2005

Tax Planning for Troubled Real Estate - Focus on the Solvent Taxpayer

Susan T. Edlavitch

Repository Citation

http://scholarship.law.wm.edu/tax/125

Copyright © 2005 by the authors. This article is brought to you by the William & Mary Law School Scholarship Repository.
http://scholarship.law.wm.edu/tax
TAX PLANNING FOR TROUBLED REAL ESTATE—
FOCUS ON THE SOLVENT TAXPAYER

By

Susan T. Edlavitch
VENABLE LLP
Washington, DC

November 11, 2005

U.S. Treasury Circular 230 Notice: These materials are for general information only. The materials are not intended or written to be used, and cannot be used for the purpose of (a) avoiding tax-related penalties; or (b) promoting, marketing or recommending to another party any tax-related matter addressed herein. This disclosure is required in order to ensure compliance with new standards of professional practice, pursuant to which certain tax advice must meet requirements as to form and substance.
# TABLE OF CONTENTS

<table>
<thead>
<tr>
<th>Section</th>
<th>Title</th>
<th>Page</th>
</tr>
</thead>
<tbody>
<tr>
<td>I.</td>
<td>BACKGROUND—MORTGAGE &amp; BASIS</td>
<td>1</td>
</tr>
<tr>
<td>A.</td>
<td>BASIS</td>
<td>1</td>
</tr>
<tr>
<td>1.</td>
<td>Amount Realized</td>
<td>1</td>
</tr>
<tr>
<td>2.</td>
<td>Cost Basis</td>
<td>1</td>
</tr>
<tr>
<td>B.</td>
<td>MORTGAGE</td>
<td>1</td>
</tr>
<tr>
<td>1.</td>
<td>Inclusion of Acquisition Mortgage in Cost Basis</td>
<td>1</td>
</tr>
<tr>
<td>2.</td>
<td>Contingent Liability</td>
<td>1</td>
</tr>
<tr>
<td>3.</td>
<td>Underwater Property</td>
<td>1</td>
</tr>
<tr>
<td>4.</td>
<td>Improvements</td>
<td>1</td>
</tr>
<tr>
<td>5.</td>
<td>Non-acquisition Mortgage</td>
<td>1</td>
</tr>
<tr>
<td>6.</td>
<td>Principal Payments</td>
<td>2</td>
</tr>
<tr>
<td>II.</td>
<td>DEBT WORKOUT ALTERNATIVES</td>
<td>2</td>
</tr>
<tr>
<td>A.</td>
<td>AVOIDING CANCELLATION OF DEBT INCOME</td>
<td>2</td>
</tr>
<tr>
<td>1.</td>
<td>Rescission</td>
<td>2</td>
</tr>
<tr>
<td>2.</td>
<td>Contested Liability</td>
<td>2</td>
</tr>
<tr>
<td>3.</td>
<td>Debt Discharge as a “Medium” for Payment</td>
<td>3</td>
</tr>
<tr>
<td>4.</td>
<td>Gift</td>
<td>3</td>
</tr>
<tr>
<td>5.</td>
<td>Compensation for Performance of Services</td>
<td>3</td>
</tr>
<tr>
<td>6.</td>
<td>Account Payable</td>
<td>3</td>
</tr>
<tr>
<td>7.</td>
<td>Other Rules</td>
<td>3</td>
</tr>
<tr>
<td>B.</td>
<td>USE OF EQUITY</td>
<td>4</td>
</tr>
<tr>
<td>1.</td>
<td>Corporations</td>
<td>4</td>
</tr>
<tr>
<td>2.</td>
<td>Partnerships</td>
<td>5</td>
</tr>
<tr>
<td>III.</td>
<td>DEBT MODIFICATION</td>
<td>7</td>
</tr>
<tr>
<td>A.</td>
<td>ISSUANCE OF NEW DEBT FOR OLD DEBT</td>
<td>7</td>
</tr>
<tr>
<td>1.</td>
<td>In General</td>
<td>7</td>
</tr>
<tr>
<td>2.</td>
<td>Issue Price</td>
<td>7</td>
</tr>
<tr>
<td>3.</td>
<td>Adequate Interest</td>
<td>7</td>
</tr>
<tr>
<td>B.</td>
<td>SIGNIFICANT MODIFICATIONS OF EXISTING DEBT TREATED AS EXCHANGE</td>
<td>7</td>
</tr>
<tr>
<td>1.</td>
<td>In General</td>
<td>7</td>
</tr>
<tr>
<td>2.</td>
<td>Prior Law</td>
<td>8</td>
</tr>
<tr>
<td>3.</td>
<td>Debt Modification Regulations</td>
<td>8</td>
</tr>
<tr>
<td>C.</td>
<td>EFFECT ON INSTALLMENT NOTE</td>
<td>12</td>
</tr>
<tr>
<td>D.</td>
<td>PURCHASE OF DEBT BY A RELATED PARTY</td>
<td>12</td>
</tr>
<tr>
<td>E.</td>
<td>EFFECT ON WORTHLESS DEBT DEDUCTION</td>
<td>13</td>
</tr>
<tr>
<td>IV.</td>
<td>DEBT REDUCTION OR CANCELLATION</td>
<td>13</td>
</tr>
<tr>
<td>A.</td>
<td>IMPACT ON DEBTOR OR MORTGAGOR</td>
<td>13</td>
</tr>
<tr>
<td>1.</td>
<td>In General</td>
<td>13</td>
</tr>
<tr>
<td>2.</td>
<td>Cancellation of Debt Income</td>
<td>13</td>
</tr>
<tr>
<td>3.</td>
<td>Exceptions—Insolvent Taxpayer</td>
<td>13</td>
</tr>
<tr>
<td>4.</td>
<td>Exceptions—Solvent Taxpayer</td>
<td>19</td>
</tr>
</tbody>
</table>
B. IMPACT ON CREDITOR OR MORTGAGEE ................................................................. 24
   1. In General ........................................................................................................... 24
   2. Character of the Loss—Ordinary Loss for Business Bad Debt .................... 25
   3. Treatment of Bad Debts ................................................................................. 26

V. VOLUNTARY/INVOLUNTARY FORECLOSURE AND ABANDONMENT .......... 28
   A. INTRODUCTION ..................................................................................................... 28
      1. In General ........................................................................................................ 28
      2. Voluntary and Involuntary Foreclosure ..................................................... 28
      3. Abandonment ................................................................................................ 29
   B. TREATMENT OF MORTGAGOR ........................................................................ 31
      1. Recourse Debt ............................................................................................... 31
      2. Nonrecourse Debt ....................................................................................... 33
      3. Timing of Mortgagee’s Tax Consequences .............................................. 35
   C. TREATMENT OF MORTGAGEE ......................................................................... 35
      1. Deed in Lieu of Foreclosure ....................................................................... 35
      2. Foreclosure Sale .......................................................................................... 36
      3. Seller Reacquisition under IRC §1038 ...................................................... 36
      4. Rescission of the Transaction .................................................................... 41
      5. Reporting Requirements upon Reacquisition by Mortgagee .................. 41

VI. DISPOSITION OF OVER-ENCUMBERED REAL ESTATE TO THIRD PARTY .... 42
   A. SALE OF PROPERTY SUBJECT TO DEBT ......................................................... 42
      1. In General ...................................................................................................... 42
      2. Installment Sale ............................................................................................ 42
      3. Installment Sale with Wraparound Mortgage ......................................... 43
   B. TRANSFER OF PARTNERSHIP INTEREST ..................................................... 43
   C. LIKE-KIND EXCHANGE ................................................................................... 44
   D. USE OF PARTNERSHIP BETWEEN SELLER AND BUYER ......................... 44
I. BACKGROUND—MORTGAGE & BASIS.

A. Basis.

1. Amount Realized. Upon a sale or exchange of real estate, the seller has an “amount realized” equal to the cash or other property (at its fair market value) received plus the amount of any outstanding unpaid principal mortgage liability that is assumed or taken subject to. Treas. Regs. §§1.1001-1(a) and 1.1001-2(a)(1). See Crane v. Com., 331 U.S. 1 (1947); and Chilingirian v. Com., 918 F.2d 1251 (6th Cir. 1990).

2. Cost Basis. The original basis of purchased property is its cost. IRC §1012. The cost of property is the amount paid in cash or other property (at its fair market value). See Treas. Reg. §1.1012-1(a).

B. Mortgage.

1. Inclusion of Acquisition Mortgage in Cost Basis. Whenever a purchaser acquires property by personally assuming an existing mortgage liability, or taking subject to mortgage debt, the purchaser's basis for the property generally includes the amount of the mortgage debt. Crane v. Com., 331 U.S. 1 (1947); and Com. v. Tufts, 461 U.S. 300 (1983).


3. Underwater Property. It is unclear whether, and to what extent, the inclusion of nonrecourse debt in basis applies to “underwater” property, where the amount of the nonrecourse debt is significantly greater than the fair market value of the property when purchased. The majority view is to disallow completely the use of any of the nonrecourse debt in determining basis under the theory that no true debt exists at all. See, e.g., Estate of Franklin v. Com., 544 F.2d 1045 (9th Cir. 1976); Lebowitz v. Com., 917 F.2d 1314 (2nd Cir. 1990); Lukens v. Com., 945 F.2d 92 (5th Cir. 1991); Milenbach v. Com., 106 T.C. 184 (1996); and Bergstrom v. Com., 37 Fed. Cl. 164 (1996). The minority position, as set forth in Pleasant Summit Land Co. v. Com., 863 F.2d 263 (3rd Cir. 1988), provides that the taxpayer may take basis in the property up to the fair market value of the property.

4. Improvements. If the mortgage proceeds are used to improve the property, the basis of the property is increased by the cost of the improvements. The cost of the improvements is a capitalized expenditure that increases basis. The fact that borrowed funds were used is inmaterial. See Blake v. Com., 8 T.C. 546 (1947).

5. Non-acquisition Mortgage. When an owner of real property places a mortgage on the property in order to secure borrowed funds, the owner realizes no immediate tax
consequences. This is so even though the mortgage is in excess of the basis in the property. See, e.g., Woodsam Associates v. Com., 198 F.2d 357 (2nd Cir. 1952).

6. Principal Payments. Any payments made by the mortgagor on the principal amount of the mortgage are treated only as debt reduction payments. Such payments have no effect upon basis and are not deductible. See Blackstone Theater Co. v. Com., 12 T.C. 801 (1949).

II. DEBT WORKOUT ALTERNATIVES.

A. Avoiding Cancellation of Debt Income.

1. Rescission. If the creditor is also the seller of the property and reacquires the property in the same taxable year as the year of the sale, without any consideration from the purchaser, the reacquisition may be treated as a rescission of the prior sale. See Rev. Rul. 80-58, 1980-1 C.B. 181. In PLR 7802003 (Sept. 28, 1977), the IRS ruled that the rescission of a prior sale during the same taxable year negates the original sale, so that no gain or loss is realized. Cf., PLR 8210015 (Nov. 23, 1981) (rescission in subsequent year is realization transaction).

2. Contested Liability. Some courts recognize a contested liability (or disputed debt) exception. This is based on the premise that, if a taxpayer disputes the original amount of a debt in good faith, a subsequent settlement of that dispute is treated as the amount of the debt that is recognized for tax purposes. The excess of the original debt over the amount determined to have been due is then disregarded in calculating gross income. See, e.g., Zarin v. Com., 916 F.2d 110 (3rd Cir. 1990).

   a. Unliquidated Debt. The contested liability doctrine applies only if the debt is unliquidated—that is, the original loan amount cannot be determined. See Algerine Allen Smith, Estate v. Com., 198 F.3d 515 (5th Cir. 1999) (no cancellation of debt income where both amount and enforceability of claim contested).

   b. Fixed and Enforceable Debt. If the original loan amount is fixed, a settlement discharge will cause the debtor to realize cancellation of debt income. See Preslar v. Com., 167 F.3d 1323 (10th Cir. 1999) (taxpayer had cancellation of debt income rather than an IRC §108(e)(5) basis reduction when contested but "unliquidated" liability was reduced); and Jelle v. Com., 116 T.C. No. 6 (2001) (cancellation of debt income realized upon release of contingent repayment obligation).

   c. IRS Offer in Compromise. Acceptance of an Offer in Compromise will not result in either cancellation of debt income or trigger the tax benefit rule. FSA 1998-296 (May 28, 1992). See also FSA 1999-491 (Offer in Compromise with buyers reducing amount required to remove Federal Tax Lien did not result in cancellation of debt income, because buyers’ liability only extended to acquired property’s fair market value less their subrogation right), relying on Ernst Kern Co. v. Com., 1 T.C. 249 (1942).
3. **Debt Discharge as a “Medium” for Payment.** Debt discharge that serves as a “medium” of payment is not cancellation of debt income under IRC §61(a)(12) but an exchange of value that is treated according to the substance of the exchange. See *Sands v. Com.*, 73 TCM 2398 (1997) (dispute settlement treated as IRC §1001 sale or exchange). See also Rev. Rul. 84-176, 1984-2 C.B. 34, which holds that an amount owed by a taxpayer but forgiven by the seller in return for a release of a contract counterclaim is not income from discharge of indebtedness under IRC §61(a)(12) and therefore is not subject to the exclusion under IRC §108. The settlement is treated as if the taxpayer actually received compensation for damages arising out of the seller’s breach of contract and then paid the full amount of the account payable. The value of the constructive payment is deemed to be equal to the value of the indebtedness.

4. **Gift.** There is no cancellation of debt income to the mortgagor where the forgiveness is intended as a gift. See *Helvering v. American Dental Co.*, 318 U.S. 322 (1943), as modified by *Commissioner v. Jacobson*, 336 U.S. 28 (1949). However, if the cancelled debt is an installment obligation, the cancellation will cause the mortgagee to income. IRC §453B(f). The gain (or loss) will equal the difference between the basis of the installment obligation and the amount realized. IRC §453B(a) generally forces the mortgagee to recognize the previously deferred gain.

5. **Compensation for Performance of Services.** There is no cancellation of indebtedness income where the debtor performs services in full or partial satisfaction of the debt, which services have a fair market value equal to the debt satisfied. The income is reported on Form W-2 for employees or Form 1099-MISC for non-employees. See ILM 200130038 (May 31, 2001) (debt discharge for service rendered is compensation income reportable under IRC §6041 and not cancellation of debt income reportable under IRC §6050P).

6. **Account Payable.** A cash-basis taxpayer is not required to recognize discharge of indebtedness income where the payment of the debt would have been deductible by the payor, as for example, in the case of forgiveness of a trade payable to a creditor or accrued wages by an employee. IRC §108(e)(2). By comparison, an accrual-basis taxpayer is required to recognize discharge of indebtedness income when the debt is forgiven to offset the tax effect of previously accrued deductions.

7. **Other Rules.**

a. **Release of Collateral.** The release of collateral securing an obligation does not, in and of itself, create income in the absence of a reduction or cancellation of the underlying debt. See *Estate of Whitthorne v. Com.*, 44 B.T.A. 1234 (1941).

b. **Release of Contingent Liability.** The release of a contingent liability to contribute capital to a partnership does not give rise to cancellation of indebtedness income. See *Hunt v. Com.*, 59 TCM 635 (1990).

c. **Release of Guarantor.**

   (1) Release of a guarantor who is secondarily liable on the loan does not generate cancellation of indebtedness income to the guarantor. *Whitmer v. Com.*, 71
TCM (CCH) 2213 (1996); Landreth v. Com., 50 T.C. 803, 813 (1968). See also Treas. Reg. §1.6050P-1(d)(7) (guarantor is not a debtor for reporting purposes). Cf., Tennessee Securities v. Com., 37 TCM 1803 (1978), aff'd, 674 F.2d 570 (6th Cir. 1982), in which guarantors who were called upon to pay the guarantee obligation which was ultimately paid by the guarantors' closely-held corporation realized disguised dividend income. See also Payne v. Com., 75 TCM 2548 (1998); and Brickman v. Com., 76 TCM 506 (1998).

(2) It is unclear, however, whether a guarantor who becomes liable for a debt due to the primary obligor's default incurs cancellation of indebtedness income for satisfying that debt for less than the full amount. See Whitmer v. Com., 71 TCM 2213 (1996), where the Court rejected the Service's contention that a guarantor realized income for satisfying a contingent debt for less than the full value of the debt, but did not explain why, thus leaving the issue open. For a detailed discussion of this issue, see Mendelson, Recent Cases Reflect Continuing IRS Uncertainties About COD Income From Contingent Debt, 84 J. TAX'N 261 (1996). See also FSA 199921008 (Feb. 12, 1999) (guarantor stockholder of general partner did not have cancellation of debt income resulting from payment of less than the full amount of partnership's debt, but the general partner was allocated its proportionate share of cancellation of debt income).

(3) Release of a guarantee may result in a “significant modification” of the debt instruction under Treas. Reg. §1.1001-3(e)(4)(iv).

B. Use of Equity.

1. Corporations.

a. Contribution of Encumbered Property. If real property with a mortgage in excess of adjusted basis is contributed to a corporation, the transferor will be required to recognize gain equal to the excess. IRC §357(c). IRC §357(d) determines the amount of any transferred recourse liability or nonrecourse liability. If the placement of the mortgage and subsequent transfer to the corporation were for a principal purpose of avoiding Federal income tax or were not for a bona fide business purpose, then entire principal amount of the liability and any other liabilities transferred at that time (not simply the excess of the transferred liabilities over basis) would be considered gain recognized. IRC §357(b). See Rev. Rul. 80-323, 1980-2 C.B. 124 (IRC §357(c) applies to contribution of partnership interest in an IRC §351 transfer).

b. Contribution of Shareholder Debt to Capital. A contribution of shareholder debt to capital does not result in cancellation of debt income to the extent of the shareholder’s basis in the debt. IRC §108(e)(6).

c. Repeal of Stock-for-Debt Exception. As a result of the repeal of the stock-for-debt exception, the transfer of stock by a corporate debtor to a creditor in satisfaction of debt gives rise to cancellation of indebtedness income to the extent that such debt exceeds the fair market value of the stock transferred. IRC §108(e)(8).
2. Partnerships.

   a. Contribution of Encumbered Property. If encumbered real property is transferred to a partnership, the contributing partner must recognize gain if the amount of the transferred liabilities deemed assumed or taken subject to by the remaining partners exceeds the contributing partner's basis in his partnership interest. IRC §752(b) and 731(a)(1). See Newman Estate v. Com., 934 F.2d 426 (2nd Cir. 1991), rev'd, 59 TCM 543 (1990). But see Gershkowitz v. Com., 88 T.C. 984 (1987). The unwary contributing partner may be required to recognize gain as a result of the disguised sales rules of IRC §707(a)(2)(B). For example, a partnership is treated as making a distribution to the contributing partner to the extent that transferred debt, referred to as non-qualified liabilities, is shifted to a noncontributing partner. Treas. Reg. §1.707-5(a)(1).

   b. Admission of Lender as Partner. IRC §108(e)(8), as amended by the 2004 American Jobs Creation Act, added a new rule for partnerships that follows the rule applicable to corporations. For exchanges on or after October 22, 2004, when a partnership transfers a partnership capital or profits interest to a creditor in satisfaction of partnership recourse or nonrecourse debt, the partnership recognizes cancellation of debt income in an amount that would be recognized if debt were satisfied with money equal to the fair market value of the partnership interest. The cancellation of debt income is allocated among the partners who held partnership interests immediately prior to the transfer of the partnership interest in satisfaction of the debt.

   c. Admission of New Money Partner. The admission of a new partner with fresh capital to pay down or eliminate existing partnership debt typically requires an adjustment of profit and loss percentages and other partnership items through an amendment to the partnership agreement. The tax implications of admitting a new money partner depend on a number of factors, including whether the new capital will be used to repay existing partnership debt and whether such debt is recourse or nonrecourse. See generally, Schwitzky, Partnership Taxation: Restructuring Partnership Debt—Life is Change, 11 VA. TAX REV. 523 (1992). The new partner or the existing partners or both may be required to recognize income or gain.

   (1) No Book-up Adjustments—No Debt Reduction. If the partnership elects not to book-up its assets upon admitting a new partner and does not reduce the partnership debt, the tax consequences are beneficial to the existing partners but detrimental to the new money partner. If the partnership assets are not revalued and the nonrecourse debt is not reduced, the partnership will retain its historic amount of minimum gain allocable to the old partners and thereby avoid any minimum gain chargeback. The old partners will also retain sufficient shares of partnership debt to avoid gain recognition under IRC §731(a). That is to say, as long as the partner’s IRC §704(b) minimum gain amount under Treas. Reg. §1.752-3(a)(1) is equal to his deficit capital account balance, IRC §752(b) deemed cash distributions will not produce taxable gain under IRC §731(a). In addition, because no IRC §704(c) minimum gain is created, basis does not shift from the old partners to the new partners. The major downside to not electing to revalue the partnership assets is that IRC §704(c) will not apply. The new money partner may receive allocations of partnership taxable income (or loss) that are greater (or less) than if the partnership had revalued its assets.
(2) No Book-up Adjustments—Debt Reduction. If any portion or all of the existing partnership nonrecourse debt is repaid, the existing partners may be required to recognize IRC §731(a) gain to the extent of any IRC §752(b) deemed distributions in excess of basis. See Rev. Rul. 84-102, 1984-2 C.B. 119. In addition, the reduction of the partnership nonrecourse debt may cause the allocation of income or gain to the existing partners under the “minimum gain chargeback” rules. Generally, a “minimum gain chargeback” is an allocation of income or gain to a partner to the extent of the greater of his share of any net decrease in “partnership minimum gain” or the deficit balance in such partner’s capital account. See Treas. Reg. §1.704-2(g). For this purpose, “partnership minimum gain” is defined, with respect to each nonrecourse liability, as the amount of gain that would be realized by the partnership if it disposed of partnership property encumbered by the nonrecourse liability. See Treas. Reg. §1.704-2(d)(1). In other words, the repayment of partnership nonrecourse debt may result in taxable income to the existing partners.

(3) Book-up Adjustments—No Debt Reduction. In order to avoid the allocation of partnership minimum gain to the existing partners, the partnership may elect to revalue the partnership assets to account for any differences between tax basis and book value of such property. IRC §704(c). The “book-up” treats the book basis of the partnership assets as being at least equal to the nonrecourse indebtedness securing the property and, therefore, any partnership minimum gain prior to the revaluation would be reduced to zero. See Treas. Reg. §1.704-1(b)(2)(iv)(f). The old partners’ capital accounts, which presumably had deficit balances, would be increased to zero, thereby avoiding any minimum gain chargeback to the old partners. See Treas. Reg. §§1.704-2(d)(4) and 1.704-2(g)(2). The admission of a new partner and the revaluation of partnership assets will trigger a shift of liabilities under Treas. Reg. §1.752-3(a). The nonrecourse debt generally will shift to the new partner in an amount equal to the new partner’s profit percentage multiplied by the old book basis. The balance of the nonrecourse debt will be allocated as IRC §704(c) minimum gain amounts solely to the old partners, who already benefited from the deductions or distributions. This shift in liabilities will produce consequences under IRC §§752(b) and 733(1), but initially should not trigger any IRC §731(a) gain, because there should be sufficient bases in the old partners’ respective partnership interests to absorb the deemed distributions. However, further liability shifts will occur over time, with accompanying deemed distributions under IRC §§752(b) and 733(1) to the old partners, as the partnership claims depreciation deductions with respect to the booked-up assets, which will increase the IRC §704(b) minimum gain and decrease the IRC §704(c) minimum gain. Eventually, the old partners may be forced to recognize gain under IRC §731(a) as a result of deemed distributions in excess of the bases in their partnership interests.

(4) Book-up Adjustments—Debt Reduction. If the nonrecourse debt is reduced following the admission of a new partner contributing cash, the old partners may be required to recognize gain under IRC §731(a). An election under IRC §754 may serve to mitigate some of the other adverse tax consequences.

(5) Other Issues. In addition to the forgoing considerations under IRC §§704(b), 731 and 752, the admission of a new partner requires a choice of allocation methods under IRC §704(c) and whether or not to make an IRC §754 election, and may involve other issues under IRC §465. See generally, Frankel and Coffin, “Partnership Workouts:
Problems and Solutions Under Final 704(b) and 752 Regulations,” 9 J. PARTNERSHIP TAX. 287 (Winter 1993).

III. DEBT MODIFICATION.

A. Issuance of New Debt for Old Debt.

1. In General. A taxpayer that issues new debt in satisfaction of old indebtedness will be treated as having satisfied such old indebtedness with an amount of money equal to the “issue price” of the new debt. IRC §108(e)(10).

2. Issue Price. Under IRC 108(e)(10)(B), the issue price is determined under IRC §§1273 and 1274, relating to original issue discount. If either the new debt or the old debt is publicly traded, the issue price of the new debt is equal to its fair market value. IRC §1273(b)(3). If neither debt instrument is publicly traded, the issue price of the new debt is equal to its stated principal amount or, where it does not provide “adequate” interest, a lower imputed principal amount as determined under IRC §1274(b).

3. Adequate Interest. A debt instrument will be deemed to provide for adequate interest if interest accrues at a rate at least equal to the applicable Federal rate, as defined under IRC §1274(d). The imputed principal amount is equal to the sum of the present values of all payments due under the debt instruments, except in the case of “potentially abusive situations” (as defined under IRC §1274(b)(3)(B)), under which the imputed principal amount is equal to the fair market value of the property for which the debt instrument was issued, adjusted to take into account other considerations involved in the transaction. IRC §1274(b).

B. Significant Modifications of Existing Debt Treated as Exchange.

1. In General. Treas. Reg. §1.1001-3, applicable to modification of debt instruments on or after September 24, 19996, provides that a “significant modification” will result in an IRC §1001 taxable exchange at the time the issuer and holder enter into the agreement. See Treas. Reg. §1.1001-3(c)(6).

   a. Treas. Reg. §1.1001-3(b) establishes two-step process for determination whether the modification of a debt instrument is a realization event: (1) whether there has been a “modification” of the original debt instrument; and (2) whether such modification is considered significant. See Treas. Regs. §§1.1001-3(c) through (e).

   b. These regulations applies to any modification of a debt instrument, regardless of the form of modification. The regulations apply to a modification of a debt instrument that the issuer and holder accomplish indirectly through one or more transactions with third parties. However, the regulations do not apply to exchanges of debt instruments between holders.
2. **Prior Law.** Generally, under a fairly well developed body of case law and Service ruling, a modification did not result in a taxable exchange under IRC §1001 unless (1) there was a change or substitution of an obligor, or (2) there was more than a minimal change in the interest rate. Conversely, a change in the maturity date of a debt obligation or the deferral of accrued interest would not constitute a material modification. In concluding that a savings and loan association was entitled to recognize loss on the exchange of one pool of real estate mortgages for another pool having different mortgagors and different collateral, *Cottage Savings Association v. Com.*, 499 U.S. 554 (1991), held that, in determining whether a realization event has occurred for purposes of IRC §1001, properties are deemed to differ materially if their respective owners "enjoy legal entitlements that are different in kind or extent." See Swartz & Thomas, Exchanging Debt under the Final 1001 Regulations, 13 TAX MGT REAL EST J. 146 (1997).

3. **Debt Modification Regulations.**

   a. **In General.** Treas. Reg. §1.1001-3, referred to as the "*Cottage Savings*" regulations, were promulgated in 1992 in response to the realization standard established by the Supreme Court case and in order more fully to clarify the rules. The regulations are generally applicable to modifications of debt instruments on or after September 24, 1996. Treas. Reg. §1.1001-3(h).

   b. **Significant Modification.** A debt instrument is viewed as being exchanged for a new debt instrument if the new debt instrument represents a "significant modification" such that the new debt instrument differs "materially either in kind or in extent" from the old debt instrument. Treas. Reg. §1.1001-3(b). The regulations establish a two-step process for determining whether the alteration of the debt instrument is a realization event: First, whether there has been a "modification" of the original debt instrument; and, second, whether such modification is considered "significant". Treas.Regs. §§1.1001-3(c) through (e).

   c. **Modification.**

      (1) **Definition.** A "modification" is any alteration, including any deletion or addition, in whole or in part, of a legal right or obligation of the issuer or a holder of a debt instrument, whether the alteration is evidenced by an express agreement (oral or written), conduct of the parties or otherwise. Treas. Reg. §1.1001-3(c)(1)(i).

      (2) **Exceptions.** Despite the broad scope of the term "modification", the Regulations provide three important exceptions which would exclude certain types of alterations to a debt instrument from modification treatment.

         (a) **Original Terms Exception.**

             (i) Alteration of a legal right or obligation that occurs by operation of the terms of a debt instrument is not a modification. Treas. Reg. §1.1001-3(c)(1)(ii).
Examples: Annual adjustments to the interest rate. Treas. Reg. §1.1001-3(d)(Ex. 1). The substitution of collateral to maintain value where the original terms of the debt instrument require the issuer to maintain collateral having a specific value. Treas. Reg. §1.1001-3(d)(Ex. 2).

However, the following alterations are modifications even if the alteration occurs by operation of the terms of a debt instrument:

(A) The substitution of a new obligor, the addition or deletion of a co-obligor, or a change in the nature of a debt instrument (i.e., recourse to nonrecourse or nonrecourse to recourse). Treas. Reg. §1.1001-3(c)(2)(i).

(B) An alteration which results in an instrument or property right that is not debt, unless the alteration occurs pursuant to a holder's option under the terms of the instrument to convert the instrument into equity of the issuer. Treas. Reg. §1.1001-3(c)(2)(ii).

(C) An alteration that results from the exercise of an option provided to an issuer or a holder to change a term of a debt instrument, unless the option is unilateral, and, in the case of an option exercisable by a holder, the exercise of the option does not result in a deferral of, or a reduction in, any scheduled payment of interest or principal. Treas. Reg. §1.1001-(c)(2)(iii).

(b) Ability to Perform Exception. Under the second exception, the failure of an issuer to perform its obligations under a debt instrument is not, in and of itself, an alteration of a legal right or obligation and is not a modification. An agreement by the holder to stay collection or temporarily waive an acceleration clause or similar default right is not a modification unless, and until, the forbearance remains in effect for a period that exceeds two years following the issuer's initial failure to perform plus any additional period during which the parties conduct good faith negotiations or during which the issuer is in bankruptcy. Treas. Reg. §1.1001-3(c)(4).

(c) Failure to Exercise an Option Exception. Under the third exception, the failure of a party to a debt instrument to exercise an option to change a term of the instrument is not an alteration and is not a modification. Treas. Reg. §1.1001-3(c)(5).

(3) Timing. An agreement to change a term of a debt instrument is a modification at the time the issuer and holder enter into the agreement, even if the change is not immediately effective. If the parties condition a change in a term of a debt instrument on reasonable closing conditions, a modification occurs on the closing date of the agreement. Treas. Reg. §1.1001-3(d)(6).

d. “Significant” Modification. Even if it is determined that a modification has occurred and the modification does not qualify under an exception for the original terms, the ability to perform or the failure to exercise an option, an exchange is not deemed to occur for purposes of IRC §1001 unless the modification is “significant.”
Definition. A modification is considered "significant" only if, based on all facts and circumstances, the legal rights or obligations that are altered and the degree to which they are altered are economically significant.

(a) In making this determination, all modifications are considered collectively, so that a series of modifications may be significant when considered together although each modification, if considered alone, would not be significant. Treas. Reg. §1.1001-3(e)(1).

(b) If the reasonable closing conditions do not occur, and so the change in the term does not become effective, a modification does not occur. Treas. Reg. §1.1001-3(c)(6)(ii).

"Significant." A modification is considered "significant" under the following circumstances:

(a) A change in the yield of a debt instrument if the yield varies from the annual yield on the unmodified instrument by more than the greater of 25 basis points or 5% of the annual yield of the unmodified instrument. This calculation applies to debt instruments that provide for only fixed payments, debt instruments with alternative payment schedules subject to Treas. Reg. §1.1272-1(c), debt instruments that provide for a fixed yield subject to Treas. Reg. §1.1272-1(d) and variable rate debt instruments. Treas. Reg. §1.1001-3(e)(2).

(b) A change in the timing of payments due under a debt instrument if it results in the material deferral of scheduled payments. Treas. Reg. §1.1001-3(e)(3). The materiality of the deferral depends on all the facts and circumstances, including the length of the deferral, the original term of the instrument, the amounts of the payments that are deferred, the time period between the modification and the actual deferral of payments. Treas. Reg. §1.1001-3(e)(3). The deferral of one or more scheduled payments within the safe-harbor period is not a material deferral if the deferred payments are unconditionally payable no later than at the end of the safe-harbor period. The safe-harbor period begins on the original due date of the first scheduled payment that is deferred and extends for a period equal to the lesser of five years or 50% of the original term of the instrument. If the period during which payments are deferred is less than the full safe-harbor period, the unused portion of the period remains a safe-harbor period for any subsequent deferral of payments on the instrument. Treas. Reg. §1.1001-3(e)(3)(ii).

(c) Substitution of a new obligor on a recourse debt instrument. Treas. Reg. §1.1001-3(e)(4)(i)(A). However, the substitution of a new obligor on a nonrecourse debt instrument is not a significant modification. Treas. Reg. §1.1001-3(e)(4)(ii). The substitution of a new obligor will not result in a significant modification if an acquiring corporation becomes the new obligor pursuant to a transaction to which IRC §381(a) applies or the new obligor acquires substantially all of the assets of the original obligor, there is no change in payment expectations, and the transaction does not result in a significant alteration (an alteration that would be a significant modification but for the fact that the alteration occurs by operation of the terms of the instrument). Treas. Reg. §§1.1001-3(e)(4)(i)(B) and (C).
The addition or deletion of a co-obligor on a debt instrument if such addition or deletion results in a change in payment expectations. Treas. Reg. §1.1001-3(e)(4)(iii). A change in payment expectations occurs if, as a result of a transaction, (i) there is a substantial enhancement of the obligor's capacity to meet the payment obligations under a debt instrument and that capacity was primarily speculative prior to the modification and is adequate after the modification, or (ii) there is a substantial impairment of the obligor's capacity (which term includes any source of payment, including collateral, guarantees or other credit enhancement) to meet the payment obligation under a debt instrument and that capacity was adequate prior to the modification and is primarily speculative after the modification. Treas. Reg. §1.1001-3(c)(4)(vi)(A). See PLR 199904017 (Oct. 29, 1998), where the removal of a co-obligor, a subsidiary finance vehicle for its parent—the other co-obligor, did not result in a change of payment expectations and, therefore, was not a significant modification.

A modification that releases, substitutes, adds or otherwise alters the collateral for, a guarantee on, or other form of credit enhancement for a recourse debt instrument, if the modification results in a change in payment expectations. Treas. Reg. §1.1001-3(e)(4)(iv)(A).

A modification that releases, substitutes, adds or otherwise alters a substantial amount of the collateral for, a guarantee on, or other form of credit enhancement for a nonrecourse debt instrument. A substitution of collateral is not a significant modification, however, if the collateral is fungible or otherwise of a type where the particular units pledged are unimportant (for example, government securities or financial instruments of a particular type or rating). In addition, the substitution of a similar commercially available credit enhancement contract is not a significant modification, and an improvement to the property securing a nonrecourse debt instrument does not result in a significant modification. Treas. Reg. §1.1001-3(e)(4)(iv)(B).

A change in the priority of a debt instrument relative to other debt of the issuer if it results in a change in payment expectations. Treas. Reg. §1.1001-3(e)(4)(v).

A modification that results in an instrument or property right that is not debt for Federal income tax purposes.

A change in the nature of a debt instrument from recourse to nonrecourse or nonrecourse to recourse. Treas. Reg. §1.1001-3(e)(5)(ii).

The determination of whether a modification of any term is a “significant” modification is examined under the specific definitions and, if not addressed, is tested under the facts and circumstances test. Treas. Reg. §§1.1001-3(f)(1)(i) and 1.1001-3(e)(1). If a modification is effective only upon the occurrence of a substantial contingency, the determination of whether the change is significant is determined under the facts and circumstances test. Treas. Reg. §1.1001-3(f)(1)(ii). If a modification is a change in the obligor or the security or a change in the nature of the instrument, and the change is effective on a substantially deferred basis, the determination of whether the change is significant is determined under the facts and circumstances test. Treas. Reg. §1.1001-3(f)(1)(iii).
Two or more modifications of a debt instrument over any period of time constitute a “significant” modification if, had they been done as a single change, the change would have resulted in a significant modification. The significant modification occurs at the time that the cumulative modification would be significant. In testing for a change of yield, any prior modification occurring more than 5 years before the date of the modification being tested is disregarded. Treas. Reg. §1.1001-3(f)(3). Modifications of different terms of a debt instrument, none of which separately would be a significant modification do not collectively constitute a significant modification. In testing a particular modification, it is assumed that all other simultaneous modifications have already occurred. Treas. Reg. §1.1001-3(f)(4).

Comment. These Regulations were promulgated to prevent taxpayers from exchanging economically different debt instruments without triggering the built-in gain. Unfortunately, the Regulations make it possible for both debtors and creditors to realize income from the sale or exchange of a debt instrument for changes made to the debt that have no economic effect.

For example, if the maturity of a note is extended by more than five years and the interest rate is correspondingly increased such that the yield does not change, a significant modification probably has occurred. Thus, if the issue price of the new debt is lower than that of the old debt, income may be realized even though nothing economically has occurred. This is possible if the old debt was purchased at a discount, and the new debt is issued at the same face amount, bears adequate interest and is not market traded. In this situation, the purchaser will have a low basis in the debt (the discounted purchase price) and a high amount realized (the face value of the debt), resulting in gain if there is a significant modification. Ironically, in this situation it would be preferable to trigger the “potentially abusive circumstances” rule because, under this rule, the amount realized is fair market value rather than face value, thus reducing the amount realized and, correspondingly, gross income. See Swartz & Thomas, Exchanging Debt under the Final 1001 Regulations, 13 TAX MGT REAL EST J. 146 (1997).

Example. A purchases a non-market traded note of Company B at its fair market value of $500 one year after Company B issued it. The note had a face value of $1000, bore interest at 7% and matured in four years. Six months later, Company B negotiates with A to increase the maturity date by six years and raise the interest rate correspondingly so as to result in no change in the effective yield. A agrees to the modification. Under the IRC §1001 regulations, a significant modification has occurred because the maturity date has changed by more than five years. Assuming no potentially abusive circumstances, A recognizes $100 of income ($600 amount realized (i.e., the FMV of the new note) minus $500 cost basis) from the sale or exchange of the note.

Effect on Installment Note. Changes made to the terms of debt instruments may result in a disposition or satisfaction of the old debt instrument under IRC §453B(a) and §453B(f). But see PLR 9412013 (Dec. 21, 1993).

Purchase of Debt by a Related Party. In the case of a direct or indirect acquisition of a debt instrument by a “related party”, the debtor will recognize cancellation of
debt income to the extent the adjusted issue price of the liability exceeds its cost or fair market value. IRC §108(e)(4). See Treas. Reg. §1.108-2.

E. **Effect on Worthless Debt Deduction.**

1. Where a creditor has gain recognition due to a significant medication of a debt instrument after a bad debt deduction for partially worthless debt was taken, the tax basis in the debt instrument is increased by the gain recognized but the creditor generally is not entitled to increase book basis or take a deduction under IRC §166(a)(2) for that amount.

2. Treas. Reg. §1.166-3(a)(3) resolves the problem by deeming the creditor to have charged off its increase in tax basis during the taxable year in which the modification occurs if (a) the creditor (or its predecessor, provided the debt instrument is transferred basis property within the meaning of IRC §7701(a)(43)) claimed a partial worthlessness debt deduction in a prior taxable year, and (b) each prior charge-off satisfied the requirements of IRC §166(a)(2) and the regulations thereunder.

IV. **DEBT REDUCTION OR CANCELLATION.**

A. **Impact on Debtor or Mortgagor.**

1. **In General.** The rules concerning cancellation of debt income and the exceptions thereto apply only to a cancellation or discharge of indebtedness and the satisfaction of a mortgage at less than its face amount. Different rules govern the tax consequences resulting from foreclosure, voluntary conveyance in lieu of foreclosure or abandonment.

2. **Cancellation of Debt Income.** Any reduction in the principal amount of the mortgage by compromise or negotiation or by modification of the mortgage terms—in the absence of a mortgage foreclosure, voluntary conveyance of a deed in lieu of such foreclosure or abandonment—will cause the mortgagor to recognize cancellation of indebtedness income, taxable at ordinary rates, to the extent of the cancellation, unless an exception applies. IRC §61(a)(12). See *U.S. v. Kirby Lumber*, 284 U.S. 1 (1931).

3. **Exceptions—Insolvent Taxpayer.**

   a. **Insolvency Exception.** An insolvent taxpayer is permitted to elect under IRC §108(a) to reduce certain tax attributes under IRC §108(b) in lieu of recognizing income currently. IRC §108(a)(1)(B).

   b. **Bankruptcy Exception.** No cancellation of debt income results if the debt is discharged in a title 11 case. IRC §108(a)(1)(A).

   c. **Reduction of Tax Attributes.** Instead of recognizing cancellation of debt income, taxpayers having debts discharged pursuant to either the insolvency exception or
the Title 11 bankruptcy exception are required to reflect the cancellation of debt income through a reduction in their overall tax attributes. IRC §108(b)(1).

(1) **Timing of Reduction.** The attribute reductions are made after the tax for the year of the discharge is determined. IRC §108(b)(4)(A).

(2) **Order of Reduction.** As specified in IRC §108(b)(2), the tax attributes and their order of reduction is as follows: (a) net operating loss; (b) general business credit under IRC §38; (c) minimum tax credit under IRC §53(b); (d) capital loss carryovers under IRC §1212; (e) basis reduction (but not in excess of the aggregate bases of the property held by the bankrupt or insolvent taxpayer over the aggregate of the liabilities of the bankrupt or insolvent taxpayer, both measured immediately after the discharge); (f) passive activity loss and credit carryovers under IRC §469(b); and (g) foreign tax credit carryovers under IRC §27.

(3) **IRC §108(b)(2)(E) Basis Reductions.** Basis reductions under the tax attribute ordering rule as a result of the exclusion of cancellation of debt income by the bankrupt taxpayer under IRC §108(a)(1)(A) or the insolvent taxpayer under IRC §108(a)(1)(B) must be made as follows.

(a) A taxpayer must reduce in the following order, to the extent of the excluded cancellation of debt income (but not below zero), the adjusted bases of property held on the first day of the taxable year following the taxable year of the discharge (in proportion to adjusted basis): (i) Real property used in a trade or business or held for investment, other than real property described in IRC §1221(1), that secured the discharged indebtedness immediately before the discharge; (ii) personal property used in a trade or business or held for investment, other than inventory, accounts receivable, and notes receivable, that secured the discharged indebtedness immediately before the discharge; (iii) remaining property used in a trade or business or held for investment, other than inventory, accounts receivable, notes receivable, and real property described in IRC §1221(1); (iv) inventory, accounts receivable, notes receivable, and real property described in IRC §1221(1); and (v) Property not used in a trade or business nor held for investment.

(b) **IRC §108(b)(2)(E) Basis Reduction Limitation under IRC §1017(b)(2).** If the cancellation of debt income arises from a discharge of indebtedness in a title 11 case or while the taxpayer is insolvent, the amount of any basis reduction under section 108(b)(2)(E) cannot exceed the excess of (i) the aggregate of the adjusted bases of property and the amount of money held by the taxpayer immediately after the discharge, over (ii) the aggregate of the liabilities of the taxpayer immediately after the discharge. Treas. Reg. §1.1017-1(b)(3). This calculation is made after reducing the debtor’s basis in property under IRC §108(b)(5).

(c) **IRC §108(b)(2)(E) Ordering Rules.** First, the amount of basis to be reduced under IRC §108(b)(2)(E) equals the amount of excluded cancellation of debt income less the prior reduction of other tax attributes required under IRC §108(b)(2) or elected under IRC §108(b)(5). Second, in the case of multiple discharged debts, the determination of what portion of each discharged debt remains to be applied against basis is
made by allocating the non-basis tax attribute reductions among the discharged debts in proportion to the amount of cancellation of debt income attributable to each discharged debt and then applying the unapplied portion of each discharged debt to reduce basis in accordance with the ordering rules. Treas. Reg. §1.1017-1(b)(1) and (2).

(d) **No Provisions for Special Requests.** Under prior law, a taxpayer could request permission from IRS to apply the basis reduction to certain properties. See Rev. Proc. 78-15, 1978-2 C.B. 488 (stock); and Rev. Proc. 85-44, 1985-2 C.B. 504 (depreciable property). The current regulations do not provide for such special requests.

(e) **Anti-abuse Rule.** Any property added or eliminated as security for indebtedness during the one-year period preceding the discharge of indebtedness is disregarded if a principal purpose of the change is to affect the basis reductions under IRC §1017. Treas. Reg. §1.1017-1(d).

(f) **Partnership Interest.** As discussed below, a partnership interest may be considered real or personal property secured by the discharged debt to the extent of the partner’s distributive share of cancellation of debt income.

d. **IRC §108(b)(5) Alternative Election to Reduce Basis First.** Instead of reducing tax attributes, the bankrupt or insolvent taxpayer may elect first to reduce the basis of depreciable property pursuant to the rules of IRC §1017.

(1) **Cancellation of Debt Income Only.** The basis reduction election only applies to income from the discharge of indebtedness, not income from a sale or exchange of property resulting from a repossession or foreclosure. See *Estate of Delman v. Com.*, 73 T.C. 15 (1979).

(2) **Election.** The taxpayer makes the election under IRC §108(b)(5) by filing Form 982 (Reduction of Tax Attributes Due to Discharge of Indebtedness) with a timely filed (including extensions) return for the taxable year in the discharge occurs. The election can be revoked only with the consent of the Commissioner. Partnership consent for basis adjustments made under IRC §108(b)(2)(E) is required under certain circumstances, discussed below, pursuant to Treas. Reg. §1.1017-1(g). Unlike previously effective Temporary Regulations, an election is not permitted with an amended return. Late election 9100 relief is available. See Treas. Reg. §§301.9100-1(a) and -3. See, e.g., PLR 199950029 (Sept. 14, 1999).

(3) **Exclusion Amount Limitation.** The reduction amount is limited to the aggregate adjusted bases of the taxpayer's depreciable property as of the beginning of the taxable year following the taxable year in which the discharge occurs. IRC §108(b)(5)(B).

(4) **Ordering Rules.** Subject to certain modifications, a taxpayer generally must reduce (to the extent of the excluded cancellation of debt income but not below zero) the bases of assets (in proportion to adjusted basis) in the following order: (i) basis in real property used in a trade or business or held for investment that secured the discharged debt; (ii) personal property used in a trade or business or held for investment that secured the
discharged debt; (iii) remaining property used in a trade or business or held for investment; (iv) inventory, accounts and notes receivable and real property described in Sec. 1221(1), I.R.C.; and (v) property not used in a trade or business or held for investment. Treas. Reg. §1.1017-1(a).

(5) Coordination with Reduction in Tax Attributes. Where the basis reduction election under IRC §108(b)(5) is made, the rules regarding the reduction of the taxpayer's tax attributes will only be applied after the bases of the taxpayer's depreciable assets have been reduced to zero and some discharge income remains. IRC §108(b)(5)(C). For a detailed discussion, see Asofsky and Tatlock, Bankruptcy Tax Act Radically Alters Treatment of Bankruptcy and Discharging Debts, 54 J. Tax. 106 (1981).

e. Modification of Ordering Rules for Basis Reductions under IRC §108(b)(5) and §108(c). The IRC §108(b)(2)(E) basis reduction ordering rules are modified for debtors electing to reduce the basis of depreciable property under IRC §108(b)(5) or electing to treat the discharged debt as "qualified real property business indebtedness" under IRC §108(c). See Treas. Reg. §1.1017-1(c)(1).

(1) A debtor under IRC §108(b)(5) can reduce only the basis of depreciable property. The debtor may elect under IRC §1017(b)(3)(E) to treat real property held for sale as depreciable property. See Treas. Reg. §1.1017-1(f)(1).

(2) A debtor electing under IRC §108(c) can reduce only the basis of depreciable real property. The basis reduction applies first against the basis of the real property securing the "qualified real property business indebtedness" and then against the basis of the debtor's other real property.


(1) IRC §§108(a), (b), (c), and (g) are applied at the corporate level. See IRC §108(d)(7).

(2) The corporate level determination includes not taking into account under IRC §1366(a) any amount excluded under IRC §108(a). See IRC §108(d)(7)(A), effective for debt discharges occurring in taxable years ending after Oct. 11, 2002, providing that cancellation of debt excluded from the gross income of the S corporation shareholder will not result in an adjustment to stock basis. The legislative change was intended to reverse the result in Giltz v. Com., 531 U.S. 206 (2001).

(3) For purposes of IRC §108(b)(2)(A) regarding a reduction in the carryover of disallowed losses and deductions, any loss or deduction which is disallowed for the taxable year of the discharge under IRC §1366(d)(1) is treated as a net operating loss for such taxable year. However, this rule does not apply to any discharge to the extent that IRC §108(a)(1)(D) applies to such discharge.
(4) For purposes of IRC §108(e)(6), a shareholder's adjusted basis in indebtedness of an S corporation is determined without regard to any adjustments made under IRC §1367(b)(2).

g. Application to Partnerships.

(1) Realization of Cancellation of Debt Income. The determination of whether cancellation of debt income has been realized is made at the partnership level. Unless a statutory exception, such as IRC §108(e)(2) or §108(e)(5), or the common law purchase price adjustment applies, the partnership will recognize cancellation of debt income, which must then be allocated among the partners.

(2) Exceptions Determined at Partner Level. IRC §108(d)(6) provides that IRC §108(a)(taxpayer exclusions), §108(b)(reduction of tax attributes), IRC §108(c)( and (g) are applied at the partner level. See S. Rep. No. 1035, 96th Cong., 2d Sess. 8, 21-22 (1980). See also Brickman v. Com., 76 TCM (CCH) 506 (1998). Partnership cancellation of debt income is allocated to the partners as a separately stated item under IRC §702(a), so that each partner can apply the provisions of IRC §108 at the partner level. See TAM 9739002 (May 19, 1997) (partner allowed to increase basis in partnership by allocable cancellation of debt income, even if income is excluded under IRC §108).

(3) General Partnership Allocation. In the case of the typical general partnership where the general partners share partnership items in accordance with their respective partnership percentages, the debt modification or discharge would not result in income to any partner in excess of any cancellation of debt income allocation. Cancellation of debt income would be allocated to the partners in accordance with their partnership percentages, the decrease in partnership liabilities would likewise be shared by the partners in accordance with their partnership percentages.

(4) Limited Partnership and LLC Allocation.

(a) Nonrecourse Debt. If nonrecourse debt is discharged, the cancellation of debt income ordinarily would be allocated among the partners in the same ratios in which the nonrecourse liabilities were allocated under IRC §752. The partners' outside basis in their partnership interest would thus be unaffected, because the upward basis adjustment for the cancellation of debt income would be offset by an equal downward basis adjustment for the deemed distribution under IRC §752(b), and each partner would only recognize his allocable share of the cancellation of debt income. See S. Rep. No. 1035, 96th Cong., 2d Sess., at 21 (1980).

(b) Recourse Debt.

(i) Profit-sharing Percentages. If recourse debt is discharged and the cancellation of debt income is allocated in accordance with the partners' profit-sharing percentages, the partners who bore no economic risk of loss for the discharged debt will be allocated cancellation of debt income and may be forced to recognize and pay tax on phantom income. See Hirschfeld, Unexpected Tax Surprises for the Creditor in Debt
Restructurings, 12 PRACTICAL TAX LAWYER 17 (1998). Phantom income can be avoided if the partner is insolvent or has net operating losses or suspended passive activity losses. Moreover, the partners who bore the risk of loss could suffer adverse tax consequences as well. In addition to recognizing cancellation of debt income, these partners could also be required to recognize gain under IRC §731(a) if the debt discharge triggered a deemed distribution under IRC §752(b) in excess of the basis increase from the allocable share of cancellation of debt income. See Rev. Rul. 95-21, 1992-1 131, obsoleting, Rev. Rul. 71-301, 1971-2 C.B. 256 (insolvency exception applied to partner who recognized IRC §731(a) gain). For these reasons, cancellation of debt income is typically allocated to the partners who bore the risk of loss for the discharged debt.

(ii) IRC §752 Risk of Loss. If the cancellation of debt income is allocated in the manner in which the partners bore the economic risk of loss under Treas. Reg. §1.752-2(a) for the discharged debt immediately before the discharge, the partners will not have phantom income and their outside bases in their partnership interests will remain unchanged. To preserve the economic arrangement among the parties and to ensure that the decline in the value of partnership assets is allocated to the partners who agreed to bear the loss, there should be a book-down of the capital accounts under Treas. Reg. §1.704-1(b)(2)(iv)(f). Alternatively, the partnership agreement could be amended to provide that the loss in the partnership assets, when recognized, will be allocated to those partners to whom cancellation of debt income was allocated.

(c) Special Allocations. Special allocations of cancellation of debt income are not prohibited. See McKee, Nelson & Whitmore, Federal Taxation of Partnerships and Partners, ¶9.02[2][a][ii], n. 216 (3rd Ed. 2004). A special allocation of cancellation of debt income will not be respected if it results in any partner having a negative capital account as which that partner has no liability to restore upon liquidation and which is not otherwise matched by a share of minimum gain. See Rev. Rul. 92-97, 1992-2 C.B. 124. Moreover, special allocations of cancellation of debt income to insolvent partners may fail the “substantiality” test of Treas. Reg. §1.704-1(b)(2)(iii). In such cases, IRS would ignore the special allocations and reallocate the cancellation of debt income in accordance with the partners’ interests in the partnership. See, e.g., Rev. Rul. 99-43, 1999-42 I.R.B. 506 (partnership special allocations lacked “substantiality”, because partnership agreement was amended to specially allocate the cancellation of debt income and book items after occurrence of events creating the items, and overall economic effect on the partners’ capital accounts did not differ substantially from economic effect of original allocations). See also FSA 200131013 (May 1, 2001).

4. Exceptions—Solvent Taxpayer.

a. Statutory Purchase Price Adjustment under IRC §108(e)(5).

(1) If the purchaser’s mortgage obligation is reduced and the mortgage debt is purchase money debt, the reduction is treated as a purchase price reduction and results in a corresponding adjustment to the basis of the property, provided (i) the purchase money debt was owed to the seller/creditor of the property, and (ii) the debtor is neither insolvent nor in a Chapter 11 bankruptcy. IRC §§108(e)(5)(A) and (B). E.g., PLR 8429001 (March 12, 1984).

(2) IRC §108(e)(5) will not apply if, at the time the debt is reduced, the property purchased is no longer owned by the original issuer of the purchase money note or such note is no longer held by the original seller.

(3) The IRS position is that the statutory purchase money debt exception does not apply to an adjustment by a third-party lender, except to the extent such adjustment is based on “an infirmity that clearly relates back to the original sale”. See Rev. Rul. 82-202, 1982-2 C.B. 35; and Rev. Rul. 92-99, 1992-2 C.B. 35. For a general discussion of Rev. Rul. 92-99 and other recent IRS rulings and procedures relating thereto, see Lipton, New Rulings on Purchase Price Reductions Do Not Provide Much Relief, 78 J. TAXATION 68 (1993).

(4) Although IRC §108(e)(5) applies at the partnership level, the partnership need not be solvent. Rev. Proc. 92-92, 1992-2 C.B. 505, provides that the IRS will not challenge the use of IRC §108(e)(5) by an insolvent or bankrupt partnership, provided the transaction would otherwise qualify as a statutory purchase price adjustment and all the partners report the transaction consistently as a purchase price reduction.

(5) A taxpayer governed by IRC §108(e)(5) must reduce the adjusted basis of the property that secured the purchase money debt. If the amount of the reduced debt exceeds the basis of the property securing the debt, it is unclear whether the excess amount is cancellation of debt income or gain from a sale or exchange. Alternatively, an argument can be made that the excess amount escapes taxation, similar to the treatment if the excluded amount under IRC §108(a) exceeds available tax attributes. See S. Rep. No. 96-1035, 96th Cong. 2d Sess. n. 6 at p. 2 (1980)


(1) The purchase price adjustment was a creature of common law prior to the enactment of IRC §108(e)(5). See Hirsch v. Com., 40-2 USTC ¶9791 (7th Cir. 1940); Allen v. Courts, 42-1 USTC ¶9393 (5th Cir. 1942); Sherman v. Com., 43-1 USTC ¶9367 (6th Cir. 1943); and Helvering v. A.L. Killian Co., 42-2 USTC ¶9487 (8th Cir.).

(2) The common law purchase price adjustment is more expansive than, and survives, the statutory purchase price adjustment.

(3) Courts have held that the debt cancellation reflecting a revaluation of the property could be treated as a reduction in basis to the purchaser, and not as
taxable income, regardless of whether the purchase money debt was owed directly to the seller. E.g., *Helvering v. A. L. Killian Co.*, 128 F.2d 433 (CA8 1942).

(4) Courts similarly have approved of a purchase price adjustment regardless of whether the purchase money debt was owed to a third-party creditor who financed the purchase. E.g., *Hirsch v. Com.*, 115 F.2d 656 (CA7 1940). But see *Fifth Avenue Fourteenth Street Corp. v. Com.*, 147 F.2d 453 (CA2 1944) (limiting *Hirsch* to direct negotiations regarding purchase price with the seller).

(5) Rev. Rul. 91-31, 1991-1 C.B. 19, held that a reduction in principal of a nonrecourse debt by a holder who was not the original seller of the property results in the realization of discharge of indebtedness income by the debtor, irrespective of whether the fair market value of the property is greater or less than the balance of the debt at the time of the principal reduction.

(a) Rev. Rul. 91-31 amplified Rev. Rul. 82-202, 1982-2 C.B 35, which held that the prepayment of a nonrecourse note at a discount results in cancellation of debt income under IRC §61(a)(12), where the fair market value of the property is greater than the principal balance of the debt at the time of the reduction. See PLR 9251023 (Sept. 18, 1992).

(b) Rev. Rul. 91-31 expressly rejects *Fulton Gold Corp. v. Com.*, 31 B.T.A. 519 (1934), which held that the satisfaction of a nonrecourse mortgage for less than its face amount results in a reduction of the mortgagor's basis in the underlying property rather than the realization of income, because there was no “freeing up” of the underlying property. See *Com. v. Tufts*, 461 U.S. 300 (1983); and *Gershkowitz v. Com.*, 88 T.C. 984 (1987). See also *Newman Estate v. Com.*, 934 F.2d 426 (2nd Cir. 1991), revg, 59 TCM 543 (1990). See generally, Cunningham, A Requiem for Fulton Gold, 72 TAXES 365 (July 1994).

c. Qualified Real Property Business Indebtedness. Under IRC §108(a)(1)(D), a debtor (other than a C corporation) can elect to avoid recognition of cancellation of debt income upon the discharge of “qualified real property business indebtedness” and to reduce the basis of depreciable real property instead. IRC §§108(a)(1)(D) and 108(c). See generally, Pollack & Oliver, Federal Income Tax Consequences of the Discharge of Qualified Real Property Business Indebtedness, 15 TAX MGMT REAL EST J 319 (1999).

(1) General Definition. “Qualified real property business indebtedness” is (i) debt that is incurred or assumed in connection with real property used in a trade or business, (ii) which debt is secured by such real property, and (iii) with respect to which debt the taxpayer has made an election under IRC §108(c). IRC §108(c)(3). See TAM 200014007 (Dec. 13, 1999). “Qualified real property business indebtedness” does not include “qualified farm indebtedness” within the meaning of IRC §108(g). IRC §108(c)(3).

(2) Post-1992. Debt incurred or assumed after January 1, 1993 must be incurred: (a) to acquire, construct or substantially improve the real property securing such debt (“qualified acquisition indebtedness”); or (b) to refinance qualified real property
business debt incurred or assumed before January 1, 1993 (but only to the extent that the amount of the debt does not exceed the amount being refinanced). Less rigorous standards apply to pre-1993 debt.

(3) **Outstanding Principal Amount.** The “outstanding principal amount” for purposes of IRC §108(c)(2)(A) is the principal amount of the indebtedness and all additional amounts owed immediately before the discharge. For example, the “outstanding principal amount” of the debt includes interest, provided the accrued interest is added to principal, and interest would accrue and compound on such added interest in the future. See Treas. Reg. §1.108-6(a). See, e.g., *Allan v. Com.*, 856 F.2d 1169, 1174 (8th Cir. 1988). See also Treas. Reg. §1.6050P-1(c) (“indebtedness” includes interest for purposes of IRC §6050P reporting) and Treas. Reg. §1.163-8T(c)(2)(ii).

(4) **Election.** The election under IRC §108(c) is made by attaching Form 982 (with the statements described in Treas. Reg. §1.1017-1(g)(2)(iii)(A) in the case of a partnership) to a timely filed (including extensions) return for the year of the discharge. See Treas. Reg. §1.108-5(b). Unlike previously effective Temporary Regulations, an election is not permitted with an amended return. Late election 9100 relief is available. See Treas. Reg. §§301.9100-1(a) and –3. See, e.g., PLR 199950029 (Sept. 14, 1999).

(5) **Exclusion Amount Limitation.**

(a) The amount of cancellation of debt income that may be excluded under IRC §§108(a)(1)(D) and 108(c) cannot exceed the lesser of the following:

(i) The excluded amount cannot exceed the aggregate adjusted bases of the depreciable real property (other than depreciable real property acquired in contemplation of the discharge) held by the taxpayer immediately preceding the discharge. IRC §108(c)(2)(B). The taxpayer’s aggregate adjusted basis is determined as of the first day of the next taxable year and after any reductions have been made to such basis pursuant to the provisions relating to the taxpayer’s bankruptcy, insolvency or discharge of farm indebtedness under IRC §§108(b) and (g). The determination is made after the basis of the depreciable real property is reduced by the depreciation claimed for the year. Treas. Reg. §1.108-6(b).

(ii) The excluded amount cannot exceed the excess of (i) the outstanding principal amount of the debt (immediately preceding the discharge), over (ii) the fair market value of the property securing the debt (immediately preceding the discharge), reduced by other qualified real property indebtedness secured by such property immediately before and after the discharge. IRC §108(c)(2)(B). See also Treas. Reg. §1.108-6(a). See generally, Latta, Cancellation of Debt and Basis Reduction: The Final Regulations under Sections 108 and 1017, 15 TAX MGMT REAL EST J 31 (1999).

(b) The exclusion is based on the taxpayer continuing to own the property securing the debt forgiven. If the depreciable property is disposed of prior to the end of the year of the discharge, the taxpayer cannot elect to exclude the cancellation of debt income as a result of the discharge.
(c) Any change made in the property securing debt within one year of the discharge of the debt, where the principal purpose is to affect basis reductions, will be ignored. Hence, the taxpayer cannot take into account his depreciable basis in any property acquired by him in contemplation of the discharge. IRC §108(c)(2)(B). Treas. Reg. §1.1017-1(d).

(6) IRC §1017 Basis Reduction Rules. The amount of discharge of indebtedness income that the taxpayer may elect to exclude from gross income is treated as a reduction in the basis of the taxpayer’s depreciable real property under the rules of IRC §1017 and the regulations thereunder. IRC §108(c)(1)(B).

(a) The basis reduction applies to property held on the first day of the taxable year following the taxable year of the discharge.

(b) The debtor electing under IRC §108(cc) can reduce only the basis of depreciable real property. Treas. Reg. §1.1017-1(c)(1) requires a taxpayer to reduce the basis of that property securing the discharged indebtedness before reducing the adjusted bases of other depreciable real property.

(c) A taxpayer electing under IRC §108(c) cannot make the election under IRC §1017(b)(3) to treat inventory as depreciable property.

(7) Ordinary Income Recapture. Cancellation of debt income excluded by reducing basis in depreciable real property is treated as a deduction allowed for depreciation under IRC §1250, subject to recapture as ordinary income. See IRC §1017(d). Hence, the basis reduction under IRC §108(c) is most useful if the debtor intends to hold the basis reduction property for a substantial period of time.

(8) Application to Partnerships.

(a) Although the determination of whether partnership debt is “qualified real property business indebtedness” is made at the partnership level, the election to reduce the basis of property in lieu of recognizing discharge of indebtedness income under IRC §108(c) is made at the partner level on a partner-by-partner basis. E.g., PLRs 9426006-9426020 (Mar. 25, 1994). See IRC §703(b)(1).

(b) The election under IRC §108(c) is made by filing Form 982 with the statements described in Treas. Reg. §1.1017-1(g)(2)(iii)(A) with the taxpayer’s return (including extensions) filed for the year of the discharge). See Treas. Reg. §1.108-5(b). Partnership consent is required under certain circumstances specified in Treas. Reg. §1.1017-1(g) and must be included with its Form 1065 for the year following the taxable year that ends with or within the taxable year in which the partner excludes the cancellation of debt income. However, a partnership is not requested to inform partners of their cancellation of debt income prior to the date the Form 1065 is filed.

(i) If a partner makes an election under IRC §108(c), the partner must treat a partnership interest as depreciable real property to the extent of the partner’s proportionate share of the partnership’s basis in depreciable real property, provided
the partnership consents to a corresponding reduction in the partnership’s inside basis in the depreciable real property with respect to such partner. See Treas. Reg. §1.1017-1(g)(2)(i). If the partnership does not grant consent, the partnership interest may not be treated as depreciable property or depreciable real property.

(ii) Subject to two exceptions, a partner may choose whether or not to request that a partnership to reduce the inside basis of its depreciable property with respect to the taxpayer, and the partnership may grant or withhold such consent, in its sole discretion. The taxpayer request must be made before the due date (including extensions) for filing the return for the taxable year in which the discharge occurred.

(iii) The partner is required to request the partnership’s consent to reduce inside basis if (1) the taxpayer, directly or indirectly, owns a greater than 50 percent interest in the capital and profits of the partnership, or (2) reductions to the basis of the partner’s depreciable property (or depreciable real property) are being made with respect to the taxpayer’s distributive share of cancellation of debt income of the partnership. Without this requirement, a debtor could avoid the general ordering rules by transferring the property that secured the debt to be discharged to a controlled partnership that would not consent to reduce the inside basis of the property.

(iv) The partnership is not required to consent to reduce its partners’ shares of inside basis, unless (1) the consent is requested by partners directly or indirectly owning an aggregate of more than 80 percent of the capital and profits interests of the partnership, or (2) the consent is requested by five or fewer partners directly or indirectly owning an aggregate of 50 percent of the capital and profits interests of the partnership.

(c) If a partner elects to exclude his share of cancellation of debt income under IRC §108(c), the partner must first reduce the basis of his partnership interest to the extent of his share of the partnerships basis in the property that secured the cancelled “qualified real property business indebtedness”. The partner then can elect to exclude the balance of his share of such cancellation of debt income by reducing the basis in other depreciable real property owned by him.

(d) A partner’s proportionate share of the partnership’s basis in depreciable real property is equal to the sum of (i) its IRC §743(b) basis adjustments to items of depreciable partnership property and (ii) the common basis depreciation deductions (excluding remedial deductions) that, under the terms of the partnership agreement effective for the tax year in which the discharge occurred, are reasonably expected to be allocated to the partner over the property’s remaining useful life. See Treas. Reg. §1.1017-1(g)(2)(iv) and (v).

(e) The partnership must actually reduce inside basis in the depreciable real property as to which the partner has elected under IRC §108(c) to reduce basis. See IRC §1017(b)(3)(C). The basis reduction generally is made on the same basis and in the same manner than basis adjustments are made under IRC §743. The amount of the basis reduction is an adjustment to such property with respect to the electing partner only. The properties in which the partnership reduces basis are determined under the ordering rules of Treas. Reg. §1.1017-1(a). See Treas. Reg. §1.1017-1(g)(3).
(f) For examples of how these rules apply to tiered partnerships, see PLRs 9426006-9426019 (Mar. 25, 1994).

(g) If the partner’s share of cancellation of debt income exceeds his share of the partnership’s inside basis, the partner presumably could exclude the cancellation of debt income by reducing the basis of other depreciable real property. If the partner has depreciable real property in multiple partnerships, the partner should be able to elect the depreciable real property the basis of which will be reduced.

(9) Application to S Corporations. In the case of an S corporation, the election to reduce the basis of property and the basis reduction itself is made by the S corporation. IRC §§1363(c)(1) and 108(d)(7).

d. Qualified Farm Indebtedness. See IRC §108(a)(1)(C).

B. Impact on Creditor or Mortgagee.

1. In General.

a. Loss Realized. Where there is a cancellation of indebtedness or a satisfaction of a mortgage debt at less than its face amount, and there is no mortgage foreclosure, deed in lieu thereof or abandonment, the mortgagee will realize a loss to the extent that its tax basis for the debt exceeds the amount actually paid by the mortgagor. Such loss is deductible whether or not the mortgagor is able to repay the mortgage debt in full and whether or not the value of the mortgaged property has increased or decreased. See Smith v. Com., 48 T.C. 872 (1967), aff’d in part and rev’d in part on other issues, 424 F.2d 219 (CA9 1970).

b. Gain Realized. If the mortgage note were issued, taken or acquired at a discount, the mortgagee could have a gain, rather than a loss, on the debt settlement. This would occur if the settlement were for an amount more than the tax basis for the note, although less than the face amount. For example, assume that a taxpayer purchases a $100,000 face value mortgage note at a time when the market rate of interest is greater than the mortgage note’s stated rate of interest. Also assume that, because of this differential in interest rates, the taxpayer is able to purchase the note for $90,000. If the taxpayer later agrees to accept $95,000 from the mortgagor as a final settlement for the mortgage debt, the taxpayer would have a $5,000 gain. The character of this gain is determined under IRC §1276. In general, to the extent that such gain reflects that the debt was issued at an interest rate below the market interest rate, such income is ordinary in character. IRC §1276(a). See generally, Auster, Market Discount Elections with Respect to Bonds after the Tax Reform Act of 1984, 63 TAXES 111 (1985).

c. Reporting. IRC §6050P requires the lender to report cancellation of debt income on Form 1099-C. See Treas. Reg. §1.6050P-1(a).
2. **Character of the Loss—Ordinary Loss for Business Bad Debt.**

   a. **Corporate Taxpayer.**

      (1) A corporate mortgagee has per se business bad debt, resulting in ordinary loss treatment. IRC §§166(a) and 166(d). See, e.g., *West Coast Securities Co. v. Com.*, 14 T.C. 947 (1950).

      (2) Different rules apply for purposes of a loss deduction under IRC §165. See *International Trading Co. v. Com.*, 484 F.2d 707 (7th Cir. 1973), rev'g, 57 T.C. 455 (1971) (holding that a corporation could not take a loss deduction under IRC §165(a) as to property neither used in a trade or business nor held for production of income). See also *Schautz Co. v. U.S.*, 567 F.2d 373 (Ct. Cl. 1977) (denying a loss deduction on the sale of residential vacation property because of the IRC §274 override); and *Blake Construction Co., Inc. v. U.S.*, 572 F.2d 823 (Ct. Cl. 1978).

   b. **Non-corporate Taxpayer.** A non-corporate mortgagee may receive ordinary loss treatment, but only if the debt was a business debt. IRC §166(d)(1).

      (1) A business debt is defined as (i) debt created or acquired in connection with a trade or business of the taxpayer, or (ii) debt the loss from the worthlessness of which is incurred in the taxpayer's trade or business. IRC §166(d)(2).

      (2) The characterization of a worthless debt as business or nonbusiness is a question of fact that depends on the relationship between the debt and the creditor's trade or business. See *Siggelkow v. Com.*, 77 TCM 1403 (1999), where the taxpayer's bad debt, related to funds borrowed to finance the purchase of a Lear jet for a corporation in which the taxpayer was a one-third owner, was treated as a nonbusiness bad debt. The test for determining what constitutes a "trade or business" for purposes of applying IRC §166 is the same as that used for ascertaining the deductibility of a loss under IRC §165—that is, whether the loss is proximately related to the conduct of the trade or business of the taxpayer. See Treas. Reg. §1.166-5(b).

      (3) Whether an individual has incurred a business bad debt or a non-business bad debt is a frequently litigated issue. The leading Supreme Court case distinguishing an investor from a person engaged in a trade or business offers little guidance. *Whipple v. Com.*, 373 U.S. 193 (1963). See also *U.S. v. Generes*, 405 U.S. 93 (1972) (bona fide business bad debt factors).

The generally accepted belief that the mere holding of rental real property constitutes a trade or business may not be wholly valid, under certain circumstances. See Lee, "Active Conduct" Distinguished from Conduct of a Rental Real Estate Business, 25 TAX LAWYER 317 (1972).

In contrast, the making of mortgage loans may constitute an individual's trade or business. If such loans are made on a frequent and continual basis, then such money lending may in and of itself constitute a business, so that bad debts therefrom will constitute ordinary losses. See, e.g., Sales v. Com., 37 T.C. 576 (1961); and Barish v. Com., 31 T.C. 1280 (1959).

As to a partner in a partnership, the type of business carried on by the partnership, and the ability to cause attribution of such business to the partner, may be determinant as to whether a loss on a loan to the partnership is an ordinary loss or capital loss. See, e.g., Butler v. Com., 36 T.C. 1097 (1961); Kazdin v. Com., 28 TCM 432 (1969); and Hambuechen v. Com., 43 T.C. 80 (1964). See also Cary v. Com., 32 TCM 913 (1973), as to the separation of the individual's activities from those of his controlled entities in the "dealer" area.

3. Treatment of Bad Debts.
   a. Wholly Worthless Bad Debts.

(1) Generally, a bad debt that is wholly worthless must be deducted in full in the year in which such worthlessness occurs. IRC §166(a)(1). See also Treas. Reg. §1.166-3(b).


(3) Legal action to enforce payment is not necessary where the facts indicate that such action would be futile. Treas. Reg. §1.166-2(b).

(4) The factors considered by the courts and the Service include: debtor receivership or bankruptcy; the termination of, or decline in, the debtor's business; the debtor's disappearance or departure from the country; and the debtor's death. See, e.g., Lunsford v. Com., 212 F.2d 878 (5th Cir. 1954); Keller v. Com., 29 TCM 369 (1970); Portland Manufacturing Co. v. Com., 56 T.C. 58 (1971); and Rev. Rul. 71-37, 1971-1 C.B. 78.

b. Partially Worthless Bad Debts.

(1) It is also possible to obtain a deduction for a partially worthless bad debt. As a general rule, a partially worthless debt is deductible in the taxable year in which it is determined that only a portion of the debt is recoverable; the worthless portion is
deductible to the extent that it is “charged off” for financial accounting purposes in such year. IRC §166(a)(2). See also Treas. Regs. §§1.166-3(a)(1) and (2).


(3) The Service determination, unless arbitrary or unreasonable, will not be overturned by the courts. See, e.g., American Processing and Sales Co. v. U.S., 371 F.2d 842 (Ct. Cl. 1967); and Stranahan v. Com., 42 F.2d 729 (6th Cir. 1930).

(4) Where the uncollectible portion of the debt cannot be clearly ascertained with a high degree of certainty, the deduction for the partially worthless debt will be disallowed, even though it can be shown that debt is truly partially worthless. Treas. Reg. §1.166-3(a)(2)(ii). See, e.g., First National Bank of Los Angeles v. Com., 6 B.T.A. 850 (1927).

(5) Lack of charge-off is not fatal to the deduction, but only to the year of deductibility. The bad debt is deducted in the year of charge-off, irrespective of whether the partial worthlessness was ascertained in the year of charge-off or an earlier year. Treas. Reg. §1.166-3(a).

(6) Disallowance of a bad debt deduction in one year does not prevent allowance of the deduction in a subsequent year. The charge-off, although in the earlier year, will be deemed to suffice, as to the portion charged off in the earlier year, in the later year. Treas. Reg. §1.166-3(a)(2)(ii). Similarly, the Tax Court has indicated that partial worthlessness need not be deducted on a year-to-year basis, but can be deducted through a charge-off in a later year. See E. Richard Mienig Co. v. Com., 9 T.C. 976 (1947); and Estate of Denton v. Com., 11 TCM 802 (1952).

(7) The entries actually charging off the partially worthless debt need not be made in the taxable year for which the deduction is taken, as where the taxpayer’s accountants do not make the charge-off until they close the books for the year, so long as they are made prior to the filing of the income tax return for that year. See, e.g., Brandtjen & Kluge, Inc. v. Com., 34 T.C. 416 (1960); Kentucky Rock and Asphalt Co. v. Helburn, 108 F.2d 779 (6th Cir. 1940); and Colorado County Federal Savings & Loan Ass’n v. Com., 36 T.C. 1167 (1961), aff’d 309 F.2d 751 (5th Cir. 1962).

(8) The burden is on the taxpayer to prove that a proper charge-off was made. See, e.g., Findley v. Com., 25 T.C. 311 (1955), aff’d per curiam 236 F.2d 959 (3rd Cir. 1956); and Klegberg v. Com., 43 B.T.A. 277 (1941).
V. VOLUNTARY/INVOLUNTARY FORECLOSURE AND ABANDONMENT.

A. Introduction.

1. **In General.** If a debtor and credit are unable to reach an agreement involving a reduction or modification of the debt or a realignment of interests, the debtor seeking to retain the property securing the debt may file bankruptcy in the hopes of achieving a satisfactory plan that permits continued possession of the property. Alternatively, the creditor will acquire the property to satisfy the debt via a voluntarily conveyance or pursuant to a foreclosure sale.

2. **Voluntary and Involuntary Foreclosure.**

a. **Sale or Exchange Treatment.** A sale of mortgaged property to a third party pursuant to a foreclosure (or deed in lieu of foreclosure or other transfer to lender in full satisfaction of the debt) is generally treated as a sale or exchange of the property. Treas. Regs. §§1.1001-2(a)(1) and (2). See *Helvering v. Hamel*, 311 U.S. 504 (1941); and *Cox v. Com.*, 68 F.3d 128 (CA5 1995). See also Rev. Rul. 78-164, 1978-1 C.B. 264; and Rev. Rul. 73-36, 1973-1 C.B. 372. See generally, Schnee, Gain in Foreclosure Sales of Realty Need Not Be Recognized, 24 TAX'N FOR LAWYERS 34 (1995).

b. **Gain or Loss Recognition.** The disposition will result in gain or loss measured by comparing the proceeds realized by the debtor to the adjusted basis in the property. IRC §1001(a). The amount of proceeds that will be deemed realized by the debtor depends on whether the debt is recourse or nonrecourse and the current fair market value of the property.

c. **Fair Market Value.** The fair market value of foreclosed property is generally the amount bid for such property at the foreclosure proceeding. Where the debtor voluntarily transfers the property to the creditor, the parties should enter into an agreement (though not binding on the Service) and report the fair market value of the property consistently. If an agreement cannot be reached, the debtor should obtain an appraisal and report the transaction consistent with the appraisal.

d. **Effect of Right of Redemption.** If the mortgagor has a right of redemption, the gain or loss realized on the foreclosure will not be recognized until the right of redemption expires. Rev. Rul 70-63, 1970-1 C.B. 36.

e. **Treatment of Unpaid Accrued Interest under Tax Benefit Rule.** The tax benefit rule of IRC §111 did not apply to a transfer of property to a creditor pursuant to a deed in lieu of foreclosure. In *Allan v. Com.*, 166 T.C. 655 (1986), aff’ed, 856 F.2d 1169 (8th Cir. 1988), when the debtor, an accrual basis partnership, defaulted on the loan, the creditor continued to pay local real estate taxes and added the payments to the loan balance. The debtor partnership continued to deduct the amount of taxes paid and accrued interest on these amounts added to the loan balance. Instead of treatment under the tax benefit rule, these advances were
treated as true loans and thus properly included as part of the sale proceeds realized on the subsequent transfer of the collateral to the creditor.

f. Allocation of Proceeds Between Principal and Accrued Interest. Absent a contrary agreement, in the case of a solvent debtor, foreclosure proceeds are allocated first to principal and then to accrued interest. In the case of an insolvent debtor, the foreclosure proceeds are allocated first to the payment of the accrued interest.

3. Abandonment.

a. Recourse Debt. The abandonment of property by a mortgagor who is personally liable on the mortgage debt is considered to be a sale or exchange. This is because a taxpayer who is personally liable under recourse debt is generally held not to have sustained a deductible loss merely by abandoning the property. There must be either a subsequent foreclosure or a voluntary conveyance that cuts off the taxpayer's interest in the property in order to give rise to the loss. See Com. v. Green, 126 F.2d 70 (3rd Cir. 1942) (subsequent foreclosure sale, not abandonment, of real property encumbered by recourse mortgage cut off mortgagor's interest and was loss realization event). See also PLR 8649051 (Sept. 10, 1986) (recognition event for recourse debt occurs only at time of foreclosure sale or other event which formally evidences mortgagee's intent not to pursue collection of the debt; whereas, in the case of nonrecourse debt, a recognition event could arise upon the mortgagor's abandonment of the mortgaged property).

b. Nonrecourse Debt. It is now well established that sale or exchange treatment also applies in the case of abandonment of property subject to a nonrecourse mortgage.

(1) Under earlier law, if the taxpayer had an adjusted basis in the property exceeding the mortgage debt, then the taxpayer could recognize an ordinary loss, provided he could prove both worthlessness of equity and abandonment by some clearly identifiable event, such as delivery of a quitclaim deed. See Hoffman v. Com., 40 B.T.A. 459 (1939), aff'd, 117 F.2d 987 (2nd Cir. 1941); and Daily v. Com., 81 T.C. 161 (1983) (footnote 4 indicating that there would be IRC §1231 ordinary loss on abandonment because the property was trade or business property), aff'd, 742 F.2d 1461 (9th Cir. 1984). See also Treas. Reg. §§1.165-2(a) and 1.167(a)-8(a)(4) (issue of when abandonment occurs). See generally, Cook, Abandonment of Property Can Convert Capital Loss into Ordinary Loss, 7 TAX. FOR LAW. 168 (1978).

(2) However, more recent cases treat the abandonment of property subject to a nonrecourse mortgage as a "sale or exchange" resulting in capital loss under IRC §165(f). See Freeland v. Com., 74 T.C. 970 (1980). See also Middleton v. Com., 77 T.C. 310 (1981), aff'd, 693 F.2d 124 (11th Cir. 1982); Yarbrough v. Com., 45 TCM 170 (1982), aff'd, 732 F.2d 479 (5th Cir. 1984); L & C Assoc. v. Com., 188 F.3d 866 (7th Cir. 1999); and Arkin v. Com., 76 T.C. 1048 (1981). See also Schmudde, Real Estate Investments: Foreclosure and Abandonment of Mortgaged Property, 3 J. TAX. INVESTS. 245 (1986).
c. Partnership Interest.

(1) In spite of Freeland, two decisions have indicated that the abandonment of a partnership interest may be treated as an ordinary loss fully deductible by the taxpayer in the year the interest is abandoned.

(a) In Citron v. Com., 97 T.C. 200 (1991), the taxpayer contributed $60,000 to a limited partnership formed to produce a motion picture. When the film production failed, the taxpayer renounced his interest in the partnership and claimed an ordinary loss in the year of the partnership's dissolution. The Tax Court held that the actions of the taxpayer in voting to dissolve the partnership and his communication to the general partner that he no longer owned an interest in the partnership or the motion picture sufficiently evidenced taxpayer's intention to abandon his partnership interest. Further, the Court held that, because no partnership liabilities existed at the time taxpayer renounced his partnership interest, the taxpayer could not be said to have constructively paid any consideration for his partnership interest. Consequently, the Court held that no sale or exchange occurred on the abandonment, and so the taxpayer's abandonment loss was an ordinary loss in the year of the partnership's dissolution.

(b) Similarly, in Echols v. Com., 935 F.2d 703 (5th Cir. 1991), rev'g, 93 T.C. 553 (1989), the taxpayer invested in a limited partnership that owned unimproved land subject to nonrecourse debt. When the value of the land plunged, the taxpayer informed the other partner that he could no longer carry his share of partnership expenses and would make no further contributions to the partnership. The taxpayer stated that he was foregoing his interest in the partnership and would transfer such interest to anyone willing to assume his share of the partnership debt. The 5th Circuit held that the taxpayer's statement to the other partner that he would make no additional capital contributions to the partnership was a "clear and unequivocal indication to [the other partner] and the world" that the taxpayer was "walking from his ownership interest". As a result, the Court held that the taxpayer's partnership interest was abandoned in the taxable year in which it was deemed worthless by the taxpayer, and so he was entitled to deduct an ordinary loss under IRC §165(a). See generally, Pickron, Some Partners Will Find That Abandonment of Partnership Interests Accelerates Gain, 77 J. Tax. 268 (1992); Levin, Recent Developments: Echols and the Worthlessness of the Partnership Interest, 20 J. Real. Est. Tax. 104 (1992); and Rieser, Jr., Hitt and Aromatorio, Obtaining an Abandonment or Worthlessness Deduction for a Partnership Interest, 15 J Partnership Tax'n 42 (1998).

(2) While the Citron and Echols courts held in favor of abandonment of the partnership interest, the issue of whether and when abandonment has occurred involves an assessment of all relevant facts and circumstances of a particular situation. In the absence of an easily ascertainable event, abandonment may be difficult to prove. For example, Equity Planning Corp. and Subsidiaries v. Com., 45 TCM 610 (1983), held that the partnership had not abandoned its property because of its continued efforts to retrieve value therefrom, which efforts were eventually successful.

(3) If the abandoned property is encumbered by a nonrecourse mortgage debt and the taxpayer's basis in the real property is less than the outstanding mortgage, the taxpayer will have gain to the extent of such difference. If the abandonment is held to be a
“sale or exchange”, such gain will be capital gain, subject to the recapture rules, unless the property fails to constitute a capital asset with respect to the taxpayer. See PLR 9214011 (Dec. 26, 1991). For a detailed discussion of the Echols case and the character of the loss resulting from an abandonment of a partnership interest, see Harris, Sec. 165(a): Losses on Troubled Real Estate, 71 TAXES 171 (March 1993); and Lipton, How to Avoid Capital Loss Treatment on the Abandonment of a Partnership Interest, 80, J. TAX'N 158 (March 1994).

d. Bankruptcy. A bankruptcy trustee may abandon property of the estate considered burdensome or of inconsequential value. 11 U.S.C. §554(b). Upon the trustee’s abandonment of property of the estate, the automatic stay of bankruptcy is lifted as to that property, and any gain attributable to such property (including gain recognized upon foreclosure) is taxable to the debtor and not dischargeable in bankruptcy. 11 U.S.C. § 101(10).


B. Treatment of Mortgagor.

1. Recourse Debt.

   a. Foreclosure Sale. A sale of mortgaged property to a third party pursuant to a foreclosure is treated as a sale or exchange of the property, with gain or loss measured by the difference between the adjusted tax basis in the property and the amount realized. Helvering v. Hammel, 311 U.S. 504 (1941). See also Rev. Rul. 73-37, 1973-1 C.B. 372.

      (1) Bifurcated Transaction. Ordinarily, a sale will produce sale proceeds in excess of the mortgage balance, in which case the amount realized is the amount of the sale proceeds. In the case of a foreclosure, however, the value of the distressed real estate typically has declined below the mortgage balance. A foreclosure of property encumbered by recourse debt for which the mortgagor is personally liable is treated as a sale or exchange. The transaction is bifurcated between the “sale element” and the “debt cancellation element” if the remainder of the debt is forgiven in the transaction.

      (2) Amount Realized.

         (a) If the mortgage balance is less than the sale proceeds, the amount realized is the amount of the foreclosure sale proceeds.

         (b) If the mortgage balance exceeds the sale proceeds and the mortgagor is discharged from liability, the amount realized is the mortgage balance and the excess is cancellation of debt income. Treas. Reg. §1.1001-2(c) (Ex. 8).

         (c) If the mortgage balance exceeds the sale proceeds but the mortgagor is not discharged from liability for the excess, the amount realized is the foreclosure sale proceeds. Alzawa v. Com., 99 T.C. 197 (1992), aff’d in an unpublished opinion

1. **Bifurcated Transaction.** If the fair market value of the property is less than the outstanding mortgage, the transaction is bifurcated between the “sale element” and the “debt cancellation element”.

2. **Sale Element.** The amount realized is equal to the fair market value of the property. The mortgagor will recognize taxable gain to the extent that the fair market value of the property exceeds the mortgagor's adjusted basis in such property. IRC §61(a)(3).

3. **Debt Cancellation Element.** The mortgagor will recognize cancellation of debt income, unless an exception applies, to the extent that the outstanding debt exceeds the fair market value of the property (assuming the mortgagee releases the mortgagor from liability). IRC §61(a)(12). See Treas. Reg. §1.1001-2(c) (Ex. 8). See also Frazier v. Com., 111 T.C. 243 (1998).

c. **Losses.** The mortgagor will recognize a loss if the adjusted basis of the transferred property is greater than the debt encumbering such property at the time of disposition.

1. **IRC §1231 Property.** The loss will be characterized as an ordinary loss under IRC §1231 or a capital loss under IRC §1221, depending on the nature of the real estate in the hands of the taxpayer. See IRC §1231(c) (ordinary losses must first be netted against IRC §1231 gains; IRC §1231 gain treated as ordinary income to the extent such gain does not exceed aggregate net IRC §1231 losses for five preceding tax years). See generally, Fogel and Allison, Planning to Allow Both Parties to Control Tax Consequences of a Real Estate Foreclosure, 12 TAX. FOR LAW. 48 (1983).

2. No loss is allowable if the mortgagor redeems property before the period provided for exercising his rights of redemption expires. Hotz v. Com., 42 B.T.A. 432 (1940).

d. **Purchase Money Mortgagee.** Special rules may apply in the case of a purchase money mortgagor who voluntarily conveys property to the seller-mortgagee in discharge of the debt. The mortgagor may be able to rescind the transaction or treat any reduction in the mortgage as a purchase price reduction under IRC §108(e)(5).

e. **Partially Recourse Debt.** A transfer of cash or the collateral to the creditor in satisfaction of partially recourse debt is allocated first to the nonrecourse portion absent an agreement otherwise. TAM 8348001 (no date). If the value of the property transferred to the creditor is less than the nonrecourse portion of the debt, the sale proceeds realized by the
debtor will equal the nonrecourse portion of the debt, the and recourse portion of the debt will constitute cancellation of debt income.

f. Conversion of Recourse Debt to Nonrecourse Debt. The conversion of recourse debt into nonrecourse debt in a case where the fair market value of the collateral is less than the loan balance prior to the conversion should not result in cancellation of debt income. The conversion should not result in cancellation of debt income or other gain to the debtor as long as the outstanding principal balance of the debt is reduced and the debt continues to bear interest at a rate greater than the applicable Federal rate.

2. Nonrecourse Debt.
   a. Foreclosure Sale.
      (1) Amount Realized. Upon the foreclosure of property encumbered by nonrecourse debt (i.e., debt for which the taxpayer is not personally liable), the amount realized will always be at least equal to the outstanding balance of the nonrecourse debt, irrespective of the fair market value of the property. IRC §7701(g); Treas. Reg. §1.1001-2(a)(1), (b) and (c)(Ex. 7). See also Estate of Delman v. Com., 73 T.C. 15 (1979); and Woodsam Associates, Inc. v. Com., 16 T.C. 649 (1951), aff'd 198 F.2d 357 (2nd Cir. 1952).

      (2) In holding that the amount realized includes the full amount of the mortgage debt, Crane v. Com., 331 U.S. 1 (1947), established the symmetry in treatment of liabilities for purposes of determining basis and amount realized, but suggested in infamous footnote 7 that a different answer might obtain if the value of the property were less than the outstanding mortgage.

      (3) Addressing the question left unanswered in footnote 7, Tufts v. Com., 461 U.S. 300 (1983), held that fair market value was irrelevant to the issue of realization. The taxpayer, having included the proceeds of a nonrecourse loan in basis because of the obligation to repay, must include the full amount of the debt relief in amount realized, regardless of the fair market value of the underlying property, because extinguishment of the obligation to repay produced value to the taxpayer.


   b. Deed in Lieu of Foreclosure. The voluntary conveyance of mortgaged property to a nonvendor mortgagee in satisfaction of the debt is treated as a sale or exchange. The amount realized is the full amount of the nonrecourse debt, regardless of the fair market value of the property. Millar v. Com., 67 T.C. 656 (1977), aff'd on this issue, 577 F2d 212 (3d Cir. 1977), cert. denied, 439 U.S. 1046 (1978).
c. **Gain (or Loss) Recognition and No Cancellation of Debt Income.**

Upon a foreclosure sale or voluntary conveyance of the property subject to a nonrecourse liability, the debtor recognizes gain or loss equal to (1) the amount of the nonrecourse liability (assuming the fair market value of the property is less), plus the amount of cash and the fair market value of any other property paid to the debtor, minus (2) the debtor’s adjusted tax basis in the property securing the nonrecourse liability. No portion of the amount realized would constitute cancellation of debt income, thereby precluding the availability of any relief under IRC §108.

d. **Creation of Cancellation of Debt Income.** In order to create cancellation of debt income for purposes of IRC §108 relief, several transactions have been suggested. To receive cancellation of indebtedness income treatment rather than sale or exchange treatment, however, the taxpayer generally must retain the underlying property after the satisfaction of the debt.

   (1) The step transaction or substance over form is likely to apply to these suggested transactions: (a) conversion of the nonrecourse liability into recourse debt, with the understanding that the creditor will forgive any unpaid balance; (b) a sale of the collateral to a third party, with the creditor’s consent and payment of the sale proceeds to the creditor in exchange for release of the debt; and (c) a cash payment in discharge of portion of the debt followed by a transfer of the property to the creditor in satisfaction of the debt. See, e.g., *Briarpark Ltd. v. Com.*, 73 TCM 3218 (1997), where two transactions—pledging the underlying asset for sale contingent upon removing the debt and then satisfying the debt with cash received from the contingent sale—were treated as inter-related steps that resulted in a foreclosure sale, not a cancellation of debt, with sale or exchange treatment.

   (2) The tax treatment is unclear if the property foreclosed upon is subject to nonrecourse debt to the partnership but is guaranteed by a partner. In light of the IRC §752 regulations, the debt is not pure nonrecourse debt, so that a foreclosure and release arguably produces cancellation of debt income. See Reeves and Shapleight, Effect of Discharge of indebtedness Income on Partnerships and Partners, “ 8 J. PARTNERSHIP TAX. 18, 26-26 (Spring 1991).

e. **Losses.** If the adjusted basis of the transferred property is greater than the balance of the nonrecourse debt encumbering such property, the taxpayer will recognize a loss (either a capital loss under IRC §1221 or an IRC §1231 ordinary loss). See *Russo v. Com.*, 68 T.C. 135 (1977). Although earlier cases suggested that a voluntary conveyance to the mortgagee in lieu of foreclosure, where the adjusted basis of the property exceeds the mortgage debt, resulted in an ordinary loss based on the theory that no sale occurred, the Service took the position that the difference between a foreclosure and a voluntary conveyance of a deed in lieu thereof was “too tenuous” to warrant any substantive difference in tax treatment. See Rev. Rul. 78-164, 1978-1 C.B. 264. The Tax Court followed the Service's lead and held that a voluntary conveyance in lieu of foreclosure, where the debt was nonrecourse, was a “sale”, and any loss was a capital loss. *Freeland v. Com.*, 74 T.C. 970 (1980) (noting that it would no longer adhere to prior holdings, such as *Commonwealth, Inc. v. Com.*, 36 B.T.A. 850 (1937), which were inconsistent. See also *Allan v. Com.*, 86 T.C. 655 (1986), aff'd 856 F.2d 1169 (8th Cir. 1988); and *Laport v. Com.*, 671 F.2d 1628 (7th Cir. 1982).
3. **Timing of Mortgagee’s Tax Consequences.** A mortgagee to whom property is conveyed voluntarily will recognize gain (or loss) to the extent that the transferred property’s fair market value is greater (or less) than the mortgagee’s basis for the cancelled mortgage debt. See, e.g., *Henry v. U.S.*, 180 F. Supp. 597 ( Ct. Cl. 1960).

   a. **Foreclosure Sale.** A foreclosure loss is deductible in the year in which the taxpayer's right of redemption expires under state law. See *Derby Realty Corp. v. Com.*, 35 B.T.A. 335 (1937).

      (1) In order to obtain a deduction in the year of foreclosure, the debtor can voluntarily quitclaim or release his right of redemption to the purchaser. See *Hill v. Com.*, 40 B.T.A. 376 (1939). Alternatively, if the right of redemption is itself worthless and is abandoned, then an earlier loss could be claimed, provided there is proof of an “identifiable event”.

      (2) If there is no right of redemption, the taxpayer recognizes gain or loss in the year of the foreclosure sale, rather than at the time of the decree of foreclosure that precedes the sale. See *Belcher v. Com.*, 24 TCM 1 (1965). See also PLR 8649051 (Sept. 10, 1986).

   b. **Voluntary Conveyance.** If there is a voluntary conveyance in lieu of foreclosure or abandonment, the loss is taken in the year such voluntary conveyance or abandonment occurs. See *Hoffman v. Com.*, 117 F.2d 982 (2nd Cir. 1941).

C. **Treatment of Mortgagee.**

1. **Deed in Lieu of Foreclosure.**

   a. A mortgagee to whom property is conveyed voluntarily will recognize gain (or loss) to the extent that the transferred property’s fair market value is greater (or less) than the mortgagee's basis for the cancelled mortgage debt. See, e.g., *Henry v. U.S.*, 180 F. Supp. 597 ( Ct. Cl. 1960).

   b. It is now clear that the transfer of property by a deed in lieu of foreclosure constitutes a sale or exchange with respect to the mortgagor. See *Freeland v. Com.*, 74 T.C. 970 (1980); and *Allan v. Com.*, 86 T.C. 655, 659 (1986), aff'd, 856 F.2d 1169 (8th Cir. 1988). See also PLR 9245023 (August 7, 1992) (debtor’s transfer of real property to a bank pursuant to a deed in lieu of foreclosure resulted in a loss to the extent that the basis exceeded the deemed amount realized). Since it is proper to view the mortgagor as having cancelled the mortgage debt in exchange for conveyance of the property, the character of any gain or loss recognized by the mortgagee will depend upon whether the mortgage debt is a capital asset in the mortgagee’s hands. See Rev. Rul. 80-57, 1980-1 C.B. 157 (REIT had ordinary income upon the cancellation of a mortgage debt in exchange for the mortgaged property because the mortgage debt was not a capital asset in its hands).
2. **Foreclosure Sale.**

   a. A loss on foreclosure is deductible in the year in which, under state law, the taxpayer's right of redemption expires. See *Derby Realty Corp. v. Com.*, 35 B.T.A. 335 (1937).

   b. If there is no right of redemption, the deduction is taken in the year of the foreclosure sale, rather than in the year of the final decree. See *Belcher v. Com.*, 24 TCM 1 (1965). See also PLR 8649051 (Sept. 10, 1986) (foreclosure sale, not the decree of foreclosure that precedes the sale, fixes the time when the taxpayer recognizes gain or loss).

   c. In addition, if the debtor wants a deduction in the year of foreclosure and has a right of redemption, he may voluntarily quitclaim his right to the same in order to obtain the deduction. See *Hill v. Com.*, 40 B.T.A. 376 (1939).

3. **Seller Reacquisition under IRC §1038.**

   a. In General. When a purchaser under a purchase money mortgage defaults, the seller typically reacquires the formerly owned property either by foreclosure or by voluntary conveyance of a deed in lieu of foreclosure, reacquires the property formerly owned.

   (1) **Tax Consequences upon Reacquisition.** In the case of (a) a sale of real property that gave rise to indebtedness to the seller which is secured by the real property sold (i.e., purchase money mortgage), and (b) the seller reacquires such property in partial or full satisfaction of such indebtedness, IRC §1038 determines the tax consequences. Upon the reacquisition, the seller does not recognize gain or loss, except as provided in IRC §1038(b) and (d). IRC §1038(a); Treas. Reg. §1.1038-1(a).

   (2) **Rationale.** Congress believed it was inequitable to tax the seller when he was really in no better position to pay tax after the foreclosure than before. If the property has increased in value, the tax would be imposed on a gain not yet realized. If the property has decreased in value, the tax would be imposed on a gain that might never be realized. Congress believed it was more desirable to treat the first sale as if it had been nullified and to limit the gain upon reacquisition to the payments actually received. S. Rep. No. 1361, 88th Cong., 2d Sess. (1964), 1964-2 C.B. 828-835.

   (3) **Mandatory Application.** If the requirements of Sec. 1038(a), I.R.C. are met, then Sec. 1038, I.R.C. will automatically be applicable to the reacquisition of the security property by the seller on the cancellation of the debt. Treas. Reg. §1.1038-1(a)(1). See Treas. Reg. §1.1038-3 for the election to apply IRC §1038 to certain taxable years beginning after December 31, 1957, but before September 3, 1964.

b. **Requirements.**

   (1) **Real Property.** IRC §1038, I.R.C. applies only to real property, not to personal property. Treas. Reg. §1.1038-1(a)(1). See *Held v. U.S.*, 75-2 USTC §9,678 (D. Ala. 1975) (IRC §1038 not applicable to corporate stock). See also Rev. Rul. 86-120,
1986-2 C.B. 145 (where shareholder received installment obligation in corporate liquidation and subsequently, upon buyer’s default, received real property securing the obligation, IRC §1038 did not apply, because liquidated corporation was the seller of the real property). Hence, if the property sold included elements of both real property and personal property, it would be necessary to separate out the personal property and treat that portion as sold under the general rules of IRC §1001.

(2) **Sale Transaction.**

(a) A sale may occur even though title to the property has not passed to the purchaser.

(b) A sale will be considered to have occurred if the purchaser has contractual rights to retain possession of the property, so long as it performs its obligations under the contract, and to obtain title upon completion of such obligations. Treas. Reg. §1.1038-1(a)(2)(i).

(c) A sale may have occurred even if the purchaser does not have the right to possession until he partially or fully satisfies the terms of the contract. For example, if the seller contracts to sell property to the purchaser, and under the contract the purchaser is to take possession of the property when 10 percent of the purchase price is paid, but is not to receive legal title until the full purchase price is paid, a sale is considered to have occurred on the date of the contract. Treas. Reg. §1.1038-1(a)(2)(i).

(d) While a “sale” may be deemed to have occurred for purposes of IRC §1038, the date of the contract may not be the date that the holding period of the property is considered to have commenced for capital gains purposes, if the purchaser did not take on the burdens and benefits with respect to the property on that date. See Rev. Rul. 54-607, 1954-1 C.B. 177. See also *Hoven v. Com.*, 56 T.C. 50 (1971); and *Borrelli v. Com.*, 31 TCM 876 (1972).

(e) A disposition of real property that constitutes an exchange of property is not considered a sale. Treas. Reg. §1.1038-1(a)(2)(i).

(f) IRC §1038 does not apply to a transaction treated as a sale under IRC §121(d)(4) or a sale of stock in a cooperative housing corporation described in IRC §121(d)(3).

(3) **Debt Secured by Real Property Sold.**

(a) This means that the seller must have the right to take title or possession of the property, or both, if there is a default with respect to the debt. Treas. Reg. §1.1038-1(a)(2)(ii).

(b) There is no requirement that the purchaser have any personal liability on the debt; rather, the seller may be “limited in his recourse to the property for payment of the indebtedness in the case of default.” Treas. Reg. §1.1038-1(a)(2)(ii).
Reacquisition.

(a) The manner in which the seller reacquires the real property is generally immaterial. Reg. § 1.1038-1(a)(3)(ii). The property may be acquired either by agreement or by process of law. Reg. § 1.1038-1(a)(3)(ii).

(b) If the seller reacquires the original tract of land that was purchased with a promissory note, which undeveloped land was subsequently improved, the seller is entitled to nonrecognition for the improvements. See Connors v. Com., 88 T.C. 541 (1987); and Hovhannissian v. Com., 74 TCM (CCH) 752 (1997). See also PLR 9833005 (May 12, 1998).

(c) There is no requirement that the property be reacquired from the original purchaser, since "purchaser" is not mentioned in IRC §1038(a). Hence, the property may be reacquired from the purchaser’s assignee or transferee or from a trustee holding title to the property pending the purchaser’s satisfaction of the terms of the sales contract or purchase money indebtedness, so long as the debt partially or completely satisfied in the reacquisition arose in the original sale and was secured by the property reacquired. Treas. Reg. §1.1038-1(a)(4).

By Seller.

(a) Originally, the Service interpreted the word "seller" as used in Sec. 1038(a)(2), I.R.C. to mean that the original seller would be the only party who could reacquire the property and receive the favorable treatment of Sec. 1038, I.R.C. See Rev. Rul. 69-83, 1969-1 C.B. 202, where the Service rejected the applicability of Sec. 1038, I.R.C. to a decedent’s estate because the original seller died between the time of the sale and the time of voluntary reconveyance of the property in lieu of foreclosure.

(b) IRC §1038(g), as enacted in 1980, extends the favorable tax treatment to the estate or beneficiary of a deceased seller in cases in which there is an installment obligation to which IRC §691(a)(4)(B) applies. The basis of the reacquired property is increased by an amount equal to the IRC §691(c) deduction that would have been allowable with respect to the gain on the exchange of the obligation for the real property. IRC §1038(g)(2).

In Partial or Full Satisfaction of the Debt. The reacquisition must be in furtherance of the seller's security rights in the property with respect to indebtedness to him that arose at the time of the sale. Treas. Reg. §1.1038-1(a)(3)(i). However, IRC §1038 applies even if a default has neither occurred nor is imminent or even if the purchaser and seller are related parties. See PLR 8402006 (Sept. 22, 1983).

IRC §1038(g) Gain Recognition.

(1) If the seller received part payment on the selling price prior to the reacquisition and the partial payment was in excess of the gain reported, tax is imposed at the time of reacquisition. Treas. Reg. §1.1038-1(a)(1). This might occur, for example, if the sale were reported on the installment method or on the deferred-payment method.
Gross Sale Price Adjustments. In determining the potential gain attributable to the initial sale, the gross selling price is reduced by selling commissions, legal fees and other expenses incident to the sale. IRC §1038(b)(2); and Treas. Reg. §1.1038-1(c)(3). See also Cramer v. Com., 55 T.C. 1125 (1971). But see Greene v. Com., 76 T.C. 1018 (1981) (taxpayer not entitled to reduce capital gain by unpaid sales commissions and selling expenses incurred at the time of the original sale).

Example. Assume that the seller sells for $300,000 an unencumbered nondepreciable parcel of land with an adjusted basis of $200,000. Also assume that the purchaser pays for the property by giving the seller $30,000 cash and executing a note in the seller's favor for $270,000. The note is payable in nine equal annual installments, together with interest on the unpaid principal balance at 10%. Furthermore, assume that the installment method of reporting applies, the purchaser defaults on the note after making two annual payments, the seller reacquires the property by voluntary conveyance in lieu of foreclosure, and the seller pays $20,000 in connection with the reacquisition. On sale, the seller has a realized, but not recognized, gain of $100,000 ($300,000 selling price less $200,000 adjusted basis). Also, prior to the reacquisition the seller has, excluding interest on the installment note, received $90,000 in cash (the initial $30,000 and two annual payments of $30,000 each) from the purchaser and recognized $30,000 of income ($90,000 received times one-third, the percentage of gain inherent in each installment receipt). Upon reacquisition, the seller's gain is limited to $50,000 (initial sales price, $300,000, less initial adjusted basis, $200,000, previously reported gain, $30,000, and money paid in connection with reacquisition, $20,000). Thus, this limitation of gain rule takes into account both the original gain realized upon the sale and the costs associated with the reacquisition.

Limitation on Gain Recognition. IRC §1038(b)(2) imposes a ceiling on the amount of taxable gain as a result of the reacquisition. In no event is the gain attributable to payments received before repossession to exceed (i) the potential gain attributable to the initial sale (that is, the amount by which the selling price of the real property exceeded its adjusted basis in the hands of the seller), reduced by (ii) the sum of (A) any amounts received before repossession already reported as income (payments by the buyer on a mortgage or other debt to which the property was subject when acquired by the buyer are considered received by the reacquiring seller before repossession pursuant to Treas. Reg. §1.1038-1(b)(2)(i)) and (B) the amount of money and the fair market value of other property (except purchase money obligations of the purchaser) paid or transferred by the seller in connection with the reacquisition. Treas. Regs. §§1.1038-1(b) and (c).

d. No Loss Recognition. IRC § 1038(a) specifically provides that no loss is recognized if IRC §1038 applies to the reacquisition. In order to recognize a loss, therefore, the seller must avoid satisfying one or more of the requirements of IRC §1038. See Hassan v. Com., 63 T.C. 175 (1974).

e. Basis of Reacquired Property.

(1) To provide symmetry analogous to the nonrecognition provisions, the basis of the reacquired property is adjusted, so that gain or loss not currently
recognized on the disposition of the purchase obligation is recognized on later disposition of the reacquired property.

(2) The reacquired property thus takes a substitute basis, namely, the basis in the purchase money obligation. See Anderson v. Com., 64 T.C. 560 (1975). The substituted basis is increased to reflect the gain reported on the reacquisition and any money or other property, at its fair market value, paid by the reacquiring seller. IRC §1038(c); and Treas. Reg. §1.1038-1(g)(1).

(3) In many situations, the purchase money mortgage debt will not be the only encumbrance on the property. For example, at the time of the sale, the purchase money mortgage may have been subordinated to a newly placed first mortgage debt to an institutional lender. When the property is reacquired, and such first mortgage is assumed or taken subject to by the seller, the unpaid balance of the first mortgage, so long as the first mortgage did not arise when the seller owned the property, will be treated as money paid by the seller on the reacquisition, thereby increasing basis. Treas. Reg. §1.1038-1(c)(4)(ii). See generally, Keatinge and Roche, The Silver Lining in the Wraparound Mortgage Rule—Free Basis on Foreclosure under Section 1038, 64 TAXES 505 (1986).

f. Holding Period of Reacquired Property. On the theory that the reacquisition is considered a nullification of the original sale, Treas. Reg. §1.1038-1(g)(3) provides for the tacking of holding periods.

(1) The tacked holding period for the reacquired property is deemed to include the period during which the seller held it prior to the original sale. The holding period does not include the period between the date of the original sale and the date of the reacquisition, however. Treas. Reg. §1.1038-1(g)(3).

(2) If the purchaser made improvements to the property, the reacquisition produces two holding periods for the seller. Tacking is permitted for the portion of the property not improved by the purchaser. However, the holding period of the improved portion is not tacked but is limited to the period beginning with the date of reacquisition. See Smith v. Com., 58 T.C. 874 (1972). See also Conners v. Com., 88 T.C. 541 (1987) (improvements reacquired without gain by reason of IRC §1038, but treated as having a zero basis in hands of sellers as well as a separate and new holding period). A separate holding period for improvements would also be required if they were constructed by the seller after the reacquisition.

g. Character. The Code does not specify whether gain resulting from a reacquisition is capital gain or ordinary income. The Regulations fill this gap with complex and somewhat illogical rules, as follows:

(1) If the original sale was reported under the installment method, then the character of the gain is capital if the property is a capital asset or used in the taxpayer's trade or business. Treas. Reg. §1.1038-1(d).
(2) If the original sale was reported as a deferred-payment sale, the character of the gain is artificially made to depend on whether title was transferred. If the seller retained title, the gain is capital gain. If title was transferred to the purchaser and there is a voluntary reconveyance, the gain is taxed as ordinary income if the purchaser was an individual, but as capital gain if the purchaser was a corporation whose obligations are satisfied by the reacquisition of corporate securities. Reg. § 1.1038-1(d).

(3) No bad debt deduction is allowed as a result of the reacquisition. Treas. Reg. §1.1038-1(f)(1).

h. IRC §1038(d) Gain Recognition. If the seller claimed a deduction for the complete or partial worthlessness of the purchaser's obligation prior to the reacquisition, the deduction is “reversed” upon the reacquisition. The seller realizes income on the reacquisition equal to the amount of the prior bad debt deduction, and the adjusted basis of the indebtedness is increased by a like amount as of the date of reacquisition. The taxability of the restored income is limited by the tax benefit rule of IRC §111. Treas. Reg. §1.1038-1(f)(2).

i. Reacquisition of Principal Residence.

(1) If the property sold was the seller's principal residence, gain on the sale may have been excluded under IRC §121. IRC §1038(e) overrides the exclusion under IRC §121, unless the seller resells the property within one year after the reacquisition. See Treas. Reg. §1.1038-2(a)(1). See generally, Burke and Friel, Reacquisitions of Seller-Financed Real Property: Evaluating Sec. 1038, 13 REV. TAX. INDIVS. 107 (1989).

(2) If the residence is resold within the one-year period, the resale basically receives the same treatment as the original sale, with corresponding adjustments to the adjusted sales price and basis to account for the effect of the prior sale and reacquisition. Treas. Reg. §1.1038-2. See also Lohman v. Com., 56 TCM 1600 (1989), wherein a taxpayer who sold a ground lease to a subtenant was required to add rental payments made on behalf of the subtenant to his adjusted basis for purposes of calculating potential gain on the resale of the lease. The court rejected the taxpayer's position that such lease payments were deductible under IRC §212 as an ordinary and necessary expense incurred for the conservation of an income-producing property.

4. Rescission of the Transaction. See II, A., 1, above.

5. Reporting Requirements upon Reacquisition by Mortgagee.

a. If property is reacquired in satisfaction of any indebtedness thereon, the mortgagee is required to file Form 1099-A in the year in which the reacquisition occurs. IRC §6050J. The information contained on Form 1099-A includes the classification of the debt as recourse or nonrecourse and, if recourse, the portion that is allocable to the “sale element” of the transaction and the portion allocable to the “debt cancellation element”.

b. The penalty for failure to file Form 1099-A is $50 for each return. IRC §6721.
VI. DISPOSITION OF OVER-ENCUMBERED REAL ESTATE TO THIRD PARTY.

A. Sale of Property Subject to Debt.

1. In General. In the event of a sale of property with debt in excess of basis, gain will be recognized equal to the excess of the amount realized over the adjusted basis of the property. IRC §1001.

   (a) Amount Realized. Amount realized includes the amount of the mortgage liabilities from which the transferor is discharged as a result of the sale or disposition. Treas. Reg. §1.1001-2(a)(1). Crane v. Com., 331 U.S. 1 (1947).

   (b) Debt Reduction. If, immediately after the sale, the purchaser arranges for a reduction of the principal balance or other material modification of the debt instrument that trigger an exchange under IRC §1001, the modification is treated as a separate transaction that takes place immediately before the sale and is attributable to the seller of the property. See Treas. Reg. §1.1274-5(b)(1). However, the seller and buyer may jointly elect under Treas. Reg. §1.1274-5(b)(2) to treat the transaction as one in which the buyer first assumed the original (unmodified) debt instrument and then subsequently modified the debt instrument. If the election is made, the modification is treated as a separate transaction that takes place immediately after the sale or exchange.

2. Installment Sale.

   (a) In an installment sale (i.e., a disposition of property where at least one payment is to be received after the close of the taxable year in which the disposition occurs), the income recognized for any taxable year is that portion of the payments received in that year which the “gross profit” (realized or to be realized when payment is completed) bears to the total “contract price”. IRC §453.

   (b) The ratio of “gross profit” to total “contract price” is referred to as the “gross profit ratio”. Temp. Treas. Reg. §15A.453-1(b)(2)(v).

   (c) “Gross profit” is equal to the “selling price” (i.e., the gross selling price without any reduction for debt) minus the adjusted basis in the property.

   (d) “Contract price” is the selling price reduced by the amount of any “qualifying indebtedness” assumed, or taken subject to, by the buyer, to the extent of the seller’s basis in the property. Temp. Treas. Reg. §15A.453-1(b)(2)(iii).

   (e) The “gross profit ratio” will always be 100% in the case of an acquisition where the buyer assumes, or takes subject to, a mortgage in an amount greater than the seller’s basis in the property.
(f) The excess of the debt assumed, or taken subject to, over the seller's basis is treated as a payment received in the year of the sale. Temp. Treas. Reg. §15A.453-1(b)(3)(i).

(g) Hence, in every case where the amount of debt assumed, or taken subject to, exceeds the seller's basis in the property, the seller recovers 100% of basis in the year of the sale, and the full amount of debt assumed, or taken subject to, in excess of basis will be treated as a payment in the year of sale.

3. **Installment Sale with Wraparound Mortgage.** A wraparound mortgage, if respected, avoids the provision in the installment sale regulations requiring the treatment of mortgage debt in excess of basis that is assumed, or taken subject to, as a deemed payment in the year of the sale.

(a) **Wraparound Mortgage.** A wraparound mortgage is an agreement in which the buyer issues to the seller an installment obligation in an amount that effectively includes the seller's outstanding mortgage encumbering the property. As between the buyer and the seller, the seller remains liable for and continues to service the underlying mortgage.

(b) **Tax Treatment.** In the case of a sale of property with wraparound notes, *Stonecrest Corp. v. Com.*, 24 T.C. 659 (1955), nonacq., 1956-1 C.B. 6, held that there was no assumption of the underlying mortgage or a conveyance subject to it, and thus the excess of the mortgage over the seller's basis was not reportable income under the installment method as a payment deemed received in the year of sale. Cf., *Goodman v. Com.*, 74 T.C. 684 (1980), aff'd without pub. Op., 673 F.2d 1332 (7th Cir. 1981) (buyer treated as having assumed underlying mortgage in substance). Temp. Treas. Reg. §15A.453-1(b)(3)(ii), providing different treatment for a wraparound mortgage, was held invalid in *Professional Equities v. Com.*, 89 T.C. 165 (1987), acq., AOD, 1988-2 C.B. 1. Hence, if a wraparound mortgage can be arranged in connection with an installment sale and its form is respected, the total contract price is not reduced by the underlying mortgage and the mortgage in excess of basis is not a deemed payment in the year of the sale.

(c) **Interest Charge.** However, if the aggregate face amount of all applicable installment obligations that arose during the tax year and are outstanding as of the close of the tax year exceeds $5 Million, the nondealer seller of real estate must pay an interest charge on the deferral of tax attributable to the installment sale. IRC §453A(a) and (b). Partnerships apply this $5 Million threshold at the partner level. See Notice 88-81, 1988-2 C.B. 397.

**B. Transfer of Partnership Interest.** If a partnership holds depreciable real property that has declined in value and the nonrecourse debt exceeds the fair market value of such real property, the partners are likely to have negative capital accounts. A transfer of the partnership interest can trigger adverse tax consequences under these circumstances.

1. Upon a sale of the partnership interest, or a transfer the partnership interest back to the partnership, a partner would be required to recapture the capital account deficit as

2. The same result would obtain if the partnership interest is abandoned. See Dakotah Hills Offices Limited Partnership v. Com., 75 TCM (CCH) 2122 (1998). See also Rev. Rul. 93-80, 1993-2 C.B. 239.

C. Like-Kind Exchange. It is unclear whether an IRC §1031(a) can apply to an exchange involving property subject to nonrecourse debt in excess of the fair market value of the property. A like-kind exchange under IRC §1031(a), if made in anticipation of foreclosure, may be challenged by IRS.

D. Use of Partnership between Seller and Buyer. Planning opportunities are available through a partnership, provided the various subchapter K issues are carefully considered.