



# tax notes<sup>SM</sup>

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<b>SPECIAL REPORTS</b>	<b>Schleier: High Court Narrows Exclusion of Damages .. 471</b>
	<b>Taxpayers Take Three Strikes From Schleier Decision .. 475</b>
	<b>What Schleier Means for Discrimination Recoveries .. 481</b>
<b>FROM CONGRESS</b>	<b>Arney Introduces Latest Version of Flat-Tax Plan .... 373</b>
	<b>IRS Funding Bill Clears House; More Cuts Expected .. 377</b>
	<b>Another Reg Reform Bill Raises IRS Concerns ..... 379</b>
	<b>W&amp;M Questions IRS Compliance Measurement Program .. 381</b>
	<b>Groups Seek Relief From 'Deficit Reduction' Excises ... 386</b>
<b>IRS NEWS</b>	<b>Let Foreign Entities 'Check the Box,' Witnesses Say .. 375</b>
	<b>IRS Issues Final Lobbying Regulations ..... 399</b>
	<b>Regs Cover Disallowance of Deduction for Club Dues .. 403</b>
	<b>Procedures Issued for Exempt Orgs. That Lobby ..... 407</b>
<b>JUSTICE DEPT.</b>	<b>Plan To Shift Funds for Attorneys Worries Officials ... 378</b>
<b>POLICY</b>	<b>The Consumption Tax and Generational Equity ..... 383</b>
<b>COURTS</b>	<b>Dividend to Employer Plan Not Deductible for ACE ... 427</b>
	<b>Lack of Recapture Agreement Nixes Special Valuation .. 436</b>
<b>PRACTICE</b>	<b>TCMP, Economic Reality, and the IRS Summons Power .. 465</b>
<b>COMMENTARY</b>	<b>Reflections on the Status of Tax Expenditures ..... 485</b>
	<b>Keep the Portfolio Interest Exemption ..... 491</b>
	<b>IRS Pubs Are Confused on Punitive Damages ..... 493</b>
	<b>Loss Deduction Proposal Gives Homeowners Too Much .. 495</b>

## DEPARTMENTS

Accounting News .....	468	IRS Letter Rulings .....	416
Applicable Federal Rates .....	410	IRS News .....	407
Bibliography .....	461	IRS Regulations .....	399
Calendar .....	497	IRS Tax Correspondence .....	407
Code Section Index .....	502	IRS Tech Advice Memos .....	415
Congressional Committee Reports .....	456	JCT Reports .....	456
Congressional Hearing Transcripts .....	456	Letters to the Editor .....	493
Congressional Press Releases .....	455	News in Brief .....	392
Congressional Tax Correspondence .....	456	Pension News .....	463
Court Opinions .....	427	Press Watch .....	459
Current and Quotable .....	491	Reports in Brief .....	487
Economic Perspective .....	485	Special Reports .....	471, 475, 481
Focus on Congress .....	455	Summary of Contents .....	368
Focus on the IRS .....	407	Tax Court Appeals .....	454
Focus on Treasury .....	395	This Week's News .....	371
Internal Revenue Bulletin .....	413	Treaty News .....	397



# reports in brief

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## Does Section 108(a) Allow 'Windfall' Basis Adjustments?

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In May 1994, the U.S. Court of Appeals for the Sixth Circuit held in *Babin v. Commissioner*<sup>1</sup> that a partner is not entitled to a basis increase in his partnership interest for income from the cancellation of debt of the partnership, when the income is excluded from income by reason of the so-called "insolvency exception" provided for under section 108(a) of the Internal Revenue Code. In Technical Advice Memorandum 9423003, 94 TNT 113-20 (June 13, 1994), the Internal Revenue Service took a comparable position with respect to income from the cancellation of indebtedness of a subchapter S corporation where the income is not recognized under the insolvency exception. The Service stated that the shareholders of the S corporation are not entitled to a basis increase in their stock. This article discusses and weighs the merits of the argument in favor of such a basis adjustment.

### Cancellation of Debt Income

In the seminal case of *Kirby Lumber Co. v. United States*,<sup>2</sup> the U.S. Supreme Court held that when a debtor

acquires its own debt instrument for less than its face amount, income is recognized in an amount equal to the difference between the purchase price and the outstanding balance of the debt. In 1980, a number of long-standing judicial exceptions to this rule were codified in section 108. Two of the most commonly invoked statutory exemptions are found at section 108(a). The first holds that when a taxpayer recognizes income under the general principles governing the cancellation of indebtedness, such income is not recognized to the extent that the debtor is "insolvent."<sup>3</sup> The second holds that income from the cancellation of indebtedness is not recognized to the extent that the debt discharge occurs in a bankruptcy proceeding.<sup>4</sup> Under these provisions, to the extent that a debtor is either insolvent immediately prior to the discharge of the relevant debt or the discharge occurs in a bankruptcy proceeding, income will not be recognized.

According to section 108(d)(7)(A), when the debtor is an S corporation, both the bankruptcy and insolvency exceptions are applied at the corporate level. Thus, if the debt is cancelled while the S corporation debtor is in a bankruptcy proceeding, the income is not recognized under the section 108(a)(1)(A) exemption. If the S corporation debtor is insolvent by at least as much as the debt discharge, the income from the cancellation of indebtedness is not recognized under section 108(a)(1)(B). Somewhat different results may follow when the debtor is a partnership. In the context of a discharge of the debt of a partnership, the bankruptcy and insolvency exceptions are applied at the partner level, not the partnership level.<sup>5</sup> Thus, if the debtor is a general partnership in which allocations of income and loss are made in proportion to each partner's interest in the partnership, each partner would be allocated his share of the income from the discharge of the partnership's debt. To the extent that an individual partner is insolvent by at least as much as his share of the discharged debt immediately prior to the discharge, the income will not be recognized under section 108(a)(1)(B). To the extent that the partnership debt is discharged while a partner is in a bankruptcy proceeding, his share of the total income from the can-

<sup>1</sup>No. 93-1614, 94 TNT 90-12 (6th Cir., May 6, 1994).

<sup>2</sup>284 U.S. 1 (1931).

<sup>3</sup>Section 108(a)(1)(B).

<sup>4</sup>Section 108(a)(1)(A).

<sup>5</sup>Section 108(d)(6).

cancellation of the indebtedness will be excluded under section 108(a)(1)(A).

#### Mandatory Tax Attribute Reduction

To the extent that income is not recognized by virtue of section 108(a) (i.e., because the debtor is either insolvent or in a bankruptcy proceeding), certain "tax attributes" of the debtor must be reduced in lieu of recognizing the income.<sup>6</sup> Tax attributes that must be reduced include: net operating losses (NOLs), tax credits, capital loss carryovers, basis, and foreign tax credit carryovers.<sup>7</sup> If the debtor's total tax attributes are less than the excluded income, the excess simply "disappears," resulting in the elimination (rather than deferral) of tax liability with respect to the income from the cancellation of the debt. Under section 108(d)(7)(B), when the debtor is an S corporation, tax losses passed through to its shareholders in prior taxable years but suspended under section 1366(d)(1) for lack of basis in their S corporation stock are treated as a NOL. The result is that suspended tax losses from prior years must be reduced dollar for dollar for income that is excluded from income by virtue of either the insolvency or bankruptcy exceptions.

#### Basis Adjustment for Tax-Exempt Income

Some tax practitioners have taken the position that when the debtor is an S corporation, and income from the cancellation of indebtedness is exempt under either the bankruptcy or insolvency exception, the shareholders of the corporation are entitled to an increase in their basis in their stock under section 1367(a)(1)(A). This provision provides that a basis increase is allowed for "items of income described in subparagraph (A) of section 1366(a)(1)." One of the items of income described in section 1366(a)(1)(A) is "tax-exempt income." Arguably, tax-exempt income for which a basis adjustment is allowed under section 1367(a)(1)(A) includes income that is excluded from income under section 108(a). This basis increase would support the deduction of previously suspended losses because the mandatory tax attribute reduction, which applies to such suspended losses, is applied *after* the computation of the current year's tax.<sup>8</sup> Hence, such a basis increase can be extremely valuable to the shareholders of an S corporation holding a distressed property that generated significant tax losses in taxable years prior to the debt discharge, but which losses the shareholders were unable to deduct for lack of basis in their stock. This newfound basis would support a deduction of previously suspended losses for each shareholder *prior* to the application of the mandatory tax attribute rule. If a shareholder had any remaining basis after the

application of the attribute reduction rule, that basis could be claimed as a capital loss upon liquidation of the corporation or could support the deduction of subsequent net operating losses of the corporation if operations were to continue following the debt work-out.

A comparable argument can be made that income from the cancellation of indebtedness of a partnership, which income is excluded from income under section 108(a) (i.e., when an individual partner is either insolvent or in a bankruptcy proceeding), also gives rise to a basis increase in that partner's interest in the partnership. Section 705(a)(1)(B) provides for a basis increase for income that is "exempt from tax" under the federal income tax laws. The argument is that income that is not recognized under section 108(a) falls into this category, and hence, that a basis increase is warranted under the statute. When the debtor is a partnership and a partner is in a bankruptcy proceeding or insolvent, under this theory the partner would claim a basis increase for his allocable share of the partnership income from the debt discharge that is "exempt" from taxation under section 108(a).

#### Babin and TAM 9423003

The issue of whether a partner is entitled to the basis increase came before the Sixth Circuit in *Babin*. There, a partnership was able to effect a work-out of its debt to a bank, which discharged just over \$2.4 million of its secured debt pursuant to a bankruptcy proceeding of the partnership. The taxpayer was one of the general partners of the partnership and was allocated 51 percent of such income under the partnership agreement. However, at all relevant times the taxpayer/partner was insolvent by more than that amount, and hence, was entitled to rely upon the insolvency exception. As such, he was not taxed on his share of the income from the discharge of the partnership's debt — which share amounted to approximately \$1.2 million. The taxpayer also claimed a basis adjustment of \$1.2 million for this "tax-exempt" income.

Under the statutory scheme of subchapter K, when a partner is relieved of his allocable share of partnership debt, a so-called "deemed distribution" under Section 752(b) will result. When the partner is taxed on his allocable share of cancellation of indebtedness income, such taxable income will give rise to a basis increase that will then support a deemed distribution in the same amount.<sup>9</sup> In *Babin*, the partner was relieved of his share of the partnership's liabilities pursuant to the work-out. The taxpayer was liable for (and hence, had been allocated) 75 percent of the debt of the partnership debt under the partnership agreement — amounting to just over \$3.9 million. Taking into account a basis in-

<sup>6</sup>Section 108(b)(1).

<sup>7</sup>Section 108(b)(2).

<sup>8</sup>Section 1366(d)(1)(A) provides an ordering rule to the effect that the basis increase would come before the section 108(b) tax attribute reduction rule, permitting the shareholder to claim a deduction for the suspended losses before the reduction rule is even applied. Suspended losses in excess of the adjusted basis would be exposed to the tax attribute reduction.

<sup>9</sup>The basis increase is given effect prior to 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 of the partner in *Babin*), the deemed distribution will be greater than the basis increase. This could result in the recognition of gain by the partner if the partner's basis was otherwise insufficient to support the deemed distribution.

crease of \$1.2 million, this deemed distribution of \$3.9 million did not trigger the recognition of any gain. Upon audit the Service disallowed the basis increase, and hence, the taxpayer recognized almost \$1.3 million of taxable gain on the deemed distribution. The assessment of gain on this amount was upheld by the Tax Court and subsequently by the Sixth Circuit on appeal.

The Sixth Circuit never reached the question of whether income that is excluded under the section 108(a) exemptions is "income exempt from tax" within the meaning of section 705(a)(1)(A). The court sidestepped that issue and reasoned that the taxpayer's \$1.2 million share of the partnership's income from the cancellation of indebtedness did not "pass through" to him because it was not taxable by virtue of the insolvency exception. The court construed the basis adjustment provided for under section 705(a)(1)(A) as applying only to cancellation of indebtedness income that "passes through" (i.e., is taxed) to a partner. Under this interpretation, if a partner makes use of the insolvency exception (or presumably the bankruptcy exception), the income is not be taxable to him, and hence, does not "pass through" to him. As such, the partner would not be entitled to a basis increase under section 705(a)(1)(A).

There is no language in section 705(a)(1)(A) to support the court's interpretation that the statute requires that only income that "passes through" to a partner as taxable income qualifies for a basis increase. On the contrary, the statute simply provides that a basis adjustment is allowed for the partner's allocable share of "taxable income of the partnership." The \$2.4 million of debt cancellation income clearly was taxable income of the partnership, and presumably some of the other partners paid tax on such income. Under a literal reading of section 705(a)(1)(A), a basis increase would seem to be warranted. Furthermore, 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, then it must have been "income exempt from tax" for which a basis increase also is allowed under section 705(a)(1)(B).

The court was motivated by its feeling that the taxpayer would reap a tax "windfall" if allowed such a basis adjustment. Conversely, the taxpayer complained that without the basis increase, he would recognize gain on the deemed distribution, and hence, Congress's intention to provide an exception to income recognition for an insolvent partner would be defeated. But the court correctly recognized that partners (and shareholders) could obtain the benefit of tax deductions in excess of their capital contributions and amounts at risk in a venture if this basis increase is allowed. In the case of the partnership in *Babin*, the taxpayer had previously included in basis his 75 percent allocable share of the partnership's debt pursuant to section 752(a). Thus, if he lacked basis to support the deemed distribution at the time that the \$2.4 million debt was dis-

charged, it was only because he had previously claimed deductions for those tax losses of the partnership, which losses had reduced his basis in his partnership interest. The discrepancy between his 50 percent allocable share of the partnership's income and his 75 percent share of its liabilities also produced gain on the deemed distribution, but that was a result unrelated to the basis increase at issue.

The extent to which this basis adjustment is a tax "windfall" can be seen more clearly in the case of a subchapter S corporation whose nonrecourse debt is discharged. As no partner was ever liable for the corporation's nonrecourse debt in the first place, none would have been entitled under subchapter S to any basis attributable to the corporate debt. In fact, any economic loss suffered with respect to the property used to secure the debt would be suffered by the lender, and not the shareholders. Thus, permitting the shareholders to claim an additional basis beyond their capital at risk could give them a tax windfall. Any additional basis would support the deduction of the previously suspended losses (e.g., depreciation deductions or operating losses incurred in taxable years prior to the debt discharge in excess of each partner's initial basis in his stock). The result of that would be that the shareholders could ultimately claim deductions in excess of the capital each invested in the venture. As the lender would also take a deduction for its uncollected debt, there would be total deductions claimed in excess of the economic loss suffered.

In TAM 9423003, the IRS announced its view that a basis increase is not allowed under these exact facts. The issue there was whether the shareholders of a subchapter S corporation that recognizes income upon a debt discharge, but is insolvent at such time, are entitled to a basis increase under section 1376(a)(1)(A). The National Office of the IRS expressed its view that a shareholder is not entitled to a basis increase for such income.

### Conclusion

A basis increase for income from the cancellation of indebtedness of an S corporation or partnership, when such income is not recognized under section 108(a), is supported by the relevant provisions of the code. It must be acknowledged that this treatment could result in a potential tax windfall for shareholders and partners. However, rather than relying on the federal courts to create new doctrines that effectively overturn a result that follows from the language of a statute (as was the case in *Babin*) or simply denying a basis adjustment by fiat (as is the case with TAM 9423003), Treasury would do better to pursue a legislative remedy. Absent such a legislative remedy, the express language of the code seems to provide for this basis adjustment — tax "windfall" or not.

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