

INTERNAL REVENUE SERVICE
NATIONAL OFFICE TECHNICAL ADVICE MEMORANDUM

Third Party Communication: None
Date of Communication: Not Applicable

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Date: February 12, 2013
Chief, Appeals Office
Dallas, TX

Taxpayer's Name:
Taxpayer's Address:

Taxpayer's Identification No:
Year(s) Involved:
Date of Conference:

LEGEND:

Taxpayer =
Creditor =
Individual A =

Date 1 =
Date 2 =
Date 3 =
Date 4 =
Date 5 =
Date 6 =
Date 7 =
Date 8 =
Date 9 =
Date 10 =
\$_a =
b% =
c% =
\$_d =

\$e =
\$f =
\$g =
\$h =
\$k =
 Year 1 =
 Year 2 =

ISSUE:

Whether Creditor discharged Taxpayer's indebtedness on or before October 11, 2001, resulting in discharge of indebtedness income to Taxpayer at that time.

CONCLUSION:

Creditor discharged Taxpayer's indebtedness on or before October 11, 2001, resulting in discharge of indebtedness income to Taxpayer at that time.

FACTS:

Taxpayer's shareholder relies on *Gitlitz v. Commissioner*, 531 U.S. 206 (2001), to claim additional basis in shares of S corporation stock from excluded discharge of indebtedness income under § 108 of the Internal Revenue Code (Code). The Supreme Court held in *Gitlitz* that excluded discharge of indebtedness income may be added to a shareholder's stock basis. *Gitlitz* was subsequently overturned prospectively when Congress amended § 108(d)(7)(A), effective after October 11, 2001.¹ Because the holding in *Gitlitz* applies to excluded discharge of indebtedness income arising on or before October 11, 2001, the date when Creditor discharged Taxpayer's indebtedness is crucial to the instant case.

On Date 1,² Taxpayer, an S corporation wholly owned by Individual A, entered into a Term Loan Agreement with an unrelated third-party lender (Creditor) and executed several Secured Promissory Notes (Notes) in favor of various Creditor entities, from which Taxpayer borrowed \$a at a stated interest rate of b% per year. The Notes further provided that, in addition to the b% rate of interest, the loan to Taxpayer would consist of the conveyance of a "royalty adjustment" sufficient to yield a c% internal rate of return to Creditor. Additionally, any overdue interest or principal amounts bore interest at c%.

¹ Section 108(d)(7) provides, in part:

(A) Certain provisions applied at corporate level. In the case of an S corporation, subsection (a), (b), (c), and (g) shall be applied at the corporate level, including by not taking into account under section 1366(a) any amount excluded under subsection (a) of this section.

² All "Dates" are in chronological order, *i.e.*, Date 1 is before Date 2, Date 2 is before Date 3 ...

During Year 1, Taxpayer's partners experienced financial difficulties that resulted in Taxpayer defaulting on the required payments to Creditor. Taxpayer then sued the partners who failed to make payments on their obligations, and Taxpayer received a \$d jury verdict and judgment on Date 2. Because the judgment was a substantial asset of Taxpayer, Creditor decided to await the outcome of the defendants' appeal before pursuing Taxpayer's collateral securing the Notes. On Date 3, Taxpayer executed additional security agreements under the Notes in favor of Creditor.

In Year 2, the appellate court reduced the \$d judgment to \$e. Of that amount, Creditor ultimately received \$f because the judgment was divided among several parties. The appellate court suggested that the reduction in the judgment was due in part to malpractice of Taxpayer's attorneys. Thereafter, Taxpayer brought suit against its former attorneys. Creditor filed a Plea in Intervention in that litigation and claimed that Taxpayer owed Creditor principal of \$g under the Notes, plus interest, royalties and other amounts, and asserted a right to recover those amounts from any liability adjudged to be owed to Taxpayer from its former attorneys.

On Date 4, the court entered an Order dividing the litigation into two phases, the "Main Phase" and the "Intervention Phase." The Main Phase referred to the claim asserted by Taxpayer against its former attorneys. The Intervention Phase referred to the claim asserted by Creditor against Taxpayer.

During Date 5, Taxpayer, Creditor, and Taxpayer's former attorneys reached a basis for settlement of the litigation during mediation. The parties memorialized the basis for settlement in a Mediation Settlement Agreement, in which the parties agreed to draw up and execute a formal settlement document. That document, the Confidential Settlement and Release Agreement (Settlement Agreement), generally became effective on Date 6 (a date on or before October 11, 2001), when the last party executed the Settlement Agreement.

The Settlement Agreement provided that Creditor would receive a \$h payment from Taxpayer's former attorneys' insurers, and approximately \$ k then held in a custodial account, in exchange for Creditor cancelling the indebtedness as of the "Creditor Payment Date." On Date 7 (a date on or before October 11, 2001), Creditor received the final settlement payment pursuant to the terms of the Settlement Agreement. On Date 8, within seven days after payment as required under the Settlement Agreement, the parties: (1) filed an Agreed Motion to Dismiss with Prejudice (Motion) and (2) requested entry of an Order Granting Agreed Motion to Dismiss with Prejudice. The Motion provided that the litigation would be "dismissed with prejudice as to all claims, cross-claims or counterclaims brought or that could have been brought" in the litigation. On Date 9 (a date on or before October 11, 2001), the court entered the Order Granting Agreed Motion to Dismiss with Prejudice (Court's Agreed Order). The Court's Agree Order provided as follows:

IT IS, THEREFORE, ORDERED that the above numbered and styled cause of action is hereby DISMISSED WITH PREJUDICE towards refiling the same as to all claims, cross-claims or counterclaims brought or that could have been brought herein, including the claims in the intervention phase, with each party bearing its own attorney's fees, costs and expenses.

Creditor included language in the Settlement Agreement that it thought would improve its position in the event that Taxpayer subsequently filed for bankruptcy protection. Creditor was concerned that the settlement payments made on behalf of Taxpayer might be viewed as preferential payments and potentially recoverable by Taxpayer's bankruptcy estate. Creditor thought that the "Creditor Effective Date" language in the Settlement Agreement would alleviate that concern. The Creditor Effective Date, Date 10 (a date after October 11, 2001), was defined as the date five months after Creditor received payment of all amounts due under the Settlement Agreement if certain events did not occur within 91 days after payment, in which case the Creditor Effective Date would be deferred until those events were cured and no claim existed that any payments to Creditor constituted a preference, fraudulent transfer, or similar conveyance that could be avoided or otherwise restored or repaid by Creditor under any bankruptcy, insolvency, or similar law. The events that would have delayed the Creditor Effective date, if they occurred within that 91 day period, were as follows:

- 1) A filing by Taxpayer for protection under bankruptcy or similar laws, an admission by Taxpayer in writing of its inability to pay its debts, an assignment by Taxpayer for the benefit of creditors, or a consent by Taxpayer to the appointment of a receiver of itself or its property,
- 2) A filing with respect to Taxpayer of an involuntary petition under bankruptcy or similar laws or an order appointing a receiver of its property, or
- 3) An assignment by Taxpayer of its claims against Creditor, which likewise were to be released under the Settlement Agreement on the Creditor Effective Date.

The Settlement Agreement further stated:

[A]ny release ... which is effective as of the [Creditor] Payment Date shall be "null, void and of no force or effect ab initio as of the [Creditor] Payment Date if prior to the [Creditor] Effective Date any of the payments to the [Creditor] ... shall have been ordered by a court of competent jurisdiction in connection with a bankruptcy or insolvency proceeding of [Taxpayer] to be avoided, rescinded, set aside or otherwise recovered, restored or repaid by recipient to [Taxpayer] or their respective bankruptcy estate(s) under any bankruptcy, insolvency or similar law.

In the instant case, none of these events occurred.

In short, the facts of the instant case reveal several possible dates when Creditor might be viewed as having discharged Taxpayer's indebtedness. These possible dates include the following:

- 1) On Date 6 (a date on or before October 11, 2001), when Taxpayer, Creditor and other parties executed the Settlement Agreement,
- 2) On Date 7 (a date on or before October 11, 2001), when Creditor received a payment of \$h from the custodial account and a payment of \$k from Taxpayer's former attorneys' insurer,
- 3) On Date 9 (a date on or before October 11, 2001), when Court's Agreed Order was entered, or
- 4) On Date 10 (a date after October 11, 2001), when the Creditor Effective Date was met because certain events did not occur.

Taxpayer argues in the alternative. First, the execution of the Settlement Agreement on Date 6 created a binding obligation on Taxpayer to compromise and settle the debt, and the execution constituted an "identifiable event" for purposes of determining when a discharge of indebtedness occurred. Second, the discharge occurred on Date 7, when all obligations under the Settlement Agreement were fully performed, including Creditor's receipt of the settlement payment. Third, the discharge occurred on Date 9, when the Court's Agreed Order was entered.

The Service argues that Taxpayer must first meet the Creditor Effective Date provision and that as a result of Taxpayer meeting that provision on Date 10 (a date after October 11, 2001), discharge of indebtedness occurred at that time.

Although Taxpayer and Appeals do not agree on the exact amount of discharge of indebtedness income, the parties agree that Taxpayer's indebtedness owed to Creditor exceeded the payments that Creditor received under the Settlement Agreement.

LAW AND ANALYSIS:

Section 61(a)(12) of the Code provides that gross income includes income from the discharge of indebtedness.

In *United States v. Kirby Lumber Co.*, 284 U.S. 1 (1931), a corporation repurchased its bonds for an amount less than their par value. The Court held that this resulted in an accession to wealth because, to the extent of the difference, the corporation's assets had been released from a liability.

In general, if a taxpayer repays its debt for less than the amount due, income from the discharge of indebtedness arises. If actual repayment on a debt is not made, income from discharge of indebtedness arises when it becomes clear that the debt will not be paid. Addressing when a discharge occurs that results in discharge of indebtedness income, the Tax Court stated in *Cozzi v. Commissioner*, 88 T.C. 435, 445 (1987):

The moment it becomes clear that a debt will never have to be paid, such debt must be viewed as having been discharged. The test for determining such moment requires a practical assessment of the facts and circumstances relating to the likelihood of payment. *Brountas v. Commissioner*, 74 T.C. 1062, 1074 (1980), *supplemental opinion to* 73 T.C. 491 (1979), *vacated and remanded on other grounds* 692 F.2d 152 (1st Cir. 1982), *affd. in part and revd. in part on other grounds sub nom. CRC Corp. v. Commissioner*, 693 F.2d 281 (3d Cir. 1982); *see Bickerstaff v. Commissioner*, 128 F.2d 366, 367 (5th Cir. 1942); *Kent Homes Inc. v. Commissioner*, 55 T.C. 820, 828-831 (1971), *revd. on other grounds* 455 F.2d 316 (10th Cir. 1972); *Cotton v. Commissioner*, 25 B.T.A. 1158 (1932). Any "identifiable event" which fixes the loss with certainty may be taken into consideration. *United States v. S.S. White Dental Mfg. Co.*, 274 U.S. 398 (1927).

Thus, the inquiry in the instant case is when did it become clear that Taxpayer would never have to pay the indebtedness. For the reasons explained below, Date 9 is when the discharge of indebtedness occurred, and the entry of the Court's Agreed Order is the "identifiable event" that fixes Creditor's loss with certainty.

It is clear that the Settlement Agreement provides for Creditor to receive a payment from Taxpayer's former attorneys' insurers in exchange for Creditor's cancellation of Taxpayer's indebtedness. Taxpayer first argues that the execution of the Settlement Agreement on Date 6 created a binding obligation to compromise and settle the debt. Thus, the execution constituted an "identifiable event" for purposes of determining when a discharge of indebtedness occurred. *See Cozzi v. Commissioner, supra*. However, the courts are in agreement that if the settlement agreement is contingent upon future events, those events or conditions must first be met. In the present situation, the mere execution of the Settlement Agreement does not fulfill all of Taxpayer's obligations, including payment, under the Settlement Agreement. *See, Walker v. Commissioner*, 88 F.2d 170 (5th Cir. 1937), *affg. White v. Commissioner*, 34 B.T.A. 424 (1936), (an agreement to cancel a debt in the future is not sufficient to discharge the indebtedness immediately if the cancellation is contingent upon future events).

Taxpayer's next argument provides that, in general, if a taxpayer repays its debt for less than the amount due, income from the discharge of indebtedness arises at the time the debt is satisfied. Thus, Taxpayer argues that on Date 7, when the final payment is received, it becomes clear that a debt will never have to be paid and that payment is the

“identifiable event” that results in discharge of indebtedness income. See *Cozzi v. Commissioner, supra*. In the present situation, the Settlement Agreement requires that the parties file the Motion and request entry of the Court’s Agreed Order after payment is received. Thus, all conditions in the Settlement Agreement were not met when payment was received. See, *Walker v. Commissioner, supra*.

The Service presents a reasonable argument that the Creditor Effective Date provision created a condition that must have been met before a discharge of indebtedness could have occurred. Under this approach, the discharge of indebtedness would have occurred on Date 10 (a date after October 11, 2001). As explained above, if Taxpayer filed for bankruptcy protection and the settlement payment was viewed as a preferential payment and recovered by Taxpayer’s bankruptcy estate, the Settlement Agreement would be rendered “null, void and of no force or effect.” If this occurred, Creditor could have continued with the litigation to pursue collection of the entire indebtedness owed, including amounts in excess of the compromised amount negotiated under the Settlement Agreement. If the litigation had continued, it would not be clear that the debt would never have to be paid. See *Cozzi v. Commissioner, supra*. Also see, *Walker v. Commissioner, supra*.

However, we conclude that Taxpayer has the better argument that the discharge of indebtedness occurred on Date 9, when the Court’s Agreed Order was entered. On Date 9, the Court’s Agreed Order dismissed with prejudice all “claims cross-claims or counterclaims brought or that could have been brought herein, including the claims in the intervention phase ...” At this point in time, neither Taxpayer nor Creditor could ever again sue for claims arising out of the same cause of action. If Taxpayer had violated the terms of the Settlement Agreement, which it did not, Creditor’s only recourse would have been to sue to enforce the terms of the Settlement Agreement. Creditor could not have sued to recover any amount in excess of the compromised amount negotiated under the Settlement Agreement. Thus, the entry of the Court’s Agreed Order locked the parties into the compromised amount negotiated, and received, under the terms of the Settlement Agreement.

The Creditor Effective Date provision simply had no effect on the finality of the Court’s Agreed Order terminating all of Creditor’s rights to seek additional amounts owed on the indebtedness. In addition, if Taxpayer’s bankruptcy estate had recovered Taxpayer’s payment to Creditor, the Creditor Effective Date would have given Creditor no rights greater than the rights available to any creditor under general bankruptcy law. Further, the faint possibility of such an event occurring would be highly remote and would not affect when a discharge occurs for federal tax purposes. See *Milenbach v. Commissioner*, 318 F.3d 924, 936 (9th Cir. 2003), (repayment of indebtedness need not have become absolutely impossible before it is considered discharged for federal income tax purposes, ... and slim possibility that debt may still be enforced does not prevent it from being treated as discharged).

Accordingly, based on the facts and circumstances presented, the discharge of indebtedness occurred on Date 9. The entry of the Court's Agreed Order is the identifiable event that makes it clear that Taxpayer's indebtedness would never have to be paid.