DISCHARGE OF INDEBTEDNESS INCOME

PLANNING OPPORTUNITIES

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A. Origin of, and Rationale for, the Rule

1. In United States v. Kirby Lumber Co., 284 U.S. 1 (1931), the taxpayer issued bonds that it later purchased at a discount. The Supreme Court held that the taxpayer realized taxable income in the amount of the discount.

Kirby Lumber Co. did not realize any gain upon receipt of the issue price for its bonds because of the equal offsetting liability to pay to the bondholders the face amount of the bonds. When the company reduced the offsetting liability by the purchasing its bonds at less than par, the amount of the offsetting liability was less than the face amount of the bonds and the company realized an economic benefit at that time in the amount of the discount.

2. Two rationales have been identified for this rule:

(a) The taxpayer has an increase in wealth due to the reduction in valid claims against the taxpayer's assets.

(b) Taxation is appropriate because the consideration received by a taxpayer in exchange for his indebtedness is not included in income when received because of the obligation to repay and the cancellation of that obligation removes the reason for the original exclusion.

When a taxpayer borrows money, it is not taxed on the loan proceeds received because of the offsetting liability to repay the loan. If the loan is cancelled for less than full payment, part of the loan proceeds that were not taxed by reason of the taxpayer repayment obligation is no longer subject to that corresponding obligation. Since the basis for not taxing that part of the loan proceeds no longer exists, the taxpayer realizes income in the amount equal to the difference between the original amount of the loan and the amount paid to cancel the loan. The cancellation of the loan for less than full payment has resulted in a net increase in the assets of the taxpayer.

B. Statutory Scheme

1. Section 61(a)(12).

(a) Gross income includes income from discharge of indebtedness. §61(a)(12) of the Internal Revenue Code ("IRC"). Section 61(a)(12) of the IRC codified the rule of *Kirby Lumber*.

(b) Discharge means a termination or cancellation of an obligation for less than full payment. Discharge of indebtedness is also referred to as cancellation of debt or "COD".

2. Section 108. Section 108 of the IRC sets forth rules for applying the COD concept. Section 108 provides many exclusions or limitations on the amount of COD that is includable in the taxpayer's income. Pursuant to this section, gross income does not include any amount which would otherwise be includible in gross income by reason of COD, in whole or in part, if:

(a) The discharge occurs in a Title 11 [bankruptcy] case. §108(a)(1)(A);

(b) The discharge occurs when the taxpayer is insolvent, to the extent of the insolvency. §108(a)(1)(B); §108(a)(3);

(c) In the case of a taxpayer other than a C corporation, the indebtedness discharged is qualified real property business indebtedness. §108(a)(1)(D);

(d) The indebtedness discharged is qualified principal residence indebtedness which is discharged before January 1, 2013. §108(a)(1)(E);

(e) Payment of the liability that was discharged would have been deductible by the taxpayer. §108(e)(2);

(f) The indebtedness discharged reduces an installment obligation given by the seller/taxpayer to the buyer/borrower. §108(e)(5);

(g) A corporation acquires its indebtedness from a shareholder as a contribution to capital. §108(e)(6).

3. Section 1017. Section 108(b) provides for a reduction in certain tax attributes (such as net operating losses, tax credits and tax basis) in connection with the exclusions applicable in the bankruptcy and insolvency situations. Section 1017 of the IRC provides for rules applicable to the reduction in tax attributes.

C. Basic Rules and Planning Opportunities

1. COD is taxed as ordinary income.

2. Recourse Loans

(a) If debt is discharged without a transfer of property, all COD is ordinary income.

(b) If property is transferred in connection with discharge of the debt, the transaction will be bifurcated into two parts:

(i) The sale of the property for an amount equal to its fair market value, which generally results in capital gain or capital loss.

(ii) COD income equal to the balance of the gain.

(c) *Example 1*. Taxpayer owns investment property worth $2,000,000 in which it has a $1,600,000 basis and owes lender $3,000,000. This loan is secured by a mortgage encumbering the property. [This example assumes that the loan is not qualified real property business indebtedness which, if it were, §108(a)(1)(D) would apply].

(i) If lender agrees to reduce the loan to $1,800,000, Taxpayer receives $1,200,000 of ordinary income.

(ii) If Taxpayer transfers the property to lender in full satisfaction of the loan, Taxpayer has $1,000,000 of COD income, taxed as ordinary income, and $400,000 of capital gain income. See Rev. Rul. 90-16, 1990-1 C.B. 12; In Frazier v. Commissioner, 111 T.C. 243 (1998); Gehl v. Commissioner, 102 T.C. 784 (1994), aff'd 50 F. 3d 12 (8th Cir. 1995), cert. denied 516 U.S. 899 (1995); FSA 200135002.

This transaction will be treated as (1) a sale of the property by taxpayer to lender for $2,000,000 resulting in a $400,000 capital gain [$2,000,000 FMV less $1,600,000 tax basis] and (2) COD income in the amount of $1,000,000 [equal to the difference between the amount of the debt ($3,000,000) and the fair market value of the property ($2,000,000)].

(d) ***Planning Opportunities***

(i) If the debt is to be settled, it should be done so in the context of transferring the mortgaged property, whether to the lender or to another person.

(ii) If the taxpayer is solvent and the disposition of the property will result in long term capital gain, the taxpayer will want to maximize the amount of capital gain. This can be done by getting the highest appraised value of the property that can be provided by the appraiser.

(iii) If the taxpayer is insolvent, the taxpayer will want to increase the amount of COD since it will not be taxable pursuant to §108(a)(1)(B). In this situation, it may be best to settle the debt without a transfer of the property that secures the debt. If, for business reasons, a transfer of the property (such as a deed in lieu of foreclosure) is required, the taxpayer would likely want to lowest appraised value of the property that can be provided by the appraiser.

(iv) Consider having the loan purchased from the lender at a discount by a person who is friendly, but not related, to the taxpayer. See Case Study No. 1 below.

3. Non-Recourse Loans

(a) If debt is discharged without a transfer of property, all COD is ordinary income. Rev. Rul. 82-202, 1982-2 C.B. 35; Rev. Rul. 91-31, 1991-1 C.B. 19.

(b) If property is transferred in connection with the discharge of the debt, there is no COD and all of the gain or loss will be determined under §1001 of the IRC (usually resulting in a capital gain or capital loss).

(c) *Example 2*. Same facts as *Example 1*, except that the loan is non-recourse to the taxpayer. If lender agrees to reduce the loan to $1,800,000, Taxpayer receives $1,200,000 of ordinary income. If Taxpayer transfers the property to lender in full satisfaction of the loan, Taxpayer has $1,400,000 of capital gain income. See Treas. Reg. §§1.1001-2(a)(1); 1.1001-2(c), Example 7; Yarboro v. Commissioner, 737 F. 2d 479 (5th Cir. 1984).

(d) ***Planning Opportunity***. If a non-recourse debt is to be settled, it should be done so in the context of transferring the mortgaged property, whether to the lender or to another person.

D. Case Studies

1. Purchase of a Loan at a Discount

(a) Facts.

Bank has agreed to accept $10,000 as full settlement of all amounts due from Taxpayer on a loan from Bank to Taxpayer in the original principal amount of $75,000, the proceeds of which were used to purchase an unimproved lot. If Taxpayer were to pay $10,000 to Bank in full satisfaction of this obligation, Taxpayer would receive discharge of indebtedness income in an amount equal to $65,000. If the settlement with Bank is restructured so that, instead of paying off the loan for $10,000, the loan is purchased from Bank by Taxpayer's brother for $10,000, there will be no discharge of indebtedness income to Taxpayer.

(b) Discussion

Section 61(a)(12) of the Internal Revenue Code (the "Code") provides that gross income includes income from discharge of indebtedness. Treasury Regulation §1.61-12(c)(2)(ii) provides that a debtor realizes income from the discharge of indebtedness upon the repurchase of a debt instrument for an amount less than its adjusted issue price. The amount of discharge of indebtedness income is equal to the excess of the adjusted issue price over the repurchase price.

If the settlement with Bank was restructured so that, instead of paying off the loan for $10,000, the loan was, instead, purchased from Bank for $10,000, there will be no discharge of indebtedness as long as the buyer of the loan is not related to the Taxpayer within the meaning of §108(e)(4) of the Code.

Section 108(e)(4)(A) of the Code provides that acquisition of outstanding indebtedness by a person bearing a relationship to the debtor specified in Section 267(b) of the Code from a person who does not bear such a relationship to the debtor shall be treated as the acquisition of such indebtedness by the debtor. Section 108(e)(4)(B) of the Code provides that for purposes of this rule, §267 shall be applied as if §267b)(c)(4) provided that the family of an individual consists of the individual's spouse, the individual's children, grandchildren and parents, and any spouse of the individual's children or grandchildren. Therefore, Taxpayer's siblings are not related to the Taxpayer within the meaning of §108(e)(4) and, consequently, any of Taxpayer's siblings, such as Taxpayer's brother, could purchase the note from Bank without that transaction resulting in discharge of indebtedness income to Taxpayer.

It is important that the debt is acknowledged by the borrower and creditor as a continuing obligation. Otherwise, the IRS could assert that discharge of indebtedness income arises at the time the liabilities are disregarded by the parties thereto. In Tsakopoulos v. C.I.R., 2002 WL 23952 (U.S. Tax Ct.), the Court held that amounts loaned by the taxpayer's brother to the taxpayer, the proceeds of which were used by the taxpayer to pay his share of environmental cleanup costs on property that the taxpayer and his brother co-owned did not result in cancellation of indebtedness income when the taxpayer transferred his entire interest in the co-owned property to his brother where the court found that the taxpayer, following the transfer of his interest in the property to his brother, continued to have a good faith intent to repay the amounts owed to his brother. This is key.

2. Short Sale of Principal Residence of Taxpayer's Daughter

(a) Facts.

In early 2006, Taxpayer's daughter ("Daughter") found a property (the "Residence") she wanted to buy for use as her principal residence. However, because of her history of financial irresponsibility, she had a low credit score and could not qualify for a mortgage loan to finance the acquisition. Notwithstanding her low credit score, she had a good job and could afford to pay the monthly mortgage payments and other costs of owning and operating the Residence.

In order to assist Daughter in acquiring the Residence, Taxpayer purchased the Residence for $300,000. This purchase was financed by means of a loan from an institutional lender ("Lender") to Taxpayer in the amount of $220,000 (the "Loan") that was secured by a mortgage encumbering the Residence. Daughter did not sign the note and her name was not on the deed.

The understanding that Taxpayer had with Daughter was that Daughter would make all mortgage payments, would pay property taxes, insurance premiums and all charges for utilities used at the Residence, would maintain the property in good condition and would generally care for and be responsible for the Residence as if she was the sole owner of it. Further, the expectation was that Daughter would refinance the Residence in 2 to 4 years and, in connection with such refinance, Taxpayer would convey all of Taxpayer's interest in the Residence to Daughter without consideration.

In summary, Taxpayer's role in the transaction was to provide those financial accommodations needed in order to allow Daughter to acquire a new principal residence.

Following closing, Daughter did, in fact, make all of the mortgage payments to Lender, pay the property taxes, pay the insurance premiums, pay all utility charges and otherwise maintained the property at her sole cost and expense and used the property as her principal residence.

Because of her inability to manage her finances, Daughter fell behind on the mortgage payments, the result of which was that Lender initiated an action to foreclose on its mortgage. Faced with the prospect of losing the house at a foreclosure sale, Taxpayer and Daughter aggressively marketed it for sale, which efforts resulted in a contract to sell the Residence to Lucky Buyer at a price of $175,000. Lender approved the sale to Lucky Buyer, agreeing to accept the net proceeds of sale in full satisfaction of the $240,000 then due on the loan. The proceeds of sale, net of selling costs, was $150,000.

As a consequence of the short sale, Taxpayer received from lender IRS Form 1099C showing cancellation of debt income in the amount of $90,000.

(b) Discussion - Discharge of Indebtedness Income to Taxpayer

The substance of the transaction, as described above, does not involve an increase in Taxpayer's assets by reason of the payoff of the loan for less than the amount due because all of the proceeds of the loan were used to purchase the Residence in which Daughter was the equitable owner. Although Taxpayer had legal title to the property, Taxpayer was holding that title for the benefit of Daughter and intended to convey that title to her, without payment of any type, at such time as she was able to refinance the loan on her own and on the basis of her credit. Viewed in this manner, Taxpayer's role in the transaction, from an income tax perspective, was that of a guarantor of a loan, rather than a borrower, since the loan proceeds effectively went to Daughter and not to the Taxpayer.

In similar factual situations, the courts have been willing to accept this characterization of the transaction. See <u>Uslu v. Commissioner</u> and <u>Trans v. Commissioner</u> discussed below.

As a general rule, cancellation of debt income is not recognized by a guarantor when the obligation is reduced or satisfied for less than full value. 63 Tax Lawyer 415; <u>Payne v. Commissioner</u>, T.C. Memo. 1998-227, 1998 WL 341843 (U.S. Tax Ct.), reversed on other grounds 224 F. 3d 415 (5th Cir. 2000).

"In cases involving loan guarantors, no discharge of indebtedness income is realized when the guarantor is relieved of the obligation to satisfy the guarantee. The courts reason that the Kirby Lumber principle is not applicable because the guarantor (in contrast to the principal obligor) did not receive the borrowed funds, and thus has no additional assets as a result of the transaction." Federal Income Taxation of Individuals, 2nd Ed. McMahon and Zelenak,§ 4.05[3][a].

The following language in the Tax Court's decision in <u>Landreth v. Commissioner</u>, 50 T.C. 803 (1968) is instructive: "If the respondent intends to suggest that any person who guarantees the payment of a loan realizes income when the principal debtor discharges the loan, we reject the proposition. The respondent cites, and we have found, no authority for the proposition that a guarantor constructively receives income when the debtor makes payments to the creditor on his obligation, and we think that it has no foundation in the principles of the tax law. The situation of a guarantor is not like that of a debtor who as a result of the original loan obtains a non-taxable increase in assets. The guarantor obtains nothing except perhaps a taxable consideration for his promise. 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. <u>United States v. Kirby Lumber Co</u>., 284 U.S. 1 (1931). However, where the guarantor is relieved of his contingent liability, either because of the 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. Commissioner v. Rail Joint Co., 61 F. 2d 751 (2nd Cir., 1932); Fashion Park, Inc., 21 T.C. 600 (1954). Payment by the principal debtor does not increase the guarantor's net worth, it merely prevents it, *pro tanto*, from being decreased. The guarantor no more realizes income from the transaction than he would if a tornado, bearing down on his home and threatening a loss, changes course and leaves the house intact."

(b)(ii) Conclusion

Based on the characterization of the transaction as described above (Daughter was the equitable owner of the Residence and the Taxpayer merely provided the financial accommodations she needed to acquire the Residence), Taxpayer did not realize discharge of indebtedness income when Taxpayer was released of any obligation to pay a deficiency on the loan in connection with the short sale of the Residence.

(c)(i) Discussion - Income Tax Considerations Affecting Daughter

Section 108(a)(1)(E) of the Code provides that gross income does not include any amount which would otherwise be includible in gross income by reason of the discharge, in whole or in part, of indebtedness of the taxpayer if the indebtedness discharged is qualified principal residence indebtedness which is discharged before January 1, 2013. Section 108(d)(1) provides that the term "indebtedness of the taxpayer" means any indebtedness (A) for which the taxpayer is liable, or (B) subject to which the taxpayer holds property. The term "qualified principal residence indebtedness" means acquisition indebtedness within the meaning of Section 163(h)(3)(B) of the Code with respect to the principal residence of the taxpayer, as modified by Section 108(h)(2). Acquisition indebtedness is any indebtedness secured by the qualified residence of the taxpayer and incurred in acquiring, constructing or substantially improving the qualified residence. Section 163(h)(3)(B).

The indebtedness generally must be an obligation of the taxpayer and not an obligation of another. However, Treasury Regulation § 1.163-1(b) provides, in part, as follows: "Interest paid by the taxpayer on a mortgage upon real estate of which he is the legal or equitable owner, even though the taxpayer is not directly liable upon the bond or note secured by such mortgage, may be deducted as interest on his indebtedness."

In Uslu v. Commissioner, T.C. Memo. 1997-551, 1997 WL 770235 (U.S. Tax Ct.), title to the taxpayer's principal residence was held by the brother/brother-in-law of the taxpayers and his wife who obtained financing, in their names, for the purchase of the property. The taxpayers and their relatives (who purchased the property and borrowed the funds to finance the purchase) had an oral agreement that the taxpayers would occupy the property as their principal residence and make all mortgage payments as well as paying all expenses for owning and operating the property. The Court found that the taxpayers were the equitable owner of the property and held that the taxpayers were entitled to deduct the interest they paid on the mortgage loan.

The Tax Court reached the same result in Trans v. Commissioner, T.C. Memo 1999-233, 1999 WL 498578 (U.S. Tax Ct.). In this case, although the taxpayers were not the legal owners of the property, they treated the property as if they were the owners, they paid the down payment, all mortgage payments and property taxes as well as improvements to the property. The Court stated that "based on all evidence, we infer that those actions were pursuant to an agreement with Son Dang (taxpayer wife's brother), who took title to the property and obtained a mortgage only as an accommodation to petitioners, who could not qualify for loan. …We conclude that petitioners held the benefits and burdens of ownership of the Milpitas property and have established equitable ownership of it during the period in question during 1994. Accordingly, we hold that petitioners are entitled to deduct the $11,738 of home mortgage interest paid by them with respect to the Milpitas property during 1994." For the same reason, the Court held that the taxpayers were entitled to deduct property taxes they paid on the property as well.

In Njenge v. Commissioner, T.C. Summary Op. 2008-84, 2008 WL 2746329 (U.S. Tax Ct.), the Court held that the taxpayers were entitled to deduct interest and property taxes they paid with respect to their principal residence when title to such property was held by their son and the mortgage loan that financed the acquisition was made to their son since the son "obtained a mortgage loan and took title to the house essentially to procure it for [taxpayers], who were unable to secure such a loan because of financial difficulties. This holding was based upon the Court's finding that the taxpayers were the equitable and beneficial owner of the property.

(c)(ii) Conclusion

Pursuant to §108(a)(1)(E) of the Code, cancellation of part of the indebtedness by Lender will not result in taxable income to Daughter.

(d) Discussion Points

(i) Importance of Understanding the Facts

(ii) Application of COD Rules to Guarantors

3. Settlement of a Disputed Liability

(a) Facts

Taxpayer purchased income producing property from Seller. The closing documents reflected that a person related to Seller ("Related Party") financed part of purchase price by means of a loan ("Loan") to Taxpayer in the amount of $300,000. Taxpayer never made any payments on the Loan because, following closing, Taxpayer determined that rental income was lower than as represented by Seller and operating expenses were higher than as represented by Seller. In order to settle this dispute, the principal of Seller and Related Party agreed to accept $50,000 as full payment on the Loan.

(b) Discussion

Further inquiry into the transaction showed that Related Person brought no funds to the closing and there were no other facts to show that the Loan was made by Related Person rather than by Seller. The Settlement Agreement contained an acknowledgement by the Seller and the Related Person that the Loan was made by Seller and not by Related Person. As a result, no COD income arose by reason of the provisions of §108(e)(5). Taxpayer reduced his basis in the property by $250,000.

An alternative basis for avoiding COD income is that the $300,000 loan amount was a contested liability because it was incurred based on false representations. See generally Zarin v. Commissioner, 916 F. 3d 110 (3rd Cir. 1990) and Preslar v. Commissioner, 167 F. 3d 1323 (1st Cir. 1999).