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A Field Guide to Cancellation of Debt Income

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I. Introduction

The United States is awash in a sea of debt. In June 2009, there was more than $14 trillion of mortgage debt outstanding—approximately $11 trillion on one to four family residences, approximately $900 billion on multifamily residences, slightly more than $2.5 trillion on nonfarm nonresidential real estate, and $111 billion on farms.[1] Over $2.5 trillion dollars of consumer debt was outstanding as of May of 2009.[2] At the end of June of 2009, over $ 1.2 trillion of commercial paper was outstanding.[3] At the end of the first quarter of 2009, over $11 trillion of nonfinancial business debt, approximately $7.2 trillion of which was owed by corporations, was outstanding.[4]

Many individuals and businesses are drowning in that debt. In the midst of the most severe recession since the Great Depression, major corporations, such as the American icon General Motors, have been unable to pay their debts and have gone into bankruptcy. Millions of individuals and small businesses have defaulted on their debts. Loan delinquencies and charge-offs are at levels heretofore unknown in the modern financial era. According to the Federal

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[1] FED. RESERVE STATISTICS AND HISTORICAL DATA, MORTGAGE DEBT OUTSTANDING (2009), *available at* http://www.federalreserve.gov/econresdata/releases/mortoutstand/current.htm.

[2] FED. RESERVE STATISTICAL RELEASE, CONSUMER CREDIT (2009), *available at* http://www.federalreserve.gov/releases/g19/current/g19.htm. This category "covers most short- and intermediate-term credit extended to individuals," including revolving credit, "automobile loans, and all other loans not included in revolving credit, such as loans for mobile homes, education, boats, trailers, or vacations, but excluding loans secured by real estate. These loans may be secured or unsecured." *Id.*

[3] FED. RESERVE STATISTICAL RELEASE, CONSUMER PAPER (2009), *available at* http://www.federalreserve.gov/releases/cp/outstandings.htm. "Commercial paper consists of short-term, promissory notes issued primarily by corporations. Maturities range up to 270 days but average about 30 days." FED. RESERVE RELEASE, ABOUT COMMERCIAL PAPER (2006), *available at* http://www.federalreserve.gov/releases/cp/about.htm.

[4] BD. OF GOVERNORS OF THE FED. RESERVE SYS., FLOW OF FUNDS ACCOUNTS OF THE UNITED STATES 3 (2009), *available at* http://www.federalreserve.gov/releases/Z1/current/Coded/coded.pdf.

Reserve Board, bank loan charge-off rates more than quadrupled from the first quarter of 2006 to the first quarter of 2009; the charge off rate in the first quarter of 2009 exceeded 2%.[5] In that same period, loan delinquency rates more than tripled and stood at 5.6% in the first quarter of 2009.[6] Almost 8% of residential real estate loans and 6.4% or commercial real estate loans were in default.[7] In the spring of 2009, the Mortgage Bankers Association reported that the share of loans entering foreclosure rose to 1.37%, the highest on record going back to 1972.[8] The number of bankruptcies filed in 2008 totaled 1,117,771, up from 850,912 bankruptcies filed in 2007.[9]

Every loan charge-off and mortgage foreclosure has tax consequences. While the creditor most often claims a bad-debt deduction or business-related loss,[10] the debtor generally must recognize gross income and pay income taxes on an amount roughly equal to the creditor's loss, unless a special exception applies to exclude the debt relief from income.

Almost every form of gross income required to be included under section 61 entails the receipt of money, property, or services of value (or the accrual of the right to receive money, property, or services in the year of receipt). The requirement that a debtor pay taxes when a loan goes unpaid is one of only a few situations in which a tax obligation arises without the contemporaneous receipt of valuable consideration. That the debtor must pay taxes in the

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[5] FED. RESERVE STATISTICAL RELEASE, CHARGE-OFF AND DELINQUENCY RATES ON LOANS AND LEASES AT COMMERCIAL BANKS: CHARGE-OFF RATES (2009), *available at* http://www.federalreserve.gov/releases/chargeoff/chgallsa.htm.

[6] FED. RESERVE STATISTICAL RELEASE, CHARGE-OFF AND DELINQUENCY RATES ON LOANS AND LEASES AT COMMERCIAL BANKS: DELINQUENCY RATES (2009), *available at* http://www.federalreserve.gov/releases/chargeoff/delallsa.htm. "Delinquent loans . . . are those past due thirty days or more and still accruing interest as well as those in nonaccrual status." FED. RESERVE STATISTICAL RELEASE, CHARGE-OFF AND DELINQUENCY RATES ON LOANS AND LEASES AT COMMERCIAL BANKS (2009), *available at* http://www.federalreserve.gov/releases/chargeoff/.

[7][7] FED. RESERVE STATISTICAL RELEASE, CHARGE-OFF AND DELINQUENCY RATES ON LOANS AND LEASES AT COMMERCIAL BANKS: DELINQUENCY RATES (2009), *available at* http://www.federalreserve.gov/releases/chargeoff/delallsa.htm.

> Residential real estate loans include loans secured by one- to four-family properties, including home equity lines of credit, booked in domestic offices only. Commercial real estate loans include construction and land development loans, loans secured by multifamily residences, and loans secured by nonfarm, nonresidential real estate, booked in domestic offices only.

Id.

[8] Kathleen M. Howley, *Mortgage Delinquencies, Foreclosures, Rates Increase*, BLOOMBERG.COM, May 28, 2009, http://www.bloomberg.com/apps/news?pid=20601087&sid=aE_j_CA8fCao.

[9] Press Release, U.S. Courts, Bankruptcy Filings Up In Calendar Year 2008 (March 5, 2009), *available at* http://www.uscourts.gov/Press_Releases/2009/BankruptcyFilingsDec2008.cfm.

[10] Losses incurred in a business or investment (other than bad-debt deductions) are deductible under section 165. Bad debts arising from a trade or business are deductible under section 166. *See* BORIS I. BITTKER, MARTIN J. MCMAHON, JR. & LAWRENCE A. ZELENAK, FEDERAL INCOME TAXATION OF INDIVIDUALS ¶¶ 16.1–16.7, 17.1–17.8 (3d ed. 2002).

year in which it is determined that a loan will not be repaid follows from the proposition that a borrower is not required to include loan proceeds in gross income upon receipt and thus not required to pay taxes at that time.[11]

This Article deals with the tax consequences to the debtor of the discharge of a debt for less than full payment.[12] Part II explain the origins and rationale for the rule, now codified in section 61(a)(12), that requires the inclusion of "[i]ncome from discharge of indebtedness." Part III examines the various events that trigger recognition of income under section 61(a)(12). Part IV deals with the manner in which the amount of income from discharge of indebtedness is computed. This part also discusses the tax consequences to a business entity that issues an equity interest to a creditor to satisfy a debt. Part V explores the myriad of statutory rules in section 108 that permit nonrecognition of income from discharge of indebtedness under particular circumstances, and the various ancillary consequences that follow from nonrecognition. Throughout, the Article will explore the relationship of income from discharge of indebtedness to realization of gain from the transfer of property to satisfy a debt by contrasting the tax consequences of transfers of property to discharge a debt with the consequences of discharge of a debt for less than full payment.

II. The Origins of the Income from Cancellation of Debt Principle

If the loan transaction is viewed as a whole, when a borrower receives money in a loan transaction and is later discharged from the liability without repaying the debt, the borrower has realized an accession to wealth. Recognizing the existence of income in this situation generally is not a problem for the income tax system. The receipt of the proceeds of a loan is not income because the receipt is offset by an obligation to repay the borrowed amount. If the obligation to repay the borrowed amount is eliminated or reduced without the concomitant repayment, the borrower realizes an accession to wealth that, as a matter of tax theory, should be included in gross income.[13]

A. *Tax Consequences of Incurring Debt*

Gross income is based on the presence of an accession to wealth (*i.e.*, an economic benefit). As a fundamental principle of tax, borrowed funds are excluded from gross income because the obligation to repay borrowed funds offsets the economic increment even though borrowed funds increase a taxpayer's assets and can be used as the taxpayer sees fit.[14] As stated by the Supreme Court in *Commissioner v. Tufts*,

[11] *See infra* Part II.A.

[12] *See* Fred T. Witt, Jr. & William H. Lyons, *An Examination of the Tax Consequences of Discharge of Indebtedness*, 10 VA. TAX REV. 1 (1990) (giving an early comprehensive survey of the issues and rules).

[13] *Id.* at 6–7.

[14] Commissioner v. Tufts, 461 U.S. 300, 307 (1983).

> When a taxpayer receives a loan, he incurs an obligation to repay that loan at some future date. Because of this obligation, the loan proceeds do not qualify as income to the taxpayer. When he fulfills the obligation, the repayment of the loan likewise has no effect on his tax liability.[15]

If borrowed money is used to acquire property, the taxpayer's basis in the property under section 1012 is the full purchase price, including the borrowed funds applied to the purchase price.[16] The repayment of the borrowed funds is a prerequisite to full enjoyment of ownership and therefore represents a cost of the property. Upon the sale of the property, the borrower's gain is the sales proceeds minus the cost of the property, including the borrowed funds.[17]

The same principles apply whether the loan is a recourse loan or a nonrecourse loan (*i.e.*, one with respect to which the creditor's rights upon default are limited to foreclosing on property secured by the loan). No gross income is realized upon the receipt of the proceeds of a nonrecourse loan, even if the amount of the loan exceeds the basis of the property.[18] Furthermore, if the acquisition of property is financed through nonrecourse borrowing, the taxpayer generally acquires a normal section 1012 cost basis in the debt-financed property.[19] Even if the borrower has no personal liability to repay the debt, just as is the case with recourse debt, before the borrower can dispose of the property and enjoy the fruits of an economic gain, the full amount of the borrowed capital must be returned to the lender. Thus, the borrower's gain is determined by subtracting from the full proceeds of borrowing the full amount of a purchase-money nonrecourse loan (and any other cost of the property).

Because the borrowing of money is not a realization event, and property acquired with borrowed funds or in exchange for the purchaser's promissory note to the seller takes a section 1012 cost basis equal the full value of the consideration provided by the buyer, tax consequences must attach to the

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[15] *Id.*

[16] *See* Brons Hotels, Inc. v. Commissioner, 34 B.T.A. 376, 379–80 (1936) ("Petitioner, as the owner of the Walton Hotel, was entitled to take—and required to take—as a 'basis' for determining gain or loss upon the sale or other disposition of such property the cost thereof [I.R.C. § 1012]. When it acquired the property, it received, as part of its cost, the benefit of the mortgage which it assumed, although it actually acquired only an equity in the property."); *see also Tufts*, 461 U.S. at 307–08 ("Another consequence to the taxpayer from this obligation occurs when the taxpayer applies the loan proceeds to the purchase price of property used to secure the loan. Because of the obligation to repay, the taxpayer is entitled to include the amount of the loan in computing his basis in the property; the loan, under section 1012, is part of the taxpayer's cost of the property.").

[17] *See Brons Hotels, Inc.*, 34 B.T.A. at 381; Crane v. Commissioner, 331 U.S. 1, 11 (1947); *Tufts*, 461 U.S. at 308–09.

[18] Milenbach v. Commissioner, 318 F.3d 924, 930 (9th Cir. 2003); Woodsam Assocs. v. Commissioner, 198 F.2d 357, 359 (2d Cir. 1952).

[19] Mayerson v. Commissioner, 47 T.C. 340, 352 (1966); *see also Tufts*, 461 U.S. at 309 ("no difference between recourse and nonrecourse obligations is recognized in calculating basis").

debtor subsequently being discharged from the debt obligation for less than full payment.

B. *Tax Consequences of Cancellation of Debt*

1. *General Background*

If a taxpayer renegotiates the amount of the debt owed or is otherwise able to discharge the debt for less than its original amount, the taxpayer generally must recognize gross income under section 61(a)(12), subject to the various exclusions and special rules in section 108. Although section 61(a)(12) refers to income from the "discharge of indebtedness," the term "cancellation of indebtedness income" is a more accurate description of the transaction, and, in fact, the income includable under section 61(a)(12) is commonly termed "COD" income, the acronym referring to "cancellation of debt." Cancellation of debt is the terminology that we will use. This change in terminology reflects the fact that section 61(a)(12) applies when a debt is "discharged" for less than full payment to the creditor or is "cancelled" in whole or in part, but section 61(a)(12) has no relevance when a debt is "discharged" either by full payment or by a novation agreement under which a third party assumes the taxpayer's liability for the debt.

Section 61 (a)(12) represents a codification of the Supreme Court's seminal 1931 decision in *United States v. Kirby Lumber Co.*,[20] a landmark case involving a corporation that had issued about $12 million of bonds and later repurchased some of them for about $138,000 less than their face amount. In holding that the transaction generated gain, the Supreme Court said:

> [T]he taxpayer made a clear gain. As a result of its dealings it made available $137,521.30 [of] assets previously offset by the obligation of bonds now extinct. . . . The [taxpayer] has realized within the year an accession to income, if we take words in their plain popular meaning, as they should be taken here.[21]

Although the result in *Kirby Lumber Co.* is clear, the rationale is not necessarily so transparent.[22]

2. *Ambiguities in the* Kirby Lumber Co. *Rationale*

The language of *Kirby Lumber Co.* suggests two separate theories for the result. On the one hand, if a debt is cancelled and the borrower is relieved of the duty to repay the loan, the cancellation of the debt has tax consequences because the benefit of receipt of cash at the time of the borrowing with-

[20] 284 U.S. 1 (1931).

[21] *Id.* at 3; *see also* Helvering v. Am. Chicle Co., 291 U.S. 426, 430 (1934) (taxpayer recognized cancellation of debt income on its purchase for less than face value of a predecessor corporation's bonds, which had been assumed by the taxpayer when purchasing the predecessor's assets several years earlier).

[22] *See* Theodore P. Seto, *The Function of the Discharge of Indebtedness Doctrine: Complete Accounting in the Federal Income Tax System*, 51 TAX L. REV. 199, 202–03 (1996).

out realization of income is offset by elimination of repayment, producing an overall economic benefit to the borrower.[23] Alternatively, as suggested by the second sentence of the quotation above, the borrower has gross income because the borrower's net worth has been increased with an elimination of the obligation to return borrowed funds.[24]

Depending on which of these theories is applied, the consequences that flow from the debt cancellation might differ. *Kirby Lumber Co.* often has been interpreted to be grounded on the rationale that when a debt is discharged for less than full repayment, the portion of the debt cancelled without payment is income because the borrower's net worth has been increased. Some of the provisions in section 108 reflect the "increase in net worth" origins of the rule. The focus in *Kirby Lumber Co.* on the freeing of the taxpayer's assets from the obligation of its cancelled indebtedness raises a question whether it is simply the reflected balance sheet improvement resulting from eliminating the offsetting obligation that creates gross income on the cancellation of indebtedness, or whether the existence of cancellation of debt income depends on the presence of some other factor.

In *Commissioner v. Jacobson*, the Supreme Court repeated both formulations.[25] In *Jacobson*, the Supreme Court held that an individual recognized cancellation of indebtedness income on the repurchase of his personal bonds for an amount less than their issue price.[26] The Court pointed out that the taxpayer's acquisition of his bonds improved his "net worth" by the difference between the face amount of the bonds and the acquisition price. The Court noted that, "[i]n the first instance [Jacobson] had received the full face amount in cash for these bonds so that his repurchase of them for 50 percent, or less, of that amount reflected a substantial benefit which he had derived from the use of that borrowed money."[27]

Some cases have analyzed *Kirby Lumber Co.* by comparing the consideration received in exchange for the taxpayer's note with the payment made to discharge the obligation. In *Commissioner v. Rail Joint Co.*, the taxpayer issued bonds as a dividend to shareholders and accounted for the bonds on the corporate books at their face value.[28] When the corporation repurchased the bonds for less than their face amount, the Commissioner asserted that the corporation realized cancellation of debt income because its balance sheet was improved by removing the bonds as a corporate liability while the corporate assets were reduced only by the lesser amount used to repurchase the bonds. The court disagreed and held that in applying *Kirby Lumber Co.*, "the consideration received for the obligation evidenced by the bond as well as the consideration paid to satisfy that obligation must be looked to in order to

[23] *See Kirby*, 284 U.S. at 3.
[24] *Id.*
[25] 336 U.S. 28 (1949).
[26] *Id.* at 38.
[27] *Id.* at 38–39.
[28] 61 F.2d 751 (2d Cir. 1932).

determine whether gain or loss is realized when the transaction is closed; i.e., when the bond is retired."[29] The Rail Joint Company did not have cancellation of debt income on retirement of its bonds because the corporation had not increased its assets at the time the bonds were issued. In fact, since the bonds were issued by the corporation as a dividend, the corporation had not received any assets in consideration of its issuance of the bonds. Viewing the transaction as a whole, the corporation received nothing that it did not possess prior to the opening and closing of the bond transaction, and thus there was no gain to be treated as income.[30]

The Tax Court reached the same conclusion in *Fashion Park, Inc. v. Commissioner*.[31] The taxpayer corporation had issued debenture bonds, each with a stated face value of $50, in a tax-free reorganization in exchange for shares of its preferred stock that also had a par and stated value of $50 per share. The preferred stock had been issued for $5 per share, and the $45 difference between the cash consideration received and the $50 face value of the stock had been transferred from earned surplus to paid-in capital on the corporation's books. The Tax Court held that no cancellation of debt income was realized when the taxpayer subsequently purchased some of the bonds for an amount in excess of $5 each, but less than $50 each, citing *Rail Joint* as authority.[32]

A number of early cases followed the freeing of assets branch of the *Kirby Lumber Co.* reasoning to hold that no gross income was realized from the cancellation of debt when the debtor taxpayer was insolvent at the time of the debt cancellation. For example, in *Dallas Transfer & Terminal Warehouse*

[29] *Id.* at 751–52.

[30] It is not entirely clear whether the taxpayer in *Kirby Lumber Co.* actually received full value for the issue of its bonds. The bonds were issued in exchange for the taxpayer's preferred stock with dividends in arrears, but the case has often been thought to have involved bonds issued for cash, perhaps because the Supreme Court said that the taxpayer, on issuing the bonds, "received their par value." *See* Boris I. Bittker, *Income from the Cancellation of Indebtedness: A Historical Footnote to the* Kirby Lumber Co. *Case*, 4 J. CORP. TAX'N 124 (1977). The case was tried before the Court of Claims on a stipulation that the bonds had been issued for their par value. "Both the Court of Claims and the Supreme Court stated that the company had received par value when the bonds were issued." Daniel L. Simmons, *Nonrecourse Debt and Amount Realized: The Demise of* Crane's *Footnote 37*, 59 OR. L. REV. 3, 36 n. 172 (1980) (citations omitted). These express statements, plus "the tenor of the Supreme Court's opinion, lead to the conclusion that" the Court's analysis is based upon the assumption that the Kirby Lumber Company received full value on issue of the bonds. *Id.*

[31] 21 T.C. 600 (1954); *accord* U.S. Steel Corp. v. United States, 848 F.2d 1232 (Fed. Cir. 1988) (repurchase of bonds at less than face value did not give rise to cancellation of debt income because the bonds had been issued to redeem preferred stock with par value of less than repurchase price; thus the corporation had not increased its assets); *see also* Bradford v. Commissioner, 233 F.2d 935 (6th Cir. 1956) (note issued to bank to obtain reduction of debt owed by taxpayer's husband; taxpayer is described as issuing her note "without receiving any consideration in return," although it might have been treated as indirect way of getting cash to reduce husband's debt); Zarin v. Commissioner, 916 F.2d 110 (3d Cir. 1990) (taxpayer did not realize income on cancellation of debt that "arose out of his acquisition of gambling chips").

[32] *Fashion Park*, 21 T.C. at 605.

Co. v. Commissioner, an insolvent debtor compromised a debt for less than its principal amount, and the Court of Appeals for the Fifth Circuit held that *Kirby Lumber Co.* did not require any of the cancelled debt to be included in gross income.[33] The court explained the reason as follows:

> In effect the transaction was 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.[34]

Dallas Transfer & Terminal Warehouse Co. was followed by the Board of Tax Appeals in *Quinn v. Commissioner*, in which debts of an insolvent taxpayer were cancelled for less than full payment.[35] The Board held that "[T]he cancellation of the mortgage in this case did not, as in *Kirby Lumber Co.*, supra, make available any assets to petitioner, and we hold that there was no realization of income from the transaction."[36]

Lakeland Grocery Co. v. Commissioner further developed the analysis of this branch of the *Kirby Lumber Co.* reasoning.[37] In *Lakeland Grocery*, the Board of Tax Appeals characterized the earlier cases as having found that income was not required to be recognized upon the forgiveness of debt where the taxpayer was insolvent both before and after the cancellation of debt. However, in *Lakeland Grocery*, although the taxpayer was insolvent before the forgiveness of indebtedness, it was solvent immediately thereafter. The Board of Tax Appeals limited the exclusion from gross income of cancellation of debt income to the amount of the taxpayer's insolvency. Thus, cancellation of debt income was realized to the extent the taxpayer's assets exceeded its liabilities after the cancellation—the extent to which it had assets freed from the claims of creditors that were no longer offset by its liabilities.[38]

Collins v. Commissioner is another example of a case that arguably applied the freeing of assets theory branch of the *Kirby Lumber Co.* rationale.[39] In that case, the taxpayer borrowed $15,000, and the loan was secured by a lien on corporate stock owned by the taxpayer having a value of only $300. The terms of the promissory note executed by the taxpayer limited the creditor's rights to foreclosure of the lien on the note and expressly provided that no deficiency action could be brought. Subsequently, at a time when the collateral

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[33] 70 F.2d 95, 96 (5th Cir. 1934).
[34] *Id.*
[35] 31 B.T.A. 142 (1934).
[36] *Id.* at 145.
[37] 36 B.T.A. 289 (1937).
[38] *Id.* at 292.
[39] 22 T.C.M. (CCH) 1467, T.C.M. (P-H) ¶ 63,285 (1963).

was worth only $100, the debt was forgiven and collateral was returned. The Tax Court found that although there was no expectation by either the taxpayer or the creditor that the taxpayer would repay the amount advanced, the original receipt was not a gift. Nevertheless, the court held that the amount of cancellation of debt income was limited to the value of the collateral released. The court reasoned as follows:

> The indebtedness on this note was limited as to collectibility to the collateral given and therefore did not create a personal debt from petitioner to Roth Steel. For this reason the return of the note to petitioner in 1959 did not result in the cancellation of any personal indebtedness of petitioner. The return of the collateral did result in freeing that collateral for petitioner's use as he saw fit. If a note representing a valid personal indebtedness of a solvent taxpayer is returned and the debt represented thereby canceled under circumstances resulting in income to that taxpayer, the amount of income is measured by the indebtedness released irrespective of the value of the note. It is the cancellation of indebtedness, thus freeing the taxpayer's assets to the extent of the cancellation, which results in the income to the taxpayer whether or not the indebtedness is evidenced by a note. The return of a note which represents no personal liability of a taxpayer does not free any assets except those from which the note might otherwise have been paid.[40]

Accordingly, the court held that the taxpayer realized only $100 of cancellation of debt income, although the court did note that "[s]ince the only year before us is 1959, it is unnecessary for us to consider the effect of the transaction on petitioner's taxable income for the year 1957."[41]

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[40] *Id.* at 1471, T.C.M. (P-H) ¶ 63,285 at 1664.

[41] *Id.* Had the year in which the taxpayer received the loan in *Collins* been in issue, the correct treatment would have been to treat only $300 of the proceeds as a loan—an amount equal to the fair market value of the property securing the loan. *See* Geftman v. Commissioner, 154 F.3d 61, 68 (3d Cir. 1998) ("For 'disbursements to constitute true loans there must have been, at the time the funds were transferred, an unconditional obligation on the part of the transferee to repay the money, and an unconditional intention on the part of the transferor to secure repayment.' Haag v. Commissioner, 88 T.C. 604, 615–16, *aff'd*, 855 F.2d 855 (8th Cir. 1988)."). *Milenbach v. Commissioner*, 106 T.C. 184 (1996), *rev'd* 318 F.3d 924 (9th Cir. 2003), also supports the inclusion in gross income of the amount by which the proceeds of a purported nonrecourse loan exceed the fair market value of the property securing the loan. In *Milenbach*, the partnership that owned the Oakland Raiders football team received a $6.7 million nonrecourse loan from the Los Angeles Coliseum Commission as an inducement to move the team from Oakland to Los Angeles. The loan was repayable only out of net rents that would be received by the Raiders from leasing luxury skyboxes in the Los Angeles Coliseum and was secured only by the skyboxes that the Raiders promised to build. In the year that loan proceeds were received, the skyboxes had not yet been built, but the Raiders partnership was required by the agreement to construct the skyboxes "as soon as practicable as determined by the Partnership in its reasonable discretion, having in mind . . . considerations deemed . . . important or significant to the partnership." *Id.* at 187. The skyboxes were never built. The Tax Court concluded that the standard for determining when the skyboxes would be built "gave the Raiders great latitude in timing the construction," which amounted to "unlimited discretion," and found that the obligation to construct the skyboxes was illusory. *Id.* at 196. Accordingly, the Raiders were required to include the funds in gross income upon receipt. The

Neither of the two potential rationales for *Kirby Lumber Co.* supports the notion that a taxpayer does not recognize cancellation of debt income if the borrowed funds are applied to a transaction that, when considered as a whole, results in an economic loss. However, prior to its decision in *Kirby Lumber Co.*, this latter principle was applied by the Supreme Court in *Bowers v. Kerbaugh-Empire Co.*, which held that a corporation that borrowed German marks before World War I, converted the borrowed marks into dollars, transferred the dollars to a subsidiary, which was unsuccessful and lost the funds, and then repaid the loans after the war with devalued marks that it purchased for substantially less in dollars than the dollar-value of the borrowed marks when they were received, did not recognize any gross income.[42] The Supreme Court stated: "The loss was less than it would have been if [the] marks had not declined in value; but the mere diminution of loss is not gain, profit, or income."[43]

Kerbaugh-Empire Co. has often has been read for the proposition that there is no cancellation of debt income when the whole transaction results in a loss.[44] This holding of *Kerbaugh–Empire Co.* is questionable because the Court linked the taxpayer's borrowing of German marks to its subsequent investment of the loan proceeds in its subsidiary corporation, failing to recognize the presence of two distinct transactions, the borrowing and repayment of marks, and the investment in stock of a subsidiary.[45] In any event, *Kerbaugh–Empire Co.* is now treated as an anomaly; the Service, the Tax Court, and the Court of Appeals for the Ninth Circuit have concluded that *Kerbaugh-Empire Co.* lacks precedential authority in light of subsequent

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Court of Appeals for the Ninth Circuit reversed the Tax Court's decision on appeal, on the grounds that the obligation to repay the loan was not illusory because, under California law, "a contract is not illusory if the obligated party's discretion must be exercised with reasonableness or good faith . . . . Here the Raiders were required to exercise their discretion reasonably and nothing in the [agreement] indicates that construction of the suites was optional." 318 F.3d 924, 930–31. Thus, even though the Tax Court's decision was reversed, the Ninth Circuit's opinion does not reflect a different view of the effect for tax purposes of an illusory obligation to repay, but only a different conclusion regarding whether the particular obligation in this case was illusory.

[42] 271 U.S. 170 (1926).

[43] *Id.* at 175.

[44] *See, e.g.*, Zarin v. Commissioner, 92 T.C. 1084, 1091 (1989), *rev'd on other grounds*, 916 F.2d 110 (3d Cir. 1990) (debtor realized no income because debt was not enforceable under state law).

[45] Section 988 now expressly requires assigning independent tax consequences to the two transactions. *See* I.R.C. § 988(a)(1)(A).

Supreme Court decisions.[46]

Bradford v. Commissioner is a rare application of the *Kerbaugh–Empire Co.* principle in the context of a debt-only transaction.[47] In *Bradford*, the taxpayer substituted her personal note in the amount of $100,000 for her husband's note to a bank in the same amount. Later, the creditor bank accepted $50,000 in a transaction that was treated by the bank as full satisfaction of the taxpayer's debt. The court rejected the Commissioner's assertion that the taxpayer realized cancellation of indebtedness income from the retirement of the debt for less than its face amount, reasoning that the taxpayer did not realize any economic gain from what was a loss transaction, citing *Kerbaugh-Empire Co.*[48] In *Bradford*, the taxpayer's borrowing did not result in the receipt of assets without realized gain, and thus the offsetting benefit of cancellation of the debt did not produce an overall gain on the transaction. Thus, the result in situations like *Bradford* can be rationalized as an application of the *Rail Joint Co.* principle, without reliance on *Kerbaugh-Empire Co.*

C. *Statutory Codification of Cancellation of Debt Rules*

Section 61(a)(12) was enacted in 1954 to codify the "discharge of indebtedness" as gross income principle. At the same time, Congress added section 108, which, although originally narrow in scope, now provides numerous exceptions to section 61(a)(12) under which a taxpayer may avoid recognizing cancellation of debt income, as well as a number of operating rules for calculating the precise amount of cancellation of debt income. In addition, section 1017 was enacted to require adjustments to the basis of property in certain instances when cancellation of debt income goes unrecognized under section 108.[49]

Recognize that section 61(a)(12) and judicial precedents establish the general principles governing realization of cancellation of debt income, and section 108 provides overriding and supplemental rules. However, because of the extensive detail in section 108, even when not expressly provided by the

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[46] *See* Vukasovich, Inc. v. Commissioner, 790 F.2d 1409, 1415–16 (9th Cir. 1986) (stating that *Kerbaugh-Empire Co.* was decided as a constitutional case and it is inconsistent with the Supreme Court's later decisions; "We have no doubt that an increase in wealth from the cancellation of indebtedness is taxable where the taxpayer received something of value in exchange for the indebtedness."); *Zarin*, 92 T.C. at 1088, 1091, 1096 (settlement for $500,000 of $3.4 million gambling debt owed to casino resulted in $2.9 million cancellation of indebtedness income even though transaction as a whole was a loss; declining to follow *Kerbaugh–Empire Co.*); Rev. Rul. 1992–99, 1992–2 C.B. 35 (*Kerbaugh–Empire Co.* has been discredited by subsequent Supreme Court cases).

[47] 233 F.2d 935 (6th Cir. 1956).

[48] *Id.* at 937.

[49] H.R. Rep. No. 88-1337, at 13 (1954).

statute, the Service and the courts tend to treat section 108 as providing the exclusive rules, supplanting prior judicial decisions with respect to issues that are addressed in the statutory provision.[50] Some judicial exceptions nevertheless survive in cases not addressed by section 108.[51]

D. *Relevance of the Nature of the Debt*

1. *Generally*

In theory, realization of cancellation of debt income does not depend on the nature of the debt. Nonetheless, many of the exceptions to recognition and other special rules under section 108 do depend on the nature of the debt. In addition, apart from specific exceptions in section 108, the use of borrowed funds does not affect whether cancellation of a debt gives rise to income realization. Regardless of the use of borrowed funds, a taxpayer generally realizes no income when funds are borrowed, because an offsetting obligation to pay in accordance with the terms of the loan arises along with the receipt of money or property. The asset is offset by a corresponding liability and the borrower has no increase in net worth as a result of the loan transaction based on the assumption that the taxpayer eventually will repay the debt.[52] The creation of the debt is generally accompanied by some tax favored treatment, which may be in the form of the tax-free cash received in a direct loan, or basis in property in the case of a debt-financed purchase, or a current deduction in the case of an accrual method taxpayer's debt for a deductible expense. In all of these instances, when the debt is discharged, in whole or in part, without payment, inclusion in gross income of cancellation of debt income is required to offset the original favorable tax treatment.

At times, however, the nature of the debt may affect these matters. In some cases, a taxpayer has not received favorable tax treatment when the debt was incurred, for example, a taxpayer who incurs a tort liability that is not connected with a business, which is later discharged for less than full payment. These types of situations give rise to more difficult questions in determining the existence and amount of cancellation of debt income.

2. *Nonrecourse Debts*

If a nonrecourse debt secured by real estate or other property is compromised for less than its principal amount and the borrower retains ownership of the property, the entire amount of the cancelled portion of the debt is realized as cancellation of debt income, without regard to the value of the released

[50] *See, e.g.*, Gitlitz v. Commissioner, 531 U.S. 206, 215 (2001) (stating that section 108 provides exclusive insolvency exception); Preslar v. Commissioner, 167 F.3d 1323, 1332–33 (10th Cir. 1999) (section 108(e)(5) provides exclusive purchase price reduction exception).

[51] *See infra* Parts III.E., G.

[52] *See* discussion *supra* Part II.A.

collateral,[53] unless the lender also sold the property to the taxpayer.[54] If, however, property subject to a nonrecourse debt is deeded to the lender in lieu of foreclosure, the entire amount of the nonrecourse debt is included in the amount realized on the sale of the property, even if the debt exceeds the fair market value of the property at the time of the transfer.[55] (In this respect, the transfer of property subject to a nonrecourse debt that is deeded to the lender in lieu of foreclosure is accorded the same treatment as a transfer of the property to a third party who merely takes the property subject to the debt.)

The amount realized through cancellation of a nonrecourse debt might be limited to the value of the collateral if the taxpayer did not receive a tax benefit from the cancelled debt. The regulations provide that relief from acquisition indebtedness is not included in amount realized "to the extent that such liability was not taken into account in determining the transferor's basis in such property."[56] For example, if the taxpayer acquires property subject to a nonrecourse debt that exceeds the value of the property and immediately pays the latter amount to discharge the debt, the taxpayer should not realize cancellation of debt income as long as the cancelled portion of the debt was not included in the taxpayer's basis for the property.[57] But in any case where the property was worth more than the existing debt when received, acquisition of the property subject to the liability is functionally equivalent to buying it with a nonrecourse purchase-money mortgage or purchasing it for cash and then pledging it for a nonrecourse loan; and if the debt is later settled for less

[53] *See* Gershkowitz v. Commissioner, 88 T.C. 984, 1013 (1987) (cancellation of debt income realized on cancellation of nonrecourse debt in consideration of cash payment in an amount less than debt); Rev. Rul. 1991-31, 1991-1 C.B. 19 (reduction to $800,000 of $1 million principal amount of secured nonrecourse debt, when value of collateral was $800,000, resulted in $200,000 cancellation of debt income); Fulton Gold v. Commissioner, 31 B.T.A. 519 (1934) (which permitted basis reduction rather than recognition of income, will not be followed); Rev. Rul. 1982-202, 1982-2 C.B. 35 (cancellation of debt income was realized upon prepayment of a nonrecourse mortgage on taxpayer's home at a discount).

[54] For the section 108(e)(5) "purchase price reduction" exception to the recognition of cancellation of debt income, see *infra* Part V.A.2.

[55] Reg. § 1.1001-2(b), -2(c), Ex. (7); *see* Yarbro v. Commissioner, 737 F.2d 479 (5th Cir. 1984). The same rule applies when property is transferred by the owner-debtor to a third person who takes the property subject to the debt; the transaction is a sale, no part of which is treated as a cancellation of debt. I.R.C. § 7701(g); Commissioner v. Tufts, 461 U.S. 300 (1983). *But see* Cozzi v. Commissioner, 88 T.C. 435 (1987) (holding that cancellation of debt income is realized in year taxpayer-partner abandoned to another partner all rights to a pornographic movie pledged to secure nonrecourse debt).

[56] Reg. § 1.1001-2(a)(3).

[57] *See* Hudson v. Commissioner, 103 T.C. 90 (1994) (holding that cancellation of debt income was not realized on discharge of purchase-money nonrecourse debt that was not included in the property's basis, and thus provided no tax benefit, because the promissory notes lacked economic substance and were not genuine), *aff'd on other issues by order*, 71 F.3d 877 (5th Cir. 1995); *see also* Pleasant Summit Land Corp. v. Commissioner, 863 F.2d 263 (3d Cir. 1988) (holding that the portion of nonrecourse debt in excess of fair market value of property is not included in basis).

than its face amount, there is no sound reason for excluding the difference from income.

III. When Has a Debt Been Cancelled?

There are a variety of methods by which a debt can be discharged, in whole or in part, without full payment, and these alternatives complicate identifying cancellation of debt income. The discharge from liability on a debt for less than full payment in cash does not necessarily give rise to cancellation of debt income. The debt might have been discharged in exchange for full payment in another medium. For example, "if an individual performs services for a creditor, who in consideration thereof cancels the debt, the debtor realizes income [under section 61(a)(1)] in the amount of the debt as compensation for services."[58]

A. *Reduction of Amount Due*

Any reduction in the principal amount of a debt results in realization of cancellation of debt income, regardless of whether a new debt instrument has been substituted or the creditor simply agrees to accept a lesser amount in satisfaction of the debt.[59] This is true even if the debtor's obligation that was cancelled is subject to revival upon the occurrence of a contingent future event. In *Jelle v. Commissioner*, the taxpayers owed $269,829 to the Farmers Home Administration (FmHA) on a mortgage loan secured by the taxpayers' farm, which was appraised at a value of $92,057.[60] The taxpayers paid the FmHA the $92,057 "net recovery value" of the loan in exchange for cancellation of the remaining $177,772 of debt, but the cancellation was subject to a "net recovery buyout recapture agreement" under which the taxpayers agreed to repay *pro tanto* the amounts written off by the FmHA in the event they disposed of the farm within a 10–year period for a price that exceeded the $92,057 net recovery value.[61] The taxpayers argued that the debt had not been cancelled before the end of the 10–year period because the "net recovery buyout recapture agreement" was a continuing obligation. The Tax Court disagreed and held that the overall agreement resulted in immediate cancellation of indebtedness income of $177,772 because the obligation to pay the recapture amount was "highly contingent." The recapture agreement was not

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[58] Reg. § 1.61-12(a). For other examples of debt cancellation in which the transaction served as a medium of payment, see *OKC Corp. v. Commissioner*, 82 T.C. 638 (1984) (reduction of pre-existing debt in settlement of litigation not cancellation of debt income because litigated claim was for recovery of lost profits, not for adjustment of the debt), and Revenue Ruling 1984-176, 1984-2 C.B. 34 (creditor's agreement to forgive taxpayer's debt in exchange for release of taxpayer's contract claim was "simply the medium of payment for some other form of income").

[59] *See* I.R.C. § 108(e)(10); Reg. § 1.1001-3(b); Michaels v. Commissioner, 87 T.C. 1412 (1986) (holding that a discount of principal balance due granted by lender on prepayment of home mortgage constitutes cancellation of debt income).

[60] 116 T.C. 63 (2001).

[61] *Id.* at 65–66.

a substitute for the taxpayers' former obligation. "[T]he mere chance of some future repayment" that is either highly contingent or of a fundamentally different nature will not delay the recognition of cancellation of debt income.[62]

Taxpayers have sometimes argued that there was no cancellation of debt income because the existence of a debt was itself uncertain, so that the taxpayer's payment of an amount less than the creditor claimed represented the settling of a dispute over the debt, not cancellation of debt income. This so-called "disputed debt" or "contested liability" doctrine is explored later in this Article.[63]

B. *Significant Modification of Debt Instrument*

1. *Generally*

In many cases, a debtor's obligation will be modified with respect to terms other than the principal amount, for example, the time for payment may be extended, the interest rate reduced, the collateral released, or restrictions imposed by a loan agreement released, without reducing the principal amount due. Historically, changes of this type did not result in the realization of cancellation of debt income even if the fair market value of the resulting new debt obligation was less than the face amount of the old debt obligation.[64] Since 1990, however, section 108(e)(10) has provided that cancellation of debt income is realized whenever a new debt instrument is issued in satisfaction of an existing debt instrument if the "issue price" of the new instrument, determined under the original issue discount rules, is less than the principal amount of the old debt obligation. Under the regulations, whether a new debt instrument has been issued is determined with reference to the principles applied to determine whether a modification is sufficient to treat the creditor as realizing gain or loss on an exchange under section 1001.[65] Generally speaking, the result under the regulations is that the debtor realizes cancellation of debt income whenever the creditor realizes a bad-debt deduction or loss on the exchange.

An exchange, and thus a realization event, occurs whenever there is a "modification" that is "significant," whether through an agreement of the debtor and creditor or a unilateral waiver of rights.[66] Significant modifica-

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[62] *Id.* at 69.

[63] *See infra* Parts III.E. and V.A.2.

[64] *See, e.g.*, Rev. Rul. 1958-546, 1958-2 C.B. 143 (holding that in a bond-for-bond exchange, which changed interest rates and maturities, but not face amount, the debtor realized income only to the extent of cancellation of liability for accrued interest previously deducted with tax benefit); *see generally* James S. Eustice, *Cancellation of Indebtedness and the Federal Income Tax: A Problem of Creeping Confusion*, 14 TAX L. REV. 225, 238–42 (1959).

[65] Reg. § 1.1001–3. The regulations provide that any significant modification of a debt instrument under Regulation section 1.1001-3 generally is treated as an exchange of the original debt instrument for a modified instrument. Reg. § 1.1001-3(b).

[66] Reg. § 1.1001-3(b), (c)(1)(i), (e), (f); *see* Reg. § 1.1001-3(d), Ex. (7) (creditor's unilateral reduction of interest rate to deter debtor from refinancing with another lender).

tions include: (1) changing the annual yield of a fixed principal debt instrument, either through an adjustment to the interest rate or a reduction of the principal, by an amount in excess of the greater of one-fourth of one percent or five percent of the yield of the unmodified instrument (unless attributable to a formula in the original instrument);[67] (2) changing the timing or amount of payments to materially defer payment, either through an extension of final maturity or rescheduling of payments;[68] (3) substituting a new obligor on a recourse debt;[69] (4) altering collateral or guarantees securing a nonrecourse note (unless the collateral is fungible); (5) altering collateral or guarantees securing a recourse debt if the alteration changes payment expectations;[70] and (6) changing a debt from recourse to nonrecourse or vice versa (other than changing a secured debt from recourse to nonrecourse without a change in repayment expectations).[71] Two or more modifications occurring at different times may be treated as a single modification to be tested for significance.[72] However, two or more modifications of different terms that are not individually significant cannot be combined to result in a significant modification.[73] In addition, any modification that, based on all of the facts and circumstances, alters the legal rights or obligations of the parties, to the extent the alterations are "economically significant," triggers a realization event.[74]

Notwithstanding the general rules regarding significant modifications, a creditor's unilateral forbearance of acceleration or collection following a default is not a modification unless it continues for more than two years.[75]

Changes of legal rights or responsibilities pursuant to the original terms of the debt instrument generally are not modifications.[76] For example, the conversion of a variable rate mortgage to a fixed rate mortgage at the borrower's option as provided in the original instrument is not a significant modification.

[67] Reg. § 1.1001-3(e)(2), (g), Ex. (3). Special rules apply to changes in the formula for determining interest under variable rate debt instruments. Reg. § 1.1001-3(e)(2)(iv).

[68] Reg. § 1.1001-3(e)(3), (g), Exs. (2), (4). Deferral of payments is not material unless the extension exceeds the lesser of five years or fifty percent of the original term of the instrument. Reg. § 1.1001-3(e)(3)(ii).

[69] Reg. § 1.1001-3(e)(4)(i), (g), Ex. (6). Addition or deletion of a co-obligor is material if it results in a change in payment expectations. Reg. § 1.1001-3(e)(4)(iii). Substitution of a new obligor is not material if it results from a corporate reorganization or the acquisition of substantially all of the assets of the original obligor (unless the change alters the repayment expectations), as long as there are no other changes. Reg. § 1.1001-3(e)(4)(i)(B), (e)(4)(i)(C), (g), Exs. (2), (4).

[70] Reg. § 1.1001-3(e)(4)(iv), (g), Ex. (9).

[71] Reg. § 1.1001-3(e)(5)(ii).

[72] Reg. § 1.1001-3(f)(3).

[73] Reg. § 1.1001-3(f)(4).

[74] Reg. § 1.1001-3(e)(1).

[75] Reg. § 1.1001-3(c)(4)(ii).

[76] Reg. § 1.1001-3(c)(1)(ii), (c)(2)(i).

However, certain alterations pursuant to the original instrument are designated as modifications by the regulations.[77] These modifications include a change of the obligor, a change of the debt from recourse to nonrecourse, conversion of debt into another property right (other than conversion of debt into equity in the issuer pursuant to the holder's option), and the exercise of certain other options.[78]

If a modification results in a deemed exchange, the obligor's cancellation of debt income is the excess of the adjusted issue price of the original obligation (determined under the original issue discount rules) over the issue price of the new obligation determined under section 1273 or section 1274;[79] it is not merely the reduction in the face amount of the debt. For example, if a substantial modification occurs because of a reduction in principal, the amount of the discharge of indebtedness income realized by the debtor will be more than the amount of nominal principal reduction if the adjusted issue price of the new instrument, determined under section 1274, is less than its stated principal amount. Any excess of the stated principal amount over the issue price will be treated as original issue discount. As a result, over the remaining term of the debt, the debtor will be treated as accruing interest obligation and the creditor will be treated as accruing interest income under the original issue discount rules.[80]

The application of these rules can produce surprising results. Under the original issue discount rules, if the original debt instrument is traded on a public market, the issue price of the new debt instrument is the trading price of the original debt instrument.[81] Because the regulations provide that a debt instrument is considered to be traded on a public market not only if it is traded on an established securities market, but also if (1) it is traded on a board of trade or interbank market, (2) it appears in a quotation medium, or (3) quotations are readily available,[82] many routine bank loans can be considered to be publicly traded, even if held by the original lender. As a result, the simple extension of the due date of a note coupled with an *increase* in the interest rate can give rise to cancellation of debt income. An example of such a situation is provided in Part IV.A.

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[77] Reg. § 1.1001–3(c)(2).

[78] Reg. § 1.1001-3(c)(2); *see* Reg. § 1.1001-3(d), Ex. (4) (substitution of new obligor through transfer of property with transferee assuming debt as permitted by the instrument).

[79] I.R.C. §§ 1271–1274. For the original issue discount rules, *see generally*, BITTKER, MCMAHON & ZELENAK, *supra* note 10, ¶¶ 42.1–42.3.

[80] *See* I.R.C. §§ 1272–1275 (original issue discount rules, which determine the exact amount to be take into account in each year); Reg. §§ 1.61-12(c)(2), 1.163-4 (bond premium and discount).

[81] *See* Reg. § 1.1273-2(c).

[82] Reg. § 1.1273-2(f).

2. *Creditor's Advance Agreement to Discharge Debt for Less than Full Payment*

A creditor might agree when a loan is made that the amount ultimately to be repaid by the debtor will be determined with respect to future events. In certain circumstances, when the reduction in the amount to be paid by the debtor is pursuant to the original terms of the obligation, rather than the result of a negotiated release of a legal obligation, the amount of reduction may constitute income to the debtor, but not cancellation of debt income. In this situation, the debtor will recognize income, but will not be permitted to take advantage of the provisions in section 108, which only apply to cancellation of debt income. For example, when an individual purchases a bank certificate of deposit, a portion of the interest provisionally credited typically will be forfeited if the depositor surrendered the certificate for payment prior to maturity. If the debtor-bank provisionally credits interest to the depositor and claims a tax deduction for the provisionally credited interest, but a portion of the interest is forfeited because the creditor-depositor redeems the certificate before maturity, the debtor bank recognizes income in the amount of the forfeited interest previously credited and deducted.[83] However, in *United States v. Centennial Savings Bank FSB*, the Supreme Court held that the forfeited interest was not cancellation of debt income, because the bank was not "discharged" from any debt.[84] The reduced amount paid was the amount the creditor was entitled to under the original agreement. Because the Court also held that section 108 applies "only to debt reductions stemming from a negotiated forgiveness of a duty to repay," which does not include "'anticipatory discharge' terms in the credit agreement at the outset," none of the section 108 exclusion provisions were available to the debtor-bank.[85]

3. *Modification of Debt in Connection With Sale of Property*

If a debt instrument is modified in connection with a sale or exchange of property, pursuant to which the buyer assumes the debt or takes the property subject to the debt, and the modification triggers exchange treatment, the modification is treated as a transaction between the seller-debtor and the creditor occurring immediately before the sale or exchange if the seller knew, or had reason to know, about the modification, even though the actual modification occurs after the exchange pursuant to an agreement between the purchaser and the creditor.[86] However, the seller and purchaser may jointly elect to treat the transaction as one in which the purchaser first assumed the original unmodified debt instrument and then entered into a transaction with the creditor to modify the debt instrument.[87] Under the general rule, any cancel-

[83]United States v. Centennial Sav. Bank FSB, 499 U.S. 573, 579 (1991).
[84]*Id.* at 579.
[85]*Id.* at 583.
[86]Reg. § 1.1274-5(b)(1).
[87]Reg. § 1.1274-5(b)(2).

lation of debt income under section 61(a)(12) or basis reduction under section 108(e)(5) or sections 108(a)(1)(D) and 108(c) occurs with respect to the seller.[88] Under the election, any such cancellation of indebtedness income or basis reduction occurs with respect to the buyer.

C. *Acquisition of Debt by a Related Party*

Section 108(e)(4) provides that when a debt is acquired by a person related to the debtor from a person who is not related to the debtor, the acquisition is imputed to the debtor and results in cancellation of debt income, to the extent provided by regulations under section 108(e)(4).[89] Section 108(e)(4) most often applies to the acquisition of corporate debt originally held by an unrelated creditor by a corporation (or partnership) affiliated with the debtor corporation. However, the definition of related parties includes any person that is related under the rules of either section 267(b) or section 707(b)(1), and thus catches individuals as well as business entities.[90] Among the more important relationships in section 267(b) are as follows: (1) sections 267(b)(1) and 267(c)(4) treat as related any family member who is a spouse, ancestor, lineal descendant, or sibling (whether by the whole or the half-blood); (2) section 267(b)(2) treats a shareholder and a corporation as related if the shareholder owns, directly or indirectly, more than 50% of the value of the corporation's stock;[91] (3) section 267(b)(3) treats two corporations as related if they are members of the same "controlled group" as defined in section 1563(a), except that 50% stock ownership (rather than 80%, as in the usual application of section 1563) is sufficient to link corporations together in a controlled group—this provision catches both parent-subsidiary corporate relationships and brother-sister corporate relationships;[92] (4) sections 267(b)

[88] *See* Reg. § 1.1274-5(b)(1).

[89] *See* Reg. § 1.108-2. For law predating section 108(e)(4), see *Forrester v. Commissioner*, 4 T.C. 907, 920–21 (1945), *acq.* 1945-4 C.B. 907 (husband and wife treated as separate taxpayers, so wife's acquisition from a creditor of a debt owed by her husband merely effected a substitution of creditors).

[90] Regulation section 1.108-2(d)(2) treats as related any person related within the meaning of section 267(b) or section 707(b), except that the term "family" means an individual's spouse, children, grandchildren, parents, and any spouse of the individual's children or grandchildren, and entities treated as a single employer under section 414(b) or section 414(c) are treated as related. *See* Rev. Rul. 1991-47, 1991-2 C.B. 16 (finding that a corporate debtor realized discharge of indebtedness income when unrelated person formed a new corporation that acquired debtor's outstanding obligations at less than their principal amount and then sold the stock of the newly formed corporation to the debtor).

[91] Ownership of the requisite amount of stock is determined by reference to the constructive ownership rules in section 267(c), which, in a wide variety of relationships, treat taxpayers as owning stock where that stock is actually owned by other persons and entities.

[92] For purposes of applying section 108(e)(4), a parent-subsidiary controlled group is one or more chains of corporations connected through stock ownership with a common parent if at least 50% of the total combined voting power or value of all classes of stock of each corporation (except the common parent) is owned by another member of the group, and the common parent owns at least 50% of the voting power or value of all classes of stock of at least one of the

(4) and 267(b)(6) treat the grantor of a trust and its beneficiaries as related to the fiduciary;[93] and (5) section 267(b)(13) treats a beneficiary of an estate and the estate as related. Under section 707(b), a partner and a partnership, in which the partner owns more than 50% of either the profits or capital interests, are related, as are two partnerships, in which the same partners own more than 50% of the profits or capital interests.[94]

If the taxpayer's obligation is acquired by a related party, the measure of cancellation of debt income generally is the excess of the principal amount of the obligation over the cost to the related party.[95] For example, the acquisition of a $1,000 debt for $600 would give rise to $400 of cancellation of debt income if the debt was owed to a third party and was acquired from the creditor by a person related to the obligor. After the acquisition, the indebtedness is treated as a new obligation issued by the debtor for the amount paid by the related party.[96] As such, the debt will bear original issue discount. As a result, over the remaining term of the debt, the related party creditor will recognize original issue discount income, and the debtor will be entitled to an interest deduction, subject to any applicable limitations under section 163 (or any other provision).

However, an acquisition by a related party is not treated as a discharge of indebtedness if the debt is due within one year after its acquisition and it is retired on or before the stated maturity date.[97]

D. *Lapse of Creditor's Rights*

The debtor realizes cancellation of debt income if a debt becomes unenforceable by the creditor through operation of law. In *Estate of Bankhead v.*

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other corporations (determined by excluding stock of any member of the group held directly by another member of the group). I.R.C. §§ 108(e)(4)(A), 267(f), 1563(a)(1). A brother-sister controlled group exists under section 1563(a)(2) if five or fewer persons who are individuals, estates, or trusts own (or constructively own) stock possessing more than 50% of the total combined voting power of all classes of stock entitled to vote, or more than 50% of the total value of all stock, taking into account the stock ownership of each person only to the extent the stock ownership is identical with respect to each corporation. Section 1563(e) provides constructive ownership rules for determining control.

[93] *See* Wyly v. United States, 662 F.2d 397 (5th Cir. 1981) (holding that no exception to section 267(b)(6) exists for remote contingent beneficiary); Dillard Paper Co. v. Commissioner, 341 F.2d 897 (4th Cir. 1965) (holding that the provision in section 267(b)(4) treating a grantor as being related to the fiduciary of any trust is not limited to a taxable trusts, and, as a result, section 267(a)(1) applies to losses on sales by corporation to employee benefit trust).

[94] *Davis v. Commissioner*, 866 F.2d 852 (6th Cir. 1989), held that for section 707(b)(1)(B) to apply, it is not necessary that the commonly owned interests of each partner in each partnership total more than 50%. Thus, for example, under section 707(b)(1)(B), the A-B partnership, in which A holds a 99% interest and B holds a one percent interest, that sells property at a loss to the B-A partnership, in which B owns a 99% interest and A owns a one percent interest, are related).

[95] Reg. § 1.108-2(f).

[96] Reg. § 1.108-2(g)(1).

[97] Reg. § 1.108-2(e)(1).

Commissioner, the taxpayer was required to recognize cancellation of indebtedness income on loans that became unenforceable because the creditor failed to file necessary claims in the probate of the deceased taxpayer's estate.[98] The court pointed out that the debtor was "enriched by the abolition of a duty to repay money he has previously received and had the unlimited use of. It is this undeniable economic benefit that creates income . . . ."[99] In a similar vein, *In re Higgins* held that the debtor taxpayer realized cancellation of indebtedness income because a secured creditor's failure to seek judicial confirmation of a nonjudicial foreclosure sale within 30 days of the sale, pursuant to state law, barred the creditor from seeking a deficiency against the debtor taxpayer.[100]

E. *Compromise of Disputed Liabilities*

Neither the Code nor regulations precisely define the term "indebtedness" for purposes of determining when there is cancellation of debt income under section 61(a)(12). A now revoked regulation under section 108 previously defined indebtedness as "an obligation, absolute and not contingent, to pay on demand or within a given time, in cash or another medium, a fixed amount."[101] Although that regulation no longer is in force, the principle generally is applied in determining when there has been a cancellation of debt for purposes of section 61(a)(12). Thus, settlement of a claim does not result in realization of cancellation of debt income if there is a bona fide dispute regarding the debtor's liability for the amount claimed by the creditor.[102] In such a case, the amount of the debt is viewed *ab initio* as whatever amount the parties agree upon or a tribunal determines is the amount due.[103] Application of the "disputed debt" (or "contested liability") doctrine requires a bona fide dispute, but does not necessarily require a valid defense.[104]

The judicial disputed debt doctrine clearly applies, where appropriate, to

[98] 60 T.C. 535 (1973).

[99] *Id.* at 540; *see also* Carl T. Miller Trust v. Commissioner, 76 T.C. 191 (1981) (same result).

[100] 403 B.R. 537 (Bankr. E.D. Tenn. 2009).

[101] Reg. § 1.108(b)-1(c) (issued under § 108(b)), removed *by* T.D. 8787, 63 1998-2 C.B. 621.

[102] *See* N. Sobel, Inc. v. Commissioner, 40 B.T.A. 1263 (1939), *nonacq.* 1940-1 C.B. 8.

[103] *See* Estate of Smith v. Commissioner, 198 F.3d 515, 530–31 (5th Cir. 1999), *nonacq. on other issues*, 2000-1 C.B. 16 (The issue was whether an estate realizes discharge of indebtedness income when it settles a disputed claim for less than the amount deducted on the estate tax return under section 2053(a)(3). The court rejected the Commissioner's argument that discharge of indebtedness income resulted from the settlement, holding that both the fact of the liability and its amount were not determined until the case was settled).

[104] *Compare* Zarin v. Commissioner, 916 F.2d 110, 113, 117 (3d Cir. 1990) (settlement for $500,000 of $3.4 million gambling debt owed to casino did not give rise to cancellation of debt income because taxpayer contested enforceability under state law when the casino sought enforcement), *with* Marcaccio v. Commissioner, 69 T.C.M. (CCH) 2420, 2427, 1995 T.C.M. (RIA) ¶ 95,174, at 1072 (settlement of suit for deficiency following mortgage foreclosure resulted in realization of cancellation of debt income because taxpayer never raised a legitimate dispute about the amount of the debt prior to the tax proceeding).

adjustments of the price of services. For example, suppose a taxpayer hires a painter to repaint the taxpayer's residence for $5,000. Upon presentation of the bill for $5,000, the taxpayer claims that because the painter did a sloppy job, the services were worth only $4,000. If the debt is settled for $4,300, the $700 difference between the original contract price and the actual payment is not gross income. As long as the taxpayer never claimed a tax benefit (deduction or basis) grounded on a $5,000 debt, the taxpayer should not be treated as realizing $700 of income when the debt is compromised. On the other hand, if the taxpayer was an accrual method taxpayer and had hired the painter to repaint the taxpayer's business premises, the taxpayer claimed a $5,000 deduction in the year the painter presented the bill for the painting services, notwithstanding the dispute over the amount, and, in a subsequent year, the debt was compromised for $4,300, the taxpayer ordinarily would recognize $700 of gross income under the tax benefit rule.[105]

The judicial disputed debt doctrine also should apply to the purchase of goods or property on credit followed by the payment of a reduced amount to satisfy the purchase price obligation as a result of a dispute over the nature or value of the property originally received.[106] The seminal disputed debt doctrine case involved cancellation of a portion of a debt due to the vendor of property. In *N. Sobel, Inc. v. Commissioner*, the taxpayer purchased 100 shares of stock in a bank from the bank, in exchange for a promissory note.[107] Subsequently, the taxpayer sued for rescission on the grounds that the sale of the stock on credit violated state law and that the seller-bank had failed to perform certain promises. The suit was settled by the taxpayer's agreement to pay half of the principal amount of the note. The Board of Tax Appeals held that the amount of the debt forgiven by the bank "was not the occasion for a freeing of assets and that there was no gain" and that the taxpayer thus did not recognize any cancellation of debt income.[108] However, one court of appeals—erroneously, in our view—has suggested that since the enactment of section 108(e)(5), which provides a statutory purchase price adjustment exception, the tax consequences of an adjustment to the purchase price of property now is governed exclusively by the rules of that statutory provision.[109] We believe that the language of section 108(e)(5) calls for its application where the cancellation of the debt otherwise would result in the recognition of gross income under section 61(a)(12), and that under the disputed debt doctrine, the compromise of purchase money debt owed to the seller of property would not otherwise

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[105] For the tax benefit rule, see generally, BITTKER, MCMAHON & ZELENAK, *supra* note 10, ¶ 3.7[2].

[106] *See* BORIS I. BITTKER & MARTIN J. MCMAHON, JR., FEDERAL INCOME TAXATION OF INDIVIDUALS ¶ 4.05[3][c] (2d ed. 1995).

[107] 40 B.T.A. 1263, 1265 (1939).

[108] *Id.*

[109] *See* Preslar v. Commissioner, 167 F.3d 1323, 1328 n.3 (9th Cir. 1999).

require recognition of gross income under section 61(a)(12). Under this view, section 108(e)(5) is necessary only to, and operates to, exclude cancelled purchase money debt from gross income when the debt is cancelled for a reason other than a dispute regarding the amount due.

In *Zarin v. Commissioner*, the Third Circuit Court of Appeals extended the disputed debt exception to a situation in which there was no question regarding the amount of the debt or what the taxpayer-debtor received.[110] The taxpayer incurred a $3.4 million debt to a gambling casino to purchase chips, which he lost at the gaming tables. The casino filed a state action to collect the funds and eventually settled for only $500,000. Resolution of *Zarin* depends largely upon the conclusion regarding the consideration that the taxpayer received in exchange for the debt. The Tax Court held that Zarin realized $2.9 million of cancellation of debt income because he had received value, in the form of chips, in the year the debt was incurred, and only his obligation to repay had prevented taxation of the value of the chips in that year.[111] The Third Circuit reversed, holding that receipt of chips was not receipt of value because they had no use other than as a medium of exchange for gambling in the casinos and, since the debt was unenforceable under state law, Zarin had merely settled a disputed debt, realizing no income. The court reasoned that "[w]hen a debt is unenforceable, it follows that the amount of the debt, and not just the liability thereon, is in dispute."[112] Therefore, the $500,000 settlement "fixed the amount of loss and the amount of debt cognizable for tax purposes."[113]

Quite simply, *Zarin* was erroneously decided and is unlikely to be generally followed. Under accepted principles that gross income includes the objective, rather than subjective, value of items received in a market transaction, the effect of the Third Circuit's opinion was to allow Zarin to receive $2.9 million tax-free, even though none of the exceptions to section 61(a)(12) or section 108 applied.

In *Preslar v. Commissioner*,[114] the Tenth Circuit dismissed *Zarin* as an erroneous application of the contested debt doctrine and explained the fallacy of its reasoning. Preslar borrowed $1 million from a bank to purchase land. Although the loan documents required payment in cash, Preslar claimed that

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[110] 916 F.2d 110 (3d Cir. 1990), *rev'g* 92 T.C. 1084 (1989). The *Zarin* case has been the subject of much commentary. *See, e.g.*, Theodore P. Seto, *Inside* Zarin, 59 SMU L. REV. 1761 (2006); Daniel Shaviro, *The Man Who Lost Too Much:* Zarin v. Commissioner *and the Measurement of Taxable Consumption*, 45 TAX L. REV. 215 (1990); I. Jay Katz, *Did* Zarin *Have a* Tufts *Day at a Casino Made Out of* Kirby Lumber?, 26 U.C. DAVIS L. REV. 261, 265 (1993).

[111] *Zarin*, 92 T.C. at 1084.

[112] *Zarin*, 916 F.2d at 116.

[113] *Id.*

[114] 167 F.3d 1323, 1328 (10th Cir. 1999).

the bank permitted him to repay the loan through the assignment to the bank of land sales contracts. Subsequently, the FDIC took over the bank and demanded payment in cash. After Preslar sued for breach of contract, he eventually settled with the FDIC by paying $450,000 less than the loan balance. The court held that the disputed debt doctrine did not apply. The *Preslar* court's reasoning explained why *Zarin* is wrong:

> The problem with the Third Circuit's holding [in *Zarin*] is it treats liquidated and unliquidated debts alike. The whole theory behind requiring that the amount of a debt be disputed before the contested liability exception can be triggered is that only in the context of disputed debts is the Internal Revenue Service (IRS) unaware of the exact consideration initially exchanged in a transaction. . . . The mere fact that a taxpayer challenges the enforceability of a debt in good faith does not necessarily mean he or she is shielded from discharge-of-indebtedness income upon resolution of the dispute. To implicate the contested liability doctrine, the original amount of the debt must be unliquidated. A total denial of liability is not a dispute touching upon the amount of the underlying debt.[115]

[115] *Id.* at 1328. The fallacious reasoning of the Third Circuit in *Zarin* is further illustrated by an absurd analogy that it drew in reaching its conclusion. The court stated:

> [I]f 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 lendor (sic) 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.

Zarin v. Commissioner, 916 F.2d 110, 115 (3rd Cir. 1990).

The fact that the obligation is not enforceable should not disguise an accession to wealth in such a case. If the taxpayer initially borrowed $10,000 of *cash*, the presence of a dispute over the enforceability of the debt does not change the fact that the taxpayer has received a $3,000 accession to wealth on this transaction. In *Preslar*, the Tenth Circuit had no difficulty in finding gross income in this situation. A dispute over enforceability or the amount of a debt should affect the recognition of gain on cancellation only if the debt is incurred in exchange for the receipt of something other than cash, such as goods or services that the taxpayer later claims were not worth the original purchase price. In the case of the receipt of cash (or a cash equivalent) there is no room for a dispute regarding the presence of an accession to wealth on cancellation of the debt for less than the amount of cash received.

It is settled law that the discharge of a debt that has become unenforceable under state law because the creditor has failed properly to pursue enforcement produces cancellation of debt income. Estate of Bankhead v. Commissioner, 60 T.C. 535, 539–40 (1973) (cancellation of debt income arose when the creditor failed to file necessary claims in the probate of the deceased taxpayer's estate and the loans therefore became unenforceable); Carl T. Miller Trust v. Commissioner, 76 T.C. 191, 196–97 (1981) (same); *In re* Higgins, 08-1 U.S.T.C. ¶ 50,220, 101 A.F.T.R.2d 910, 913 (Bankr. E.D. Tenn. 2008) (expiration of 30-day statutory period for pursuing a deficiency judgment following a mortgage foreclosure "was an 'identifiable event' giving rise to the discharge of indebtedness . . . taxable to the debtors as income").

Because the debt was for the loan of cash, the amount of the debt was liquidated, and there was no "contest" regarding the amount owed, Preslar realized cancellation of debt income.[116]

Recognize that the fact that a debt was compromised, standing alone, does not establish the existence of a dispute over its amount or validity. To successfully involve the disputed debt doctrine, the taxpayer must introduce direct evidence that he disputed the debt with the creditor in reaching the compromise.[117]

F. *Transfer of Property*

If a debtor transfers property to satisfy a recourse debt owed to the transferee, the transfer is treated as a sale or exchange of the property.[118] The debt is included in the amount realized under section 1001. The debtor-transferor realizes either a gain includable under section 61(a)(3) or a loss, which might be deductible under section 165, as long as the fair market value of the property transferred is at least equal to the amount of the debt satisfied.[119] The same result occurs if property subject to the lien is sold through a foreclosure sale.[120] When a recourse debt secured by a lien is reduced to judgment in a foreclosure suit, the amount realized on a subsequent sale of the property is the actual sales price.[121] Any deficiency resulting from a sales price less than the judgment is a continuing obligation of the debtor, the discharge from which for less than full payment will give rise to cancellation of debt income.

[116] *See also* Waterhouse v. Commissioner, 68 T.C.M. (CCH) 744, 748, 1994 T.C.M. (RIA) ¶ 94,467, at 2476 (disabled veteran realized cancellation of debt income when the Veterans' Administration waived its claim for reimbursement of disability benefits, previously received tax-free under section 104(a)(4) but to which taxpayer was not entitled, following administrative determination that the claim was a valid debt and he was obligated to repay amounts).

[117] *See* Rood v. Commissioner, 71 T.C.M. (CCH) 3125, 3125, 1996 T.C.M. (RIA) ¶ 96,248, at 1785 ("disputed debt" exception did not apply because taxpayer failed to prove existence of any bona fide dispute), *aff'd per curiam*, 122 F.3d 1078 (11th Cir. 1997); Melvin v. Commissioner, 98 T.C.M. (CCH) 159, 2009 T.C.M. (RIA) ¶ 2009-199 (none of the documentary evidence indicated that the debt was "disputed" before it was compromised).

[118] Reg. § 1.1001-2(a)(1). *But see* I.R.C. § 1398(f) (transfer of assets from bankrupt individual to bankrupt estate, or vice versa, is not a disposition of property, unless effected by sale or exchange).

[119] *See* Yarbro v. Commissioner, 737 F.2d 479, 484 (5th Cir. 1984).

[120] Helvering v. Hammel, 311 U.S. 504, 505, 511 (1941).

[121] Aizawa v. Commissioner, 99 T.C. 197, 202 (1992), *aff'd by order*, 29 F.3d 630 (9th Cir. 1994); *see also* Frazier v. Commissioner, 111 T.C. 243 (1998) (where mortgagee bids-in property at an arbitrary amount at a foreclosure sale, the fair market value of property can be established by extrinsic evidence; the sales price is fair market value, not the bid price, and the excess of recourse debt over fair market value is cancellation of debt income, which might be excludable under section 108(a)(1)(B)). *But see* Chilingirian v. Commissioner, 918 F.2d 1251, 1254 (6th Cir. 1990) (treating the entire amount of recourse debt discharged as a result of foreclosure as the amount realized on disposition of the property, without any discussion of the fair market value of the property).

However, the regulations provide that the recourse debt is included in the amount realized only to the extent of the fair market value of the property.[122] Any amount by which the cancelled recourse debt exceeds the fair market value of the property constitutes cancellation of debt income under section 61(a)(12).[123] The regulations provide the following example: A taxpayer "transfers to a creditor an asset with a fair market value of $6,000 and the creditor discharges $7,500 of debt on which [the taxpayer] is personally liable."[124] The regulations bifurcate the transaction into: (1) a disposition of the property with an amount realized of $6,000 (the fair market value of the property); and (2) cancellation of debt income of $1,500 ($7,500 minus $6,000).[125] This distinction is important because, depending on the property involved, any gain might be capital gain or section 1231 gain, taxed at a preferential rate, while cancellation of debt income is ordinary income, but might be excludable under section 108.[126]

If the debt is nonrecourse, then the full amount of the debt is treated as the amount realized on the transfer of the property, regardless of the value of the property, and no cancellation of debt income is realized.[127] However, the amount realized through cancellation of a nonrecourse debt will be limited to the extent the debt was incurred by reason of the acquisition of the encumbered property (*i.e.*, the debt was purchase money debt) and the debt was not taken into account in determining the taxpayer's basis in the property.[128]

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[122] Reg. § 1.1001–2(a), (c), Ex. (8).

[123] Reg. § 1.1001–2(c), Ex. (8); *see* Bressi v. Commissioner, 62 T.C.M. (CCH) 1668, 1674–75, T.C.M. (P-H) ¶ 91,651, at 3228–29 (1993) (applying the bifurcation rule of Regulation section 1.1001-2(a)(2), the excess of the discharged recourse debt over the fair market value of encumbered property transferred to lender in satisfaction of debt was ordinary income; none of the section 108 exceptions applied), *aff'd by order*, 989 F.2d 486 (3d Cir. 1993); Gehl v. Commissioner, 102 T.C. 784 (1994) (applying Treasury Regulation section 1.1001–2(c), only the amount by which a cancelled debt exceeded the fair market value of property transferred to creditor by an insolvent taxpayer in satisfaction of debt could be excluded under section 108(a)), *aff'd by order*, 50 F.3d 12 (8th Cir. 1995); Martin v. Commissioner, T.C. Summ. Op. 2009-121, 2009 WL 2381577 (T.C. Aug. 4, 2009) (taxpayer did not realize any COD income upon foreclosure of lien on an automobile, despite lender's filing of Form 1099-C reporting that taxpayer realized $6,704.92 of COD income, because taxpayer proved that the value of the automobile at least equaled the amount of the $6,704.92 debt that was charged off by the lender).

[124] Reg. § 1.1001-2(c), Ex. (8); *see also* Reg. § 1.1001-2(a)(2) (excluding from amount realized discharged recourse mortgage debt in excess of the fair market value of the encumbered property, but cross-referencing section 108).

[125] Reg. § 1.1001-2(c), Ex. (8).

[126] Reg. § 1.1001-2(a)(2).

[127] Reg. § 1.1001–2(a)(4)(i), (b); Commissioner v. Tufts, 461 U.S. 300, 312 (1983).

[128] Reg. § 1.1001-2(a)(3). This provision is intended to deal with what is commonly called "the purchaser's basis in *Tufts*" issue. For the basis issue, see Erik M. Jensen, *The Unanswered Question in* Tufts*: What Was the Purchaser's Basis?*, 10 VA. TAX REV. 455 (1991).

G. *Compromise of Loan Guarantees*

Notwithstanding that *Kerbaugh–Empire Co.* generally has been discredited as precedent, in some cases the nature of the origin of the debt might be important in determining whether cancellation of debt income has been realized. Generally, cancellation of debt income is not recognized by a guarantor when the obligation is reduced or satisfied for less than full value.[129] In *Payne v Commissioner*, the taxpayer had guaranteed a debt owed by a corporation of which he was a shareholder.[130] Following a default on the loan by the corporation, the taxpayer made a partial payment and the debt was restructured, reducing the debt and, accordingly, his obligation on the guarantee by several hundred thousand dollars. The Tax Court rejected the Commissioner's argument that the taxpayer realized cancellation of debt income and held that the guarantor of a promissory note does not recognize any cancellation of debt income when the amount of the debt is compromised.[131]

When a loan is satisfied by a guarantor, the primary obligor can realize cancellation of debt income. In *Miller v. Commissioner*, the taxpayer-debtor realized cancellation of debt income upon the guarantor's payment of the debt to the creditor because the guarantor had waived any right to reimbursement from the taxpayer-debtor in advance.[132] However, if the guarantor has a right of subrogation, the primary obligor does not realize cancellation of debt income until the resulting obligation to the guarantor is cancelled or

[129] *See* Payne v. Commissioner, 75 T.C.M. (CCH) 2548, 1998 T.C.M. (RIA) ¶ 98,227, *rev'd on other grounds*, 224 F.3d 415 (5th Cir. 2000).

[130] *Id.* at 2553, 1998 T.C.M. (RIA) ¶ 98,227 at 1279.

[131] In reaching its holding, the Tax Court relied on an earlier case that discussed the implications of a release from a loan guarantee.

> In Landreth v. Commissioner, 50 T.C. 803, 812–813 (1968), we distinguished the situation involving a guarantor of a debt from that of a primary obligor on a debt, and we concluded that a guarantor of a debt, upon the payment of the debt by the primary obligor, does not realize discharge of indebtedness income when relieved of an obligation under a guaranty. We stated as follows:
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>> The situation of a guarantor is not like that of a debtor who as a result of the original loan obtains a nontaxable increase in assets. . . . Where a debtor is relieved of his obligation to repay the loan, his net worth is increased over what it would have been if the original transaction had never occurred. This real increase in wealth may be properly taxable. However, where the guarantor is relieved of his contingent liability, either because of payment by the debtor to the creditor or because of a release given him by the creditor, no previously untaxed accretion in assets thereby results in an increase in net worth.
>
> . . . When petitioner's contested liability as guarantor of the debt obligation was settled, petitioner did not realize an increase in net worth, and petitioner is not to be charged with discharge of indebtedness income with regard thereto.

Id. at 2561, 1998 T.C.M. (RIA) ¶ 98,227 at 1290.

[132] 91 T.C.M. (CCH) 1267, 1277–78, 2006 T.C.M. (RIA) ¶ 2006-125, at 921–22.

compromised.[133]

Friedland v. Commissioner involved a related issue.[134] In that case, the taxpayer made an accommodation pledge of appreciated stock in a closely held corporation to secure a debt owed to the bank by a corporation in which his adult son was a majority shareholder. When the debtor corporation defaulted on the loan, the taxpayer's stock was transferred to the bank in satisfaction of the debtor-corporation's debt. The Tax Court held that the taxpayer did not recognize any gain because no amount was realized on the transfer.[135] The regulations treat as an amount realized only the amount of the taxpayer's own indebtedness that is discharged by the transfer of property—not the amount of indebtedness of a third party.[136]

In these situations the primary debtor (not the guarantor) may incur cancellation of indebtedness income. In a guarantee situation, satisfaction of the debt obligation by a guarantor creates a debt from the original debtor to the guarantor. Thus, the failure of the primary debtor to pay the guarantor generally will produce cancellation of debt income for the primary obligor. In certain instances, however, the cancellation of the debt from the primary obligor to the guarantor might be treated as a nontaxable gift, for example, where a parent guarantees a debt of a child, and after the child defaults and the parent pays the child's debt the parent waives the resulting subrogation claim.[137]

IV. Determination of the Amount of Cancellation of Debt Income

If a debt is simply discharged in exchange for a cash payment of less than the full amount of the debt, the amount of cancellation of debt income is easily determined. It is the amount by which the debt exceeds the cash payment. Unless the taxpayer is in a trade or business, or the debt relates to a transaction entered into for profit, transaction costs incurred to secure the cancellation of the debt are neither deductible nor an offset against the amount of the debt cancellation that must be included under section 61(a)(12).[138] There

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[133] *See id.*

[134] 82 T.C.M. (CCH) 492, 494–95, 2001 T.C.M. (RIA) ¶ 2001-236, at 1717.

[135] *Id.*

[136] Reg. § 1.1001-2(a)(1); *see also* INI, Inc. v. Commissioner, 69 T.C.M. (CCH) 2113, 2124, 1995 T.C.M. (RIA) ¶ 95,112, at 693 (finding that, to the extent property transferred to a lender discharged the debts of another corporation owned by the transferor's shareholder, the transferor was not required to include that portion of the discharged debt in its amount realized because the other corporation, not the transferor, was indebted to lender with respect to such debt).

[137] *Compare* Bosse v. Commissioner, 29 T.C.M. (CCH) 1772, 1777, T.C.M. (P-H) ¶ 70,355, at 1937 (1970) (cancellation of debt treated as a gift), *with* Dosek v. Commissioner, 30 T.C.M. (CCH) 688, 690, T.C.M. (P-H) ¶ 71,160, at 721 (1971) (gift status rejected).

[138] Melvin v. Commissioner, 98 T.C.M. (CCH) 159, 2009 T.C.M. (RIA) ¶ 2009-199 (section 61(a)(12) "manifestly does not provide for any kind of deduction;" taxpayers did not argue for a deduction under section 162 because they acknowledged that the amount was not paid with respect to a business and they did not argue for a section 212 deduction because they were in the AMT).

are however, a variety of other manners in which the amount of a debt might be reduced, or the debt satisfied for less than full payment in cash, and determining the amount of cancellation of debt income in those situations can be more complicated.

A. *Substitution of New Debt Instruments*

As explained earlier, under the regulations, a significant modification of a debt instrument, whether or not effected by an exchange of instruments, will result in realization of cancellation of debt income if the principal amount of the previously outstanding debt obligation exceeds the principal amount of the new debt obligation.[139] Computing the amount of cancellation of debt income is not complicated if neither the original debt nor new substituted debt is an original issue discount instrument. A simple comparison of the face amount of the two debts suffices. The computation is more difficult if a debt obligation is issued at a discount, which increases the effective interest rate (or premium, which is an indirect way of reducing the nominal interest rate). Section 108(e)(10) provides that cancellation of debt income is realized whenever a new debt instrument is issued in satisfaction of an existing debt instrument if the "issue price" of the new instrument, determined under the original issue discount rules, is less than the principal amount of the old debt obligation.[140] Thus, the debtor taxpayer's cancellation of debt income is the excess of the adjusted issue price of the original obligation, computed over the issue price of the new obligation, both determined under the original issue discount rules in section 1273 or section 1274, rather than merely the reduction in the face amount of the debt.[141]

That having been said, the new debt instrument will be an original issue discount instrument in many surprising circumstances. As noted earlier, under the original issue discount rules, if the original debt instrument is traded on a public market, the issue price of the new debt is the trading price of the original debt instrument,[142] and under the regulations, a debt can be publicly traded merely as a result of it appearing in a quotation medium or quotations being readily available.[143] Thus, for example, if the due date on a $1,000,000, six percent note is extended, and the interest rate is increased to seven percent at a time when the note is being quoted as available for sale or for purchase at $750,000, there has been a deemed exchange of obligations. The issue price of the new debt instrument is $750,000, and the debtor realizes $250,000 of cancellation of debt income. The $250,000 difference between the $750,000 principal amount of the new debt instrument and its $1,000,000 face amount will be taken into account as original issue discount by both the debtor and

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139 See *supra* Part III.B.1.

140 I.R.C. § 108(e)(10).

141 For the original issue discount rules, see I.R.C. §§ 1272–1275. *See generally* BITTKER, MCMAHON & ZELENAK, *supra* note 10, ¶¶ 42.01–42.03.

142 Reg. § 1.1273-2(c).

143 Reg. § 1.1273-2(f).

creditor over the term of the instrument, giving rise to interest deductions and interest income, respectively.[144]

If a taxpayer issues a debt obligation at a premium (*i.e.*, the proceeds exceed the face amount of the obligation), the issuer does not report the premium as income to the issuer at the time of receipt.[145] Instead, the issuer generally includes bond premium over the term of the bond, using the constant interest method, by reducing the issuer's interest deductions.[146] If a debt instrument issued at a premium is repurchased or otherwise cancelled, section 108(e)(3) requires that any unamortized premium be included in the amount of cancellation of debt income. Thus the cancellation of debt income includes any unamortized premium in addition to the difference between the face amount of the obligation and the lower repurchase price (or amount for which the debt is compromised). If an obligation issued at a discount is repurchased (or compromised), the cancellation of debt income does not include any portion of the original issue discount that has not yet been deducted. But if the obligation is repurchased (or compromised) for an amount less than its adjusted issue price, the amount of cancellation of debt income realized includes all or part of the previously deducted original issue discount previously deducted.[147]

B. *Conversion of Debt into Equity*

1. *Corporate Debtor*

If a corporation issues stock in exchange for outstanding debt obligations, the corporation normally does not recognize cancellation of debt income as long as the value of the newly issued stock is not less than the amount of the debt—section 1032 provides nonrecognition to the corporation. If the debt is represented by a security, the transaction is treated as a tax-free recapitalization under section 368(a)(1)(E).[148] If, however, the corporation is solvent and not in bankruptcy, and the sum of the principal amount of the debt, whether or not represented by a security, plus accrued but unpaid interest exceeds the fair market value of the stock issued in the transaction, then, pursuant to section 108(e)(8), the corporation is treated as having satisfied the indebtedness with an amount of money equal to the fair market value of the stock.[149] As a result, the transaction produces cancellation of debt income to the extent the

[144]Note that in certain circumstances the debt instrument might become an "applicable high yield debt obligation" under section 163(i), with respect to which interest deductions will be partially disallowed under section 163(e)(5). See Notice 2010-11, 2010-4 I.R.B. 326 (Suspending ¶ 163(e)(5) through Dec. 31, 2010 for certain debt modifications).

[145]Reg. § 1.61–12(c)(1).

[146]Reg. § 1.163–13(a).

[147]I.R.C. § 108(e)(5)(C).

[148]*See* Reg. §1.368-2(e)(1); Commissioner v. Capento Secs. Corp., 140 F.2d 382, 385 (1st Cir. 1944).

[149]Any cancellation of indebtedness income realized by an insolvent or bankrupt debtor is excluded from gross income pursuant to section 108(a)(1). *See infra* Part V.B.1.a.

amount of the debt exceeds the value of the stock. Neither section 1032 nor section 361(a), which can apply if a corporation exchanges property for stock in another corporation pursuant to a reorganization, will apply to provide nonrecognition to the corporation.[150]

If a shareholder merely cancels a debt owed by the corporation to the shareholder, the transaction, which otherwise would be treated as a contribution to capital that was tax-free to the corporation under section 118, is treated by section 108(e)(6) as if the corporation satisfied the debt with an amount of money equal to the shareholder's basis in the debt. Cancellation of debt income thus results only if the shareholder's basis in the debt is less than its issue price, which would be unusual. Even if the debt was not originally issued to the shareholder, and the shareholder had subsequently purchased the debt at a discount, section 108(e)(4) would have triggered cancellation of debt income upon the purchase by the shareholder of the corporation's debt at a discount, unless the shareholder was a minority shareholder (and therefore not a related person under section 267(b)(2)).

2. *Partnership Debtor*

Similar principles apply when a partnership's debt is converted into an equity interest in the partnership or increases a pre-existing equity interest in the partnership. The transaction generally is a nonrecognition event under section 721. But if the amount of the debt exceeds the value of the equity interest in the partnership obtained in exchange for the cancellation of the debt, pursuant to section 108(e)(8) the transaction gives rise to cancellation of debt income to the extent the amount of the debt exceeds the value of the partnership interest. The partnership, and thus each partner, realizes cancellation of debt income.[151] Any cancellation of debt income recognized by a partnership under this provision is allocated among the taxpayers who were partners in the partnership immediately before the discharge of the debt.

Proposed regulations would provide that section 721 applies to the creditor's contribution of debt to the partnership in exchange for a partnership interest.[152] Thus, the creditor would not recognize gain or loss on the exchange of partnership debt for a partnership interest. The proposed regulations reflect the Service's belief that a partner or new partner should not recognize an

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[150]Rev. Rul. 1977–437, 1977–2 C.B. 28 (section 361 did not apply to prevent corporation from recognizing cancellation of debt income when, pursuant to a recapitalization, the corporation issued new debt obligations in exchange for old debt obligations with a higher principal amount).

[151]*See* Parker Props. Joint Venture v. Commissioner, 71 T.C.M. (CCH) 3195, 1996 T.C.M. (RIA) ¶ 96,283, *aff'd sub nom.* Twenty Mile Joint Venture v. Commissioner, 200 F.3d 1268 (10th Cir. 1999) (cancellation of approximately $3.5 million of indebtedness to a lender who also held an existing equity interest in the partnership effected through a purported capital contribution of $3.5 million in the form of debt reduction was not respected under substance over form doctrine; partnership recognized discharge of indebtedness income).

[152]Prop. Reg. § 1.721-1(d)(1), 73 Fed. Reg. 64,903, 64,905 (2008).

immediate loss in a debt-for-equity interest exchange subject to section 721 where the liquidation value of the partnership interest received is less than the outstanding principal balance of the indebtedness surrendered.[153] The creditor's basis in the partnership interest would be determined under section 722. The creditor-partner's capital account would be increased by the liquidation value of the partnership interest, and the outside basis of the creditor would include the amount of the adjusted basis of the indebtedness so exchanged. However, under the proposed regulation, the nonrecognition rule of section 721 would not "apply to a transfer of a partnership interest in satisfaction of a partnership indebtedness for unpaid rent, royalties, or interest."[154]

The proposed regulations also would provide that the fair market value of a partnership interest received by the creditor in exchange for debt, which is the benchmark for determining the amount of cancellation of debt income recognized by the partnership, will be treated as the liquidation value of the partnership interest if the partnership properly maintains capital accounts (thereby increasing the amount of the creditor-partner's capital account by the same amount), and the partnership treats the liquidation value of partnership interest as its fair market value for determining the tax consequences of the exchange.[155] This valuation rule would apply only if the debt for equity exchange is an arm's length transaction and, subsequent to the exchange, the creditor's partnership interest is not redeemed by either the partnership or a person related to the partnership in a transaction that is intended to avoid cancellation of debt income by the partnership. If these requirements are not satisfied, then the value of a partnership interest received in exchange for debt would be determined based on all of the facts and circumstances.

3. *Single Member Limited Liability Company Debtor*

A single member limited liability company that has not elected to be taxed as a corporation is a disregarded entity,[156] and its assets, liabilities, income items, and deduction items will be treated as owned, owed, received, and incurred directly by its owner. If one or more additional memberships are issued by the limited liability company to one or more additional persons, the limited liability company automatically becomes a partnership for tax purposes, unless it elects to be taxed as a corporation.[157] There are no authorities dealing specifically with the issuance of a membership unit in a limited liability company in payment of, or in compromise of, a debt of the limited liability company. However, Revenue Ruling 1999-5 addresses the treatment of the conversion of a disregarded entity into a partnership when a limited liability company issues an additional membership to a new member.[158]

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153 Prop. Reg. § 1.108-8, 73 Fed. Reg. 64,903, 64,905 (2008).
154 Prop. Reg. § 1.108-8(b)(1), 73 Fed. Reg. 64,903 (2008).
155 *Id.*
156 Reg. § 301.7701-3(a), (b)(1)(ii).
157 Reg. § 301.7701-3(a), (b)(1)(ii); Rev. Rul. 1999-5, 1999-1 C.B. 434.
158 1999-1 C.B. 434.

In Situation 1 in Revenue Ruling 1999-5, the sole member of the limited liability company sells a membership unit to a purchaser. The revenue ruling treats the transaction as the sale and purchase of a partial interest in each of the limited liability company's assets, followed immediately by a contribution of all of the assets to a partnership. The selling member recognizes gain or loss on the asset sale, but pursuant to section 721, no gain or loss is recognized by either member on the subsequent asset contribution. The selling member's basis in the limited liability company membership interest will be the same as the member's basis in the contributed portion of the limited liability company assets.[159] The purchasing member's basis in the limited liability company membership interest will be the same as the purchase price of the assets deemed to have been contributed.[160]

In Situation 2 in the revenue ruling, on the other hand, a new member contributes cash or property to the limited liability company, the transaction is treated as the formation of a new partnership by both the continuing member, who is deemed to contribute the assets of the existing limited liability company, and the new member, who contributes cash, other property or both. The contributions are nonrecognition transactions under section 721, with transferred and exchanged bases under sections 722 and 723.

The principles of Revenue Ruling 1999-5, combined with the general principles that apply in determining the extent to which cancellation of debt income is realized in connection with the transfer of property to a creditor,[161] can be applied to determine the consequences when a disregarded limited liability company issues a membership unit to a creditor in payment of, or in compromise of, a debt of the limited liability company. The proper treatment, however, depends on the particular facts of the structure of the transaction and on whether the original member of the limited liability company has guaranteed the debt owed to the limited liability company's creditor. There are several possible scenarios.

> *Structure 1*: The original single member has guaranteed the debt, with the result that the debt is a recourse debt, and the transaction is structured as the direct issuance to the creditor by the limited liability company of a membership unit in exchange for cancellation of all or part of the debt. In this case the transaction should be treated as Situation 2 in Revenue Ruling 1999-5; the original member recognizes no gain or loss with respect to the assets of the limited liability company. However, the original limited liability company member recognizes cancellation of debt income to the extent the cancelled debt exceeded the value of the interest in the limited liability company issued to the creditor.[162]

[159] I.R.C. § 722.

[160] I.R.C. §§ 722, 1012.

[161] *See supra* Part III.F.

[162] In addition, the original member may recognize gain under Section 731 as a result of the operation of Section 752(b).

Structure 2: The original single member has not guaranteed the debt, with the result that the debt is a nonrecourse debt, and the transaction is structured as the direct issuance to the creditor by the limited liability company of a membership unit in exchange for cancellation of all or part of the debt. The results in this instance should be the same as in Structure 1. The original member recognizes no gain or loss with respect to the assets of the limited liability company, but would recognize cancellation of debt income to the extent the cancelled debt exceeded the value of the interest in the limited liability company issued to the creditor.[163]

Structure 3: The original single member has guaranteed the debt, with the result that the debt is a recourse debt, and the transaction is structured as the sale of a membership unit to the creditor by the original single member in exchange for cancellation of all or part of the debt. The transaction should be treated as Situation 1 in Revenue Ruling 1999-5. The original member recognizes gain or loss with respect to a proportionate amount of the assets of the limited liability company, with the amount realized being limited to their fair market value.[164] In addition, the original single member recognizes cancellation of debt income to the extent the cancelled debt exceeded a pro rata portion of the value of the underlying assets of the limited liability company.[165]

Structure 4: The original single member has not guaranteed the debt, with the result that the debt is a nonrecourse debt, and the transaction is structured as the sale of a membership unit to the creditor by the original single member in exchange for cancellation of all or part of the debt. The transaction should be treated as Situation 1 in Revenue Ruling 1999-5, but the results differ from those in Structure 3. The original member recognizes gain or loss with respect to a proportionate amount of the assets of the limited liability company. However, in this situation, the amount realized is the full amount of the cancelled debt, and no cancellation of debt income is realized.[166]

C. *Cancellation of Shareholder's Debt to a Corporation*

If a corporation cancels a debt of a shareholder to the corporation (or distributes the instrument to the shareholder), the transaction is not ordinarily treated as a cancellation of debt under section 61(a)(12); the transaction is a distribution from the corporation under section 301, which ordinarily will be taxed as a dividend. The amount of the distribution will be equal to the fair market value of the debt instrument.[167] As a result, none of the exclusions in section 108 will apply to avoid recognition. However, because the distribu-

[163] *See* Rev. Rul. 1991-31, 1991-1 C.B. 19 (reduction to $800,000 of $1 million principal amount of secured nonrecourse debt when value of collateral was $800,000, resulting in $200,000 cancellation of debt income).

[164] Reg. § 1.1001–2(a), (c), Ex. (8).

[165] Reg. § 1.1001–2(c), Ex. (8); *see supra* note 123.

[166] Reg. § 1.1001-2(b), (c), Ex. (7).

[167] Reg. § 1.301-1(d).

tion is treated as a repurchase by the shareholder of the debt instrument for an amount equal to its fair market value, the shareholder realizes cancellation of debt income to the extent the issue price of the debt instrument exceeds its fair market value on the date of the distribution.[168] Similarly, if a corporation cancels a shareholder's debt to the corporation in connection with the liquidation of the corporation, the transaction is not treated as cancellation of debt, but instead the amount of the debt is treated as an additional amount distributed to the shareholder in the liquidation, which under section 331 results in capital gain (or loss).[169]

V. Statutory Exceptions to Recognition of Cancellation of Debt Income

Section 108 provides a significant number of exceptions to recognition of cancellation of debt income. The exceptions that originated as judicial exceptions to the *Kirby Lumber Co.* principle prior to the codification of the cancellation of debt rules are mostly grounded on tax theory. Exceptions that have been enacted by Congress to relieve perceived hardships are not so grounded. This dichotomy has led to differences in the operation of the exceptions. Those exceptions that are grounded in tax theory largely provide permanent nonrecognition; indeed they might better be described as nonrealization rules. On the other hand, most of the exceptions providing nonrecogniton that are grounded on hardship relief are accompanied by a companion rule requiring a reduction of favorable tax attributes. These exceptions are best understood as deferred recognition rules. There are, however, outlier rules on both sides of the dichotomy.

Most of the exceptions in section 108 are permanent features of the Code, but two are temporary rules, enacted in response to the recession that began in 2008. The permanent exceptions are as follows:

1. The section 108(a)(1)(A) exception for discharges in bankruptcy cases.
2. The section 108(a)(1)(B) exception for insolvency situations.
3. The section 108(a)(1)(C) exception for "qualified farm indebtedness."
4. The section 108(a)(1)(D) exception for noncorporate "qualified real property indebtedness."
5. The section 108(e)(2) exception for debts that would have been deductible when paid.
6. The section 108(e)(5) exception for reduction of certain purchase price debt obligations.
7. The section 108(f) exception for certain student loans.

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[168] Rev. Rul. 2004-79, 2004-2 C.B. 106; Reg. § 1.61-12(c)(2).

[169] Robson v. Commissioner, 71 T.C.M. (CCH) 2225, 2229, 2000 T.C.M. (RIA) ¶ 2000-201, at 1140 (shareholder-debtor realized a liquidating distribution equal to the amount of the cancelled debt upon the liquidation of a corporation).

The two temporary exceptions are:

1. The section 108(a)(1)(E) exception for "qualified principal residence indebtedness," which applies if the cancellation occurs on or after January 1, 2007, and before January 1, 2013.
2. The section 108(i) deferral rule allowing cancellation of trade or business debt income realized in 2009 and 2010 to be deferred and included ratably over five tax years beginning in 2014.[170]

A. *Theoretically Grounded Exceptions*

1. *Lost Deductions*

Section 108(e)(2) provides that no cancellation of debt income is realized from the cancellation of a debt that would have given rise to a deduction if it had been paid. Because the taxpayer has not previously received any tax benefit (*i.e.*, a deduction or basis increase) with respect to this type of debt, there is no reason for realization of an offsetting income item when the debt is cancelled. This provision applies primarily to the accounts payable of a cash method trade or business, but it may apply to other items, such as home mortgage interest deductible under section 163(h). It does not apply to accounts payable of accrual method taxpayers because a deduction is allowed when the debt is incurred.[171] No real exclusion is provided by this provision, however, since the deduction is lost by virtue of the debt not having been paid. Section 108(e)(2) simply eliminates the requirement that the discharged amount be included in income and then be treated as constructively paid, thus giving rise to an offsetting deduction.[172]

When a debt for interest due on a loan is cancelled, the application of section 108(e)(2) turns on whether the interest would have been deductible under section 163 if it had been paid. In *Hahn v. Commissioner*, a cash method taxpayer was discharged from an obligation to pay accrued but unpaid interest.[173] The Tax Court held that cancellation of debt income can be realized under the *Kirby Lumber Co.* "freeing of assets" rationale even though the debtor does not receive any cash or other property when he incurred the liability.[174] When a creditor writes off accrued but unpaid interest and fees owed by a cash method debtor, discharge of indebtedness income is realized unless the interest and fees would have been deductible if it had been paid, and section 108(e)(2) thus would have excluded the amount. The court rea-

[170] I.R.C. § 108(i).

[171] *See* Rev. Rul. 1967-200, 1967-1 C.B. 15 (clarified by Rev. Rul. 1970-406, 1970-2 C.B. 16).

[172] *See* I.R.C. § 108(e)(2).

[173] 93 T.C.M. (CCH) 1055, 2007 T.C.M. (RIA) ¶ 2007-075 (denying taxpayer's motion for summary judgment because the issue of whether the interest expenses incurred in a horse breeding activity were deductible as a trade or business expense was a question of fact on which a trial was necessary).

[174] *Id.* at 1056–57, 2007 T.C.M. (RIA) ¶ 2007-075 at 584.

soned that "the right to use money represents a valuable property interest," and that when the taxpayer obtained the right to use the money, he incurred liability for interest and fees that accrued.[175] The release of the obligation to pay interest and the other related items resulted in an accession to wealth due to the freeing of the assets that were offset by this liability. A similar result was reached in *Payne v. Commissioner*, where the taxpayer compromised a credit card debt, including nondeductible interest incurred for personal living expenses.[176]

2. *Purchase Price Reduction*

Section 108(e)(5) provides that cancellation of debt income is not recognized as a result of the reduction of an obligation from the purchaser of property to the seller of the property that arose out of the sale of the property.[177] This statutory exception first arose under the pre-1954 case law.

In *Hirsch v. Commissioner*, the taxpayer acquired property for cash plus the assumption of a mortgage held by a third party.[178] The value of the property declined below the face amount of the mortgage and the taxpayer offered to convey the property to the creditor in exchange for cancellation of the debt. The creditor refused the offer but agreed to reduce the amount of the mortgage by $7,000. The Commissioner asserted that the taxpayer realized cancellation of debt income as a result of a $7,000 balance sheet improvement resulting from reduction of the mortgage. The court held that there was no cancellation of debt income, concluding instead that the taxpayer had merely obtained a reduction in the cost of the property.[179] With a reference to the whole transaction approach of *Kerbaugh–Empire Co.*, the *Hirsch* court stated:

> [The taxpayer's] ultimate gain or loss can not be determined until liquidation of his capital investment. When costs go into property, whether one is to gain or lose must of necessity remain undecided until the property is sold. Credits upon the cost of the investment do not become gain until we find that what is realized upon sale exceeds the total cost, after deducting such voluntary reductions.[180]

A similar result was reached in *Commissioner v. Sherman*.[181] The taxpayer had purchased property for cash and assumption of an existing mortgage debt. Subsequently, the mortgagee accepted partial payment on the debt when the taxpayer contested liability on the debt on the grounds that various

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[175] *Id.* at 1057, 2007 T.C.M. (RIA) ¶ 2007-075 at 584.

[176] 95 T.C.M. (CCH) 1253, 2008 T.C.M. (RIA) ¶ 2008-066, *aff'd per curiam*, No. 08-2396, 2009 WL 4909437 (8th Cir. Dec. 22, 2009); *accord* Melvin v. Commissioner, 98 T.C.M. (CCH) 159, 2009 T.C.M. (RIA) ¶ 2009-199.

[177] I.R.C. § 108(e)(5).

[178] 115 F.2d 656 (7th Cir. 1940).

[179] *Id.* at 658.

[180] *Id.*

[181] 135 F.2d 68 (6th Cir. 1943).

fraudulent misrepresentations had been made to him in connection with the purchase of the property. The *Sherman* court relied on *Hirsh* and *Kerbaugh-Empire Co.* to find only a reduction in the purchase price of the property and no cancellation of debt.

Subsequently, in *Fifth Avenue–Fourteenth Street Corp. v. Commissioner*, the Second Circuit held that the purchase money exception is limited to direct negotiations between the seller and purchaser of encumbered property.[182] The court rejected the logic of various cases, like *Hirsh* and *Sherman*, which had held that *Kirby Lumber Co.* was inapplicable where the debt being reduced was a purchase money obligation incurred by the taxpayer when acquiring property. The court stated that it considered the distinction "irrational . . . and . . ., if valid, . . . limited to a case of a purchase money obligation where the vendor-mortgagee, in negotiations directly relating to the purchase price, agrees to a reduction."[183]

The purchase price reduction exception, as now codified in section 108(e)(5), provides that cancellation of debt income does not include a reduction of an obligation from the purchaser of property to the seller of the property that arose out of the sale of the property. The reduction or cancellation of purchase money debt is treated as a reduction of the purchase price, resulting in a reduction of the basis of the property. The purchase price reduction exception does not apply, however, if the reduction occurred in a Title 11 case or if the purchaser was insolvent. The result of this ordering rule is not to require inclusion in gross income of the discharged indebtedness, but to invoke the reduction of tax attributes rules of section 108(b).[184]

Section 108(e)(5) was enacted to end disputes between the Commissioner and taxpayers over whether cancellation of debt attributable to the purchase of property should be treated as income or as a true reduction in the purchase price of property.[185] The legislative history indicates that the provision applies only to a reduction of debt resulting from direct negotiations between buyer and seller.[186] It is unlikely that *Hirsch* and its progeny represent a more broadly applicable judicial purchase money exception that survived the enactment of section 108(e)(5). Revenue Ruling 1992-99 held that section 108(e)(5) did not apply when a purchase money debt due to a third party lender was reduced through negotiations between the taxpayer-debtor and the creditor.[187] The Service expressly rejected the application of *Hirsch* to a reduction of a nonrecourse debt to a third party lender that was incurred to purchase property that had declined in value.

[182] 147 F.2d 453 (2d Cir. 1944).
[183] *Id.*
[184] *See* discussion *infra* Part V.B.1.
[185] S. Rep. No. 96–1035, at 16 (1980), *as reprinted in* 1980 U.S.C.C.A.N. 7017, at 7031.
[186] *Id.* at 16–17.
[187] Rev. Rul. 1992-99, 1992-2 C.B. 35.

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.[188]

However, the Service indicated that although it would not follow *Sherman* to the extent that *Sherman* relied on *Kerbaugh-Empire Co.* to permit a purchase price adjustment, the Service would treat debt reduction by a third party lender as a purchase price reduction to the extent that the debt reduction was based on an infirmity that clearly related back to the original sale, such as a misrepresentation of a material fact or fraud. But apart from that narrow situation, the Service will not allow a purchase price exclusion, except as provided by section 108(e)(5).[189] There is a logical inconsistency in Revenue Ruling 1992-99, because although the Service suggested it might follow *Sherman* in an instance where the debtor claimed fraud or misrepresentation by the seller as a defense to the creditor's claim, it also described *Fifth Avenue–Fourteenth Street Corp.*, which expressly rejected *Sherman*, as the common law prior to the enactment of section 108(e)(5).[190]

In *Michaels v. Commissioner*, the taxpayer was required to recognize cancellation of debt income on prepayment at a discount of a purchase money home-mortgage debt to a third party lender.[191] The court rejected the taxpayer's argument that the cancellation of debt income was excludable under section 108.[192] *Preslar v. Commissioner* reached the same conclusion: the enactment of section 108(e)(5) pre-empted any pre-existing common law purchase price adjustment exception.[193] Thus, the taxpayer in *Preslar* recognized cancellation of debt income when his obligation on a purchase money mortgage owed to a bank that financed his purchase of the property from a third party was reduced.[194] Similarly, *Payne v. Commissioner* held that the compromise of consumer credit card debt incurred for personal living expenses, including interest, was cancellation of debt income; section 108(e)(5) was inapplicable because the only relationship between the debtor and creditor was the debtor-creditor relationship and there was no purchase of

[188] *Id.*

[189] *Id.*

[190] *Id.*

[191] 87 T.C. 1412 (1986).

[192] *Id.* at 1417.

[193] 167 F.3d 1323, 1332–33 (10th Cir. 1999).

[194] *Id.* at 1333; *see also* Sutphin v. United States, 14 Cl. Ct. 545 (1988) (section 108(e)(5) purchase price adjustment rule did not apply to discount on prepayment of debt to third party lender). *Sutphin* discusses *Hirsh* and *Sherman* as if they might have continued viability in certain circumstances, but *Sutphin* predates *Preslar*. *See supra* note 114. Revenue Ruling 1992-99, 1992-2 C.B. 35, is contrary to Hirsh. *See supra* note 187.

property from the creditor.[195] Following these principles, the purchase money reduction exception also should not be available if there has been a transfer of either the debt or the purchased property to a third party.[196]

Revenue Ruling 2004-37 dealt with the problem of distinguishing disguised compensation from a purchase price adjustment with respect to the purchase of stock in the corporation that employed the taxpayer.[197] The employee purchased stock from his employer by giving the employer a promissory note, and the employer and employee subsequently agreed to reduce the principal amount of the note. The ruling held that the employee recognizes compensation income under section 83, rather than cancellation of debt income excluded under section 108(e)(5).

B. *Legislative Grace Statutory Exceptions*

Section 108 provides a variety of statutory exceptions providing for the exclusion of realized cancellation of debt income. Several of the exceptions are accompanied by rules requiring reduction of tax attributes that convert the exceptions from exclusions to deferred recognition rules, but some of the exceptions provide exclusions.

1. *Bankruptcy and Insolvency Exceptions*

a. *Exclusionary Rules.* Section 108(a)(1)(A) excludes from the debtor's gross income any amount that would otherwise be includable as cancellation of debt income by reason of the discharge of the taxpayer's indebtedness if the discharge occurs in a bankruptcy case, including reorganizations, under Title 11 of the United States Code, provided the taxpayer is under the jurisdiction of the court and the discharge is granted either by the court or pursuant to a plan approved by the court.[198]

Section 108(a)(1)(B) excludes cancellation of debt income realized while the debtor is insolvent, as defined by section 108(d)(3).[199] As discussed above, the insolvency exception originated as a judicial rule based on the freeing of

[195] 95 T.C.M. (CCH) 1253, 2008 T.C.M. (RIA) ¶ 2008-066, *aff'd per curiam*, No. 08-2396, 2009 WL 4909437 (8th Cir. Dec. 22, 2009); *see also* Melvin v. Commissioner, 98 T.C.M. (CCH) 159, 2009 T.C.M. (RIA) ¶ 2009-199 (compromise of consumer credit card debt gave rise to COD income; "[taxpayers] received goods and services (and cash advances) on credit; when Chase relieved them of their corresponding obligation to pay, petitioners without question received an 'accession to income'").

[196] S. Rep. No. 96–1035, at 16–17 (1980), *as reprinted in* 1980 U.S.C.C.A.N. 7017, at 7031.

[197] Rev. Rul. 2004-37, 2004-1 C.B. 583.

[198] I.R.C. § 108(a)(1)(A), (d)(2); *see generally* Paul H. Asofsky, *Discharge of Indebtedness Income in Bankruptcy After the Tax Act of 1980*, 27 St. Louis U. L.J. 583 (1983).

[199] When the year in which a debt is cancelled is important, the fact that a corporation is insolvent and being administered by a trustee in bankruptcy does not in and of itself effect a cancellation of those of the corporation's debts that are highly unlikely to be paid. In addition to the improbability of payment, there must be some identifiable event that fixes the loss with certainty to evidence the cancellation. *See* Friedman v. Commissioner, 216 F.3d 537 (6th Cir. 2000).

assets theory of cancellation of debt income in *Kirby Lumber Co.*[200] *Lakeland Grocery Co. v. Commissioner*, probably the most frequently cited early judicial decision regarding cancellation of debt income, held that an insolvent taxpayer did not recognize cancellation of its debt income only to the extent of the taxpayer's insolvency, but that cancellation of debt income was realized to the extent the taxpayer's assets exceeded its liabilities after the cancellation.[201] The principles of *Lakeland Grocery* are now incorporated into the relevant provisions of section 108. Section 108(a)(3) limits the exclusion of cancellation of debt income under the insolvency exception to the amount by which the taxpayer is insolvent, thus requiring inclusion to the extent that the cancellation of indebtedness renders the taxpayer solvent.[202]

Insolvency is defined in section 108(d)(3) as the excess of the taxpayer's liabilities over the fair market value of the taxpayer's assets.[203] *Carlson v. Commissioner* held that the definition of "insolvent" in section 108(d)(3) requires that all of the taxpayer's assets, including assets exempt from the claims of creditors under state law, be included in determining whether the taxpayer's liabilities exceed his assets.[204] The taxpayer had argued that assets exempt from creditors' claims under state law should be excluded from the calculation, thus making it easier for a taxpayer to demonstrate insolvency. The court rejected this argument. It compared the definition of "insolvent" under the Bankruptcy Code,[205] which expressly excludes exempt property from the calculation, with the definition under section 108(d)(3), which does not do so, and concluded that the difference was intentional.[206] By using the different definition, Congress intended exempt assets not to be excluded from the calculation in determining whether the taxpayer is insolvent for purposes of section 108.

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[200] *See supra* text accompanying note 37.

[201] 36 B.T.A. 289, 292 (1937).

[202] If an insolvent taxpayer transfers property to a lender in satisfaction of a recourse debt, the transferor recognizes gain or loss to the extent of the difference between the fair market value of the transferred property and its basis; only the excess of the cancelled debt over the fair market value of the transferred property is cancellation of debt income that can be excluded under section 108(a). *Compare* Rev. Rul. 1990-16, 1990-1 C.B. 12 (transfer to mortgagee by insolvent taxpayer of property encumbered by recourse debt resulted in realization of gain to the extent the fair market value of property exceeded basis; to the extent debt exceeded fair market value of property, taxpayer realized cancellation of debt income excludable under section 108(a)(1)(B)), *with* Gehl v. Commissioner, 102 T.C. 784 (1994), *aff'd by order*, 50 F.3d 12 (8th Cir. 1995) (applying Treasury Regulation section 1.1001–2(c), only the amount by which a cancelled debt exceeded the fair market value of property transferred to creditor by an insolvent taxpayer in satisfaction of debt could be excluded under section 108(a)).

[203] *See* Rev. Rul. 1992-53, 1992-2 C.B. 48 (amount by which a nonrecourse debt exceeds the value of the secured property is taken into account in determining insolvency only to the extent that the excess nonrecourse debt is discharged).

[204] 116 T.C. 87 (2001).

[205] 11 U.S.C. § 101(26).

[206] *Carlson*, 116 T.C. 87 (2001).

The requirement that all of the taxpayer's assets be taken into account in determining whether the taxpayer is insolvent (and the amount by which the taxpayer is insolvent) can present difficult factual issues if the taxpayer is engaged in a trade or business, because the value of all the taxpayer's intangible assets, such as goodwill and going concern vale of the business, must be included in the calculation.[207]

The original judicial logic still influences the application of the insolvency exception, even though the Supreme Court has held that the statutory insolvency exception is exclusive and prior judicial principles cannot be applied to expand or narrow the statutory rules.[208] Under the logic of *Lakeland Grocery*, only obligations that are certain to offset assets should be taken into account. As a result, contingent liabilities are not taken into account, even at a discounted value that reflects the probability that they will become due and owing. In *Merkel v. Commissioner*, the taxpayers attempted to exclude cancellation of debt income under the insolvency exclusion by including contingent liabilities in the insolvency calculation.[209] Most of the contingent liabilities were in the form of guarantees made by the taxpayers. Under a compromise settlement, about one-third of the amount due to a creditor of a corporation owned by the taxpayers was paid, and the creditor agreed not to exercise any remedies against the corporation or the taxpayers' guarantees with respect to the remaining portion of the loan if a voluntary or involuntary bankruptcy was not filed with respect to the corporation within 400 days. However, the remaining portion of the obligation would become due, and the guarantees could be enforced if taxpayers or their corporation filed for bankruptcy within 400 days of the settlement. The taxpayers also attempted to include corporate debts for uncollected state sales taxes that had been asserted against the corporation, but were being protested by the corporation, for which they might have been contingently liable as corporate officers. Neither the creditors nor the state had yet asserted claims against taxpayers.

The Tax Court held that the taxpayers were not insolvent as defined in section 108(d)(3), and that contingent liabilities are not taken into account in determining whether the taxpayer is insolvent for purposes of section 108(d)(3). The court reasoned that the analytical framework underlying the insolvency exception is based on the freeing of assets theory of discharge of indebtedness income. Under this analytical framework, if all of the debtor's assets are subject to the claims of creditors after the cancellation of a debt, the taxpayer is no better off by reason of the debt cancellation, and thus realizes no income. To meaningfully apply this analysis, only obligations that offset

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[207] *See* Conestoga Transp. Co. v. Commissioner, 17 T.C. 506 (1951) (going concern value); J.A. Mauer, Inc. v. Commissioner, 30 T.C. 1273 (1958) (goodwill; semble). However, an individual's business "experience" and business relationships that do not amount to going concern value or goodwill are not valued and taken into account. Davis v. Commissioner, 69 T.C. 814 (1978).

[208] Gitlitz v. Commissioner, 531 U.S. 206 (2001).

[209] 109 T.C. 463 (1997), *aff'd*, 192 F.3d 844 (9th Cir. 1999).

assets with a sufficient degree of certainty should be taken into account. The opinion noted that the insolvency exception does not necessarily produce the same result as the bankruptcy exception. On appeal, the Court of Appeals for the Ninth Circuit affirmed the Tax Court and held that for the purposes of determining insolvency under section 108(d)(4), a contingent liability would be included as a liability only if the taxpayer could prove by a preponderance of the evidence that he or she would be called upon to pay the contingent liability—a more-likely-than-not test.[210] The contingent liabilities could not be taken into account at a discounted value reflecting the probability of that the liability ripening.

On the other hand, if the taxpayer is unconditionally obligated to repay a debt, the fact that it is unlikely that the taxpayer ever actually will be called upon to pay the debt does not prevent the debt from being taken into account. In *Miller v. Commissioner*, the taxpayer's liabilities, the cancellation of which give rise to cancellation of debt income, were counted in full as liabilities in determining whether the taxpayer was insolvent, even though, because the taxpayer was insolvent and the loan was guaranteed by a solvent third party, there was virtually no likelihood that taxpayer would be called upon to pay the debt and the guarantor had waived his right to indemnification in advance.[211]

Nonrecourse debt presents yet another problem in determining insolvency because it reduces the net value of the encumbered property, but does not otherwise reduce the taxpayer's net worth. Thus, the Service has ruled that 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, but only with respect to a cancellation of the nonrecourse debt.[212] For example, if a taxpayer has an asset worth $1,000, which is encumbered by a $900 recourse liability, and a second asset worth $2,000, which is encumbered by a $2,300 nonrecourse liability, and a portion of the nonrecourse liability is cancelled, the taxpayer is insolvent before the cancellation. The taxpayer's liability is determined to be the sum of the $900 recourse liability, the $2,000 fair market value of the property encumbered by the nonrecourse debt, and the amount of the excess nonrecourse debt to the extent that it has been cancelled. The taxpayer has assets worth $3,000 ($2,000 plus $1,000) and liabilities of up to $3,200. Cancellation of up to $200 of the nonrecourse debt will be excluded from cancellation of debt income under the insolvency exception. But if the recourse liability is cancelled, the taxpayer is not insolvent before the cancellation. In this case, the nonrecourse liability in excess of the fair market value of the encumbered property is not counted. So the taxpayer again has $3,000 of assets, but only $2,000 of liabilities ($900 recourse and only $2,000 nonrecourse).

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[210] *Merkel*, 192 F.3d at 851–52.

[211] 91 T.C.M. (CCH) 1267, 2006 T.C.M. (RIA) ¶ 2006-125.

[212] Rev. Rul. 92-53, 1992-2 C.B. 48.

b. *Attribute Reduction Rules.* When cancellation of debt income is excluded under section 108(a)(1), the taxpayer is required to reduce certain tax attributes by the amount of income excluded under section 108. Thus, to the extent tax attributes are reduced, sections 108(a)(1)(A) and (B) operate only to defer tax liability, rather than as an absolute exclusion. Section 108(b)(2) requires the taxpayer to reduce favorable tax attributes in the following order: (1) net operating losses,[213] (2) general business credit carryovers, (3) minimum tax credits, (4) net capital loss carryovers, (5) basis of property, (6) passive activity loss and credit carryovers, and (7) foreign tax credit carryovers. The affected tax attributes are reduced by one dollar for each dollar of excluded cancellation of debt income, except for credits, which are reduced by one-third of excluded cancellation of debt income.[214] These attribute reductions will increase the taxpayer's taxable income or gain (or decrease the taxpayer's loss) on the disposition of property in future years.[215] To the extent the basis of depreciable property is reduced, the attribute reduction results in lesser depreciation deductions in future years thereby increasing future taxable income by the amount of the deferred cancellation of debt income. If the amount of excluded cancellation of debt income cannot be absorbed by the taxpayer's tax attributes, the excess is effectively exempt from tax.

In lieu of the attribute reductions mandated by section 108(b)(2), the taxpayer may elect under section 108(b)(5) to first reduce the basis of depreciable property.[216] (A basis reduction under section 108(b)(2)(E) attributable

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[213]The amount of net operating loss (NOL) carryovers to which a taxpayer succeeds from his bankruptcy estate pursuant to section 1398(i) may be limited because of this rule. *See* Firsdon v. United States, 95 F.3d 444 (6th Cir. 1996) (the taxpayer failed to prove that the bankruptcy estate's NOL carryover of $345,424 was the NOL remaining after reduction under section 108(b)); *see also* Kahle v. Commissioner, 73 T.C.M. (CCH) 2080, 1997 T.C.M. (RIA) ¶ 97,091 (taxpayer's bankruptcy estate succeeded to prebankruptcy NOL because taxpayer did not make a short year election under section 1398(d), and pursuant to sections 108(b) and 108(d)(8), as a result of nonrecognition of cancellation of indebtedness income arising from bankruptcy, the NOL was eliminated and thus unavailable to the taxpayer for postbankruptcy years).

[214]I.R.C. § 108(b)(3).

[215]In *Williams v. Commissioner*, the bankrupt taxpayer owned all of the shares of an S Corporation. 123 T.C. 144 (2004). The Tax Court held that under section 1398(f)(1), "a transfer of an asset from the debtor to the bankruptcy estate when the debtor files for bankruptcy is not a disposition triggering tax consequences, and the estate is treated as the debtor would be treated with respect to that asset." *Id.* at 148–49. Thus, the bankruptcy estate was treated as if it had owned all of the shares of the S corporation for the entire year and was entitled to all of the passed-through losses. Furthermore, pursuant to section 108(b)(2), any passed-though losses to which the bankruptcy estate succeeded, or losses that were passed through to the bankruptcy estate and which were not used to offset income realized by the bankruptcy estate, were reduced by the amount of cancellation of debt income that was not recognized under section 108(a) before being passed on to the taxpayer upon termination of the bankruptcy proceeding pursuant to section 1398(i).

[216]I.R.C. § 1017(b)(3); *see* Reg. §§ 1.108-4, 1.1017-1 (operating rules governing the election to reduce the basis of depreciable property); *see also* Rev. Proc. 1985-44, 1985-2 C.B. 504 (procedures for closing agreements).

to cancellation of debt income excluded under section 108(a) can apply to property that is not depreciable.)

Section 1017 and the regulations thereunder provide complex rules regarding basis reductions, whether under section 108(b)(2) or section 108(b)(5). If the basis of property is reduced under section 108(b)(2)(E) by virtue of the taxpayer's insolvency or bankruptcy, the aggregate basis reduction cannot exceed the amount by which the aggregate of the bases of the property held by the taxpayer immediately after the debt cancellation exceeds the aggregate of the liabilities of the taxpayer immediately after the cancellation.[217] This limitation does not apply, however, if the taxpayer elects under section 108(b)(5) to bypass the section 108(b)(2) attribute reduction rules and reduce only the basis of depreciable property.[218]

Section 1017(d) requires that basis reductions under section 108(b)(2) and section 108(b)(5) be treated as depreciation adjustments to basis, which will be subject to recapture as ordinary income under sections 1245 and 1250. As a result, whenever the basis of depreciable real property is reduced, the property will carry with it until the end of its cost recovery period some amount of section 1250 ordinary income recapture taint. Furthermore, any property for which the basis is reduced under section 1017 that is neither section 1245 property nor section 1250 property is treated as section 1245 property.[219] As a result, assets such as land and corporate stock, which otherwise would be a capital asset (or in the case of land, often a nondepreciable section 1231 asset), the basis of which has been reduced under section 1017, will carry with them a permanent section 1245 ordinary income recapture taint.

The regulations under section 1017 prescribe the rules regarding basis reductions under section 108(b)(2)(E) that are required if the bankruptcy or insolvency exception applies. To the extent of the excluded cancellation of debt income, the adjusted bases of property held on the first day of the taxable year following the taxable year that the taxpayer excluded the income are reduced (but not below zero) in the following order: (1) real property used in a trade or business or held for investment (other than real property described in section 1221(a)(1) (*i.e.*, property held for sale primarily to customers in the ordinary course of business)) that secured the cancelled debt immediately before the cancellation; (2) personal property used in a trade or business or held for investment (other than inventory, accounts receivable, and notes receivable) that secured the cancelled debt immediately before the cancellation; (3) any remaining property used in a trade or business or held for investment (other than inventory, accounts receivable, notes receivable, and real property described in section 1221(a)(1)); (4) inventory, accounts receivable, notes receivable, and real property described in section 1221(a)(1); and (5)

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[217] I.R.C. § 1017(b)(2).

[218] *Id.*

[219] I.R.C. § 1017(d)(1)(A).

property not used in a trade or business nor held for investment.[220] Within each category, the bases of the properties are reduced in proportion to their respective bases.[221] Section 1017(b)(3)(F) allows the taxpayer to elect to treat real property held for sale to customers in the ordinary course of business as depreciable property for purposes of applying the basis reduction rules.[222]

When the bankruptcy exception of section 108(a)(1)(A) applies to an individual, the attribute reduction rules apply to the bankruptcy estate, not to the individual.[223] However, the basis reduction rules of section 1017 apply to the individual bankrupt taxpayer to the extent property is transferred by the bankruptcy estate to the individual.[224]

The taxpayer's tax liability for the year of cancellation is determined without any reduction under section 108(b) in attributes that carryover to the current year or that carryback to prior years, before such tax attributes are reduced.[225] "This ordering rule affords the taxpayer the use of certain of its tax attributes described in section 108(b)(2), including any losses carried forward to the taxable year of cancellation, for purposes of determining its tax for the taxable year of discharge, before subjecting those attributes to reduction."[226] Basis reductions under section 1017 occur at the beginning of the taxable year following the year in which the cancellation occurred.[227]

An interesting—and for the taxpayer, unpleasant—result occurs when the section 108(a)(1)(A) bankruptcy exception applies and a mortgage lien survives the bankruptcy. When personal liability on the debt is discharged but the lien survives, the debt is transformed into a nonrecourse debt. When the property is sold or foreclosed upon, the amount of any remaining nonrecourse debt encumbering the property is included in the amount realized by the taxpayer along with any cash received.[228]

c. *Special Issues Regarding Cancellation of Debt Income of Pass-Through Entities.*

i. *Partnerships and Limited Liability Companies.* Section 108(d)(6) requires that the bankruptcy and insolvency exceptions to cancellation of debt income be applied at the individual partner level rather than at the partnership level.[229] Thus, cancellation of debt income realized by an insolvent or bankrupt partnership or limited liability company may be excluded only by those part-

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[220] I.R.C. § 108(b)(4)(A); Reg. § 1.1017-1(a).

[221] Reg. § 1.1017-1(a).

[222] I.R.C. § 1017(b)(3)(F).

[223] I.R.C. § 108(d)(8).

[224] I.R.C. § 108(d)(8).

[225] Reg. § 1.108-7(b).

[226] T.D. 9080, 2003-2 C.B. 696 (Reduction of Tax Attributes Due to Discharge of Indebtedness).

[227] *See* Reg. § 1.1017-1(a), (b)(4).

[228] *See* Neighbors v. Commissioner, 76 T.C.M. (CCH) 128, 1998 T.C.M. (RIA) ¶ 98,263.

[229] Thus, partnership cancellation of debt income is a separately stated item under section 702(a). Rev. Rul. 1992-97, 1992-2 C.B. 124.

ners that are themselves insolvent.[230] Concomitantly, the attribute reduction rules of section 108(b) are applied at the individual partner level. However, the Service will not challenge the treatment by an insolvent or bankrupt partnership of a discharge of a purchase money indebtedness as an adjustment to purchase price under section 108(e)(5), rather than as separately stated cancellation of indebtedness income, if the cancellation otherwise would have qualified as a purchase price adjustment, as long as all partners report the treatment consistently.[231] In effect, this permits an insolvent partnership to elect whether to treat the debt cancellation as a purchase price reduction under section 108(e)(5) or to pass through cancellation of debt income, which could be excluded only by insolvent partners.

ii. *S Corporations.* In the case of an S Corporation, the insolvency and bankruptcy exceptions in section 108(a) are applied at the corporate level.[232] However, section 108(d)(7), which was enacted in 1992 to overturn the Supreme Court's decision in *Gitlitz v. Commissioner*,[233] provides that amounts excluded under section 108(a) will not be taken into account as a separately

[230]Revenue Ruling 1992-97, 1992-2 C. B. 124, held that under Regulation section 1.731-1(a)(1)(ii) the deemed distribution to a partner under section 752(b) resulting from the cancellation of a partnership debt that gave rise to cancellation of debt income under section 61(a)(12) is treated as occurring after the increase in the partners' bases in their partnership interests resulting from the cancellation of debt income. Thus, if the partners share income and loss in the same percentages as they shared the cancelled debt, each partner will take into account a pro rata share of the cancellation of debt income, and the basis adjustments for the passed-though income and the deemed distribution exactly offset each other, with no gain resulting under section 731. If, however, a particular partner's share of partnership liabilities exceeds the partner's distributive share of partnership income from the cancellation of the debt, the constructive distribution might exceed the partner's basis for his partnership interest, resulting in recognition of gain under section 731.

[231]Rev. Proc. 1992-92, 1992-2 C.B. 505.

[232]I.R.C. § 108(d)(7)(A).

[233]531 U.S. 206 (2001). In *Gitlitz*, the taxpayer was the sole shareholder of an S corporation that realized cancellation of debt income while it was insolvent. Under section 108(a), the corporation properly excluded the cancellation of debt income. Upon the subsequent disposition of the stock (in the same year), the taxpayer shareholder claimed an increase in the basis of his stock in the corporation pursuant to sections 1367(a)(1)(A) and 1366(a)(1)(A) on the theory that the cancellation of debt income was passed-through "exempt" income, and reported a long-term capital loss. Reversing the lower courts, the Supreme Court concluded that cancellation of the debt was "income" within the meaning of section 1366(a)(1)(A), which increases shareholder basis under section 1367(a)(1)(A). In addition, although section 108(d)(7)(A), as in effect for the year in question, provided that the exclusions of section 108(a) and the attribute reductions required by section 108(b) were to be applied to an S corporation at the corporate level, the Supreme Court concluded that section 108(b)(4)(A), which provides that attribute reduction under section 108(b)(2) takes place "after the determination of the tax imposed by this chapter," expressly requires that the S corporation's shareholder's pass-through of income and basis adjustment must be taken into account before the cancellation of debt income is reduced by corporate level net operating losses. As a result of this reasoning, the S corporation shareholder in *Gitlitz* received a tax-free step-up in basis that he was able to convert into a deductible capital loss.

stated item of tax exempt income under section 1366(a)(1)(A).[234] As a result, the S corporation's shareholders do not receive any step-up in the basis of their shares under section 1367.

2. *Qualified Farm Debt Exception*

Section 108(a)(1)(C) excludes cancellation of "qualified farm indebtedness," which is defined in section 108(g). Qualified farm indebtedness is a debt that was incurred directly in connection with the taxpayer's operation of a farming trade or business. To qualify, fifty percent or more of the taxpayer's aggregate gross receipts for the three taxable years preceding the taxable year in which the cancellation of the debt occurs must be "attributable to the trade or business of farming".[235] Furthermore, to qualify the debt must be owed to a "qualified person," which generally speaking is a person actively and regularly engaged in the business of lending money other than a person related to the taxpayer, a person from which the taxpayer acquired the property (or a related person to such person), or a person who receives a fee with respect to the taxpayer's investment in the property (or a related person to such person).[236]

The amount excluded under the qualified farm debt exception cannot exceed the sum of: (1) the taxpayer's "adjusted" tax attributes described in section 108(b)(2), excepting the basis of property, and (2) the aggregate adjusted bases of the taxpayer's "qualified property." Qualified property is defined as any property that is used or is held for use in a trade or business or for the production of income as of the beginning of the taxable year following the taxable year in which the cancellation occurred.[237] "Adjusted tax attributes" are the sum of the tax attributes described in section 108(b)(2), excepting the basis of property, redetermined by taking into account $3 for each $1 of general business credit, minimum tax credit, foreign tax credit carryover, and passive activity credit carryover.[238]

If the qualified farm indebtedness exception applies, any basis reduction under section 108(a)(2)(B) is made only with respect to qualified property, in the following order: (1) depreciable property; (2) land used or held for use in

[234]*See also* Reg. § 1.1366-1(a)(2)(viii).

[235]I.R.C. § 108(g)(2). *See* Lawinger v. Commissioner, 103 T.C. 428 (1994) (cancellation of debt income could not be excluded under section 108(a)(1)(C) because less than one half of taxpayer's gross receipts, including proceeds from sale of farming equipment, were from farming; rents and credits from the State of Wisconsin for preserving land as farmland were not taken into account as farm income).

[236]I.R.C. §§ 108(g)(1), 49(a)(1)(D)(iv). Through a string of cross-references, "related person" is defined as a person in a relationship described in section 267(b) or section 707(b)(1), or persons engaged in trades or business under common control.

[237]I.R.C. § 108(g)(3). For purposes of determining the ceiling on qualified farm indebtedness, the adjusted basis of any qualified property and the amount of the adjusted tax attributes are determined after any reduction under section 108(b) resulting from application of the insolvency exclusion. I.R.C. § 108(g)(3)(D).

[238]I.R.C. § 108(g)(3)(B).

farming; and (3) other qualified property.[239]

With respect to partnerships, as in the case of the bankruptcy and insolvency exceptions, section 108(d)(6) requires that the qualified farm indebtedness exception in section 108(a)(1)(C) and (g), and the concomitant attribute reduction rules, be applied at the individual partner level. In the case of cancellation of debt of an S Corporation, the qualified farm indebtedness exception in section 108(a)(1)(C) and (g) and the concomitant attribute reduction rules are applied at the corporate level.[240]

3. *Real Property Business Debt*

Sections 108(a)(1)(D) and 108(c) allow noncorporate taxpayers to elect to exclude income arising from cancellation of "qualified real property business indebtedness."[241] Qualified real property business indebtedness is indebtedness incurred in connection with, and secured by, real property used in a trade or business.[242] This provision is intended to facilitate refinancing for distressed real estate projects. Accordingly, the exclusion is limited to the amount by which qualified real property indebtedness exceeds the fair market value of property secured by the debt.[243] This limitation has the effect of limiting the exclusion under section 108(a)(1)(D) to so-called "phantom gain." To assure that the exclusion results only in deferral and not permanent exclusion, section 108(c)(2)(B) further limits the amount of the exclusion to the aggregate adjusted basis of depreciable real property held by the taxpayer immediately before the cancellation.

"Qualified real property business indebtedness" includes only: (1) debt incurred or assumed by the taxpayer before 1993 "in connection with" real property used by the taxpayer in a trade or business and secured by the real property; and (2) debt incurred or assumed after 1992 to acquire, construct, reconstruct, or substantially improve the property secured by the debt or to refinance qualifying pre-1993 indebtedness to the extent the refinancing does not exceed the original debt. Under this definition, the use of the proceeds of pre-1993 indebtedness appears to be irrelevant as long as the debt is secured by real property used in the taxpayer's trade or business.[244]

If the taxpayer elects to apply the qualified real property business indebtedness exception, the taxpayer must reduce the basis of depreciable real prop-

[239] I.R.C. § 1017(b)(4)(A).

[240] I.R.C. § 108(d)(7)(A).

[241] The election must be made on a timely return (including extensions) for the taxable year in which the cancellation of indebtedness income was realized, and it is revocable only with the consent of the Service. Reg. § 1.108-5.

[242] I.R.C. § 108(c)(3) (qualified real property business indebtedness is defined to expressly exclude qualified farm indebtedness).

[243] I.R.C. § 108(c)(2)(A); Reg. § 1.108-6. For this purpose the fair market value of the property is reduced by the principal amount of any other qualified real property business indebtedness secured by the property.

[244] I.R.C. § 108(c)(3), (c)(4).

erty by the excluded amount under the rules of section 1017.[245] In effect, the exception operates as a purchase price reduction. The regulations provide ordering rules under which the basis of the qualifying real property with respect to which the debt was cancelled is reduced first, and any remaining excluded cancellation of debt income is applied to reduce the basis of other real property held by the taxpayer for use in a trade or business or as an investment.[246] The basis reduction applies only to depreciable real property.[247] Generally, the basis reduction occurs at the beginning of the taxable year following the year of the debt cancellation.[248]

If the taxpayer is in the trade or business of farming, the qualified farm indebtedness rules take precedence, if applicable.[249] If a debtor is insolvent at the time of the debt cancellation, the insolvency exception, rather than the qualified real property business indebtedness exception applies.[250]

If the cancelled debt is partnership debt, section 108(d)(6) requires that the qualified real property business indebtedness exception in section 108(a)(1)(D) and section 108(c), and the concomitant attribute reduction rules be applied at the individual partner level, rather than at the partnership level.[251] Because the required basis reduction must be made only with respect to real property, and the exclusion is available only if the basis of depreciable real property is reduced, section 1017(b)(3)(C) permits a partner to treat the partner's interest in a partnership as depreciable property to the extent of the partner's proportionate interest in the partnership's depreciable property, provided that the partnership makes a corresponding reduction in its basis in depreciable property with respect to the electing partner.[252] As result of such a basis reduction, section 1250 ordinary income recapture will apply with respect to any real estate the basis of which has been adjusted, and section 751(a) of section 751(b) ordinary income treatment, respectively, will be triggered with respect to the partner upon a subsequent sale or exchange of the partnership interest or upon receipt of a distribution that alters the partner's interest in section 751(c) "hot assets."[253]

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[245] I.R.C. §§ 108(c)(1)(A), 1017(a)(1).

[246] Reg. § 1.1017–1(c)(1).

[247] I.R.C. § 1017(b)(3); Reg. § 1.1017–1(c)(1).

[248] I.R.C. § 1017(a).

[249] I.R.C. § 108(c)(3).

[250] I.R.C. § 108(a)(2)(B).

[251] I.R.C. § 108(d)(6).

[252] A partner's proportionate share of the partnership's basis in depreciable real property equals the sum of (1) the partner's section 743(b) basis adjustments to partnership depreciable real property, and (2) the common basis depreciation deductions (excluding allocations of depreciation deductions under section 1.704-3(d)) that are reasonably expected to be allocated to the partner over the property's remaining useful life. Reg. § 1.1017-1(g)(2)(iv). *See* Reg. § 1.1017-1(g)(2)(i)–(iii) for the procedural rules governing such elections.

[253] I.R.C. §§ 751(a)-(c), 1250(d)(5).

In the case of an S Corporation, the qualified real property business indebtedness exception in section 108(a)(1)(D) and section 108(c) and the concomitant attribute reduction rules are applied at the corporate level.[254]

4. *Election to Defer and Ratably Include Cancellation of Debt Income*

The American Recovery and Reinvestment Tax Act of 2009 added section 108(i), which allows a taxpayer to irrevocably elect to defer and include cancellation of debt income realized in 2009 and 2010 ratably over five tax years, rather than in the year the discharge occurs, if the debt was issued in connection with the conduct of a trade or business or by a corporation.[255] Although the statute refers to cancellation of debt income arising from "reacquisition" of an "applicable debt instrument," the statutory definitions of "reacquisition" and "an applicable debt instrument," respectively, are broad enough for the provision to apply regardless of the manner in which the debt is cancelled. Section 108(i)(4)(B) defines "acquisition" to include: (1) an acquisition of the debt instrument for cash; (2) the exchange of the debt instrument for another debt instrument, including an exchange resulting from a modification of the debt instrument (which includes a reduction of the principal amount of the debt); (3) the exchange of the debt instrument for corporate stock or a partnership interest; (4) the contribution of the debt instrument to capital; and (5) the complete forgiveness of the indebtedness by the holder of the debt instrument. In addition, published Service guidance provides that "the term 'acquisition' also includes an acquisition of the debt instrument for other property."[256] Thus, for example, the cancellation of a debt in connection with a deed in lieu of foreclosure qualifies as a reacquisition. Section 108(i)(3)(B) broadly defines "applicable debt instrument" to include a bond, debenture, note, certificate, or any other instrument or contractual arrangement constituting indebtedness within the meaning of section 1275(a).

The section 108(i) election is made separately for each debt instrument. An election may be made for one debt instrument, but not for another.[257] A taxpayer may elect to defer only a portion of the cancellation of debt income realized from the reacquisition of any applicable debt instrument.[258] Thus, for example, if a taxpayer realized $1,000 of cancellation of debt income eligible for deferral under section 108(i), the taxpayer may defer only $300 of the $1,000. Any cancellation of debt income that the taxpayer does not elect to defer may be excluded from income under section 108(a)(1)(A), (B), (C), or (D), if applicable.

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[254] I.R.C. § 108(d)(7)(A).

[255] For election procedures, see Rev. Proc. 2009-37, 2009-36 I.R.B. 309.

[256] Rev. Proc. 2009-37, 2009-36 I.R.B. 309, § 2.03.

[257] Rev. Proc. 2009-37, 2009-36 I.R.B. 309, § 2.04.

[258] *Id.*

For partnerships and S corporations, the election is made by the partnership or S corporation, not by the individual partners or shareholders.[259] If a partnership elects to defer less than all of the cancellation of debt income realized from the reacquisition of an applicable debt instrument, the partnership may allocate among the partners, in any manner, (1) the deferred cancellation of debt income and the cancellation of debt income that is not deferred, (2) the portion, if any, of each partner's cancellation of debt income amount that is deferred, and (3) the portion, if any, of each partner's cancellation of debt income amount that is not deferred.[260] Thus, for example, all of one partner's share of cancellation of debt income can be deferred while none (or only part) of another partner's share of cancellation of debt is deferred. Any portion of a partner's share of cancellation of debt income that is not deferred may be excluded under section 108(a)(1)(A), (B), (C), or (D), if applicable.[261]

Under the section 108(i) election, income from a debt cancellation in 2009 is recognized beginning in the fifth taxable year following the debt cancellation; the income is recognized ratably in each of 2014 through 2018. Income from a debt cancellation in 2010 is recognized beginning in the fourth taxable year following the debt cancellation; the income is recognized ratably in each of 2014 through 2018.[262] If a taxpayer elects to defer cancellation of debt income under section 108(i), the section 108(a) exclusions for bankruptcy, insolvency, qualified farm indebtedness, and qualified real property business indebtedness do not apply to the year of the election or any subsequent year.[263] Thus, the election cannot be used to move the year of inclusion to a year in which it is expected that one of those exceptions might apply. Once the election is made, inclusion is inevitable. Deferred recognition is accelerated into the year of death of an individual taxpayer, the liquidation or termination of a business of an entity, the year of sale of substantially all of the assets of the taxpayer, or the cessation of the taxpayer's business.[264] The acceleration rule also applies in the event of the sale, exchange, or redemption of an interest in a partnership or S corporation by a partner or shareholder.

If a taxpayer makes a section 108(i) election and reacquires (or is treated as reacquiring) the debt instrument generating the cancellation of debt income for a new debt instrument with original issue discount, the interest deductions for the resulting original issue discount also are deferred.[265] However,

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[259] I.R.C. § 108(i)(5)(B)(iii). Sections 2.08 and 2.09 of Revenue Procedure 2009-37, 2009-36 I.R.B. 309, provide special rules for allocations under section 704 of partnership cancellation of debt income deferred under section 108(i). *See* Blake D. Rubin, Andrea Macintosh Whiteway & Jon G. Finkelstein, *Stimulus COD Income Deferral Raises Issues for Partnerships*, 124 TAX NOTES (TA) 677 (Aug. 17, 2009).

[260] Rev. Proc. 2009-37, 2009-36 I.R.B. 309, § 4.04(3).

[261] *Id.*

[262] I.R.C. § 108(i)(1).

[263] I.R.C. § 108(i)(5)(C).

[264] I.R.C. § 108(i)(5)(D).

[265] I.R.C. § 108(i)(2).

the original issue discount deferral rule does not apply if the amount of original issue discount is less than a *de minimis* amount, as determined under section 1273(a)(3).[266]

5. *Cancellation of Home Mortgage Debt*

Section 108(a)(1)(E), which was added by the Mortgage Forgiveness Debt Relief Act of 2007 and amended by the Emergency Economic Stabilization Act of 2008, excludes from gross income the cancellation of "qualified principal residence indebtedness" if the cancellation occurs on or after January 1, 2007 and before January 1, 2013. Congress enacted this provision in response to the subprime mortgage loan crisis because it was moved by the specter of thousands of homeowners restructuring their mortgage debts or losing their homes in foreclosures and having to recognize cancellation of debt income cancellation of indebtedness income as a result.[267] "Qualified principal residence indebtedness" is limited to acquisition indebtedness, as defined in section 163(h)(3)(B),[268] with respect to a taxpayer's principal residence (as defined for purposes of section 121)[269] that does not exceed $2,000,000 for married couples filing joint returns and $1,000,000 for other taxpayers.[270] Section 108(a)(1)(E) does not apply to (1) indebtedness on a home that is not the taxpayer's principal residence, or (2) home equity indebtedness. Furthermore, the provision applies only if the debt cancellation was on account of either (1) a decline in the value of the home, or (2) the taxpayer's financial condition.[271] The taxpayer's basis in the residence must be reduced by the excluded amount.[272] This basis reduction will not result in any subsequent income rec-

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[266] A *de minimis* amount of OID is OID of not more than one-quarter of one percent per year. I.R.C. § 1273(a)(3).

[267] *See* H.R. Rep. No. 110-356, at 4–5 (2007), *as reprinted in* 2008 U.S.C.C.A.N. 572, at 572.

[268] Whether interest is paid with respect to indebtedness that was incurred to acquire, construct, or substantially improve a residence generally is determined under the tracing rules of Temporary Regulation section 1.163-8T, except that special "90-day rules" permit the allocation of certain debt to the acquisition (or construction or improvement) of a residence notwithstanding the tracing rules. Notice 1988-74, 1988-2 C.B. 385.

[269] There is no statutory definition of a taxpayer's principal residence. Under the regulations, a taxpayer's principal residence depends upon all the facts and circumstances, but the residence used for a majority of the time during the year ordinarily will be considered the taxpayer's principal residence. Reg. § 1.121–1(b)(1), (b)(2). The regulations provide a nonexclusive list of factors that are relevant in identifying a property as a taxpayer's principal residence. Among the factors considered when the taxpayer has two or more residences are the location of the taxpayer's business or employment, the address on the taxpayer's tax returns, the address for voter registration and driver's licensure, and the location of the taxpayer's place of worship. No particular factor is conclusive, because that can produce inconsistent evidence. Reg. § 1.121–1(b)(2). A taxpayer cannot have more than one principal residence at a time. Temp. Reg. § 1.163–10T(p)(2). A taxpayer's principal residence may be a boat or recreational vehicle with appropriate accommodations and facilities. Reg. § 1.121–1(b)(1).

[270] I.R.C. § 108(h)(2).

[271] I.R.C. § 108(h)(3).

[272] I.R.C. § 108(a)(1)(E).

ognition as long as the taxpayer does not dispose of the residence; and even if the taxpayer does sell the residence, the taxpayer could exclude all or part of the realized gain under section 121.

If only a portion of a cancelled debt is qualified principal residence indebtedness, the exclusion applies only to the extent the cancelled debt exceeds the portion of the debt that is not qualified principal residence indebtedness.[273] Assume, for example, a principal residence secures an indebtedness of $400,000, of which only $300,000 is qualified principal residence interest. If the residence is sold for $260,000, and $140,000 of debt is cancelled, then only $40,000 qualifies for the exclusion.

If a taxpayer qualifies for both the qualified principal residence indebtedness exclusion and the insolvency exclusion in section 108(a)(1)(B), the qualified principal residence indebtedness exclusion applies, unless the taxpayer elects to apply the insolvency exclusion.[274]

6. *Cancellation of Student Loans*

Section 108(f)(1) and (2) exclude from gross income forgiveness of student loans (and certain refinancings of student loans) incurred to attend a qualified institution of higher learning if the discharge of the indebtedness is pursuant to a provision in the loan under which all or part of the debt would be discharged if the student works for a period of time in certain professions or for any broad class of employers. The exclusion applies only to loans made by governmental entities, tax-exempt public benefit corporations, and qualified educational organizations, under an agreement or program designed to encourage students to serve in occupations with unmet needs or in areas with unmet needs, and the services provided by the student must be provided under the supervision of a governmental unit or tax-exempt charitable organization.[275] If the conditions of section 108(f)(2) are not met, the discharge of student loan debt for less than full payment gives rise to cancellation of debt income.[276]

Section 108(f)(4) excludes from gross income amounts received under the National Health Service Corps loan repayment program and under state loan repayment programs that receive federal grants.[277] Such programs require the

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[273] I.R.C. § 108(h)(4).

[274] I.R.C. § 108(a)(2)(C).

[275] I.R.C. § 108(f)(2); *see* Porten v. Commissioner, 65 T.C.M. (CCH) 1994, 1993 T.C.M. (RIA) ¶ 93,073 (forgiveness of a student loan from the State of Alaska conditioned upon working in any capacity as a resident of Alaska (and not in designated professions or for a designated class of employers) was not excludable).

[276] Plotinsky v. Commissioner, 96 T.C.M. (CCH) 292, 2008 T.C.M. (RIA) ¶ 2008-244 (discharge of a portion of consolidated student loans pursuant to an incentive provision providing for such discharge if the debtor made 36 timely payments, which was provided as an incentive to consolidate loans with the refinancing creditor, gave rise to cancellation of debt income).

[277] I.R.C. § 108(f)(4).

recipient of the repayment to provide services in a geographic area identified as having a shortage of healthcare professionals.

VI. Conclusion

In light of the volume of currently outstanding debt owed and the historically high rates of default and foreclosure, as explained in the Introduction, in the immediate future the rules with respect to cancellation of debt income will be applied to a greater number of transactions annually than ever before. In some of these transactions, the existence of cancellation of debt income will be clear; in others, particularly those involving contested liabilities, it might not be so clear. In most instances, where cancellation of debt income is realized, determining the amount is not exceedingly difficult, but in those cases in which the amount of cancellation of debt income depends in whole or in part on the value of property transferred to the creditor in connection with the discharge of the debt, including cases in which a creditor accepts an equity interest in the debtor in connection with the discharge of the debt, important factual valuation questions arise and must be answered before the amount of cancellation of debt income can be ascertained.

Whenever cancellation of debt income is realized, the critical question is whether and to what extent the debtor can take advantage of one of the exclusions in section 108. If more than one such exclusion might apply, the taxpayer must choose which one to apply, either through an express election, where allowed, or by structuring the transaction effecting the discharge of the debt to fit within the most advantageous exception. In most instances, that choice will be dictated by the ancillary consequences facing the taxpayer, usually the loss of favorable tax attributes. No exposition of a catalogue of rules of thumb is possible. Both the course of action in planning a transaction to effect a discharge of indebtedness for less than full payment, thereby giving rise to cancellation of debt income, and *ex post* arguments for a result more favorable to the taxpayer than that proposed by the Internal Revenue Service, depend on each taxpayer's particular situation. For example, an insolvent taxpayer might prefer to recognize cancellation of debt income, which would otherwise be taxed as ordinary, while a solvent taxpayer might prefer to structure or characterize a transaction as a transfer of property in payment of a debt to recognize capital or section 1231 gain taxed at a preferential rate.

Finally, care must be taken not to let the tax tail wag the economic dog. A solvent taxpayer that otherwise might recognize cancellation of debt income might be tempted to seek nonrecognition by filing a bankruptcy petition for Chapter 13 individual debt adjustment or Chapter 11 reorganization of a business. There are, however, significant nontax consequences to such an action that must be thoroughly considered before engaging in such an action as a tax planning technique.

In the end, this Article is designed merely to provide a taxonomy of the various rules that must be considered by the careful tax professional in advising debtor taxpayers with respect to the structuring and reporting of transactions that can or do give rise to realization and recognition of cancellation of debt income. It is a roadmap to be consulted in devising plans and arguments, but it does not in and of itself provide those plans and arguments. Each transaction warrants careful consideration of its specific facts and the taxpayer's overall set of tax attributes before the various rules are applied to produce a customized transaction or argument.