DEBT RELATED TAX ISSUES
CURRENT DEVELOPMENTS

SECTION: 42
NOTIFICATION PROCEDURES TO BEGIN RUNNING OF STATUTE OF LIMITATIONS FOR DISPOSITIONS OF LOW-INCOME HOUSING PROPERTY ISSUED BY IRS

Citation: Revenue Procedure 2012-27, 5/2/12

Taxpayers who claim a low income housing credit under IRC §42 face a potential recapture of the tax if their basis in a building is less at the end of any taxable year than it was at the end of the preceding tax year at any time during the 15-year compliance period. Such a decrease will not trigger the tax if it occurs as a result of a disposition of the building or an interest in the building if it is reasonably expected that the building will continue to be operated as a qualified low-income building for the remaining compliance period. [IRC §42(j)(6)(A)]

However, IRC §42(j)(6)(B) provides that the statute of limitations for assessing tax based on that decrease in basis will not start until three years after the IRS is notified of the reduction in basis in a form that the IRS has prescribed. In Revenue Ruling 2012-27 the IRS gave details of what will be required for a compliant notice.

Notification must be made by the taxpayer in a letter to the Internal Revenue Service at the address contained in the instructions for the then current Form 8609, Low-Income Housing Credit Allocation and Certification for filing current certifications. The notice is deemed given to the IRS on the postmark date of the letter. The letter must contain the following items:

- A lead-in declaration stating: "By this letter I am making the notification prescribed by § 42(j)(6)(B)(i) of the Internal Revenue Code.";
- The taxpayer's name, address, and taxpayer identification number;
- The name (if any), address, and Building Identification Number of each building to which the taxpayer's disposition relates. If a taxpayer received a credit from a pass-through entity but does not know the information required by the preceding sentence, the taxpayer must provide the name and employer identification number of the pass-through entity from which the taxpayer received the credit;
- To the extent known, the name, address, and taxpayer identification number of any person(s) to whom the increase in tax under § 42(j)(6)(B) applies as a result of a reduction in the qualified basis of any building to which the taxpayer's disposition relates; and
- A concluding declaration stating: "Under penalties of perjury, I declare that I have examined this letter and the representations made therein, and to the best of my knowledge and belief, they are true, correct, and complete."

The Revenue Procedure is effective for notifications made on or after May 2, 2012. Any notifications sent the IRS before that date will not be not be effective to start the 3-year statute unless it meets specific criteria found in Section 5.03 of the Revenue Procedure.

The qualifications required for an earlier declaration to start the statute are that it must contain, at a minimum, the second and third items listed above for current notices and contains a declaration under penalties of perjury similar to the one required for current notices. If a prior notification does not meet this criteria, the statute will not begin to run until a notification meeting all of the criteria of Revenue Procedure 2012-27 is filed.

SECTION: 42
LOSS OF BUILDING IN FORECLOSURE OR DEED IN LIEU OF FORECLOSURE MAY NOT TRIGGER RECAPTURE OF LOW INCOME HOUSING CREDIT

Citation: CCA 201146016, 11/18/11

In Chief Counsel Advice 201146016, the IRS ruled that either a foreclosure or deed in lieu of foreclosure does not automatically result in an automatic recapture of low income housing credits under the provisions of IRC §42(j). Rather, a foreclosure is treated like any other disposal, thus if the facts indicate that the exception under §42(j)(6)(A) apply there would be no recapture.

Generally a disposition of the building does trigger recapture under §42(j), but if it is reasonably expected the building will continue to be operated as low-income housing building for the remainder of the required period.

It is important to note that this ruling does not say there will not be a recapture event in the event of a foreclosure or a deed in lieu of foreclosure. Rather, evidence must exist that the requirements of §42(j)(6)(A) have been met and obtaining such documentation is key to defending any position taken that a recapture event has not occurred.

SECTION: 61
INTEREST TRACING REGULATIONS CITED TO TRACE NATURE OF INCOME FOR PUBLICLY TRADED PARTNERSHIP RULES

Citation: Revenue Procedure 2012-28, 6/18/12

While cancellation of debt income recognized under IRC §61(a)(12) is ordinary income, in many cases such income may also need to be otherwise classified. In Revenue Procedure 2012-28 the IRS again turned to the general interest tracing rules of Reg. §1.163-8T to find the nature of the cancellation of debt income, this time when dealing with qualifying income for a publicly traded partnership seeking to escape corporate tax treatment pursuant to the qualifying income rules of IRC §7704(c).

To meet that exception, 90 percent or more of the entity's gross income must arise from sources described in IRC §7704(d)(1). While containing a long list of qualifying income, the list does not mention income under IRC §61(a)(12) from cancellation of indebtedness. However, due to economic difficulties, such a partnership that borrowed in order to invest in assets generating qualifying income might find that it was unable to repay the debt and/or might renegotiate the debt. In either case, cancellation of debt income would arise, and that amount could be substantial.

The IRS found that, in such a case, the cancellation of debt income could be treated as qualifying income if the taxpayer can show the cancellation of debt income is attributable to debt incurred in direct connection with the activities that gave rise to qualifying income. The IRS goes on to specifically provide a safe harbor that references Reg. §1.163-8T's tracing rules:

> One reasonable method for demonstrating that COD income is attributable to debt incurred in direct connection with the PTP's qualifying activities is to trace the proceeds of the debt generating COD income to qualifying activities under an approach similar to the one used in section 1.163-8T.

The ruling rejects as generally not "reasonable" a method that simply allocates COD income based solely on the proportion of other gross revenues received. Advisers can presume the "assumption" that debt generally should be traced based on income would likely be held to be unreasonable in other similar context (such as determining the portion of COD income to be treated as passive activity income).

SECTION: 61
ISSUANCE OF FORM 1099C DID NOT ESTABLISH YEAR OF CANCELLATION OF INDEBTEDNESS INCOME

Citation: Stewart v. Commissioner, TC Summary Opinion 2012-46, 5/21/12

The IRS again lost a cancellation of debt case in the Tax Court where they attempted to rely on the Form 1099C as establishing the year a debt was cancelled. In Stewart v. Commissioner, TC Summary Opinion 2012-46 that the issue of the year of cancellation revolves around the first identifiable event that establishes a debt will not be paid occurred, not when the lender finally gets around to issuing a Form 1099C.

In this case the taxpayer had a credit card debt on which they ceased payment on sometime before September 6, 1996. The bank that issued the card charged off the debt on September 12,1996. The debt was then transferred to a collection agency, which transferred to yet another agency later.

In 2001 the statute of limitations on collecting the debt under applicable state law expired. However, despite being aware of that fact, the collection agency began making attempts to collect the debt. In 2008 the taxpayer issued a letter demanding that collection activities stop and the agency complied. The agency then issued a Form 1099C for 2008. The IRS attempted to assess tax on the taxpayer based on the issuance of that Form 1099C.

The Tax Court found for the taxpayers—not that there was no cancellation of indebtedness, but rather that such cancellation had occurred years before. In deciding the case, the Tax Court looked to the regulations regarding information reporting and found that those regulations created a rebuttable presumption that an identifiable event had occurred when no payments are made and no attempts at collection take place over a 36-month period. That period would have expired in 1999.

To rebut the presumption it must be shown the lender had engaged in significant bona fide collection activities over that 36-month period or that facts and circumstances existing on January 31st in the year following the expiration of the period indicate that the debt had not been discharged. The court found no evidence of that being true, and so found an identifiable event had taken place in 1999.

But the court notes that merely finding identifiable events is not enough—the court has to find the event that makes clear a discharge has taken place. There can be multiple "identifiable events" that will vie for that position, but only the first one to show clear intent of discharge will count. The cessation of activities would be another such event, and that took place in 2008, the year for which the Form 1099C was issued.

However the Court found that the debt had been truly discharged no later than the 1999 identifiable event. As such, there was no taxable income in 2008, but rather such income would have taxable in 1999.

The key lesson to take away from this case is the reminder that issuance of a Form 1099C does not establish there is a taxable event in the year in question. Rather, advisers must make inquiries about the facts surrounding the debt to determine whether such cancellation has taken place and, if so, when that event took place.

SECTION: 61
NO CANCELLATION OF DEBT INCOME EVEN THOUGH SOLE COLLATERAL FOR NONRECOURSE DEBT WAS NOTE WHOSE OBLIGOR HAD FILED FOR BANKRUPTCY AND DEFAULTED

Citation: Field Attorney Advice 20121701F, 5/8/12

In Field Attorney Advice 20121701F the IRS gave some additional guidance on the application of the "identifiable event" trigger for recognition of cancellation of indebtedness income.

In this situation the taxpayer had borrowed funds and pledged as collateral an installment note it held from another party. The lender had no effective recourse in the event of nonpayment of the note except to look to the collateral—that is, the installment note.

The installment note debtor eventually filed bankruptcy and defaulted on the installment note. The taxpayer filed a claim in bankruptcy with regard to the installment note and the claim is being pursued. Initially the taxpayer believed they had cancellation of debt income at this point since the payor of the installment note was in default and in bankruptcy, and paid estimated taxes based on that income. However the taxpayer had a change of opinion when it came time to file the return, and took the position there had not yet been cancellation of debt.

In the FAA, the IRS concluded the taxpayer was correct in this view. Citing the Tax Court's opinion in the case of Cozzi v. Commissioner, 88 TC 435 (1987) the opinion notes that discharge takes place for tax purposes upon the occurrence of any "identifiable event" which fixes the loss with certainty. Abandonment of worthless collateral specifically is found to be such an event when the debt is a nonrecourse debt where the creditor only had the right to look to the collateral. But the note would not be worthless until such time as it could be established there was no reasonable possibility the collateral would ever have value in the future.

In bankruptcy all is not necessarily lost for unsecured creditors. Even though the debtor's liabilities exceeded its assets, it still had assets, some of which would be available to partially pay unsecured creditors. In this particular bankruptcy, the FAA notes that while the collateral only has value based on future bankruptcy payouts, but such payouts are reasonably expected to be made in this case.

Thus the installment note collateral is not worthless and certainly has not been abandoned. As such, no identifiable event sufficient to fix the loss with certainty had occurred by year end and therefore there was no cancellation of debt income.

While the FAA does not go on to discuss the matter in more detail, it would appear that even in the future there may not be cancellation of debt but rather a sale pursuant to IRC §1001 of the underlying installment note if it is not worthless.

SECTION: 61
COURT RELUCTANTLY AGREES TO RULE ON QUESTION PARTIES ASKED, FINDING EMPLOYEE HAD TO INCLUDE FORGIVEN INTEREST IN INCOME

Citation: Brooks v. Commissioner, TC Memo 2012-25, 1/26/12

The Tax Court gave us a decision in the case of Brooks v. Commissioner, TC Memo 2012-25, though the Court clearly believes it was asked the wrong question by the parties. The question the Court answered involved whether a taxpayer who had principal and interest forgiven on a loan by his employer could, under the facts of the case, avoid the inclusion of cancellation of indebtedness income on the interest portion of the debt that was forgiven.

The problem the Court found was that it wasn't really sure there had really been a loan to begin with, thus whether there was either principal or interest that could be forgiven in the year in question. The taxpayer upon beginning employment with the employer (a stock brokerage firm) had received $500,000 cash. The employer and taxpayer had a note written up making the amount a loan that was due in five years and had a stated interest rate. If the taxpayer was still employed with the employer at the end of the five years, the employer agreed to forgive the balance of the loan. If he left before then, he still would only need to repay a prorata portion of the loan.

While the parties had stipulated that the amount was a loan and that Mr. Brooks had $500,000 of cancellation of debt income in year five, the Court believed that this transaction likely should not have been recognized as a loan for tax purposes. The Court found the facts of this case virtually identical to those found in the case of Winter v. Commissioner, T.C. Memo. 2010-287.

Since the reason for the "loan" was to induce Mr. Brooks to provide services and the repayment obligation was conditional, the Court believed the proper treatment was to have treated the $500,000 as income in the year it was received. Mr. Brooks had unrestricted use of the funds and only a contingent obligation to repay, so under the claim of right doctrine he should have included the entire balance in income.

As the Court pointed out, that would create a problem for the IRS because they were litigating the wrong year (the one five years after the taxable event). And, as well, without the "loan" there also would be no forgiveness of interest (which was the issue the parties were disputing).

But the parties had stipulated that the $500,000 principal was taxable income. The court noted:

> There are limits to what parties can stipulate, and pure statements of law that are just plain wrong may well be out of bounds. But we read the stipulation in this case as an agreement that Brooks received at least $506,300--the principal of the loan--as income in 2003. Because neither party has argued that the stipulation on this mixed question of fact and law doesn't bind us, we deem this issue waived.

The Court noted, in a footnote, that the parties had also ignored the question of, if there had been a real debt that the income should have been recognized each year as a prorata portion of the debt was "earned" but that for the same reason as it was ignoring the question of the reality of the loan, it would ignore that issue as well.

The Court then moved on to decide the issue that, however questionable its relevance should have been in the Court's view, was the one the parties wanted resolved—could the taxpayer exclude from income the interest forgiven. The taxpayer argued that he should be able to exclude the interest under the forgone deduction provision of IRC §108(e)(2). That provisions holds that if an amount forgiven would have given rise to a deduction had it been paid, the debtor does not include that amount as cancellation of debt income.

Mr. Brooks claimed he used the $500,000 to purchase investment assets, arguing that the purpose behind the loan was to give him a "stake to showcase his skills as a stockbroker to produce income for himself and his wife" which would prove useful for his employer who employed him as a stockbroker. Unfortunately Mr. Brooks produced no records to trace the proceeds as required under Regulation §1.163-8T. Since Mr. Brooks could not trace the debt to such investment assets, the Court ruled that he had not shown the interest would have been investment interest if he had paid it.

Second, the Court also agreed with the IRS that investment interest is only contingently deductible—a taxpayer must have investment income in order to be able to claim a deduction. For the year in question his return showed net investment income of only $25. So the Court agreed with the IRS that even if he had been able to trace the funds to investment assets, he could not have excluded the income because the amount would not have been otherwise deductible.

SECTION: 108
TAXPAYER FAILS TO ESTABLISH VALUE OF THREE ASSETS, NO INSOLVENCY EXCLUSION ALLOWED

Citation: Shepherd v. Commissioner, TC Memo 2012-212, 7/24/12

Taxpayers who have income from cancellation of indebtedness are allowed to exclude that income for income tax purposes to the extent they are insolvent at the time of discharge, in accordance with IRC §108(a)(1)(B). In the case of Shepherd v. Commissioner, TC Memo 2012-212 the IRS and the taxpayers disagreed about the values of the taxpayers' assets. Specifically, the IRS argued the taxpayers failed to meet their burden of proof of the value of certain assets.

The key disputes arose around two items of real estate and the value of the interest in the taxpayer's pension. The Tax Court's commentary on quality (or lack thereof) of the evidence of value is very instructive for advisers who have clients that may be attempting to meet the insolvency test.

Property Tax Valuation Not Sufficient

The taxpayers looked to use a "Civil Stipulation of Settlement" with a city taxing agency to determine the value of their beach house property, which they claimed was $340,000. The stipulation agreed that for local property tax purposes in 2010 the house would be valued at $380,000. The Tax Court first noted that the actual discharge for which the taxpayers sought relief took place in 2008, well before the effective date of this agreement. Thus, to the extent this did offer any evidence of value, it was not at the proper time. The taxpayer must show insolvency at the date of discharge, not at some date well into the future.

Second, the Court found that the agreement did not provide sufficient detail as to the valuation methods used. The agreement did not describe the property, or what methodology was used to obtain that value. Thus, even if it had valued the property in 2008, the valuation would not have been sufficient to carry the taxpayer's burden.

The taxpayer also presented his view of the value based upon comparable sales he had assembled for his property tax appeal. The Court noted, again, that the year in question was 2010 and not 2008. As well, the Court found that it would have need more than the taxpayer's testimony that he had consulted comparable sales, but the actual detail of those comparable sales to make such a determination of their relevance in establishing value. Thus the court found the taxpayer had failed to establish the value of the beach house.

Lender's Statement of Value Insufficient

The taxpayers did not fare any better on the valuation used for their principal residence. The taxpayer offered a letter from their mortgage lender that discussed the value for purposes of qualification for a federally sponsored loan modification program. The bank stated, in a letter date in March 2011, that an "exterior broker price opinion/appraisal" set the value at $380,000. The Court again complained that this value was as of a date long after the date of discharge, thus not relevant to the matter that needed to be determined.

As well, the Court that the letter "does not describe the property nor explain, even briefly, the methodology used to determine its value." For both of these reasons, the Court found the bank letter irrelevant in this case.

Again the taxpayer's attempted to turn to local property tax values and, again, the Court refused to consider the item. The Court noted that a value placed upon property for local taxation purposes is not determinative of fair market value of the property for Federal income tax purposes in the absence of evidence of the method used in arriving at that valuation."

Thus, the taxpayers also failed to establish the value of this property as well.

Pension Asset Inclusion

By this point the Court had already concluded the taxpayers did not show they were insolvent, having failed to establish values for either piece of real estate. But the Court went on to also comment on the value of the taxpayer's rights in his pension plan.

The Court pointed out one obvious problem with the taxpayers' method of computing insolvency. The taxpayers had listed as a liability the amount they had borrowed from Mr. Shepherd's employer sponsored retirement plan account, but argued none of the plan asset should be listed as an asset. Even if Mr. Shepherd had been correct in that assertion, which the Court would hold he was not, he would not then have been allowed to include the liability secured by that asset without counting at least the value of the security pledged.

But the Court noted that rights to pension plans couldn't be excluded from the insolvency calculation merely because they are exempt from the claims of creditors. Citing the prior decision of Carlson v. Commissioner, 116 TC 87, the opinion notes:

> We reasoned that if a debtor's assets, including assets exempt from the claims of creditors under State law, exceed liabilities, then the debtor has the ability to pay a tax on income from the discharge of indebtedness.

The Court then went on to an asset value. Mr. Shepherd had the right to borrow up to 50% of his vested interest in the plan at any time, an amount he would be obligated to repay. The Court decided that this meant Mr. Shepherd could have drawn out that much money and used it to pay the discharged debts. The Court thus determined that this "right to borrow" was an asset of Mr. Shepherd. Mr. Shepherd had not produced evidence of his borrowing capacity at the date of discharge, thus he had also failed to provide a value for this asset.

It is important to read the footnote before going too far down this valuation path. In a footnote the Court clarified that the amount calculated was not necessarily the value of his plan interest. The Court noted "...it is unnecessary for us to decide whether Mr. Shepherd's entire pension constitutes an asset under sec. 108(d)(3)."

Conclusion

The Court notes clearly that the burden is on the taxpayer to "establish the fair market value for all of his assets and liabilities in order to make a determination of insolvency." Thus, the failure to establish the value of three assets meant that none of the debt discharge could be excluded from income under the insolvency exclusion. In fact, the Court's emphasis on valuing all assets makes it clear that just one of these flawed valuations was sufficient to deny the taxpayer the ability to exclude the cancellation of debt income under IRC §108.

Advisers should take note that the case makes clear there is a high bar the Court expects taxpayers claiming insolvency to clear, and that a taxpayer's "guess" at the value of property, even if based on property tax values or lender letters, simply will not be sufficient. Taxpayers who do not want to incur the cost of getting solid valuations for such assets that are as of the proper date and contain sufficient detail to explain valuation methods and support need to be advised that they are forfeiting the ability to asset the insolvency exclusion.

Advisers who are tempted, perhaps out of sympathy with the taxpayer's plight, to take the position anyway should remember that the signing and advice standards of Circular 230 §10.34, IRC §6694 and AICPA Statements on Standards for Tax Services No. 3 are almost certainly violated when such a position is taken without a Form 8275 disclosure on a taxpayer's return. In fact, an adviser will likely need to do some serious work considering the authorities even to obtain a "reasonable basis" comfort level necessary to advise such a position even with disclosure.

SECTION: 108
ALLOCATION OF EXCESS NONRECOURSE DEBT UNDER REV. RUL. 92-53 TO PARTNERS EXPLAINED BY IRS

Citation: Revenue Ruling 2012-14, 5/25/12

One consequence of the real estate crash and recession is that we've seen a lot more developments in the area of cancellation of indebtedness and the exclusions available under IRC §108. In Revenue Ruling 2012-14 the IRS gives guidance on handling a tricky issue in the overlap of partnership taxation and the insolvency exclusion under §108, specially applying the special rule for reductions in nonrecourse liabilities in cases where title remains with the debtor.

The problem is how we deal with the computation of insolvency for purposes of the insolvency exemption under §108(a)(1)(B). Generally in computing a taxpayer's lack of solvency, a nonrecourse debt is only treated as a liability for the lesser of its outstanding balance or the value of the property securing the debt.

But under Revenue Ruling 92-53 a special rule applies if there is cancellation of indebtedness income due to a modification of a nonrecourse note, most often to reduce its balance to the value of the underlying security. Had the lender taken back the property there would not have been cancellation of indebtedness, as the sale provisions of IRC §1001 would have governed the entire transaction. But if title is not transferred, there is no sale or exchange. Rather the borrower will now be able to retain the property by paying a lesser amount than the borrower had originally agreed to pay—and that is cancellation of indebtedness income.

In that case, that "excess nonrecourse debt" is allowed to be treated as a separate debt of the taxpayer to the extent that it is discharged in the transaction.

However a partnership introduces other quirks. First, insolvency is not measured at the partnership level, but rather must be measured at the partner level. [IRC §108(d)(1)] Second, there is the question of how we must allocate such debt to the partners in order to compute each partner's solvency or lack thereof, given the IRC §752 rules application to the allocation of partnership debts.

This ruling holds that, for purposes of the solvency calculation, each partner treats as a liability the amount of the partnership's discharged excess nonrecourse debt in same manner as the allocation is made of the COD income under IRC 704(b) and the related regulations. Thus the partner will most often end up with a liability deemed equal to the COD allocated to him/her if the excess nonrecourse debt discharge is the only COD income allocate to the partner that year.

Given that a number of commercial building debts are coming up for refinancing and renegotiation, advisers may see more and more cases where lenders faced with nonrecourse debts with a face balance far above the fair value of the security will enter into negotiations to accepted a reduced payoff amount rather than risk ending up with a commercial building that may be difficult to move. Thus this computation may need to be made a number of times over the next few years.

SECTION: 108
IRS FINALIZES REGULATIONS ON TREATMENT OF DEBT-FOR-EQUITY TRANSFERS OF PARTNERSHIPS

Citation: TD 9557, 11/15/11

In TD 9557 the IRS added final regulation §1.108-8 dealing with the treatment under IRC §108(e)(8) of indebtedness satisfied by a transfer of a partnership interest from the debtor partnership. Under that provision, the debt is treated as satisfied for an amount of money equal to the fair market value of the interest. If that value is less than the outstanding debt, cancellation of debt income is recognized by the partners of the partnership immediately before the discharge.

The regulation provides at Reg. §1.108-8(b)(1) that, generally, all facts and circumstances are considered when determining the fair market value of the interest transferred. However the regulation provides for a liquidation value safe harbor fair market value interest if all of the following four conditions are satisfied:

1. The creditor, debtor partnership, and its partners treat the fair market value of the indebtedness as being equal to the liquidation value of the debt-for-equity interest for purposes of determining the tax consequences of the debt-for-equity exchange;

2. If, as part of the same overall transaction, the debtor partnership transfers more than one debt-for-equity interest to one or more creditors, then each creditor, debtor partnership, and its partners treat the fair market value of each debt-for-equity interest transferred by the debtor partnership to such creditors as equal to its liquidation value;

3. The debt-for-equity exchange is a transaction that has terms that are comparable to terms that would be agreed to by unrelated parties negotiating with adverse interests; and

4. Subsequent to the debt-for-equity exchange, the debtor partnership does not redeem the debt-for-equity interest, and no person bearing a relationship to the debtor partnership or its partners that is specified in section 267(b) or section 707(b) purchases the debt-for-equity interest, as part of a plan at the time of the debt-for-equity exchange that has as a principal purpose the avoidance of COD income by the debtor partnership.[Reg. §1.108-8(b)(2)(i)]

Liquidation value is defined as the cash the creditor would receive if all assets of the partnership (tangible and intangible) were sold for cash equal to the fair value of the asset and the partnership then liquidated. [Reg. §1.108-8(b)(2)(iii)]

At the same time, the IRS issued regulations clarifying the income related to the discharge of nonrecourse indebtedness would be included in any first-tier minimum gain chargeback. [§§1.704-2(f)(6), 1.704-2(j)(2)(i)(A), and 1.704-2(j)(2)(ii)(A)]

The IRS also clarified the regulations under §721 for the treatment of such a transaction under that section. Reg. §1.721-1(d)(1) provides that except as otherwise provided in §721 and regulations under that section, §721 applies to transfers of partnership debt for a capital or profits interest in the partnership. Reg. §1.721-1(d)(2) provides, however, that §721 does not apply to a debt-for-equity exchange to the extent the transfer of interest is in exchange for unpaid rent, royalties or interest accrued on or after the beginning of the creditor's holding period for the debt.

SECTION: 108
DEBT ACTUALLY CANCELLED WELL BEFORE 1099C ISSUED

Citation: Kleber v. Commissioner, TC Memo 2011-233, 9/28/11

In Kleber v. Commissioner, TC Memo 2011-233, the IRS yet again lost a case regarding cancellation of indebtedness, with the Tax Court finding that the IRS failed to overcome the rebuttable presumption that debt discharge had occurred in an earlier year under the information reporting regulations as well as the facts and circumstances indicating the debt had been cancelled well earlier.

The taxpayers had entered into a lease of farmland with the Navy. She stopped making payments in mid-1998, and in late December of that year she wrote the Navy informing it she was unable to continue to pay under the lease. The Navy terminated the lease and billed the taxpayer for the unpaid rent prior to termination in February 1999.

A number of letters were sent in early 1999 demanding repayment, with the last one sent in April 1999. In September of 2001 the collection action was referred to the Treasury Department. The Treasury Department returned the matter to the Defense Department on September 30, 2004 indicating the debt was uncollectible. In November of 2005 the debt was written off by the Department of Defense. The Department of Defense then issued a Form 1099C in tax year 2006.

The IRS argued that the taxpayers had to pick up the income from the Form 1099C in 2006. The taxpayers argued that if there was debt forgiveness in any amount it occurred long before 2006 and also argued the amount reported was in error. The taxpayers did successfully assert the right to shift the burden to the IRS under the special provisions of §6201(d) that deals with reasonably disputing an information return.

The IRS did follow up in this case and argued that 2006 was the proper year, pointing towards the referral to the Treasury Department and the eventual write off in 2005. However, the Tax Court noted that the taxpayers had received no correspondence or contact since April 1999, with the only "collection activity" being moving papers around inside the federal government.

The Court noted that the regulations governing the information reporting provisions provided at Reg. §1.6050P-1(b)(2)(iv) established a presumption of debt cancellation for reporting purposes if the creditor received no payment in a 36 month period, rebuttable if the lender had undertaken significant, bona fide collection activity at any time during the 12 month period ended at the close the calendar year or if facts and circumstances existing at January 31 of the following year indicated the debt had not been discharged.

The Court found the 36 month period had expired in 2002, and that there had been no meaningful collection activity during 2002. The court found the facts and circumstances that existed at that time did not indicate the debt had not been effectively discharged. Thus, no matter what the amount of debt discharge truly was, the event had taken place in 2002 and not 2006. Thus the taxpayers had no income event in the year the IRS was attempting to assess the tax in.

This is not the first case in recent years the IRS has lost due to attempting to assert cancellation of debt income based on a 1099C the court determined was issued well after the true date of debt discharge. Advisers need to take care not to blindly follow Form 1099Cs or, conversely, to assume there was no debt discharge just because the Form 1099C wasn't issued.

In the cases to date the prior year tax has not been asserted by the IRS. However, remember that if the amount of debt was significant, the six year statute could be tripped and the IRS could then go back to the earlier year—and pick up additional penalties to boot. So these taxpayer victories should remind practitioners of the care that needs to be exercised regarding debt issues.

SECTION: 108
PROPOSED REGULATIONS HOLD BANKRUPTCY OR INSOLVENCY OF DISREGARDED ENTITIES AND GRANTOR TRUSTS NOT RELEVANT IN DETERMINATION OF TAXATION OF CANCELLATION OF DEBTS OF SUCH ENTITIES

Citation: Proposed Reg. §1.108-9, REG-154159-09, 4/13/11

The IRS has issued proposed regulations to make explicit its position that the bankruptcy and insolvency provisions of §108(a)(1) must be applied at the taxpayer level, and not applied to disregarded entities such as single member LLCs or grantor trusts.

Some taxpayers have taken the position that if a grantor trust or LLC has debts discharged in bankruptcy or is insolvent at the time debts owed by the entity are cancelled, the applicable exclusions found in §108(a)(1) apply even if the taxpayer that was treated for tax purposes as the owner of the underlying assets and liabilities is not him/herself involved in the bankruptcy or insolvent.

The proposed regulations take the position that the special rule applicable to partnerships under §108(d)(6) applies to these situations. The preamble also notes that "no inference is intended that the provisions set forth in these proposed regulations are not current law." Or, to translate that piece of "IRS-speak," the IRS believes the proposed regulations do reflect current law. Thus taxpayers that attempt to take the position that the cancellation income of their disregarded entity is not taxable to them will likely find the IRS disagrees with that viewpoint if the return is examined.

SECTION: 162
UNAMORTIZED DEBT ISSUANCE COSTS NOT INCLUDED IN COMPUTATION OF CANCELLATION OF INDEBTEDNESS INCOME

Citation: PLR 2012200004, 5/25/12

In PLR 201220004 the IRS ruled that unamortized debt issuance costs being amortized by a taxpayer on a various debts to be involved in the taxpayer's bankruptcy proceeding are deductible as an item separate and apart from any cancellation of indebtedness income.

The issue is important because if such costs were "netted" against the taxpayer's cancellation of indebtedness income, the costs would serve to reduce the cancellation of indebtedness income. As such debts are being discharged in a bankruptcy proceeding, the entire amount will be excluded from income under IRC §108(a)(1)(A). The remaining unamortized costs would, for all practical purposes, be "lost" as a deduction. If such costs were not netted in computing cancellation of indebtedness income then the opposite would be true—while there would a larger amount of cancellation of indebtedness income, that income would not be taxable. However, the unamortized loan costs would still be available as a deduction.

The letter ruling notes that under Reg. §1.446-5 such costs are treated as adjusting the yield on the debt in order to determine the deductible amount. However, the regulation begins by noting this computation is "[s]olely for purposes of determining the amount of debt issuance costs that may be deducted in any period" and concludes that this means the amount is not treated as part of the debt for purposes of computing cancellation of indebtedness income under Reg. §1.61-12(c)(2)(ii) and are therefore "deductible under § 162 as an item separate from the determination of the amount of COD income."

Note that this result would not necessarily always result in an advantage to the taxpayer. By increasing the cancellation of indebtedness income the change would also increase the amount by which tax attributes will be required to be reduced. Potentially the taxpayer might prefer forgoing the deduction in what might be a low marginal rate year in order to preserve more attributes for use in a later year when tax rates could be higher.

However, in most cases it would seem that this result would likely be either preferable or, at the very least, no less favorable in result than the alternative.

SECTION: 408
NO LATE ROLLOVER RELIEF FOR TAXPAYER UNABLE TO SELL HOME TO OBTAIN FUNDS TO COMPLETE ROLLOVER

Citation: PLR 201146024, 11/18/11

In PLR 201146024, the IRS declined to grant a taxpayer a waiver of the 60 day rollover period that was tied to problems selling the taxpayer's residence. In the ruling request, the taxpayer's daughter, acting under a power of attorney, withdrew funds from her IRA to be used to pay for an assisted living facility. She intended to replace those funds with the proceeds from the sale of the taxpayer's residence.

However, the daughter discovered the property had become run down due to the lack of care that had taken place due to her mother's dementia. As well, the poor real estate market made it more difficult to sell the property than the daughter had expected it to be. Thus the sixty day period expired before the residence could be sold.

The taxpayer asked the IRS to waive the 60 day period due to this hardship. The IRS declined to do so, noting that while the taxpayer may have been unfit to manage her affairs, the daughter was actually doing so during the entire period in question. As well, the ruling makes clear that if a taxpayer "borrows" from an IRA with the hope of being able to replace the funds due to a later access to funds (in this case selling the residence), the taxpayer has to accept the risk if the access to the funds does not take place.

The IRS is generally insistent that taxpayers looking for relief must show one of the factors enumerated in Rev. Proc. 2003-16, which generally includes showing errors committed by a financial institution, death, hospitalization, postal error, incarceration and/or disability. The ruling does suggest that if the taxpayer herself had withdrawn the funds and only later had the daughter taken over control that the IRS might have been willing to find the withdraw itself was due to the disability of the taxpayer (dementia has been held to be such a disability by the IRS in prior rulings). But with that not being the case here, the IRS refused to grant relief.

SECTION: 1001
DETERIORATION OF ISSUER'S FINANCIAL CONDITION NOT TO BE CONSIDERED IN DETERMINING IF MODIFIED AGREEMENT REMAINS A DEBT INSTRUMENT

Citation: TD 9513, Reg. §1.1001-3, 1/6/11

The IRS published in final form modifications to Reg. §1.1001-3 that provide protection from consideration of a debt issuer's financial condition in certain cases when determining if a modified instrument remains debt. That factor is important because if it is determined the item has changed from debt to equity or some other asset, generally the transaction would become a taxable exchange under IRC §1001.

Under Reg. §1.1001-1(f) changes in the instrument that derive solely from a deterioration in the issuer's financial condition (such as a decrease in the fair market value of the obligation) will not be considered in determining if the new item is debt so long as there is no substitution of a new obligator or the addition or deletion of a co-obligor.

The new provisions of Reg. §1.1001-1(f) will apply to alteration of the terms of a debt instrument on or after January 7, 2011. However, taxpayers may rely on the revisions for alterations of debt instruments occurring before that date.

SECTION: 6050P
CLASS ACTION SETTLEMENT RELIEVING PLAINTIFFS OF REQUIREMENTS TO REPAY DEBT REQUIRED ISSUANCE OF FORMS 1099C BY LENDER

Citation: PLR 201217001, 4/27/12

In Private Letter Ruling 201217001 the IRS determined that a lender would be required to issue Forms 1099C as part of a class action settlement of a lawsuit. In this case the plaintiffs had alleged the lender had violated certain State law notice requirements on certain collection actions. Under the applicable State law the lender would have faced an absolute bar on any further collection action.

Both parties to the settlement asked the IRS for a ruling that no Forms 1099C would need to be filed. The IRS declined to do so.

The IRS noted that while the parties had agreed that all of the debts would be discharged, the lender had never admitted any more than the possibility that it may have violated notice requirements.

Because of this, the IRS held that the agreement constituted, first, an identifiable event requiring information reporting under the requirements of Reg. §1.6050P-1(b)(2)(F) as "an agreement between an applicable financial entity and a debtor to discharge indebtedness at less than full consideration…" The agreement would serve to eliminate the liability for the debt regardless of any violation. Since the lender had never conceded that they had failed to give the required notice (just that they may have) and neither the settlement agreement nor court ever made such a determination under Law, the IRS would not on its own attempt to make that determination. Rather, in this case, the settlement agreement is treated as creating an identifiable event requiring reporting.

The IRS went on to suggest that Reg. §1.6050-1(b)(2)(G) also likely requires reporting. That provision requires reporting if the creditor discontinues collection activity pursuant to a decision by the creditor. The creditor voluntarily entered into the settlement agreement that discharged the debts to settle the case at a time when it had not conceded that any violation had taken place. That action, the IRS reasoned, likely rose to the level of a "decision by the creditor" as envisioned by Reg. §1.6050-1(b)(2)(G).

For debtors it should be noted that the mere fact the 1099Cs will be issued does not necessarily mean a debt discharge event took place in the year the 1099C is issued. The IRS specifically did not determine if the lender had failed to issue proper notice, an event that would clearly under state law have foreclosed any possibility for the lender to collect on a deficiency. The taxpayer, while having the burden of demonstrating this factual issue is met in a challenge, may nevertheless be able to show that and thus argue the cancellation took place upon the failure of the lender to issue the required notice. Reg. §1.6050P-1(a) clearly holds that its rules apply only for information reporting purposes and the form be issued "whether or not an actual discharge of indebtedness has occurred on or before the date on which the identifiable event has occurred."

As well, had the IRS held for the opposite position (that no 1099C was required), the debtors would not have been relieved from ever having to recognize taxable income. The lack of notice when collection began did not address the validity of the taxpayer's original debt, and thus when the lender lost its ability to collect the balance due to its failure to give notice it would appear the taxpayer had cancellation of indebtedness income (subject to possible exclusion under one of the provisions of IRC §108) unless the taxpayer could show an intent to pay off the debt regardless of whether the lender could force such repayment.

SECTION: 7434
MOTHER-IN-LAW FILING FORM 1099C NOT LIABLE TO EX-SON-IN-LAW FOR FRAUDULENT INFORMATION RETURN

Citation: Cavoto v. Hayes, CA7, 2011-1 U.S.T.C. ¶50,247 (affirming DC-IL, 2010-2 U.S.T.C. ¶50,503), 2/28/11

A divorce that spilled over into the arena of Form 1099C was the key issue in the case of Cavoto v. Hayes, CA7, 2011-1 U.S.T.C. ¶50,247 (affirming DC-IL, 2010-2 U.S.T.C. ¶50,503). In this case, Robert Cavoto was suing his former mother-in-law because she had issued a Form 1099C to him.

Mr. Cavoto had, per his former mother-in-law, borrowed $30,000 from her, an amount which he did not repay to her. Her other daughter, a CPA, advised her to issue Mr. Cavoto a Form 1099-C. That caused the IRS to issue a notice to him demanding $11,000 in taxes, interest and penalties. Eventually the IRS decided not to pursue this collection, but Mr. Cavoto sued to be paid the legal fees he had incurred in defending the IRS notice.

Robert had two objections. First, he claimed he truly did not owe the $30,000. Second, he noted that his mother-in-law was not in any of the businesses that are required to issue a Form 1099C, as that form is only required to be issued by certain entities. Robert claimed that either action amounted to issuance of the 1099C fraudulently, and he asked for damages under IRC §7434.

The trial court found that even though his mother-in-law was not required to issue a Form 1099C, the mere issuance of the form was not fraud. As well, the Court found that his mother-in-law had a good faith belief she had been owed the $30,000 and was not repaid, thus she did not fraudulent file the form.

The Court of Appeals affirmed the District Court, but noted that the case should have been dismissed without worrying about either issue that Robert raised. Damages under IRC §7434 can only be awarded for the information returns specified at IRC §6724(d)(1)(A). The Court noted that a Form 1099C isn't covered in that list, and thus no damages could have been awarded even for a fraudulent Form 1099C.