

Section 108. – Income from Discharge of Indebtedness

26 CFR 108(a)-1: Income from Discharge of Indebtedness
(Also: Sections 61(a)(12); 704; 752; 1.752-3).

Rev. Rul. 2012-14

ISSUE

How do partners treat the partnership's discharged excess nonrecourse debt in measuring insolvency under § 108(d)(3) of the Internal Revenue Code?

FACTS

X, an investor other than a partnership, and Holdco, a corporation, are equal partners in PRS, a partnership for federal tax purposes. In Year 1, PRS borrows \$1,000,000 from Bank and signs a note payable to Bank for \$1,000,000 that bears interest at a fixed market rate payable annually. The note is secured by real estate valued in excess of \$1,000,000 that PRS acquires from Seller, in part with the proceeds of the note. The note is a nonrecourse liability within the meaning of § 1.752-1(a)(2) of the Income Tax Regulations. Neither PRS nor its partners (X and Holdco) are personally liable on the note.

In Year 2, when the value of the real estate is \$800,000 and the outstanding principal on the note is \$1,000,000, Bank agrees to modify the terms of the note by reducing the note's principal amount to \$825,000. At the time that the Bank reduces the note's principal amount, PRS has no partnership minimum gain with respect to the note under § 1.704-2(d)(1). The modified note bears adequate stated interest within the meaning of § 1274(c)(2). The PRS partnership agreement provides for income to be allocated equally to X and Holdco under § 704(b) and the regulations thereunder. X and Holdco share PRS nonrecourse liabilities equally under § 1.752-3. At the time of the modification of the note, X and Holdco have no assets or liabilities other than their partnership interests in PRS. PRS's sole asset is the real estate subject to the note, and PRS's sole liability is the note. The specific exclusion provided by § 108(a)(1)(A) (bankruptcy exception) does not apply in this case.

LAW

Section 61(a)(12) provides that gross income includes income from the discharge of indebtedness (COD). Section 1.61-12(a) provides that the discharge of indebtedness, in whole or in part, may result in the realization of income.

Section 108(a)(1)(B) generally excludes discharged indebtedness from a taxpayer's gross income if the discharge occurs when the taxpayer is insolvent. Section 108(a)(3) limits the amount of income excluded by reason of § 108(a)(1)(B) to the amount by which the taxpayer is insolvent.

Section 108(d)(3) defines "insolvent" as the excess of liabilities over the fair market value of assets. That section further provides that whether a taxpayer is insolvent, and the amount by which the taxpayer is insolvent, is determined on the basis

of the taxpayer's assets and liabilities immediately before the discharge.

Section 108(d)(1) provides that indebtedness of the taxpayer means any indebtedness for which the taxpayer is liable, or subject to which the taxpayer holds property. Section 108(d)(6) provides that in the case of cancelled partnership debt, the insolvency exception of § 108(a)(1)(B) applies at the partner level.

Rev. Rul. 92-53, 1992-2 C.B. 48, provides that the amount by which a nonrecourse debt exceeds the fair market value of the property securing the debt (excess nonrecourse debt) is treated as a liability in determining insolvency for purposes of § 108 to the extent that the excess nonrecourse debt is discharged.

ANALYSIS

In order to properly apply Rev. Rul. 92-53 in a partnership context, the partnership's discharged excess nonrecourse debt should be associated with the partner who in the absence of the insolvency or other § 108 exclusion would be required to pay the tax liability arising from the discharge of that debt. Therefore, a partnership's discharged excess nonrecourse debt is treated as a liability of the partners for purposes of measuring the partners' insolvency under § 108(d)(3) based upon how the COD income with respect to that portion of the debt is allocated among the partners under § 704(b) and the regulations thereunder. See Rev. Rul. 99-43, 1999-2 C.B. 506, and Rev. Rul. 92-97, 1992-2 C.B. 124, regarding the application of § 704(b) to allocations of COD income.

In this case, Bank cancels \$175,000 of PRS's \$200,000 excess nonrecourse debt, generating \$175,000 of COD income. PRS's \$175,000 COD income is allocated equally between X and Holdco under § 704(b) and the regulations thereunder. For

purposes of measuring the insolvency of the partners, PRS's discharged excess nonrecourse debt is treated as a liability of its partners based upon the COD income allocation. Thus, X treats \$87,500 of PRS's debt as a liability of X, and Holdco treats \$87,500 of PRS's debt as a liability of Holdco. X and Holdco treat their shares of the cancelled PRS excess nonrecourse debt as their own liabilities in determining whether, and to what extent, each is insolvent within the meaning of § 108(d)(3).

X and Holdco have no assets or liabilities other than their partnership interests in PRS. In this case, the value of X's and Holdco's partnership interests in PRS is zero.

Immediately before Bank discharges the indebtedness, X's liability exceeds the value of X's partnership interest by \$87,500, and similarly Holdco's liability exceeds the value of Holdco's partnership interest by \$87,500. Therefore, X and Holdco are each insolvent to the extent of \$87,500 under § 108(d)(3). Accordingly, X and Holdco each exclude their \$87,500 amount of COD income under § 108(a)(1)(B).

HOLDING

For purposes of measuring a partner's insolvency under § 108(d)(3), each partner treats as a liability an amount of the partnership's discharged excess nonrecourse debt that is based upon the allocation of COD income to such partner under § 704(b) and the regulations thereunder.

EFFECT ON OTHER REVENUE RULINGS

Rev. Rul. 92-53 is amplified.

DRAFTING INFORMATION

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