

BUS 225H – Taxation of Property Transactions

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Week 4 Reading – Effects of Debt on Property Transactions

- What is debt?
- Effects of debt related to property
- COD income and its relevance to property transactions
- Planning considerations

In addition to the items in this reading packet, also read at the Bus 225H Website:

- IRC Sections 108 and 1017 (skim)
- IRS Publication 4681, *Cancelled Debts, Foreclosures, Repossessions and Abandonments (for individuals)* (skim)
- Form 982, Reduction of Tax Attributes Due to Discharge of Indebtedness (and Section 1082 Basis Adjustment) (skim)
- IRS and FTB Information on Home Foreclosure and Debt Cancellation

Also recall that you have read some materials on debt and property in prior readings, such as the *Crane* case and summaries of *Estate of Franklin* and *Odend'hal* in Reading 2.

This reading consists of key primary authority for understanding what is debt, and what happens when debt – particularly debt tied to property is forgiven or cancelled.

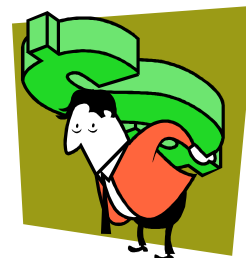
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What is Debt?

Zarin, 916 F2d 110 (3rd Cir. 1990) [footnotes omitted; minor editing]

David Zarin ("Zarin") appeals from a decision of the Tax Court holding that he recognized \$2,935,000 of income from discharge of indebtedness resulting from his gambling activities, and that he should be taxed on the income. This Court has jurisdiction to review the Tax Court's decision under section 7482 of the Internal Revenue Code (1954) (the "Code"). After considering the issues raised by this appeal, we will reverse.



I

Zarin was a professional engineer who participated in the development, construction, and management of various housing projects. A resident of Atlantic City, New Jersey, Zarin occasionally gambled, both in his hometown and in other places where gambling was legalized. To facilitate his gaming activities in Atlantic City, Zarin applied to Resorts International Hotel ("Resorts") for a credit line in June, 1978. Following a credit check, Resorts granted Zarin \$10,000 of credit. Pursuant to this credit arrangement with Resorts, Zarin could write a check, called a marker, and in return receive chips, which could then be used to gamble at the casino's tables.

Before long, Zarin developed a reputation as an extravagant "high roller" who routinely bet the house maximum while playing craps, his game of choice. Considered a "valued gaming patron" by Resorts, Zarin had his credit limit increased at regular intervals without any further credit checks, and was provided a number of complimentary services and privileges. By November, 1979, Zarin's permanent line of credit had been raised to \$200,000. Between June, 1978, and December, 1979, Zarin lost \$2,500,000 at the craps table, losses he paid in full.

Responding to allegations of credit abuses, the New Jersey Division of Gaming Enforcement filed with the New Jersey Casino Control Commission a complaint against Resorts. Among the 809 violations of casino regulations alleged in the complaint of October, 1979, were 100 pertaining to Zarin. Subsequently, a Casino Control Commissioner issued an Emergency Order, the effect of which was to make further extensions of credit to Zarin illegal.

Nevertheless, Resorts continued to extend Zarin's credit limit through the use of two different practices: "considered cleared" credit and "this trip only" credit. Both methods effectively ignored the Emergency Order and were later found to be illegal.

By January, 1980, Zarin was gambling compulsively and uncontrollably at Resorts, spending as many as sixteen hours a day at the craps table. During April, 1980, Resorts again increased Zarin's credit line without further inquiries. That same month, Zarin delivered personal checks and counterchecks to Resorts which were returned as having been drawn against insufficient funds. Those dishonored checks totaled \$3,435,000. In late April, Resorts cut off Zarin's credit.

Although Zarin indicated that he would repay those obligations, Resorts filed a New Jersey state court action against Zarin in November, 1980, to collect the \$3,435,000. Zarin denied liability on grounds that Resort's claim was unenforceable under New Jersey regulations intended to protect compulsive gamblers. Ten months later, in September, 1981, Resorts and Zarin settled their dispute for a total of \$500,000.

The Commissioner of Internal Revenue ("Commissioner") subsequently determined deficiencies in Zarin's federal income taxes for 1980 and 1981, arguing that Zarin recognized \$3,435,000 of income in 1980 from larceny by trick and deception. After Zarin challenged that claim by filing a Tax Court petition, the Commissioner abandoned his 1980 claim, and argued instead that Zarin had recognized \$2,935,000 of income in 1981 from the cancellation of indebtedness which resulted from the settlement with Resorts.

Agreeing with the Commissioner, the Tax Court decided, eleven judges to eight, that Zarin had indeed recognized \$2,935,000 of income from the discharge of indebtedness, namely the difference between the original \$3,435,000 "debt" and the \$500,000 settlement. *Zarin v. Commissioner*, 92 T.C. 1084 (1989). Since he was in the seventy percent tax bracket, Zarin's deficiency for 1981 was calculated to be \$2,047,245. With interest to April 5, 1990, Zarin allegedly owes the Internal Revenue Service \$5,209,033.96 in additional taxes. Zarin appeals the order of the Tax Court.

II

The sole issue before this Court is whether the Tax Court correctly held that Zarin had income from discharge of indebtedness. Section 108 and section 61(a)(12) of the Code set forth "the general rule that gross income includes income from the discharge of indebtedness." I.R.C. §108(e)(1). The Commissioner argues, and the Tax Court agreed, that pursuant to the Code, Zarin did indeed recognize income from discharge of gambling indebtedness.

Under the Commissioner's logic, Resorts advanced Zarin \$3,435,000 worth of chips, chips being the functional equivalent of cash. At that time, the chips were not treated as income, since Zarin recognized an obligation of repayment. In other words, Resorts made Zarin a tax-free loan. However, a taxpayer does recognize income if a loan owed to another party is cancelled, in whole or in part. I.R.C. §§61(a)(12), 108(e). The settlement between Zarin and Resorts, claims the Commissioner, fits neatly into the cancellation of indebtedness provisions in the Code. Zarin owed \$3,435,000, paid \$500,000, with the difference constituting income. Although initially persuasive, the Commissioner's position is nonetheless flawed for two reasons.

III

Initially, we find that sections 108 and 61(a)(12) are inapplicable to the Zarin/Resorts transaction. Section 61 does not define indebtedness. On the other hand, section 108(d)(1), which repeats and further elaborates on the rule in section 61(a)(12), defines the term as any indebtedness "(A) for which the taxpayer is liable, or (B) subject to which the taxpayer holds property." I.R.C. §108(d)(1). In order to bring the taxpayer within the sweep of the discharge of indebtedness rules, then, the IRS must show that one of the two prongs in the section 108(d)(1) test is satisfied. It has not been demonstrated that Zarin satisfies either.

Because the debt Zarin owed to Resorts was unenforceable as a matter of New Jersey state law, it is clearly not a debt "for which the taxpayer is liable." §108(d)(1)(A). Liability implies a legally enforceable obligation to repay, and under New Jersey law, Zarin would have no such obligation.

Moreover, Zarin did not have a debt subject to which he held property as required by section 108(d)(1)(B). Zarin's indebtedness arose out of his acquisition of gambling chips. The Tax Court held that gambling chips were not property, but rather, "a medium of exchange within the Resorts casino" and a "substitute for cash." Alternatively, the Tax Court viewed the chips as nothing more than "the opportunity to gamble and incidental services ..." *Zarin*, 92 T.C. at 1099. We agree with the gist of these characterizations, and hold that gambling chips are merely an accounting mechanism to evidence debt.

Gaming chips in New Jersey during 1980 were regarded "solely as evidence of a debt owed to their custodian by the casino licensee and shall be considered at no time the property of anyone other than the casino licensee issuing them." Thus, under New Jersey state law, gambling chips were Resorts' property until transferred to Zarin in exchange for the markers, at which point the chips became "evidence" of indebtedness (and not the property of Zarin).

Even were there no relevant legislative pronouncement on which to rely, simple common sense would lead to the conclusion that chips were not property in Zarin's hands. Zarin could not do with the chips as he pleased, nor did the chips have any independent economic value beyond the casino. The chips themselves were of little use to Zarin, other than as a means of facilitating gambling. They could not have been used outside the casino. They could have been used to purchase services and privileges within the casino, including food, drink, entertainment, and lodging, but Zarin would not have utilized them as such,

since he received those services from Resorts on a complimentary basis. In short, the chips had no economic substance.

Although the Tax Court found that theoretically, Zarin could have redeemed the chips he received on credit for cash and walked out of the casino, Zarin, 92 T.C. at 1092, the reality of the situation was quite different. Realistically, before cashing in his chips, Zarin would have been required to pay his outstanding IOUs. New Jersey state law requires casinos to "request patrons to apply any chips or plaques in their possession in reduction of personal checks or Counter Checks exchanged for purposes of gaming prior to exchanging such chips or plaques for cash or prior to departing from the casino area." N.J. Admin. Code. Since his debt at all times equalled or exceeded the number of chips he possessed, redemption would have left Zarin with no chips, no cash, and certainly nothing which could have been characterized as property.

Not only were the chips non-property in Zarin's hands, but upon transfer to Zarin, the chips also ceased to be the property of Resorts. Since the chips were in the possession of another party, Resorts could no longer do with the chips as it pleased, and could no longer control the chips' use. Generally, at the time of a transfer, the party in possession of the chips can gamble with them, use them for services, cash them in, or walk out of the casino with them as an Atlantic City souvenir. The chips therefore become nothing more than an accounting mechanism, or evidence of a debt, designed to facilitate gambling in casinos where the use of actual money was forbidden. Thus, the chips which Zarin held were not property within the meaning of I.R.C. §108(d)(1)(B).

In short, because Zarin was not liable on the debt he allegedly owed Resorts, and because Zarin did not hold "property" subject to that debt, the cancellation of indebtedness provisions of the Code do not apply to the settlement between Resorts and Zarin. As such, Zarin cannot have income from the discharge of his debt.

IV

Instead of analyzing the transaction at issue as cancelled debt, we believe the proper approach is to view it as disputed debt or contested liability. Under the contested liability doctrine, if a taxpayer, in good faith, disputed the amount of a debt, a subsequent settlement of the dispute would be treated as the amount of debt cognizable for tax purposes. The excess of the original debt over the amount determined to have been due is disregarded for both loss and debt accounting purposes. Thus, if a taxpayer took out a loan for \$10,000, refused in good faith to pay the full \$10,000 back, and then reached an agreement with the lender that he would pay back only \$7000 in full satisfaction of the debt, the transaction would be treated as if the initial loan was \$7000. When the taxpayer tenders the \$7000 payment, he will have been deemed to have paid the full amount of the initially disputed debt. Accordingly, there is no tax consequence to the taxpayer upon payment.

The seminal "contested liability" case is *N. Sobel, Inc. v. Commissioner*, 40 B.T.A. 1263 (1939). In *Sobel*, the taxpayer exchanged a \$21,700 note for 100 shares of stock from a bank. In the following year, the taxpayer sued the bank for rescission, arguing that the bank loan was violative of state law, and moreover, that the bank had failed to perform certain promises. The parties eventually settled the case in 1935, with the taxpayer agreeing to pay half of the face amount of the note. In the year of the settlement, the taxpayer claimed the amount paid as a loss. The Commissioner denied the loss because it had been sustained five years earlier, and further asserted that the taxpayer recognized income from the discharge of half of his indebtedness.

The Board of Tax Appeals held that since the loss was not fixed until the dispute was settled, the loss was recognized in 1935, the year of the settlement, and the deduction was appropriately taken in that year. Additionally, the Board held that the portion of the note forgiven by the bank "was not the occasion for a freeing of assets and that there was no gain ..." *Id.* at 1265. Therefore, the taxpayer did not have any income from cancellation of indebtedness.

There is little difference between the present case and *Sobel*. Zarin incurred a \$3,435,000 debt while gambling at Resorts, but in court, disputed liability on the basis of unenforceability. A settlement of \$500,000 was eventually agreed upon. It follows from *Sobel* that the settlement served only to fix the

amount of debt. No income was realized or recognized. When Zarin paid the \$500,000, any tax consequence dissolved.

Only one other court has addressed a case factually similar to the one before us. In *United States v. Hall*, 307 F.2d 238 (10th Cir. 1962), the taxpayer owed an unenforceable gambling debt alleged to be \$225,000. Subsequently, the taxpayer and the creditor settled for \$150,000. The taxpayer then transferred cattle valued at \$148,110 to his creditor in satisfaction of the settlement agreement. A jury held that the parties fixed the debt at \$150,000, and that the taxpayer recognized income from cancellation of indebtedness equal to the difference between the \$150,000 and the \$148,110 value affixed to the cattle. Arguing that the taxpayer recognized income equal to the difference between \$225,000 and \$148,000, the Commissioner appealed.

The Tenth Circuit rejected the idea that the taxpayer had any income from cancellation of indebtedness. Noting that the gambling debt was unenforceable, the Tenth Circuit said, "The cold fact is that taxpayer suffered a substantial loss from gambling, the amount of which was determined by the transfer." *Id.* at 241. In effect, the Court held that because the debt was unenforceable, the amount of the loss and resulting debt cognizable for tax purposes were fixed by the settlement at \$148,110. Thus, the Tenth Circuit lent its endorsement to the contested liability doctrine in a factual situation strikingly similar to the one at issue.

The Commissioner argues that *Sobel* and the contested liability doctrine only apply when there is an unliquidated debt; that is, a debt for which the amount cannot be determined. See *Colonial Sav. Ass'n v. Commissioner*, 85 T.C. 855, 862-863 (1985) (*Sobel* stands for the proposition that "there must be a liquidated debt"), *aff'd*, 854 F.2d 1001 (7th Cir. 1988). See also *N. Sobel, Inc. v. Commissioner*, 40 B.T.A. at 1265 (there was a dispute as to "liability and the amount" of the debt). Since Zarin contested his liability based on the unenforceability of the entire debt, and did not dispute the amount of the debt, the Commissioner would have us adopt the reasoning of the Tax Court, which found that Zarin's debt was liquidated, therefore barring the application of *Sobel* and the contested liability doctrine. *Zarin*, 92 T.C. at 1095 (*Zarin's* debt "was a liquidated amount" and "[t]here is no dispute about the amount [received].").

We reject the Tax Court's rationale. When a debt is unenforceable, it follows that the amount of the debt, and not just the liability thereon, is in dispute. Although a debt may be unenforceable, there still could be some value attached to its worth. This is especially so with regards to gambling debts. In most states, gambling debts are unenforceable, and have "but slight potential ..." *United States v. Hall*, 307 F.2d 238, 241 (10th Cir. 1962). Nevertheless, they are often collected, at least in part. For example, Resorts is not a charity; it would not have extended illegal credit to Zarin and others if it did not have some hope of collecting debts incurred pursuant to the grant of credit.

Moreover, the debt is frequently incurred to acquire gambling chips, and not money. Although casinos attach a dollar value to each chip, that value, unlike money's, is not beyond dispute, particularly given the illegality of gambling debts in the first place. This proposition is supported by the facts of the present case. Resorts gave Zarin \$3.4 million dollars of chips in exchange for markers evidencing Zarin's debt. If indeed the only issue was the enforceability of the entire debt, there would have been no settlement. Zarin would have owed all or nothing. Instead, the parties attached a value to the debt considerably lower than its face value. In other words, the parties agreed that given the circumstances surrounding Zarin's gambling spree, the chips he acquired might not have been worth \$3.4 million dollars, but were worth something. Such a debt cannot be called liquidated, since its exact amount was not fixed until settlement.

To summarize, the transaction between Zarin and Resorts can best be characterized as a disputed debt, or contested liability. Zarin owed an unenforceable debt of \$3,435,000 to Resorts. After Zarin in good faith disputed his obligation to repay the debt, the parties settled for \$500,000, which Zarin paid. That \$500,000 settlement fixed the amount of loss and the amount of debt cognizable for tax purposes. Since Zarin was deemed to have owed \$500,000, and since he paid Resorts \$500,000 no adverse tax consequences attached to Zarin as a result.

V

In conclusion, we hold that Zarin did not have any income from cancellation of indebtedness for two reasons. First, the Code provisions covering discharge of debt are inapplicable since the definitional requirement in section 108(d)(1) was not met. Second, the settlement of Zarin's gambling debts was a contested liability. We reverse the decision of the Tax Court and remand with instructions to enter judgment that Zarin realized no income by reason of his settlement with Resorts.

Dissent: STAPLETON, Circuit Judge. I respectfully dissent because I agree with the Commissioner's appraisal of the economic realities of this matter. Resorts sells for cash the exhilaration and the potential for profit inherent in games of chance. It does so by selling for cash chips that entitle the holder to gamble at its casino. Zarin, like thousands of others, wished to purchase what Resorts was offering in the marketplace. He chose to make this purchase on credit and executed notes evidencing his obligation to repay the funds that were advanced to him by Resorts. As in most purchase money transactions, Resorts skipped the step of giving Zarin cash that he would only return to it in order to pay for the opportunity to gamble. Resorts provided him instead with chips that entitled him to participate in Resorts' games of chance on the same basis as others who had paid cash for that privilege. Whether viewed as a one or two-step transaction, however, Zarin received either \$3.4 million in cash or an entitlement for which others would have had to pay \$3.4 million. Despite the fact that Zarin received in 1980 cash or an entitlement worth \$3.4 million, he correctly reported in that year no income from his dealings with Resorts. He did so solely because he recognized, as evidenced by his notes, an offsetting obligation to repay Resorts \$3.4 million in cash. See, e.g., *Vukasovich, Inc. v. Commissioner*, 790 F.2d 1409 (9th Cir. 1986); *United States v. Rochelle*, 384 F.2d 748 (5th Cir. 1967), cert. denied, 390 U.S. 946 (1968); *Bittker and Thompson, Income From the Discharged Indebtedness: The Progeny of United States v. Kirby Lumber Co.*, 66 Calif. L. Rev. 159 (1978). In 1981, with the delivery of Zarin's promise to pay Resorts \$500,000 and the execution of a release by Resorts, Resorts surrendered its claim to repayment of the remaining \$2.9 million of the money Zarin had borrowed. As of that time, Zarin's assets were freed of his potential liability for that amount and he recognized gross income in that amount. *Commissioner v. Tufts*, 461 U.S. 300 (1983); *United States v. Kirby Lumber Company*, 284 U.S. 1 (1931); *Vukasovich, Inc. v. Commissioner*, 790 F.2d 1409 (9th Cir. 1986). But see *United States v. Hall*, 307 F.2d 238 (10th Cir. 1962). The only alternatives I see to this conclusion are to hold either (1) that Zarin realized \$3.4 million to income in 1980 at a time when both parties to the transaction thought there was an offsetting obligation to repay or (2) that the \$3.4 million benefit sought and received by Zarin is not taxable at all. I find the latter alternative unacceptable as inconsistent with the fundamental principle of the Code that anything of commercial value received by a taxpayer is taxable unless expressly excluded from gross income. *Commissioner v. Glenshaw Glass Co.*, 348 U.S. 426 (1955); *United States v. Kirby Lumber Co.*, supra. I find the former alternative unacceptable as impracticable. In 1980, neither party was maintaining that the debt was unenforceable and, because of the settlement, its unenforceability was not even established in the litigation over the debt in 1981. It was not until 1989 in this litigation over the tax consequences of the transaction that the unenforceability was first judicially declared. Rather than require such tax litigation to resolve the correct treatment of a debt transaction, I regard it as far preferable to have the tax consequences turn on the manner in which the debt is treated by the parties. For present purposes, it will suffice to say that where something that would otherwise be includable in gross income is received on credit in a purchase money transaction, there should be no recognition of income so long as the debtor continues to recognize an obligation to repay the debt. On the other hand, income, if not earlier recognized, should be recognized when the debtor no longer recognizes an obligation to repay and the creditor has released the debt or acknowledged its unenforceability. In this view, it makes no difference whether the extinguishment of the creditor's claim comes as a part of a compromise. Resorts settled for 14 cents on the dollar presumably because it viewed such a settlement as reflective of the odds that the debt would be held to be enforceable. While Zarin should be given credit for the fact that he had to pay 14 cents for a release, I see no reason why he should not realize gain the same manner as he would have if Resorts had concluded on its own that the debt was legally unenforceable and had written it off as uncollectible.⁵ I would affirm the judgment of the Tax Court.

Rev. Rul. 93-27 – H was required to pay W \$500 per month for child support. In 1991, H failed to pay \$5,000 of this support. Thus, W had to spend \$5,000 of her own funds in support of the children. At issue in the ruling was whether W was entitled to a bad debt deduction under §166(a)(1) for the \$5,000.

The IRS ruled that no bad debt deduction was allowed because W had no basis in the debt created by the child support obligation (relying on *Swenson*, 43 TC 897 (1965)). In *Swenson*, the court held that H's obligation was imposed by the divorce court and was not contingent on W's support expenditures. Thus, those expenditures did not create the arrearage or constitute its cost to W.

Question 1 – Do you agree with the majority or the dissent in *Zarin*? Why?

Question 2 – What is debt?

COD Income versus Gain From Property Disposition

Rev. Rul. 90-16

ISSUE

A taxpayer transfers to a creditor a residential subdivision that has a fair market value in excess of the taxpayer's basis in satisfaction of a debt for which the taxpayer was personally liable. Is the transfer a sale or disposition resulting in the realization and recognition of gain by the taxpayer under sections 1001(c) and 61(a)(3)?

FACTS

X was the owner and developer of a residential subdivision. To finance the development of the subdivision, X obtained a loan from an unrelated bank. X was unconditionally liable for repayment of the debt. The debt was secured by a mortgage on the subdivision.

X became insolvent (within the meaning of section 108(d)(3)) and defaulted on the debt. X negotiated an agreement with the bank whereby the subdivision was transferred to the bank and the bank released X from all liability for the amounts due on the debt. When the subdivision was transferred pursuant to the agreement, its fair market value was 10,000x dollars, X's adjusted basis in the subdivision was 8,000x dollars, and the amount due on the debt was 12,000x dollars, which did not represent any accrued but unpaid interest. After the transaction X was still insolvent.

LAW AND ANALYSIS

Sections 61(a)(3) and 61(a)(12) provide that, except as otherwise provided, gross income means all income from whatever source derived, including (but not limited to) gains from dealings in property and income from discharge of indebtedness.

Section 108(a)(1)(B) provides that gross income does not include any amount that would otherwise be includible in gross income by reason of discharge (in whole or in part) of indebtedness of the taxpayer if the discharge occurs when the taxpayer is insolvent. Section 108(a)(3) provides that, in the case of a discharge to which section 108(a)(1)(B) applies, the amount excluded under section 108(a)(1)(B) shall not exceed the amount by which the taxpayer is insolvent (as defined in section 108(d)(3)).

Section 1.61-6(a) provides that the specific rules for computing the amount of gain or loss from dealings in property under section 61(a)(3) are contained in section 1001 and the regulations thereunder.

Section 1001(a) provides that gain from the sale or other disposition of property shall be the excess of the amount realized therefrom over the adjusted basis provided in section 1011 for determining gain.

Section 1001(b) provides that the amount realized from the sale or other disposition of property shall be the sum of any money received plus the fair market value of the property (other than money) received.

Section 1001(c) provides that, except as otherwise provided in subtitle A, the entire amount of the gain or loss, determined under section 1001, on the sale or exchange of property shall be recognized.

Section 1.1001-2(a)(1) provides that, except as provided in section 1.1001-2(a)(2) and (3), the amount realized from a sale or other disposition of property includes the amount of liabilities from which the transferor is discharged as a result of the sale or disposition. Section 1.1001-2(a)(2) provides that the amount realized on a sale or other disposition of property that secures a recourse liability does not include amounts that are (or would be if realized and recognized) income from the discharge of indebtedness under section 61(a)(12). *Example (8)* under section 1.1001-2(c) illustrates these rules as follows:

Example (8). In 1980, F transfers to a creditor an asset with a fair market value of \$6,000 and the creditor discharges \$7,500 of indebtedness for which F is personally liable. The amount realized on the disposition of the asset is its fair market value (\$6,000). In addition, F has income from the discharge of indebtedness of \$1,500 (\$7,500 – \$6,000).

In the present situation, X transferred the subdivision to the bank in satisfaction of the 12,000x dollar debt. To the extent of the fair market value of the property transferred to the creditor, the transfer of the subdivision is treated as a sale or disposition upon which gain is recognized under section 1001(c) of the Code. To the extent the fair market value of the subdivision, 10,000x dollars, exceeds its adjusted basis, 8,000x dollars, X realizes and recognizes gain on the transfer. X thus recognizes 2,000x dollars of gain.

To the extent the amount of debt, 12,000x dollars, exceeds the fair market value of the subdivision, 10,000x dollars, X realizes income from the discharge of indebtedness. However, under section 108(a)(1)(B) of the Code, the full amount of X's discharge of indebtedness income is excluded from gross income because that amount does not exceed the amount by which X was insolvent.

If the subdivision had been transferred to the bank as a result of a foreclosure proceeding in which the outstanding balance of the debt was discharged (rather than having been transferred pursuant to the settlement agreement), the result would be the same. A mortgage foreclosure, like a voluntary sale, is a "disposition" within the scope of the gain or loss provisions of section 1001 of the Code. ...

HOLDING

The transfer of the subdivision by X to the bank in satisfaction of a debt on which X was personally liable is a sale or disposition upon which gain is realized and recognized by X under sections 1001(c) and 61(a)(3) to the extent the fair market value of the subdivision transferred exceeds X's adjusted basis. Subject to the application of section 108, to the extent the amount of debt exceeds the fair market value of the subdivision, X would also realize income from the discharge of indebtedness.

Danenberg v. Comm'r., 73 TC 370 (1979); acq. 1980-2 CB 1 – The issue in this case was whether an insolvent taxpayer was required to recognize gain or loss under §1001 from the sale or exchange of property. The court held that the individual taxpayer did have to treat transfers of property to a lender as sale of property. T argued that it had not sold the property, but had instead transferred them to the lender in satisfaction of his debts with the lender forgiving the balance of the debt. T noted that he never received the proceeds from the lender's disposition of the property.

"Case law is clear that when a debt is discharged or reduced upon the debtor's transfer of property to his creditor or a third party, such transaction is treated as a sale or exchange of the debtor's assets, and not as a mere transfer of assets in cancellation of indebtedness."

"The commentators have also recognized that when the fair market value of property transferred is less than the amount of debt discharged, a separate tax issue of gain or loss on the disposition of property is raised:

If rather than paying cash to discharge an obligation the debtor transfers other assets with a value less than the face amount of the debt, the difference should constitute income to the debtor under the *Kirby Lumber* principle. If the debtor's basis in the property differs from its fair market value at the time of transfer, the transaction simultaneously raises a separate tax issue of gain or loss on the disposition of property, for the transaction could be considered equivalent to selling the property for its fair market value and then using the proceeds to discharge the debt. [B. Bittker and B.

Thompson, "Income from the Discharge of Indebtedness: The Progeny of *United States v. Kirby Lumber Co.*," 66 Calif. L. Rev. 1159, 1172 (1978).]

"The facts of this case clearly indicate that the petitioner was involved in two separate transactions each time he disposed of the assets held by UCB as collateral: (1) There was an initial transaction whereby he disposed of such properties through a sales arrangement with a third party; and (2) there was a second transaction whereby the proceeds of the sale were paid to the bank and applied to reduce the amount of his indebtedness, and after all the collateral of the petitioner had been liquidated, the balance of his outstanding loan was forgiven by the bank.

“The record overwhelmingly establishes that the transactions whereby the petitioner disposed of the assets held as collateral by the bank were indeed sales of such assets.”

Question 3 – Mr. Jones owns an office building with recourse debt attached to it of \$200x. The FMV is \$150x and the adjusted basis is \$120x. Mr. Jones is experiencing financial difficulties and can no longer make payments on the debt. He allows the lender to take the building and they forgive the balance of the loan. What is the tax effect of this transaction to Mr. Jones? What is your authority?

Question 4 – Would your answer to the prior question change if the debt on the office building were nonrecourse instead? What is the authority and rationale for your answer?

Amount Realized on Foreclosure Sale

Forced versus Voluntary Dispositions: “[T]he fact that such transactions may have taken place under the threat of foreclosure proceedings instituted by the bank is irrelevant to the determination of whether the petitioner is required to recognize a gain or loss. The Supreme Court in *Helvering v. Hammel*, 311 U.S. 504 (1941), and its companion case of *Electro-Chemical Engraving Co. v. Commissioner*, 311 U.S. 513 (1941), did away with the distinction between forced and voluntary sales. A voluntary sale and a mortgage foreclosure are both "dispositions" within the scope of the gain or loss provisions of section 1001.” [*Danenberg v. Comm’r.*, 73 TC 370 (1979); acq. 1980-2 CB 1]

Richard D. Frazier, et ux., 111 TC 243 (1998) [excerpt]

Official Tax Court Syllabus

Ps owned investment real property subject to a recourse mortgage. Upon default, the property was acquired by the lender at a foreclosure sale. At the foreclosure sale, the lender bid in an amount for the property which was in excess of the property's fair market value. R determined that the “amount realized” by Ps at the foreclosure sale was the amount bid in by the lender, regardless of fair market value.

- Held: P's “amount realized” at the foreclosure sale is the property's fair market value.
- Held, further: Bifurcated analysis used to determine income tax consequences of “amount realized” and income from cancellation of indebtedness.
- Held, further: Ps are not liable for accuracy- related penalty determined by R.

FINDINGS OF FACT

Respondent determined deficiencies in petitioners' Federal income tax for taxable years 1988 and 1989 in the amounts of \$387 and \$40,482, respectively. In the answer, respondent asserted that petitioner is liable for an addition to tax pursuant to section 6662(a).

After concessions, the issues for decision are: (1) Whether for 1989 petitioners realized \$571,179 on the foreclosure sale of certain real property or a lower amount which represents the property's fair market value. We hold petitioners realized a lower amount which represents the property's fair market value. (2) Whether for 1989 petitioners are liable for the accuracy-related penalty pursuant to section 6662(a). We hold they are not.

Some of the facts have been stipulated and are so found. The stipulated facts and the accompanying exhibits are incorporated herein by this reference. At the time the petition in this case was filed, petitioners resided in Austin, Texas.

Petitioners owned real property located at 3501 Dime Circle in Austin, Texas (the Dime Circle property). The Dime Circle property was not used in any trade or business of petitioner. The mortgage on the Dime Circle property, which secured a recourse obligation against petitioner, was foreclosed by the lender on August 1, 1989, at which time petitioners were insolvent. The lender bid in the Dime Circle property at the foreclosure sale for \$571,179. The record is silent as to how the bid-in price was determined. Apparently, the only bid was that of the lender.

At the time of the foreclosure sale, the outstanding principal balance of the debt was \$585,943. The lender did not attempt to collect the difference between the outstanding balance of the debt and the bid-in amount. On August 1, 1989, petitioners' adjusted basis in the Dime Circle property was \$495,544 (cost basis of \$682,682 minus accumulated depreciation of \$187,138). After the transaction, petitioners were still insolvent.

At the time of the sale, real estate prices had dropped dramatically throughout Texas, causing many foreclosures and bank failures throughout the State. The Dime Circle property was not resold until about 2 and a half years later for approximately \$382,000.

The fair market value of the Dime Circle property at the time of the foreclosure sale was \$375,000.

OPINION

Issue 1. Amount Realized on Foreclosure Sale

Respondent determined that petitioners realized \$571,179 on the foreclosure sale of the Dime Circle property, which represents the amount bid in by the lender. Petitioners assert that the amount realized on the foreclosure sale is determined by the fair market value of the property, which is different from the amount bid in by the lender. We agree with petitioners.

In general, the transfer of property in consideration of the discharge or reduction of indebtedness is equivalent to the sale of property upon which gain or loss is realized. ... The amount of gain realized is the excess of the amount realized over the taxpayer's adjusted basis in the property, and the amount of loss realized is the excess of the adjusted basis over the amount realized. Sec. 1001(a).

For purposes of computing gain or loss, the "amount realized" is defined by section 1001(b) as the sum of any money received plus the fair market value of the property received. However, the amount realized from the transfer of property in consideration of the discharge or reduction of indebtedness depends on whether the debt is recourse or nonrecourse in nature. In the case of nonrecourse debt, the amount realized includes the full amount of the remaining debt. See, e.g., *Commissioner v. Tufts*, 461 U.S. 300 (1983); ... In the case of recourse debt, on the other hand, the amount realized from the transfer of property is the fair market value of the property. ...

Furthermore, the amount realized from the sale or other disposition of property that secures a recourse debt does not include income from the discharge of indebtedness under section 61(a)(12). See sec. 1.1001-2(a)(2). Such income will arise when the discharged amount of the recourse debt exceeds the fair market value of the property.

Generally, a taxpayer must recognize income from the discharge of indebtedness. Sec. 61(a)(12); *United States v. Kirby Lumber Co.*, 284 U.S. 1 (1931). There are exceptions, however, to the recognition of income from the discharge of indebtedness, including cases where the discharge occurs when the taxpayer is insolvent. See sec. 108(a).

Absent clear and convincing proof to the contrary, the sale price of property at a foreclosure sale is presumed to be its fair market value. ... In this case, however, petitioners have rebutted this presumption with the required clear and convincing proof. Petitioners introduced an appraisal opining that the fair market value of the Dime Circle property on August 1, 1989, was \$375,000, not \$571,179 as bid in by the lender. Respondent offered no expert testimony on the fair market value and does not challenge the accuracy of the appraisal. Respondent merely argues that the bid-in amount must be used to determine the amount realized, regardless of how arbitrarily that amount may have been determined. We disagree.

In arguing that the bid-in amount must be used to determine the amount realized, respondent, in effect, maintains that we must respect the transaction for Federal income tax purposes. We are not bound to blindly accept a transaction, and the law is clear that courts may look behind a paper facade to find the actual substance and economic realities of a transaction. ... In a case such as this, where the transaction is so disparate from the actual substance and economic realities of the situation, we are empowered, and in fact duty-bound, to look behind the transaction in order to apply the Internal Revenue Code accurately. ...

The facts of the instant case are analogous to those provided in an example in the regulations. Section 1.1001-2(c), Example (8), Income Tax Regs., provides as follows:

In 1980, F transfers to a creditor an asset with a fair market value of \$6,000 and the creditor discharges \$7,500 of indebtedness for which F is personally liable. The amount realized on the disposition of the asset is its fair market value (\$6,000). In addition, F has income from the discharge of indebtedness of \$1,500 (\$7,500 - \$6,000).

Respondent relies on *Aizawa v. Commissioner*, 99 T.C. 197 (1992), affd. without published opinion 29 F.3d 630 (9th Cir. 1994), for the proposition that the amount realized constitutes the amount of the

proceeds of the foreclosure sale, i.e., the bid-in amount of the lender. In *Aizawa*, the taxpayers owned rental property which was subject to a recourse mortgage, and upon default, the property was acquired by the mortgagee at a foreclosure sale. We held that the amount of the proceeds of the foreclosure sale constituted the amount realized under section 1001(a). Notwithstanding the similar facts and circumstances, *Aizawa* is distinguishable from the instant case on one key matter. In *Aizawa*, the amount that the lender paid for the property at the foreclosure sale was equal to the fair market value of the property. In *Aizawa v. Commissioner*, *supra* at 200-201, the Court stated:

It cannot be gainsaid that the property was sold for \$72,700 (*an amount which we have no reason to conclude did not represent the fair market value of the property*) and that petitioners received, by way of a reduction in the judgment of the foreclosure, that amount and nothing more. That is the “amount realized” under section 1001(a) which is subtracted from petitioners' basis in order to determine the amount of their loss. [Fn. ref. omitted; emphasis added.]

In the instant case, we have clear and convincing proof to conclude that the bid-in price of the lender does not represent the fair market value of the Dime Circle property.

We note that this was not an arm's-length transaction between a willing buyer and a willing seller, neither being under compulsion to buy or sell and both having reasonable knowledge of relevant facts. ... The amount bid in by a lender at a foreclosure sale may be arbitrary. As petitioners stated on brief, there are many possible reasons why a lender would bid in higher than the fair market value, such as if the lender believed it would be unable to collect a deficiency judgment because the debtor is contemplating bankruptcy, or simply to erase the loss from its books. ... However, we need not determine the intent of the lender in formulating the bid-in price. We are satisfied that the bid-in price did not represent the fair market value of the Dime Circle property. We find that the fair market value of the Dime Circle property on August 1, 1989, was \$375,000. Accordingly, petitioners realized \$375,000 on the disposition of the Dime Circle property.

...

As discussed above, petitioners' gain or loss on their disposition of the Dime Circle property is computed pursuant to section 1001 and, as a general rule, the amount realized includes the full amount of the remaining debt. Sec. 1.1001-2(a)(1), Income Tax Regs. However, section 1.1001-2(a)(2), provides an exception for recourse liabilities. The regulation states that:

The amount realized on a sale or other disposition of property that secures a recourse liability does not include amounts that are (or would be if realized and recognized) income from the discharge of indebtedness under section 61(a)(12). ***

This regulation effectively bifurcates the instant transaction into a taxable transfer of property and a taxable discharge from indebtedness. ... Thus, according to the regulation, each should be treated as a separate transaction for tax purposes.

Therefore, on the first step of the bifurcation analysis, petitioners realized a capital loss of \$120,544 on the transfer of the Dime Circle property. On the second step of the analysis, petitioners realized \$210,943 of ordinary income from discharge of indebtedness.

Under certain circumstances, a taxpayer may exclude from gross income the income from discharge of indebtedness if the discharge occurs when the taxpayer is insolvent. Sec. 108(a)(1)(B). However, the exclusion cannot exceed the amount by which the taxpayer is insolvent. For purposes of this section, “insolvent” is defined as “the excess of liabilities over the fair market value of assets.” Sec. 108(d)(3).

Petitioners' insolvency exceeded the income they realized from discharge of indebtedness. Accordingly, the income petitioners realized from discharge of indebtedness in the instant transaction is excluded from their gross income pursuant to section 108(a)(1)(B).

Question 5 – What is the rule for determining amount realized when property had been transferred for its (a) recourse debt? (b) nonrecourse debt?

Question 6– Do you think the parties in *Frazier* would have made the same arguments if the taxpayer had not been insolvent? Why or why not?

Information Reporting

- §6050J - Returns relating to foreclosures and abandonments of security
 - Reg §1.6050J-1T. Questions and answers concerning information returns relating to foreclosures and abandonments of security (temporary): [excerpt]

“Requirement of Reporting

In General

Q-1. What does section 6050J provide with respect to the reporting of acquisitions and abandonments of property that secures indebtedness?

A-1. Section 6050J provides that an information return must be made by any person who, in connection with a trade or business conducted by the person (except as provided in A-13), lends money and, in full or partial satisfaction of the debt, acquires an interest in any property that is security for the debt, or has reason to know that the property has been abandoned. For purposes of these questions and answers, a person who lends money in connection with a trade or business is referred to as a “lender”.

- Form 1099-A, *Acquisition or Abandonment of Secured Property*

COD Income

§108 and §1017 [skim (obtain from RIA Checkpoint or CCH)]

Rev. Rul. 91-31

ISSUE

If the principal amount of an undersecured nonrecourse debt is reduced by the holder of the debt who was not the seller of the property securing the debt, does this debt reduction result in the realization of discharge of indebtedness income for the year of the reduction under section 61(a)(12) or in the reduction of the basis in the property securing the debt?

FACTS

In 1988, individual *A* borrowed \$1,000,000 from *C* and signed a note payable to *C* for \$1,000,000 that bore interest at a fixed market rate payable annually. *A* had no personal liability with respect to the note, which was secured by an office building valued at \$1,000,000 that *A* acquired from *B* with the proceeds of the nonrecourse financing. In 1989, when the value of the office building was \$800,000 and the outstanding principal on the note was \$1,000,000, *C* agreed to modify the terms of the note by reducing the note's principal amount to \$800,000. The modified note bore adequate stated interest within the meaning of section 1274(c)(2).

The facts here do not involve the bankruptcy, insolvency, or qualified farm indebtedness of the taxpayer. Thus, the specific exclusions provided by section 108(a) do not apply.

LAW AND ANALYSIS

Section 61(a)(12) provides that gross income includes income from the discharge of indebtedness. Section 1.61-12(a) of the Income Tax Regulations provides that the discharge of indebtedness, in whole or in part, may result in the realization of income.

In Rev. Rul. 82-202, a taxpayer prepaid the mortgage held by a third party lender on the taxpayer's residence for less than the principal balance of the mortgage. At the time of the prepayment, the fair market value of the residence was greater than the principal balance of the mortgage. The revenue ruling holds that the taxpayer realizes discharge of indebtedness income under section 61(a)(12), whether the mortgage is recourse or nonrecourse and whether it is partially or fully prepaid. Rev. Rul. 82-202 relies on *United States v. Kirby Lumber Co.*, 284 U.S. 1 (1931), in which the United States Supreme Court held that a taxpayer realized ordinary income upon the purchase of its own bonds in an arm's length transaction at less than their face amount.

In *Commissioner v. Tufts*, 461 U.S. 300 (1983), the Supreme Court held that when a taxpayer sold property encumbered by a nonrecourse obligation that exceeded the fair market value of the property sold, the amount realized included the amount of the obligation discharged. The Court reasoned that because a nonrecourse note is treated as a true debt upon inception (so that the loan proceeds are not taken into income at that time), a taxpayer is bound to treat the nonrecourse note as a true debt when the taxpayer is discharged from the liability upon disposition of the collateral, notwithstanding the lesser fair market value of the collateral. See section 1.1001-2(c), Example 7.

In *Gershkowitz v. Commissioner*, 88 T.C. 984 (1987), the Tax Court, in a reviewed opinion, concluded, in part, that the settlement of a nonrecourse debt of \$250,000 for a \$40,000 cash payment (rather than surrender of the \$2,500 collateral) resulted in \$210,000 of discharge of indebtedness income. The court, following the *Tufts* holding that income results when a taxpayer is discharged from liability for an undersecured nonrecourse obligation upon the disposition of the collateral, held that the discharge from a portion of the liability for an undersecured nonrecourse obligation through a cash settlement must also result in income.

The Service will follow the holding in *Gershkowitz* where a taxpayer is discharged from all or a portion of a nonrecourse liability when there is no disposition of the collateral. Thus, in the present case, A realizes \$200,000 of discharge of indebtedness income in 1989 as a result of the modification of A's note payable to C.

In an earlier Board of Tax Appeals decision, *Fulton Gold Corp. v. Commissioner*, 31 B.T.A. 519 (1934), a taxpayer purchased property without assuming an outstanding mortgage and subsequently satisfied the mortgage for less than its face amount. In a decision based on unclear facts, the Board of Tax Appeals, for purposes of determining the taxpayer's gain or loss upon the sale of the property in a later year, held that the taxpayer's basis in the property should have been reduced by the amount of the mortgage debt forgiven in the earlier year.

The *Tufts* and *Gershkowitz* decisions implicitly reject any interpretation of *Fulton Gold* that a reduction in the amount of a nonrecourse liability by the holder of the debt who was not the seller of the property securing the liability results in a reduction of the basis in that property, rather than discharge of indebtedness income for the year of the reduction. *Fulton Gold*, interpreted in this manner, is inconsistent with *Tufts* and *Gershkowitz*. Therefore, that interpretation is rejected and will not be followed.

HOLDING

The reduction of the principal amount of an undersecured nonrecourse debt by the holder of a debt who was not the seller of the property securing the debt results in the realization of discharge of indebtedness income under section 61(a)(12) of the Code.

EFFECT ON OTHER REVENUE RULINGS

Rev. Rul. 82-202 is amplified to apply whether the fair market value of the residence is greater or less than the principal balance of the mortgage at the time of the refinancing.

Question 7 – How does Rev. Rul. 91-31 reconcile with the freeing of assets theory of *Kirby Lumber* and §61(a)(12) and §108?

Rev. Rul. 92-53

ISSUE

Is the amount by which a nonrecourse debt exceeds the fair market value of the property securing the debt taken into account in determining whether, and to what extent, a taxpayer is insolvent within the meaning of section 108(d)(3)?

FACTS

SITUATION 1. In 1988, individual A borrowed \$1,000,000 from C and signed a note payable to C for \$1,000,000 that bore interest at a fixed market rate payable annually. The note was secured by an office building valued in excess of \$1,000,000 that A acquired from B with the proceeds of the note. A was not personally liable on the note. In 1989, when the value of the office building was \$800,000 and the outstanding principal on the note was \$1,000,000, C agreed to modify the terms of the note by reducing the note's principal amount to \$825,000. The modified note bore adequate stated interest within the meaning of section 1274(c)(2) of the Code. At the time of the modification, A's only other assets had an aggregate fair market value of \$100,000, and A was personally liable to D on other indebtedness in the amount of \$50,000.

SITUATION 2. The facts are the same as SITUATION 1, except that D agreed to accept assets from A with a fair market value (and basis to A) of \$40,000 in settlement of A's recourse indebtedness of \$50,000, and C did not reduce A's nonrecourse note.

SITUATION 3. The facts are the same as SITUATION 1, except that pursuant to a prearranged work-out plan D agreed to accept assets from A with a fair market value (and basis to A) of \$40,000 in settlement of A's recourse indebtedness of \$50,000, and shortly thereafter C reduced the principal amount of A's nonrecourse note to \$825,000.

These examples do not involve the bankruptcy or qualified farm indebtedness of the taxpayer. Thus, the specific exclusions provided by sections 108(a)(1)(A) and 108(a)(1)(C) of the Code do not apply.

LAW AND ANALYSIS

Section 61(a)(12) of the Code provides that gross income includes income from the discharge of indebtedness. Section 1.61-12(a) of the Income Tax Regulations provides that the discharge of indebtedness, in whole or in part, may result in the realization of income.

Section 108(a)(1)(B) of the Code generally excludes discharged indebtedness from a taxpayer's gross income if the discharge occurs when the taxpayer is insolvent. Section 108(a)(3) limits the amount of income excluded by reason of section 108(a)(1)(B) to the amount by which the taxpayer is insolvent.

Section 108(d)(3) of the Code defines "insolvent" as the excess of liabilities over the fair market value of assets. That section further provides that whether a taxpayer is insolvent, and the amount by which the taxpayer is insolvent, is determined on the basis of the taxpayer's assets and liabilities immediately before the discharge.

Section 108 of the Code does not define the term "liabilities" as used in the section 108(d)(3) definition of insolvency. However, the legislative history underlying the section 108 insolvency exclusion provides, as a rationale for the insolvency exclusion, that an insolvent taxpayer should not be burdened with current taxation on the discharge of indebtedness to preserve the taxpayer's "fresh start" resulting from that discharge. H.R. Rep. No. 833, 96th Cong., 2d Sess. 7, 9 (1980); S. Rep. No. 1035, 96th Cong., 2d Sess. 8, 10 (1980), 1980-2 C.B. 620, 624. That is, discharging a taxpayer from liability gives the taxpayer a fresh start that should not be impeded by imposing a tax liability on the taxpayer when the taxpayer is unable to pay either the indebtedness or the tax. But, to the extent a discharge of indebtedness removes a taxpayer from insolvency, the taxpayer is treated as having the ability to pay tax, and thus must pay a current tax on that portion of the discharge. See section 108(a)(1)(B) and (a)(3).

To provide tax relief that will preserve a fresh start, the amount by which a nonrecourse debt exceeds the fair market value of the property securing the debt ("excess nonrecourse debt") should be treated as a

liability in determining insolvency for purposes of section 108 of the Code to the extent that the excess nonrecourse debt is discharged. Otherwise, the discharge could give rise to a current tax when the taxpayer lacks the ability to pay that tax. Nonrecourse debt should also be treated as a liability in determining insolvency under section 108 to the extent of the fair market value of the property securing the debt.

However, excess nonrecourse debt that is not discharged does not have a similar effect on a taxpayer's ability to pay a current tax resulting from the discharge of another debt (whether recourse or nonrecourse). Thus, that excess nonrecourse debt should not be treated as a liability in determining insolvency for purposes of section 108 of the Code.

SITUATION 1. In this situation, \$175,000 of A's \$200,000 excess nonrecourse debt is discharged and, therefore, that portion of the excess nonrecourse debt is taken into account in determining whether, and to what extent, A is insolvent within the meaning of section 108(d)(3) of the Code. Thus, A has liabilities of \$1,025,000, consisting of the full \$50,000 amount for which A is personally liable, plus the portion of the nonrecourse debt equal to the sum of the \$800,000 fair market value of the property securing the nonrecourse debt and the \$175,000 of excess nonrecourse debt that is discharged. Because A's \$1,025,000 of liabilities exceed the \$900,000 fair market value of A's assets (\$800,000 + \$100,000) by \$125,000 immediately before the indebtedness is discharged, A is insolvent to the extent of \$125,000. Accordingly, pursuant to section 108(a)(1)(B) and (a)(3), A must include only \$50,000 of the \$175,000 of discharged indebtedness ($\$175,000 - \$125,000$) in income under section 61(a)(12).

SITUATION 2. In this situation no portion of the excess nonrecourse debt is discharged. Instead, \$10,000 of A's recourse debt is discharged. Therefore, the excess nonrecourse debt is not taken into account in determining whether, and to what extent, A is insolvent within the meaning of section 108(d)(3) of the Code. As a result, A is solvent immediately before the discharge because its \$850,000 of liabilities ($\$800,000 + \$50,000$) do not exceed the \$900,000 fair market value of its assets ($\$800,000 + \$100,000$). Accordingly, A must include the entire \$10,000 of discharged indebtedness in income under section 61(a)(12).

SITUATION 3. In this situation, pursuant to the prearranged work-out plan, \$10,000 of A's recourse debt is discharged, and shortly thereafter \$175,000 of A's nonrecourse debt is discharged. Because of the prearranged plan, the discharges are viewed as occurring simultaneously, but solely for purposes of determining whether, and to what extent, A is insolvent within the meaning of section 108(d)(3) of the Code. As a result, A must include only \$60,000 of the total of \$185,000 of discharged indebtedness in income under section 61(a)(12). The \$60,000 is comprised of (1) the \$50,000 discharge of indebtedness income as determined with respect to the nonrecourse debt in SITUATION 1, and (2) the \$10,000 discharge of indebtedness income as determined with respect to the recourse debt in SITUATION 2.

HOLDING

The amount by which a nonrecourse 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 within the meaning of section 108(d)(3) of the Code, but only to the extent that the excess nonrecourse debt is discharged.

EFFECT ON OTHER DOCUMENTS

Rev. Rul. 91-31, 1991-1 C.B. 19, is distinguished from this revenue ruling. Rev. Rul. 91-31 holds that the reduction of the principal amount of an undersecured nonrecourse indebtedness (by the holder of a debt who was not the seller of the property securing the debt) results in discharge of indebtedness income under section 61(a)(12) of the Code. However, Rev. Rul. 91-31 does not address the treatment of nonrecourse indebtedness in applying the section 108 insolvency exclusion.

Must be bona fide debt

Merkel, 109 TC 463 (1997), aff'd 192 F3d 844 (1999) – the court held that certain contingent liabilities could not be included in measuring whether the individual was insolvent for §108 purposes. To claim the §108 insolvency exclusion, a taxpayer must prove “(1) with respect to any obligation claimed to be a liability, that, as of the calculation date, it is more probable than not that he will be called upon to pay that obligation in the amount claimed and (2) that the total liabilities so proved exceed the fair market value of his assets.” Taxpayer’s possibility of paying a debt of his corporation for which he was a guarantor was not certain, and a sales and use tax liability proposed against the corporation had not been shown to be the responsibility of the corporate officers.

Must be Discharge

Centennial Savings, 499 US 573 (1991) – the Court held that when bank paid out less than the deposit amount on its CD accounts because of early withdrawal penalties owed by depositors, there was no discharge of indebtedness income because there was no discharge. “As used in § 108, the term “discharge of indebtedness” conveys *forgiveness of, or release from*, an obligation to repay.⁶ A depositor who prematurely closes his account and pays the early withdrawal penalty does not forgive or release any repayment obligation on the part of the financial institution. The CD agreement itself provides that the depositor will be entitled only to the principal and accrued interest, less the applicable penalty, should the depositor prematurely withdraw the principal. Through this formula, the depositor and the bank have determined in advance precisely how much the depositor will be entitled to receive should the depositor close the account on any day up to the maturity date. Thus, the depositor does not “discharge” the bank from an obligation when it accepts an amount equal to the principal and accrued interest minus the penalty, for this is exactly what the bank is obligated to pay under the terms of the CD agreement.”

The Court viewed the penalty as income for a separate obligation performed by the bank. It noted that §108 does not apply when a lender discharges a debt in exchange for services or some other form of non-monetary consideration by the borrower such as the performance of services or in exchange for settlement of a lawsuit. The debt is not forgiven in such instances, it is just paid off in a non-monetary form.

The Court noted that to call the penalty §108 COD income, would go against the purpose of §108. It concluded “that Congress did not intend to extend the benefits of §108 beyond the setting in which a creditor agrees to release a debtor from an obligation assumed at the outset of the relationship.” Where the reduction in debt was agreed to when the debt was taken out as is the case with a depositor who agrees to take less if he withdraws funds early, the reduction decision has been left solely to the lender, not the borrower.

Measuring Assets for Insolvency Purposes

Roderick E. Carlson, et ux., 116 TC 87 (2001) [excerpt]

[The issue was whether the taxpayers were required to include an asset exempt from creditor claims under state law in their measure of whether or not they were insolvent for §108 purposes. If the asset was required to be considered, then their assets exceeded their debts and they were not insolvent so would have taxable COD income (not excludable under §108 since they were not insolvent and no other provision of §108 applied. If the state exempt asset could be ignored, then their debts exceeded the FMV of their assets and their debt discharge could be excluded from income under §108 to the extent of their insolvency. This question had been a challenging one and the IRS informal position had been contrary at one point (such as in PLR 9125010, which the IRS overturned in PLR 199932013). The case has a nice review of statutory interpretation, *Kirby Lumber* and the theory of how cancellation of debt affects gross income.]

Our starting point in resolving the parties' dispute over the meaning of the word "assets" as used in section 108(d)(3) is the plain meaning of the language used by Congress. ... Where, as is the case here, the statute does not define the word, we generally interpret it by using its ordinary and common meaning. ... If the ordinary and common meaning of the statutory language in question supports only one construction, that statutory language is unambiguous. ... However, where the ordinary and common meaning of the statutory language supports more than one interpretation, the statutory language is ambiguous, and we may consult legislative history to assist us in interpreting the language in question. See *Merkel v. Commissioner*, 109 T.C. at 468-469. We are to construe exclusions from income, like section 108(a)(1)(B), narrowly in favor of taxation. ...

Bearing in mind the foregoing principles of statutory construction, we shall consider initially respondent's contention that the plain meaning of the word "assets" supports only one construction of that word as used in section 108(d)(3). As pertinent here, the common and ordinary meaning of the word "assets" set forth in Merriam- Webster's Collegiate Dictionary 69 (10th ed. 1996) is:

1 *pl a* : the property of a deceased person subject by law to the payment of his or her debts and legacies b : the entire property of a person, association, corporation, or estate applicable or subject to the payment of debts *** 3 *** b *pl* : the items on a balance sheet showing the book value of property owned

The first and second dictionary definitions of the word "assets" quoted above appear to exclude from that definition assets exempt from the claims of creditors under applicable State law. That is because under applicable State law such assets generally are not subject to the payment of debts. However, the third dictionary definition of the word "assets" quoted above seems to include assets exempt from the claims of creditors under applicable State law. That is because such assets are items appearing on a balance sheet showing the value of property owned. ... We conclude that the common and ordinary meaning of the word "assets" as reflected in the dictionary definition of that word does not support only one construction. We next turn to pertinent legislative history for guidance in interpreting what Congress intended by its use of the word "assets" in the definition of the term "insolvent" in section 108(d)(3).

Congress enacted section 108(a)(1)(B) and related provisions (i.e., section 108(a)(3), (d)(3), and (e)(1)) into the Code in 1980 as part of the Bankruptcy Tax Act of 1980 The stated purpose of the 1980 Bankruptcy Tax Act was to "accommodate bankruptcy policy and tax policy." ... Such an accommodation was necessary after Congress made significant changes to the Federal bankruptcy laws in 1978 by passing the Bankruptcy Reform Act of 1978... In passing the 1980 Bankruptcy Tax Act, Congress "intended to complete the process of revising and updating Federal bankruptcy laws by providing rules governing the tax aspects of bankruptcy and related tax issues." ... Both the Senate and House reports accompanying H.R. 5043, 96th Cong., 2d Sess. (1980) (H.R. 5043), which became the 1980 Bankruptcy Tax Act, indicate that the proposed insolvency exception in section 108(a)(1)(B) was intended to ensure that an insolvent debtor outside of bankruptcy (like a debtor coming out of bankruptcy who is accorded a "fresh start" under the Federal bankruptcy laws) is not to be burdened with an immediate tax liability. ...

The committee reports accompanying H.R. 5043 describe in pertinent part the tax law governing DOI income that was extant at the time Congress passed the 1980 Bankruptcy Tax Act, as follows:

Under present law, income is realized when indebtedness is forgiven or in other ways cancelled (sec. 61(a)(12) of the Internal Revenue Code). For example, if a corporation has issued a \$1,000 bond at par which it later repurchases for only \$900, thereby increasing its net worth by \$100, the corporation realizes \$100 of income in the year of repurchase (*United States v. Kirby Lumber Co.*, 284 U.S. 1 (1931)).

There are several exceptions to the general rule of income realization. Under a judicially developed "insolvency exception," no income arises from discharge of indebtedness if the debtor is insolvent both before and after the transaction; ¹ and if the transaction leaves the debtor with assets whose value exceeds remaining liabilities, income is realized only to the extent of the excess. ***

We shall discuss in greater detail the three cases referred to in the foregoing excerpt of the committee reports accompanying H.R. 5043. In *United States v. Kirby Lumber Co.*, 284 U.S. 1 (1931), the Supreme Court of the United States (Supreme Court) established the rule that a debtor realizes (and must recognize) income when discharged of indebtedness, i.e., when relieved of indebtedness without full payment of the amount owed. In *Kirby Lumber Co.*, the taxpayer had issued bonds for which it received par value. In the same year, the taxpayer repurchased some of those bonds in the open market for less than their par value issue price. See *id.* at 2. The Supreme Court held that the taxpayer must recognize income in an amount (i.e., \$137,521.30) equal to the difference between the issue price and the repurchase price of the bonds in question. ...

Several years after the Supreme Court decided *Kirby Lumber Co.*, the U.S. Court of Appeals for the Fifth Circuit distinguished that case and established an insolvency exclusion to the rule that the Supreme Court had announced in that case. See *Dallas Transfer & Terminal Warehouse Co. v. Commissioner*, 70 F.2d 95 (5th Cir. 1934), *rev. g.* 27 B.T.A. 651 (1933). In *Dallas Transfer & Terminal Warehouse Co.*, the taxpayer was relieved of indebtedness as the lessee of certain real property with respect to unpaid rent and other bills totaling \$107,881 when it conveyed to the lessor of that property certain real property of lesser value (i.e., \$42,507) in which the taxpayer's equity at the time of conveyance was \$17,507. See *id.* The Court of Appeals held that the taxpayer did not realize income as a result of that transaction. See *id.* at 96. In so holding, the Court of Appeals stated:

In effect the transaction was similar to what occurs in an insolvency or bankruptcy proceeding when, upon a debtor surrendering, for the benefit of his creditors, property insufficient in value to pay his debts, he is discharged from liability for his debts. This does not result in the debtor acquiring something of exchangeable value in addition to what he had before. There is a reduction or extinguishment of liabilities without any increase of assets. There is an absence of such a gain or profit as is required to come within the accepted definition of income. *** It hardly would be contended that a discharged insolvent or bankrupt receives taxable income in the amount by which his provable debts exceed the value of his surrendered assets. ***

Id. The Court of Appeals distinguished *United States v. Kirby Lumber Co.*, *supra*, as follows:

The instant case is substantially different from the [*Kirby Lumber Co.*] case ***. In the last-mentioned case a corporation issued its bonds at par and in the same year repurchased some of them at less than par. The taxpayer's [*Kirby Lumber Co.*'s] assets having been increased by the cash received for the bonds, by the repurchase of some of those bonds at less than par the taxpayer, to the extent of the difference between what it received for those bonds and what it paid in repurchasing them, had an asset which had ceased to be offset by any liability, with a result that after that transaction the taxpayer had greater assets than it had before. The decision [*Kirby Lumber Co.*] *** that the increase in clear assets so brought about constituted taxable income is not applicable to the facts of the instant case, as the cancellation of the respondent's [*Dallas Transfer & Terminal Warehouse Co.*'s] past due debt to its lessor did not have the effect of making the respondent's assets greater than they were before that transaction occurred. ***

Dallas Transfer & Terminal Warehouse Co. v. Commissioner, *supra* at 96.

In *Lakeland Grocery Co. v. Commissioner*, 36 B.T.A. 289 (1937), the Board of Tax Appeals (Board) considered the insolvency exclusion established by *Dallas Transfer & Terminal Warehouse Co. v. Commissioner*, *supra*. In *Lakeland Grocery Co.*, the taxpayer entered into a so-called composition settlement under which the taxpayer paid its creditors \$15,473 in consideration of being relieved of its indebtedness to those creditors in the amount of \$104,710. Prior to entering into the composition settlement, the taxpayer was insolvent. After that settlement, the taxpayer had net assets of \$39,597, which, as noted by the Board, “were freed from the claims of creditors as a result of the *** [discharge of indebtedness].” *Lakeland Grocery Co. v. Commissioner*, *supra* at 291. The Board distinguished *Dallas Transfer & Terminal Warehouse Co. v. Commissioner*, *supra*, from the facts before it and concluded that

the rationale of *United States v. Kirby Lumber Co.*, 284 U.S. 1 (1931), was applicable to those facts. ... The Board held that the taxpayer realized gain to the extent of the value of the assets freed from the claims of its creditors, i.e., to the extent it had assets (i.e., \$39,597) which ceased to be offset by any liability. See *id.* at 292.

We recently had occasion in *Merkel v. Commissioner*, 109 T.C. 463 (1997), to review the three cases (*United States v. Kirby Lumber Co.*, *supra*, *Dallas Transfer & Terminal Warehouse Co. v. Commissioner*, *supra*, and *Lakeland Grocery Co. v. Commissioner*, *supra*) to which the committee reports accompanying H.R. 5043 refer and which we discuss above. In *Merkel*, as here, we had to determine whether a debtor qualified for the insolvency exception in section 108(a)(1)(B). However, in order to resolve that issue in *Merkel*, we had to determine the meaning of the word “liabilities” as used in the definition of the term “insolvent” in section 108(d)(3). See *Merkel v. Commissioner*, *supra* at 466-467.

We observed in *Merkel*:

The Board's approach to a taxpayer in financial distress being discharged of an indebtedness, which approach was crystallized in *Lakeland Grocery Co. v. Commissioner*, *supra*, has been called, among other things, the “net assets” test. That test is based on the so-called freeing-of-assets theory derived from the Supreme Court's statement in *Kirby Lumber* that the transaction “made available \$137,521.30 assets previously offset by the obligation of bonds now extinct”. *** The net assets test is a corollary of the principle in *Dallas Transfer* that an insolvent debtor does not realize income when discharged of indebtedness. Under the net assets test, if the debtor remains insolvent (liabilities exceed assets) after being discharged of indebtedness, no assets have been freed as a result of the discharge since the debtor's assets are still more than offset by his postdischarge liabilities, and, thus, no gross income is realized; if the debtor is solvent (assets exceed liabilities) after being discharged, then the discharge has freed the debtor's assets from the offset of his liabilities to that extent, and, thus, gross income is realized from the discharge. In essence, the net assets test is simply an examination of the debtor's net worth after he is discharged of indebtedness — an increase in net worth gives rise to income, but a decrease in negative net worth does not.

Id. at 472-473; fn. ref. omitted.

We explained in *Merkel* that Congress

codified the net assets test in section 108(a)(1)(B), (a)(3), and (d)(3) as a means of determining an *exclusion* from gross income of an item of income derived from the discharge of indebtedness. Aside from the parallel descriptions in the committee reports of the preexisting law and of the proposed insolvency exclusion, *** that codification is apparent from the statutory insolvency calculation coupled with the insolvency exclusion limitation provided in section 108(a)(3), which together share the same underlying analytical framework as the net assets test. That framework requires an examination of the debtor's assets and liabilities for the purpose of determining whether the debtor's net worth turns positive (assets exceed liabilities), i.e., whether assets are freed, as a result of the debtor's being discharged of indebtedness.

From our examination of the statutory language, the legislative history, and the relevant cases cited in the committee reports, we conclude that the analytical framework of the insolvency exclusion and its related provisions [in section 108] is based on the freeing-of-assets theory. ***

A solvent debtor is capable of meeting his financial obligations because his assets equal or exceed his liabilities. That excess (if any) is not increased when an obligation that offsets assets is paid in full because the reduction in liabilities is equal to the reduction in assets. If the reduction in liabilities exceeds the reduction in assets, then, under the

freeing-of-assets theory, the solvent debtor has realized a gain to the extent of that excess. *** Pursuant to the freeing-of-assets theory, a debtor does not realize income when discharged of a particular indebtedness, however, if his postdischarge liabilities equal or exceed his postdischarge assets (if any); i.e., under the net assets test, the debtor's liabilities equal or exceed his assets after the discharge (or, the statutory insolvency calculation shows that the debtor is insolvent by an amount greater than or equal to the discharge of indebtedness income ***

Id. at 473-475; fn. ref. omitted.

With the foregoing in mind, we shall now consider petitioners' argument that we follow *Cole v. Commissioner*, 42 B.T.A. 1110 (1940), in defining the word "assets" as used in the definition of the term "insolvent" in section 108(d)(3). In *Cole*, the Board began its analysis by acknowledging that under *Lakeland Grocery Co. v. Commissioner*, 36 B.T.A. 289 (1937), the taxpayer, a resident of New York, would realize income upon the discharge of his indebtedness "to the extent of the excess of total assets over total liabilities immediately after *** [discharge]." *Cole v. Commissioner*, supra at 1112. In determining whether there was such an excess, the Board stated:

In determining the amount in [sic] which petitioner's net assets were increased as a result of the cancellation of petitioner's indebtedness by his creditor, i.e., the amount of petitioner's assets which ceased to be offset by claims of creditors, there should be, and has been, omitted from the value of petitioner's assets the value of his equity in ten life insurance policies. ***

Id. at 1113. The Board explained in *Cole* that it excluded the value of the taxpayer's equity in certain life insurance policies from its determination of the value of the taxpayer's assets because "Under the applicable law of New York *** such equity in insurance was free from claims of creditors." Id.

We reject petitioners' argument that we apply *Cole* in this case. When Congress enacted the insolvency exception into the Code as section 108(a)(1)(B), one of the related provisions it also enacted is section 108(e)(1). Section 108(e)(1) provides that, for purposes of title 26 of the United States Code (i.e., the Internal Revenue Code, including section 61(a)(12)), "there shall be no insolvency exception from the general rule that gross income includes income from the discharge of indebtedness" except as provided in, section 108(a)(1)(B). As the Supreme Court very recently stated, "Section 108(e)[(1)] precludes us from relying on any understanding of the judicial insolvency exception that was not codified in "108." *Gitlitz v. Commissioner*, 531 U.S. at ___, 69 U.S.L.W. at 4063. Even before *Gitlitz* was decided, we reached a similar conclusion in *Merkel v. Commissioner*, 109 T.C. 463 (1997). We stated in pertinent part:

As Congress enacted the insolvency exclusion [section 108(a)(1)(B)], it eliminated the net assets test as a judicially created exception to the general rule of income from the discharge of indebtedness. See sec. 108(e)(1). The fundamental difference between the insolvency exclusion [in section 108(a)(1)(B)] and the [judicially developed] net assets test is that the insolvency exclusion is applicable only if there exists income from the discharge of indebtedness, whereas the net assets test engages in the threshold inquiry. Therefore, unlike the net assets test, the insolvency exclusion does not necessarily invade the province of section 61(a)(12).

Essentially, the insolvency exclusion defers to section 61(a)(12) as to the definition of the term "gross income", but represents a policy judgment that certain of that income should not give rise to an immediate tax liability. The relevant committee reports intimate that the policy judgment underlying the insolvency exclusion serves a humanitarian purpose — to avoid burdening an insolvent debtor outside of bankruptcy with an immediate tax liability. ***

Merkel v. Commissioner, supra at 481-482; fn. ref. omitted.

We conclude that section 108(e)(1) precludes in this case (or in any other case involving the insolvency exception in section 108(a)(1)(B)) the application of *Cole v. Commissioner*, supra, and any other

judicially developed insolvency exception to the general rule of section 61(a)(12) that gross income includes income from the discharge of indebtedness. ...

Our conclusion that *Cole v. Commissioner*, 42 B.T.A. 1110 (1940), has no application in the instant case not only carries out the directive of section 108(e)(1), it also carries out the intention of Congress in enacting section 108(d)(3) that assets exempt from the claims of creditors under applicable State law are not to be excluded in determining the fair market value of a taxpayer's assets for purposes of ascertaining whether the taxpayer is insolvent within the meaning of section 108(d)(3). ... One of the stated policies of the 1978 Bankruptcy Reform Act was “to provide a fresh start”, S. Rept. 95-989, at 6 (1978), for debtors coming out of bankruptcy. The principal mechanism adopted by Congress in the 1978 Bankruptcy Reform Act for providing such a “fresh start” in the Federal bankruptcy laws is through the discharge of debts. ...

Congress also adopted another method in the 1978 Bankruptcy Reform Act for providing a “fresh start” to debtors coming out of bankruptcy, namely, allowing debtors in bankruptcy to retain after bankruptcy certain property classified as exempt property for purposes of title 11 (title 11 exempt property), which includes property exempt from the claims of creditors under applicable State law. ... The role of title 11 exempt property in the Federal bankruptcy laws is evidenced by, for example, the definition of the term “insolvent” for purposes of title 11 that Congress adopted in section 101(26) of the 1978 Bankruptcy Reform Act, 92 Stat. 2553, 11 U.S.C. sec. 101(26) (Supp. II, 1978). In determining whether a debtor in bankruptcy is insolvent for purposes of title 11, the debtor's title 11 exempt property, which includes property exempt from the claims of creditors under applicable State law, is excluded from the property he otherwise owns. ...

When it passed the 1980 Bankruptcy Tax Act, Congress was aware of the role that it had decided to give title 11 exempt property in the 1978 Bankruptcy Reform Act. In particular, when Congress enacted into the Code the insolvency exception in section 108(a)(1)(B) and the definition of “insolvent” in section 108(d)(3), it knew that it had decided to, and did, define the term “insolvent” in section 101(26) of the 1978 Bankruptcy Reform Act, 11 U.S.C. sec. 101(26) (Supp. II, 1978), to exclude specifically title 11 exempt property of a debtor in bankruptcy, including property exempt from the claims of creditors under applicable State law, in determining whether that debtor is insolvent for purposes of the Federal bankruptcy laws. ..., Congress decided to, and did, adopt a different definition of the term “insolvent” in section 108(d)(3) for purposes of section 108. Unlike the definition of the term “insolvent” in section 101(26) of the 1978 Bankruptcy Act, 11 U.S.C. sec. 101(26) (Supp. II, 1978), which Congress adopted for purposes of the Federal bankruptcy laws, the definition of that term which Congress adopted for purposes of section 108 does not specifically exclude assets of a debtor that are exempt from the claims of creditors under applicable State law or any other title 11 exempt property in determining whether the debtor is insolvent. We conclude that the decision of Congress not to define the term “insolvent” in section 108(d)(3) to exclude specifically such exempt assets in determining whether a debtor is insolvent for purposes of section 108 was intentional. We further conclude that Congress did not intend to exclude assets exempt from the claims of creditors under applicable State law from a taxpayer's assets for purposes of determining whether the taxpayer is insolvent within the meaning of section 108(d)(3). If Congress had intended to exclude such exempt assets from a taxpayer's assets in determining whether the taxpayer is insolvent for purposes of section 108, Congress would have so stated in section 108(d)(3). It did not.

Our conclusion that *Cole v. Commissioner*, 42 B.T.A. 1110 (1940), has no application in the instant case also leads to a result that comports with the intention of Congress in enacting section 108(a)(1)(B) and related provisions into the Code. As we explained in *Merkel v. Commissioner*, 109 T.C. at 475,

Congress' indicated purpose of not burdening an insolvent debtor outside of bankruptcy with an immediate tax liability, ***, together with the operation of the insolvency exclusion [section 108(a)(1)(B)] and its limitation under section 108(a)(3), in accordance with the statutory insolvency calculation [section 108(d)(3)], suggest that Congress intended to make a debtor's *ability to pay an immediate tax* on income from discharge of indebtedness the controlling factor in determining whether a tax burden is imposed. ***

Ability to pay an immediate tax (i.e., the statutory notion of insolvency) is a question of fact ***.

Although an asset of a debtor may be exempt from the claims of creditors under applicable State law, if that asset and the debtor's other assets exceed the debtor's liabilities, the debtor has the ability to pay an immediate tax on income from discharged indebtedness. In the instant case, immediately preceding the foreclosure sale on February 8, 1993, the aggregate fair market value of petitioners' assets was \$875,251, which included petitioners' fishing permit valued at \$393,400 that they claim is exempt from the claims of creditors under the law of the State of Alaska. At that time, petitioners' liabilities totaled \$515,930. On the record before us, we find that petitioners had the “*ability to pay an immediate tax on*”, id., the \$42,142 of DOI income resulting from the foreclosure sale in question.

Requiring petitioners to include that income in their gross income for the year at issue and pay a tax thereon is a result that is consistent with the intention of Congress in enacting section 108(a)(1)(B) and related provisions into the Code.

We hold that the word “assets” as used in the definition of the term “insolvent” in section 108(d)(3) includes assets exempt from the claims of creditors under applicable State law. The parties agree that if we were to so hold, petitioners would not be “insolvent” within the meaning of section 108(d)(3), and the insolvency exception of section 108(a)(1)(B) would not apply to the \$42,142 of DOI income resulting from the foreclosure sale in question. Consequently, we sustain respondent's determination to include that DOI income in petitioners' gross income for the year at issue.

COD Income versus Purchase Price Adjustment

Rev. Rul. 92-99

ISSUE

If the principal amount of an undersecured nonrecourse debt that arose out of the purchase of property is reduced by the holder of the debt who was not the seller of the property, does the debt reduction result in discharge of indebtedness income under section 61(a)(12), or is the debt reduction treated as a purchase price adjustment that reduces the basis of the property securing the debt?

FACTS

In 1988, individual A purchased an office building from B for \$1,000,000, its fair market value. To pay for the building, A signed a note payable to C, a third-party lender, for \$1,000,000. The note bore interest at a fixed market rate payable annually and was secured by the office building. In 1989, when the value of the office building was \$800,000 and the outstanding principal on the note was \$1,000,000, C agreed to modify the terms of the note by reducing the note's principal amount to \$800,000. C's reduction in the note was not based on an infirmity that clearly related back to B's original sale (e.g., B's inducement of a higher purchase price by a misrepresentation of a material fact or by fraud). The modified note bore adequate stated interest within the meaning of section 1274(c)(2).

The facts here do not involve the bankruptcy, insolvency, or qualified farm indebtedness of the taxpayer. Thus, the specific exclusions provided by section 108(a) of the Code do not apply.

LAW AND ANALYSIS

Section 61(a)(12) provides that gross income includes income from the discharge of indebtedness. Section 1.61-12(a) provides that the discharge of indebtedness, in whole or in part, may result in the realization of income.

Section 108(e)(5) permits a debt reduction to be treated as a purchase price adjustment under certain circumstances. Section 108(e)(5) provides that if (A) the debt of a purchaser of property to the seller arising out of the purchase is reduced, (B) the debt reduction does not occur in a title 11 bankruptcy case

or when the purchaser is insolvent, and (C) the reduction would be treated as income to the purchaser from the discharge of indebtedness but for paragraph (e)(5), then such reduction will be treated as a purchase price adjustment. This purchase price adjustment treatment will result in a reduction in the basis of the property securing the debt rather than discharge of indebtedness income.

The debt in this case was reduced by an agreement between C (the third-party lender) and A (the purchaser) of the property. Even though the debt arose in connection with the purchase of the property by A from B, it was not a debt of the purchaser (A) "to the seller" (B), as required by section 108(e)(5)(A). Thus, the debt reduction by C does not qualify as a purchase price adjustment under section 308(e)(5).

In addition, the debt reduction by C is not considered a purchase price adjustment under common law. See *Fifth Avenue- Fourteenth Street Corp. v. Commissioner*, 147 F.2d 453, 456-57 (2d Cir. 1945), in which the court stated that a purchase price adjustment is limited to a case where the seller-mortgagee agreed to the debt reduction. The Service generally will not follow cases permitting a purchase price adjustment by third-party lenders, such as *Hirsch v. Commissioner*, 115 F.2d 656 (7th Cir. 1940), and *Allen v. Courts*, 127 F.2d 127 (5th Cir. 1942). An agreement to reduce a debt between a purchaser and a third-party lender is not a true adjustment of the purchase price paid for the property because the seller has received the entire purchase price from the purchaser and is not a party to the debt reduction agreement. The debt reduction relates solely to the debt and results in discharge of indebtedness income to the debtor.

Hirsch and Allen relied on *Bowers v. Kerbaugh-Empire Company*, 271 U.S. 170 (1926), to conclude that no discharge of indebtedness income resulted from a reduction of third-party debt. These cases reasoned that the proceeds of third-party debt should be traced to the investment for which the proceeds were used, and any loss (realized or unrealized) on that investment may be used to offset any income from the discharge of the debt.

However, subsequent Supreme Court decisions and other court cases, when viewed together, have discredited *Kerbaugh-Empire*. See *Burnet v. Sanford & Brooks Co.*, 282 U.S. 359 (1931), which established the annual accounting period concept; *United States v. Kirby Lumber Co.*, 284 U.S. 1 (1931), which held that the discharge of an indebtedness resulted in gross income; *Commissioner v. Glenshaw Glass Co.*, 348 U.S. 426 (1955), which held that gross income included all accessions to wealth from whatever source; *Commissioner v. Tufts*, 461 U.S. 300 (1983), which held that the amount realized on the sale of property encumbered by a nonrecourse obligation (that exceeded the fair market value of the property) included the amount of the obligation discharged; and *Vukasovich v. Commissioner*, 790 F.2d 1409 (9th Cir. 1986), which held that the discharge of an indebtedness resulted in gross income, notwithstanding the loss that the taxpayer incurred on the underlying transaction. Citing the above Supreme Court cases, the Ninth Circuit in *Vukasovich* stated that *Kerbaugh- Empire* was inconsistent with those decisions, and concluded that when an accession to wealth resulting from the discharge of indebtedness was otherwise includible in gross income, *Kerbaugh-Empire* did not prevent the taxation of that income.

Further, the Service will not follow *Commissioner v. Sherman*, 135 F.2d 68 (6th Cir. 1943), involving a third-party lender, to the extent that it relied on *Kerbaugh-Empire* to permit a purchase price adjustment. The Service will, however, treat a debt reduction in third-party lender cases as a purchase price adjustment to the extent that the debt reduction by the third-party lender is based on an infirmity that clearly relates back to the original sale (e.g., the seller's inducement of a higher purchase price by misrepresentation of a material fact or by fraud). Cf. *Commissioner v. Sherman*, 135 F.2d at 70. No other debt reduction by a third-party lender will be treated as a purchase price adjustment.

The reduction in the note by the third-party lender (C) in this case was not based on an infirmity that clearly relates back to the original sale, so A cannot treat C's debt reduction as a purchase price adjustment. Thus, A realizes \$200,000 of discharge of indebtedness income in 1989 under section 61(a)(12) of the Code.

HOLDING

If the principal amount of an undersecured nonrecourse debt that arose out of the purchase of property is reduced by the holder of the debt who was not the seller of the property, this debt reduction may not be treated as a purchase price adjustment (in the absence of an infirmity that clearly relates back to the original sale), but results in discharge of indebtedness income under section 61(a)(12).

Similarly, see *Ancil N. Payne, Jr.*, TC Memo 2008-66. “Insofar as petitioners used the credit card to buy merchandise, the Commissioner treats debt forgiveness in third-party lender cases as a purchase price adjustment only if the forgiveness is directly related to an aspect of the sale, as where a seller inflates the purchase price by misrepresentation. Rev. Rul. 92-99, 1992-2 C.B. 35.”

§108(e)(5)

“Purchase-money debt reduction for solvent debtor treated as price reduction. If—

(A) the debt of a purchaser of property to the seller of such property which arose out of the purchase of such property is reduced,

(B) such reduction does not occur—

(i) in a title 11 case, or

(ii) when the purchaser is insolvent, and

(C) but for this paragraph , such reduction would be treated as income to the purchaser from the discharge of indebtedness,

then such reduction shall be treated as a purchase price adjustment.”

Question 8 – If the borrowers in the *Tufts* case had had the lender reduce the amount of the debt before the property was sold, would the result have been different for the owners? Explain.

Question 9 – Your client abandoned their principal residence when they no longer had any equity, that is, the market value had dropped below the balance of the recourse debt on the home. How will you report this transaction on your client’s tax return? Will your answer differ if the client is insolvent? What if the mortgage also included a home equity debt amount?

Reporting of COD Income

- §6050P, Returns relating to the cancellation of indebtedness by certain entities
- Form 1099-C, *Cancellation of Debt*
- Form 982, *Reduction of Tax Attributes Due to Discharge of Indebtedness (and Section 1082 Basis Adjustment)*

COD Income Complexity

In the National Taxpayer Advocate's annual report issued to Congress in January 2009 (12/31/08), dealing with COD income is noted as a serious complexity issue.

“the rules for claiming one of these [§108] exclusions are so complex that many and probably most taxpayers who qualify to exclude CODI from gross income do not do so. As a result, some taxpayers unnecessarily include CODI in gross income. Other taxpayers fail to report CODI and fail to claim a corresponding exclusion because they do not realize that debt forgiveness is a taxable event. These taxpayers may unnecessarily face IRS examination and tax assessment” [p. 391; at http://www.irs.gov/pub/irs-utl/08_tas_arc_legrec.pdf]

More specifically, the NTA 2008 report notes:

“In earlier Annual Reports to Congress, we have highlighted the “confounding complexity of the Internal Revenue Code” as one of the most serious problems facing taxpayers. We do so again this year. While in past reports we have focused on the Alternative Minimum Tax as the primary example of this complexity, this year the “poster child” for complexity is Cancellation of Debt Income (CODI). This issue – which has received very little attention in the media – threatens to undermine any nascent recovery by homeowners facing loan restructuring or foreclosures, not to mention by taxpayers who find themselves unable to pay their automobile or credit card debts as a result of declining economic conditions. Although Congress provided partial relief to taxpayers with home mortgages in the Mortgage Forgiveness Debt Relief Act, CODI problems persist. The Act provided that taxpayers may exclude CODI resulting from taxable mortgage debt cancellation where the proceeds were used to acquire or improve their principal residence. But it appears that the majority of homeowners who took out subprime mortgages used a portion of the loan proceeds for other purposes, including paying off car loans, credit card balances, student loans, and medical bills. Thus, if these taxpayers either work out a debt reduction agreement with their lenders or abandon or lose their homes in foreclosure, they will have CODI unless some other exclusion – such as insolvency – applies.

“Moreover, lenders are required to report CODI to the IRS on Form 1099-C, *Cancellation of Debt*, and the IRS generally may assume any reported CODI is taxable unless the taxpayer files a form with his tax return to claim an exclusion. Very few taxpayers know to file this form, and as a result, taxpayers may be unnecessarily targeted for examination and tax assessment in tens of thousands of cases. It is probably safe to say that taxpayers facing eviction from their homes and the resulting disruption of their financial and personal lives will not be thinking about CODI. These taxpayers and those who are able to arrange debt reduction will find, a few years down the road when they are about to achieve some measure of financial stability, that they owe the IRS a sizable sum. In our report, we make several administrative recommendations and one legislative recommendation that should mitigate this problem and prevent millions of taxpayers from getting ensnared in this incredibly complex, burdensome, and devastating regime.” [pgs. vi – vii; at http://www.irs.gov/pub/irs-utl/08_tas_arc_intro_toc_msp.pdf]

Question 10 – What types of complexities do you see in §108 and what simplifications do you recommend?