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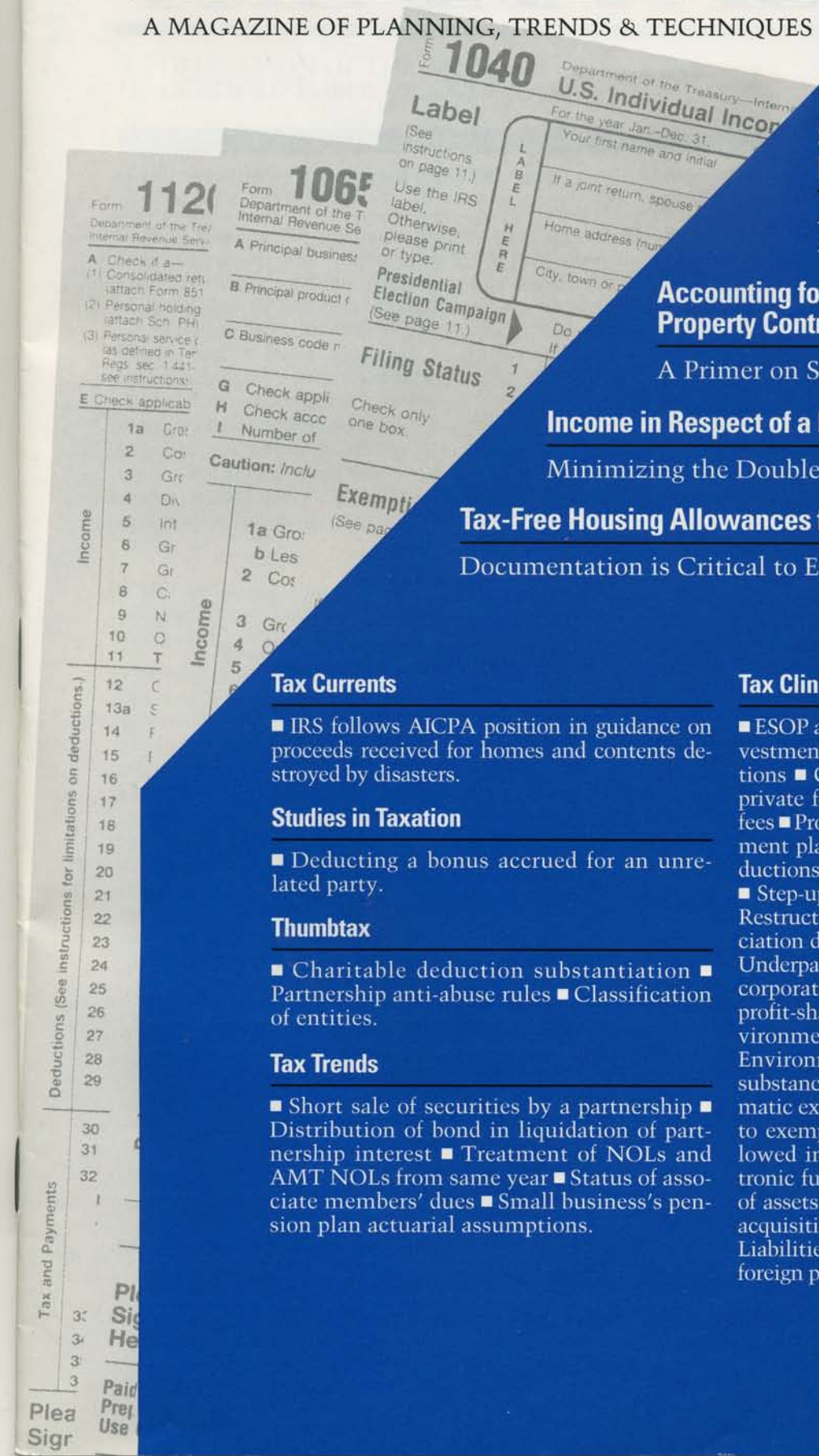

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ARTICLES

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Sec. 108(a)(1) Excluded COD Income

Are "Windfall" Basis Adjustments Allowed?

Last year, the Sixth Circuit held in *Babin*[1] that a partner is not entitled to an increase in the basis of his partnership interest for partnership cancellation of debt (COD) income, when the income is excluded from tax under the Sec. 108(a)(1)(B) insolvency exception. Subsequently, in Letter Ruling (TAM) 9423003,[2] the IRS took a comparable position with respect to COD income of an insolvent S corporation; the S shareholders were not entitled to an increase in the basis of their S stock for their pro rata shares of excluded income.

With respect to both partnerships and S corporations, the Service's position is that income excluded from tax under Sec. 108(a)(1) is not tax-exempt income for which a basis adjustment is allowed under subchapters K and S. Arguably, this position can be justified from a policy perspective: under certain facts, such a basis adjustment can produce a windfall to the partners or shareholders of the debtor, a passthrough entity for tax purposes whose debt has been discharged. However, the basis adjustment is warranted under the language of the Code. For this reason, the Service's litigation position is problematic; legislative amendment by Congress, not equitable decisionmaking by the Federal courts, is the appropriate remedy.[3] This article examines the pro and con arguments surrounding this basis adjustment.

Background

According to the Supreme Court in *Kirby Lumber Co.*,[4] when a debtor acquires its own debt instrument for less than its face amount, income is recognized equal to the difference between the purchase price and the debt's outstanding balance. Likewise, a lender's COD results in COD income to the debtor. Whether a debt discharge results in COD income is still determined under this judicial doctrine, rather than by the Code. Once it is determined that COD income has been recognized (and that no relevant judicial exception applies), it is includible in gross income under Sec. 61(a)(12), unless otherwise excluded.

A number of the original cases involving debt discharge were decided during the Depression, when the value of real estate significantly declined; many of the recent cases and rulings have facts reminiscent of these leading decisions and involve debt workouts in the context of distressed real estate projects.[5] These cases and rulings often involve the use of tax entities that either did not exist or were less commonly used in the 1930s (e.g., partnerships and S corporations). Further, Congress added Sec. 108 to the Code via the Bankruptcy Tax Act of 1980 (BTA '80), which codified several of the judicial exceptions to the general rule that COD results in COD income.

[1] *C. Stephen Babin*, 23 F3d 1032 (6th Cir. 1994)(73 AFTR2d 94-1961, 94-1 USTC ¶50,224), aff'g TC Memo 1992-673, *cert.* denied.
[2] IRS Letter Ruling (TAM) 9423003 (2/28/94).
[3] AICPA letter to the IRS, dated Apr. 5, 1995; see *BNA Daily Tax Report* (4/10/95), at G-2.
[4] *Kirby Lumber Co.*, 284 US 1 (1931)(10 AFTR 458, 2 USTC ¶814).
[5] See, e.g., *John F. Tufts*, 461 US 300 (1983)(51 AFTR2d 83-1132, 83-1 USTC ¶9328); *Joseph Y. Aizawa*, 99 TC 197 (1992); Rev. Ruls. 91-31, 1991-1 CB 19, and 92-53, 1992-2 CB 48.

These developments in tax law have forced the courts, the IRS and taxpayers to grapple with the intricacies of subchapters K and S, as well as the many peculiarities that can arise when COD income is realized in the context of a debtor partnership or S corporation. Technical glitches arise because tax rules enacted at different times under different Code provisions are not well integrated with one another.

Exceptions to Income Recognition

Historically, the courts have recognized a number of exceptions to *Kirby Lumber;* after that Supreme Court decision, many of those exceptions continued to be respected by the lower courts. Among the many judicial exceptions enunciated by the courts over the years (some of which may no longer be good law), the most significant have held that income is not recognized (1) when the "overall transaction" is a loss,[6] (2) when the cancellation is of nonrecourse debt,[7] (3) when a debt discharge is in economic substance a "purchase price reduction"[8] and (4) to the extent that debt discharge occurs while the debtor is insolvent.[9]

A number of these judicial exceptions were codified in the enactment of Sec. 108. Under Sec. 108(a)(1)(B), when a taxpayer realizes COD income, the income is not recognized to the extent that the debtor is insolvent. Sec. 108(d)(3) defines "insolvency" for this purpose as the excess of liabilities over the fair market value (FMV) of assets, as of immediately before the discharge. Under Sec. 108(a)(1)(A), COD income is not recognized to the extent that the debt discharge occurs in a bankruptcy proceeding. The following examples illustrate how these two statutory exceptions are applied to an S corporation debtor.

Example 1: An S corporation ("Debtor") is owned by two equal shareholders, *X* and *Y*, who each contributed $500,000 in exchange for stock. On Jan. 1, 1996, Debtor purchases a commercial office building on leased land for $11,000,000, using the $1,000,000 in capital contributions and a $10,000,000 bank loan. The loan, which is interest only for 10 years and a balloon payment at maturity, is secured by a first mortgage on the building. The shareholders do not guarantee the loan and are not personally liable for the debt.

For the first five years of operation, Debtor's operating expenses exactly equal its revenues; hence, there is no net cash flow. Annual tax losses of $282,040 (0.02564 × $11,000,000) attributable to depreciation on the building are allocated 50% to each shareholder.[10] Thus, after five years of operation, both *X* and *Y* will have an adjusted basis of zero in their stock, and each will have been allocated $705,100 of tax losses over the period. The deduction for the last $205,100 ($705,100 − $500,000) of such losses would be suspended for each shareholder under Sec. 1366(d)(1) because of the zero basis in stock.

Due to a decline in the real estate market, the FMV of the building decreases to $5,000,000 after five years. On Jan. 1, 2001, Debtor files for chapter 7 bankruptcy. Pursuant to the liquidation, Debtor sells its only asset, the building, for $5,000,000, which the bank accepts in full satisfaction of the loan.

Example 2: The facts are the same as in Example 1, except that on Jan. 1, 2001, Debtor negotiates with the bank outside of bankruptcy. Under a negotiated workout, and because the bank does not want to foreclose on the building or otherwise take title to it, the bank agrees to reduce the outstanding debt from $10,000,000 to the $5,000,000 FMV of the building. Immediately before the workout, Debtor's liabilities exceed the FMV of its assets by more than $5,000,000.

■ Tax implications

In each example, Debtor will realize $5 million of COD income, because it has satisfied its debt for less than the outstanding balance due the bank. In Example 1, the building is sold and Debtor's $10 million debt is satisfied for $5 million, with the balance forgiven. In Example 2, the building is retained and the $10 million debt is written down to $5 million, with the balance forgiven. Under Sec. 108(d)(7)(A), for an S corporation debtor, the Sec. 108(a)(1) bankruptcy and insolvency exceptions are applied at the corporate level. Thus, in Example 1, the $5 million COD income would be excluded from tax under Sec. 108(a)(1)(A); in Example 2, the COD income would be excluded under Sec. 108(a)(1)(B).

Different results may ensue if the debtor is a partnership. Sec. 108(d)(6) provides that the bankruptcy and insolvency exceptions are applied at the partner, not the partnership, level. This provision was

[6] *Bowers v. Kerbaugh-Empire Co.*, 271 US 170 (1926) (repayment of foreign currency loan with devalued currency does not result in income of the difference between the amount received and amount repaid, when the overall transaction is a loss). This case has long been held in disregard, and should not be considered good law; see, e.g., *Herbert Gershkowitz*, 88 TC 984 (1987).

[7] *Fulton Gold Corp.*, 31 BTA 519 (1934). The IRS, never satisfied with the outcome of this case, stated in Rev. Rul. 91-31, note 4, that it does not consider it to be good law. For a discussion of its continued relevance, if any, see Cunningham, "A Requiem for *Fulton Gold*," 72 *TAXES* 365 (July 1994).

[8] *Kalman Hirsch*, 115 F2d 656 (7th Cir. 1940)[25 AFTR 1038, 40-2 USTC ¶9791]; *A.L. Killian Co.*, 128 F2d 433 (8th Cir. 1942)[29 AFTR 528, 42-2 USTC ¶9487].

[9] *Dallas Transfer & Terminal Warehouse Co.*, 70 F2d 95 (5th Cir. 1934)[13 AFTR 930, 4 USTC ¶1270].

[10] Under Sec. 168(c)(1), nonresidential real property is depreciable over 39 years; 1/39 = 0.02564. For the sake of simplicity, the Sec. 168(d)(4)(B) mid-month convention has been ignored.

added to Sec. 108 by the BTA '80 to overturn the Fifth Circuit's holding in *Stackhouse*,[11] which had applied the insolvency exception at the partnership level (to the benefit of the solvent partners).

Under current law, if Debtor is a general partnership in which *X* and *Y* are 50% general partners, all allocations of income and loss are in proportion to each partner's partnership interest and the $10 million loan is nonrecourse, each partner would be allocated $2.5 million of the $5 million COD income. Under Sec. 108(a)(1)(B), the income would be excluded from tax by a partner who is insolvent by at least $2.5 million immediately before the discharge; if the partner were undergoing bankruptcy, the $2.5 million COD income would be excluded under Sec. 108(a)(1)(A).

The separate rules for S corporations and partnerships may come into play pursuant to the same debt discharge. For instance, it is common for an S corporation to be the general partner of a limited partnership. In the case of COD income, Sec. 704(a) and (b) provide that such income will be allocated among the limited partners and the corporate general partner in accordance with the partnership agreement or the partners' respective partnership interests. Often, the result is that the corporate general partner will be allocated most of the COD income, because the limited partners are unlikely to have basis (or an obligation to make up a deficit in their capital accounts) at the time of a debt workout. If this occurs, to the extent that the corporate general partner is insolvent (which often is the case, as such partners tend to be thinly capitalized and liable for most, if not all, of the partnership's debt), it should be able to rely on Sec. 108(a). Tracing the allocation of income and basis adjustments attributable to the release of liability, however, can be complex and produce unexpected results, as several other rules must be considered.

Tax Attribute Reduction

Sec. 108(b)(1) and (2) provide that to the extent income is excluded under Sec. 108(a)(1), the following tax attributes of the debtor must be reduced: NOLs, tax credits, capital loss carryovers, asset bases, passive activity carryovers and foreign tax credit carryovers. If the debtor's total tax attributes are less than the excluded income, the excess income disappears.

Under Sec. 108(d)(7)(B), if the debtor is an S corporation, COD income is applied to reduce passthrough losses and deductions for the year of the COD that would have been allowed to the shareholders but for the fact that the losses exceeded their bases. Any remaining COD income reduces the bases of S corporation assets.

In Example 2 above, Debtor would be required to reduce its tax attributes by the $5 million of COD income excluded under Sec. 108(a)(1). Debtor's sole tax attribute is its adjusted basis in the building, which had already been reduced to $9,589,800 by five years' worth of depreciation ($11,000,000 − $1,410,200). Thus, Sec. 108(d)(7)(B) would require that the building's adjusted basis be reduced by $5 million to $4,589,800. This would result in the recognition of $410,200 of capital gain ($5,000,000 − $4,589,800), rather than a $4,589,800 capital loss, on a subsequent sale of the building for its $5 million FMV. In other words, the effect of the exclusion in this case is merely to defer taxation.

In Example 1, in which the building is conveyed for $5 million prior to the debt discharge, the Debtor would recognize a $4,589,800 capital loss ($9,589,800 − $5,000,000); thereafter, it would recognize $5 million of COD income. Debtor would have no tax attributes to reduce at that time, having previously disposed of the building. However, the $205,100 of previously suspended losses of shareholders *X* and *Y* would be deemed NOLs of the Debtor under Sec. 108(c)(7)(B) and eliminated.

Basis Adjustments

Some tax practitioners have taken the position that when the debtor is an S corporation, and COD income is excluded under Sec. 108(a)(1)(A) or (B), the S shareholders can increase their stock bases under Sec. 1367(a)(1)(A), which provides that a basis increase is allowed for income items described in Sec. 1366(a)(1)(A). One such income item is tax-exempt income. Thus, there is a strong argument that tax-exempt income for which a basis adjustment is allowed under Sec. 1367(a)(1)(A) includes income excluded under Sec. 108(a).

This basis increase would support the deduction of previously suspended losses because tax attribute reduction, which applies to such suspended losses, is applied after the computation of

[11] *Vincent Stackhouse*, 441 F2d 465 (5th Cir. 1971)(27 AFTR2d 71-1211, 71-1 USTC ¶9352); see S. Rep. No. 96-1035, 96th Cong., 2d Sess. (1980), 1980-2 CB 631, n. 26.

the current year's tax.[12] Hence, such a basis increase can be extremely valuable to shareholders of an S corporation holding a distressed property that generated significant tax losses in tax years prior to the COD, which shareholders were unable to deduct for lack of stock basis.

In Examples 1 and 2 above, an additional $5 million of basis would be allocated between *X* and *Y* in proportion to their stock interests in the corporation. This new-found basis would support a deduction of the $205,100 of previously suspended losses for *X* and *Y* prior to the application of the tax attribute rule. If *X* or *Y* had basis remaining after tax attribute reduction, it could be claimed as a capital loss on corporate liquidation or support the deduction of subsequent corporate NOLs if operations continued following the debt workout.

A comparable argument can be made that COD income of a partnership excluded under Sec. 108(a)(1) results in a basis increase in the partners' partnership interests. Sec. 705(a)(1)(B) provides for a basis increase for income that is exempt from tax under the Federal income tax laws. Again, the argument is that income excluded under Sec. 108(a) is tax-exempt income for this purpose, so that a basis increase is warranted.

Although the IRS has criticized this position,[13] until recently, there was no authority involving an S corporation debtor. Thus, a return position in which an S shareholder claimed a basis increase might have been supportable by a reasoned construction of the statutes and supported by "substantial authority" for purposes of avoiding the Sec. 6662 accuracy-related penalty.[14]

However, there probably is no such authority for a partner attempting to claim a basis increase for his allocable share of partnership COD income excluded under Sec. 108(a)(1). In 1991, in *Est. of Newman*,[15] the Second Circuit held that a partner is not allowed a basis increase under Sec. 705(a)(1) for such income. Since that case, there has been no substantial authority for a return position under which an insolvent or bankrupt partner can obtain a basis increase under these circumstances. Possibly, the same negative authority carries over to S shareholders.

Babin and TAM 9423003

In *Babin*, a bankrupt partnership worked out its $5,170,019 debt to a bank by paying it $2.75 million and having the bank forgive the $2,420,019 balance. It also sold all its assets to a third party for $100,000; thus, it realized a total of $5,270,019 from the sale of assets and COD. The taxpayer, one of the general partners, was allocated 51% of income and 75% of partnership liabilities under the partnership agreement. Because he was insolvent, he excluded from income his $1,234,210 ($2,420,019 × 0.51) share of the partnership's COD income under Sec. 108(a)(1)(B). He claimed a basis adjustment in his partnership interest under Sec. 705(a)(1)(A) in the same amount for the excluded income.

Under Sec. 752(b), the cancellation of a partnership debt results in a deemed distribution to a partner in the amount of the partner's share of the discharged liabilities. When the partner is taxed on his allocable share of such COD income, he increases basis to the extent of that share.[16] In *Babin*, the taxpayer was relieved of $3,877,514 ($5,170,019 × 0.75) of partnership liabilities because of the workout. By adding his $1,234,210 share of the partnership's COD income to his preexisting $2,663,180 basis in his partnership interest, the taxpayer's new basis ($3,897,390) exceeded his share of relieved liabilities ($3,877,514), precluding gain recognition on the workout. On audit, however, the Service disallowed the $1,234,210 basis increase and required the taxpayer to recognize $1,289,334 ($3,952,514[17] − $2,663,180) of gain on the deemed distribution; the Tax Court agreed.

On appeal, the Sixth Circuit never reached the question of whether income excluded from tax under Sec. 108(a)(1) is exempt from tax under Sec. 705(a)(1)(A). Instead, it concluded that the taxpayer's $1,234,210 share of the partnership's COD

[12] Sec. 1366(d)(1)(A) provides an ordering rule such that the basis increase applies before the Sec. 108(b) tax attribute reduction, permitting an S shareholder to deduct suspended losses before the reduction rule is applied. Suspended losses in excess of adjusted basis would be subject to tax attribute reduction.

[13] See, e.g., Tax Clinic, "Exempt COD Income Creates S Corp. Basis Adjustment," 24 *The Tax Adviser* 788 (December 1993).

[14] Sec. 6662(d)(2)(B)(i) provides that the accuracy-related penalty will be reduced by the portion of an understatement attributable to the tax treatment of an item for which there is or was substantial authority.

[15] *Est. of Michael Newman*, 934 F2d 426 (2d Cir. 1991)(67 AFTR2d 91-1116, 91-1 USTC ¶50,281).

[16] The basis increase occurs before the deemed distribution. However, if the partner's allocable share of partnership debt is greater than his share of partnership income (as was the case in *Babin*), the deemed distribution will exceed the basis increase. This could result in gain recognition by the partner if the partner's basis were otherwise insufficient to support the deemed distribution.

[17] The IRS calculated the taxpayer's share of COD income to be $3,952,514 ($5,270,019 × 0.75).

income did not pass through to him because he was insolvent (i.e., because the taxpayer was insolvent, no taxable income passed through to him as a result of the discharge of the partnership's debt). Thus, the taxpayer was not entitled to a basis increase under Sec. 705(a)(1)(A).

There is no language in Sec. 705(a)(1)(A) supporting the Sixth Circuit's interpretation that only income that "passes through" to a partner as taxable income qualifies for a basis increase. On the contrary, the section provides that a basis adjustment is allowed for the partner's allocable share of "taxable income of the partnership." The $2,420,519 of COD income clearly was taxable income *of the partnership*, and presumably some of the other partners paid tax on their share of such income. Under a literal reading of Sec. 705(a)(1)(A), a basis increase is warranted. Further, the logical response to the court would be that if the income did not pass through because it was not taxable income of the partnership, it must have been "income exempt from tax" for which a basis increase is allowed under Sec. 705(a)(1)(B). Either way, the statute supported a basis increase.

The Sixth Circuit's conclusion in *Babin* seems to have been motivated by the view that the taxpayer would reap a tax windfall if allowed such a basis adjustment. The taxpayer, however, argued that without the basis increase, he would recognize gain on the deemed distribution and, hence, Congress's intention to provide an exception to COD income recognition for an insolvent partner would be defeated. At first glance, the taxpayer's argument is persuasive; on further reflection, several flaws are apparent.

First, the court seems to have correctly sensed that partners (and S shareholders) can obtain the benefit of tax deductions in excess of their capital contributions and amounts at risk if such a basis increase is allowed. In *Babin*, the taxpayer had previously included in basis his 75% allocable share of the partnership's debt pursuant to Sec. 752(a). Thus, if he lacked basis to support the deemed distribution at the time the $2,420,519 debt was discharged, it was only because he had previously claimed deductions for those tax losses of the partnership, which had reduced his basis in his partnership interest. The discrepancy between his 51% allocable share of the partnership's income and his 75% share of its liabilities also produced gain on the deemed distribution, but was unrelated to the basis increase at issue.

The extent to which this basis adjustment is a windfall can be seen more clearly in the case of the Debtor in Examples 1 and 2 above. There, shareholders *X* and *Y* each had an initial basis of $500,000 in their stock. Because neither was liable for the Debtor's $10 million debt, neither was entitled to basis attributable to that debt. In fact, $5 million of the total $6 million economic loss with respect to the building was suffered by the bank, not the shareholders. Thus, permitting *X* and *Y* each to claim an additional $2.5 million in basis beyond their capital contributions would provide a windfall to them. As shown, the additional basis would support the deduction of the previously suspended losses (e.g., attributable to the depreciation incurred in tax years before the COD and in excess of each shareholder's $500,000 initial basis in his stock). The result would be that *X* and *Y* could ultimately claim deductions in excess of the $500,000 in capital each originally invested. Because the bank would also take a deduction for its $5 million loss, total deductions would exceed the total economic loss actually suffered.

In TAM 9423003, the IRS concluded that a basis increase is not permitted under these facts. The issue there was whether shareholders of an insolvent S corporation that realized COD income were entitled to a basis increase under Sec. 1376(a)(1)(A) for their shares of such income. The IRS National Office, without any support for its position, concluded that the shareholders were not entitled to a basis increase for such income.

Conclusion

A basis increase for COD of a partnership or S corporation, when such income is excluded from tax under Sec. 108(a)(1), is supported by the literal language of the Code. However, *Babin* and TAM 9423003 hold otherwise and create the risk of penalties for taxpayers claiming the basis increase. The potential windfall for S shareholders and partners resulting from such a basis increase in cases such as *Babin* probably warrants the Service's position from a tax policy standpoint. However, rather than relying on the courts to create new doctrines that effectively overturn results following from the literal language of the Code or simply denying a basis adjustment by fiat, the Treasury is advised to pursue a legislative remedy. Absent a legislative correction, the Code seems to provide this basis adjustment—windfall or not. TTA