Tax Talk For Tough Times: A Primer On Cancellation Of Debt And Related Partnership Matters

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Tough times often result in canceled debt—and unexpected income.

IN GOOD TIMES, clients' income tax interests are often deferral of income, acceleration of deductions, conversion of ordinary income into capital gain, and other similar planning based on an optimistic view of the economy. With economic contractions, falling asset values, reduced availability of credit, workouts, and restructurings, tax conversations frequently include different subjects, such as how to avoid taxable income arising from the discharge of indebtedness.

THE BASICS • Although borrowed funds are not income for income tax purposes, a taxpayer generally does realize income if the taxpayer's debt is discharged without payment. IRC §61(a)(12) (gross income includes "[i]ncome from discharge of indebtedness"); Treas. Reg. §1.61-12(a) (citing as examples cancellation of debt in exchange for services from the debtor and payment or purchase of obligations by debtor at less than face value). The law is clear that income from the discharge of indebtedness is an element of gross income for income tax purposes. Thus, a taxpayer's relief when a creditor cancels or compromises a debt is often not complete. Unless an exception applies, the taxpayer will have ordinary income in the amount of the debt relief.

Fortunately for taxpayers, there are a number of exceptions to the rule that income from the discharge of indebtedness (or as it is more commonly called, cancellation of debt, or COD, income) is subject to tax. Some of the exceptions to COD income are judicial exceptions, but most of the exceptions are statutory exclusions from gross income or statutory measures of COD income and are found in section 108. (Unless otherwise noted, references to "sections" are to sections of the federal Internal Revenue Code of 1986, as amended.) Many of the exceptions are complex.

The taxpayer's cost for avoidance of taxable COD income under certain exclusions is a reduction of the taxpayer's other useful tax attributes such as basis in property or loss or credit carryovers. Section 108 describes the required reductions in tax attributes, and section 1017 adds details concerning reductions in the basis of the taxpayer's property as a result of the exclusion of COD income under section 108.

COD INCOME RULES • In addition to spelling out the statutory exclusions of COD income and related requirements for reducing the taxpayer's tax attributes, section 108 sets out certain additional, fundamental COD income rules. These include rules concerning the effect of the acquisition of a taxpayer's debt by a related party (§108(e)(4)), the effect of contribution of debt to corporate capital (§108(e)(6)), and the effect of exchanges of debt for new debt (§108(e)(10)). Before examining the exceptions and exclusions applicable to COD income, let's look at these statutory rules.

Acquisition Of Debt By Related Party

If a debtor acquires its own debt for less than the amount owed, unless some exception applies, the debtor has COD income. Treas. Reg. §1.61-12(c)(2)(ii) (when debtor acquires its own debt for less than the adjusted issue price debtor realizes COD income in the amount of the excess of the adjusted issue price over the acquisition price). Section 108(e)(4) and the Treasury Regulations issued under section 108(e)(4) expand this rule by treating the debtor as acquiring debt acquired by certain persons related to the debtor. (Whether or not the person is "related" to the debtor is determined under sections 267(b) and 707(b)(1) with a modified definition of "family" and a special rule for entities treated as a single employer under section 414. §108(e)(4)(A), (B), and (C). The debt must be acquired from someone who is not "related" to the debtor. §108(e)(4)(A).) The debt may be acquired directly by a related person or "indirectly" in a transaction in which a holder of the debt becomes related to the debtor after having acquired the debt in anticipation of becoming related to the debtor. Treas. Reg. §1.108-2(c). Although whether debt was acquired by a holder in anticipation of becoming related to the debtor is generally a question to be determined based on the facts and circumstances, debt is deemed to be acquired in anticipation of becoming related to the debtor if the holder of the debt acquired the debt less than six months before becoming related to the debtor. Treas. Reg. §1.108-2(c)(2) and (3). The regulations require disclosure by the debtor in certain other circumstances thought by the Treasury to indicate an indirect acquisition of indebtedness by a related person. Treas. Reg. §1.108-2(c)(4). Exceptions to the related-party COD income rules exist for (i) debt with a stated maturity date that is within one year of the date the debt is acquired by the related person (or, in indirect acquisitions, the date the unrelated holder of the debt becomes a related person) and that is retired by the maturity date and (ii) debt acquired by securities dealers in the ordinary course of business. Treas. Reg. §1.108-2(e)(1), (2).

In direct acquisitions by a related person, the amount of the debtor's COD income is generally measured by reference to the basis of the related person in the debt on the date the related person acquired the debt. Treas. Reg. §1.108-2(f). (More

complicated rules apply to determine the debtor's COD income when the acquisition is an "indirect" acquisition or the debt is substituted basis property in the hands of the holder under section 7701(a)(42).) The calculations can be complex when the debt was originally issued at a discount, but in simple situations the debtor's COD income is the excess of the principal amount of the debt over the price the related party paid for it. After the acquisition of a debt by a related party, the debt undergoes a transformation. If the debtor realized COD income (whether or not it qualified for some exclusion from gross income), going forward the debt is treated as new debt issued by the debtor. For original issue discount (OID) purposes, the issue price of the new debt is the amount used to determine the debtor's COD income (for example, in a direct acquisition by a related person, the new holder's basis in the debt). Since the terms of the debt do not change, if the related person acquired the debt at a discount, the stated redemption price of the "new" debt at maturity will exceed the issue price, and there will be OID to be taken into account over the remaining term of the debt by the debtor and by the related person who holds the debt. Treas. Reg. §1.108-2(g)(1). *See* examples at Treas. Reg. §1.108-2(g)(4).

Debt Contributed To Capital

Another basic rule to bear in mind is that for purposes of determining COD income, if a corporation acquires its debt from a shareholder as a contribution to capital (as opposed to in exchange for additional equity in the corporation), the corporation is treated as satisfying the debt with an amount of money equal to the shareholder's basis in the debt. §108(e)(6). (Section 118 (providing generally that contributions to corporate capital are excluded from gross income) does not apply. §108(e)(6)(A); *see also* Treas. Reg. §1.61-12(a) (shareholder's gratuitous forgiveness of corporate debt is generally a contribution to capital to the extent of the principal of the debt).) A shareholder will usually have a basis in the debt if the shareholder has loaned money to the corporation. However, a cash basis shareholder will usually not have a basis in a corporate debt the shareholder received for services. Thus, some contributions of corporate debt to capital can result in COD income to the corporation. Section 108(e)(2) (concerning exclusion from COD income if payment of the debt would have given rise to a deduction) may also come into play in this context.

Debt-For-Debt Exchanges

When a debtor buys back its debt at a discount, the debtor realizes COD income. Treas. Reg. §1.61-12(c)(2)(ii). To put it more precisely, a debtor realizes COD income when it repurchases its debt for less than its adjusted issue price. *Id.* The amount of the COD income is the excess of the adjusted issue price over the repurchase price. *Id.* But when a debtor gives new debt in satisfaction of old debt the debtor realizes no COD income if the new debt is equivalent to the old debt. This follows from section 108(e)(10), which provides that for purposes of determining a debtor's COD income, if a debtor exchanges a new debt for an old debt, the debtor is treated as satisfying the old debt with an amount of money equal to the issue price of the new debt. What we must keep in mind in this context are the tax principles that determine when new debt is exchanged for old debt and, to do the math, the tax principles that determine the adjusted issue price of the old debt and the issue price of the new debt.

An exchange of one debt instrument for another is not the only type of debt-for-debt exchange. A change in the terms of a loan is a debt-for-debt exchange if the change is a "modification" and the modification is "significant" under the income tax regulations. Treas. Reg. §§1.1001-1(a) and 1.1001-3. (A creditor may realize gain or loss on an exchange of debt obligations, including loan modifications that are deemed to be "exchanges." But an

exchange of corporate securities may be a nontaxable (to the creditor) exchange. *See* §§354, 355, and 356.)

The regulations go into great detail concerning what is a "modification" for these purposes and what modifications are "significant." Treas. Reg. §1.1001-3. "Modification" is defined broadly as any alteration of a legal right or obligation of the issuer or the holder of the debt instrument. Treas. Reg. §1.1001-3(c)(1)(i). Alterations that occur by operation of the terms of the debt instrument are generally not modifications, but this rule is subject to a number of exceptions. Treas. Reg. §1.1001-3(c)(1)(ii) and (2). For example, a change from nonrecourse to recourse debt is a modification even if the change occurs by operation of the terms of the debt instrument. Treas. Reg. §1.1001-3(c)(2)(i).

As a general rule, a modification is "significant" only if, based on all the facts and circumstances, the legal rights or obligations that are altered, and the degree to which they are altered, are economically significant. Treas. Reg. §1.1001-3(e)(1). There are, however, specific rules that apply to determine whether a change (i) in yield, (ii) in the timing of payments, (iii) in obligor or security, (iv) in the nature of the debt instrument (such as changing an unsecured debt from recourse to nonrecourse), or (v) in accounting or financial covenants is "significant." Treas. Reg. §1.1001-3(e)(2) through (6).

"Issue price" and "adjusted issue price" are OID concepts. *See* §§1271-1275 concerning OID. (Section 108(e)(10)(B) states that generally the issue price of a debt instrument is determined under sections 1273 and 1274. "Adjusted issue price" is defined in section 1272(a)(4) and, more helpfully, in Treas. Reg. § 1.1275-1(b). The adjusted issue price is initially the debt instrument's issue price. It is increased by the amount of OID previously included in the holder's income and decreased by any payment previously made on the debt instrument other than a payment of qualified stated interest. Treas. Reg. § 1.1275-1(b)(1). Qualified stated interest is stated interest that is unconditionally payable in cash or property (other than the issuer's debt) at least annually at a single fixed rate. Treas. Reg. § 1.1273-1(c).) A thorough understanding of the intricate OID rules is necessary for a thorough understanding of the federal tax treatment of debt instruments and, consequently, COD income. But let's keep things simple in reviewing how COD income is calculated in debt-for-debt exchanges.

Let's assume an old debt instrument, not publicly traded, bearing interest at a fixed rate payable at least annually which has been issued in exchange for cash in the amount of the stated principal amount of the debt instrument—in other words, an ordinary loan. The issue price of the old debt instrument will have been the amount loaned or the stated principal amount. §1273(b)(2) (issue price of debt instrument not issued for property and not publicly offered is the price paid by the first buyer of the debt instrument); *see also* Treas. Reg. §1.1273-2(a). Since the old debt did not have any OID, if the borrower has not paid down any of the principal, the adjusted issue price of the old debt will be the same as the amount loaned, that is, the stated principal amount of the old debt. Treas. Reg. §1.1275-1(b). (OID is the excess of a debt instrument's "stated redemption price at maturity" over its "issue price." §1273(a)(1). A debt instrument's stated redemption price at maturity is the sum of all payments provided by the debt instrument other than "qualified stated interest" payments. §1273(a)(2) and Treas. Reg. §1.1273-1(b). In our example, the old debt's stated redemption price at maturity is the same as its issue price.) Let's also assume the new debt instrument is not publicly traded, has the same principal amount and bears interest at the current applicable federal rate payable at least annually. (The new interest rate may be lower than the old interest rate, and the amortization of principal may be over a longer period.) Under these assumptions, the issue price of the new debt will be the same as its stated principal amount, the ad-

justed issue price of the old debt will be the same as the issue price of the new debt, and the debtor will realize no COD income on the exchange. §108(e)(10) and Treas. Reg. §1.61-12(c)(2)(ii). Since in our example neither the old debt nor the new debt is publicly traded, the issue price of the new debt instrument is its stated redemption price at maturity so long as it bears adequate stated interest. §1273(b)(4). (Section 1274 does not apply because the new debt bears adequate stated interest and the stated redemption price at maturity does not exceed the stated principal amount. Section 483, another factor in valuation of debt instruments, also would not apply because the new debt bears adequate stated interest.) The debt instrument in our example bears "adequate stated interest" because it bears interest at the current "applicable federal rate." §1274(c)(2).

The key to avoiding COD income in this example—when neither debt instrument is publicly traded and the principal amount of the loan does not change—is setting interest at a rate no less than the applicable federal rate.

Let's now vary our assumptions and say the new debt instrument is publicly traded. (Perhaps the more common situation would be that both the old and the new debt instruments are publicly traded.) The issue price of a publicly traded debt instrument issued for property (here, the "property" is the old debt) is the fair market value of the property. §1273(b)(3). Therefore, if the fair market value of the old debt has declined to less than its adjusted issue price (because of concerns with creditworthiness or other reasons), the exchange of the new debt for the old debt will result in the debtor realizing COD income in the amount of the decline in value. §108(e)(10) and Treas. Reg. §1.61-12(c)(2)(ii). The issue price of the new debt will be less than the adjusted issue price of the old debt. It does not matter that the stated principal amounts of the old and new debts are the same, although if the new debt's stated redemption price at maturity is greater than its issue price, there will be OID to take into account over the term of the new debt.

DISPOSITIONS OF PROPERTY SECURING DEBT • In addition to these statutory COD income rules, it is necessary to keep in mind another basic rule applicable to dispositions of property securing debt in exchange for release from the debt. When a debtor disposes of property and is released from the debt that the property secures, the nature of the debt is important in determining whether there is COD income and therefore whether any of the income realized may be excluded under one of the exclusions that apply to COD income. A voluntary conveyance or foreclosure of property in satisfaction of a *recourse debt* is divided for tax purposes into two parts: a sale of the property for an amount equal to the property's fair market value and a cancellation of debt to the extent the amount of the debt exceeds the property's fair market value. Treas. Reg. §1.1001-2(a)(2) and (c), Example 8. *See also* Rev. Rul. 90-16, 1990-1 C.B. 12. Thus, when the amount of the recourse debt is greater than the fair market value of the property, the debtor will have COD income as a result of the transaction as well as gain or loss on the sale. (If the fair market value is greater than the debtor's adjusted basis in the property, the debtor will have a gain on the sale part of the transaction. If the fair market value is less that the debtor's adjusted basis in the property, the debtor will have a loss. §1001.) An exclusion may keep some or all of the COD income out of the debtor's gross income. Note that COD income is ordinary income, and the gain or loss on the sale part of the transaction may be capital gain or loss.

A voluntary conveyance or foreclosure of property in satisfaction of a *nonrecourse debt* is treated differently. The whole transaction is a sale. The debtor realizes gain or loss equal to the difference between the principal amount of the nonrecourse debt and the debtor's adjusted basis in the property. Treas. Reg. §1.1001-2(a)(1) and (c), Example 7. The prop-

erty's fair market value does not matter. There is no COD income.

Example (Recourse Debt)

A transfers to a creditor an asset with an adjusted basis of $5,000 and a fair market value of $6,000. The creditor discharges $7,500 of indebtedness secured by the asset for which A is personally liable. The amount realized on the disposition of the asset is its fair market value ($6,000). The amount of gain realized on the disposition of the asset is the excess of the fair market value over the adjusted basis ($6,000 - $5,000 = $1,000). In addition, A has COD income of $1,500 ($7,500 - $6,000).

Example (Nonrecourse Debt)

B transfers to a creditor an asset with a fair market value of $6,000 with an adjusted basis of $5,000. The creditor discharges $7,500 of indebtedness secured by the asset for which B is not personally liable. The amount realized on the disposition of the asset is the amount of indebtedness discharged ($7,500). The amount of gain realized on the disposition of the asset is the difference between the amount realized and the adjusted basis of the asset ($7,500 - $5,000 = $2,500). B has no COD income on the discharge of the nonrecourse indebtedness.

Armed with this background, let's look at the judicial and statutory exceptions to COD income.

THE COURTS TAKE EXCEPTION • Several important exceptions to the rule that discharge of the taxpayer's debt results in COD income have been established through court decisions and have not been codified.

Contingent Or Contested Liabilities

Cancellation of a contingent liability does not result in COD income because a contingent liability is not a true debt for COD purposes. *Hunt v. Commissioner*, 59 T.C. M. (CCH) 635 (1990) (a contractual obligation to make payments based on future profits was not a true debt; its cancellation did not give rise to income); *Graf v. Commissioner*, 80 T.C. 944 (1983) (nonrecourse loan repayable out of future profits is not a loan for tax purposes). Taxpayers have also been able to avoid COD income on the settlement of contested obligations. *N. Sobel, Inc. v. Commissioner*, 40 B.T.A. 1263 (1939), *nonacq*. 1940-1 C.B. 8. The scope of the judicial exception to COD income for contested obligations is not clear. The cautious view is that the exception is only available when there is a valid dispute concerning the amount of the original liability or when the debt reduction is based on an "infirmity" that relates back to the purchase of property (such as the seller's misrepresentation or fraud). *See Preslar v. Commissioner*, 167 F.3d 1323 (10th Cir. 1999). The infirmity permits the taxpayer to treat the debt reduction as a price adjustment even though the debt is not owed to the seller and thus falls outside of section 108(e)(5).

Debt That Is Equity

Satisfaction of a debt for less than the face amount cannot give rise to COD income if the debt was really an equity interest. It is possible that a taxpayer's nominal debt to a lender might, for tax purposes, be an acknowledgment of an equity interest in exchange for an advance. In such cases, a return of less than all of the investor's advance should not be regarded as a cancellation of indebtedness.

STATUTORY EXCLUSIONS FROM COD INCOME • Now let's look at the statutory exclusions from COD income found in section 108. Perhaps the most important are the bankruptcy and insolvency exclusions.

Bankruptcy

Section 108(a)(1)(A) excludes any amount that would otherwise be includible in gross income by reason of the discharge of the taxpayer's debt if the discharge occurs in a case under the Bankruptcy Code. To enjoy the benefit of the exclusion, the taxpayer must be under the jurisdiction of the court in the bankruptcy case and the discharge of the debt must be granted by the court or pursuant to a court-approved plan. §108(d)(2). In return for the exclusion of COD income generated in bankruptcy, the taxpayer must reduce certain of its tax attributes. §108(b). (The bankruptcy, insolvency, "qualified farm indebtedness," "qualified business real property indebtedness," and "qualified principal residence indebtedness" exclusions all require a corresponding reduction of tax attributes. We will look at the attribution reduction rules after reviewing the statutory exclusions.) The bankruptcy exclusion is especially valuable to a taxpayer because it is not limited by the extent of the taxpayer's insolvency or by the extent of the taxpayer's tax attributes available for reduction.

With partnerships, the bankruptcy exclusion and the related reduction of tax attributes are applied at the partner level. §108(d)(6). What this means is that when partnership debt is discharged in a bankruptcy case, the bankruptcy exclusion will not apply to any partner who is not also in bankruptcy. *But see Estate of Martinez, v. Commissioner,* 87 T.C.M. (CCH) 1428 (2004) (Tax Court permitted exclusion of COD income from bankrupt partnership even though partner neither bankrupt nor insolvent). If, however, a partner is insolvent, he or she may be able to exclude his or her share of partnership COD income arising from the discharge of partnership debt in a bankruptcy of the partnership under the insolvency exclusion, which is also applied at the partner level. §§108(a)(1)(B) and 108(d)(6).

Insolvency

Section 108(a)(1)(B) excludes any amount that would otherwise be includible in gross income by reason of the discharge of the taxpayer's debt if the discharge occurs when the taxpayer is insolvent. (The insolvency exclusion does not apply if the debt is discharged in a bankruptcy case. §108(a)(2)(A).) This exclusion is limited, however, to the extent of the taxpayer's insolvency. §108(a)(3). "Insolvent" for this purpose means the condition of an excess of liabilities over the fair market value of assets. §108(d)(3). To determine whether or not a taxpayer is insolvent, and the amount by which the taxpayer is insolvent, one looks to the taxpayer's assets and liabilities immediately before the discharge of the debt. §108(d)(3).

Example

A has assets of $500 and liabilities of $650, including debt to creditor C of $300. A settles debt to creditor C for $100. Since A is insolvent to the extent of $150 ($650 - $500), A may exclude $150 of the $200 in cancellation of debt from COD income. A recognizes $50 of COD income as a result of settling A's debt to creditor C at a reduced amount.

Determining Insolvency

According to the IRS, the amount by which a nonrecourse debt exceeds the fair market value of the property securing the debt is taken into account in determining insolvency, but only to the extent that the excess nonrecourse debt is discharged. Rev. Rul. 92-53, 1992-2 C.B. 48. The excess nonrecourse debt that is not discharged is not treated as a liability in determining insolvency.

As with the bankruptcy exclusion, in return for the exclusion of COD income generated while the taxpayer is insolvent, the taxpayer must reduce certain of its tax attributes. §108(b). As noted above, with partnerships, the insolvency exclusion of part-

nership COD income is determined at the partner level. §108(d)(6).

The statutory insolvency exclusion is exclusive. §108(e)(1). There are no additional judicial insolvency exclusions available.

Qualified Farm Indebtedness

Section 108(a)(1)(C) excludes any amount that would otherwise be includible in gross income by reason of the discharge of the taxpayer's debt if the debt is "qualified farm indebtedness." (The bankruptcy and insolvency exclusions take precedence over the QFI exclusion. §108(a)(2)(A) and (B).) As with the bankruptcy and insolvency exclusions, in return for the exclusion of COD income on the discharge of QFI, the taxpayer must reduce certain of its tax attributes. §108(b). The QFI exclusion is closely drawn. QFI is debt incurred by the taxpayer directly in connection with the taxpayer's farming trade or business, but only if at least 50 percent of the taxpayer's aggregate gross receipts for the three tax years preceding the tax year in which the debt is discharged is attributable to farming. §108(g)(2). The QFI exclusion only applies if the discharge of the debt is by a "qualified person," which term basically describes persons in the lending business unrelated to the taxpayer (including federal, state and local government agencies). §108(g)(1). The amount excluded from COD income cannot exceed the sum of (i) the taxpayer's "adjusted tax attributes" and (ii) the aggregate adjusted bases of the taxpayer's "qualified property" at the beginning of the tax year following the tax year in which the debt is discharged. §108(g)(3). The taxpayer's "adjusted tax attributes" are generally the tax attributes subject to reduction on account of the bankruptcy and insolvency exclusions (other than the basis of the taxpayer's property). §108(g)(3)(B). The taxpayer's "qualified property" is any property held for use in a trade or business or for the production of income. §108(g)(3)(C). Thus, the QFI exclusion, unlike the bankruptcy and insolvency exclusions, is limited by the taxpayer's tax attributes and basis in qualified property available for reduction.

Qualified Real Property Business Indebtedness

For taxpayers other than C corporations, section 108(a)(1)(D) provides an elective exclusion from COD income for the discharge of "qualified real property business indebtedness." (The bankruptcy and insolvency exclusions take precedence over the QRPBI exclusion. IRC §108(a)(2)(A) and (B).) QRPBI is debt incurred or assumed by a taxpayer in connection with real property used in a trade or business which is secured by such real property. §108(c)(3)(A). The QRPBI definition also requires the debt to be "qualified acquisition indebtedness" or to have been incurred or assumed before 1993. §108(c)(3)(B). Finally, for the exclusion to apply, the taxpayer must make an election to treat the debt as QRPBI. §108(c)(3)(C). (IRS Form 982 is to be attached to the return for the taxable year of discharge. Section 108(c)(3) also makes it clear that QRPBI does not include QFI and contains a rule to apply when QRPBI is refinanced.) "Qualified acquisition indebtedness" is debt incurred or assumed to acquire, construct, reconstruct, or substantially improve the property securing the debt. §108(c)(4). In return for the exclusion of COD income as QRPBI, the taxpayer must reduce the taxpayer's basis in the taxpayer's depreciable real property. §108(c)(1)(A). The QRPBI exclusion is subject to two separate limitations. First, the amount of the exclusion cannot exceed the excess of (i) the outstanding principal amount of the debt before the discharge over (ii) the fair market value of the real property reduced by any other QRPBI secured by the property. §108(c)(2)(A); Treas. Reg. §1.108-6(a). Second, the amount of the QRPBI exclusion cannot exceed the aggregate adjusted bases of the taxpayer's depreciable real property. §108(c)(2)(B); Treas. Reg. §1.108-6(b). (The statute provides special adjustments in the case of reductions in basis as

a result of the application of other statutory exclusions and prevents the taxpayer from counting the basis of property acquired in contemplation of the discharge of the debt.) Thus, the QRPBI exclusion is doubly limited—first by the amount of debt in excess of property value (net of other QRPBI secured by such property), and second, like the QFI exclusion, by the taxpayer's aggregate adjusted basis of depreciable real property.

Qualified Principal Residence Indebtedness

A temporary exclusion for the discharge of "qualified principal residence indebtedness" appears in section 108(a)(1)(E). (The bankruptcy exclusion takes precedence over the QPRI exclusion. IRC §108(a)(2)(A). The QPRI exclusion takes precedence over the insolvency exclusion unless the taxpayer elects otherwise. §108(a)(2)(C).) The statute excludes the discharge of QPRI from gross income if the QPRI is discharged before 2013. QPRI is "acquisition indebtedness" with respect to the taxpayer's principal residence. §108(h)(2). In the QPRI definition, "acquisition indebtedness" is a modified version of that term as used to describe the qualified residence interest deduction under section 163(h)(3)(B). *Id.* The modifications cap the amount of QPRI at $2 million (rather than the $1 million cap applicable for the interest deduction) for joint filers. *Id*. (The QPRI exclusion limit is $1 million in the case of a married taxpayer filing a separate return.) The statute requires a reduction in the basis of the taxpayer's principal residence in the amount excluded from gross income on the discharge of QPRI. §108(h)(1). The QPRI exclusion will not apply if the mortgage debt is discharged on account of any factor not directly related to the residence's decline in value or the taxpayer's financial condition. §108(h)(3). (In particular, the QPRI exclusion will not apply if the discharge of the mortgage debt is on account of services performed for the lender.)

OTHER COD SPECIAL RULES • In addition to the exclusions and special rules we have reviewed, section 108 contains other special rules dealing with COD income. These rules address the discharge of debt the payment of which would have given the taxpayer a deduction, the reduction of purchase money debt, student loans, debt-for-equity exchanges, and the new deferral available for COD income attributable to the reacquisition of certain business debt.

Lost Deductions

Section 108(e)(2) provides that a taxpayer does not realize COD income to the extent that the taxpayer's payment of the debt discharged would have given rise to a deduction. An obvious beneficiary of this rule is the cash (but usually not accrual) basis taxpayer whose trade account payable is discharged.

Purchase Money Debt Reduction

Under section 108(e)(5), a purchase money debt reduction of a solvent taxpayer is treated as a price reduction, not COD income, if the reduction occurs outside of bankruptcy and while the purchaser is solvent. The result is a reduction in basis, but not under the attribute reduction rules that apply in the case of certain other statutory exclusions from COD income. The legislative history of section 108(e)(5) indicates that the purchase price reduction exception is not available if (i) the original seller of the property has assigned the debt, (ii) the debtor has transferred the purchased property, or (iii) the debt reduction arises from events unrelated to actions of the purchaser and the seller, such as the expiration of the statute of limitations on the enforcement of the debt. S. Rep. No. 96-1035, 96th Cong., 2d Sess., at 16-17, *as reprinted in* 1980-2 C.B. 620, 628.

Student Loans

There is also a statutory exception for discharge of debt under certain student loans if the discharge is under a loan provision to the effect that the debt will be discharged, in whole or in part, if the former student works for a certain period of time in certain professions for specified employers. §108(f).

Stock For Debt

Section 108(e)(8)(A) provides that if a corporation transfers stock to a creditor in satisfaction of the corporation's debt, then for purposes of determining the corporation's COD income, the corporation will be treated as having satisfied the debt with an amount of money equal to the fair market value of the stock. This means there is COD income to the extent the debt discharged is greater than the value of the stock. Note, this rule differs from the rule for determining COD income on the contribution of debt to capital when the creditor receives no additional equity interest in the corporation. Section 108(e)(7) provides rules for the recapture of the creditor's loss deductions on the sale of the stock.

Partnership Interest For Debt

Under section 108(e)(8)(B), a similar rule applies when a partnership transfers a capital or profits interest to a creditor in satisfaction of partnership debt. For purposes of determining the partnership's COD income, the partnership will be treated as having satisfied the debt with an amount of money equal to the fair market value of the partnership interest. §108(e)(8). *See* Prop. Reg. §1.108-8, REG-164370-05 (October 31, 2008) (setting out a safe harbor under which the value of the partnership interest is its liquidation value). This means there is COD income to the extent the debt discharged is greater than the value of the partnership interest. Any COD income recognized on an exchange of a partnership interest for debt must be included in the distributive shares of the taxpayers who were the partners in the partnership immediately before the discharge of the debt. §108(e)(8). Under regulations to be prescribed, the creditor's loss deductions are to be recaptured on the sale of the partnership interest in a fashion similar to the recapture of loss deductions in a corporate debt-for-equity exchange as spelled out in section 108(e)(7). §108(e)(7)(E).

Deferral Of COD Income When Business Indebtedness Discharged By Reacquisition

As noted above, generally, if a debtor acquires its own debt for less than the amount owed, the debtor has COD income. A new statutory provision permits certain taxpayers to elect irrevocably to defer COD income arising in connection with the taxpayer's reacquisition of the taxpayer's debt so long as the reacquisition takes place in 2009 or 2010. §108(i). (The taxpayer's election to apply section 108(i)'s deferral regime to COD income precludes the application of the bankruptcy, insolvency, QFI and QRPBI exclusions to the COD income from the debt for the year of the election (or any later year). §108(i)(5)(C). Pass-thru entities must make the election at the entity level. §108(i)(5)(B)(iii).) When the taxpayer elects to defer such COD income, the taxpayer must include the deferred amount in income ratably over the five-taxable-year period beginning with either (i) the fifth taxable year following the taxable year in which the reacquisition occurs (if the reacquisition occurs in 2009) or (ii) the fourth taxable year following the taxable year in which the reacquisition occurs (if the reacquisition occurs in 2010). §108(i)(1) (in other words, beginning in 2014). To qualify for the deferral, the debt instrument reacquired must be one issued by a C corporation or one issued in connection with the taxpayer's conduct of a trade or business. §108(i)(3)(A). Reacquisition may be by the debtor under the debt instrument or by certain related persons. §§108(i)(4)(A) and 108(i)(5)(A). Reacquisition may be by means of the payment of cash, in exchange for another debt instrument (including a deemed ex-

change upon modification of the debt instrument), in exchange for corporate stock or a partnership interest, or by contribution of the debt to capital. §108(i)(4)(B). The holder's complete forgiveness of the debt is also a reacquisition under the statute. *Id*. Recognition of the deferred COD income will be accelerated upon the taxpayer's death, liquidation, sale of substantially all assets, or cessation of business or upon "similar circumstances" (apparently to be specified in future IRS guidance). §§108(i)(5)(D)(i) and 108(i)(7)(A). In the case of pass-thru entities, the deferred COD income will also be accelerated upon the sale, exchange, or redemption of an interest in the entity by the owner of the interest. §108(i)(5)(D)(ii).

If the taxpayer's reacquisition of its debt takes the form of an exchange of debt instruments (either an actual exchange or a deemed exchange as a result of a modification of the debt) and there is OID with respect to the new debt instrument issued in the exchange, a special rule applies with respect to the issuer's deductions with respect to the OID. §108(i)(2). (The issuer of a debt instrument with OID generally deducts OID as interest over the term of the debt as it accrues. *See* §163(e)(1). There is a notable exception for certain "applicable high yield discount obligations" or AHYDOs. *See* §163(e)(5).) The law does not allow any deduction with respect to the portion of the OID (up to the amount of the COD income deferred) that accrues before the taxpayer must begin to take the deferred COD income into account as gross income. §108(i)(2)(A). The disallowed OID deductions are allowed over the five-taxable year period in which the taxpayer must include the deferred COD income in gross income. *Id.*

ATTRIBUTE REDUCTION • As noted above, the taxpayer's price for exclusion of COD income under the bankruptcy, insolvency, and QFI exclusions is the reduction of certain of the taxpayer's favorable tax attributes. The concept is to at least try to turn the exclusion into a mere deferral. The required reduction in tax attributes applies (in order) to the taxpayer's (i) net operating losses, (ii) general business credits, (ii) minimum tax credit, (iii) capital loss carryovers, (iv) basis in the taxpayer's property, (v) passive activity loss and credit carryovers, and (vi) foreign tax credit carryovers. §108(b); Treas. Reg. §1.108-7(a)(1). In the case of the bankruptcy and insolvency exclusions, if the excluded COD income is greater than the total of the taxpayer's tax attributes, the excess COD income is permanently excluded from the taxpayer's gross income. Treas. Reg. §1.108-7(a)(2). The QFI exclusion, as we have seen, has a built-in limitation based on the tax attributes available for reduction. The reductions are generally made on a dollar-for-dollar basis with respect to the excluded COD income except in the case of the reduction in the credits, where the reduction is 33 1/3 cents for each dollar excluded. §108(b)(3). The taxpayer makes the reductions after determining income tax for the year the COD income is realized. §108(b)(4). (Special ordering rules apply to the reduction of carryover tax attributes.) Section 1017 and the Treasury Regulations under section 1017 describe how any reduction in the basis of the taxpayer's property is to be made.

Basis Reductions

A taxpayer may elect to reduce the basis of the taxpayer's depreciable property first before reducing any other tax attributes. §108(b)(5); Treas. Reg. §1.108-4. Section 1017 also governs this reduction in basis. The election to reduce basis in depreciable property is limited in application to the aggregate adjusted bases of the taxpayer's depreciable property at the beginning of the taxable year following the taxable year in which the discharge of debt giving rise to COD income occurs. §108(b)(5)(B). By making the election to reduce basis first, the taxpayer can preserve other tax attributes, like loss carryovers, that may be more immediately valuable.

Section 1017 deals with the reduction in basis of property necessary as a result of the application of the bankruptcy, insolvency, or QFI exclusions, whether under the general reduction rules or under the elective reduction of basis of depreciable property before the application of the general reduction rules. Section 1017 also deals with the reduction in basis of property necessary as a result of the application of the elective QRPBI exclusion. In general, as noted above, the amount of COD income excluded which is to be applied to basis reduction is applied to reduce the basis of property held by the taxpayer at the beginning of the year following the year in which the debt was discharged. §1017(a). In bankruptcy and insolvency cases the amount of the reduction is limited. In such cases the reduction cannot exceed (i) the aggregate of the bases of the taxpayer's property immediately after the discharge of the debt over (ii) the aggregate of the taxpayer's liabilities immediately after the discharge of the debt. §1017(b)(2). However, when the taxpayer elects under section 108(b)(5) to reduce its basis in depreciable property first before reducing other tax attributes, the taxpayer's liabilities are not taken into account in determining the maximum basis reduction. *Id.*

Order Of Reduction

In the case of the bankruptcy and insolvency exclusions, the income tax regulations require the taxpayer to reduce its bases in its property in the following order: (i) real property used in a trade or business or held for investment (other than real property held for sale to customers in the ordinary course) that secured the discharged debt; (ii) personal property used in a trade or business or held for investment (other than inventory or accounts or notes receivable) that secured the discharged debt; (iii) remaining property used in a trade or business or held for investment (other than inventory, accounts or notes receivable, or real property held for sale to customers in the ordinary course); (iv) inventory, accounts and notes receivable, and real property held for sale to customers in the ordinary course; and (v) property not used in a trade or business nor held for investment. Treas. Reg. §1.1017-1(a)(1). (The reductions are in proportion to adjusted basis.) The regulations apply the same ordering rules, with appropriate modifications, when the reduction in basis follows as a result of the taxpayer's election under section 108(b)(5) to reduce basis before applying the general attribute reduction rules and when the reduction is as a result of the QRPBI exclusion. Treas. Reg. §1.1017-1(c)(1).

When the reduction is by reason of the taxpayer's election under section 108(b)(5) to reduce basis before applying the general attribute reduction rules or is by reason of the QRPBI exclusion, the reduction is only in the basis of the taxpayer's depreciable property. §1017(b)(3). The reduction is generally applied to the basis of the taxpayer's depreciable property at the beginning of the tax year following the tax year in which the debt is discharged. However, with the QRPBI exclusion, the basis reduction takes place immediately before the property is disposed of if that date is earlier. §1017(b)(3)(F)(iii). Thus, under the QRPBI exclusion there is less opportunity for planning based on the time of disposition than under the bankruptcy or insolvency exclusions. Property is "depreciable" for this purpose only if the reduction will reduce the amount of depreciation or amortization which would otherwise be allowed for the period immediately following the reduction. §1017(b)(3)(B); Treas. Reg. §1.1017-1(e). Special rules may apply to classify partnership interests, corporate subsidiaries, and real property held for sale in the ordinary course of business as depreciable property. §1017(b)(3)(C), (D), and (E); Treas. Reg. §1.1017-1(f) and (g). When the reduction is by reason of the QRPBI exclusion, "depreciable property" includes only depreciable real property and may not include real property held for sale in the ordinary course of business. §1017(b)(3)(F).

When the reduction is by reason of the QFI exclusion, the reduction in basis is limited to the basis of "qualified property," that is, business property and property held for the production of income. §1017(b)(4). The reduction is applied first to the taxpayer's depreciable property, next to the taxpayer's farm land, and finally to the taxpayer's other business or income property. *Id*. (Special rules may apply to classify partnership interests, stock in subsidiaries of consolidated groups, and, at the taxpayer's election, real property held for sale in the ordinary course of business as "qualified property" subject to basis reduction by reason of the QFI exclusion.)

Recapture

Property that the taxpayer treats as exempt property in the taxpayer's bankruptcy case does not have its basis reduced under section 1017. §1017(c)(1).

Exempt Property

Reductions in basis under section 1017 are recaptured as ordinary income on the disposition of the property by treating the reduction as depreciation subject to recapture under section 1245, or if the property is section 1250 property, treating the reduction as depreciation in excess of straight line. §1017(d).

PARTNERSHIP ASPECTS • We will often see a partnership's or a limited liability company's debt discharged in one of the same ways an individual or corporate taxpayer's debt might be discharged. When a partnership realizes COD income, the tax analysis becomes more complex. Not only are there the usual complexities of Subchapter K to deal with, but there are also special provisions in section 108 concerning the application of exclusions, and in section 1017 concerning attribute reduction, that apply in the context of the cancellation of partnership debt.

It may be helpful first to put cancellation of partnership debt in context. If a partnership realizes COD income, it is income that is allocated to the partners as part of the partners' distributive shares of income in accordance with the partnership agreement, or if the allocation under the agreement does not have substantial economic affect, in accordance with the partners' interests in the partnership. §§702 and 704. A partner's basis in his or her partnership interest is increased by the partner's distributive share of the partnership's COD income. §705(a). The cancellation of the partnership debt giving rise to the COD income will also result in a decrease in the share of partnership liabilities of each partner to whom the debt was allocated. Under section 752(b) such a decrease in a partner's share of the partnership's liabilities is treated as a distribution of money by the partnership to the partner. The deemed distribution of money decreases the partner's basis in his or her partnership interest. §733. If the amount of money deemed distributed exceeds the adjusted basis of the partner's interest in the partnership, the partner must recognize gain on the deemed distribution under section 731(a) in the amount of the excess. That is the beginning of the analysis. Note that it is possible that the partner's share of the partnership's COD income may be more or less than the amount of the discharged debt allocated to the partner. In these cases the basis increase (for the income) will not equal the basis decrease (for the deemed distribution of money on reduction of partnership liabilities), possibly triggering gain recognition under section 731(a).

Application At The Partner Level

Next there is section 108(d)(6). Section 108(d)(6) requires that the bankruptcy, insolvency, QFI and QRPBI exclusions be applied at the partner level. Thus, the COD income that arises at the partnership level may only be excluded under such provisions if the partner qualifies for the exclusion. For

example, to qualify for the bankruptcy exclusion, the partner must be in bankruptcy. *But see Estate of Martinez,* supra. In addition, the reduction of the taxpayer's tax attributes must be applied at the partner level with respect to the partner's tax attributes. §108(d)(6).

In the case of the QRPBI exclusion there are further nuances. The legislative history indicates that the QRPBI election is made at the partner level. House Ways and Means Committee Report No. 103-11, H.R. 2141, May 19, 1993. The limitation on the exclusion determined by the taxpayer's basis is determined at the partner level, but the character of the debt and the limitation based on the principal amount of the debt and the value of the real property are determined at the partnership level. *Id.*

The new deferral provision in section 108(i) adds its own complexity in the partnership context. Section 108(i)(6) establishes a special rule for partnerships with respect to any COD income deferred by a partnership under the new statutory provision permitting certain taxpayers to elect irrevocably to defer COD income arising in connection with the taxpayer's reacquisition of the taxpayer's business debt in 2009 or 2010. Under section 108(i)(6), any COD income deferred under this provision must be allocated to the partners in the partnership immediately before the discharge of the debt, as such income would have been included in such partners' distributive shares if the COD income were recognized at such time. Any decrease in a partner's share of partnership liabilities as a result of the discharge of the debt is not taken into account for purposes of section 752 at the time of the discharge to the extent it would cause the partner to recognize gain under section 731. Any decrease in partnership liabilities thus deferred must be taken into account by the partner at the same time, and to the extent remaining in the same amount, as income deferred under section 108(i) is recognized. §108(i)(6). (Section 108(i)(7) includes a grant of authority to the Treasury to prescribe regulations for the application of section 108(i) to partnerships, including for the allocation of deferred deductions.)

As noted above, following exclusion of COD income under the bankruptcy, insolvency, or QFI exclusions, a taxpayer may elect to reduce the basis of its depreciable property first before reducing any other tax attributes. §108(b)(5). In addition, when a taxpayer excludes COD income under the QRPBI exclusion, the taxpayer must reduce the basis of the taxpayer's depreciable real property. §108(c)(1). In both cases, a partner may treat the partner's interest in a partnership as depreciable property to the extent of such partner's proportionate interest in the depreciable property held by the partnership. §1017(b)(3)(C). The partner may do so, however, only if the partnership reduces the partnership's basis in depreciable property with respect to such partner. *Id.*; *see also* Treas. Reg. §1.1017-1(g)(2). (The regulations require a partner to request the partnership's consent under certain circumstances and also describe when a partnership must consent to reduce its partners' shares of inside basis.)

IRS Guidance

The IRS has furnished guidance to help with several questions arising at the intersection of partnership and COD income tax principles.

In Rev. Proc. 92-92, 1992-2 C.B. 505, the IRS said it will not challenge a bankrupt or insolvent partnership's treatment of a reduction of partnership debt as a purchase price adjustment (rather than COD income), provided the transaction would qualify as a purchase price adjustment but for the bankruptcy or insolvency of the partnership. As we have seen, section 108(e)(5), which describes the purchase price adjustment exception to COD income, says that if (i) the debt of a purchaser of property to the seller is reduced, (ii) the debt reduction does not occur in bankruptcy or when the purchaser is insolvent, and (iii) the reduction would be treated as COD income but for the purchase

price adjustment exception, then the reduction in debt will be treated as a purchase price adjustment. (The purchase price adjustment results in a reduction in the basis of the property securing the debt rather than the realization of COD income.) Here, the IRS has applied the purchase price adjustment provided by section 108(e)(5) in the partnership context in a manner consistent with section 108(d)(6)'s rule that the bankruptcy and insolvency exclusions are applied at the partner, rather than the partnership, level. The IRS says that just as the bankruptcy or insolvency of a partnership is not relevant to the application of the bankruptcy or insolvency exclusions to a partner's share of the partnership's COD income, the bankruptcy or insolvency of the partnership is also not a limiting factor in the application of the purchase price adjustment exception to COD income to a reduction of partnership purchase money debt. (The IRS indicates in Rev. Proc. 92-92 that the treatment described will not apply to a partnership if any partner adopts a tax reporting position with respect to the debt discharge that is not consistent with the partnership's treatment.)

Rev. Rul. 92-97, 1992-2 C.B. 124, answers the question whether the allocation of partnership COD income to a partner has substantial economic effect under section 704(b) when the share of COD income differs from the share of the canceled debt allocated to the partner under section 752(b). The Revenue Ruling holds that the allocation has substantial economic effect if (i) the deficit restoration obligations of the partnership agreement covering any negative capital account balances resulting from the COD income allocations can be invoked to satisfy other partners' positive capital account balances, (ii) the requirements of the economic effect test under Treas. Reg. §1.704-1(b)(2) are otherwise met, and (iii) substantiality is independently established. Thus, in the examples given in the Revenue Ruling, the allocation of the partnership's COD income was found to have the necessary economic effect when the partnership agreement's deficit restoration obligations did not depend on the canceled debt (that is, were not limited to the extent necessary to pay only creditors) and could be invoked to satisfy another partner's positive capital account. Rev. Rul. 92-97 is also useful because it recognizes that the increase in a partner's basis resulting from an allocation of the partnership's COD income to the partner and the decrease in the partner's basis resulting from the deemed distribution of money to the partner under section 752(b) from the canceled debt both occur at the end of the partnership's tax year and may be netted against each other. *See also* Rev. Rul. 94-4, 1994-1 C.B. 195 (A deemed distribution of money under section 752(b) resulting from a decrease in a partner's share of partnership liabilities is treated as an advance or drawing of money under Treas. Reg. §1.731-1(a)(1)(ii) to the extent of the partner's distributive share of income for the partnership's tax year. The amount is taken into account at the end of the partnership's tax year.) Use of the COD income to increase basis at the same time the debt discharge causes a deemed distribution of money will often eliminate gain under section 731(a) from a deemed distribution of money in excess of basis.

KNOWING IT WHEN YOU SEE IT • To be helpful in advising clients concerning COD income, we have to know it when we see it. As noted above, the common situations in which a debtor may realize COD income include the following:

- Cancellation of debt;
- Acquisition of debt by the debtor or a person related to the debtor;
- Loan modification;
- Surrender of property securing debt in exchange for cancellation of debt;
- Contribution of debt to corporate capital; and
- Exchange of debt for equity interest in a corporation or partnership.

PLANNING • Once we find we have COD income to deal with, the next questions are planning questions. The law concerning COD income is complex and provides many planning opportunities. Obviously, the planning opportunities available to a particular taxpayer will depend on the facts of that taxpayer's situation as well as the law.

The planning opportunities include the following choices for the taxpayer:

- The election (in many situations) to file for bankruptcy protection;
- The ability (in many situations) to determine the timing of the discharge of indebtedness;
- The election (for a solvent taxpayer other than a C corporation) to claim the QRPBI exclusion;
- The election (for a limited time) to defer COD income attributable to the reacquisition of business debt;
- The election to reduce the basis of the taxpayer's depreciable property before reducing other tax attributes; and
- The opportunity (in most situations) to do tax planning for the year of the discharge of indebtedness taking into account that the attribute reduction rules are applied after the tax is determined for the year of discharge.

These choices all have their own limitations and consequences and are just the beginning of the tax planning opportunities available.

Planning in the partnership context involves keeping basic Subchapter K principles in mind as well as the basic COD income rules and the special COD income rules that apply to partners and partnerships. These special rules reflect Congressional and Treasury decisions to focus on matters at the partnership level or at the partner level for different purposes.

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