



DEPARTMENT OF THE TREASURY  
INTERNAL REVENUE SERVICE  
WASHINGTON, D.C. 20224

OFFICE OF  
CHIEF COUNSEL

August 14, 2000

Number: **200038044**  
Release Date: 9/22/2000  
UIL No. 61.09-18  
TL-N-3393-99/CC:IT&A:3

MEMORANDUM FOR Associate District Counsel, Salt Lake City

FROM: Associate Chief Counsel, Income Tax & Accounting

SUBJECT: Significant Service Center Advice

This responds to your request for Significant Service Center Advice dated June 2, 1999 in connection with a question posed by the Underreporter Unit at the Ogden Service Center.

#### ISSUE

When a penalty equal to three times the scholarship funds awarded, plus interest, is imposed for an individual's failure to complete the required period of service for a scholarship awarded under the Indian Health Scholarship Program, and the penalty is subsequently discharged, is there discharge of indebtedness income under section 61(a)(12) in the amount of the discharged penalty?

#### CONCLUSION

A penalty imposed for an individual's failure to complete the required period of service for a scholarship awarded under the Indian Health Scholarship Program, which is subsequently discharged results in discharge of indebtedness income under section 61(a)(12).

#### DISCUSSION

A Service Center has received Forms 1099-C from the Department of Health and Human Services (DHHS) reporting cancellations of indebtedness. The cancellations of indebtedness resulted from DHHS determining not to pursue collection on amounts owed as a result of penalties imposed for breach of a scholarship contract. Under the scholarship contract, DHHS provided a scholarship for medical school expenses, and the student agreed to complete a period of obligated service in designated hardship areas upon finishing school. The contracts were entered into under authority of Section 757 of the Public Health Service Act (42 U.S.C.A. 294y-1).<sup>1</sup>

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<sup>1</sup>Section 757 of the Public Health Service Act was added by P.L. 95-83, Title III, § 307(n)(1), 91 Stat. 392, and states, "Effective October 1, 1977, subpart IV of part C of title VII of such Act (relating to National Health Service Corps Scholarships) is amended by adding at the end thereof the following new section:

Section C of the contract, entitled "Breach of Scholarship Contract" states, "After this contract is signed by both the applicant and the Secretary, if the applicant ... Fails to begin or complete the period of obligated service incurred under this contract for any reason, the United States shall be entitled to recover an amount equal to three times the scholarship funds awarded, plus interest ... The amount the United States is entitled to recover shall be paid within one year of the date the Secretary determines that the applicant has failed to begin or complete the period of obligated service."

You have requested assistance regarding whether the amounts reported on the 1099C by DHHS are properly treated as discharge of indebtedness income.

## ISSUE 1

The first issue is whether there is cancellation of indebtedness income as a result of the cancellation of the amounts owed as a result of the contract's penalty provision. Arguably, forgiveness of an indebtedness that arises from the imposition of a penalty should not constitute COD income because the taxpayer did not receive loan proceeds that were excluded from income when the indebtedness was incurred. This rationale originated in several cases in which the courts determined that the debtor did not have cancellation of indebtedness income when the debtor had not received anything of value when the indebtedness was incurred.

Commissioner v. Rail Joint, Co., 61 F.2d 751 (2d Cir. 1932) and Fashion Park Inc. v. Commissioner, 21 T.C. 600 (1954) first elucidated this rationale. In Rail Joint, a corporation reappraised its assets and added \$3,000,000 to its surplus account. It then declared a dividend payable in bonds and distributed bonds with a face amount of \$2,000,000. The corporation subsequently repurchased the unmatured bonds for less than their face value. The court held that the repurchase, at a discount, of corporate

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### "Indian Health Scholarship Program"

"Section 757. (A) In addition to the sums authorized to be appropriated under section 756 (a) to carry out the Scholarship Program, there are authorized to be appropriated ... to provide scholarships under the Scholarship Program to provide physicians, osteopaths, dentist, veterinarians, nurses, optometrists, podiatrists, pharmacists, public health personnel, and allied health professionals to provide services to Indians. Such scholarships shall be designated 'Indian Health Scholarships' and shall be made in accordance with this subpart, except as provided in subsection (b)."

Thus, amounts appropriated as Indian Health Scholarships were provided under the National Health Service Corps Scholarship (NHSC) program, but were specifically to provide services to Indians. However, Indian Health Scholarships were administered in accordance with other NHSC scholarships. The Internal Revenue Service has consistently taken the position that NHSC scholarships should be taken into income in years after 1986. (See section 117(c) of the Code, implementing changes made by the Tax Reform Act of 1986, Pub. L. No. 99-514 and Rev. Rul. 76-183, 1976-2 C.B. 43).

debt that had been issued as a dividend did not give rise to cancellation of indebtedness income. In reaching its conclusion, the court stated:

[I]n paying dividends to shareholders, the corporation does not buy property from them. Here the respondent never received any increment to its assets, either at the time the bonds were delivered or at the time they were retired. They were issued against a surplus created by reappraising assets already owned. ... The bonds were merely a way of distributing a part of such surplus among shareholders. When certain of the bonds were retired at less than par, all that happened was that the corporation retained a part of the surplus it had expected to distribute, because it paid those shareholders whose bonds were redeemed at a discount less than it has promised to pay them. Hence it is apparent that the corporation received no asset which it did not possess prior to the opening and closing of the bonds transaction, and it is impossible to see wherein it has realized any taxable income. In such circumstances the Kirby case cannot be regarded as controlling. 61 F.2d at 752.

Similarly, in Bradford v. Commissioner, 233 F.2d 935 (6th Cir. 1956), the court decided that there was no income from cancellation of indebtedness when a bank canceled a debt that a taxpayer executed in exchange for an indebtedness of her husband. The taxpayer's husband owed \$205,000 to a bank. The bank accepted the taxpayer's note for that of her husband. Several years later, the bank sold the note at a discount to a person related to the taxpayer's husband with funds furnished by the taxpayer. The court stated,

stripped of superficial distinctions, the Rail Joint Co. case is identical in principle with the present case. In that case, as in this, the taxpayer received nothing of value when the indebtedness was assumed. Although the indebtedness was discharged at less than its face value, the taxpayer was in fact poorer by virtue of the entire transaction.

The Service nonacquiesced to the holding in Rail Joint, nonacq. X-2 C.B. 99 (July-Dec. 1931) and Fashion Park, nonacq., 1955-1 C.B. 7. The rationale underlying these nonacquiescences indicates that a distribution of bonds is treated as economically equivalent to a borrowing of cash by the corporation and a distribution of that cash as a dividend to shareholders. The subsequent repayment of the borrowing for less than its face amount would clearly give rise to discharge of indebtedness income under § 61(a)(12). Similarly, applying the implied borrowing analysis to the facts of this case, cancellation of a penalty owed to the Department of Health and Human Services is equivalent to a transaction in which the taxpayer borrowed cash, and used the proceeds to pay the penalties. A forgiveness of the loan would give rise to income under § 61(a)(12). Since such a transaction would clearly give rise to COD income, the direct reduction of the penalty by the Department of Health and Human Services should also give rise to COD income.

You have also raised the issue whether section 108(f) might apply to exclude the amounts forgiven under the Indian Health Scholarship Program. Section 108(f) provides:

In the case of an individual, gross income does not include any amount which (but for this subsection) would be includible in gross income by reason of the discharge (in whole or in part) of any student loan if such discharge was pursuant to a provision of such loan under which all or part of the indebtedness of the individual would be discharged if the individual worked for a certain period of time in certain professions for any of a broad class of employers.

Penalties imposed under the Indian Health Scholarship Program do not qualify as student loans. Amounts originally disbursed under the program are scholarships. Rev. Rul. 76-183, 1976-1 C.B. 43. Penalties are imposed for failure to perform the required services. The penalties do not qualify as student loans, and therefore we conclude that section 108(f) does not apply to the forgiven penalties. Furthermore, even if such a penalty obligation qualified as a student loan, we would not consider a discharge of such an obligation to be "pursuant to a provision of such loan under which ... the indebtedness of the individual would be discharged if the individual worked for a certain period of time in certain professions for any of a broad class of employers" as required by section 108(f). Section 108(f) is intended to exclude from income amounts that are forgiven when an individual works in the required professions; not when an individual fails to fulfil a work requirement.

If you have any further questions regarding this matter, contact Sharon Hall at (202) 622-4930.