

**Office of Chief Counsel
Internal Revenue Service
Memorandum**

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subject: Gain Recognition

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ISSUES

- I. Whether _____ (“Taxpayer”) must recognize income in _____ or _____ from the discharge of \$ _____ in nonrecourse debt pursuant to Internal Revenue Code section 61(a)(12)¹ as a result of the bankruptcy filing of _____, the guarantor of the collateral securing the \$ _____ debt.
- II. Whether Taxpayer must recognize in _____ or _____ the gain deferred under the installment sale rules pursuant to sections 453 and 453B as a result of the bankruptcy filing by _____.

¹ Unless otherwise indicated, section references are to sections of the Internal Revenue Code effective for the taxable years at issue.

- III. Whether Taxpayer must recognize gain in _____ or _____ from a disposition of an installment obligation under section 1001 as a result of the bankruptcy filing by _____.

CONCLUSIONS

- I. Taxpayer is not required to recognize income in _____ or _____ from the discharge of indebtedness because the debt has not been discharged and no identifiable event occurred to indicate that the collateral underlying the debt has become worthless or was abandoned.
- II. Taxpayer is not required to recognize in _____ or _____ the gain deferred pursuant to its installment sale because the _____ bankruptcy filing did not trigger any payments on the installment sale notes and the notes were not disposed of and did not become unenforceable as a result of the bankruptcy filing.
- III. Taxpayer is not required to recognize gain in _____ or _____ on a disposition of the installment obligation because Taxpayer did not effectively or actually disposed of the installment obligation.

FACTS

In _____, _____ (Taxpayer), sold _____ to _____, a newly created corporation controlled by _____, a private equity investment firm. Taxpayer received \$ _____ on the sale: _____ in cash and _____ in the form of installment notes. _____ formed two limited liability companies to issue the installment notes: _____ and _____.²

_____ issued Taxpayer a _____ Installment Note in the amount of \$ _____ ("Installment Note"). Under the Installment Note, Taxpayer was to receive semi-annual interest payments beginning in _____; the principal of \$ _____ would not be paid until the Installment Note's maturity date, _____. The Installment Note bears an interest rate of _____ % per year.

In order to finance the payment of interest and principal required under the Installment Note, _____ sold the _____ to a third party and purchased a Collateral Note from _____ for \$ _____ cash. Interest on the Collateral Note was due quarterly beginning _____; the principal would not be due until the Collateral Note matured on _____. The Collateral Note had an interest rate of _____ % per annum. Thus, the Collateral Note provided _____ with the funds to make payments of interest and principal due to Taxpayer under the terms of the

² Only the Installment Note issued by _____ is relevant.

Installment Note. The Installment Note holder does not have recourse against the or the affiliates of . The only asset of is the Collateral Note.

pledged the Collateral Note to in exchange for a guaranty issued by (“Guaranty”). Through the Guaranty, guaranteed payment of principal and interest due to the holder of the Installment Note from .

In , Taxpayer formed a wholly owned subsidiary, , which in turn formed a wholly owned subsidiary, . Taxpayer contributed both the Installment Note and the Guaranty to , which in turn contributed both the Installment Note and the Guaranty to . Both and are disregarded entities.

issued notes collateralized by the Installment Note and the Guaranty in exchange for \$ cash (“ Notes”). The

Notes required to make semi-annual, interest-only payments to the Note holders beginning in . The principal of \$ would not be due until the Notes matured on . The terms of the Notes allowed to extend the maturity date to subject to an increased interest rate during the extension period.

Recourse on the Notes is limited to the proceeds of the Installments Notes and the Guaranty. There is no recourse against Taxpayer or the Collateral Note. . agreed to purchase the entire initial principal amount of the Notes. As the initial purchaser, had the right to resell the Notes. The Notes are currently registered to , a company that acts as a clearing house for stock and bond transactions. As of the time of default, held the Notes for the benefit of .

acted as the Indenture Trustee for the issuance of the Notes, with the right to collect payments under the Installment Note directly from and to use the proceeds to make the payments required under the Notes. also had the right to make a demand for payment under the Guaranty if an event of default occurred related to the Installment Note. As part of the transaction, we understand obtained possession of the Installment Note on behalf of the Notes holders and still holds that note as of the current time in its capacity as Indenture Trustee.

The following chart summarizes the above described obligations.

	<u>Installment Note</u>	<u>Collateral Note</u>	<u>Guaranty</u>	<u>Notes</u>
Issuer				(Taxpayer)
Holder	as Indenture Trustee for (Taxpayer)		as Indenture Trustee for holders of Notes	
Principal Amount	\$	\$	Up to amount of Installment Note, \$	\$
Interest payments due	% per year payable semi- annually, beginning	% per year payable quarterly, beginning	Upon written demand when principal or interest due under Installment Note is not timely paid by	% per year payable semi- annually, last day of beginning
Principal due (Maturity)				(option to extend to)

This series of transactions, through which Taxpayer essentially received cash for , allowed Taxpayer to defer reporting the gain on the sale of the until the Installment Note’s maturity in pursuant to the installment method of section 453, or another event triggered section 453 gain recognition. Taxpayer’s taxable year was audited by the IRS. Taxpayer’s treatment of the was not adjusted; the pledge of the Installment Notes to was not treated as a constructive sale in part because the Notes

Installment Note’s value.³

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On _____, _____ filed a petition for _____ bankruptcy in the United States Bankruptcy Court _____ . As a result of the _____ bankruptcy filing, an event of default occurred under the Installment Note. An event of default also occurred under the Installment Note on _____ when _____ failed to make the scheduled interest payments under the Installment Note. _____ formally notified _____ of the event of default on _____. Due to the event of default under the Installment Note, an event of default occurred under the _____ Notes. The interest due on _____ was not paid to the _____ Note holders. _____, as Indenture Trustee, made a demand for accelerated payment on _____.

Since this time, there have been no payments on the Installment Note and _____ continues to hold the Installment Note as collateral for the _____ Notes.

At the time of the _____ bankruptcy filing reasonable estimates projected that claims filed with respect the Guaranty or the Collateral Note had more than a nominal value. Reasonable estimates since that time have continued to reflect more than a nominal value for the claims, with recovery estimates being between _____ % of the claim face values. In fact, while the _____ bankruptcy was pending, the estimated value of the claims increased over time.

_____ filed a claim in the _____ bankruptcy based on the Collateral Note. _____ and _____ have each filed a claim based on the Guaranty. The claims of _____ and _____ have since been consolidated; _____, _____, and _____ have agreed that _____ will pursue the claim filed by _____ in the bankruptcy proceedings.⁴ The Guaranty and the Collateral Note are classified as _____ .⁵ On _____ the bankruptcy court entered an

_____ (“Bankruptcy Plan”). Pursuant to the _____, _____ will make a distribution of available cash to claim holders on the effective date of the plan and semi-annually thereafter. Bankruptcy Plan _____. The effective date of the Bankruptcy Plan was _____. The process of _____ selling its assets and distributing the

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⁵ Id.

proceeds to claim holders is expected to take .

Taxpayer originally believed it had to recognize gain on the Installment Note in based on the bankruptcy filing. Accordingly, Taxpayer paid an estimated tax bill which included a potential gain from the Installment Note. However, on its finalized tax return, Taxpayer changed its position based on its current belief that it does not have to recognize the income until the bankruptcy becomes final and any payout to Taxpayer is transferred to the holders of the Notes or until the Installment Note and the Guaranty are transferred to the holders of the Notes as payment in full of Taxpayer's obligation to them.⁶ Taxpayer obtained an opinion from in support of its position. Taxpayer requested and received a refund of the taxes paid. Taxpayer never took the position that it recognized discharge of indebtedness income in on the Notes as result of the bankruptcy filing. Taxpayer also believes that any such discharge of indebtedness income will be deferred until the bankruptcy is completed and distributions are made under the confirmed bankruptcy plan. The opinion did not deal with this latter issue.

LAW AND ANALYSIS

The below discussion presents alternative theories under which Taxpayer could be required to recognize gain in or on the \$ Installment Note and or with respect to the \$ in Notes, which were secured by the Installment Note and Guaranty. Events of default occurred under the Installment Note and consequently under the Notes when filed for bankruptcy in because the flow of money depended on payments under the Collateral Note. Exam has questioned whether Taxpayer was essentially forgiven of the debt it owed to the holders of the Notes, which could result in income recognition from a discharge of indebtedness under section 61(a)(12) as a result of the bankruptcy filing (Issue 1 below). Alternatively, Exam has questioned whether Taxpayer may have effectively disposed of the Installment Note, which could result in income recognition under the installment method rules in sections 453 and 453B (Issue 2 below) or result in income recognition on the disposition of property pursuant to section 1001 (Issue 3 below).

I. Cancellation of Indebtedness on Notes

Gross income means all income from whatever source derived, including income from discharge of indebtedness. I.R.C. § 61(a)(12). "Whether a debt has been

⁶ The case may be subject to review by the Joint Committee due to the amount of losses claimed by Taxpayer; Joint Committee review is likely dependant on whether Taxpayer should recognize income in or as a result of the bankruptcy as additional income recognition would reduce losses and eliminate the need for Joint Committee review.

discharged is dependent on the substance of the transactions.” Cozzi v. Comm’r, 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.” Id. “Any ‘identifiable event’ which fixes the loss with certainty may be taken into consideration.” Id. There may be more than one identifiable event sufficient to trigger recognition of income. Id. at 447. The abandonment of worthless collateral that represents the sole payment source of a nonrecourse debt “is an ‘identifiable event’ which establishes the moment when the underlying debt is discharged.” Carlins v. Comm’r, T.C. Memo 1988-79. Worthlessness is established when there is no reasonable possibility that the underlying collateral will have value in the future. Cozzi, 88 T.C. at 446.

Taxpayer has an outstanding debt of \$ _____ to the holders of the _____ Notes with interest due semi-annually and the principal due in _____. Payment under the _____ Notes is secured by and limited to Taxpayer’s proceeds from the Installment Note and the Guaranty. If that collateral becomes worthless so that Taxpayer will never receive payments under either the Installment Note or the Guaranty to finance the debt it owes to the holders of the _____ Notes, then Taxpayer will not have to repay the debt it owes to the holders of the _____ Notes. In that case, Taxpayer should recognize discharge of indebtedness income from the holders of the _____ Notes.

The collateral for the _____ Notes likely does not have value aside from potential bankruptcy payouts. Upon an event of default, such as a failure to pay interest when due, the holder of the Installment Note (Taxpayer), must make a demand for payment from _____ pursuant to the Guaranty before it can exercise other rights and remedies under the Installment Note at law or in equity. Because it made a demand for payment from _____ pursuant to the Guaranty, Taxpayer can enforce its rights under the terms of the Installment Note. However, the Installment Note provides that its holder shall have no recourse to the _____ or to any affiliate of _____. _____, a special purpose entity, was established to buy the _____ and _____ does not have other assets from which Taxpayer’s claim for amounts owing under the Installment Note could be satisfied.

However, the Installment Note and Guaranty have not been abandoned and have value as a result of the future bankruptcy payouts. The rights held under the Installment Note and Guaranty have always had value while the _____ bankruptcy was pending; the value actually increased since the bankruptcy filing. All parties are still pursuing their rights under the _____ Notes’ collateral: the Installment Note and the Guaranty. Taxpayer, through _____, filed a claim in the _____ bankruptcy seeking to recover the value of the Guaranty. _____, as indenture trustee also filed a claim in the bankruptcy case to recover the value of the

Guaranty.⁷ Any amount recovered in the bankruptcy case pursuant to the claim under the Guaranty would be paid to the holders of the

Notes.

Additionally, filed a claim in the bankruptcy for the value of the Collateral Note, payment of which finances payments to under the Installment Note. Any amount recovered pursuant to claim under the Collateral Note would be paid to under the Installment Note and then to the holders of the Notes.

Although its liabilities exceed its assets, has some assets to be distributed in the bankruptcy case and the amount that unsecured creditors will receive is still unknown. The claims under the Installment Note and the Guaranty have had substantially more than a nominal value since the original bankruptcy filing. Any amount that Taxpayer may recover on the Installment Note through the Collateral Note or on the Guaranty was not certain when Taxpayer paid an estimated tax on discharge of indebtedness income in , nor was the amount certain in . Taxpayer and other relevant parties are still pursuing claims and have not abandoned the collateral as worthless. Thus, Taxpayer is not required to recognize income from the discharge of indebtedness in or because no identifiable event indicated that the Installment Note and the Guaranty became worthless or that the Notes holders had abandoned their rights to payments under the Collateral Note or the Guaranty securing the Notes.

II. Income Recognition on Installment Note as Installment Sale

An installment sale is defined by the receipt of at least one payment after the close of the taxable year of the disposition. I.R.C. § 453(b)(1). A payment must be recognized as income in proportional relationship between gross profit and the contract price. I.R.C. § 453(c). A payment does not include receipt of a bond or other evidence of indebtedness unless payable on demand. I.R.C. § 453(f). Taxpayer sold in exchange for the Installment Note in an installment sale because Taxpayer was to receive payment in rather than in the year of the sale, . Taxpayer's receipt of the Installment Note was not receipt of a payment because the Installment Note was not payable on demand when received by Taxpayer; the Installment Note only became payable on demand after an event of default.

A taxpayer must also recognize income on an installment obligation when it sells or otherwise disposes of the installment obligation. I.R.C. § 453B(a). If the installment obligation becomes unenforceable, the obligation is treated as if it were disposed of in a transaction other than a sale or exchange. I.R.C. § 453B(f). The gain is the fair market value of the installment obligation at the time it becomes unenforceable less the taxpayer's basis in the installment obligation. I.R.C. § 453B(a).

⁷ As mentioned above, the claims have been consolidated

Taxpayer retained the Installment Note and pledged it as collateral for the Note, through _____, who took a security interest in the Installment Note as the indenture trustee.⁸ The Installment Note has not become unenforceable. The Installment Note can be enforced against _____ and a demand has been made under the Guaranty. Claims under the Guaranty cannot be pursued outside of the _____ bankruptcy case, but all relevant parties filed claims in the bankruptcy case seeking to recover amounts that would ultimately be paid to the holders of the Notes. Taxpayer enforced its installment obligation by filing a claim in bankruptcy court. Therefore, the Installment Note did not become unenforceable in or _____ so as to require Taxpayer to recognize gain.

III. Other Disposition of Installment Note

“A debtor’s transfer, or abandonment, of property to a creditor in satisfaction of a nonrecourse liability is treated as a sale or other disposition of the property, and any resulting income constitutes gain on the disposition of property rather than discharge of indebtedness income.” Coburn v. Comm’r, T.C. Memo 2005-283 (citing L&C Spring Assocs. v. Comm’r, 188 F.3d 866 (7th Cir. 1999); Treas. Reg. § 1.1001-2(a)). When the abandonment of collateral would result in income recognition, an act of abandonment need not be overt if the taxpayer clearly did not retain the collateral. L&C Springs Assocs., 188 F.3d at 870; Great Plains Gasification Assocs. v. Comm’r, T.C. Memo. 2006-276 at *22. A taxpayer realizes gain from the sale or other disposition of property in an amount determined by subtracting from the amount realized the taxpayer’s adjusted basis. I.R.C. § 1001(a). Any gain realized during a taxable year must be recognized in the same taxable year. I.R.C. § 1001(c). In the case of abandonment of an installment obligation, a taxpayer would recognize gain or loss equal to the difference between the taxpayer’s basis in the obligation and the obligation’s fair market value at the time of disposition. I.R.C. § 453B(a)(2).

The _____ Note holders cannot recover the \$ _____ due from Taxpayer except from the value of the collateral, the Installment Note and the Guaranty. Taxpayer has not yet transferred the collateral to the _____ Note holders. Therefore, Taxpayer does not yet have to recognize gain as the result of a transfer of collateral in satisfaction of its liability to the holders of the _____ Notes. Once Taxpayer transfers the Installment Note and the Guaranty to the _____ Note holders, Taxpayer’s \$ _____ debt (or some lesser portion thereof) will be extinguished. Taxpayer must then recognize income from the discharge of indebtedness. As discussed above, the Taxpayer cannot be deemed to have disposed of the Installment Note at the time of the _____ bankruptcy filing because the Installment Note had not become unenforceable, abandoned, or essentially worthless.

⁸ While there could be arguments for treating the transaction as a sale, rather than a pledge, of the Installment Note, we understand the period of limitations for assessment is no longer open for Taxpayer’s tax year.



In conclusion, Taxpayer did not recognize income from discharge of indebtedness in _____ or _____ as a result of the _____ bankruptcy. Taxpayer did not recognize income on the Installment Note in _____ or _____ since Taxpayer had not disposed of the Installment Note and the Installment Note had not become unenforceable or worthless in either year. This opinion was coordinated with _____ Counsel and CC:ITA:B05. Please feel free to contact me with any questions at (312) 368-8545.

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