

**Table of Contents**

**11.0 CANCELLATION OF INDEBTEDNESS INCOME**

- 11.1 The Tax Treatment of Cancellation of Indebtedness Income – In General
- 11.2 Discharge That Occurs in a Title 11 Case or When a Taxpayer is Insolvent - IRC §108(a)(1)(A) and (a)(1)(B)
- 11.3 Special Rules for Discharge of Qualified Farm Indebtedness - IRC §108(a)(1)(C)
- 11.4 Discharge of Indebtedness Income from Qualified Real Property Business Indebtedness for Taxpayers Other than a C Corporation - IRC §108(a)(1)(D) and IRC §108(c)
- 11.5 Purchase-Money Debt Reduction for Solvent Debtor Treated as Price Reduction - IRC §108(e)(5)
- 11.6 Reduction of Tax Attributes - IRC §108(b)
- 11.7 Time and Manner for Making Election - IRC §108(d)(9) Filing and Disclosure Requirements
- 11.8 Effect of Excluded CODI on Shareholder Basis in the S Corporation
- 11.9 Exhibits

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**11.1 THE TAX TREATMENT OF CANCELLATION OF INDEBTEDNESS INCOME – IN GENERAL**

The receipt of borrowed funds or borrowed property is not income to the borrower. (Commissioner v. Tufts (1983) 461 U.S. 300, 307.) However, when the creditor cancels all or a portion of a debt without receiving adequate consideration, the forgiveness or discharge of a debt could constitute income to the debtor. (United States v. Kirby Lumber Co. (1931) 284 U.S. 1.) The Supreme Court's decision is codified in Internal Revenue Code §61(a)(12) and Revenue and Taxation Code §§17071 and 24271, which include the amount of a taxpayer's discharge of indebtedness in gross income.

Note that a prerequisite to the general rule that receipt of loan proceeds is not income is that the loan is bona fide indebtedness. While the determination of whether the loan is bona fide indebtedness is beyond the scope of this chapter, this issue should be carefully examined.

For purposes of this chapter, the statutory term "discharge of indebtedness" (from IRC §§61 and 108) will be used interchangeably with the terms "cancellation of indebtedness", "cancellation of indebtedness income", "COD income", or "CODI".

For purposes of the IRC §108 insolvency test, the relevant taxpayer is either an individual, a partner in a partnership (IRC §108(d)(6)), an S corporation (IRC §108(d)(7)) or a C corporation. The insolvency test is not applied to S corporation shareholders or partnerships.

Currently, there exist several provisions in federal income tax laws that allow a taxpayer to defer the recognition of debt discharge income. Following is a list of those provisions we will discuss in this chapter:

- Discharge that occurs in a title 11 case without regard to whether the bankruptcy is filed under Chapter 7, Chapter 11, or Chapter 13 (IRC §108(a)(1)(A), S. Rep. No. 96-1035, 2nd Sess.),
- Discharge that occurs when a taxpayer is insolvent (IRC §108(a)(1)(B)),
- Discharge of indebtedness originating from qualified farm indebtedness (IRC §108(a)(1)(C)),

## CALIFORNIA FRANCHISE TAX BOARD

- In the case of a taxpayer other than a C corporation, the discharge of indebtedness originating from qualified real property business indebtedness (IRC §108(a)(1)(D)),
- Discharge of indebtedness to the extent that payment of the liability would have given rise to a deduction. (IRC §108(e)(2)), and
- In the case of a purchase-money debt reduction for solvent debtor treated as a price reduction (IRC §108(e)(5)).

In general, California income tax law incorporates IRC §108 by reference in R&TC §17131, and R&TC §24307 as modified by R&TC §17144.

In addition, California income tax law conforms to IRC §108 precedence rules. That is, the exclusion for title 11 cases takes precedence over an insolvency case or in cases in which the debt discharge originated from qualified farm indebtedness or qualified real property business indebtedness. (IRC §108(a)(2)(A).) Excluding debt discharge income under the insolvency provision takes precedence over cases in which the discharge that gave rise to the income originated from qualified farm indebtedness and qualified real property business indebtedness. (IRC §108(a)(2)(B).)

The first four deferral provisions listed above offer current year tax relief under specific situations. IRC §108(e)(2) provides that taxpayers do not realize debt discharge income to the extent that had a taxpayer paid the item, a tax deduction would have resulted. This provision may be used in combination with any other debt discharge exclusion provision (IRC §108(e)(2)). In fact, there is nothing in the Code that prevents a taxpayer from availing him or herself of any combination of the debt discharge exclusion provisions listed, provided the precedence rules are observed and the exclusion provision is applicable.

Once you have determined that the transaction under examination has given rise to CODI, and that the taxpayer excluded or deferred the recognition of that income under IRC §108 on a timely filed return, you should,

- Determine if the taxpayer applied the appropriate non-recognition provision(s) correctly, and
- Verify if the pass-through entity's basis in property was correctly computed through the beginning of the tax year following the year the of debt discharge.

## **11.2 DISCHARGE THAT OCCURS IN A TITLE 11 CASE OR WHEN A TAXPAYER IS INSOLVENT**

IRC §108(a)(1)(A) and (a)(1)(B), in general, provide protection to insolvent taxpayers whether a taxpayer formally files bankruptcy or chooses not to obtain bankruptcy protection. However, the most notable difference concerns those assets that are exempt in determining whether and to what extent a taxpayer is insolvent. The Code offers the most protection to those taxpayers who are attempting to reorganize their debt structure so as to provide the best possible opportunity to survive after re-organization. However, taxpayers who file bankruptcy under Chapter 7 and Chapter 13 are also given the same protection in either case, the tax consequence is similar and therefore, title 11 cases and insolvency cases will be presented together.

### 11.2.1 Bankruptcy Tax Act

#### **11.2.1 Bankruptcy Tax Act**

IRC §108(a)(1)(A) states that gross income does not include discharge of indebtedness income if the discharge occurs in a Title 11 case. California conforms to federal law by reference (R&TC §§17131 and 24307). Under IRC §108(d)(2), the term "Title 11 case" means a case under the Bankruptcy Code if: (1) the taxpayer is under the jurisdiction of the court and, (2) the discharge of indebtedness is granted by the court or pursuant to a plan approved by the court. Under IRC §108(b), amounts excluded from income under §108(a)(1)(A) must be applied to reduce certain specific tax attributes. It is the reduction of these attributes that result in the recognition of the income at a later date, but only to the extent there are attributes to reduce.

The Bankruptcy Tax Act also provides for exclusion from gross income of any amounts arising from a discharge of indebtedness outside bankruptcy. IRC §108(a)(1)(B) states that gross income does not include amounts otherwise includible in income because of the discharge of indebtedness if the discharge occurs when the taxpayer is insolvent. California conforms to federal law by reference (R&TC §§17131 and 24307). Under IRC

## CALIFORNIA FRANCHISE TAX BOARD

§108(a)(2)(A), the insolvency provision does not apply to a discharge that occurs in a bankruptcy case.

Under IRC §108(a)(3), the amount excluded from gross income by reason of the insolvency cannot exceed the amount by which the taxpayer is insolvent. IRC §108(d)(3) defines insolvency as the excess of liabilities over the fair market value of assets. This determination is based on assets and liabilities held immediately before the discharge and may be referred to as the balance sheet insolvency test. (IRC §108(d)(3).)

The statutory language of IRC §108(d)(3) does not specify which assets and which liabilities are taken into consideration for determining the definition of "insolvent." However, the Tax Court offers some guidance in *Hunt, et al. v. Commissioner* (1989) TC Memo 1989-335. Note that this is only an issue for partners and individual taxpayers.

In the above referenced case, the Tax Court held that in determining whether a taxpayer was insolvent is based on exempting only those assets that are exempt from the claim of creditors under state law (Also see *Marcus Est. v. Commissioner*, (1979) TC Memo 1979-9 and TAM 9130005). Where a state's law allows debtors who file bankruptcy petitions under Title 11 to claim the greater of the state law exemptions or the Federal Bankruptcy Code exemptions, a taxpayer not in bankruptcy must use only the state law exceptions to determine whether the taxpayer is insolvent (*Hunt, et al. v. Commissioner*, TC Memo 1989-335, *Marcus Est. v. Commissioner*, TC Memo 1979-9 and TAM 9130005). Generally, corporate taxpayers will not have exempt assets, as this tax attribute is available only to individual taxpayers.

California has enacted legislation "opting out" of the federal exemptions for bankruptcy purposes (Cal. Civ. Proc. Code §703.130). Therefore debtors in California are only permitted to exempt property under state law or federal law other than 11 U.S.C. §522(d).

California law makes available two alternative sets of exemptions in bankruptcy cases. Cal. Civ. Proc. Code §703.140(a) states that if a bankruptcy petition is filed, a "debtor may utilize all the exemptions provided in chapter 1 of title 9 of the Cal. Civ. Proc. Code except for those listed in §703.140(b); alternatively, a debtor may elect to utilize Cal. Civ. Proc. Code

## CALIFORNIA FRANCHISE TAX BOARD

§ 703.140(b) exemptions in lieu of all other exemptions in the chapter, subject to the following conditions:”

- A husband and wife filing jointly must both elect the same alternative (Cal. Civ. Proc. Code §703.140(a)(1));
- A married debtor filing individually can only elect the Cal. Civ. Proc. Code §703.140(b) exemptions if both the debtor and the non-filing spouse waive in writing the right to claim the other exemption alternative during the pendency of the case in any other bankruptcy case concerning either of them (Cal. Civ. Proc. Code §703.140(a)(2));
- An unmarried debtor may elect either alternative, but not both (Cal. Civ. Proc. Code §703.140(a)(3)).

Thus, the alternatives are mutually exclusive and may not be combined on an individual petition, a joint petition, or on separate petitions filed simultaneously by married debtors. Cal. Civ. Proc. Code §703.140(b) is based upon, and is practically identical in wording to, the 11 U.S.C. §522(d) as it existed prior to being amended by the Bankruptcy Amendments and Federal Judgeship Act of 1987 (Pub. L. No. 98-353).

Not explicitly addressed by Cal. Civ. Proc. Code §703.140 is the extent of availability in bankruptcy proceedings of exceptions that are created by other chapters of California law. These exemptions (and those created for a bankruptcy proceeding) are presented in Exhibit 110000-1, but its effect in a bankruptcy context is unclear. However, this circumstance may not create a substantial audit issue, as the FTB may not have an occasion to audit a bankruptcy case.

At a minimum, assets accounted for in an insolvency determination (without regard to whether the case is under the jurisdiction of the court) include property subject to claims of the taxpayer's creditors. Such assets include personal property such as automobiles, appliances, furniture, bank accounts and so on. Property statutorily subject to creditor claims is delineated in Cal. Civ. Proc. Code §487.010.

A taxpayer whose spouse was not insolvent and held assets immediately before the debt discharge may not include his or her spouse's separate property for determining whether and to what extent he or she is insolvent because the spouse's separate property is not subject to claims of the

## CALIFORNIA FRANCHISE TAX BOARD

taxpayer's creditor claims. This is without regard to whether the taxpayer and his or her spouse filed a joint or separate income tax return. (See PLR 89-20019.)

The following is a summary list of assets:

- Interest in real property except leasehold estates with unexpired terms of less than one year.
- Accounts receivable, chattel paper, and general intangibles arising out of the conduct by the taxpayer of a trade, business, or profession, except any such individual claim with a principal balance of less than \$150.
- Equipment.
- Farm products.
- Inventory.
- Final money judgments arising out of the conduct by the taxpayer of a trade, business, or profession.
- Money on the premises where a trade, business, or profession is conducted by the taxpayer and, except for the first \$1,000.
- Negotiable documents of title.
- Instruments.
- Securities.
- Minerals or the like to be extracted (i.e., oil or gas).

Property not within the reach of creditor claims is provided in Cal. Civ. Proc. Code §487.020. Except as provided elsewhere, the following property is exempt from attachment:

- All property exempt from enforcement of a money judgment.
- Property that is necessary to earn a living.
- Compensation payable by an employer to an employee (Cal. Civ. Proc. Code §706.011(a)).
- All property not subject to attachment pursuant to Cal. Civ. Proc. Code §487.010.

Outside of a bankruptcy proceeding, California law does not provide taxpayers the protection offered to those who make such a filing because

## CALIFORNIA FRANCHISE TAX BOARD

exempt assets may not be excluded from the taxpayer's net worth. Therefore, in making an insolvency determination where the discharge occurs outside of a bankruptcy proceeding, the auditor need only obtain the FMV of all (material) assets of the taxpayer.

Under certain situations, interest that has not yet been paid is cancellation of debt income along with principal that has been canceled. These situations arise when a taxpayer is on an accrual method of accounting. Under Revenue Ruling (Rev. Rul.) 67-200 and Rev. Rul. 70-406, the amount of any interest that has been accrued and deducted (but not paid) in prior years by the taxpayer is considered cancellation of debt income under IRC §61 and R&TC §17071. However, if the taxpayer can show that the prior year deduction resulted in no tax benefit, then under IRC §111, Treasury Regulation (Treas. Reg.) §1.111-1 and R&TC §17131 (tax benefit rules) it will be excluded from gross income.

Under IRC §§108(d)(6), the §108(a), (b), (c) and (g) exclusions are applied at the partner level if the income realized was done so from debt discharge in a partnership context.

However, if an S corporation has cancellation of indebtedness income, then IRC §108(a), (b), (c), and (g) are applied at the corporate level (IRC §108(d)(7)(A)). [IRC §108(a) provides for that amount of debt discharge income that may be excluded; Subsection (b) details the rules for the reduction of tax attributes; and Subsection (g) provides for special cases in which the debt discharge originated from qualified farm indebtedness.

In addition, where a debtor has property subject to nonrecourse debt in excess of the value of the property, the excess of the amount of the nonrecourse debt over the fair market value of the property securing the debt is taken into account in determining whether, and to what extent, the debtor is insolvent only to the extent that the excess debt is discharged. The reason for this is that the excess nonrecourse debt that is not discharged does not affect the debtor's solvency. Thus, even though the cancellation of nonrecourse debt in excess of the value of the property is treated as taxable income, the excess nonrecourse debt that is not canceled is not taken into account in determining solvency (Rev. Rul. 92-53, Situation 1, 1992-2 CB 48).

## CALIFORNIA FRANCHISE TAX BOARD

Also, note that when a debtor engages in two (or more) exchanges as part of one plan for discharge of debt, for purposes of determining solvency, the debtor is treated as engaging in both exchanges simultaneously (Rev. Rul. 92-53, Situation 3, 1992-2 CB 48). In these cases, it will be necessary to compute the taxpayer's state of solvency for each debt discharge date and then give the taxpayer the outcome that offers the most tax relief.

The amount of debt discharge income eligible for deferred recognition depends on the particular taxpayer's facts and circumstances. For determining the application of IRC §108(a), the relevant taxpayer facts and circumstances include (1) at the individual level, whether the debt discharge occurred outside of a partnership or corporation, (2) the partner level, whether the debt discharge occurred under a partnership shell and, (3) at the S and C corporation level whether the debt discharge occurred under these shells. Under no circumstance does the solvency of the partnership have a direct bearing on a taxpayer's (i.e., individual, partner, S or C corporation) insolvency determination. (See Exhibit 11.2, Part 1.)

### **11.3 SPECIAL RULES FOR DISCHARGE OF QUALIFIED FARM INDEBTEDNESS**

IRC §108(a)(1)(C) provides that gross income does not include any amount which would be includible in income by reason of a discharge of indebtedness if the indebtedness discharged originated from qualified farm indebtedness. Therefore, a taxpayer must meet three requirements in order to defer the recognition of debt discharge income under this provision:

- The taxpayer must have tax attributes available in order to recognize the income at a later date,
- The debt must be incurred from a qualified person, and
- The debt must be incurred in connection with a farm trade or business—gross receipts test.

A “qualified person” and “qualified farm indebtedness” are defined in IRC §49(a)(1)(D)(iv) and IRC §108(g), respectively:

For purposes of this paragraph, the term “qualified person” means any person which is actively and regularly engaged in the business of lending currency and which is not:

- A related person with respect to the taxpayer,
- A person from which the taxpayer acquired the property (or a related person to such person), or
- A person who receives a fee with respect to the taxpayer’s investment in the property (or a related person to such person). (IRC §49(a)(1)(D)(iv))

For purposes of this section, indebtedness of a taxpayer shall be treated as qualified farm indebtedness if:

- Such indebtedness was incurred directly in connection with the operation by the taxpayer of the trade or business of farming, and
- 50 percent or more of the aggregate gross receipts of the taxpayer for the 3 taxable years preceding the taxable year in which the discharge of such indebtedness occurs is attributable to the trade or business of farming. (IRC §108(g)(2))

IRC §108(g)(3)(C) defines “qualified property” as any property used or held for use in a trade or business or for the production of income. In addition, if

**CALIFORNIA FRANCHISE TAX BOARD**

Internal Procedures Manual  
S-Corporation Manual

Rev.: December 2007  
Page 11 of 34

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a taxpayer availed him or herself of the insolvency provision, then the adjusted basis of the qualified property and the amount of the adjusted tax attributes shall be determined after any reduction by reason of amounts excluded from gross income under IRC §108(a)(1)(B).

In the absence of meeting these requirements, the taxpayer will recognize the debt discharge income in the tax year it occurred. See Exhibit 11.2, Part 2.

**11.4 DISCHARGE OF INDEBTEDNESS INCOME FROM QUALIFIED REAL PROPERTY BUSINESS INDEBTEDNESS (QRPBI) FOR TAXPAYERS OTHER THAN A C CORPORATION.**

IRC §108(a)(1)(D) and IRC §108(c) allows solvent taxpayers who would otherwise be required to recognize "qualified real property business indebtedness" discharge income under IRC §61(a)(12) (R&TC §§ 17071 and 24307) to defer that recognition to the extent a taxpayer has depreciable property basis to reduce. This subparagraph was added to the IRC on August 10, 1993, effective December 31, 1992. Recall that although the amount of indebtedness discharged is excluded from income in the year of discharge, the taxpayer may only be deferring recognition of the amount.

However, for California purposes there is a different effective date than for federal. As noted previously, in general, California incorporates IRC §108 by reference in R&TC §17024.5, R&TC §17131, and R&TC §24307. In addition, California uses the concept of a specified date to identify which version of the IRC applies to which taxable years. (R&TC §17024.5) The amendment adding IRC §108(a)(1)(D) and IRC §108(c) was not enacted until August 10, 1993. At that time, the date specified in the R&TC was January 1, 1993. (R&TC §17024.5) Therefore, IRC §108(a)(1)(D) and IRC §108(c) did not apply for California purposes.

In 1996, legislation was enacted in California, which specifically provided that IRC §108(a)(1)(D) and IRC §108(c) applies to discharges occurring on or after January 1, 1996 in taxable years beginning on or after January 1, 1996. (R&TC §§17144 and 24307.) Note that R&TC §17144 was amended in 1999 to remove the specific provision regarding the applicability of IRC §108(a)(1)(D) and IRC §108(c) to discharges and taxable years beginning after 1/1/96. However, at that time, the specified date of the IRC was 1/1/98 so those provisions applied under the general principles of conformity. In addition, it does not retroactively repeal those provisions for the earlier years.

This provision was added to the code because of the decline in real property values. (103<sup>rd</sup> Congress, House Report 103-111, Section 5.) In some cases, the declines in real property values were so severe that the property could no longer support the debt that it secured. Congress legislated that where an individual has discharge of indebtedness income resulting from a decline in

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the value of business real property securing that indebtedness, "it is appropriate to provide for deferral, rather than current inclusion, of the resulting income. Generally, that deferral should not extend beyond the period that the taxpayer owns the property."

IRC §108(a)(1)(D) is significant because prior to the Revenue Reconciliation Act of 1993 a solvent taxpayer who realized COD income from QRPBI could not defer that income; the income would be included in current year gross income. As far as GTA is concerned, a taxpayer includes individuals including partners, and S corporations. C corporations are not provided the benefit of IRC §108(a)(1)(D).

In order to effect the income deferral, the taxpayer is required to reduce depreciable basis in real property as prescribed by IRC §108(C). This section along with IRC §1017 (as amended by the RRA, §13150(C)) provides guidance on how real property basis is reduced.

In general, IRC §108 and IRC §1017 operate as illustrated in the following example:

**Example A**

A taxpayer incurs debt to purchase nonresidential real property on January 1, 2004. (Investment A). The purchase price is \$100,000,000. The entire cost is financed. Of that \$100,000,000 cost basis, \$80,000,000 is allocated to the building, which has a depreciable basis. The appropriate depreciation method is straight-line, with a recovery period of 39 years and zero salvage value. (For simplicity, assume California conformed). Accordingly, the allowable depreciation per calendar tax year is \$2,050,000 (approx.). This is without regard to the mid-month convention.

For income year ending (IYE) 12/04, the taxpayer incurred a \$5,000,000 loss on this property. However, his spouse had income from another nonresidential real property investment. (Investment B). The income for IYE 12/04 was \$7,500,000. The taxpayers' commercial property management firm along with other investment properties owned by non-related parties managed both investments. The management firm operated under a C corporation shell. The spouses were paid an executive salary of \$650,000 and \$950,000, respectively, which essentially cashed out the C corp.

## CALIFORNIA FRANCHISE TAX BOARD

Consequently, the taxpayers' AGI for IYE 12/04 was \$4,100,000.

For IYE 12/05, the taxpayers incurred the same income and loss; investment A incurred a loss of \$5,000,000; investment B had income of \$7,500,000; and executive salaries paid equaled \$650,000 and \$950,000. Therefore, the taxpayers' AGI was \$4,100,000 for year.

For IYE 12/06, the taxpayers incurred the same income and loss as IYE 12/04 and 12/05 with one exception. The loan on Investment A was renegotiated. The bank agreed to discharge \$45,000,000 of the outstanding debt. The discharge occurred on 12/31/06. At that time, the taxpayers still owed \$100,000,000. Since the taxpayers were solvent, they could not obtain COD income deferral under the insolvency provision of IRC §108. Their only available tax relief is the QRPBI provision; the discharge occurred after December 31, 02 and the IYE was also after that date (Federal requirement), and the discharge occurred after 1/1/06 for an income year beginning after 1/1/06. So the taxpayers would qualify for relief under IRC §108(a)(1)(D) and R&TC §17144. If the taxpayer elects to defer the COD income, the election is not revocable under California law.

By operation of the QRPBI provision, the taxpayers' AGI would remain the same for IYE 12/06 as for IYE 12/05 and 1/04. However, the taxpayers would have to reduce the depreciable basis in the real property that was used to secure the liability partially discharged on 12/31/06 (IRC §108(c), IRC §1017, and R&TC §17144). The adjusted basis of the building for investment A on 12/31/06 is \$73,850,000 - \$80,000,000 cost basis less three years of depreciation (\$6,150,000). Since the taxpayers elected to defer the recognition of the \$45,000,000 of COD income, the adjustment to depreciable basis is made for the income year beginning after the tax year in which the debt was discharged. Accordingly, on 1/1/07 the adjusted basis of the building is reduced by the \$45,000,000 of deferred COD income to \$28,850,000.

This \$28,850,000 depreciable basis is used as the basis amount for re-computing depreciation over the remaining 36-year recovery period. As a result, the amount of allowable depreciation for IYE 12/07 and subsequent years is \$801,300 per tax year. If we assume the taxpayers' business operating activity remained the same with the exception of this depreciation

## CALIFORNIA FRANCHISE TAX BOARD

adjustment, for IYE 12/07 and subsequent years, the taxpayers gross income increases by the difference between the depreciation allowable prior to the debt discharge of (\$2,050,000) and depreciation allowable after the debt discharge (\$801,300) for a net increase to AGI of \$1,248,700. This additional gross income multiplied by 36 years equals approximately \$45,000,000.

In effect, the taxpayers are allowed to spread the COD income over at least a 36-year period. Although the total amount of income recognized over the 36 years will be the same amount as if the income was recognized in the year of the debt discharge, because of the time value of money, the amount recognized over the 36 years is materially less than if it were all recognized in IYE 12/06. If we assume the taxpayers' cost of capital is 9%, then the present value of 36 payments of \$1,248,700 is \$13,250,000.

Please refer to the California modifications to federal law in R&TC §17144(e)(1) and (e)(2) and R&TC §24307(f)(2) and (f)(3).

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## 11.5 PURCHASE-MONEY DEBT REDUCTION FOR SOLVENT DEBTOR TREATED AS PRICE REDUCTION

IRC §108(e)(5) - This provision originated from judicial doctrine and evolved over a 50-year period. Like the 1993 amendment adding “qualified real property business indebtedness” as a category eligible for deferral under IRC §108, the reduction-of-purchase-price doctrine was also prompted by a sharp decline in real property values caused by the Great Depression.

The theory, as presented in the principle case, *Hirsch v. Commissioner*, 40-2 USTC ¶ 9791, was that the debtor “received ‘nothing of taxable exchangeable value;’ he received a credit upon the cost of a capital investment; he merely entered into a transaction whereby he procured a decrease in his capital loss...But his ultimate gain or loss cannot be determined until liquidation of his capital investment.” This rationale was affirmed in subsequent cases (*Commissioner v. Sherman*, 43-1 USTC ¶ 9367, and *Helvering v. A.L. Killian Co.*, 42-2 USTC ¶ 9487). This doctrine was developed solely in the context of recourse debt (*Hirsch v. Commissioner*, 40-2 USTC ¶ 9791).

However, applying the reduction-of-purchase-price doctrine to third party or non-recourse debt has since been discredited both by the courts (*Helvering v. American Chicle Co.*, 4 USTC ¶ 1240, *Edwards v. Commissioner*, 19 TC 275), and the Internal Revenue Service (Rev. Rul. 92-99), except in the limited case of fraud (*Commissioner v. Sherman*, 43-1 USTC ¶ 9367). In its judicial formulation, it now applies, if at all, only to reduction in purchase-money encumbrances on property retained by a solvent debtor following the discharge and negotiated directly by him or her with the seller (*Nutter v. Commissioner*, 7 TC 408). It is this application of the doctrine that was codified by the Bankruptcy Tax Act of 1980.

IRC §108(e)(5) sets forth the following three requirements:

- That the debt be purchase-money debt from the purchaser to the seller;
- That the reduction not arise while the debtor is bankrupt or insolvent; and
- That “but for” this statutory exception, the reduction would be treated as debt-discharge income.

## CALIFORNIA FRANCHISE TAX BOARD

Three additional requirements, not apparent from the face of the statute but reflective of the doctrine's judicial evolution, are set forth in the legislative history. The requirements are:

- That no transfer of the debt has been made by the seller to a third party;
- That no transfer of the debt-financed property has been made by the purchaser to a third party; and
- That the debt reduction occurs as a result of a direct agreement between the seller and the buyer, rather than because of extraneous factors such as the running of the statute of limitations on enforcement (H.R. Rep. No. 96-833, 96th Cong., 2d Sess. 13 (1980)).

Provided that these conditions are met, then, as under the common law doctrine, the debt reduction results in no debt discharge income even if the discharge is occasioned by the debtor's inability to pay rather than by a dispute over sales terms.

Although the statute does not expressly so provide, apparently a reduction in the basis of debt-financed property is required to reflect the price reduction. This follows both from legislative history, which provides that a reduction satisfying the requirements of the statute is to be treated (for both the seller and the buyer) as a purchase price adjustment on that property (H.R. Rep. No. 96-833, 96th Cong., 2nd Sess. 13 (1980)), and from case law, which regarded the debt reduction as a credit against the cost of the capital investment and imposed a corresponding basis reduction (*Hirsch v. Commissioner*, 40-2 USTC 9791, *Commissioner v. Sherman*, 43-1 USTC ¶ 9367, and *Helvering v. A.L. Killian Co.*, 42-2 USTC ¶ 9487).

The IRS has taken the position in Revenue Procedure 92-92 that they would not challenge a purchase price adjustment as long as the transaction would otherwise qualify as a purchase price reduction within the meaning of IRC §108(e)(5). Thus, if a direct debt of a bankrupt or insolvent partnership–purchaser of the property to the seller is reduced and the reduction would result in cancellation of debt income to the purchaser, but for IRC §108(e)(5), Revenue Procedure 92-92 applies. If the original purchaser transfers the property to another person or if the seller assigns the purchaser's obligation, then IRC §108(e)(5) does not apply.

## **11.6 REDUCTION OF TAX ATTRIBUTES**

IRC §108(b) - The amount excluded by reason of both the insolvency and bankruptcy exclusions must be applied to reduce tax attributes under IRC §108(b). In general, tax attributes are taxpayer specific and are not tied to a particular taxpayer activity. Therefore, tax attributes that originated from an activity that did not give rise to the debt discharge income may also be subject to the attribute reduction.

In general, the attributes are reduced, in the order given, as follows (IRC §108(b)(2)):

- NOL—any net operating loss for the taxable year of the discharge, and any net operating loss carryover to such taxable year (IRC §108(b)(2)(A)),
- General Business Credit—Any carryover to or from the taxable year of the discharge of an amount for purposes for determining the amount allowable as a credit (IRC §108(b)(2)(B), modified by R&TC §24307). In the case where more than one credit is allowable, the credit is reduced on a pro rata basis (R&TC §17144(a) and (c)),
- Minimum Tax Credit—This attribute was added to the 1993 RRA effective January 1, 1993. California income tax law incorporated IRC §108(b)(2)(C) with SB 38, effective January 1, 1996.
- Capital Loss Carryovers—Any capital loss for the taxable year of the discharge, and any capital loss carryover to such taxable year under IRC §1212 (IRC §108(b)(2)(D)),
- Basis Reduction—The basis of the property of the taxpayer (IRC §108(b)(2)(E)). Real property held as inventory may also be reduced (S. Rep. No. 96-1035, 2d. Sess.),
- Passive Activity Loss and Credit Carryover— This attribute was added to the 1993 RRA on an amendment that was enacted subsequent to January 1, 1993. California income tax law incorporates IRC §108(b)(2)(F) effective January 1, 1996.
- Foreign Tax Credit Carryover—IRC §108(b)(2)(G) is not subject to attribute reduction for California income tax purposes (R&TC §24307(c)).

Tax attributes are reduced after taxable income is determined for the year the discharge occurred without regard to the reduction of tax attributes (IRC §108(b)(4)(A)).

## CALIFORNIA FRANCHISE TAX BOARD

Non-credit tax attributes are reduced on a dollar for dollar basis (IRC §108(b)(3)(A)). Thus, one dollar of NOL is reduced for every dollar of debt discharge income deferred. However, credit tax attributes are reduced at a rate of 33.3 cents and 11.1 cents per debt discharge income dollar deferred for Federal and State income tax purposes, respectively (IRC §108(b)(3)(B), R&TC 17144(c) and R&TC §24307(d)). In addition, current year NOLs and capital losses are reduced prior to reducing carryover amounts in the order in which the carryover amounts arose (IRC §108(b)(4)(B)). Credits are reduced in the order in which they would be applied against taxable income (IRC §108(b)(4)(C)). For California income tax purposes, if more than one credit is available, all credits are reduced on a pro rata basis (R&TC §§ 17144(c) and 24307(d)).

The taxpayer may, however, elect to apply basis reductions first against depreciable property under IRC §§108(b)(5) and 1017(b)(3)(E) in order to preserve current year tax deductions or credits. This election limits the amount of depreciable basis that may be reduced in lieu of or prior to reducing other tax attributes. Depreciable property (as defined in IRC §1017(b)(3)(B)) basis reduction may not exceed the aggregate adjusted bases of the depreciable property held by the taxpayer as of the beginning of the taxable year following the taxable year in which the discharge occurs (IRC §108(b)(5)(B)). Any excess debt discharge income not applied to basis reduction is then used to reduce other tax attributes except depreciable property basis (IRC §108(b)(5)(C)).

If the taxpayer reduces tax attributes in the order specified in IRC §108(b)(2), (i.e., NOL, General Business Credit, Capital Losses, Basis reduction, etc.), and is either bankrupt or insolvent, then any basis reduction may not exceed the excess of the aggregate basis of the property held by the taxpayer immediately after the discharge, over the aggregate of the liabilities of the taxpayer immediately after the discharge (IRC §1017(b)(2)). However, this basis limitation does not apply if the taxpayer elects to apply reductions first against depreciable property under IRC §108(b)(5) (IRC §1017(b)(2)). (See IRC §1017(b)(1) and Treas. Reg. §1.1017-1 for property basis reduction ordering rules. Essentially, the regulation indicates that trade or business depreciable property basis is reduced first followed by non-depreciable basis, inventory, notes and accounts receivable, and then non-trade or non-business property basis).

**Example A**

Jon, a California resident, is in financial difficulty, but he has been able to avoid declaring bankruptcy. This year he reached an agreement with his creditors, whereby they agreed to forgive \$10,000 of debt, in return for his setting up a schedule for repayment of the rest of his debt.

Before the debt cancellation, Jon's liabilities totaled \$120,000 and the FMV of his assets was \$100,000. His total basis in all assets was \$90,000. Therefore, Jon was insolvent by \$20,000. He may exclude from income the entire \$10,000 debt cancellation since it is not more than the amount by which he was insolvent.

Jon's only depreciable asset is a rental condominium with an adjusted basis of \$50,000. Of this, \$10,000 is allocated to the land, leaving a depreciable basis of \$40,000. During the tax year of the debt discharge, Jon had a net capital loss of \$5,000 resulting from sales of stock. He also has a net operating loss carryover to this year of \$3,000 from a previous tax year.

Jon's AGI for the year, without considering the discharge of debt income, the capital loss, or the net operating loss carryover, is \$20,000. He does not itemize deductions, and he has no general business credit arising in the year of the debt discharge or carried to this year.

In applying the \$10,000 debt discharge amount to reduce tax attributes, Jon would first eliminate his \$3,000 net operating loss carryover, and then his \$5,000 capital loss. He would then have \$2,000 remaining to apply to basis reduction, but he would not have to reduce his basis because his total basis in the assets (\$90,000) was less than his total liabilities, immediately after the debt cancellation ( $\$120,000 - \$10,000 = \$110,000$ ).

However, Jon decides it is better for him to preserve his current deductions of \$3,000 for NOL carryover and \$3,000 for the net capital loss, plus the \$2,000 capital loss carryover to the following year. He may do this by choosing to reduce the basis of his depreciable property before making other attribute reductions.

Jon elects to reduce basis first. Therefore, Jon can reduce the depreciable

## CALIFORNIA FRANCHISE TAX BOARD

basis of the rental condominium (his only depreciable asset) by \$10,000. The tax effect of doing this will be to reduce Jon's depreciation deductions for years following the year of the debt cancellation. However, if Jon later sells the condominium at a gain, the part of the gain attributable to the basis reduction will be taxable as ordinary income.

The IRC does not provide guidance in either IRC §108 or §1017 on whether the taxpayer is required to re-compute the rate of depreciation over the remaining life of the asset subsequent to basis reduction. Without a specific requirement, it is reasonable to expect taxpayers to continue depreciating affected assets at the depreciation rate scheduled when the asset was originally acquired. If the depreciation rate is not adjusted, a taxpayer will completely eliminate the depreciable basis sooner than if the rate was re-computed. In either case, the gain recognized would be dependent on the adjusted basis of the property that is reduced as depreciation expense is used to offset income.

However, legislative history suggests the collection of tax on ordinary debt discharge income deferred pursuant to IRC §108 should occur within a reasonable amount of time. The FTB could argue legislative intent requires the rate of depreciation on depreciable property be re-computed to accommodate the reduction of depreciable basis.

In cases that exclude or defer debt discharge income under the insolvency and the qualified farm indebtedness provisions, the attribute reduction is first applied by reducing tax attributes by that amount excluded by reason of insolvency (IRC §108(g)(3)(D)). Any remaining debt discharge income that qualifies for qualified farm indebtedness treatment is then limited to attributes remaining after reduced by reason of insolvency. If there is debt discharge income left, then that income is recognized under IRC §61(a)(12) and R&TC §§ 17071 and 24307.

Both IRC §108(c) and IRC §1017(b)(3)(F) also provide guidance on the mechanics of reducing depreciable property basis on a dollar for dollar basis. To the extent the taxpayer has depreciable real property tax basis, he or she may elect to defer the recognition of the debt discharge income in exchange for basis reduction.

**CALIFORNIA FRANCHISE TAX BOARD**

Any IRC §1231 property subject to IRC §1245 or IRC §1250 treatment that is reduced in order to defer debt discharge income recognition is subject to recapture under IRC §1017(d). Regardless of the depreciation rate used for tax purposes, the gain recognized in a disposition as a result of basis reduction will be given ordinary income treatment. However, for purposes of IRC §1250(b), the determination of what would have been the depreciation adjustment under the straight-line method shall be made as if there had been no reduction under IRC §1017.

## **11.7 TIME AND MANNER FOR MAKING ELECTION AND FILING AND DISCLOSURE REQUIREMENTS**

IRC §108(d)(9) - As mentioned earlier, the income recognition deferral benefit contained in IRC §108(a) is mandatory with the exception of IRC §108(a)(1)(D) (Treas. Reg. §1.108-5 and H.R. Rep. No. 111, 103 Cong., 1st Sess. 623 (1993)). However, in all cases the taxpayer is required to file federal Form 982 with the original income tax return reporting (1) the amount and the relevant facts that gave rise to the debt discharge (filing and disclosure requirement) and (2) indicating what amount of debt discharge income is used to reduce tax attributes.

In order to take advantage of IRC §108 income exclusion, the taxpayer must file consent to applicable regulations relating to the adjustment of basis, in accordance with Treas. Reg. §1.108-5. California law conforms to Federal law in filing consents (R&TC §§17024.5 & 23051.5(e) and (f)).

In all cases the consent shall be made by or on behalf of the taxpayer on federal Form 982 with the original return for the taxable year in question (Treas. Reg. §1.108-5). This section applies to indebtedness incurred or assumed either (i) by a corporation, or (ii) by an individual in connection with property used in their trade or business; and it covers any such indebtedness for which the corporation or individual taxpayer is liable or subject to which the taxpayer holds property. However, in special cases where the taxpayer establishes reasonable cause for failure to file the necessary consent with their original return, they may file the consent with an amended return or claim for credit or refund; and in such cases, the consent shall be to the regulations which, at the time of filing the consent, are applicable to the taxable year for which such consent is filed (Treas. Reg. §1.108-5). In all cases, the consent shall be made by or on behalf of the taxpayer on Form 982 in accordance with regulations and instructions on the form (Treas. Reg. §1.108-5).

For purposes of IRC §108(a) and Treas. Reg. §1.108-5, the determination as to whether an indebtedness is incurred or assumed by an individual in connection with property used in a trade or business depends on the facts of each particular case. Where indebtedness (whether secured or unsecured) is incurred or assumed by an individual and where the proceeds of such indebtedness are used to purchase, improve, or repair property used in the

## CALIFORNIA FRANCHISE TAX BOARD

trade or business, IRC §108(a) shall apply to the discharge of such indebtedness (Treas. Reg. §1.108-5).

For California purposes, a taxpayer is deemed to make a proper election if the election filed with the IRS is filed in accordance with the IRC or regulations issued by "the secretary" (R&TC §17024.5(e)(1) and 23051.5(e)(1)) unless otherwise provided for in the R&TC. To obtain treatment other than that elected for federal purposes, a separate election shall be filed at the time and in the manner required by the FTB (R&TC §17024.5(e)(3) and 23051.5(e)(3)).

However, within the conformity provision in the R&TC § 17024.5, it states that whenever this part—California's personal income tax law—allows or requires a taxpayer to file an application or seek consent, the rules set forth in subdivision (e) of R&TC § 17024.5 shall be applicable with respect to any such application or consent (R&TC §17024.5(f)). Therefore, if a taxpayer desires treatment other than that elected for federal purposes, they are required to make an election for California purposes at the time and manner required under federal law. (Note: California regulations reference the code (R&TC §17024.5) on this issue).

If a taxpayer fails to file federal Form 982 with the original return, the taxpayer may not reduce tax attributes in any order other than that specified in IRC §108(b).

## **11.8 EFFECT OF EXCLUDED CODI ON SHAREHOLDER BASIS IN THE S CORPORATION**

- Discharge of Indebtedness Occurring on or before December 31, 2001

The U.S. Supreme Court, reversing the 10th Circuit court, held in *Gitlitz v. Commissioner*, 2001-1 USTC 50, 147 that the S Corporation's excluded discharge of debt is an item of income that passes through to the shareholders pursuant to IRC §1366(a)(1)(A).

The cancellation of debt (COD) income increases the shareholder's stock basis before the tax attributes reduction takes place pursuant to IRC §108(b)(4)(A).

Previously, the Franchise Tax Board (FTB) took a position consistent with the 10th Circuit Court, which states that the S Corporation's COD income does not pass through to the shareholder and does not increase the shareholders basis. FTB has revised our position to conform to the U.S. Supreme Court decision to allow the S Corporation to pass the COD income to the shareholder and increase the shareholder's basis. The basis increase takes place at the time of the discharge (the year in which the COD income is incurred), and before the tax attributes reduction (the year following the discharge).

Treas. Reg. §1.1366-1(a)(2)(viii) was amended to specifically state that the COD income is not tax-exempt income. Nevertheless, the U.S. Supreme Court decision holds that S Corporation COD income is an item of income for pass through purposes per IRC §1366. Treas. Reg. §1.1366-1(a)(2)(viii) no longer has a bearing on the COD income issue.

In summary,

- The S corporation COD income is "an item of income" for pass through purposes.
- The S corporation COD income will pass through to the shareholders.

- The S corporation COD income will pass through to the shareholders in the year of the discharge, prior to the tax attributes reduction under IRC §108.

The Supreme Court has considered that the taxpayer will receive the "double windfall" benefit. (TP incurred no payout but received basis). The Supreme Court indicated that the double benefit realized by the taxpayer was required by the plain text of the statute.

- Discharge of Indebtedness Occurring after December 31, 2001

Congress passed a provision that reversed the U.S. Supreme court's decision in *Gitlitz v. Commissioner*, 2001-1 USTC 50, 147 and revised IRC §108. Now if an S Corporation has discharge of indebtedness income that is excluded from income it is not taken into account as an item of income by the shareholder and thus does not increase the basis of the shareholders stock in the S Corporation.

CA conformed to the federal change by way of AB 1122. The effective date of the state's conformity is for discharges of indebtedness occurring after December 31, 2001, in taxable years ending after that date.

**CALIFORNIA FRANCHISE TAX BOARD**

**11.9 EXHIBITS**

- Exhibit 11.1 Checklist of California Exemptions
- Exhibit 11.2 Insolvency \ Qualified Farm Indebtedness \ Accuracy-Related Penalty Case

**Exhibit 11.1**

California Bankruptcy Exemptions as of April 2005	
California has two systems; You must select one or the other. Federal Bankruptcy Exemptions are not available for state purpose. All law references are to California Bankruptcy Code (Cal. Civ. Proc. Code)	
California Bankruptcy Exemptions System 1	
<b>Type of Property</b>	<b>Section</b>
<b>Homestead:</b>	
Real or personal property occupied at time of filing for bankruptcy, including mobile home, boat, stock cooperative, community apartment, planned development or condominium, up to the following limits: \$50,000 if single and not disabled; \$75,000 if family and no other member has homestead; \$150,000 if 65 or older or if physically or mentally disabled; \$150,000 if creditors are seeking to force sale of your home and you are either (a) 55 or older, single and earn under \$15,000 per year, or (b) 55 or older, married and earn under \$20,000 per year. Sale proceeds are exempt for up to 6 months after sale.	§704.730
<b>Personal Property:</b>	
• Motor vehicle or insurance if the vehicle is lost, destroyed or damaged up to \$2,300.	§704.010
• Food, clothing, appliances and furnishings.	§704.020
• Building materials to repair or improve home up to \$2,425.	§704.030

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**CALIFORNIA FRANCHISE TAX BOARD**

• Jewelry, heirlooms and art up to \$6,075 total.	\$704.040
• Health aids.	\$704.050
• Bank deposits from Social Security Administration up to \$2,435 for single payee (\$3,650 for husband and wife payees); proceeds from exempt property in form of cash or bank deposits.	\$704.080
• Inmates trust funds up to \$1,000.	\$704.090
• Personal injury causes of action, and recoveries needed for support.	\$704.140
• Wrongful death causes of action, and recoveries needed for support.	\$704.150
• Burial plot.	\$704.200
<b>Wages:</b>	
• 75% of wages paid within 30 days prior to filing bankruptcy.	\$704.070
• Public employee vacation credits (75% minimum if receiving installment payments).	\$704.113
<b>Pensions:</b>	
• Public retirement benefits.	\$704.110
• Private retirements benefits to extent tax-deferred, including IRA and Keogh.	\$704.115
• Public employees.	Cal. Govt. Code §21201
• County employees.	Cal. Govt. Code §31452
• County peace officers.	Cal. Govt. Code §31913
• County fire fighters.	Cal. Govt. Code §32210
<b>Public Benefits:</b>	
• Unemployment benefits and union benefits due to labor dispute.	\$704.120
• Workers' compensation.	\$704.160
• AFDC and aid to blind, aged and disabled.	\$704.170
• Relocation benefits.	\$704.180

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**CALIFORNIA FRANCHISE TAX BOARD**

<ul style="list-style-type: none"> <li>Financial aid to students.</li> </ul>	§704.190
<b>Tools of Trade:</b>	
<ul style="list-style-type: none"> <li>Tools, implements, materials, books, uniforms, instruments, equipment, furnishings, motor vehicle, and vessel up to \$6,075, or up to \$12,150 if used by both spouses in the same occupation. Can't claim motor vehicle here if already claimed under 704.010.</li> </ul>	§704.060
<b>Insurance:</b>	
<ul style="list-style-type: none"> <li>Matured life insurance benefits needed for support of unlimited value, or unmaturred life insurance policy up to \$9,700 in value. (subject to doubling)</li> </ul>	§704.100
<ul style="list-style-type: none"> <li>Fraternal unemployment benefits and union benefits in a labor dispute.</li> </ul>	§704.120
<ul style="list-style-type: none"> <li>Disability or health benefits.</li> </ul>	§704.130
<ul style="list-style-type: none"> <li>Homeowners' insurance proceeds for 6 months after received, up to amount of homestead.</li> </ul>	§704.720
<ul style="list-style-type: none"> <li>Other - Fidelity bonds. Refer to as "Labor 404."</li> </ul>	
<ul style="list-style-type: none"> <li>Other - Life insurance proceeds if policy prohibits use to pay creditors.</li> </ul>	
<b>Misc.:</b>	
<ul style="list-style-type: none"> <li>Corp. 16501 - Business partnership property</li> </ul>	

**Exhibit 11.2**

<b>Insolvency \ Qualified Farm Indebtedness \ Accuracy-Related Penalty Case</b>
Part 1
Summary of Case Facts:  The following fact pattern follows that of a case decided by the U.S. Tax Court. The facts are:

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**CALIFORNIA FRANCHISE TAX BOARD**

- Dan and Margaret owned and operated a beef farm.
- Between 1966 and 1978, Dan borrowed money under four (4) separate loans, from the Farmers Home Administration (FmHA), using his farmland as collateral. A note was executed for each loan, and Dan granted mortgages to the FmHA.
- Dan died in 1986; He and Margaret still owed on their loans.
- In 1986, Margaret sold all the livestock and farm equipment related to the beef farm but retained and continued to live on the farm. Margaret supported herself through employment as a waitress.
- Other Income—Interest on bank account. Margaret also rented the farmland for agricultural use. (The land was rented under a cash rent agreement at a fixed rate per acre without regard to farm production).
- Margaret agreed that the rental income was not attributable to farming.
- In 1989, Margaret, a cash basis taxpayer, applied for and agreed to a loan re-structuring on March 17, 1989 as follows:

Aggregate Principle (Before Discharge)	\$242,452
Aggregate Principle (After Discharge)	\$42,752
Debt Discharge Income	\$199,700

Prior to the due date of Margaret’s 1989 Return, the FmHA issued four (4) 1099-Gs showing \$199,700 of debt discharge income. Margaret neither reported the income nor did she include form 982, disclosing the debt discharge income.

	Insolvency (Live Case)	Bankruptcy (Fictitious Case)
FMV of Assets (on March 17, 1989):		
Cash	\$18,310	\$18,310
Land	89,500	89,500
Auto	2,000	2,000
Personal Property	<u>15,000</u>	<u>15,000</u>
	<u>\$124,810</u>	<u>\$124,810</u>

Exempt Assets:

**CALIFORNIA FRANCHISE TAX BOARD**

Home <sup>1</sup>		\$0
Auto <sup>2</sup>		-1,200
Personal Property (all ordinary and necessary) <sup>3</sup>	-15,000	
Net Asset Value:	\$124,810	\$108,610
Liabilities (book values on March 17, 1989):		
Aggregate Mortgages	\$242,453	\$242,453
Property Taxes	11,746	11,746
Total	\$254,199	\$254,199
Net Worth	-\$129,389	-\$145,589
Debt Discharge Income	199,700	199,700
Adjustment to Income	\$70,311	\$54,111
Note(s):		
<p>The residence used by Margaret is worth less than the amount owed. Consequently, she is not able to exempt any equity in her insolvency computation.</p> <p>Margaret is limited to a total of \$1,200 exemption in any combination of the aggregate equity in automobiles.</p> <p>Personal Property-Ordinary and necessary household furnishings, appliances, wearing apparel, and other personal effects are exempt (including a wedding ring set, without regard to value). Other Jewelry, heirlooms and art works are exempt up to \$1,200 of equity.</p>		
Part 2		
Debt Discharge (w/Accrued Interest) Computation		
	Cash Basis	Accrual Basis

**CALIFORNIA FRANCHISE TAX BOARD**

Aggregate Principle (Before Discharge)	\$242,452	\$242,452
Aggregate Principle (After Discharge)	42,752	42,752
Debt Discharge Income	\$199,700	\$199,700
Accrued Interest	\$160,916	\$160,916
Interest Expensed	\$0	160,916
Debt Discharge Income	\$0	\$160,916
 Total Debt Discharge Income	 \$199,700	 \$360,616
 FMV of Assets	 \$124,810	 \$124,810
Liabilities	-254,199	-415,115
Net Worth	-\$129,389	-\$290,305
Total Debt Discharge Income	199,700	360,616

Part 3

Test 1-Is the lender a Qualified Lender?

Is the lender actively and regularly engaged in the business of lending? Yes. Lender was Farmers Home Administration.

Is lender a related party? No.

Is the lender the party from whom Margaret acquired the property? No.

And,

Is the lender a person who received a fee with respect to Margaret's investment in the property? No. If a related party to the lender received a fee, then this event would also be disqualifying.

Test 2-Qualified Farm Indebtedness

Is the debt incurred directly in connection with the operation of the farm, by Dan and Margaret? Yes. These are the only types of loans FmHA provides.

Test 3-Gross receipts test.

Is 50% or more of the aggregate gross receipts of Margaret for the three (3)

**CALIFORNIA FRANCHISE TAX BOARD**

taxable years preceding the taxable year in which the discharge occurred attributable to farming income?

	1986	1987	1988
Wages	\$18,136	\$19,280	\$18,705
Interest Income	0	1,800	1,831
Live-stock (gross)	12,868*	0	0
Farm Equip. (gross)	37,566*	0	0
Land Rental Income (gross)	6,810	8,000	6,600
Farm Inc. (gross)	29,319*	0	0
Totals	\$104,699	\$29,080	\$27,136
Total Receipts			\$160,915
Total Farming Income			\$79,753
Percent attributable to Farming Income		49.6%	

Therefore, Margaret may not exclude the remaining \$70,311 of debt discharge income under IRC §108(a)(1)(C). This income must be recognized in her 1989 taxable income (IRC §61(a)(12) and RTC §17071).

Part 4

Reduction of Tax Attributes-\$129,389 (amount excluded from insolvency).

Note: Reduction of basis will be limited to the amount of basis over liabilities.

Amount that can be excluded under IRC §108(a)(1)(C) is limited to the sum of the tax attributes and business and investment assets. Margaret does not have qualifying assets available to exclude remaining \$70,311.

Part 5

## CALIFORNIA FRANCHISE TAX BOARD

Margaret failed to include or disclose debt discharge income on Form 982. She received 1099-Gs indicating disclosure of indebtedness income of \$199,701.

FmHA warned Margaret that the income may have tax ramifications on the 1099-G.

Margaret could not provide substantial authority for excluding the remaining \$70,311 of debt discharge income from her gross income.

The IRS adjusted Margaret's taxable income upward by the remaining \$70,311 and imposed an accuracy-related penalty on the deficiency assessment.

6. The Tax Court upheld the imposition of an accuracy related penalty for substantial under statement of income tax (*Lawinger v. Comm.*, 103 USTC 428 (1994)).