxed on the remaining \$5,000 as ordinary income. Sylvia had sufficient tax deductions that year that she had no tax liability for the year.

After the transaction, Sylvia had \$3,000 of cash and the unimproved land. Her \$28,000 basis in the land is to be reduced under §1017 at the beginning of the next tax year. Because \$25,000 of Sylvia's COD was excluded from income, if there were no limitation on the amount of the reduction, Sylvia's basis in the land would be reduced by that amount, and she would have a basis of \$3,000 in the land. The statutory limitation prevents that from occurring.

Immediately after the COD, Sylvia has a liability of \$10,000 outstanding. She has a basis of \$28,000 in the lot. She also has \$3,000 in cash, which is treated as basis for this purpose. So, her total basis is \$31,000. Her basis in the land cannot be reduced by more than the difference between her aggregate basis and her aggregate liability immediately after the COD. Her aggregate basis is \$31,000, and her aggregate liability is \$10,000. The difference of \$21,000 is the maximum amount of reduction that can be applied to Sylvia's basis in the land. Her \$28,000 basis in the land is reduced by \$21,000, and Sylvia will have a basis of \$7,000 in the land as of the beginning of the next year.

As of the beginning of next year, if no other events occurred, Sylvia will have \$3,000 in cash and land with a basis of \$7,000. If she were to sell the land, there would be no tax on \$7,000 of the amount realized on the sale because that is her basis. Thus, the tax system will not prevent Sylvia from having the \$10,000 to satisfy her liability.

An unresolved question in determining the amount of an insolvent debtor's liability at the time of a COD and immediately afterwards is whether to account for the debtor's income tax liability that has accrued at the time of discharge (including the tax liability for any income the debtor recognized by becoming solvent). That issue does not arise on the facts of this problem because Sylvia's deductions were such that she had no income tax liability for that year.

The limitation on the reduction of basis does not apply to basis reduced by reason of an election under section 108(b)(5) to elevate depreciable property over other tax attributes in determining the order in which they are to be reduced.⁷⁸

e. The Determination of the Amount of Insolvency. Because insolvency is defined as the excess of the fair market value of the debtor's assets over the aggregate of his liabilities, it is necessary to determine what assets of the debtor are included in that computation and what liabilities are taken into account.

⁷⁸§ 1017(b)(2)(B).

e.1. *Exempt Assets.* The principal issue in determining the assets to be included in the computation is whether assets that are exempt by state or federal law from the claims of creditors are to be included.⁷⁹

Prior to the 1980 amendments to section 108, the Tax Court held that assets that are exempted from the claims of creditors by state or federal law are not taken into account in measuring a taxpayer's insolvency.⁸⁰ The rationale was that because those assets were insulated from the claims of creditors, the discharge of the debt did not free those assets from restrictions. As a consequence of the adoption of the amendments made in 1980, the Tax Court changed its position on this issue. The Tax Court held that the 1980 codification of the insolvency exclusion impliedly expanded the types of assets to be included in the calculation of insolvency, and so assets exempt from creditors are to be included in the computation.⁸¹ It appears, therefore, that exempt assets are to be taken into account.

If a debtor has assets that cannot be reached by the debtor to pay his debts, then those assets should be excluded from the computation of insolvency. In *Shepherd v. Commissioner*,⁸² the question was whether to include the debtor's interest in a pension fund in the calculation. The debtor had the right to borrow up to 50% of his interest in the fund but otherwise could not currently reach the fund's assets.⁸³ The Tax Court held that the 50% of the fund that the debtor could borrow was available to the debtor and thus includable in his assets for determining his insolvency.⁸⁴ The 50% that he could not borrow was not available to him and thus excluded from the calculation.⁸⁵

e.2. *Contingent Liabilities.* In order for a debtor to be permitted to take a contingent liability into account in determining solvency, the debtor must show by a preponderance of the evidence that he will be called upon to pay the contingent obligation.⁸⁶ If the debtor is able to carry that burden of proof, he can include the entire amount of the contingent liability in measuring his solvency. If not, none of the contingent liability is taken into account. It is an all or nothing proposition. The debtor is not permitted to take into account a discounted figure reflecting the probability that the debtor will be called upon to make the payment.⁸⁷

⁷⁹For a discussion of rules concerning determination of the debtor's assets, see Helen C. Naimi, *The Definition of Assets Under the Insolvency Exclusion*, 136 TAX NOTES (TA) 1035 (Aug. 27, 2012).

⁸⁰See, e.g., *Hunt v. Commissioner*, 58 T.C.M. (CCH) 965, T.C.M. (P-H) ¶ 89,660 (1989); *Cole v. Commissioner*, 42 B.T.A. 1110, 1113 (1940).

⁸¹See *Carlson v. Commissioner*, 116 T.C. 87, 104 (2001).

⁸²104 T.C.M. (CCH) 108, 111, 2012 T.C.M. (RIA) ¶ 2012-212, at 1543.

⁸³*Id.* at 111.

⁸⁴*Id.*

⁸⁵*Id.* at 112.

⁸⁶See *Merkel v. Commissioner*, 192 F.3d 844, 850 (9th Cir. 1999) (2-1 decision), *aff'g* 109 T.C. 463 (1997).

⁸⁷*Id.* at 850-51.

e.3. *Nonrecourse Liabilities.* A nonrecourse debt is a debt which is secured by property of the debtor but for which the debtor has no personal obligation to repay. Thus, if the debtor defaults, the creditor's only recourse is to levy on the property securing the debt because the creditor cannot require any payments from the debtor. For the purposes of the COD rules, a nonrecourse debt that is secured by a taxpayer's property is treated as a debt of the taxpayer.⁸⁸ Consequently, the discharge of a nonrecourse debt by a creditor who was not the seller of the encumbered property can cause COD income even when the amount of the debt is greater than the fair market value of the property securing it.⁸⁹

In determining whether and to what extent a debtor is insolvent, should the amount by which a nonrecourse debt exceeds the fair market value of the property that secures the debt (excess nonrecourse debt) be treated as a liability of the debtor? Because the creditor cannot collect the excess nonrecourse debt unless its security increases in value, that portion of the nonrecourse debt has no effect on the debtor's solvency and so, with one exception, is ignored by the Service in determining the extent to which a debtor is solvent or insolvent.

However, if all or a portion of the nonrecourse debt is discharged, it would contravene the policy for the insolvency exception if the amount of the nonrecourse debt that was cancelled were ignored in determining the amount of the debtor's insolvency. Accordingly, the Service has ruled that, while the excess nonrecourse debt generally is ignored in determining the debtor's solvency, the amount of an excess nonrecourse debt that is discharged will be taken into account.⁹⁰

Illustration 1. B owns a building with a fair market value of \$300,000. The building is subject to a nonrecourse \$250,000 mortgage. B owns other properties with an aggregate value of \$80,000, and B has recourse debts totaling \$200,000. None of B's debts is a purchase-money debt and none would be deductible when paid. A creditor of B cancels \$62,000 of B's recourse debts for a payment of \$12,000, which constitutes a cancellation of \$50,000 of indebtedness. Because the amount of B's nonrecourse debt is less than the value of its security, it is treated as a liability for purposes of determining B's insolvency. Therefore, immediately before the discharge, B was insolvent in the amount of \$70,000. Under section 108, none of the discharged debt is income to B, but his tax attributes may be reduced.

⁸⁸I.R.C. § 108(d)(1)(B).

⁸⁹See Rev. Rul. 91-31, 1991-1 C.B. 19. If the nonrecourse debt is a purchase-money debt, its cancellation typically will be excluded from COD and treated as a price reduction by section 108(e)(5). See *infra* Part III.A.8.

⁹⁰See Rev. Rul. 92-53, 1992-2 C.B. 48. The application of that position to partnerships is examined in Revenue Ruling 2012-14, 2012-24 I.R.B. 1012. The latter ruling provides that, when the excess nonrecourse debt of a partnership is discharged, each partner is allocated his share of that discharged debt in determining whether the partner is insolvent.

Illustration 2. The same facts as in **Illustration 1**, except that: (1) the amount of the nonrecourse debt secured by the building is \$450,000, and (2) the value of B's other assets (*i.e.*, his assets other than the building) is \$180,000. To the extent that the nonrecourse debt exceeds the fair market value of the building (it exceeds that value by \$150,000), it is not treated as a liability of B's for purposes of applying the insolvency exception. So, before the discharge occurred, B's assets had a value of \$480,000, and his liabilities totaled \$500,000 (\$200,000 recourse debts and only \$300,000 of the nonrecourse debt is counted as a liability). Because B was insolvent by \$20,000 immediately before the discharge of \$50,000 of his recourse debts, \$20,000 of that discharge is not included in B's income, and the remaining \$30,000 is recognized as ordinary income.

Illustration 3. The same facts as those in **Illustration 2** except that in addition to the discharge of \$50,000 of the recourse debts, on the same day, the creditor of the nonrecourse debt forgave \$150,000 of that debt. After the cancellation of \$150,000 of the nonrecourse debt, the balance of that debt (\$300,000) equaled the fair market value of the building that secured it. The entire amount of the nonrecourse debt that was discharged was excess nonrecourse debt. If the excess nonrecourse debt that was discharged were not treated as a liability of B's, the discharge of that amount would cause B to recognize an additional \$150,000 of ordinary income. B would have been insolvent in the amount of only \$20,000 immediately prior to the discharge of \$200,000 of debts (\$50,000 recourse debts and \$150,000 nonrecourse debt), and so B would recognize \$180,000 of income from those discharges. But after the discharges were completed, the value of B's assets would exceed the amount of his liabilities by only \$30,000, and so B would have only that amount available to pay the taxes on the COD income. That would contravene the congressional policy for the insolvency exclusion to limit the amount of COD income to the amount of net asset value the debtor has after the discharge. It would be unfair to treat the cancellation of the excess nonrecourse debt as COD and not treat that debt as a liability of the debtor. Accordingly, the entire \$150,000 of excess nonrecourse debt that was cancelled is treated as a liability of B's. The amount of B's insolvency immediately prior to the discharges was \$170,000, and so that amount of the \$200,000 discharged debts is excluded from B's income. Only the remaining \$30,000 of discharged debts is recognized as income.

e.4. *Tax Liability.* To what extent, if any, are the debtor's tax liabilities that have accrued at discharge to be taken into account in determining his insolvency? To what extent are the debtor's accrued tax liabilities (including the tax on any income the debtor recognized because the COD made him solvent) existing immediately after the discharge taken into account in applying the limitation on basis reduction provided by section 1017(b)(2)? The amount of the debtor's tax liability will not be known until after the end of the taxable year because it can be affected by subsequent events in that year. All of the events that will determine the amount of the tax

liability have not occurred at the time of the discharge. Because the all events test is not met, the debtor's tax liabilities have not accrued for tax purposes. Nevertheless, it seems that the tax liabilities should be taken into account in determining solvency. They are liabilities that arise from events occurring at or prior to the discharge, and they can be determined at the end of the year.

e.5. *The Bankruptcy Exclusion.* The bankruptcy (Title 11) exclusion requires the same reduction of tax attributes in the same manner as applies to the insolvency exclusion.⁹¹ The principal difference in the operation of this exclusion from the insolvency exclusion is that the amount of COD to be excluded for a discharge in a bankruptcy case is not limited to the insolvency of the debtor. Regardless of whether the debtor is solvent after the debts are forgiven in a bankruptcy case, the total amount forgiven is excluded from income.⁹² Another difference is that the basis of property that is exempt from the reach of creditors under federal bankruptcy law cannot be reduced because of the exclusion of COD under the bankruptcy exclusion.⁹³

The bankruptcy exclusion is given priority over all of the other exclusions.⁹⁴

e.6. *The Qualified Real Property Business Exclusion.* If a debtor (other than a C corporation) elects, the cancellation of a qualified real property business indebtedness is excluded from income.⁹⁵ The amount excluded is subject to two limitations.

First, as to any single qualified real property business indebtedness (defined below), the amount excluded cannot exceed the difference between the principal amount of that debt immediately before the discharge and the fair market value of the realty that it secures.⁹⁶ The fair market value of such realty must first be reduced by any qualified real property business indebtedness securing that property that is not discharged in the transaction.⁹⁷ In other words, the exclusion from income for the discharge of any one qualified debt can apply only to a reduction of the excess of the amount of that debt over the net value of the realty that secures it.

In addition to the limitation on each single qualified debt, there is an overall limitation on the amount excludable under this provision. The total amount excluded cannot exceed the aggregate bases of depreciable real property that the debtor holds immediately before the discharge (other than realty acquired in contemplation of the discharge).⁹⁸ The bases of the debtor's depreciable realty must first be reduced by the reductions required for the insolvency and bankruptcy exclusions and by the reduction for the qualified farm exclusion.⁹⁹

⁹¹ § 108(b)(1).

⁹² § 108(a)(1)(A).

⁹³ I.R.C. § 1017(c)(1).

⁹⁴ § 108(a)(2)(A).

⁹⁵ § 108(a)(1)(D).

⁹⁶ § 108(c)(2)(A).

⁹⁷ § 108(c)(2)(A)(ii).

⁹⁸ § 108(c)(2)(B).

⁹⁹ § 108(c)(2)(b).

The amount of qualified real property business indebtedness that is excluded under this provision will reduce the debtor's basis in his depreciable realty.¹⁰⁰ The reduction of basis of depreciable real property is determined under the provisions of section 1017.¹⁰¹ While section 1017(b)(3)(E) permits a debtor to elect to treat real property held for sale to customers in the ordinary course of a trade or business as depreciable property, that provision does not apply to the real property business indebtedness exclusion.¹⁰²

The exclusion for the forgiveness of qualified real property business indebtedness is an elective provision.¹⁰³ The election must be made on the debtor's return for the year in which the discharge occurred unless the Service grants an extension.¹⁰⁴ The standards that the Service employs in determining whether to grant an extension are set forth in Treasury Regulation sections 301.9100-1 through 301.9100-3. In general, in addition to an automatic extension granted in certain circumstances by Treasury Regulation section 301.9100-2, the standard for granting an extension is that "the taxpayer acted reasonably and in good faith and that the grant of the extension will not prejudice the interests of the Government."¹⁰⁵ One situation in which a taxpayer is deemed to have acted reasonably in good faith is if he relied on the advice of a qualified tax professional whose competence he had no reason to doubt, and the tax professional failed to make the election or advise the taxpayer to do so.¹⁰⁶

The qualified real property business exclusion is not available to a debtor that is a C corporation.¹⁰⁷

A qualified real property business indebtedness is a debt incurred or assumed by the debtor in connection with real property that is used in a trade or business and is security for that debt. It is treated as such indebtedness only if an election is made. If the debt was assumed or incurred by the debtor after 1992, it will not qualify unless it is qualified acquisition indebtedness.¹⁰⁸ Prior to 1993, the debt was not required to be an acquisition indebtedness. A debt that constitutes qualified farm indebtedness will not be qualified real property business indebtedness.¹⁰⁹ A qualified real property business indebtedness includes a debt resulting from the refinancing of a qualified real property

¹⁰⁰I.R.C. §§ 108(c)(1), 1017(b)(3)(F).

¹⁰¹§§ 108(c)(1), 1017(b)(3)(F).

¹⁰²§ 1017(b)(3)(F)(ii).

¹⁰³§ 108(c)(3)(C).

¹⁰⁴§ 108(d)(9)(A).

¹⁰⁵Reg. § 301.9100-3(a).

¹⁰⁶Reg. § 301.9100-3(b). For an example where an extension was granted, see P.L.R. 2014-32-009 (Apr. 21, 2014).

¹⁰⁷§ 108(a)(1)(D).

¹⁰⁸§ 108(c)(3).

¹⁰⁹§ 108(c)(3)(C).

business indebtedness, but only to the extent that the amount of the refinanced debt does not exceed the amount of the debt that was refinanced.¹¹⁰

Qualified acquisition indebtedness is a debt incurred or assumed to acquire, construct, reconstruct, or substantially improve real property that is used in a trade or business and is security for that debt.¹¹¹

The bankruptcy, insolvency, and farm exclusions are given priority over the qualified real property business exclusion.¹¹² Section 108(e)(5)(C) gives the qualified real property business exclusion priority over the exclusion for purchase-money debt reductions.¹¹³

As noted above, a debt that otherwise would constitute a qualified real property business indebtedness will not qualify if it also constitutes qualified farm indebtedness.¹¹⁴ But a qualified farm indebtedness is not excluded from income unless the creditor who forgave the debt constitutes a "qualified person" as defined in section 108(g)(1)(B).¹¹⁵ As literally written, the statute would disqualify for any exclusion a real property business indebtedness which is also a qualified farm indebtedness when the latter debt is not excluded from income because the creditor was not a qualified person. That literal language is contrary to the legislative purpose, which was merely to give the farm exclusion priority over the qualified real property business exclusion. It is unlikely that Congress intended to deny any exclusion for the discharge. It seems likely that the statute will be construed to allow the exclusion under the qualified real property business provision in that circumstance.

e.7. The Farm Exclusion. A discharge by a qualified person of a qualified farm indebtedness is excluded from the debtor's income.¹¹⁶ Subject to two exceptions, a qualified person is one who is actively and regularly engaged in the business of lending money and who is not a person related to the debtor.¹¹⁷ In addition, a qualified person includes any federal, state or local government or agency or instrumentality thereof.¹¹⁸

The insolvency and bankruptcy exclusions have priority over the qualified farm exclusion, but the latter has priority over the qualified real property business exclusion.

A debt is a qualified farm indebtedness if it is incurred directly by the debtor in connection with his operation of the trade or business of farming and if at least 50% of the aggregate gross receipts of the debtor for the three

¹¹⁰ § 108(c)(3)(C). If a pre-1993 qualified real property business indebtedness that was not a qualified acquisition indebtedness is refinanced after 1992, the refinanced debt will qualify even though it is not a qualified acquisition debt.

¹¹¹ § 108(c)(4).

¹¹² § 108(a)(2)(A)-(B), (c)(3).

¹¹³ See *supra* Part III.A.8.

¹¹⁴ § 108(c)(3).

¹¹⁵ § 108(g)(1)(A).

¹¹⁶ § 108(a)(1)(C).

¹¹⁷ § 108(g)(1)(B).

¹¹⁸ § 108(g)(1)(B).

taxable years prior to the year in which the discharge occurred “is attributable to the trade or business of farming.”¹¹⁹

There is a limitation on the amount that can be excluded under this provision. The amount excluded from income cannot exceed the sum of the adjusted tax attributes of the debtor and the aggregate bases of “qualified property” as of the beginning of the taxable year following the year in which the discharge occurred.¹²⁰ The adjusted tax attributes are the attributes listed in section 108(b)(2) (*i.e.*, those subject to reduction because of the bankruptcy or insolvency exclusion) except for the basis of the debtor’s property and a modification of the amount of credits taken into account.¹²¹ In calculating the amount of the adjusted tax attributes, they are first reduced by the reductions caused by the insolvency exclusion.¹²² Qualified property is any property that is used or held for use by the debtor in a trade or business or for the production of income.¹²³ The basis of qualified property that can be used for this purpose is first reduced by any reduction required because of the application of the insolvency exclusion.¹²⁴

The amount excluded by this provision reduces the tax attributes listed in section 108(b)(2) in the same manner as the reductions for the insolvency and bankruptcy exclusion are applied.¹²⁵ However, the reduction of basis of the debtor’s property applies only to the basis of qualified property.¹²⁶ The order in which the basis of qualified property is reduced is: (1) depreciable property, (2) land used or held for use in trade or business of farming, and (3) other qualified property.¹²⁷

e.8. *Purchase-Money Debt.* Prior to the Bankruptcy Act of 1980, courts held that a discharge of a debt that was incurred as part of the purchase of property and was owed to the seller constituted a reduction of the purchase price of the encumbered property.¹²⁸ The Tax Court restricted the doctrine to situations where the amount of the debt was greater than the value of the property, and only the cancellation of the excess amount of the debt could be treated as a price reduction.¹²⁹ That limitation does not apply to the provision as codified in the Code by the Bankruptcy Act of 1980. In

¹¹⁹ § 108(g)(2).

¹²⁰ § 108(g)(3)(A).

¹²¹ § 108(g)(3)(B). It would seem the reason that the basis of property is deleted from the list of tax attributes, which are part of the limitation on the amount that can be excluded from income, is to restrict the limitation’s use of the basis of property to the basis of “qualified property.”

¹²² § 108(g)(3)(D).

¹²³ § 108(g)(3)(C).

¹²⁴ See § 108(g)(3)(D).

¹²⁵ § 108(b)(1).

¹²⁶ I.R.C. § 1017(b)(4)(A)(i).

¹²⁷ § 1017(b)(4)(A)(ii).

¹²⁸ See, *e.g.*, *Montgomery v. Commissioner*, 65 T.C. 511, 521 (1975); *L.D. Coddon & Bros., Inc. v. Commissioner*, 37 B.T.A. 393, 397 (1938).

¹²⁹ See *e.g.*, *Montgomery*, 65 T.C. at 521; *L.D. Coddon & Bros. Inc.*, 37 B.T.A. at 398-99.

several acquiring cases, courts held that the doctrine would be applied only with proof that the value of the property had declined and that the seller and the debtor had negotiated over the cancellation as a reduction of the selling price.¹³⁰ Those requirements do not apply to the statutory adoption of the doctrine. The result of this doctrine was to reduce the debtor's basis in the encumbered property and to prevent the cancellation from being treated as income to the debtor. The doctrine was applied in several cases when the creditor of the debt was not the person who sold the property,¹³¹ but that position is not likely to be followed now.

When the creditor and the seller of the property are the same person—a requirement for the application of the doctrine—the doctrine can be seen as an example of the transactional approach to the COD rules. When the debtor purchased the property, he obtained a basis that included the debt that he owed to the seller.¹³² It was assumed that he would pay that debt, and so the amount of the debt constituted part of his purchase price and was included in his basis. When part or all of the debt is discharged, it becomes clear that he will not pay that amount. Because the debt was owed to the seller, a reduction of the debt amounts to a reduction of the price paid for the property. Rather than to treat the discharge as income to the debtor, the cancellation can be seen as a retroactive adjustment to the price payable for the property. This is a generous application of the transactional approach because the additional basis the debtor obtained may have provided him with tax benefits in the years prior to the discharge. If the purchased property were a building, the debtor would have had greater depreciation deductions in the intervening years than if his initial basis in the building had not included the discharged amount of the debt.

This doctrine concerning the discharge of a purchase-money debt was codified with some modifications in the 1980 amendment of section 108. Section 108(e)(5) provides that the reduction of a purchase-money debt of a solvent debtor is treated as a reduction of the property's purchase price.¹³³ A purchase-money debt is a debt owed to the seller of the property as part of its purchase. It does not refer to a debt incurred in the purchase that is owed to someone other than the seller. The statute does not require that the property's value be less than the outstanding debt. If the seller was the original creditor,

¹³⁰ See *Commissioner v. Coastwise Transportation Corp.*, 71 F.2d 104 (1st Cir. 1934). See also *Amphitrite Corp. v. Commissioner*, 16 T.C. 1140 (1951) (Acq).

¹³¹ See, e.g., *Fulton Gold Corp. v. Commissioner*, 31 B.T.A. 519 (1934). The Service rejected the holding of that case in Revenue Ruling 91-31, 1991-1 C.B. 19. See also *Hirsch v. Commissioner*, 115 F.2d 656 (7th Cir. 1940) (COD was excluded under the purchase-money debt rule where the debt had been refinanced so that the creditor was not the seller); *Freedom Newspapers, Inc. v. Commissioner*, 34 T.C.M. 1755 (1977); *Brown v. Commissioner*, 10 B.T.A. 1036 (1928).

¹³² See *Crane v. Commissioner*, 331 U.S. 1, 11 (1947).

¹³³ S. REP. NO. 96-1035, at 12-13 (1980), Bankruptcy Tax Act of 1980, Pub. L. No. 96-589, § 108(e)(5), 94 Stat. 3389, 3393 (1980).

but had transferred the debt to a third party before the discharge took place, the statutory provision will not apply. Nor will it apply when prior to the discharge the property was transferred by the buyer to a third person. Also, even if the seller is the creditor, if the cancellation occurred for reasons other than an agreement between the buyer and the seller, such as the expiration of the statute of limitations, section 108(e)(5) will not apply.¹³⁴

All of the other exclusions from income take priority over the purchase-money debt exclusion.¹³⁵

The question arises as to whether the statutory provision is not exclusive so that the cases¹³⁶ applying the doctrine to a debt owed to a third party could be applicable. Even if the common law on this doctrine is still viable, it is virtually certain that it will not apply to a debt owed to a third party who is not the seller.¹³⁷ In Part VI.B. of this Article, we point out one situation in which a cancellation of such a debt to a third party *might* be excluded from income, but the prospects for prevailing on that issue are not good.

Section 108(e)(5)(B) states that the purchase-money exclusion does not apply if the reduction occurs in a Title 11 case or when the debtor is insolvent.¹³⁸ The apparent purpose of that exception is to give priority to the insolvency and bankruptcy exclusions so that the reduction of tax attributes caused by those provisions will apply instead of a price reduction. However, it appears that the exception is redundant because section 108(e)(5)(C) apparently grants all the other exclusions priority over the purchase-money exclusion.¹³⁹

That raises a question as to what should be the treatment of a cancellation of a purchase-money debt of a debtor who was insolvent but became solvent as a result of the cancellation. The insolvency exclusion will not apply to the discharged debt to the extent that the debtor became solvent. Will the amount that is not excluded by the insolvency exception be excluded by section 108(e)(5)? The express language of section 108(e)(5) provides that it applies only if the purchaser is not insolvent when the reduction of the debt occurred. Yet, it is one thing to give priority to the insolvency exclusion and quite another to cause income recognition because of a limitation on that exclusion. It seems plausible that the purchase-money debt exclusion will apply to the amount not excluded by the debtor's insolvency.

Illustration 1. In Year One, Hilda purchased an apartment building. Hilda paid \$200,000 cash and took the building subject to an \$800,000 mortgage. Hilda's initial basis in the building was \$1,000,000. In Year Six, the mortgagee agreed to cancel \$200,000 of the mortgage debt in exchange for Hilda's

¹³⁴S. REP. No. 96-1035, at 16-17 (1980).

¹³⁵I.R.C. § 108(e)(5)(C).

¹³⁶Hirsch v. Commissioner, 115 F.2d 656 (7th Cir. 1940); *Fulton Gold Corp. v. Commissioner*, 31 B.T.A. 519 (1934).

¹³⁷See, e.g., *Preslar v. Commissioner*, 167 F.3d 1323 (10th Cir. 1999).

¹³⁸See *id.*

¹³⁹§ 108(e)(5)(B).

payment of \$50,000, and that took place. Immediately before the discharge took place, the adjusted basis of the building was \$800,000; and the outstanding balance of the mortgage was \$700,000. The mortgagee was not the person who sold the property to Hilda. Hilda was solvent when the discharge took place. Section 108(e)(5) does not apply to the discharge, and Hilda will have \$150,000 of income unless some other exclusion applies (such as the qualified real property business exclusion).¹⁴⁰

Illustration 2. In Year One, Frank purchased an office building from Alice. Frank paid Alice \$200,000 cash and took the property subject to a \$800,000 nonrecourse debt that is owing to Alice. Thus, Alice loaned Frank \$800,000 to finance his purchase of the property. In Year Six, Alice cancelled \$200,000 of the nonrecourse debt in exchange for Frank's payment of \$50,000. Frank was solvent when the discharge took place. Immediately before the discharge took place, Frank's adjusted basis in the property was \$800,000, the outstanding balance of the nonrecourse debt was \$700,000. The property had a value of \$900,000 at that time. Section 108(e)(5) precludes any recognition of income by Frank on the cancellation of the debt. Instead, Frank's basis in the building is reduced by the \$150,000 discharge to \$650,000. The fact the property had a value that was greater than the amount of the outstanding debt does not prevent the application of section 108(e)(5).

Illustration 3. The same facts as those stated in **Illustration 2**, except that, immediately before the discharge took place, Frank was insolvent in the amount of \$100,000. As a result of the discharge, Frank became solvent in the amount of \$50,000. So, of the \$150,000 debt that was discharged, \$100,000 is excluded from Frank's income by the insolvency exclusion; that amount will reduce Frank's tax attributes. The remaining \$50,000 of the discharged debt is not excluded by the insolvency provision. Can that \$50,000 of discharged debt be excluded by section 108(e)(5)? While the literal language of that provision would seem to prevent its application, the question is unresolved.

e.9. *Discharge of a Deductible Liability.* Section 108(e)(2) provides that the discharge of a debt that would have been deductible when paid is excluded from the debtor's income.¹⁴¹ The genesis of this statutory rule is a 1977 Tax Court decision involving the meaning of the word "liability" in the application of a corporate tax statute.¹⁴² In *Focht*, the Tax Court held that liability in that statute did not include an obligation to make a payment that would be deductible when paid.¹⁴³ Congress codified this holding in 1978

¹⁴⁰Note that if the qualified real property business exclusion were elected, it would have taken priority over the purchase-money debt exclusion even if the latter had otherwise applied. See § 108(e)(5)(C).

¹⁴¹§ 108(e)(2).

¹⁴²*Focht v. Commissioner*, 68 T.C. 223 (1977) (reviewed by the court). The corporate tax statute at issue was section 357(c).

¹⁴³*Focht*, 68 T.C. at 238.

with Code sections 357(c)(3) and 358(d)(2).¹⁴⁴ The same concept has been adopted in the partnership tax area by administrative ruling and in the COD area through section 108(e)(2).

A question can arise as to the meaning of the statutory requirement that the "payment of the liability would have given rise to a deduction." Typically, there will not be a problem in applying section 108(e)(2) because either the liability would be a nonitemized deduction when it was paid or the debtor is a corporation. But what if the debtor is an individual and the payment of the liability would have been an itemized deduction? In our view, all the statute requires is that a payment of the liability would come within a provision for a deduction, regardless of whether it would be fully deductible in specific circumstances. A contrary construction would be too difficult to administer. The question is unresolved.

The *Focht* case arose in the context of a transfer of assets and liabilities by a cash method taxpayer to a corporation in which the nonrecognition provision of section 351(a) generally prevents income recognition.¹⁴⁵ Some of the liabilities were accounts payable that would be deductible expenses when paid by the cash method taxpayer.¹⁴⁶ It was the transferee corporation's assumption of those liabilities that the Tax Court held did not cause income to the taxpayer.¹⁴⁷ But what is the tax treatment to the transferee of the liabilities when the transferee pays them?

One might expect that the transferee who receives a deductible liability as part of a purchase of assets would not be permitted to take a deduction for the payment of that liability. The acceptance of the liability would be part of the purchase price, and so the payment of that liability would be pursuant to the purchase of the assets and treated as a capital expenditure. But in the context of a transfer to a controlled corporation as part of an exchange that is granted nonrecognition by section 351(a), it was determined that the purposes of that nonrecognition provision would be frustrated if the transferee were not permitted to deduct the payments. Accordingly, the Service has ruled that the transferee can deduct the payment of the liabilities.¹⁴⁸

Permission for a transferee of a deductible liability to deduct its payment should be restricted to circumstances where that treatment accords with the

¹⁴⁴Revenue Act of 1978, Pub. L. No. 95-600, § 365, 92 Stat. 2763 (codified as amended at I.R.C. §§ 357(c)(3), 358(d)(2)).

¹⁴⁵See *Focht*, 68 T.C. at 226.

¹⁴⁶See *id.* at 229.

¹⁴⁷See *id.* at 237-38.

¹⁴⁸Rev. Rul. 80-198, 1980-2 C.B. 113. See also Rev. Rul. 95-74, 1995-2 C.B. 36 (affirming Revenue Ruling 80-198).

legislative purpose of a specific provision such as section 351 exchanges. In more ordinary circumstances, the transferee will not be allowed a deduction.¹⁴⁹

e.10. *Purchase of Debt by a Person Related to the Debtor.* Section 108(e)(4) treats an acquisition of a debt by a person who is related to the debtor as if it were an acquisition by the debtor himself. Consequently, the acquisition can give rise to COD income if the price paid is less than the amount owing on the debt. The statute defines who constitutes a related person for this purpose. Related persons include: (1) an individual and the spouse, children, grandchildren, and parents of the individual (and spouses of the individual's children and grandchildren); (2) an individual and a corporation in which the individual owns more than 50% of the value of the stock; and (3) a grantor or beneficiary of a trust and the fiduciary of that trust.¹⁵⁰ The section 108(e)(4) mandate for a constructive purchase of the debt by the debtor does not apply when the related party purchases the debt from a person who also is related to the debtor.¹⁵¹

The obvious purpose of this provision is to prevent a debtor from circumventing the discharge of indebtedness rules by having his debt acquired by a person who is closely related to him. While the debtor remains liable for the repayment of the entire debt, the excess of the debt over what was paid for it may represent a gift from the debtor to the related person or a contribution to its capital. Alternatively, the related person may simply never collect the debt and never cancel it.

The related person who acquired the debt is referred to herein as the "holder." Although the transaction is treated as if the debtor acquired the debt, the debt is still outstanding in the hands of the holder. How is that outstanding debt to be treated? The treatment is described in Treasury Regulation section 1.108-2. In general, the outstanding debt is treated as cancelled in exchange for a new debt from the debtor to the holder. The new debt is treated as having been issued for a price equal to the basis that the holder has in the debt if the holder acquired the debt by purchase on or less than six months prior to the "acquisition date." The acquisition date is described below. If the holder did not acquire the debt by purchase on or within that six-month period, the issue price is equal to the fair market value of the debt at the acquisition date. If the principal amount of the debt exceeds the constructive issue price so that the debtor has COD, the excess is treated as original issue discount (OID) regardless of whether the COD is excluded from the debtor's income under

¹⁴⁹ Compare *David R. Webb Co. v. Commissioner*, 77 T.C. 1134 (1981), *aff'd*, 708 F.2d 1254 (7th Cir. 1983) (denying a deduction in such a case), with *Commercial Sec. Bank v. Commissioner*, 77 T.C. 145 (1981) (allowing a transferee who assumed a debt to deduct its payment). The latter decision is questionable because the liability was assumed as part of the purchase price of assets and should have been capitalized.

¹⁵⁰ I.R.C. § 108(e)(4)(B). That is an incomplete list of who constitutes a related person.

¹⁵¹ Reg. § 1.108-2(b).

section 108(a).¹⁵² The OID may be deductible by the debtor and included in the holder's income under sections 163 and 1272.

When a debt is acquired by a person related to the debtor, that is a "direct acquisition." A direct acquisition occurs on the date that the debt is acquired by the holder. But what if the holder acquired the debt when he was not related to the debtor and became related subsequently? If the holder acquired the debt in anticipation of becoming related to the debtor, that is covered by the statute and is referred to as an "indirect acquisition." An indirect acquisition occurs on the date that the holder becomes related to the debtor. The "acquisition date" is the date on which either a direct or an indirect acquisition occurs.¹⁵³

The regulations provide criteria for determining whether a person acquired a debt in anticipation of becoming related to the debtor.¹⁵⁴ If the holder acquired the debt within six months prior to becoming related, he is treated as having acquired the debt in anticipation of becoming related to the debtor.¹⁵⁵ Otherwise, the determination is made on the basis of the facts and circumstances that are present.¹⁵⁶ If the holder acquired the debt more than six months before the holder became related but within 24 months, he is required to make certain disclosures on an attachment to his tax return.¹⁵⁷ In addition to other penalties, a failure to disclose will create a presumption that the holder acquired the debt in anticipation of becoming related to the debtor.¹⁵⁸ This presumption can be rebutted by presenting facts and circumstances that clearly establish the holder did not anticipate a relationship.

The treatment in section 108(e)(4) of a related person's purchase of a debtor's debt does not apply to a direct or indirect acquisition of a debt with a stated maturity date not greater than one year after the acquisition date, provided that the debt is actually retired on or before its maturity date.¹⁵⁹

e.11. *Student Loans.* The discharge of certain student loans will not cause the debtor to recognize income if the discharge is pursuant to a provision in the loan agreement that all or a portion of the debt will be cancelled if the student worked for a specified period of time in certain professions for a broad class of employers.¹⁶⁰ To qualify, the purpose of the loan must be to assist the student in attending a qualified educational institution, and the lender must be an entity that is one of those listed in section 108(f)(2).¹⁶¹ The

¹⁵²Reg. § 1.108-2(g)(1).

¹⁵³Reg. § 1.108-2(d)(1).

¹⁵⁴Reg. § 1.108-2(c).

¹⁵⁵Reg. § 1.108-2(c)(3).

¹⁵⁶Reg. § 1.108-2(c)(2).

¹⁵⁷Reg. § 1.108-2(c)(4) (noting, also, that there are other circumstances in which a disclosure is required).

¹⁵⁸Reg. § 1.108-2(c)(2), (4).

¹⁵⁹Reg. § 1.108-2(e).

¹⁶⁰I.R.C. § 108(f).

¹⁶¹For example, the loan must be made by, among others, the government, a public benefit corporation or an educational organization. § 108(f)(2).

exclusion does not apply if the student is required to perform services for the same educational institution making the loan to the student.¹⁶²

The 2004 American Jobs Creation Act added subsection (f)(4) to section 108, and the Affordable Care Act of 2010 expanded that subsection. The subsection excludes from income amounts received under specified federal and state loan forgiveness or repayment programs designed to increase health care services in underserved areas.

e.12. *Effect on the Creditor.* A creditor may have tax consequences when it cancels a debt. For example, the creditor may be entitled to a bad debt deduction, have made a gift for which a gift tax return is required, or have paid a dividend to the debtor or made a contribution to the debtor's capital. If the creditor is a certain financial entity or government unit, and if the amount discharged is \$600 or more, the creditor may be required by section 6050P to file a return disclosing certain information.

If both principal and interest were owing on a debt that was partially discharged, the creditor and the debtor are permitted to determine by their agreement how much of the discharged debt was principal and how much was interest.¹⁶³ The tax treatment of a creditor when a corporate debtor transfers its stock in exchange for a cancellation of its debt, or a partnership transfers an interest in that partnership in exchange for a cancellation of its debt, is discussed in Part III.C. of this Article.

e.13. *Recapture of Ordinary Income.* As noted, COD income is recognized as ordinary income. An exclusion of COD income causes a reduction of tax attributes, which constitutes a kind of deferral of the tax consequence of the COD. If the tax attribute that is reduced is a net operating loss or a tax credit, the deferred tax consequence will be of the same character as the excluded income.¹⁶⁴ On the other hand, if the tax attribute reduced is a net capital loss carryover, it will not be of the ordinary income character of the excluded COD income. The current tax law does nothing to prevent the change of character from occurring in that circumstance.

The same change of character might occur if the tax attribute reduced is the basis of property. The reduction of basis of depreciable property will cause a loss of ordinary deductions, and so the character of the deferral will be consistent with the excluded income. However, if the property whose basis was reduced is sold or exchanged, the gain (or part of the gain) recognized might be a capital gain or a section 1231 gain. The Code addresses that situation by requiring that the gain on a disposition of the property attributable to the reduction of basis be treated as ordinary income and thereby correlated with the COD gain that was excluded from income. This is accomplished by utilizing the recapture of depreciation rules applied by section 1245.

¹⁶² § 108(f)(3).

¹⁶³ See *Estate of Hagen v. Commissioner*, 28 T.C.M. (CCH) 341, 345-46, T.C.M. (P-H) ¶ 69,059 (1969).

¹⁶⁴ I.R.C. §§ 61(a)(12), 1221.

Section 1017(d) provides that any property whose basis is reduced under that section and that is neither section 1245 property nor section 1250 property will be treated as section 1245 property. Moreover, any reduction of basis in that property under section 1017 will be treated as a deduction that was allowed for depreciation. As a consequence, the amount of the reduction of basis for the COD income will be recaptured as ordinary income to the extent of gain recognized on the property disposition.

Illustration. In Year One, Paula had \$10,000 of COD, all of which was excluded from her income because she was insolvent. The only tax attribute that Paula had was her \$60,000 of basis in stock of the X corporation. Although Paula was still insolvent immediately after the discharge, her basis in her X stock exceeded her aggregate liabilities by more than \$10,000. Consequently, the limitation on the reduction of basis in section 1017(b)(2) was inapplicable. As a consequence of the exclusion of the COD income, Paula's basis in her X stock was reduced to \$50,000 at the beginning of Year Two.

In Year Six, Paula sold her X stock for \$80,000, which was its value. Paula's basis in the X stock was still \$50,000, so she recognized a gain of \$30,000. If the exclusion from income of the COD had not taken place, the X stock would be a capital asset, and Paula would have recognized a long-term capital gain of \$20,000. Instead, because of section 1017(d), Paula must treat the stock as section 1245 property, and she must treat the \$10,000 reduction in basis as depreciation deductions that were allowed. As a result, Paula will recognize ordinary income of \$10,000, and she will have a long-term capital gain of \$20,000.

B. *S Corporations and Partnerships*

1. *S Corporations*

Section 108(d)(7)(A) states that the determination of the applicability of the exclusions for insolvency, bankruptcy, qualified farm indebtedness, and qualified real property business indebtedness for the COD of an S corporation is made at the corporate level and not at the shareholder level. Also, it is the tax attributes of the S corporation that are reduced because of any exclusion.¹⁶⁵ As a consequence of a 2002 amendment of that statutory provision, the COD excluded from the S corporation's income is not passed through to its shareholders and so does not increase the basis of their stock under section 1366(a).¹⁶⁶ That 2002 amendment overturned the 2001 decision of the Supreme Court in *Gitlitz* that allowed the shareholders to increase their stock basis by their share of the excluded income.¹⁶⁷

The S corporation's income, loss, deductions, and credits for the taxable year pass through to its shareholders under section 1366(a) before any

¹⁶⁵ § 108(d)(7)(A); Reg. § 1.108-7(d)(1).

¹⁶⁶ See Preamble to T.D. 9469, 2009-48 C.B. 687.

¹⁶⁷ *Gitlitz v. Commissioner*, 531 U.S. 206 (2001).

reduction of those tax items is made as a consequence of the exclusion of the corporation's COD.¹⁶⁸

Under section 1366(d)(1), when an S corporation has a loss in a taxable year that passes through to its shareholders, a shareholder can deduct the loss that passed through to him only to the extent that he has a basis in the corporation's stock or in a debt owed to him from the corporation.¹⁶⁹ Any nondeductible losses can be carried forward to subsequent years.¹⁷⁰ If an S corporation has excluded COD in a taxable year, that can cause the termination of some of the losses that had passed through to the shareholders but which the shareholders have to carry forward because of their lack of basis in the corporation's stock or debt. The manner in which the Code does this is described below.

If, in the taxable year in which an S corporation had COD excluded from income under section 108(a), other than by the real property business exclusion, a shareholder had a loss that passed through from the corporation (either in that year or as a carryover from a prior year), and if the shareholder was prevented from deducting all or any part of that loss because of his lack of basis in stock or debt of the corporation, the shareholder's disallowed deduction for that loss is treated as a net operating loss (NOL) of the S corporation for purposes of determining the corporation's tax attributes that are to be reduced because of the exclusion of the COD from income.¹⁷¹ The constructive net operating loss (NOL) of the corporation is then reduced by the excluded COD, except it is not reduced by COD that is excluded under the real property business exclusion.¹⁷² If the constructive NOL of the corporation exceeds the amount of reduction, then the amount of the remaining constructive NOL is allocated among the shareholders. Each shareholder's portion of the remaining constructive NOL is a fraction: the amount by which that shareholder's disallowed loss exceeds the amount of the COD income that would have been allocated to him if not excluded from income, over the total remaining constructive NOL.¹⁷³ The loss allocated back to a shareholder is characterized in proportion to the character of that shareholder's losses that

¹⁶⁸ See Preamble to T.D. 9469, 2009-48 C.B. 687.

¹⁶⁹ The basis requirement is only one of the limitations on the deductibility of a pass-through loss. In addition, the at-risk rules of section 465 and the passive activity loss limitation of section 469 apply.

¹⁷⁰ I.R.C. § 1366(d)(2).

¹⁷¹ I.R.C. § 108(d)(7)(B).

¹⁷² § 108(d)(7)(B). The only tax attribute that is reduced because of the real property business exclusion is the basis of depreciable property. § 108(c)(1). So, that exclusion does not reduce the corporation's NOL.

¹⁷³ Reg. § 1.108-7(e), Ex. (5).

were changed to an NOL of the S corporation.¹⁷⁴ The following illustration is drawn from an example in the regulations.¹⁷⁵

Illustration. A, B, and C are equal shareholders of X, an S corporation. As of the end of Year One, none of the shareholders has any basis in his X stock, and X has no indebtedness to any of its shareholders. In Year One, X excludes \$45,000 of COD from its income under section 108(a).¹⁷⁶ Had it not been excluded, \$15,000 of the COD income would have been allocated to each shareholder. In that same year, X had \$30,000 of losses, allocated equally among its three shareholders. A has a loss of \$10,000 allocated to him. B has \$10,000 of loss allocated to him, and B also has \$20,000 of pass-through losses from prior years that were disallowed and carried over to Year One by section 1366(d). C has \$10,000 of loss allocated to him, and C also has a carryover of \$30,000 of pass-through losses from prior years. All of the shareholders' losses are nondeductible because of section 1366(d)—because they have no basis in their X stock and no corporate debt is owing to them. The total loss that is disallowed is \$80,000 (\$10,000 for A, \$30,000 for B, and \$40,000 for C). That \$80,000 of total loss is treated as an NOL of X for purposes of applying the reduction of tax attributes rule.

X's \$45,000 of excluded COD income reduces its \$80,000 of constructive NOL to \$35,000. The remaining \$35,000 of NOL is allocated back to the shareholders in proportion to the amount by which their nondeductible loss exceeded the amount of COD that would have been allocated to them if the exclusion from income had not applied. So, none of the remaining NOL is allocated to A because his \$10,000 disallowed loss is less than his share of the COD that would have been allocated to him (\$15,000). B's \$30,000 of disallowed loss exceeds his share of COD income by \$15,000. C's \$40,000 of disallowed loss exceeds his share of COD income by \$25,000. So, 15/40 or 3/8 of the remaining \$35,000 of X's NOL is allocated to B, who thereby has a loss of \$13,125 allocated to him. C has allocated to him 25/40 or 5/8 of the \$35,000 of X's remaining NOL, and so C has \$21,875 of loss allocated to him. The character of the losses allocated to B and C is determined by the proportion of the character of the disallowed losses that each had before the reduction.¹⁷⁷ B and C carry over the losses allocated to them to subsequent years.

Only the losses passed through to shareholders that are not deductible because of a lack of basis in stock or debt are subjected to the above treatment. If a shareholder was denied a deduction for a pass-through loss because

¹⁷⁴Reg. § 1.108-7(e), Ex. (5). Thus, if 1/6 of a shareholder's loss was a long-term capital loss, 1/2 was an ordinary loss, and 1/3 was a section 1231 loss, then those fractions of the remaining constructive NOL that is allocated to that shareholder will have the same character. That is, 1/6 will be long-term capital loss, 1/2 will be an ordinary loss, and 1/3 will be a section 1231 loss.

¹⁷⁵See Reg. § 1.108-7(e), Ex. (5).

¹⁷⁶The applicable exclusion in this problem was not the qualified real property business debt exclusion.

¹⁷⁷Reg. § 1.108-7(e), Ex. (5).

of some other provision such as the at risk rules¹⁷⁸ or the passive activity loss limitation rules,¹⁷⁹ those losses will not be treated as an NOL of the corporation.¹⁸⁰

If one of the shareholders in the **Illustration** above had transferred all of his stock before the end of Year One, his disallowed losses for that year would still be treated as NOL of the corporation.¹⁸¹ In that case, X corporation's remaining constructive NOL that otherwise would have been allocated to that terminating shareholder will be permanently disallowed unless the stock was transferred to the spouse of the terminating shareholder.¹⁸² If the transfer of the stock was made to the terminating shareholder's spouse in a transaction that qualified under section 1041(a), the constructive NOL that would have been allocated to the terminating shareholder will be allocated to the spouse in the next taxable year.¹⁸³

If a C corporation with net operating losses becomes an S corporation, the NOLs incurred while it was a C corporation cannot be carried over to years when it is an S corporation.¹⁸⁴ Also, capital losses and business credits of a C corporation cannot be carried over to years in which it is an S corporation.¹⁸⁵ Consequently, the S corporation's tax attributes that are reduced by excluded COD income do not include items incurred when the corporation was a C corporation.

2. Partnerships

The exclusionary rules for the cancellation of a debt of a partnership are determined at the partner level.¹⁸⁶ The partnership's COD is allocated among the partners. Each partner determines whether the share of COD allocated to him is excluded from income. For example, the insolvency exclusion is applied only to a partner insolvent in his own regard. If the cancelled debt was a qualified real property business debt, each partner can elect whether to exclude his share of that COD. The determination of whether the debt constitutes a qualified real property business debt is made at the partnership level. Each partner who excludes any of the COD allocated to him reduces his own tax attributes.¹⁸⁷

A cancellation of a partnership's debt will reduce the partnership's liability. Section 752(b) will cause the partners to be treated as having received a cash distribution from the partnership for their share of the reduction of

¹⁷⁸I.R.C. § 465.

¹⁷⁹I.R.C. § 469.

¹⁸⁰See Preamble to T.D. 9469, 2009-48 C.B. 687.

¹⁸¹Reg. § 1.108-7(d)(1).

¹⁸²Reg. § 1.108-7(d)(2)(iii); see also Reg. § 1.1366-2(a)(5).

¹⁸³See Reg. §§ 1.108-7(d)(2)(iii), Reg. § 1.1366-2(a)(5). See also I.R.C. § 1366(d)(2)(B).

¹⁸⁴I.R.C. § 1371(b)(1).

¹⁸⁵See Preamble to T.D. 9469, 2009-48 C.B. 687.

¹⁸⁶I.R.C. § 108(d)(6).

¹⁸⁷§ 108(d)(6).

the partnership's liability. That constructive cash distribution will reduce each partner's basis in his partnership interest.¹⁸⁸ At the same time, the allocation of the COD income to each partner will increase his basis in his partnership interest regardless of whether the COD is excluded from his taxable income.¹⁸⁹ However, if the COD is excluded from a partner's income by section 108, that will usually cause a reduction of the partner's tax attributes, which could result in a reduction of his basis in his partnership interest.

Illustration. Alex and Betty are equal partners of the AB partnership. They each have a substantial basis in their partnership interest. In Year One, the AB partnership has a recourse debt of \$20,000 cancelled, and the cancellation constitutes COD income. While AB is insolvent, that has no effect on the characterization of the COD or its tax treatment. Of the COD income, \$10,000 is allocated to Alex and \$10,000 to Betty. Both Alex and Betty will increase their basis in their partnership interests by \$10,000.

Alex is insolvent in the amount of \$15,000, and so he excludes the \$10,000 COD from his income under the insolvency exclusion. The exclusion of the COD from Alex's taxable income does not prevent the increase in his basis in his partnership interest. The cancellation of the \$20,000 recourse debt reduced Alex's share of the partnership's liabilities by \$10,000, and so that caused a constructive distribution to Alex of that amount. The constructive distribution of \$10,000 cash reduced Alex's basis in his partnership interest by that amount. Because Alex had the same share of the partnership's liability as he did of the COD, the resulting increase and decrease of his basis in his partnership interest is a wash. However, because of the insolvency exclusion, Alex must reduce his tax attributes listed in section 108(b)(2). Depending upon what attributes Alex possesses, he might have to reduce his basis in his partnership interest.

Because Betty is solvent, she must include her \$10,000 share of the COD in her taxable income. It does not matter that the AB partnership is insolvent. Betty will increase her basis in her partnership interest by \$10,000 because of the COD income allocated to her. The reduction of the partnership's liability will cause a constructive distribution of \$10,000 cash to Betty, which will reduce her basis in her partnership interest by that amount. The net result is that Betty will recognize \$10,000 of income, and her basis in her partnership interest will be unchanged.

¹⁸⁸I.R.C. §§ 705(a)(2), 733(1).

¹⁸⁹§ 705(a)(1). The Tax Court and the Sixth Circuit held in *Babin v. Commissioner*, 23 F.3d 1032 (6th Cir. 1994), *aff'g* 64 T.C.M. 1357 (1992), that the allocation of COD to a partner who excluded the item from income under the insolvency exclusion could not increase his basis in his partnership interest. Those cases involved the 1978 tax year, which preceded the amendments made to section 108 by the Bankruptcy Tax Act of 1980. In T.A.M. 1997-39-002 (May 19, 1997), the Service determined that the *Babin* decisions do not apply to years subsequent to the adoption of the 1980 Act. The Service concluded that a partner's basis in his partnership interest is increased by the partner's share of COD even when the COD is excluded from the partner's taxable income.

A person whose tax attributes are to be reduced because of an exclusion of COD from income is permitted to treat as depreciable property his interest in a partnership that holds depreciable property, but only to the extent of his proportionate interest in the partnership's depreciable property.¹⁹⁰ This provision applies only if the partnership agrees to reduce its basis in its depreciable property with respect to that partner.¹⁹¹ The same treatment is available for a parent corporation's stock in its subsidiary that holds depreciable property if the two corporations are part of an affiliated group.¹⁹²

C. *Equity for Debt Exchange*

1. *Corporate Stock*

If a corporation transfers its stock to a creditor in satisfaction of a recourse or nonrecourse debt, the corporation is treated as having paid the creditor an amount of money equal to the fair market value of the stock plus any other property transferred by the corporate debtor.¹⁹³ If the principal amount of the debt is greater than the amount paid by the corporation, the difference constitutes COD.¹⁹⁴ While a corporation does not recognize income on a disposition of its stock,¹⁹⁵ it can recognize income from a COD unless one of the exclusions applies. If the creditor is also a shareholder of the corporation, section 108(e)(6) will apply; that provision is discussed in Part IV.B. of this Article.

If the exchange of stock for debt takes place in the context of a corporate reorganization as defined in section 368(a), and if the debt qualifies as a security, the creditor will not recognize income on the exchange except for stock it receives in payment of accrued interest.¹⁹⁶ In the case of a corporate reorganization, the creditor's basis in the stock received for the debt will equal the basis that the creditor had in the debt.¹⁹⁷

If the debt was not a security or if the exchange was not made pursuant to a reorganization, the creditor can recognize gain or loss depending upon the creditor's basis in the debt.¹⁹⁸ Prior to the adoption of section 1271 in 1984, a gain or loss that was recognized by a creditor on the satisfaction of a debt usually would be ordinary income or loss because there would not have been a sale or exchange. As a result of the adoption of section 1271, a gain or loss

¹⁹⁰I.R.C. § 1017(b)(3)(C).

¹⁹¹§ 1017(b)(3)(C).

¹⁹²§ 1017(b)(3)(D).

¹⁹³I.R.C. § 108(e)(8).

¹⁹⁴§ 108(e)(8).

¹⁹⁵I.R.C. § 1032.

¹⁹⁶I.R.C. § 354(a).

¹⁹⁷I.R.C. § 358(a).

¹⁹⁸I.R.C. § 1271.

is more likely to be a capital gain or loss, but there are circumstances in which a gain can be ordinary.¹⁹⁹

A creditor who receives stock in cancellation of a debt may have previously treated the debt as partially worthless and taken a bad debt deduction under section 166(a)(2). Instead, a creditor might previously have treated the debt as completely worthless and taken a bad debt deduction under section 166(a)(1). Also, the creditor might recognize a loss on the exchange if it is a taxable transaction. Section 108(e)(7) provides that, when a creditor receives stock of a corporation in satisfaction of that corporation's debt, regardless of whether the debtor corporation is solvent, insolvent or in bankruptcy, the stock acquired by the debtor is treated as section 1245 property. It does not matter whether the stock was received by the debtor as part of a nonrecognition or a taxable transaction. The statute further provides that the aggregate amount of bad debt deductions taken by the creditor on the debt and any *ordinary* loss recognized by the creditor on the exchange is treated as amounts allowed as depreciation deductions in applying section 1245 to a subsequent disposition of the stock. In this regard, one can see how a debtor could recognize a loss on such an exchange, but there are not likely to be many circumstances in which the loss is ordinary. If the creditor recognized a gain on the exchange, the amount treated as depreciation deductions is reduced by the amount of that gain.²⁰⁰ The purpose of this provision is to require the creditor to recognize ordinary income on a disposition of the stock to the extent of any ordinary deductions the creditor obtained through a claim of a bad debt or on a loss recognized on the exchange of the debt. If an accrual method creditor never took a bad deduction nor recognized an ordinary loss on the exchange, the characterization of the stock as section 1245 property will have no tax significance.

In the case of a creditor who reports his income on the cash method, any amount that was not included in the creditor's income but that would have been included if the debt had been satisfied in full will be added to the amount treated as allowed depreciation deductions.²⁰¹

If the creditor subsequently exchanges the stock in a nonrecognition transaction, such as in a corporate reorganization, that will not trigger ordinary income, but the potential for recognizing ordinary income will apply to a disposition of the newly acquired property.²⁰²

If a corporation's debt is held by its shareholders in the same proportion that they hold its stock, and if the stock distributed in cancellation of all or part of that debt is distributed pro rata among the corporation's shareholders,

¹⁹⁹For example, if the creditor had previously taken a bad debt deduction for a partially worthless business bad debt, a gain recognized by the creditor on the subsequent satisfaction of the debt would be ordinary income to the extent of the ordinary deduction taken on the bad debt. See *Merchs. Nat'l Bank v. Commissioner*, 199 F.2d 657 (5th Cir. 1952).

²⁰⁰I.R.C. § 108(e)(7)(A).

²⁰¹§ 108(e)(7)(B).

²⁰²§ 108(e)(7)(B).

there is a question as to whether section 108(e)(8) applies. We believe that in such a case, the transaction should be treated as a stock dividend to the shareholders and a cancellation of the corporation's debt. If so, the stock dividend typically will be excluded from the shareholder's income by section 305, and the cancellation of the debt will be treated in the manner provided by section 108(e)(6), which provision is discussed in Part IV.B. of this Article.

If a creditor holds convertible debt of the corporation, there is a question whether the exercise of that conversion privilege is subject to section 108(e)(8). We believe that it is not subject to that provision and that no income or loss is recognized.

2. *Partnership Interest*

The Service is to issue regulations that will apply the same treatment described above for a transfer by a debtor corporation of its stock in satisfaction of its debt to a debtor partnership that transfers an interest in the partnership to a creditor in satisfaction of its debt. However, there are some different tax consequences when a partnership interest is transferred.

The partnership interest transferred could be either a capital interest or a profits interest. If certain conditions are met, the fair market value of the partnership interest will be its liquidation value.²⁰³ If the partnership interest is a profits interest, and if liquidation value is used, the partnership interest will have a value of zero. A zero value will cause the debtor partnership to have COD income for the entire amount of the cancelled debt.

Generally, the creditor will not recognize income or loss on transferring the debt for a partnership interest.²⁰⁴ The creditor can recognize gain or loss on that part of a payment made in satisfaction of unpaid interest or rent.

IV. Gifts and Contributions to Capital

A. *Gifts*

If a creditor forgives a debt as a gift to the debtor, the COD is excluded from the debtor's income by section 102.²⁰⁵ For tax purposes, a gift is a transfer made out of detached and disinterested generosity.²⁰⁶ In a 1943 decision, the Supreme Court held that when a creditor cancelled a debt in order to collect the maximum amount that appeared feasible, the transaction could qualify as a gift.²⁰⁷ Six years later, the Supreme Court repudiated that view and held that a COD under such circumstances can cause the debtor to recognize income.²⁰⁸ Since that time, a cancellation of a debt in a commercial

²⁰³ Reg. § 1.108-8(b)(2)(i).

²⁰⁴ I.R.C. § 721(a).

²⁰⁵ I.R.C. § 102.

²⁰⁶ *Commissioner v. Duberstein*, 363 U.S. 278, 285 (1960) (quoting *Commissioner v. LoBue*, 351 U.S. 243, 246 (1956)).

²⁰⁷ *Helvering v. Am. Dental Co.*, 318 U.S. 322, 331 (1943).

²⁰⁸ *Commissioner v. Jacobson*, 336 U.S. 28, 51-52 (1949).

setting is virtually certain not to be treated as a gift. In a noncommercial setting, such as a cancellation by a relative of the debtor, it is possible for the COD to be a gift.²⁰⁹ If the amount of the gift is large enough, there could be gift tax consequences.²¹⁰

If a debtor takes a deduction for an unpaid accrued debt, which is subsequently cancelled by the creditor as a gift, should the debtor recognize income in order to recapture the prior deduction? We discuss this issue in Part V dealing with the tax benefit rule.

B. *Contribution to a Corporation's Capital*

A shareholder's contribution to the corporation in which he holds stock can be excluded from income by section 118(a). The contribution clearly is not a gift, but the statutory exclusion from income bears some similarity to the exclusion of gifts from income. One might expect then that if a shareholder forgives a debt of the corporation, that would be excluded from the corporation's income as a contribution to its capital. However, the actual treatment is more complicated.

The situation arose in which a corporation on the accrual method had accrued and deducted interest on a debt to a cash method shareholder. The shareholder did not take into income the accrued but unpaid interest because of the shareholder's method of accounting. In a subsequent year, the shareholder forgave the debt. The Tax Court and the Fifth Circuit held that the cancellation of debt was excluded from the corporation's income as a contribution to its capital.²¹¹ The Tax Court also held that the shareholder did not recognize income; while that ruling on the shareholder's income seems incorrect, the government did not appeal.²¹² Congress responded to that decision by adding section 108(e)(6) in 1980.

Section 108(e)(6) provides that a shareholder's discharge of a corporation's debt will not be excluded from the corporation's income under section 118, and the corporation can recognize income to the extent that the amount of the debt exceeds the shareholder's basis therein. Specifically, section 118 is inapplicable. The corporation is treated as having paid the creditor an amount equal to the creditor's basis in the debt, and the excess of the debt over that amount is treated as COD. The corporation will include the COD in income unless another exclusion applies.

V. The Tax Benefit Rule

If a taxpayer deducted an item on his federal tax return and enjoyed a tax benefit thereby, a subsequent recovery of any of the deducted item will cause

²⁰⁹W.F. Young, Inc. v. Commissioner, 120 F.2d 159, 164 (1st Cir. 1941).

²¹⁰I.R.C. § 2503(b).

²¹¹Putoma Corp. v. Commissioner, 66 T.C. 652, 675 (1976), *aff'd*, 601 F.2d 734 (5th Cir. 1979).

²¹²*Putoma*, 66 T.C. at 675.

the taxpayer to recognize income.²¹³ This treatment is referred to as the tax benefit rule. The rule has both an inclusionary and an exclusionary component: the recovery is included in the taxpayer's income to the extent that the taxpayer obtained a tax benefit from the prior year's deduction, and the recovery is excluded from the taxpayer's income to the extent that the prior year's deduction did not provide a tax benefit.²¹⁴ The exclusionary aspect of the tax benefit rule is codified in section 111.

Section 111(a) excludes from income the recovery of a previously deducted item "to the extent such amount did not reduce the amount of tax imposed by this chapter." Accordingly, if only part of a deduction provided the taxpayer with a tax benefit, a recovery of a portion of the deducted item is first treated as a recovery of the part that did not provide a tax benefit, and only the amount of recovery in excess of the excluded amount will be included in the taxpayer's income.

When an accrual method taxpayer was allowed a deduction for an accrued but unpaid expense, the subsequent cancellation of that debt may cause the taxpayer to recognize income under the tax benefit doctrine even when the cancellation would not otherwise have caused COD income because of the application of the transactional approach.²¹⁵ However, if the taxpayer did not derive a tax benefit from all or part of the deduction, then that amount of cancelled debt will be excluded from the taxpayer's gross income by section 111(a). The Service expressly ruled section 111 applies to a cancellation of debt in such circumstances.²¹⁶

As noted above, if a taxpayer deducted an accrued liability and obtained a tax benefit for it, the cancellation of that debt usually will cause the debtor to recognize income. One exception is where the cancellation constitutes a gift. In Revenue Ruling 76-316, the Service ruled that when a subsidiary corporation accrued and deducted unpaid interest owing on a debt to its parent corporation, and obtained a tax benefit from those deductions, the parent's cancellation of that debt caused the subsidiary to recognize income under the tax benefit rule. The Service rejected the contention that the cancellation should be treated as a contribution by the parent to the capital of the subsidiary that is excluded from income by section 118(a). The Tax Court and the Fifth Circuit came to a contrary view in *Putoma*, holding the cancellation in such circumstances was excluded from the debtor's income.²¹⁷ As noted previously in Part IV.B. of this Article, Congress adopted section 108(e)(6) to change the result reached in *Putoma*. Congress precluded the application of section 118 in such circumstances and requires the corporation usually to recognize income to the extent the COD exceeds the creditor's basis in the debt.

²¹³ See generally *Dobson v. Commissioner*, 320 U.S. 489 (1943) (discussing the tax benefit rule, although not formally adopting it).

²¹⁴ See *Hillsboro Nat'l Bank v. Commissioner*, 460 U.S. 370, 380-81 n.12 (1983).

²¹⁵ See *infra* Part VI.

²¹⁶ Rev. Rul. 67-200, 1967-1 C.B. 15.

²¹⁷ *Putoma*, 601 F.2d at 751.

Congress did not take any action with regard to a donative cancellation of a debt. A gratuitous cancellation of a debt that comes within the purview of section 102 is excluded from the debtor's income regardless of whether the debtor had previously deducted the item and obtained a tax benefit therefrom.²¹⁸ If a third party had made a gift of cash to the debtor who then used that cash to satisfy the debt, there would be no question of the debtor's recognizing income. If the creditor had made a cash gift to the debtor who then used the cash to satisfy the debt, the debtor would not recognize income. A cancellation of the debt as a gift to the debtor is substantively equivalent to giving cash to the debtor followed by the debtor's payment of the debt. There is no reason to treat the cancellation as income to the debtor.

VI. Transactional Approach

A. General

While the courts have utilized a transactional approach in some cases,²¹⁹ it has a bad reputation because of its misuse by the Supreme Court in *Kerbaugh-Empire*.²²⁰ When properly applied, the approach is appropriate and helpful. The transactional approach is actually an element of what we described earlier in this Article as the proper standard for determining whether a forgiveness of a debt constitutes COD that may be included in income. As discussed earlier, the proper explanation for taxing COD as income is not because of an increase in the debtor's net worth. A forgiveness should be treated as COD income only if the debt prevented the debtor from recognizing income for the receipt of something or permitted the debtor to take a deduction or obtain a basis in property. If none of those situations exist, the forgiveness should not be treated as COD income. The transactional approach is useful to determine whether the standards for imposing COD treatment have been met.

The gist of the transactional approach is to examine the entire transaction beginning with the creation of the debt and ending with the cancellation.²²¹ If the debtor did not obtain a tax benefit because of the debt, the debtor should not have COD income. The tax benefit could be the receipt of cash or other property that would have been income to the debtor if the presence of the debt had not prevented the recognition of income. The tax benefit could be a deduction or the acquisition of basis that was made possible by the presence of the debt. Even in the case of an acquisition of basis, there are circumstances where a transactional approach will exclude the cancellation of the debt from income. In the case of a deduction, income will be recognized only to the extent that the deduction provided a tax benefit.

²¹⁸ See *id.*

²¹⁹ See, e.g., *Bradford v. Commissioner*, 233 F.2d 935 (6th Cir. 1956); *Commissioner v. Rail Joint Co.*, 61 F.2d 751 (2d Cir. 1932).

²²⁰ See, e.g., *Burnet v. Sanford & Brooks Co.*, 282 U.S. 359, 365 (1931); *Vukasovich v. Commissioner*, 790 F.2d 1409 1415-16 (9th Cir. 1986).

²²¹ See *Bowers v. Kerbaugh-Empire*, 271 U.S. 170, 175 (1926).

An obvious situation in which the transactional approach is valid is the illustration we used earlier in this Article of a legally binding promise to make a gift to a qualified charity where the charity subsequently forgives part of that promise. Another example is where a corporation pays a dividend to its shareholder in the form of a distribution of the corporation's bond in the principal amount and fair market value of \$1,000. In a subsequent year, the corporation purchases the bond from the shareholder for \$800. The corporation should not have COD income from that transaction. The effect of the transaction is that what appeared to be a \$1,000 dividend to the shareholder was retroactively changed to an \$800 dividend.²²²

The following illustrations demonstrate the operation of the transactional approach.

Illustration 1. In Year One, Paul opened a gourmet restaurant in Grand Rapids, Michigan. Paul hired a prominent chef and contracted to pay her a salary of \$15,000 per month for five years. Paul reports his income on the accrual method, and the chef reports her income on the cash method. In its first two years of operation, the restaurant was slow to be accepted and did not produce the income that Paul had anticipated. Consequently, Paul was unable to pay the chef the full amount of her monthly salary. By the end of Year Two, the shortfall amounted to \$20,000 that was owing to the chef as unpaid wages. Despite that disappointment, Paul and the chef were convinced that the restaurant would prosper in the immediate future. In order to facilitate the future success of the restaurant, the chef agreed to forgive the \$20,000 of back salary owed to her. Paul was solvent at that time. We will consider the tax consequences of the cancellation of that \$20,000 debt in the following three alternative circumstances.

(a) On his tax return for Years One and Two, Paul accrued and deducted the unpaid salary to the chef, and Paul obtained a tax benefit from that deduction. Under the tax benefit rule,²²³ the COD that occurred in Year Three will be included in Paul's income for that year.

(b) The same facts as those stated in (a), except that Paul did not obtain a tax benefit from the accrued deductions he took for the chef's unpaid salary. In that situation, section 111(a) will exclude the cancellation from Paul's income.²²⁴ In Revenue Ruling 67-200, the Service ruled that section 111(a) applied in a comparable circumstance. Note that while Paul got no benefit from taking the deduction, Paul did get the benefit of the chef's services, and nevertheless the COD is excluded from Paul's income. The reason for that treatment is explained in (c) below.

(c) The same facts as in (a), except that in his tax returns for Years One and Two, Paul had erroneously failed to claim a deduction for the unpaid salary.

²²² See *Rail Joint Co.*, 61 F.2d at 752.

²²³ See *Hillsboro Nat'l Bank*, 460 U.S. at 389.

²²⁴ I.R.C. § 111(a) (a statutory application of one aspect of the tax benefit rule, which is described *supra* Part V).

In that situation, because no deduction was taken, neither the tax benefit rule nor section 111(a) is applicable. Nevertheless, the COD is not included in Paul's income because of the transactional approach. In effect, what has occurred is that the parties agreed on a specified amount of salary for the chef's services, and then retroactively changed the amount of her wages by cancelling the \$20,000 debt in Year Three. If Paul and the chef had set her wages at a lower figure at the time she was hired, Paul would not have recognized income even if that meant he paid the chef a lower wage than the fair value of her services. The cancellation of the debt puts the parties in the same position they would have occupied if the original contract had provided for a lower salary. Putting it another way, Paul never received anything that would have been taxable to him if the debt had not existed, nor did he obtain a deduction. The transactional approach is a useful means of exploring whether the standards of imposing income for a COD have been met.

Illustration 2. Rachel owns and operates a boutique retail dress shop in Columbus, Ohio. In Year One, she bought a line of dresses from a French manufacturer for €4,000. She bought the dresses on credit, and so she was indebted to the manufacturer for the €4,000. At the time that she incurred the debt, €4,000 had a value of \$6,000 (U.S.). By March of Year Two, the value of euros had fallen against the dollar so that Rachel was able to purchase €4,000 for \$4,000 in U.S. currency. Rachel then used those €4,000 to pay her debt to the French manufacturer. Did Rachel recognize ordinary income because of having paid back the loan of €4,000 with currency that had a lower value than it had when she borrowed it?

In *Church's English Shoes, Ltd. v. Commissioner*, the Second Circuit held that in similar circumstances involving the purchase of foreign shoes on credit, the debtor recognized income on repaying the debt with foreign currency that had fallen in value.²²⁵ The court noted the transactional approach used in *Kerbaugh-Empire*, but it concluded that that approach did not apply in the *English Shoes* case because there was no showing that the debtor suffered a loss on the sale of the shoes.²²⁶ While the result reached in that case was correct, the court's construction of the transactional approach was incorrect.

The debtor's income or loss on the sale of the items is irrelevant. In the facts of this **Illustration 2**, it is of no significance to the tax treatment of the COD what amount of income or loss Rachel had on the sale of the dresses. The application of the transactional approach would be to change Rachel's basis in the dresses she bought to reflect that they cost less than originally expected. The difficulty with that approach is that some or all of the dresses may have been sold before the debt was cancelled. It is not practical to go back and alter the income recognized on those sales. How should the COD be treated then? One possible treatment is to conclude that the transactional approach is not available here because the parties cannot be put back into the same position

²²⁵ 229 F.2d 957 (2d Cir. 1956).

²²⁶ *Id.* at 958.

they would have occupied if the lower price for the dresses had been known at the time of their purchase. That would result in ordinary income to Rachel in the amount of the COD. An alternative approach, which reaches the same result, is to apply the transactional approach in the following manner. In calculating Rachel's income from the dress shop for Year Three, reduce her opening inventory by the amount of the COD, and do not change her closing inventory. That will reduce Rachel's cost of goods sold for that year, and so will increase her ordinary income by the amount of the COD.

Illustration 3. In Year One, Henry purchased undeveloped land from Ruth. Henry paid Ruth \$20,000 cash and took the land subject to an \$80,000 nonrecourse debt that is payable to Ruth. Interest only is payable on the nonrecourse debt for four years, after which the principal of the debt is payable in installments over a ten-year period. Henry made all of the interest payments on time.

In Year Three, Ruth agreed to forgive \$10,000 of the debt, thereby reducing the principal of the debt from \$80,000 to \$70,000. Henry was solvent at that time. At the time of the cancellation, the land had a value of \$125,000.

Under the transactional approach, Henry did not recognize income on the cancellation of \$10,000 of the debt. Instead, Henry's basis in the land would be reduced from \$100,000 to \$90,000. The transaction should be treated as a reduction of the purchase price for the land.

The same result is reached by the application of Code section 108(e)(5) (B), the purchase-money debt exclusion. It is clear from that overlap that the purchase-money debt statutory exclusion is actually an application of the transactional approach to a specific circumstance.

The *Zarin* case provides an excellent example of how the transactional approach can be useful in applying the COD rules.²²⁷ In that case, a majority of the Tax Court arrived at the wrong result and was reversed by a divided decision of the Third Circuit.²²⁸ The Third Circuit's majority was probably influenced by a desire to avoid the harshness of the Tax Court's decision. To arrive at the result for the taxpayer, the Third Circuit advanced two independent rationales neither of which is convincing. The facts of the *Zarin* case are set forth below.

The taxpayer in *Zarin* was a compulsive gambler. He did most of his gambling at a hotel (hereinafter referred to as "the Hotel") in Atlantic City. In 1978, he was given a line of credit of \$10,000 at the Hotel. Within a year and a half, his line of credit was increased to \$200,000.²²⁹

Gambling at the Hotel was done with chips provided by the casino. The chips could not be used outside of the casino for any purpose. Taxpayer's line of credit allowed him to obtain chips from the casino with which to gamble. To obtain the chips, taxpayer signed negotiable drafts commonly

²²⁷ *Zarin v. Commissioner*, 916 F.2d 110 (3d Cir. 1990), *rev'g* 92 T.C. 1084 (1989).

²²⁸ *Id.*

²²⁹ *Id.* at 111-12.

called “markers.” The Hotel would hold the markers for about 90 days after which taxpayer would redeem them by giving the Hotel his personal check.²³⁰

In 1979, the New Jersey Casino Control Commission ordered the Hotel to cease and desist giving credit in excess of a properly approved credit limit. The complaints of credit abuse that led to the cease and desist order included 100 instances of abuse in providing credit to the taxpayer and a gambling companion. In violation of that order, the Hotel substantially increased the credit that taxpayer could draw upon to purchase chips.²³¹

By 1980, taxpayer was gambling daily at the Hotel and betting heavily. By April 1980, the Hotel held personal checks and markers from taxpayer in the aggregate amount of \$3,435,000. The Hotel was unable to collect on the checks, which were returned because of insufficient funds. The Hotel sued taxpayer for the unsatisfied amount, and the suit was settled by the taxpayer’s paying the Hotel \$500,000 in discharge of the \$3,435,000 debt. The government claimed that this settlement resulted in taxpayer’s having COD income in the amount of \$2,935,000. With accumulated interest, the Service claimed that the taxpayer’s tax liability was over \$5,000,000. A majority of the Tax Court upheld the Service’s position and held that the taxpayer owed that amount.²³²

One of the issues in *Zarin* was whether the taxpayer’s gambling debts were enforceable. The excessive credit granted by the Hotel to taxpayer in contravention of a cease and desist order made the enforceability of those debts highly questionable. Because of the procedural framework in which the case arose, the Service had the burden of proof on that question. Because the Service could not meet its burden of proof, both the Tax Court and the Third Circuit treated the debts as unenforceable at the time that they were incurred.²³³

In a 2-1 decision, the Third Circuit reversed the Tax Court and held that the cancellation of the debt did not cause the taxpayer to recognize income.²³⁴ The court gave two independent reasons for its decision, and neither holds up well under scrutiny.

One basis for the court’s decision rested on the unenforceability of the debt. Section 61(a)(12) states that cancellation of indebtedness is included in the debtor’s gross income. The majority of the court held that the meaning of indebtedness in section 61(a)(12) is the same as the definition of that term in section 108(d)(1).²³⁵ That provision defines indebtedness of a taxpayer as either a debt for which the taxpayer is liable, or a debt to which property of the taxpayer is subject. Because the debt was unenforceable, the taxpayer was

²³⁰ *Id.*

²³¹ *Id.* at 112.

²³² *Id.*

²³³ *Id.*

²³⁴ *Id.* at 117.

²³⁵ *See id.* at 113.

not liable for it.²³⁶ The court concluded therefore that the taxpayer did not have COD income when the debt was cancelled.²³⁷

The problem with that approach is pointed out in the dissent. The dissent contends the debt must be given recognition by the tax law, because if not the taxpayer would have had income when he acquired the chips.²³⁸ If the taxpayer were treated as having borrowed money from the Hotel to purchase the chips, he would have had income on the receipt of the money unless his “debt” was recognized as an offset that kept him from recognizing income.²³⁹

The dissent concluded that either the taxpayer had income when he acquired the chips or he had income when the debt was forgiven.²⁴⁰ While the dissent discloses a flaw in the majority’s rationale, we will show that the dissent is not correct either. One way to deal with the problem posed by the dissent is to hold that an unenforceable debt should prevent recognition of income for so long as there is no indication that the debtor does not intend to pay. Once it is known that the debtor will not pay the debt, then the receipt of value that the debtor obtained when the debt arose is taken into his income unless the discharge can be seen as a reduction of purchase price. In the *Zarin* case, the taxpayer never received anything of value whose purchase price could not be adjusted when the amount of debt was reduced.

The second basis on which the majority of the court grounded its decision is the so-called “contested liability” exception to COD income. The court stated that the settlement of a disputed or contested liability does not cause COD income.²⁴¹ The court cited cases where there was a settlement of a dispute as to the amount of debt that was owed.²⁴² The settlement at a lower figure than claimed by the creditor did not cause the debtor to recognize income. The court concluded that the same doctrine applied when the debtor contended that there was no debt at all, and so the court applied the doctrine to the taxpayer.²⁴³

The court’s use of the contested liability exclusion is unsound. The question should be whether the settlement can properly be characterized as establishing the price paid for a purchased item. The Third Circuit set forth a hypothetical to illustrate what it meant by the contested liability exclusion,²⁴⁴ and that hypothetical illustrates the error in the court’s use of that concept. The court’s hypothetical involves a taxpayer who borrows \$10,000, and then, in good faith, refuses to repay the full amount. The debt is settled for a payment of \$7,000. The court concluded that the taxpayer would have no income

²³⁶ *Id.*

²³⁷ *Id.* at 114.

²³⁸ *Id.* at 118 (Stapleton, J., dissenting).

²³⁹ *Id.*

²⁴⁰ *Id.*

²⁴¹ *Id.* at 115-16 (majority opinion).

²⁴² *Id.* at 115.

²⁴³ *Id.*

²⁴⁴ *Id.*

for settling for that amount.²⁴⁵ It is obvious that this conclusion is incorrect. The borrower obtained \$10,000 cash and returned only \$7,000. The \$3,000 cash he received that was not included in his income because of the debt is now free from any liability. Regardless of what legitimate reasons there might be for the borrower to not be liable for part of that debt, the borrower must include \$3,000 in income when that amount of the debt is cancelled.

The Tenth Circuit rejected the Third Circuit's use of the contested liability exclusion in *Preslar v. Commissioner*.²⁴⁶ The Tenth Circuit held that the contested liability exclusion does not apply to a debt whose amount is certain but whose enforceability is challenged. The court held that the exclusion applies only when the amount of a debt is in question. The court distinguished liquidated debts from unliquidated debts.

In our view, there is either no contested liability exclusion or there should not be one. The issue should be resolved by determining whether the reduction of the debt at the time it was incurred would have resulted in the debtor's recognition of income. If not, the cancellation of the debt does not cause the debtor to recognize income. On the other hand, if the reduction of the debt at the outset would have resulted in the debtor's recognizing income, the cancellation should be income to the debtor unless some other exclusion applies.

Consider the facts of the *Zarin* case. What did the taxpayer purchase in that case? He did not purchase the chips. Any chips remaining when he finished gambling were returned to the Hotel. What he purchased was the opportunity to gamble. The chips he received served merely as an accounting device to determine how much he won or lost. If a gambling house were to charge a patron \$1 for each \$3 chip he acquires, and if the patron is returned only \$1 for each such chip he returns to the house, all that the patron acquires is a gambling program in which he receives a return of \$3 for each \$1 he bets. The house can set whatever price it chooses for the privilege of gambling and can set whatever return it chooses for winnings. The patron would not have income for having purchased chips for less than their face amount. The face amount of the chips is merely the means of calculating gains and losses. The cancellation of the debt in *Zarin* can be seen through the transactional approach as nothing more than a reduction of the cost of the gambling experience.

B. *Third Party Creditors and the Transactional Approach*

We have seen that the reduction of a purchase-money debt by the seller of the property will be treated as a reduction of the property's purchase price. That provision does not apply if the creditor is not the seller. Similarly, the transactional approach applies to change the terms of a transaction only when the creditor is a principal party to the transaction. Are there circumstances

²⁴⁵ *Id.* at 116.

²⁴⁶ 167 F.3d 1323 (10th Cir. 1999).

where a form of transactional approach can be used even though the creditor is a third party?

One circumstance in which there is a remote possibility for utilizing that approach is where the third party creditor was so connected to the sale of an item as to make it reasonable to treat a reduction of the debt as a reduction of the purchase price. For example, a bank holds a mortgage on property whose owner is in bankruptcy. The bank is eager to find a buyer for the property to take over the mortgage liability. The bank solicits an offer from the taxpayer to purchase the property and offers very liberal terms for a mortgage in order to induce the taxpayer to buy. The taxpayer accepts the offer and purchases the property. Subsequently, the mortgagee forgives a part of the debt. Can the mortgagee be so tied to the sale of the property that a reduction of the debt can be treated as a reduction of the purchase price of the property? That is a difficult contention to sustain, but it is a possibility. There are two Tax Court decisions that adopted that view. *Freedom Newspapers, Inc. v. Commissioner* did not involve a COD, but the principles involved are similar.²⁴⁷ In that case, a broker gave a potential buyer a guaranty that the buyer could resell one of several properties that were for sale in order to induce the buyer to purchase the properties.²⁴⁸ The Tax Court held that a subsequent payment by the broker pursuant to his guaranty constitutes a reduction of the buyer's purchase price and was not income to the buyer.²⁴⁹ The court relied on the involvement of the broker in inducing the taxpayer to buy.²⁵⁰ The result in that case could be explained on other grounds,²⁵¹ but it does provide some support for this proposition. Another case supporting this approach is *Brown v. Commissioner*.²⁵² On the other hand, the decision of the Tenth Circuit in *Preslar v. Commissioner* impliedly rejected that approach.²⁵³ The prospects for prevailing on this contention are not strong.

In Revenue Ruling 92-99, the Commissioner determined that a discharge of a debt by a third party caused the debtor to recognize income. Surprisingly, however, the Commissioner made the following statement in his ruling:

The Service will, however, treat a debt reduction in third-party lender cases as a purchase price adjustment to the extent that the debt reduction by the third party is based on an infirmity that clearly relates back to the original sale (e.g., to the seller's inducement of a higher purchase price by misrepre-

²⁴⁷ See *Freedom Newspapers, Inc. v. Commissioner*, 36 T.C.M. (CCH) 1755, T.C.M. (P-H) ¶ 77,429 (1977).

²⁴⁸ *Id.* at 1756, T.C.M. (P-H) ¶ 77,429, at 1751 (1977).

²⁴⁹ *Id.* at 1759, T.C.M. (P-H) ¶ 77,429, at 1751 (1977).

²⁵⁰ *Id.*

²⁵¹ The exclusion from income could be explained by treating the guaranty as similar to insurance, and so the receipt of the payment would be a reduction of the taxpayer's capital. However, that is not the basis of the court's decision.

²⁵² 10 B.T.A. 1036, 1054-5 (1928).

²⁵³ *Preslar v. Commissioner*, 167 F.3d 1323, 1332-33 (10th Cir. 1999).

sentation of a material fact or by fraud). . . . No other debt reduction by a third party lender will be treated as a purchase price reduction.²⁵⁴

The concession made by the Commissioner in that statement appears to be overly generous. It is difficult to see why a misrepresentation by the seller should affect the characterization of a discharge by a third party. Perhaps the Commissioner's position is based on an assumption that the third party would not cancel a part of the debt because of a misrepresentation or fraud of the seller unless the third party had played a role in the seller's effort to sell the property and perhaps participated in the fraud or misrepresentation itself. Even if the third party's involvement in the sale should affect the treatment of the discharge, it is generous simply to assume that involvement and not require evidence of it.

VII. Mixed Sale and Cancellation of Indebtedness

When property is secured by a debt, and when the debt is satisfied by the creditor's receipt of the property, the tax consequences depend upon whether the debt is a recourse or a nonrecourse debt.

A. *Recourse Debt*

Consider this situation. Roger owns improved realty (Blackacre), which is security for a recourse debt of \$300,000 owed to Friendly Bank. The Bank was not the seller of Blackacre to Roger. Roger's basis in Blackacre is \$280,000. The fair market value of Blackacre is \$220,000. Roger defaults on the debt and the Bank forecloses and sells the property for its value of \$220,000.²⁵⁵ Roger was solvent. Because it is a recourse debt, Roger remains liable to the Bank for the \$80,000 deficiency that the Bank failed to obtain from its foreclosure sale.²⁵⁶ Because Roger is still liable for that \$80,000, there has been no cancellation of a debt, and Roger has no income.²⁵⁷ Roger effectively sold Blackacre for \$220,000, and so Roger recognizes a loss of \$60,000.²⁵⁸ If the Bank subsequently forgives the unpaid debt, then at that time Roger would have COD.²⁵⁹

Alternatively, the Friendly Bank agrees to accept the receipt of Blackacre in satisfaction of the entire \$300,000 of the recourse debt. In that circumstance, Roger has no further liability on the debt.²⁶⁰ The result is that Roger recognizes a loss of \$60,000 on the use of Blackacre to satisfy \$220,000 of the debt,

²⁵⁴ Rev. Rul. 92-99, 1992-2 C.B. 35.

²⁵⁵ If the sale of Blackacre was at arm's length, the courts will accept the selling price as representing the fair market value of the property. If the seller and the buyer are not at arm's length, the court will apply its own estimate of the value of the property. *See Frazier v. Commissioner*, 111 T.C. 243, 246-47 (1998).

²⁵⁶ *See id.* at 249.

²⁵⁷ *See Aizawa v. Commissioner*, 99 T.C. 197, 199-200 (1992)

²⁵⁸ *See id.* at 201.

²⁵⁹ *See id.*

²⁶⁰ *See id.*

and Roger has COD of \$80,000 for the balance of the debt that was forgiven by the Bank.²⁶¹ Roger will recognize that \$80,000 of COD as income unless an exclusion applies.²⁶²

B. *Nonrecourse Debt*

The treatment of the transfer of encumbered property in satisfaction of a nonrecourse secured debt is different from that applied to a recourse debt. Consider the facts of the situation described above except that the debt that secures Blackacre and is owed to the Friendly Bank is a nonrecourse debt.

Because it is a nonrecourse debt, the Bank's only remedy for default by Roger is to foreclose on Blackacre. The Bank forecloses, and the property is sold for \$220,000, which is its fair market value. Roger has no liability to pay the deficiency of \$80,000 that the Bank did not collect on its debt. The transaction is treated as a sale of Blackacre by Roger to the Bank for the full amount of the nonrecourse debt (\$300,000). Roger has a gain of \$20,000 on the sale of Blackacre for \$300,000 even though its value was only \$220,000. Roger has no COD income.

In her concurring opinion in the *Tufts* case, Justice O'Connor criticized the rule treating recourse and nonrecourse debt differently.²⁶³ Justice O'Connor was convinced by an amicus brief filed by Professor Wayne Barnett that the better rule would be to treat both the same.²⁶⁴ To the contrary, the current rule is the proper one as a matter of good tax policy and principle.

In the case of the recourse debt, the transfer of the property does not relieve the debtor of a liability for the deficiency. If the creditor chooses to forgive the deficiency, that event is separate from the taking of the property. The payment on the debt is limited to the value of the property received by the creditor, and the debtor has gain or loss from the effective sale of the property for the amount of its value. If the rest of the debt is forgiven by the creditor that properly is treated as COD to which all of the rules pertaining to COD apply.

The situation is very different in the case of a nonrecourse debt. When a lender agrees to provide a loan on a nonrecourse basis, the lender effectively gives the borrower the option of either satisfying the debt with cash or satisfying it with the encumbered property. In essence, the borrower has a put by which he has the option to sell the property to the lender at a price equal to the amount of debt that is outstanding at the time in which the sale takes place. In the nonrecourse problem above, when the creditor foreclosed on Blackacre the debtor had no liability beyond the transfer of Blackacre itself. So, there was no debt for the creditor to forgive. Instead, it was a sale

²⁶¹ Reg. § 1.1001-2(a)(2), -2(c), Ex. (8).

²⁶² *Aizawa*, 99 T.C. at 201.

²⁶³ *Commissioner v. Tufts*, 461 U.S. 300, 317-18 (1983) (O'Connor, J., concurring).

²⁶⁴ *Id.* at 317. However, Justice O'Connor concluded that the rule was too well established to change it at that later date. *Id.* at 319-20.

pursuant to the terms of the loan by which the debtor can sell the property for the balance owing on the debt.

VIII. Decedent's Installment Note

When a decedent has been reporting gain on the installment method, and on the decedent's death the installment note passes to the decedent's estate or to any other person other than the obligor, the recipient of the note will have income in respect of a decedent (IRD) to the extent the face amount of the obligation exceeds the basis the decedent had in it.²⁶⁵ The recipient recognizes that IRD pro rata as he receives installment payments from the obligor unless an event occurs that accelerates recognition of that income.²⁶⁶ The decedent's basis at his death is determined under section 453B(b) as the excess of the face value of the note over the amount that would have been treated as income to the decedent if the debt had been satisfied in full.²⁶⁷ The decedent's estate or the person who is entitled to the IRD by bequest or inheritance will report income from each payment received on the note in the same proportion that the decedent would have reported it if he had lived and received those payments.²⁶⁸ The character of the recipient's income is the same as it would have been in the hands of the decedent.²⁶⁹

There is no gain to be reported on the decedent's final income tax return because of the transmission of the note to the estate or to a beneficiary other than an obligor of the note.²⁷⁰ The transfer of the note because of the decedent's death to anyone other than the obligor is not a disposition that accelerates the recognition of the deferred gain.²⁷¹

If the estate or other person who holds the installment note sells it or gives it away, the disposition will cause the holder to recognize income under section 453(B) in an amount equal to the difference between the fair market value of the note or the amount received in payment for it, whichever is greater, and the basis that the decedent had in the obligation.²⁷² The decedent's basis in the obligation is reduced by any installment payments received after his death that were not included in the holder's income.²⁷³ If the installment note is sold to the obligor and the obligor was a related person to the decedent (within the scope of the statute), the fair market value of the installment note is treated as not being less than its face amount.²⁷⁴

²⁶⁵ I.R.C. § 691(a)(4); Reg. § 1.691(a)-5(a).

²⁶⁶ See I.R.C. § 453B; Reg. § 1.691(a)-5(a).

²⁶⁷ § 691(a)(4).

²⁶⁸ Reg. § 1.691(a)-5(a).

²⁶⁹ § 691(a)(3).

²⁷⁰ § 691(a)(5)(A)(i); Reg. § 1.691(a)-5(a).

²⁷¹ §§ 453B(c), 691(a)(2).

²⁷² Reg. § 1.691(a)-5(b). The basis that the decedent had in the note at the time of his death is the excess of the face value of the note over the amount that would be treated as income to the decedent if the debt were satisfied in full. § 453B(b).

²⁷³ Reg. § 1.691(a)-5(b).

²⁷⁴ § 691(a)(5)(B).

If the installment note is transferred because of the death of the decedent (*i.e.*, made to the decedent's estate or to a beneficiary of a bequest or inheritance), the disposition does not cause the transferor to recognize income.²⁷⁵ However, that exclusion from income does not apply if the transfer because of death is made to the obligor of the note.²⁷⁶ If the transfer is made to the obligor, it is equivalent to a cancellation of the note; and so the transferor is required to recognize the deferred income.²⁷⁷

An installment note can contain a provision that cancels the note upon the death of the holder. A note that contains that provision is referred to as a "self-cancelling installment note" (SCIN) or a "death terminating installment note." That is simply one form of cancelling the installment note and is treated the same as any cancellation. The decedent's estate will recognize the deferred income as IRD.

A cancellation of an installment note is treated as a disposition of the note that triggers the holder's recognition of the remaining IRD.²⁷⁸ The holder will recognize IRD to the extent the fair market value of the note exceeds the holder's basis.²⁷⁹ The effect of the cancellation is to require the immediate recognition of any income that had been deferred by the use of the installment method. If the obligor was a related person to the holder, the fair market value of the note is deemed to be no less than the face amount of the note.²⁸⁰

If the installment note becomes unenforceable, that is treated as a disposition of the note, which requires the holder to recognize income.²⁸¹

If an installment note is cancelled by the terms of the note on the holder's death, does the obligor have COD that might be taxable? It would seem that the cancellation is a form of gift or bequest that is excluded from the obligor's income by section 102.

²⁷⁵ §§ 453B(c), 691(a)(2).

²⁷⁶ § 691(a)(5)(A)(i).

²⁷⁷ § 691(a)(5)(iii).

²⁷⁸ § 691(a)(5)(A)(ii).

²⁷⁹ § 453B(a)(2).

²⁸⁰ § 453B(f)(2).

²⁸¹ § 453B(f)(1).

