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# CANCELLATION OF DEBT AND RELATED TRANSACTIONS

By Douglas A. Kahn and Jeffrey H. Kahn

The goal of this article is to set out the tax treatment of cancellation of debts, including the many exceptions that apply. 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. This doctrine is referred to by several terms that are used interchangeably—namely “cancellation of indebtedness or debt,” “discharge of debt,” and “forgiveness of debt.” In this article, the authors often refer to it as “cancellation of debt” or by its acronym “COD.”

The two principal sections of the Internal Revenue Code (IRC) that deal with COD issues are section 108 (1976), which provides for nonrecognition of COD income in certain circumstances, and section 1017 (1976), providing for the reduction of the debtor’s basis in property in certain circumstances where COD income was not recognized. Section 61(a)(12) provides that gross income includes “income from discharge of indebtedness,” 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.

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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 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.

IN COMMERCIAL SETTINGS, CANCELLATION OF DEBT IS VIRTUALLY CERTAIN NOT TO BE TREATED AS A GIFT.

Section 108 applies only to the cancellation of an “indebtedness” of a taxpayer. For purposes of this 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. 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.

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. The other four exclusions are: (1) the discharge occurs in a Title 11 case, (2) the discharge occurs when the debtor is insolvent (the insolvency exclusion), (3) the discharged debt is qualified farm indebtedness, and (4) the discharged debt is qualified real property business indebtedness. When these several exclusions overlap, there is an order of priority as to which applies.

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. 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). The S corporation’s income, loss, deductions, and credits for the taxable year pass through to its shareholders under section 1366(a) before any reduction of those tax items is made as a consequence of the exclusion of the corporation’s COD.

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. Any nondeductible losses can be carried forward to subsequent years.

The exclusionary rules for the cancellation of a debt of a partnership are determined at the partner level. The partnership's COD is allocated among the partners. Each partner determines whether the share of COD allocated to him is excluded from income. 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 the partnership's liability. That constructive cash distribution will reduce each partner's basis in his partnership interest. 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. 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.

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. If the principal amount of the debt is greater than the amount paid by the corporation, the difference constitutes COD. Although a corporation does not recognize income on a disposition of its stock, it can recognize

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income from a COD unless one of the exclusions applies.

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. 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. 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 on the creditor's basis in the debt.

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, there is a question whether section 108(e)(8) applies.

If a creditor forgives a debt as a gift to the debtor, the COD is excluded from the debtor's income by section 102. For tax purposes, a gift is a transfer made out of detached and disinterested generosity. A cancellation of a debt in a commercial 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.

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 the taxpayer to recognize income. This treatment is referred to as the tax benefit rule. ■