CHAPTER 24: CANCELLATION OF DEBT FOR PA PIT PURPOSES.

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CHAPTER 24: CANCELLATION OF DEBT FOR PENNSYLVANIA PERSONAL INCOME TAX PURPOSES.

I. PENNSYLVANIA PERSONAL INCOME TAX TREATMENT – CANCELLATION OF INDEBTEDNESS – OVERVIEW.

1. In General.

The Federal income tax treats the income that is derived from the discharge of indebtedness as a separate and distinct class of gross income. The Pennsylvania Personal Income Tax, however, treats a discharge of indebtedness either as a form of payment or as a reduction in cost, not as a separate and distinct class of gross income. Thus, a cancellation of a genuine, uncontested and enforceable obligation for less than its face value can have varying Pennsylvania personal income tax effects, depending upon whether the debtor is insolvent after such discharge, the cancelled debt constitutes the unpaid balance of a purchase price or the discharge is ordered under the Bankruptcy Act. The effects may also vary depending upon the identity of the parties to the transaction and other factors. Accordingly, special Pennsylvania Personal Income Tax rules apply when a debtor is legally discharged from primary liability for a debt and it is probable that the debtor will not be required to make future payments as guarantor of the debt.

If the liabilities of a partnership are decreased, thereby decreasing each partner's share of the liabilities, each partner's decrease is treated as a distribution of money to the partner by the partnership and if a decrease in liabilities exceeds the partner's basis in his partnership interest, the excess constitutes a Schedule D gain.

2. When Cancellation of Indebtedness Occurs.

An indebtedness is "cancelled" **only** on the occurrence of an identifiable event indicating that the debt will never have to be repaid. There are seven identifiable events:

- Discharges of indebtedness in bankruptcy.
- Discharges of indebtedness in receivership.
- Expiration of the statute of limitations for collecting the indebtedness.
- Cancellation of indebtedness arising from the creditor's election to pursue foreclosure which statutorily extinguishes its right to pursue further collection.
- Extinquishment of a debt under a probate proceeding.
- Discharge pursuant to an agreement between the creditor and debtor for less than full consideration.
- Discharge according to a decision by the creditor, and under a defined policy of the creditor, to discontinue collection activity and discharge the debt.

A liability is not forgiven or cancelled merely because it is temporarily uncollectible or unenforceable as a matter of fact. However, it is the position of the Department that, when a 36-month testing period during which there has been no payment made expires, the 36-month period provides a rebuttable presumption that the indebtedness has been cancelled.

3. How Is Income From Cancellation of Indebtedness Classified?

Cancellation of indebtedness generally occurs:

- Under **Generally Accepted Accounting Principles (GAAP)**, the debt forgiven was considered a liability;

- Where the debt forgiven constitutes a *quid pro quo* or incentive that would be taxable under Pennsylvania Personal Income Tax law if it had been paid to the debtor in cash or in property.

Taxpayers report taxable debt forgiveness in the class of income for which the debt was cancelled. For example:

- If the cancellation of indebtedness relates to rent, royalty, patent, or copyright income, it is reported in that class.

- If the cancellation of indebtedness relates to an employee/employer relationship, it is reported as compensation.

- If the debt forgiveness relates to the sale, discontinuation, or abandonment of a business or segment thereof, it is reported as gain on the sale of property.

4. Cancellation of Indebtedness Incurred In Business, Profession, or Farm Income.

If the debt forgiveness was related to business, profession, or farm income in the past, then it will be reported in that class of income.

5. Rental and/or Royalty Business Activity.

Pennsylvania Personal Income Tax rental or royalty income can result if the taxpayer's indebtedness is cancelled and the indebtedness was incurred in the rental or royalty activity.

6. Investment Activity.

Pennsylvania Personal Income Tax interest or dividend income constitutes Pennsylvania Personal Income Tax reportable income if the cancellation of indebtedness resulted from the purchase of assets used in the investment activity.

7. Compensation Income.

Compensation income constitutes Pennsylvania Personal Income Tax reportable income if the indebtedness is cancelled in exchange for services rendered.

8. Pennsylvania Personal Income Tax Insolvency Provision.

If the taxpayer is solvent, the amount of indebtedness is generally reported as income. If the taxpayer is insolvent, the cancellation of indebtedness amount may not be taxable.

Insolvent taxpayers not filing for bankruptcy recognize cancellation of debt as income. The reportable amount is the lesser of:

- The amount of indebtedness forgiven or discharged, or

- The excess over the taxpayer's fair market value of assets (net worth) immediately after the cancellation.

If an insolvent taxpayer is not rendered solvent by the cancellation of indebtedness, no income is recognized.

Solvent taxpayers would report the amount of indebtedness forgiven or discharged with the associated class of income.

9. Basis Adjustment.

The basis of an insolvent debtor's property must be reduced but not below its fair market value. Basis reductions for amounts cancelled shall be allocated in any manner that has the effect of reducing the difference between the fair market value and the adjusted basis of the properties. Requisite basis adjustments are required as a result of a bankruptcy discharge and to the extent that income was not reported as a result of the Pennsylvania Personal Income Tax insolvency provision.

10. Individuals filing for Bankruptcy.

Unless the case is dismissed, an individual bankruptcy filed under Chapters 7, 11, or 12 of the Bankruptcy Act leads to the creation of a bankruptcy estate and no income shall be considered to have been realized by reason of discharge of indebtedness under bankruptcy laws.

II. "FREEING OF ASSETS" – REPORTABLE INCOME (EIGHT CLASSES OF INCOME) FOR PENNSYLVANIA PERSONAL INCOME TAX PURPOSES.

1. Pennsylvania Personal Income Tax Statute Does Not Conform To Internal Revenue Code Sections 61(a)(12) and 108 Relating To COD.

The Pennsylvania Personal Income Tax Statute does not conform to the following Internal Revenue Code Sections relating to cancellation of indebtedness:

IRC Section 61(a)(12) – Income from discharge of indebtedness; and

IRC Section 108 – Income from discharge of indebtedness.

For a taxpayer in a Title 11 Bankruptcy, income is not realized by the estate debtor or a successor to the debtor by reason of a discharge of indebtedness in bankruptcy except to the extent such income is subject to tax under the Internal Revenue Code. As a result, Section 108 is only operative for Pennsylvania Personal Income Tax reporting purposes in determining whether "such income is subject to tax under the Internal Revenue Code."

For taxpayers not in a Title 11 Bankruptcy case, Section 108 is not operative.

2. Internal Revenue Code Section 61(a)(12) Does Not Define Pennsylvania Personal Income Tax Reportable Income.

Pennsylvania Personal Income Tax reportable income only consists of the eight enumerated classes of income. Cancellation of indebtedness is only taxable if it falls under one of the enumerated classes of income.

3. Cancellation Of Indebtedness Incurred In A Business Activity Generally Reportable As Pennsylvania Personal Income Tax Taxable Income.

For Pennsylvania Personal Income Tax reporting purposes, cancellation of debt for debt incurred in a business activity (business, profession or farm), is generally taxable.

4. Cancellation Of Indebtedness Incurred In An Investment Activity Generally Reportable As Pennsylvania Personal Income Tax Taxable Income.

For Pennsylvania Personal Income Tax reporting purposes, cancellation of debt for a debt incurred in an investment activity is generally taxable if the debt was used to purchase investments generating interest or dividend income.

5. Cancellation Of Indebtedness Incurred In An Exchange For Employee Services Generally Reportable As Pennsylvania Personal Income Tax Taxable Compensation Income.

For Pennsylvania Personal Income Tax reporting purposes, cancellation of debt of an employee or subcontractor in exchange for services rendered is compensation income to the

employee or subcontractor.

6. Pennsylvania Personal Income Tax Insolvency Provision.

A. Application to partnerships and Pennsylvania S corporations.

i. Applied at the partner level.

ii. Applied at the S corporation level.

B. Insolvency is determined immediately before the transaction.

i. At the partner level to determine whether that partner is insolvent immediately before the cancellation of indebtedness transaction.

ii. At the S corporation level to determine whether that S corporation is insolvent immediately before the cancellation of indebtedness transaction.

C. Recognition of Pennsylvania Personal Income Tax Reportable Income.

Recognition of Pennsylvania Personal Income Tax reportable income to the extent that:

i. The partner is made solvent as a result of the transaction.

ii. The S corporation is solvent at a result of the transaction

D. Required Basis Adjustment Relating to Cancellation Of Indebtedness Not Reported for Pennsylvania Personal Income Tax Purposes.

Required basis adjustment relating to cancellation of indebtedness transaction not reported for Pennsylvania Personal Income Tax purposes.

i. First reducing the insolvent partner's Pennsylvania Personal Income Tax adjusted basis in the entity. Any excess requires applicable adjustment at the partnership level for partner's percentage share of assets.

ii. Reducing S corporation Pennsylvania Personal Income Tax adjusted basis in its assets.

7. Pennsylvania Personal Income Tax Treatment in Bankruptcy Cases.

"Section 346 of the Bankruptcy Code is amended to generally follow the same provisions that apply for federal income tax purposes. Considerable conflicts existed between state and local taxes and federal taxes. Congress indicated at the time the Bankruptcy Reform Act of 1978 became law that the state and local tax issues would be changed when the Congress passed the federal bankruptcy tax laws. A few years later Congress passed the Bankruptcy Tax Act of 1980 and no action has been taken to eliminate the tax problems that arise because of the differences between the two federal laws. To correct these problems, the amendment to section 346 of the Bankruptcy Code conforms section 346 to that of section 1398, etc…."

"Section 346 of the Bankruptcy Code contains a series of detailed provisions that mandate a uniform outcome at the state and local level with respect to a variety of bankruptcy tax matters, both substantive and procedural. For example, Section 346(g)(1)(c) provides that, for state and local tax purposes, neither gain nor loss shall be recognized on a transfer that qualifies as a bankruptcy reorganization for federal income tax purposes. Section 346(j) provides a comprehensive series of rules governing the state and local tax consequences of discharge of indebtedness in bankruptcy. Other, more specialized tax rules appear in Chapter 762 and Chapter 11.63. Under the Act, Section 346 is completely rewritten, and the provisions previously housed in Section 728 and Sections 1146(a) and (b) are largely transferred to

Section 346. Among other things, the new rules require uniformity among federal, state, and local tax administrative rules by (a) preventing a bankruptcy filing from resulting in the creation of a new taxable estate (or the termination of the debtor's taxable year) for federal purposes but not for state and local purposes (or vice versa), (b) conforming the federal, state, and local tax consequences of property transfers from the debtor to the estate (or vice versa), (c) preventing state or local tax from being imposed on discharge of indebtedness income unless that income is also subject to tax under the Internal Revenue Code, and (d) generally requiring states and localities to reduce tax attributes to reflect untaxed discharge of indebtedness income following the same rules applicable for Federal purposes."

8. Bankruptcy Code Section 346. Special Provisions Related to the Treatment of State and Local Taxes.

Section 346 provides in part:

> Whenever the Internal Revenue Code of 1986 provides that a separate taxable estate or entity is created in a case concerning a debtor under this title, and the income, gain, loss, deductions, and credits of such estate shall be taxed to or claimed by the estate, a separate taxable estate is also created for purposes of any State and local law imposing a tax on or measured by income and such income, gain, loss, deductions, and credits shall be taxed to or claimed by the estate and may not be taxed to or claimed by the debtor. The preceding sentence shall not apply if the case is dismissed. The trustee shall make tax returns of income required under any such State or local law.
>
> To the extent that any State or local law imposing a tax on or measured by income provides for the carryover of any tax attribute from one taxable period to a subsequent taxable period, the estate shall succeed to such tax attribute in any case in which such estate is subject to tax under subsection (a).
>
> After such a case is closed or dismissed. The debtor shall succeed to any tax attribute to which the estate succeeded under paragraph (1) to the extent consistent with the Internal Revenue Code of 1986.
>
> For purposes of any State or local law imposing a tax on or measured by income, income is not realized by the estate, the debtor, or a successor to the debtor by reason of discharge of indebtedness in a case under this title. Except to the extent, if any, that such income is subject to tax under the Internal Revenue Code of 1986.
>
> Whenever the Internal Revenue Code of 1986 provides that the amount excluded from gross income in respect of the discharge of indebtedness in a case under this title shall be applied to reduce the tax attributes of the debtor or the estate, a similar reduction shall be made under any State or local law imposing a, tax on or measured by income to the extent such State or local law recognizes such attributes. Such State or local law may also provide for the reduction of other attributes to the extent that the full amount of income from the discharge of indebtedness has not been applied.
>
> For Federal tax purposes, the provisions of this section are subject to the Internal Revenue Code of 1986 and other applicable Federal nonbankruptcy law.

As stated above, the changes to Section 346 conform state and local income tax administrative practices to those under the Internal Revenue Code in several important respects including: the "split year" for filing returns in the year of the bankruptcy filing, the division of tax liabilities and responsibilities between the bankruptcy estate and the debtor, tax consequences with respect to partnerships and transfers of property, and the taxable period of a debtor. The section does

not, however, conform state and local tax rates.

9. Pennsylvania Personal Income Tax Reduction In Tax Attributes Relating To a Discharge In a Title 11 Bankruptcy.

Pennsylvania Personal Income Tax reduction in tax attributes relating to a discharge in a Title 11 Bankruptcy proceeding:

A. Partners.

i. First reducing the partner's percentage or any carryover Pennsylvania Personal Income Tax credits.

ii. Adjusted basis in the entity which is not liquidated.

iii. Adjusted basis in the entity's assets for any excess to the extent of the partner's share of the partnership assets.

iv. Adjusted basis in any property received in liquidation.

B. S Corporations.

Reduction in adjusted basis in Pennsylvania S corporation Pennsylvania Personal Income Tax assets is required at the entity level.

III. PENNSYLVANIA PERSONAL INCOME TAX REPORTING BASE CONSIDERATIONS.

1. Federal Taxable Income (Loss).

If Federal taxable income (loss) per the taxpayer's filed Federal tax return is the Pennsylvania Personal Income Tax reporting base, then classification and/or adjustments are required to account for amounts excluded under Sections 108 and/or 111. Adjustments are also required to account for differences in either of the application of the Pennsylvania Personal Income Tax insolvency computation, Pennsylvania Personal Income Tax purchase price reduction provision, or Pennsylvania Personal Income Tax attribute reduction amount.

2. Accepted Accounting Principles and Practices – Book Income (Loss).

If accepted accounting principles and practices are used in the Pennsylvania reporting base, then adjustments are required to account for certain Pennsylvania Personal Income Tax adjustments which require the application of the bankruptcy rules. Adjustments are also required to account for differences in the application of the Pennsylvania Personal Income Tax insolvency computation, Pennsylvania Personal Income Tax purchase price reduction provision, or Pennsylvania Personal Income Tax attribute reduction amount.

3. Requisite Pennsylvania Personal Income Tax Adjustment to Reflect Reduction To Adjusted Basis Calculations To Reflect Associated Reductions In Tax Attributes.

Requisite adjustment must be made to reflect requisite Pennsylvania Personal Income Tax reduction to Pennsylvania Personal Income Tax adjusted basis calculations to reflect associated reductions in Pennsylvania Personal Income Tax tax attributes.

IV. TREATMENT OF CANCELLATION OF INDEBTEDNESS OF RECOURSE DEBT FOR PENNSYLVANIA PERSONAL INCOME TAX PURPOSES.

1. No Bifurcation for Pennsylvania Personal Income Tax Purposes.

There is no required bifurcation between PA Schedule D gain or other Pennsylvania Personal Income Tax reportable income for Pennsylvania Personal Income Tax purposes. For Federal income tax purposes, a bifurcation is required based on the relationship between fair market value of the property and adjusted basis. If the collateral encumbered by recourse debt is transferred, foreclosed or abandoned to the creditor, then Pennsylvania Schedule D gain occurs.

2. Net Profit (Loss) From A Business, Profession Or Farm.

If the collateral is not transferred, foreclosed or abandoned, but the indebtedness is reduced, business income generally occurs if the debt was incurred in the business activity.

3. Rental Or Royalty Business Income Or Losses.

If the collateral is not transferred but the indebtedness is reduced, rental or royalty income generally occurs if the debt was incurred in the rental or royalty activity.

4. Cancellation Of Recourse Debt In A Title 11 Bankruptcy Proceeding.

The cancellation of recourse debt in a Title 11 Bankruptcy proceeding is covered by the bankruptcy Code provisions. See Bankruptcy Code Section 346.

5. Cancellation Of Recourse Debt For Solvent Debtor With Seller Purchase Price Reduction.

The cancellation of recourse debt for a solvent debtor associated with a purchase price reduction by the seller does not constitute Pennsylvania Personal Income Tax reportable income. Rather, Pennsylvania Personal Income Tax basis in the property is reduced as a result of the purchase price reduction.

6. Cancellation Of Recourse Debt That Is Personal In Nature Not Pennsylvania Personal Income Tax Reportable Income.

The cancellation of recourse debt that is personal in nature does not constitute Pennsylvania Personal Income Tax reportable income.

V. TREATMENT OF CANCELLATION OF INDEBTEDNESS OF NON–RECOURSE DEBT FOR PENNSYLVANIA PERSONAL INCOME TAX.

1. Pennsylvania Personal Income Tax Schedule D Gain on Pennsylvania Personal Income Tax Reportable Cancellation of Indebtedness.

a. Computing Pennsylvania Personal Income Tax Schedule D Gain If Property Is Transferred to Lender Or Foreclosed By Lender.

Collateral transferred, foreclosed or abandoned in exchange for cancellation of indebtedness is always treated as Pennsylvania Schedule D gain and not business income, rental or royalty income or as interest and/or dividend income. The Pennsylvania Schedule D gain is computed as follows:

Adjusted Issue Amount of the Debt
<u>Pennsylvania Personal Income Tax Adjusted Basis</u>
Pennsylvania Schedule D Gain

b. Collateral Is Not Transferred – Net Profit (Loss) From a Business, Profession or

Farm.

If the collateral is not transferred, foreclosed or abandoned, business income generally occurs if the debt proceeds were incurred in a business activity.

c. Collateral Is Not Transferred – Rental or Royalty Business Income (Loss).

If the collateral is not transferred, foreclosed or abandoned, then rental or royalty income generally occurs if the debt proceeds were incurred in the rental or royalty activity.

d. Constructive Cash Distributions Pass Through to Owners.

The treatment of non–recourse debt discharged in a Title 11 Bankruptcy proceeding is governed by the bankruptcy Code Section 346.

e. Non–recourse Debt Discharged By Seller In A Purchase Price Reduction.

The discharge of indebtedness of non–recourse debt by a seller in a purchase price reduction for a solvent debtor is determined under the Pennsylvania Personal Income Tax purchase price reduction provisions.

f. Discharge of Personal Non–recourse Debt Is Not Pennsylvania Personal Income Tax Reportable Income.

The discharge of non–recourse indebtedness that is personal in nature does not constitute Pennsylvania Personal Income Tax reportable income.

g. Discharge of Investment Activity Non–recourse Debt Is Reportable Pennsylvania Personal Income Tax Interest Or Dividend Income.

The discharge of non-recourse indebtedness associated with an investment activity where the funds were used to purchase assets generating interest and dividend income, constitutes reportable Pennsylvania Personal Income Tax interest or dividend income.

VI. PENNSYLVANIA PERSONAL INCOME TAX APPLICATION TO PARTNERS – CANCELLATION OF INDEBTEDNESS.

1. Pennsylvania Personal Income Tax Follows Federal Bankruptcy Code Section 346 If Taxpayer Is In Bankruptcy.

Pennsylvania Personal Income Tax treatment will follow Federal Bankruptcy Code Section 346 for determining Pennsylvania Personal Income Tax reportable income if the taxpayer is in bankruptcy.

2. Discharge of Debt For Insolvent Taxpayer Not In Bankruptcy.

The cancellation of debt for a taxpayer who is insolvent and not in bankruptcy before the transaction is nontaxable to the extent that the taxpayer is still insolvent after the transaction. A taxpayer will recognize gain to the extent the taxpayer was made solvent after the transaction.

3. Discharge of Debt For Solvent Taxpayer Accounted For As a Purchase Price Reduction.

The cancellation of debt associated with a purchase price reduction by the seller, for a solvent taxpayer, is accounted for as a purchase price reduction.

4. Discharge of Debt Incurred in Business or Commercial Activities Is Generally Taxable.

The cancellation of debt incurred in the following activities is generally taxable if the debt was incurred in:

a. A business, profession or farm;

b. Rental or royalty income activity;

c. Investment activity.

5. Discharge of Debt By Partnership Employee or Subcontractor Is Included In Compensation.

The cancellation of debt owed by an employee or subcontractor is included in the employee's or contractor's compensation.

6. Cancellation of Personal Debt or Student Loans Is Not Taxable For Pennsylvania Personal Income Tax Purposes.

The cancellation of personal debt, including student loans, is not taxable for Pennsylvania Personal Income Tax purposes.

7. Application of Insolvency Rules Based on State Law.

The insolvency computation is determined under Pennsylvania law. The insolvency is determined at the individual partner level. To the extent that an amount of the cancellation of debt is excluded as a result of the insolvency exclusion, a requisite reduction in the partner's Pennsylvania Personal Income Tax adjusted basis is required. If an excess amount remains a respective percentage of the partnership property that the partner owns is reduced for that partner by the partnership. The partnership would make a special allocation to the partner to account for the reduced depreciation.

8. Partnership Transfers Collateral to Lender Reports Pennsylvania Schedule D Gain.

If the collateral is transferred by the partnership to the lender, then the partnership will report PA Schedule D gain on the PA–20S/PA–65 Schedule D and on the associated RK–1's and NRK–1's.

9. Pennsylvania Personal Income Tax Reporting of Debt Reduced or Discharged If Partnership Retains Collateral.

If the partnership retains the collateral but the debt is reduced or discharged, the amount is reported as follows:

a. As business income if the debt was incurred in a business activity;

b. As rental or royalty income if the debt was incurred in a rental or royalty activity;

c. As interest or dividend income if the debt was incurred to purchase interest or dividend portfolio assets.

10. Reduction in Liability Decreases Partner's Pennsylvania Personal Income Tax Basis – Increase Pennsylvania Personal Income Tax Basis For Inclusion of Additional Income.

A partner receives a basis increase for the inclusion of additional income. The partner's basis is then decreased by any associated constructive cash distribution. The effect on Pennsylvania Personal Income Tax adjusted basis is as follows:

- Reduction in liabilities – constructive cash distribution – decrease in Pennsylvania Personal Income Tax basis.
- Increase in Pennsylvania Personal Income Tax adjusted basis for either:

  a. Reportable business income;

b. Reportable rental or royalty income;

c. Reportable interest or dividends.

11. Classify Accrued But Unpaid Expenses To Arrive at Partnership Pennsylvania Personal Income Tax Reportable Income.

Accrued but unpaid expenses are recorded as income in the respective class of income where the accrued expense was taken in arriving at Pennsylvania Personal Income Tax reportable income.

VII. PENNSYLVANIA PERSONAL INCOME TAX APPLICATION TO S CORPORATION SHAREHOLDERS – CANCELLATION OF INDEBTEDNESS.

1. For Pennsylvania Personal Income Tax Purposes Cancellation of Debt Is Also Determined at S Corporation Shareholder Level.

For Pennsylvania Personal Income Tax purposes, a cancellation of indebtedness is treated as follows:

a. Under Title 11 Bankruptcy – The Bankruptcy Code provisions are applicable as they apply to S corporations.

b. Not taxable to the extent the S corporation is still insolvent immediately after the discharge. The determination of insolvency is based on Pennsylvania law. The S corporation must be insolvent before the transaction.

c. Not taxable to the extent the cancellation of indebtedness relates to a purchase price reduction made by the seller for a solvent S corporation.

d. Generally taxable to the extent the indebtedness was incurred:

i. in a business activity (net profit from a business, profession or farm);

ii. in a rental or royalty activity;

iii. in an investment activity where funds were borrowed to purchase portfolio assets used in an investment activity. Note: an investment activity is not a commercial activity.

e. Not taxable to the extent that the debt discharge relates to personal debt including student loans.

f. Taxable to the extent the debt forgiven was exchanged for compensation.

2. For Pennsylvania Personal Income Tax Purposes Internal Revenue Code Section 108 Only Applies in Title 11 Bankruptcy Case.

IRC Section 108 is not applicable in determining whether Pennsylvania Personal Income Tax income is reportable except in a Title 11 Bankruptcy case.

3. Application of Insolvency Rule Based on State Law.

The Pennsylvania Personal Income Tax insolvency rule discussed above is not based on Section 108 of the Internal Revenue Code. Pennsylvania Personal Income Tax has a parallel provision. For purposes of applying this rule, insolvency is determined at the S corporation level. Insolvency is determined immediately before the discharge occurs. The S corporation will report Pennsylvania Personal Income Tax reportable income where the S corporation is

solvent after the transaction.

4. Pennsylvania S Corporation Reports Pennsylvania Schedule D Gain If Collateral Transferred or Foreclosed.

If the collateral is transferred or foreclosed, the PA S Corporation will report PA Schedule D gain on the PA–20S/PA–65 return. The gain is computed based on the following computation:

Adjusted Issue Amount of Debt
Pennsylvania Personal Income Tax Adjusted Basis
Pennsylvania Schedule D Gain

The PA Schedule D gain should be reflected on the respective K–1's or NRK–1's.

5. Collateral Not Transferred – Discharged Debt Reportable In Respective Pennsylvania Personal Income Tax Income Classes.

If the collateral is retained but the associated debt is forgiven, the Pennsylvania S Corporation will report the following where applicable:

a. As business income if the indebtedness cancelled was incurred in a business, profession or farm activity;

b. As rental or royalty income if the indebtedness cancelled was incurred in a rental or royalty activity;

c. As interest or dividend income to the extent the indebtedness cancelled related to the purchase of investment assets.

6. Discharge of Debt By S Corporation Employee or Subcontractor Is Included In Compensation.

If the S corporation cancels an employee's or subcontractor's outstanding loan amount, then the amount of the cancellation is included in the employee's or subcontractor's compensation.

7. Classify Accrued But Unpaid Expenses To Arrive at S Corporation Pennsylvania Personal Income Tax Reportable Income.

Accrued but unpaid expenses are recorded as income in the respective class of income where the accrued expense was taken in arriving at Pennsylvania Personal Income Tax reportable income.

8. Application of the Pennsylvania Personal Income Tax "Tax Benefit" Rules.

For coordination with the application of the Pennsylvania Personal Income Tax "tax benefit" rules when the entity is liquidated or discontinued, see PA PIT Guide chapters on the utilization of losses.

VIII. CANCELLATION OF INDEBTEDNESS – ACCEPTED ACCOUNTING PRINCIPLES AND PRACTICES.

1. Troubled Debt Restructuring.

Troubled debt restructuring is defined in **Statement of Financial Accounting Standards (SFAS) 15**, "*Accounting for Debtors and Creditors in a Troubled Debt Restructuring*", and expanded upon in various **Emerging Issues Task Force (EITF)** issues. **EITF 02-04**, "*Determining Whether a Debtor's Modification or Exchange of Debt Instruments is within the scope of FASB Statement No. 15*", requires that debtor companies apply these special rules upon a restructuring when:

- Debtors are "experiencing financial difficulties" – Among the factors to consider when assessing whether a company is experiencing financial difficulties include whether the company (i) is in default on its debt, (ii) has either filed or will soon file for bankruptcy, (iii) is able to continue as a going concern, (iv) projections indicate that cash flows will be insufficient to satisfy its contractual debt obligations, (v) has outstanding securities that have been de-listed, or (vi) has limited access to capital due to deteriorating creditworthiness.

- Creditors grant a concession in the restructuring – To determine whether a "qualifying" concession has occurred, the company must determine that the renegotiated interest rate has been reduced due to the company's financial difficulties, rather than a decline in prevailing market interest rates,

IX. APPLICATION OF ACCEPTED ACCOUNTING PRINCIPLES AND PRACTICES CONCERNING PENNSYLVANIA PERSONAL INCOME TAX CANCELLATION OF DEBT TREATMENT.

1. Financial Accounting Implications.

The financial accounting for a particular troubled debt restructuring transaction depends in large part on what the creditor receives in exchange for any concessions granted. If no assets are transferred and the transaction simply modifies the company's cash flow either by delaying or reducing outstanding principal or interest the company cannot recognize a gain on the transaction date. The only exception is if the aggregate of all renegotiated future payments is less than the carrying amount of the debt. In all other instances, the company simply reports a reduced interest charge in future income statements. That interest charge will be the discount rate that equates the present value of the future cash payments to the carrying amount of the debt.

When companies extinguish troubled debt obligations by transferring assets or making equity grants to their lenders, they can record an accounting gain equal to the difference between the amount of debt appearing in their financial statements and the fair value of the consideration exchanged. They must also record a gain or loss equal to the difference between the fair value and carrying amount of the assets transferred.

Hybrid troubled debt restructurings are employed, which combine an asset or equity transfer with modified loan terms. In these cases, the company must first reduce the carrying amount of its financial statement debt or the fair value of the assets or equity transferred. It can then determine whether it must record a gain on the transaction date by comparing the newly adjusted book value of the debt instrument with the renegotiated value of its aggregate cash flows.

The tax consequences of a troubled debt restructuring hinge on whether it simply cancels indebtedness, or whether there is also cash flow modifications combined with an exchange of assets or equity. Generally, companies have to assess whether the troubled debt restructuring triggers cancellation of debt (COD) income, as well as whether any asset or equity transfers generate other taxable gains or losses. COD income is recognized if the present value of the restructured payments is less than the total future payments due pursuant to the original terms of the debt. Furthermore, the original issue discount provisions of the Internal Revenue Code may force limitations on the future deductibility of interest. A COD tax gain can be avoided when the company is deemed insolvent for tax purposes (tax basis liabilities are greater than the fair market value of its assets) or is in bankruptcy. In this instance, the COD income will not trigger a current tax liability, but rather would be applied to reduce tax attributes such as net operating losses, tax credits or tax basis of assets.

2. Examples of Troubled Debt Restructuring Disclosure.

Transfer of Assets in Full Settlement.	At [date of transfer], the amount due to the supplier exceeded the fair market value of the assets transferred, and accordingly a gain of $xx,xxx has been included in income in 20x2.
Transfer of Equity in Full Settlement.	At [date of transfer], the amount due to debenture holders exceeded the aggregate market value of the shares transferred, and accordingly a gain of $xx,xxx has been included in income in 20x2.
Modification of Terms – Carrying Value of Debt Exceeds Future Cash Payments.	The bank has agreed to accept [reduced amount] at no interest over the same period. Accordingly, the amount of the note has been reduced by $xx,xxx, and a gain of $xx,xxx has been included in operations in 20x2.
Modification of Terms – Future Cash Payments Exceed Carrying Value of Debt.	The bank has agreed to accept [reduced amount] in 20x7 and to reduce the interest rate to x% on the new balance. The modifications have resulted in an effective interest rate of x%, and interest expense through 20x7 will be reduced accordingly.
Partial Settlement and Modification of Terms – Carrying Value of Debt Exceeds Future Cash Payments.	The fair market value of the [description of assets] exceeded their book value by $xx,xxx at [date of transfer], and accordingly a gain of $xx,xxx has been included in operations in 20x2. The amount of the note payable has been further reduced by $xx,xxx, and a gain of $xx,xxx has also been included in operations in 20x2.
Partial Settlement and Modification of Terms – Future Cash Payments Exceed Carrying Value of Debt.	The fair market value of the [description of assets] exceeded their book value by $xx,xxx at [date of transfer], and accordingly a gain of $xx,xxx has been included in operations for 20x2. The modifications have resulted in an effective interest rate of x%, and interest expense through 20x6 will be reduced accordingly.
Partial Settlement and Modification of Terms – Carrying Value of Debt Exceeds Future Cash (and Contingent) Payments.	The supplier has agreed to accept xx,xxx shares of the company's $x par value common stock and to reduce the annual payments to (reduced amount). In addition, the supplier will receive an additional $xx,xxx annual payment for each year in which the company's earnings exceed $xxx,xxx. These modifications have resulted in a reduction of the maturity value of the note and a gain of $xx,xxx in 20x2.
Disclosure Required in Subsequent Years When Modification of Terms Includes Contingent Payments.	At [date of financial statements], 20x2 and 20x1, the aggregate amounts contingently payable included in the carrying value of the notes were $xx,xxx and $xx,xxx, respectively.

X. PENNSYLVANIA PERSONAL INCOME TAX TREATMENT OF BANKRUPTCY DISCHARGE.

Pennsylvania Personal Income Tax treatment conforms to Federal law as defined under Section 346 of the Bankruptcy Code.

1. Internal Revenue Code Sections 108(a), 108(b) and 108(g) are applied at the partner level.

Sections 108(a), 108(b) and 108(g) are applied at the partner level. Section 108(a)(1)(A) provides for an exclusion from gross income by reason of the discharge (in whole or in part) of indebtedness of the taxpayer if the discharge occurs in a Title 11 Bankruptcy case. Section 108(a)(2)(A) provides that a Title 11 exclusion takes precedence.

Section 108(b) provides for a reduction in tax attributes which includes amounts excluded under subparagraph (A). See Internal Revenue Code Section 108(a)(1)(A).

Both Sections 108(a)(1)(A) and 108(b) are applied at the partner level.

Section 346 of the Bankruptcy Code provides in part:

"For purposes of any state or local law imposing a tax on or measured by income, income is not realized by the estate, debtor, or a successor to the debtor by reason of discharge of indebtedness in a case under this Title except to the extent, if any, that such income is subject to tax under the Internal Revenue Code."

2. Requisite Reduction in Pennsylvania Personal Income Tax Attributes Required as Result of Bankruptcy Discharge.

A requisite reduction in Pennsylvania Personal Income Tax attributes is also required as a result of the bankruptcy discharge.

Section 346 of the Bankruptcy Code also provides in part.

"For purposes of any state law imposing a tax on or measured by income, income is not realized."

Whenever the Internal Revenue Code provides that the amount excluded from gross income in respect of the discharge of indebtedness in a case under this Title shall be applied to reduce the tax attributes of the debtor or the estate, a similar reduction shall be made under any state or local law imposing a tax on or measured by income to the extent such state or local law recognizes such attributes.

Such state or local law may also provide for the reduction of other attributes to the extent that the full amount of income from the discharge of indebtedness has not been applied.

3. Internal Revenue Code Sections 108(a) and (b) Apply at the S Corporation Level.

Internal Revenue Code Sections 108(a) and (b) apply at the S corporation level. Section 108(a)(1)(A) provides for an exclusion from gross income by reason of the discharge (in whole or in part) of the indebtedness of the taxpayer if the discharge occurs in a Title 11 case.

Section 108(a)(2)(A) provides that a Title 11 exclusion takes precedence.

Section 108(d)(7) provides for the special rules for S corporations. Subsections (a), (b), (c), and (g) shall be applied at the corporate level. Subsection (c) relates to the treatment of discharged of qualified real property indebtedness.

4. Internal Revenue Code Sections 108(a)(1)(B), 108(a)(1)(C), and 108(a)(1)(D) Not Operative For Pennsylvania Personal Income Tax Reporting Purposes.

For Pennsylvania Personal Income Tax purposes, the following are not operative for Pennsylvania Personal Income Tax reporting purposes:

i. 108(a)(1)(B) – Discharge occurs when taxpayer is insolvent

ii. 108(a)(1)(C) – Discharge is qualified farm indebtedness

iii. 108(a)(1)(D) – Discharge is qualified real property indebtedness

5. Federal Precedence Rule – Internal Revenue Code Section 108(a)(2).

According to Internal Revenue Code Section 108(a)(2), the exclusions from income resulting from discharge of indebtedness have an order of priority which must be followed. Exclusion under bankruptcy has precedence over the other exclusions listed under IRC Section 108. Therefore, exclusions for debt discharged to insolvent taxpayers, discharged qualified farm indebtedness and discharged qualified real property indebtedness are not applicable to a debt that is discharged in a bankruptcy situation. In turn, when a taxpayer is insolvent and has income resulting from discharged qualified real property business indebtedness, the exclusion for qualified real property business indebtedness only applies to the extent the taxpayer is not able to exclude income under the insolvency exception.

6. Precedence Rule for Pennsylvania Personal Income Tax.

The following Internal Revenue Code Sections are not operative – 108(a)(1)(B), 108(a)(1)(C), 108(a)(1)(D). The Pennsylvania Personal Income Tax insolvency rule is operative. The Pennsylvania Personal Income Tax insolvency rule is applied at the partner and S corporation level.

XI. NONTAXABILITY OF CANCELLATION OF DEBT INCOME FOR PENNSYLVANIA PERSONAL INCOME TAX PURPOSES.

1. Personal Indebtedness.

Discharge of indebtedness income is not fully specifically mentioned in any of the eight classes of taxable income. However, the Department has consistently taken the position that a discharge of indebtedness is only taxable when it represents a direct substitute for one of the eight classes of taxable income as provided for in the Tax Reform Code. For example, if there is a discharge of indebtedness in exchange for an employee performing services for the obligee, that discharge would be considered taxable compensation.

2. Student Loans.

Forgiveness of student loans would not qualify as a substitute for any of the eight classes of taxable income. Rather, this discharge of indebtedness amounts to an incentive from your nursing school to encourage its students to practice public interest nursing regardless of the extent of their nursing school debt.

3. Other. [Reserved.]

XII. APPLICATION OF OTHER FEDERAL RULES CONCERNING CANCELLATION OF DEBT – PENNSYLVANIA PERSONAL INCOME TAX REPORTING BASIS – FEDERAL TAXABLE INCOME (LOSS) – [RESERVED.]

1. Acquisition of Related Party Debt.

2. Debt for Stock.

3. Debt for a Partnership Interest.

4. Tax Benefit Rule.

XIII. FEDERAL INCOME TAX STATUTORY PROVISIONS – OVERVIEW.

1. Federal Statutes – Internal Revenue Code Sections 61(a)(12), 108, 111.

If a debt is cancelled or forgiven, other than as a gift or bequest, the debtor generally must include the cancelled amount in gross income for tax purposes. A debt includes any indebtedness for which the debtor is liable or which attaches to property the debtor holds. The applicable Federal Statutes are Internal Revenue Code Sections 61(a)(12), 108, 111.

2. Gross Income Defined – Internal Revenue Code Section 61(a)(12).

Gross Income Defined – Internal Revenue Code Section 61(a)(12):

a. Net operating losses and net operating loss carryovers;

b. General business credits under Section 38;

c. Alternative minimum tax credits;

d. Net capital losses and capital loss carryovers;

e. The basis of depreciable property (to the extent the basis exceeds remaining liabilities);

f. Passive activity losses and credit carryovers; and

g. Foreign tax credits and carryovers.

3. Required Reduction in Attributes.

A. Reduction in Attributes.

The reduction in attributes occurs after the determination of tax for the year of the discharge. Attributes are reduced dollar-for-dollar, except for tax credits, which are reduced 33 1/3 cents for each dollar. A taxpayer may instead elect to first reduce the basis of depreciable property. The reduction in basis is limited to the taxpayer's adjusted basis of depreciable property held at the beginning of the taxable year following the taxable year in which the debt is discharged. (The reduction in basis is not limited to the excess of the basis in depreciable property over remaining liabilities.)

B. Basis Reduction.

The required basis reduction generally applies to depreciable real property held by the taxpayer at the beginning of the taxable year following the taxable year in which the debt is discharged. If the taxpayer disposes of real property (in the transaction that gave rise to the discharge or otherwise) prior to the first day of the next taxable year,

then the reduction in basis of such property is made immediately before the disposition. Taxpayers may not make the election available under present law to treat as depreciable real property real estate held primarily for sale to customers. When depreciable real property, the basis of which has been reduced, is disposed of, then for purposes of determining the amount of ordinary income depreciation recapture under Section 1250; (i) the basis reduction is treated as an allowance for depreciation, and (ii) the determination of depreciation under the straight line method is made as if there had been no reduction. Accordingly, the amount of ordinary income depreciation recapture is reduced over time as the taxpayer forgoes depreciation deductions.

4. Exclusion From Gross Income – Internal Revenue Code Section 108.

A. Exceptions and Exclusions.

There are several exceptions and exclusions from the inclusion of cancelled debt in income. The exceptions include:

- The cancellation of a student loan for a student required to work for certain employers.
- The cancellation of debt that would have been deductible if paid.
- The reduction of a debt by the seller of property if the debt arose from the purchase of the property.

B. Exclusions.

Taxpayers do NOT include a cancelled debt in gross income if any of the following situations apply:

- The cancellation takes place in a bankruptcy case under the U.S. Bankruptcy Code.
- The cancellation takes place when a taxpayer is insolvent, and the amount excluded is not more than the amount by which he or she is insolvent.
- The cancelled debt is qualified farm debt (debt incurred in operating a farm).
- The cancelled debt is qualified real property business indebtedness (certain debt connected with business real property).

C. Order of Exclusions.

If the cancellation of debt occurs in a Title 11 bankruptcy case, the bankruptcy exclusion takes precedence over the insolvency, qualified farm debt, or qualified real property business indebtedness exclusions.

To the extent that the taxpayer is insolvent, the insolvency exclusion takes precedence over qualified farm debt or qualified real property business indebtedness exclusions.

D. Bankruptcy Case Exclusion.

A bankruptcy case is a case under Title 11 of the United States Code, but only if the debtor is under the jurisdiction of the court and the cancellation of the debt is granted by the court or occurs as a result of a plan approved by the court.

None of the debt cancelled in a bankruptcy case is included in the taxpayer's gross income in the year cancelled. Instead, certain losses, credits, and basis of property

must be reduced by the amount of excluded income (but not below zero). These losses, credits, and basis in property are called tax attributes.

5. Tax Benefit Approach – Internal Revenue Code Section 108(e)(2).

Under the Internal Revenue Code Section 108(e)(2), taxpayers can exclude discharge of indebtedness income to the extent that the payment of the liability would have given rise to a deduction by the debtor. See Internal Revenue Code Section 108(e)(2).

The effect of Section 108(e)(2) is that there is no debt discharge income where a trade account payable of a cash basis taxpayer is discharged.

6. Gifts.

Courts have allowed taxpayers to exclude discharge of indebtedness income in situations involving gifts and overall loss transactions. Under the gift exception, if the creditor intends to cancel all or part of the debt, expecting nothing in return, there is no discharge of indebtedness income. However, there must be donative intent, making this exception inapplicable in the commercial setting.

7. Student Loan.

Complete or partial cancellations of some student loans do not generate forgiveness of indebtedness income. For this exception from debt discharge income to apply, the loan cancellation must be conditioned on the student working in a certain profession for a certain period of time for any of a broad class of employers. For student loans to qualify for this exception, which include loans from qualified educational organizations or other tax-exempt entities that refinance qualified student loans, the loans must also help students attend qualified educational organizations.

8. Purchase Price Reduction.

When a lender reduces a buyer's purchase money debt, the debt relief is treated as an adjustment to the purchase price requiring reduction of the property's basis, instead of as discharge of indebtedness income. This rule applies only if the bankruptcy or insolvency exclusions do not, and only if the reduction otherwise would have given rise to discharge of indebtedness income.

To qualify for this exclusion, the debt must run from the buyer to the seller and not to either's transferee (even if related) or to a third-party holder of the debt. A debt reduction by a third-party lender can be treated as a purchase price adjustment only if it is based on an infirmity that clearly relates back to the original price, such as the seller's inducement of a higher purchase price by misrepresentation of a material fact or by fraud where a debt discharge was part of a larger transaction resulting in a transfer of ownership (from debtor to a third party), the Tax Court found a sale or exchange of an asset. However, the Internal Revenue Service (IRS) has privately ruled that when a sole shareholder sold all of the stock in his old company for cash and debt to a newly formed corporation, and after the new corporation was merged into the old company the shareholder agreed to reduce the amount of debt due him from the sale, the old company had a purchase price reduction rather than forgiveness of indebtedness income.

The debt reduction is not treated as a purchase price adjustment if it is directly the result of dealings between the buyer and seller, such as the running of the limitations period. See Senate Committee Report to P.L. 96-589 (1980), S. Rep. No. 96-1035,16.

This treatment can apply to a partnership even if it is insolvent or bankrupt. However, it applies only if no partner in the partnership takes a position that is not consistent with the partnership's treatment of the discharge as a purchase price adjustment.

XIV. INTERNAL REVENUE CODE SECTION 61(a)(12).

1. General Application.

In general, a taxpayer must include in gross income the amount of any debt that is cancelled. See Internal Revenue Code (IRC) §§108 and 61 (a)(12). Generally, this includes accrued original issue discount (OID). See I.R.C. §163(e)(3), Treasury Regulation §1.61-12(c)(3). For example, a taxpayer/debtor recognizes cancellation of indebtedness income where it acquires its own indebtedness for less than the face amount.

Under Section 108(e)(4), a taxpayer/debtor is treated as acquiring its own indebtedness and therefore may recognize cancellation of indebtedness income when its indebtedness is acquired by a person "related" to the taxpayer/debtor, within the meaning of IRC Section 267(b) or Section 707(b)(1). Under Section 267(b)(3), two corporations which are members of the same controlled group (as defined in Section 267(f)) are related. Section 267(f) provides that the term "controlled group" has the same meaning as in Section 1563(a) (without regard to Section 1563(a)(4)) (insurance companies) and Section 1563(e)(3)(C) (no attribution of stock owned by qualified employee's trust), except that "more than 50 percent" is substituted for "more than 80 percent." Thus, for purposes of Section 108(e)(4), members of the same controlled group are "related," control being defined as owning more than 50 percent of vote and value.

2. Internal Revenue Service Reporting Requirements.

An applicable entity that discharges $600 or more of the debt of any person generally must file an information return showing the person's name, address and taxpayer identification number (TIN), the date and amount of discharge, and any other information required by the IRS. This requirement applies whether the discharge is total or partial.

The required information must be filed on Form 1099-C, Cancellation of Debt, by February 28 of the year following the year in which the discharge occurred. The due date for electronically filing Form 1099-C is March 31 of the year following the year of discharge. In addition, the debtor must be given a written statement showing the Form 1099-C information, and any information required by current revenue procedures, by January 31 of the year after the discharges.

A discharge of indebtedness for information return purposes is one of eight identifiable events as defined in Internal Revenue Service Regulation Section 1.6050P-1.

a. Chapter 11 Bankruptcy.

b. A cancellation or extinguishment of debt that renders it unenforceable in a receivership, foreclosure or similar proceeding in a federal or state court, other than a bankruptcy proceeding.

c. A cancellation or extinguishment of debt resulting from expiration of the statute of limitations for collecting the debt. However, this type of cancellation arises only when a debtor's affirmative statute of limitations defense is upheld in a final judicial proceeding and the time for appeal has expired.

d. A cancellation or extinguishment of debt arising from a creditor's election of foreclosure remedies that statutorily extinguishes or bars his right to collection. However, reporting is required only when local law bars a mortgage lender or holder from pursuing a deficiency judgment or note collection proceeding after exercise of a power of sale contained in the mortgage or deed of trust.

e. A cancellation or extinguishment of debt rendering it unenforceable under a probate or similar proceeding.

f. A discharge under an agreement with an applicable entity to reduce the debt for less than full consideration. The last act needed to effect the agreement must occur.

g. A discharge under a creditor's decision, or the application of a defined policy of the creditor, to discontinue collection activity. A defined policy can be either a written or established business practice; or

h. The expiration of a nonpayment testing payment period. There is a presumption that a discharge has occurred if a creditor has not received a payment on a debt during the nonpayment testing period. The nonpayment testing period is a 36 month period, increased by the number of months during all or part of which collection was stayed by bankruptcy or similar state or local law. However, the presumption of discharge can be rebutted by significant, bona fide collection activity during the 12 months preceding expiration of the period, or by the facts and circumstances existing as of January 31 of the calendar year following expiration. Significant collection activity does not include merely nominal or ministerial action, such as an automated mailing. Facts and circumstances showing no discharge include the existence of a lien against the debtor, or the sale or packaging for sale of the debt.

XV. INTERNAL REVENUE CODE SECTION 108.

1. Title 11 Bankruptcy Discharge of Unpaid Tax.

Debts are divided into two categories: dischargeable and non–dischargeable. Dischargeable debts are those that the debtor is no longer personally liable to pay after the bankruptcy proceedings are concluded. Non–dischargeable debts are those that are not cancelled because of the bankruptcy proceedings. The debtor remains personally liable for their payment.

As a general rule, there is no discharge for a taxpayer as an individual debtor at the termination of a bankruptcy case for the second and eighth priority taxes, or for taxes for which no return, a late return (filed within two years of the filing of the bankruptcy petition), or a fraudulent return was filed. However, claims against a taxpayer for other taxes predating the bankruptcy petition by more than three years may be discharged.

2. Discharge When Taxpayer is Insolvent and Not in Bankruptcy.

Gross income does not include income from discharge of indebtedness of an insolvent taxpayer. The amount excludable from gross income by an insolvent taxpayer is limited to the amount by which the taxpayer is insolvent. A taxpayer is considered insolvent if the liabilities of the taxpayer immediately preceding the discharge of the debt exceed the fair market value of the taxpayer's assets.

Liabilities – In Revenue Ruling 92-53, the Service stated that, in determining solvency it will ignore non–recourse debt in excess of the value of the property securing that debt (except where that excess non–recourse debt itself is being forgiven). Commentators have asserted it is unclear as to whether contingent liabilities should be valued and included in liabilities.

Assets – In determining solvency, exempt assets under state law are not included in the taxpayer's assets. To value partnership interests, the taxpayer should evaluate the partnerships assets and liabilities. If there is equity in the partnership interest, then the partner should apply an appropriate marketability discount.

3. Insolvency.

a. If a partner is insolvent, then he or she may exclude Cancellation of Debt (COD)

income to the extent insolvent (IRC section 108(a)(1)(B) and IRC section 108(a)(3). If the cancellation of debt removes a partner from insolvency, the partner must recognize income to the extent made solvent. That is, to the extent the fair market value of the partner's assets exceeds his or her liabilities immediately after the cancellation.

b. Insolvency is determined immediately before discharge of debt (IRC section 108(d)(3)).

c. The amount by which a non–recourse debt exceeds the fair market value of the property securing the debt is taken into account in determining whether, and to what extent, a taxpayer is insolvent, but only to the extent that the excess non–recourse debt is discharged. See Revenue Ruling 92-53.

d. The fair market value of assets that are exempt under state law are not excludable in determining insolvency.

e. Contingent liabilities (guarantees) are not included in the insolvency computation. See *Merkel*, 109 T.C. 463 (1997), affd, [99-2 U.S.T.C. ¶50,848], (9th Cir. 1999).

f. The burden of proving insolvency is on the taxpayer. See *Bressi*, T.C. Memo. 1991-651.

g. Federal Insolvency Computation:

Fair Market Value of Assets (less selling costs)

- Cash
- IRAs/Pensions
- Life insurance (cash surrender value)
- Personal property
- Real property
- Stocks, Bonds, & Other Securities
- Business interests (Partnerships, S-Corporations, LLCs, etc.)
- Accounts/Notes Receivable

Less: Liabilities

- Recourse Debt
- Non–recourse Debt

= (Insolvency) – Solvency

4. Qualified Farm Indebtedness.

Farmers can exclude a limited amount of income that would otherwise be included as a result of the discharge of indebtedness if the indebtedness discharged is qualified farm indebtedness and tax attributes are reduced accordingly. This exclusion applies to solvent farmers. If the farmer is insolvent, the insolvency exclusion takes precedence to the extent the farmer is insolvent. However, the exclusion for qualified real property business indebtedness does not. A farmer is insolvent if his liabilities exceed the fair market value of assets.

5. Qualified Real Property Business Indebtedness.

Taxpayers other than C corporations can elect to exclude income realized from the discharge of qualified real property business indebtedness. Qualified real property business indebtedness is debt that ' incurred or assumed on real property used in a trade or business, and that is secured by this real property. It cannot have been incurred or assumed after December 31, 1992, unless it is qualified acquisition indebtedness used to refinance pre-1993 qualified real property business indebtedness. Qualified acquisition indebtedness is debt used to acquire, construct, reconstruct, or substantially improve the property. Debt used to refinance qualified real property business indebtedness does not qualify to the extent that it exceeds the amount of debt being refinanced. Qualified real property business indebtedness does not include qualified farm indebtedness.

6. Stock-for-Debt.

The stock-for-debt exception has been repealed. For purposes of determining the income of a debtor attributable to the cancellation of indebtedness (COD), a debtor that issues a debt instrument in satisfaction of indebtedness is treated as having satisfied the indebtedness with an amount of money equal to the issue price of that debt instrument (Code Sec. 108(e)(10)). For this purpose, the issue price of the new obligation is determined under the general rules applicable to debt instruments issued for property (Code Sections 1273(b) and 1274). For debt instruments subject to interest on deferred payments (Code Sec. 483), the issue price, determined under Code Sec. 1273(b)(4), is reduced to exclude unstated interest for purposes of determining income from COD.

A corporation that issues its own stock to a creditor in satisfaction of outstanding debt realizes income from discharge of indebtedness to the extent that the principal of the debt exceeds the value of the stock or any other property transferred (Code Sec. 108(e)(8)). There is no insolvency or bankruptcy exception to recognition of discharge of indebtedness income when a corporation exchanges its outstanding stock for debt; recognition can be avoided only by reduction of tax attributes.

XVI. REDUCTION OF TAX ATTRIBUTES – INTERNAL REVENUE CODE SECTION 108(b).

1. Amount of Reduction – Insolvency Exclusion.

Taxpayers are insolvent when, and to the extent, their liabilities exceed the fair market value of their assets. Taxpayers determine liabilities and the fair market value of their assets immediately before the cancellation of debt to determine whether or not they are insolvent and the amount by which they are insolvent.

Taxpayer can exclude from gross income debt cancelled when a taxpayer is insolvent, but only up to the amount by which he or she is insolvent. However, taxpayers MUST use the amount excluded to reduce certain tax attributes.

2. Reduction of Tax Attributes.

If a debtor excludes cancelled debt from income because it is cancelled in a bankruptcy case or during insolvency, he or she MUST use the excluded amount to reduce certain “tax attributes.” Tax attributes include the basis of certain assets and the losses and credits listed next. By reducing these tax attributes, tax on the cancelled debt is in part postponed instead of being entirely forgiven. This prevents an excessive tax benefit from the debt cancellation.

If a separate bankruptcy estate was created, the trustee or debtor–in–possession must reduce the estate’s attributes (but not below zero) by the cancelled debt.

3. Order of Reduction.

Generally, use the amount of cancelled debt to reduce the tax attributes in the order listed below. However, taxpayers may choose to use all or a part of the amount of cancelled debt to first reduce the basis of depreciable property before reducing the other tax attributes.

- *Net Operating Loss* – First, reduce any net operating loss for the tax year in which the debt cancellation takes place, and any net operating loss carryover to that tax year.
- *General Business Credit Carryovers* – Second, reduce any carryovers, to or from the tax year of the debt cancellation, of amounts used to determine the general business credit.
- *Minimum Tax Credit* – Third, reduce any minimum tax credit that is available as of the beginning of the tax year following the tax year of the debt cancellation and any capital loss carryover to that year.
- *Basis* – Fifth, reduce the basis of property as described under basis reduction, later. This reduction applies to the basis of both depreciable and non-depreciable property.
- *Passive Activity Loss and Credit Carryovers* – Sixth, reduce any passive activity loss or credit carryover from the tax year of the debt cancellation.
- *Foreign Tax Credit* – Last, reduce any carryover, to or from the tax year of the debt cancellation, of an amount used to determine the foreign tax credit or the Puerto Rico and possessions tax credit.

4. The Required Reductions.

The required reductions in tax attributes occur after figuring the tax for the tax year of the debt cancellation. In reducing net operating losses and capital losses, first reduce the loss for the tax year of the debt cancellation, and then any loss carryovers to that year in the order of the tax years from which the carryovers arose, starting with the earliest year. Make the reductions of credit carryovers in the order in which the carryovers are taken into account for the tax year of the debt cancellation.

5. Basis Reduction.

If any amount of the debt cancellation is used to reduce the basis of assets, the following rules apply to the extent indicated:

- Taxpayers make the reduction in basis at the beginning of the tax year following the tax year of the debt cancellation. The reduction applies to property held at that time.
- Bankruptcy and Insolvency Reduction Limit – The reduction in basis because of cancelled debt in bankruptcy or in insolvency cannot be more than the total basis of property held immediately after the debt cancellation, minus the total liabilities immediately after the cancellation. This limit does not apply if an election is made to reduce basis before reducing other attributes.
- Exempt Property Under Title 11– If debt is cancelled in a bankruptcy case under Title 11 of the United States Code, make no reduction in basis for property that the debtor treats as exempt property under Section 522 of Title 11.
- Election to Reduce Basis First – Taxpayers (the estate in the case of an individual bankruptcy under Chapters 7 or 11) may choose to reduce the basis of depreciable property before reducing any other tax attributes. However, this reduction of the basis of depreciable property cannot be more than the total basis of depreciable property held at the beginning of the tax year following the tax year of the debt cancellation.

6. Depreciable Property.

Depreciable property means any property subject to depreciation, but only if a reduction of basis will reduce the amount of depreciation or amortization otherwise allowable for the period immediately following the basis reduction. Taxpayers may choose to treat as depreciable property any real property that is stock in trade or is held primarily for sale to customers in the ordinary course of a trade or business.

Taxpayers must generally make this choice on the tax return for the tax year of the debt cancellation, and, once made, taxpayers can only revoke it with IRS approval. However, if taxpayers establish reasonable cause, they may make the choice with an amended return or claim for refund or credit.

A. Making Elections.

Make the election to reduce the basis of depreciable property before reducing other tax attributes as well as the election to treat real property inventory as depreciable property, on Form 982, reduction of tax attributes due to discharge of indebtedness (and Section 1082 basis adjustment).

B. Recapture of Basis Reductions.

If any basis in property is reduced under these provisions and is later sold or otherwise disposed of at a gain, the part of the gain that is from this basis reduction is taxable as ordinary income. Figure the ordinary income part by treating the amount of this basis reduction as a depreciation deduction and by treating any such basis-reduced property that is not already either Section 1245 or Section 1250 property as Section 1245 property. In the case of Section 1250 property, make the determination of what would have been straight line depreciation as though there had been no basis reduction for debt cancellation.

7. Federal Tax Election to Apply Reduction First Against Depreciable Property.

A. Partnership or S Corporation Level Election.

With respect to partnerships and S corporations, the determination of whether the debt is qualified real property indebtedness is made at the entity level. For partnerships the election to exclude income and reduce the basis of property is made by the partner. For S corporations the election is made by the S corporation, not by its shareholders. Partners which are C corporations are not eligible to make the election. If a partner makes the election, basis is reduced in the partner's interest in the partnership to the extent of the partner's proportionate interest in the depreciable real property held by the partnership. The partnership's basis in depreciated real property with respect to such partner is correspondingly treated. It appears that a partner may reduce the basis of depreciable real estate held outside the partnership if the partner's share of partnership depreciable basis is insufficient. However, this may give rise to partnership tax problems.

B. Tax Attribute Reduction – Insolvent and Bankrupt Partners.

If cancelled debt is excluded under IRC Section 108 because a partner is bankrupt or insolvent, he or she must use the excluded amount to reduce net operating losses, capital losses, basis, suspended passive losses, and other tax attributes.

C. Qualified Real Property Business Indebtedness.

Solvent partners, other than C corporations, may exclude cancellation of Qualified Real Property Business Indebtedness (referred to as "QRPBI") income if certain requirements are met (IRC Section 108(c)).

- The determination of whether cancelled debt is QRPBI is made at the

partnership level. The debt cancelled must be secured by real property used in the trade or business and incurred before January 1, 1993, or be Qualified Acquisition Indebtedness.

- The excluded cancellation of debt (COD) income cannot exceed the partner's share of the difference between the outstanding principal amount of debt (before discharge) and the fair market value of the real property (reduced by the outstanding principal amount of any other qualified real property business indebtedness secured by such property); and the partner's total adjusted bases of depreciable real property. The outstanding principal amount includes prior year accumulated accrued and unpaid interest (Final Treasury Regulation Section 1.108-6(a)).

D. Partner Must Timely Elect to Reduce Basis of Depreciable Real Property.

The partner must make a timely election to reduce the bases of his or her depreciable real property (Note: Depreciable real property does not include land, furniture and fixtures, equipment or intangible assets). A partnership interest is considered depreciable real property to the extent of the partner's share of depreciable real property. To make the election, the partner uses Form 982, Reduction of Tax Attributes Due to Discharge of Indebtedness in the year COD income is received. The partner must attach a detailed description, by property, identifying any reduction in basis under IRC Section 1017.

For the partner's basis in his or her partnership interest to be reduced the partnership must make a corresponding reduction in the partner's share of depreciable real property on its books. If the partnership does not make the reduction, then the partner may not exclude the COD income (See Treasury Regulation Section 1.1017-1(g) (2) for general rules and exceptions).

The partnership must consent to the reduction of partner's share of inside basis if:

i. The partner owns (directly or indirectly) more than 80 percent interest in the capital and profits of the partnership, or

ii. Five or fewer partners own (directly or indirectly) an aggregate of more than 50 percent of the capital and profits interests of the partnership (See Treasury Regulation Section 1.1017-1(g)(2)(ii)(C)).

XVII. GENERAL RULES FOR FEDERAL RULE DISCHARGE OF INDEBTEDNESS (INCLUDING DISCHARGES NOT IN TITLE 11 BANKRUPTCY CASES OR INSOLVENCY).

1. General Rules On Recognition of Cancellation Of Debt Income.

A. COD Income May Be Recognized Even If the Debt Is Not Actually Cancelled.

COD income may be recognized even if the debt is not actually cancelled. A change in the terms of a debt instrument can trigger COD income to the debtor or creditor. This result may occur if the debt is either replaced by new debt or the terms of the debt are materially modified.

B. Replacement of Existing Debt.

If a debtor replaces an existing debt with new debt, the debtor will be treated as having satisfied the old indebtedness with an amount of money equal to the issue price (determined under Sections 1273 and 1274) of the new debt. Therefore, if the issue price of the new debt is less than the adjusted issue price of the old debt, the debtor will

realize COD income. The new debt instrument may also contain original issue discount ("OID") that would provide the debtor with interest deductions, however, the deductions will be spread over the term of the debt instrument. Because of the time value of money, the deductions will not fully offset any recognized COD income.

C. Significant Modification In the Terms of a Debt Instrument.

Treasury Regulations §1.1001 were issued in response to the Supreme Court decision in *Cottage Savings Association v. Commissioner*. The regulations expand the scope of circumstances under which COD income may be triggered in a negotiated workout. Under Treasury Regulations §1.1001, any "significant modification" in the terms of a debt instrument will be considered an exchange. A modification of a debt instrument is defined as any alteration in any legal right or obligation of the issuer or holder unless the modification occurs by operation of the original terms of the instrument.

The final Regulations state that the following modifications are considered "significant":

i. *General Rule*. – A modification is significant only if, based upon all the facts and circumstances, the legal rights or obligations that are altered and the degree to which they are altered are economically significant;

ii. A change in the yield to maturity of more than 25 basis points or 5% of the annual yield of the unmodified instrument.

2. Special Rules On the Discharge Of Indebtedness.

A. No Other Insolvency Exception.

B. Income Not Realized to Extent of Loss Deductions.

C. Adjustments for Unamortized Premium and Discount.

D. Acquisition of Indebtedness by Persons Related to Debtor.

E. Purchase Money Debt Reduction for Solvent Debtor Treated as a Price Reduction.

F. Indebtedness Contributed to Capital.

G. Indebtedness Satisfied by Corporate Stock or Partnership Interest.

H. Indebtedness Satisfied by Issuance of Debt Instrument.

I. Other Rules.

XVIII. FEDERAL CANCELLATION OF DEBT (COD) INCOME PROVISIONS ARE APPLIED AT PARTNER LEVEL.

1. Applicable Internal Revenue Code Sections 108(a)(b)(c) and (g).

2. Application to Partners.

A. When A Debt Modification Causes Cancellation Of Debt (COD) Income at the Partnership or Partner Levels.

A debt modification that does not cause cancellation of debt (COD) income at the

partnership level nevertheless may give rise to income at the partner level under the following provisions.

The determination of bankruptcy or insolvency and the reduction of tax attributes is made at the partner rather than the partnership level. Therefore, items of income related to the discharge of debt should be separately stated on the partnership return to allow individual partners to make this determination on their own behalf. IRC Section 108 also allows taxpayers who are not bankrupt or insolvent to elect to exclude income from the discharge of "qualified real property business debt" with regard to debt discharged after December 31, 1992, in tax years ending after that date.

The first question that arises in a partnership setting is whether the discharge of partnership debt results in "income". This is determined at the partnership level. While discharge of debt generally produces partnership income, no income arises from the discharge of debt which, if paid, would give rise to a deduction. Nor does income arise from a reduction or discharge of purchase money debt owed by the partnership purchaser to the seller of property if the purchaser is not insolvent and the reduction does not occur as part of a bankruptcy proceeding. Such a discharge is treated as a purchase price adjustment. Revenue Procedure 92-92 1992-2 CB 505 states that the IRS will not challenge a partnership's treatment of cancellation of purchase money debt as a purchase price adjustment simply because the partnership is bankrupt or insolvent.

When a partner files bankruptcy and his share of a partnership debt is discharged, there is no income from discharge of indebtedness under IRC Section 61(a)(12). The court ordered debt discharge applies only to that partner and does not reduce or eliminate the partnership's recourse debt. The debt that the partner is discharged from is assumed by the other partners, thereby creating a deemed distribution under IRC Section 752(b) to that partner.

B. Distribution in Excess of Basis – Internal Revenue Code Section 731(a)(1).

A partner's basis in his or her partnership interest includes the partner's share of partnership liabilities. The basis is decreased by any decrease in the partner's share of partnership liabilities, which is treated as a distribution of money. If a partner receives a distribution of money from a partnership (including a deemed distribution under Section 752(b) caused by a reduced share of liabilities) and the amount distributed exceeds the partner's basis in the partnership interest, the partner will recognize gain to the extent of the excess. A constructive cash distribution occurs when debt is paid down, forgiven, or debt is reallocated to another partner pursuant to Section 752 and the Regulations thereunder.

Debt can be reallocated pursuant to Section 752 when it is converted from non–recourse to recourse, or if it is converted from non–recourse to partner non–recourse by virtue of a partner guaranteeing the debt or a lender becoming a partner. Under Section 731(a)(1) the test for determination of gain is to be made immediately before the distribution. However, in Revenue Ruling 92-97, the Service stated that where debt was forgiven in mid-year, the test for debt relief will be made at year end and the earlier distribution will be treated like a partnership draw. Otherwise income could be triggered twice since the cancellation of indebtedness is not allocated to the partners until year end to increase their tax bases.

C. Minimum Gain Charge–backs Under Internal Revenue Code Section 704(b) and Associated Affect with Internal Revenue Code Section 108(c).

When partners take losses based on non–recourse liabilities they increase their share of partnership minimum gain. If there is a net decrease in partnership minimum gain for any year, the Treasury Regulations require that the partners be allocated items of gross income as a minimum gain charge–back to reflect such decrease. There are

limited exceptions to this minimum gain charge–back, such as (i) where a partner has become personally liable on what was non–recourse debt, or (2) has contributed money to the partnership to the extent of the reduction or (3) the charge–back would cause a distortion to the economic deal of the parties through its impact on capital accounts. A partner's election under new Section 108(c) to reduce basis beyond his or her share of the partnership's basis of depreciable real property could trigger gain under a minimum gain charge–back.

D. The determination of the existence or amount of Cancellation Of Debt (COD) income and the amount of sale/exchange gain or loss are both made at the partnership level.

E. When Debt Discharge Does Not Result in Cancellation Of Debt (COD) Income Under Internal Revenue Code section 108(e)(2).

If debt is discharged and the payment of the debt would have given the taxpayer a deduction, then the taxpayer does not realize COD income under IRC section 108(e)(2). For example, when a cash basis taxpayer's obligation to pay an expense is cancelled no COD income is recognized.

F. Purchase Price Reduction Is Not Cancellation Of Debt (COD) Income Under Internal Revenue Code section 108(e)(2).

If seller financed debt is reduced for a solvent taxpayer, the reduction is treated as a purchase price reduction. It is not considered COD income. IRC section 108 (e)(5).

G. Partner's Share of Cancellation Of Debt (COD) Income and Sale or Exchange Gain Separately Stated on Schedule K–1.

Each partner's distributive share of COD income and sale or exchange gain is separately stated on his or her Schedule K–1.

H. Taxability of Cancellation Of Debt (COD) Income and Exception Determined at the Partner Level.

Partners must include COD income in taxable income unless an exception applies (IRC section 61(a)(12)). The taxability of COD income is determined at the partner level (IRC sections 108(d)(6) and 6231(a)(5)).

I. Conditions Apply to Partner Exclusion of Cancellation Of Debt (COD) Income Under Internal Revenue Code Section 108.

A partner may exclude COD income under IRC section 108 if:

i. Partner is bankrupt (Title 11 discharge).

ii. Partner is insolvent (limited to level of insolvency).

iii. Qualified farm indebtedness is cancelled.

3. Amendments to Internal Revenue Code Section 108 by the Bankruptcy Tax Act of 1980.

In *Babin*, 6th Cir. 1994, the Sixth Circuit affirmed a Tax Court decision holding that COD income not taken into income because of an individual partner's insolvency does not increase the partner's basis in the partnership. The specific issue in *Babin* was the proper calculation of the partner's basis in his partnership interest pursuant to §705.

"The *Babin* decision involved a 1978 tax year, which predates amendments to 108 by the Bankruptcy Tax Act of 1980 ("1980 Act"). The Service has concluded that the *Babin* decision does not apply to partnership transactions commencing after December 31, 1980. The Committee Reports to the 1980 Act specifically address the basis

increase issue:

"The bill provides that the rules of exclusion from gross income and reduction of tax attributes in section 108 of the Code (as amended by the bill) are to be applied at the partner level and not at the partnership level. Accordingly, income from discharge of a partnership debt is not excludable at the partnership level under amended section 108. Instead, such income is treated as an item of income which is allocated separately to each partner pursuant to section 702(a) of the Code…

This allocation of an amount of debt discharge income to a partner results in that partner's basis in the partnership being increased by such amount (Section 705). At the same time, the reduction in the partner's share of partnership liabilities caused by the debt discharge results in a deemed distribution (under Section 752), in turn resulting in a reduction (under Section 733) of the partner's basis in the partnership. The section 733 basis reduction, which offsets the section 705 basis increase, is separate from any basis reduction pursuant to the attribute reduction rules of the bill. [Emphasis added]…

See S. Rep. 96-1035, 96th Cong., 2d Sess. 21 (1980) provides in part: "Accordingly, for cancellation of partnership debt occurring after December 31, 1980, the amount of COD income allocated to a partner, whether solvent or insolvent, will result in an increase in that partner's partnership basis…

Under the facts in this case, COD income from the discharge of Partnership's indebtedness was not excludable at the partnership level pursuant to §108(d)(6) . Instead, the COD income was treated as an item of income that was allocated separately to each partner, including Taxpayer, pursuant to §702(a). This allocation of an amount of COD income to each partner, including Taxpayer, resulted in that partner's basis in the partnership being increased by the amount under §705(a)(1)(A). At the same time, the reduction in any partner's share of partnership liabilities caused by the debt discharge resulted in a deemed distribution under §752, which in turn resulted in a reduction of that partner's basis in the partnership under §733. The tax treatment of the COD income allocated to each partner, including Taxpayer, depended on that partner's own circumstances, such as insolvency, and should not affect the basis increase under §705(a)(1)(A)."

4. Separate Determination of Income for Each Partner.

If a partnership realizes COD income, whether such income must be recognized is determined separately for each partner. A bankrupt or insolvent partner would not recognize taxable income currently but would reduce other tax attributes and would have the opportunity to elect to reduce the basis of depreciable property. A partner's interest in depreciable property includes the basis of partnership interests to the extent of the partner's proportionate interest in the partnership depreciable property if there is a corresponding reduction in the partnership's basis in the property with respect to such partner.

A solvent partner would recognize taxable income unless the exclusion for qualified real property business indebtedness (discussed below), the qualified farm indebtedness exception, or the purchase price adjustment exception applies.

Where the debtor is a partnership, the purchase price adjustment is made at the partnership level. Where the partnership is bankrupt or insolvent, but the partners are solvent, the Service stated in Revenue Procedure 92-50 that it would not challenge the partnership's use of the purchase price adjustment provided that all of the partners use consistent income tax reporting.

5. Basis Reduction Elections at the Partner Level.

Two special partner–level attribute reduction elections are available under IRC Sections 108(b)(5) and 1017. Instead of reducing tax attributes in the order prescribed, the partner that

is excluding debt discharge income under the exceptions for bankruptcy, insolvency, or qualified farm indebtedness can elect under IRC Section 108(b)(5) to first reduce the basis of depreciable assets. Debt discharge income in excess of the reduction in basis of depreciable assets is then used to reduce other attributes according to the normal ordering procedure. This special "basis reduction" election can be beneficial to taxpayers with NOL or credit carryovers that will be utilized in the near future and depreciable property that will be held for the long term. An election can also be made at the partner level under IRC Section 1017 to treat real property inventory as described in IRC Section 1221(1) as depreciable property for purposes of the election to first reduce the basis of depreciable property before reducing other tax attributes.

6. Timing of Partner Attribute Reduction.

When a bankrupt or insolvent partner's tax attributes are reduced because of excluded debt discharge income, the required attribute reductions are deemed to occur after determination of the partner's taxable income for the year of discharge. This rule allows the partner to use any NOL, capital loss, or credit carryovers in the year of discharge to offset other taxable income for that year before the carryovers are reduced for debt discharge income occurring in that year. Furthermore, the partner can depreciate or amortize the full tax basis of property in determining taxable income for the year of discharge before reducing tax basis because of excludable debt discharge income in that year. The attribute reductions are deemed to occur on the first day of the tax year after the debt discharge occurs.

Revised Regulation 1.1017-1 indicates that partnership interests are treated as depreciable property if an election is made under IRC Section 108(b)(5) to reduce the basis of depreciable property before reducing other tax attributes or under IRC Section 108(c) for qualified real property indebtedness.

XIX. SPECIAL RULES FOR S CORPORATION.

1. Applicable Federal Internal Revenue Code Sections 108(a)(b)(c) and (g).

2. Statute Applied at the Corporate Level.

a. The cancellation of an S corporation's debt may cause an S corporation to recognize discharge of indebtedness income. However, under Internal Revenue Code (IRC) Section 108, the discharge of some debts is not a taxable event. As discussed previously, Section 108 provides that gross income does not include discharge of indebtedness income occurring in connection with bankruptcy proceedings or with respect to an insolvent taxpayer.

An S corporation’s excluded COD income does not pass through. Income from the cancellation of indebtedness of an S corporation that is excluded from the S corporation’s income because the corporation is bankrupt or insolvent is not a pass through item and does not increase the basis of any shareholder’s stock. See IRC Section 108(d)(7)(A).

IRC Section 108(d)(7)(A), which denies pass through treatment of such excluded COD income, generally applies to discharges of indebtedness after October 11, 2001.

b. A bankrupt or insolvent taxpayer who does not recognize income under IRC Section 108 however, must reduce certain of its tax attributes, such as net operating losses, net operating loss carryovers, credit carryovers, capital loss carryovers and the basis of property he owns. In the Subchapter S context, Section 108(a) and (b) apply at the corporate level. Therefore, the bankruptcy or insolvency of an S corporation, not its shareholders triggers the application of Section 108.

c. In addition Section 108(d)(7)(B) provides that any loss suspended under the basis limitation of IRC Section 1366(d)(1) at the shareholder level for the year of the discharge is treated as a net operating loss of the corporation for purposes of Section 108.

d. IRC Section 108(d)(7)(B) limits the treatment of losses suspended under Section 1366(d)(1) as net operating losses to losses disallowed for the taxable year of the discharge. After the tax is determined for the year, the Section 108 attribute reduction rules are applied. This means that suspended losses may be used to reduce income arising during the year of the discharge of debt. Also, losses or deductions suspended under the at risk, passive loss, or investment interest limitations are not subject to reduction under this rule.

e. Under Section 108(b), the debtor is required to reduce future tax benefits in the following order: (i) NOL carryovers, (ii) general business credits, (iii) capital loss carryovers, and (iv) the basis of the property held by the taxpayer immediately after the discharge, but only to the extent such basis exceeds the taxpayer's remaining liabilities. The reduction is dollar for dollar of excluded cancellation of indebtedness income for non-credit items. For credit items, the reduction is 33 1/3 cents for each dollar. Section 108(b)(4)(B) provides that net operating losses are reduced first "for the taxable year of the discharge and then in carryovers to such taxable year in the order of the taxable years from which each such carryover arose. Because the treatment of losses suspended under section 1366(d)(1) as net operating losses under section 108(b) is limited to losses disallowed for the taxable year of the discharge, those net operating losses are treated as arising in the taxable year of the discharge.

f. Section 108(b)(5) provides that a taxpayer having cancellation of indebtedness income resulting from tax attribute reduction under Section 108(b)(1) may elect under Section 1017, to reduce the depreciable basis of its assets before reducing other tax attributes. One means of avoiding the reduction of losses suspended under Section 1366(d)(1) would be to elect under Section 108(b)(5). Unfortunately, the Section 108(b)(5) election is available only to the corporation, which must elect to reduce the basis of its depreciable assets. Thus, if a shareholder is required to reduce the basis of debt owed to that shareholder by an S corporation, that adjustment is ignored when determining an S corporation's income from discharge of debt owed to that shareholder.

g. Section 108(e)(6) provides that discharge of corporate debt owed to a shareholder results in gross income to an S corporation only to the extent that the face amount of the debt exceeds the shareholder's adjusted basis in the debt. For purposes of applying this rule, Section 108(d)(7)(C) provides that the corporation ignores the reduction in the basis of the debt attributable to the pass-through of an S corporation's losses.

h. Section 108(e)(5) provides that a reduction of a purchase money debt owed by an S corporation that is solvent and has not filed a bankruptcy petition is a reduction in basis, not cancellation of indebtedness income, if the adjustment is made between the original buyer and seller of the property. The settlement of a liability by an S corporation that is on the cash method, or the cancellation of a contested or contingent liability, does not give rise to cancellation of indebtedness income under Section 108.

3. Discharge of Qualified Real Property Indebtedness.

Section 108(c) constitutes an exception to the cancellation of indebtedness income inclusion rules. It provides that a taxpayer, other than a C corporation, may elect to exclude from gross income what would otherwise constitute includible cancellation of indebtedness income arising from the discharge of "qualified real property business indebtedness" (referred to as QRPBI). The exclusion is elective and it applies only after the bankruptcy or insolvency exceptions apply. The exception applies to the discharge of indebtedness secured by real property used in

a trade or business. If such indebtedness was incurred after 1992, it must be incurred in the acquiring or refinancing of such property. The cancellation of indebtedness income excluded from income through the operation of the QRPBI rules reduces the basis of the taxpayer's depreciable real property.

Under IRC Section 108(d)(7)(A), the QRPBI rules are applied at the corporate level in the Subchapter S context. This rule has important consequences for the S corporation and its shareholders because the income to be excluded cannot exceed the basis of certain depreciable real property and reduces the basis of that property. The amount excludible under this provision may not be more than the excess of the outstanding principal amount of such debt immediately before the discharge over the fair market value immediately before the discharge of the business real property that is security for the debt. For this purpose, the property's fair market value is reduced by the outstanding principal amount of any other QRPBI secured by the property immediately before the discharge. Under Section 108(a)(20), the QRPBI exclusion does not apply to the extent that the taxpayer is insolvent or in bankruptcy under Title 11. The election to exclude income and reduce depreciable basis is available only to an S corporation, not is shareholders. Therefore, even if a shareholder had depreciable real property basis outside of the corporation, the shareholder cannot use the depreciable basis to offset such income passed through to him.

Once an S corporation has reduced its depreciable real property basis under the QRPBI rules, there would be no reason to reduce losses suspended under Section 1366(d)(1) as a further tax attribute reduction. Section 108(d)(7)(B) explicitly provides that any loss or deduction that is disallowed because it exceeds the shareholders basis in stock and debt is a net operation loss for the tax year of the discharge and is subject to the tax attribute reduction rules.

Most debt is secured by property. If the property is transferred to the lender as part of a loan workout involving recourse debt, the Internal Revenue Service treats the debtor as recognizing gain or loss in an amount equal to the difference between the fair market value of the property transferred and the adjusted basis of the property; if the indebtedness exceeds the fair market value of the property, the debtor recognizes discharge of indebtedness income. If non–recourse indebtedness is involved, the gain or loss recognized as the transfer of the property to the lender equals the difference between the amount of the debt and the adjusted basis of the property. The Internal Revenue Service also takes the position that the reduction in non–recourse debt, without relinquishment of the property, results in discharge of indebtedness income. These rules are important because the indebtedness exclusion rules of Section 108(a) only apply with respect to discharge of indebtedness income.

4. S Corporation Losses Pass Through to Its Shareholders Even Though It Is In Bankruptcy.

An S corporation can continue to pass losses through to its shareholders under IRC Section 1374 even though it is in bankruptcy. Section 1374 allows a shareholder in a Subchapter S corporation to deduct his portion of the corporation's net operating loss from his gross income. Section 1374(c) limits the amount of the deduction to the sum of the adjusted basis of the shareholder's stock in the corporation and the adjusted basis of any indebtedness of the corporation to the shareholder. In *Estate of Leavitt*, the Tax Court held that there must be an "economic outlay or a realization of income by the shareholder in order to increase basis in the stock in a Subchapter S corporation." For Section 1374(c) purposes, the term "basis" is defined in Section 1012, which provides that the basis of property shall be the cost of such property. Regulation Section 1.1012-1(a) defines "cost" to mean the amount paid for property in cash or other property. Thus, the existence of Section 1374 is very important in determining whether or not a shareholder has realized any income in order to increase basis.

5. Debt Cancellation Transaction May Not Produce COD Income – Relationship of the Parties.

Even if a debt is cancelled, the transaction may not produce COD income if the transaction may be characterized differently because of the relationship of the parties.

a. *Gift* – If the parties are related, the transaction may constitute a gift instead of a loan.

b. *Compensation* – If an employer cancels his employee's debt, the transaction could be re–characterized as compensation. The employer would be responsible for employment taxes and withholding on the amount canceled. The transaction would be viewed as if the employer paid compensation to the employee and then the employee used the compensation to repay the loan.

c. *Dividend* – Cancellation of a debt owed by a shareholder to its corporation may be treated as a dividend or distribution followed by repayment of the debt by the shareholder.

d. *Contribution to Capital* – Cancellation of a debt owed by a corporation to its shareholder may be treated as a contribution to capital by the shareholder followed by repayment of the debt by the corporation. The shareholder is treated as contributing to the corporation an amount of money equal to his basis in the indebtedness. Thus, if basis is less than the face amount, the corporation could still recognize COD income.

6. Shareholder Basis in S Corporation Stock is Not Increased.

In the case of S corporations, some of the rules for excluding discharge of indebtedness (DOI) income are applied at the corporate level. Corporate-level application affects the rules for reducing tax attributes in Title 11 bankruptcy cases, insolvency cases, and cases where the discharged indebtedness is qualified farm indebtedness or qualified real property business indebtedness. (Code Section 108(d)(7)).

In G*itilitz*, the Supreme Court held that income from the discharge of indebtedness of an S corporation that is excluded under Section 108(a) increased a shareholder's basis in his or her stock.

Congress has passed legislation reversing the Supreme Court's decision in *Gitilitz*. Income from the discharge of indebtedness of an S corporation that is excluded from the corporation's income under Code Section 108(a) is not taken into account as an item of income that flows through to any shareholder under Code Section 1366(a) (Code Section 108(d)(7)(A)). Thus, a shareholder's basis in S corporation stock does not increase and the corporation's suspended loss does not pass through to the shareholder. The tax consequences now reflect the economics of the situation and an S corporation shareholder will no longer be allowed to deduct a loss that it did not economically incur.

Any loss or deduction that is disallowed because it exceeds the shareholder's basis in stock and indebtedness of the corporation is treated as a net operating loss that is reduced by amounts excluded from gross income arising from the discharge of indebtedness.

If a debt is contributed to an S corporation's capital, corporate income does not result to the extent that the basis of the debt has previously been reduced by the pass–through of losses from the corporation.

XX. RECOVERY OF TAX BENEFIT ITEMS FOR FEDERAL INCOME TAX.

1. Federal Tax Benefit Rule – Overview.

Certain items that were deducted in one year may need to be included in income in a later tax year if an event occurs in the later year that is inconsistent with the original grounds for the deduction and makes the deduction improper. The amount that must be included in income is limited to the amount of the tax benefit that resulted from the deduction (Code Sec. 111).

2. Inclusionary Component.

The Federal tax benefit rule is a judicially developed doctrine that "ordinarily applies to require the inclusion of income when events occur that are fundamentally inconsistent with an earlier deduction." (*Hillsboro National Bank v. Commissioner*, 460 U.S. 370, 372 (1983)). It has two components, the inclusionary component and the exclusionary component. (*Hudspeth v. Commissioner*, 914 F.2d 1207, 1212 (9th Cir. 1980), rev'd and remanding on another issue T.C. Memo. 1985-628; *Frederick v. Commissioner*, 101 T.C. 35, 40-41 (1993)). The exclusionary component is partially codified in I.R.C. §111(a), but does not become an issue unless, and until, the inclusionary component of the rule is first satisfied. The inclusionary component provides that an amount deducted from gross income in one year is included in income in a subsequent year if an event occurs in the subsequent year that is fundamentally inconsistent with the premise on which the deduction had previously been based.

3. Inclusion in Gross Income.

An amount must be included in gross income in the current year if, and to the extent that: (1) the amount was deducted in a year prior to the current year, (2) the deduction resulted in a tax benefit, (3) an event occurs in the current year that is fundamentally inconsistent with the premises on which the deduction was originally based, and (4) a non–recognition provision of the Internal Revenue Code does not prevent the inclusion in gross income. A current event is considered fundamentally inconsistent with the premises on which the deduction was originally based when the current event would have foreclosed the deduction if that event had occurred within the year that the deduction was taken.

4. Amounts Previously Deducted.

The Federal tax benefit rule is not limited to “recoveries”, but requires the inclusion of amounts previously deducted if the deductions are inconsistent with later events. As the Supreme Court noted in *Hillsboro National Bank*, “it has long been accepted that a taxpayer using accrual accounting who accrues and deducts an expense in a tax year before it becomes payable and who for some reason eventually does not have to pay the liability must then take into income the amount of the expense earlier deducted.”

Revenue Ruling 67-200, 1967-1 C13 15 provides in part: “An accrual basis taxpayer had deducted, but not paid, interest accrued on his indebtedness. On a later forgiveness of the debt, the taxpayer was permitted to exclude the amount of interest forgiven which did not give rise to a tax benefit (Code Sec. 111). That portion not excluded under Code Sec 111 could be excluded under Code Sec. 108 provided the consent to a basis adjustment was filed. However, any portion of the forgiven interest which exceeded the basis to be adjusted was includible in income.”

XXI. FEDERAL INCOME TAX TREATMENT – RECOURSE DEBT.

1. Property Dispositions.

Cancellation of Debt (COD) income may be realized when property that is security for recourse debt is disposed or sold. If recourse debt cancelled is more than the fair market value/sales price of the property, the difference is treated as COD income. If recourse debt is equal or less than the fair market value/sales price of the property, no COD income is realized. The difference between the fair market value/sales price and adjusted basis of the property will be treated as gain or loss on sale/disposition of property (IRC section 1001(a)).

2. Debt Cancellation – Computation of Gain.

A. Property Dispositions.

Cancellation of Debt (COD) income may be realized when property that is security for recourse debt is disposed or sold. If recourse debt cancelled is more than the FMV/sales price of the property, the difference is treated as COD income. If recourse

debt is equal or less than the FMV/sales price of the property, no COD income is realized.

B. Example.

			Computation
FMV	$100,000	Debt Owed	$200,000
Recourse Debt	$200,000	FMV	$(100,000)
Adjusted Basis	$ 75,000	COD Income	$100,000
		FMV Amount	
		Realized	$100,000
		Adjusted Basis	$ 75,000
		Gain-Taxable	$ 25,000

3. Property Retained Debt Reduced.

If the debtor retains the property and the creditor reduces debt, COD income will be realized.

Recourse Debt Before Cancellation	$200,000
Recourse Debt After Cancellation	$100,000
COD Income (IRC Section 61(a)(12))	$100,000

XXII. FEDERAL TAX TREATMENT – NON–RECOURSE DEBT.

1. Property Dispositions.

Property Dispositions: (that is, Foreclosures, Abandonments, Sales, etc.).

Cancellation of Debt (COD) income is not realized when property that secures non–recourse debt is disposed or sold (that is, sale, foreclosure, deed-in-lieu of foreclosure, abandonment, etc.). The non–recourse obligation is considered the amount realized (that is, sales proceeds)

(*Tufts v. Commissioner*, 461 U.S. 300 and IRC section 7701(g)). It does not matter that the fair market value is equal to or less than the amount of the debt.

2. Property Retained – Debt Reduced.

If the debtor retains the property and the creditor reduces non–recourse debt, COD income will be realized (*Gershkowitz v. Commissioner*, 88 T.C. 984 (1987) and Rev. Rul. 91-31)

3. Property Sold and Debt Discharged.

The following sequence of events is considered part of one overall sales transaction:

i. Partnership sells a building subject to non–recourse debt to a third party.

ii. The sales proceeds go to the lender.

iii. The lender discharges the difference between the debt and the sales proceeds.

iv. The lender settles a partner's personal guarantee for a lesser amount.

4. Sale Transaction – Foreclosure of Property.

The amount realized will equal the amount of the non–recourse debt less the amount required to be paid by the guarantor. (*2925 Briarpark, Ltd.*, T.C. Memo. 1997-298, affd. 99-1, ¶50,209, (5th Cir.)).

"A foreclosure constitutes a "sale or exchange" for purposes of Federal income taxation. (*Helvering v. Hammel* [41-1 USTC ¶9169], 311 U.S. 504 (1941); *Allan v. Commissioner* [Dec. 42,9801], 86 T.C. 655 (1986); *Middleton v. Commissioner* [Dec. 38,124], 77 T.C. 310 (1981), affd. *per curiam* [82-2 USTC ¶9713], 693 F.2d 124 (11th Cir. 1982); *Freeland v. Commissioner* [Dec. 37,1271], 74 T.C. 970 (1980)). The amount realized on such a sale includes the balance of the non–recourse mortgage debt. (*Crane v. Commissioner* [47-1 USTC ¶9217], 331 U.S. 1 (1947)). That is true even if the non–recourse mortgage debt exceeds the fair market value of the mortgaged property. (*Commissioner v. Tufts* [83-1 USTC ¶9328], 461 U.S. 300, 317 (1983); *Millar v. Commissioner* [Dec. 34,206], 67 T.C. 656, 600 (1977), affd. on this issue [78-2 USTC ¶9514], 577 F.2d 212, 214-216 (3d Cir. 1978); *Woodsam Associates, Inc.* v. Commissioner [Dec. 18,178], 16 T.C. 649, 654-655 (l9xx), affd. [52-2 USTC ¶351] (2d (Ar. 1952); *Mendham Corp. v. Commissioner* [Dec. 16,004], 9 T.C. 320, 323-325 (1947)).."…

5. Sale Transaction – Transfer of Property.

The Courts have held that abandonments and voluntary reconveyances likewise constitute sales or exchanges. See *Middleton v. Commissioner* [Dec. 38,124], 77 T.C. 310 (1981), affd. *per curiam* [82-2 USTC ¶9713], 693 F.2d 124 (11th Cir. 1982); *Freeland v. Commissioner* [Dec. 37,127], 74 T.C. 970 (1980).

6. Insolvency of the Partnership Is Immaterial.

It is immaterial whether or not the partnership was or is insolvent, since any determination of insolvency would be made at the partner, not the partnership, level. (*Gershkowitz v. Commissioner* [Dec. 43,857], 88 T.C. 984 (1987); *Slavin v. Commissioner* [Dec. 45,679(M)], T.C. Memo. 1989-221).

XXIII. FEDERAL TAX TREATMENT – NON–RECOURSE DEBT.

1. Cancellation of Indebtedness – Reduction of Non–recourse Indebtedness.

COD income is not realized when property that secures non–recourse debt is disposed or sold (that is, sale, foreclosure, deed–in–lieu of foreclosure, abandonment, etc.) The non–recourse obligation is considered the amount realized (that is, sales proceeds). (*Tufts v. Commissioner*,

461 U.S. 300 [83-1 USTC ¶9328], and IRC Section 7701(g)). It does not matter that the fair market value is equal to or less than the amount of the debt.

2. Example, Sale, Foreclosure, or Deed–in–Lieu of Foreclosure.

Sales Price of Property	$100,000
Adjusted Basis	$50,000
Non-recourse Liability	$200,000
Computation of Gain	
Amount Realized (Non-recourse Debt)	$200,000
Adjusted Basis	$(50,000)
Gain on Sale/Exchange	$150,000

3. Collateral Retained and Non–recourse Debt Reduced.

If the debtor retains the property and the creditor reduces non–recourse debt, COD income will be realized. (*Gershkowitz v. Commissioner*, 88 T.C. 984 (1987) and Rev. Rul. 91-31).

Non-recourse Debt Before Cancellation	$200,000
Non-recourse Debt After Cancellation	$100,000
COD Income (IRC Section 61(a)(12))	$100,000