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DEPARTMENT OF THE TREASURY
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INTERNAL REVENUE SERVICE NATIONAL OFFICE FIELD SERVICE ADVICE

MEMORANDUM FOR: **District Counsel,**

Attn:

FROM: **Deborah A. Butler**
Assistant Chief Counsel (Field Service)

SUBJECT:

This Field Service Advice responds to your memorandum dated February 18, 1999. Field Service Advice is not binding on Examination or Appeals and is not a final case determination. This document is not to be cited as precedent.

LEGEND:

A =
B =
C =
Year 1 =
Year 2 =
X = \$
Y = \$
Z = \$
State D =

ISSUE:

Whether assets held by taxpayer and his spouse as tenants by the entirety should be included in determining whether taxpayer falls within the insolvency exception to the recognition of cancellation of indebtedness income set forth in I.R.C. § 108(a)(1)(B).

CONCLUSION:

Assets held by taxpayer and his spouse as tenants by the entirety should be included in determining whether taxpayer falls within the insolvency exception to the recognition of cancellation of indebtedness income under section 108(a)(1)(B).

FACTS

We rely on the statement of facts contained in your memorandum of February 18, 1999. A and B, a married couple, are residents of State D. They own both real and personal property, such as bank accounts, securities and a residence, as tenants by the entirety. A took out a commercial loan from C. The loan did not name B as an obligor. In year 1, C obtained a judgment against A for the balance due on the loan. In year 2, C canceled a portion of the loan owed by A, and issued a Form 1099-C to A indicating that A had been discharged of its indebtedness to C by \$X. A did not report \$X on his tax return for year 2, since he claimed that his total liabilities exceeded his total assets in that year, and thus he fell within the insolvency exception to the reporting of cancellation of indebtedness income. To demonstrate his insolvency, A calculated his net worth, excluding assets held by himself and B as tenants by the entirety. In year 2, A's net worth, excluding assets held as tenants by the entirety, was \$Y. In that same year, when the tenancy by the entirety assets were included in A's net worth calculation, his net worth increased over eight times to \$Z, which significantly exceeded \$X, the amount by which the debt was canceled.

LAW AND ANALYSIS

I.R.C. § 61(a)(12) provides that income resulting from the cancellation of indebtedness [hereinafter "COD income"] constitutes gross income. I.R.C. § 108(a)(1)(B) sets forth an exception to this recognition rule for insolvent taxpayers. Insolvency is defined in the Code as "the excess of liabilities over the fair market value of assets," and is measured immediately prior to the time of the discharge of indebtedness. I.R.C. § 108(d)(3). No other exception to the recognition of COD income for insolvent taxpayers is provided in the Code. I.R.C. § 108(e)(1). The insolvency exception excludes income only up to the amount by which a taxpayer is insolvent. I.R.C. § 108(a)(3).

The insolvency exception to the recognition of cancellation of indebtedness income was codified by the Bankruptcy Tax Act of 1980. Prior to its enactment, an insolvency exception was created through precedent. See Fifth Avenue-Fourteenth Street Corp. v. Commissioner, 147 F.2d 453, 457 (2d Cir. 1945); Dallas Transfer & Terminal Warehouse Co. v. Commissioner, 70 F.2d 95, 96 (5th Cir. 1934); Lakeland Grocery Co. v. Commissioner, 36 B.T.A. 289, 291 (1937). The Dallas Transfer court recognized that when an insolvent debtor is discharged of a portion of his or

her indebtedness, no income is generated, as no gain or profit is realized. Dallas Transfer, 70 F.2d at 96. There is merely a decrease in the debtor's liabilities. Id. Thus, if the cancellation of an insolvent taxpayer's debt results only in a decrease in his or her liabilities, a taxpayer should not be forced to report the amount by which the debt was canceled as income. Id.

Prior to the Bankruptcy Tax Act's codification of the judicially created insolvency exception, the United States Tax Court addressed the issue of whether assets exempt from the claims of creditors should be included in determining whether a taxpayer is insolvent for section 108 purposes. Several Tax Court decisions held that assets exempt from creditors' claims pursuant to state law should not be included in a taxpayer's assets when calculating whether a taxpayer is insolvent under section 108(a)(3). See Cole v. Commissioner, 42 B.T.A. 1110, 1113 (1940), nonacq., 1941-1 C.B.13 (1941) (life insurance policies payable to a named beneficiary were exempt assets under New York State law and thus not counted as assets for insolvency calculation); Marcus Estate v. Commissioner, T.C. Memo. 1975-9, 34 T.C.M. 38, 41 (same). The Cole court referred to the "freeing of assets" theory in holding that assets exempt from the claims of creditors should not be included in calculating the debtor's assets. As set forth in your memorandum, the "freeing of assets" theory was first introduced in United States v. Kirby Lumber Co., 284 U.S. 1 (1931). The theory provides that a debtor has income to the extent that a cancellation of indebtedness "frees up" assets from creditors' claims and makes them available to the debtor. Kirby Lumber, 284 U.S. at 3. The Cole court also relied upon Underleak v. Scott, 134 N.W. 731 (Minn. 1912), a fraudulent conveyance case decided by the Supreme Court of Minnesota, in which the defendant transferred a parcel of real property prior to declaring bankruptcy. Underleak, 134 N.W. at 733. In determining whether the conveyance was fraudulent, the court examined whether defendant was insolvent at the time of the conveyance. Id. The Underleak court then noted that the question of what assets may be counted in making the insolvency determination should be governed solely by state law, and that assets exempt under state law should not be included. Id. In reaching a similar holding, the Marcus Estate court cited Cole, and provided no additional reasoning for excluding exempt assets.

Following the enactment of the Bankruptcy Tax Act of 1980, the Tax Court continued to hold that state exempt assets are excluded from the insolvency determination. See Babin v. Commissioner, T.C. Memo. 1992-673, 64 T.C.M. 1357, 1366; Hunt v. Commissioner, T.C. Memo. 1989-335, 57 T.C.M. 919, 946. Both Babin and Hunt involved cancellation of indebtedness which occurred prior to the effective date of the Bankruptcy Tax Act. Nevertheless, the Hunt court discussed this issue in the context of the newly enacted Code provisions. The Hunt court concluded that state law controls the definition of insolvency for section 108 purposes, and assets exempt from creditors' claims under state law are not included in the insolvency calculation. Hunt, 57 T.C.M. at 947. In Babin and Hunt,

the court relied upon the “freeing of assets” theory to conclude that assets exempt from creditors’ claims under state law should not be included in the insolvency calculation. Applying this theory, the Tax Court in both decisions reasoned that assets exempt from creditors’ claims should not be included in the insolvency calculation, since these assets are not “freed up” from the claims of creditors as a result of the cancellation of indebtedness. Consequently, such assets remain unaffected by a cancellation of indebtedness, since they are beyond the reach of creditors’ claims under the relevant state law. Babin, 64 T.C.M. at 1366; Hunt, 57 T.C.M at 946.

The Service initially agreed with the position taken by the Tax Court in the Hunt case.¹ After further consideration, however, we believe that exempt assets should be included as part of the taxpayer’s assets for purposes of the insolvency calculation.

Section 108(d)(3) defines insolvency as “the excess of liabilities over the fair market value of assets”. Neither this provision nor any other provision in section 108 defines the term assets, or qualifies it by specifically including or excluding certain classes of assets from the insolvency calculation. The Regulations are similarly silent on this issue. Therefore, the plain meaning of this Code provision should be followed to include all of a taxpayer’s assets in determining insolvency. This interpretation is in accordance with the rules of statutory construction, which provide that if a statute is clear on its face, then no other sources need be consulted to ascertain its meaning. Griffin v. Oceanic Contractors, Inc., 458 U.S. 564, 571 (1982); McCaughn v. Hershey Chocolate Co., 283 U.S. 488, 491, 492 (1931). Only where a statute is facially ambiguous should its legislative history be consulted. American Tobacco v. Patterson, 456 U.S. 63, 68 (1982); United States v. American Trucking Associations, Inc., 310 U.S. 534, 542, 543 (1940). Even if we were to examine the legislative history of the Bankruptcy Tax Act, it contains no evidence that Congress intended to exclude exempt assets from the insolvency determination. The legislative history fails to mention any of the Tax Court cases, cited above, which held that exempt assets should be excluded from the insolvency calculation. Furthermore, section 108(e)(1), also enacted as part of the Bankruptcy Tax Act, provides that the insolvency exception in section 108(a)(1)(B) is to be the sole insolvency exception.

On the other hand, protection is explicitly afforded to a taxpayer’s exempt assets by other sections of the Code. Section 1017(c) provides that a taxpayer in bankruptcy who has realized COD income shall not be compelled to reduce the basis of assets

¹ See TAM 9130005 (March 29, 1991); LTR 9125010 (March 19, 1991); LTR 8920019 (Feb. 14, 1989).

which are treated as exempt under the Bankruptcy Code.² Congress did not insert language providing similar protection to exempt assets for insolvent taxpayers outside of bankruptcy. Thus, if Congress intended to exclude exempt assets from the definition of insolvency under section 108, it would have expressly stated this intention. This principle is in conformity with precedent holding that Code provisions permitting exemptions are to be construed narrowly, and any doubt must be interpreted in favor of the taxing authority. See Commissioner v. Jacobson, 336 U.S. 28, 49 (1949); Associated Master Barbers & Beauticians of America v. Commissioner, 69 T.C. 53, 62 (1977).

Permitting taxpayers to exclude exempt assets from the insolvency determination would have several negative effects which would contradict the plain meaning of section 108(a)(1)(B), as well as Congress's intent in codifying the insolvency exception. As you point out in your memorandum, allowing taxpayers to exclude state exempt assets from the insolvency calculation may cause taxpayers who are not insolvent (when their total assets are taken into account) to exclude COD income. It is clear from the legislative history of the Bankruptcy Tax Act that in codifying the insolvency exception, Congress was concerned primarily with the inability of an insolvent taxpayer to pay a tax liability resulting from a discharge of a debt. See S. REP. NO. 96-1035, pt. II, at 9-10 (1980); H.R. REP. NO. 96-833, pt. II, at 8-9 (1980). Congressional reports analogized the concern for insolvent taxpayers to the desire to provide taxpayers recently discharged from bankruptcy with a "fresh start", rather than burdening them with a tax liability upon discharge of their debts. H.R. REP. NO. 96-833, at pt. II, at 9; S. REP. NO. 96-1035, pt. II, at 10. The Subcommittee reports acknowledged the difficulty that insolvent taxpayers would have in paying taxes arising from a discharge of their indebtedness, and expressed a desire not to discourage creditors from canceling part of an insolvent taxpayer's debt by imposing a tax liability on COD income which may be due prior to the remainder of the taxpayer's debt to the forgiving creditor. Hearings Before the Subcomm. on Select Revenue Measures of the House Ways and Means Comm., 96th Cong., 1st Sess., 8 (statement of Hon. Daniel I. Halperin, Deputy Asst. Sec. for Tax Policy, Treasury Dept.).

Allowing exempt assets to be excluded from a taxpayer's total assets in calculating his or her net worth distorts a taxpayer's true net worth figure, and would have the effect of allowing solvent taxpayers, who have sufficient assets to pay the tax liability, to utilize the insolvency exception. This approach also creates an incentive for a taxpayer to hold as many assets as possible as property exempt under state law to avoid paying tax on COD income. If a taxpayer's assets consist mainly of

² See 11 U.S.C. § 522. This section provides a list of a bankrupt debtor's assets which are exempt from creditors' claims. This section also permits the debtor to choose to be governed by exempt asset provisions under a debtor's state law.

property defined by a taxpayer's state law as exempt from creditors' claims, and the level of these assets, plus a taxpayer's non-exempt assets, exceeds a taxpayer's liabilities, then a taxpayer should not be permitted to benefit from the insolvency exception by excluding the exempt assets from his or her net worth calculation. Considering Congress's concerns in codifying the insolvency exception, it is reasonable to conclude that it would not have intended such a result to occur.

As you noted, the Tax Court in Merkel v. Commissioner, 109 T.C. 463 (1997), has recently acknowledged Congress's concern for a taxpayer's ability to pay in examining what liabilities should be included in calculating whether the taxpayer is insolvent under section 108. In Merkel, the parties disputed whether taxpayers' guarantees on a loan, and taxpayers' personal liability for their corporation's taxes constituted liabilities for purposes of whether or not they were insolvent under section 108. The Service argued that these items were too contingent to be characterized as liabilities, and that Congress did not intend liabilities to extend to those which were not in "existence on the measurement date." Merkel, 109 T.C. at 467. The court examined the legislative history of the statute to aid in determining the extent to which a liability must be certain before it may be included in the insolvency calculation, and noted that Congress's failure to address this issue in section 108 made the term "liabilities" ambiguous. The court highlighted Congress's concern relating to a debtor's ability to pay an immediate tax liability on COD income, and concluded that this should be a controlling factor in deciding whether an obligation should be included as a liability. Merkel, 109 T.C. at 469. The court observed that the insolvency exception was enacted for the humanitarian purpose of excusing insolvent taxpayers who received COD income from paying a tax liability they were unable to pay. Id. at 482. Thus, the court concluded that Congress did not intend the insolvency exception to apply where it was evident that a debtor had the ability to pay the tax liability. Id. at 483.³ In addition, allowing states' definitions of exempt assets to affect the calculation of insolvency under section 108 would not promote uniformity in the application of section 108, since the categories and levels of assets exempt from creditors' claims vary from state to state. For example, state law varies as to the extent to which a debtor's personal residence is protected from creditors' claims.⁴ In states which

³ As noted in your memorandum, the Service also acknowledged Congress's concern with a debtor's ability to pay in the context of a Revenue Ruling addressing the scope of liabilities to be used in the insolvency calculation. See Rev. Rul. 92-53, 1992-2 C.B. 56.

⁴ Compare FLA. CONST. art. X, § 4 (providing an unlimited homestead exemption); KY. REV. STAT. ANN. § 427.060 (Michie 1996) (limiting homestead exemption to \$5,000) and MICH. CONST. art. X, § 3 (limiting homestead exemption to \$3,000); TEX. PROP. CODE ANN. § 41.001 (providing unlimited homestead

provide that a debtor's personal residence is an asset fully exempt from creditors' claims, regardless of its fair market value, a debtor would be able to exclude the entire fair market value of the residence from his or her assets in an insolvency calculation under section 108.

In the present case, A and B hold several assets as tenants by the entirety. Under State D's common law, spouses may hold both real and personal property as tenants by the entirety.

. Tenants by the entirety are each deemed to own an undivided, one hundred per cent interest in property.

. The property interest is indivisible, and any act affecting title to the property must be undertaken by both spouses. Id. Accordingly, assets held by spouses as tenants by the entirety are not subject to a judgment lien where the judgment is against only one spouse, since the spouses do not have separate interests in the property.

.⁵ This rule protects the non-debtor spouse from the claims of creditors of the debtor spouse.

Based on the foregoing analysis, the fair market value of each of A's tenancy by the entirety assets should be included in calculating whether A was insolvent immediately before his debt was partially discharged, despite the fact that under the law of State D, tenancy by the entirety assets are not subject to creditors' claims against A individually. It appears from the facts that A's total assets, including tenancy by the entirety property, exceeded his total liabilities immediately prior to the partial discharge, and thus A was not insolvent under the definition of section 108(d)(3). Consequently, the entire \$X should be included as COD income to A.

As you noted in your memorandum, allowing taxpayers such as A to exclude state exempt assets from the insolvency calculation would motivate them to hold a significant portion of their assets as tenants by the entirety. In State D, taxpayers may hold a substantial amount of assets in this manner, including both personal and real property, and thus benefit from the insolvency exception, even though their total assets may exceed their total liabilities.

exemption).

⁵ If a judgment is entered against both spouses, however, State D courts have held that a creditor may execute it against the spouses' tenancy by the entirety property.

CASE DEVELOPMENT, HAZARDS AND OTHER CONSIDERATIONS:

[REDACTED]

[REDACTED]

[REDACTED]

6 [REDACTED]

[Redacted]

[Redacted]

[Redacted]

[Redacted]

If you have any further questions, please call (202) 622-7900.

7 [Redacted]

8 [Redacted]

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