

# Bankruptcy Taxation/ Consumer

## Real Estate Partnership Bankruptcies: Effects on Individual Partners— from Main Street to Wall Street

**Steven R. Schneider, Moderator**  
*Goulston & Storrs, P.C.; Washington, D.C.*

**Robert D. Schachat**  
*Ernst & Young LLP; Washington, D.C.*

**Alan D. Lasko**  
*Alan D. Lasko & Associates PC; Chicago*



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**I. Overview**

When leveraged property values decline, tax consequences are critical both for historical borrowers and lenders, and for those seeking to make value investments. For borrowers, it is critical to minimize phantom taxable income from debt write downs or conversions of debt to equity. For lenders, getting the tax benefits from economic losses are critical. For investors, improper tax planning can produce unexpected results such as substantial tax without cash by merely buying a creditor interest and entering into a workout with the borrower.

**A. Borrower Considerations**

In a workout of a troubled loan, a lender may agree to reduce the principal on the debt. The lender’s forgiveness may result in immediate ordinary income to the borrower, in the form of cancellation of debt (“COD”) income, which cannot be offset by capital losses. A borrower may also trigger COD income if the borrower (or its affiliate) purchases its own debt at a discount.

The consequences to a borrower upon a foreclosure of the underlying property will differ drastically depending on whether the debt is nonrecourse debt or recourse debt. Where a lender forecloses on a property encumbered by recourse debt and forgives the amount of the loan that exceeds the property's then fair market value, the forgiveness is treated as COD income, taxed as ordinary income. In contrast, where a lender forecloses on a property encumbered by nonrecourse debt, the borrower is treated as having sold the property for the entire amount of the nonrecourse debt, with the gain generally taxed as capital gain. There is some uncertainty regarding whether a recourse obligation of a special purpose vehicle falls into the recourse or nonrecourse category for tax purposes, with significant tax differences at stake. Partial forgiveness of debt, however, whether recourse or nonrecourse, results in cancellation of debt income.

A borrower may also trigger COD income to the extent that a debt is satisfied at a discount by issuing an equity interest in the borrower, whether the borrower is a corporation or an entity taxed as a partnership. A conversion from debt to equity could happen either pursuant to the parties' negotiations, or as a result of debt modification. Reduction of the principal amount of debt, where the borrower is taxed as a partnership, may also have adverse consequences to its partners. If a partner relies on its share of the partnership's debt to be included in the basis of its partnership interest in order to avoid triggering gain from a negative tax capital account, a reduction of the amount of that debt could trigger gain to the partner.

A borrower may be able to avoid recognizing COD income if certain exceptions apply. For example, a direct corporate borrower may be able to exclude cancellation of debt income where it is insolvent or bankrupt. A non-corporate borrower owning real estate directly, or as a partner

in a partnership owning real estate, may also be able to avoid tax if the debt is so-called “qualified real property business debt.” These exclusions, however, come at the expense of the borrower’s losing certain tax benefits or tax basis in property to the extent of the amount excluded. Recent legislation also added a new election to defer COD income for certain acquisitions of debt by the borrower in 2009 or 2010. The taxpayer would instead recognize the income ratably between 2014 and 2018. However, the election has significant costs and limitations, particularly in the partnership context.

### **B. Lender Considerations**

The historical lender may be at odds with the borrower because a borrower’s ordinary income is a lender’s ordinary loss.<sup>1</sup> The historical lender may prefer to structure any concession as a reduction in the principal amount to recognize an ordinary loss, whereas the issuer might prefer to leave the principal amount of a debt unchanged (to avoid COD income) and receive the concession as a future reduction in the interest rate.

Where the lender agrees to accept equity in a partnership borrower in satisfaction of the debt, new regulations prevent a lender from recognizing an immediate loss in the event that the value of the equity was less than the outstanding amount of the debt.<sup>2</sup> This is true even though the

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<sup>1</sup> Note, in some cases the lender may be able to write the debt down independently under section 166 as partially worthless.

<sup>2</sup> T.D. 9557, 76 Fed. Reg. 71255 (11/17/11).

borrower would recognize immediate COD income. Furthermore, when the lender eventually recognizes its deferred loss, it is likely a capital loss, not useable against ordinary income.<sup>3</sup>

If a lender is not receiving current loan payments, another concern is accruing taxable interest income without receipt of the corresponding cash. In some instances, a lender may be able to assert that this income does not need to be accrued if there is serious doubt that the interest will ever be collected. Unfortunately, the IRS may argue that interest, such as “original issue discount,” must continue to be accrued. Moreover, where a holder of a debt receives a partial payment on the debt, the tax rules generally treat this as first paying interest over principal.

### **C. Opportunistic Investor Considerations**

Investors with capital and an appetite for risk may find opportunities to invest in portfolios of distressed debt instruments, and distressed real estate, purchasing these assets at a deep discount. However, debt investors need to be aware of some potential pitfalls prior to acquiring these bargains. For example, the investor’s agreement to modify some debt instruments in the portfolio (e.g., extending the maturity, changing the yield, reducing the principal) may result in an unexpected triggering of taxable gain to the investor.

If the “face” amount of non-publicly traded debt is greater than the discounted purchase price, the discount is taxable gain to the debt investor upon this modification. Some of this gain may be ordinary income due to the “market discount” rules. There are some ways to minimize the

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<sup>3</sup> For a discussion of the section 108(e)(8) regulations on contributions of debt for partnership equity, *see* Schneider & O’Connor, *Is It the End or Just the Beginning: Planning with The Final Partnership Debt-for-Equity Regulations*, 28 Real Estate Journal 39 (2012).

debt investor's tax cost from a workout that creates taxable gain. For example, an investor may be able to defer gain under the installment method. However, to the extent that the investor's total amount deferred under the installment method exceeds \$5 million, the IRS charges interest on the deferred tax.

A property investor may be able to avoid COD income on a loan modification that occurs in connection with acquiring distressed property if the seller had "reason to know" of the modification. For example, where a property investor acquires troubled real estate subject to debt, and as part of the acquisition modifies the debt, COD income may occur to the seller if the seller had reason to know of the modification.<sup>4</sup> As such, the consequences of a modification, such as possible cancellation of debt, would fall on the seller, and not the investor. On the other hand, this rule would not apply if the seller did not know of, or have reason to know of, the modification of the debt. In this case the COD income would fall on the property investor.

## **II. DETAILS**

### **A. COD Income Recognition Rules Generally**

#### 1. Debt write down, discounted pay off

In general, a loan modification or write down creates taxable COD income equal to the reduction in the loan principal balance owed. For tax purposes the loan principal is known as the Adjusted Issue Price (AIP), which is the face of the loan adjusted for items such as below market interest

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<sup>4</sup> The regulations allow the buyer and seller to elect to shift the incidence of the COD income to the buyer in certain circumstances. *See* Reg. §1.1274-5(b)(1).

rates.<sup>5</sup> Similarly COD income occurs if the borrower or a related party buys the debt at a discount to the AIP.<sup>6</sup> If the loan is significantly modified (including partial write downs), COD may result because the new modified loan is treated as exchanged for the old loan and the COD income equals the amount the AIP of the old loan exceeds the issue price of the new loan.<sup>7</sup> For non-publicly traded debt, the issue price of the new loan is deemed to be the stated redemption price at maturity if the debt pays at least the minimum applicable federal rate for interest.<sup>8</sup>

Example - COD computation on loan modification.

Borrower has an outstanding nonrecourse loan with a principal amount of \$100 million and an annual stated interest rate of 9%.<sup>9</sup> The sole property securing the loan has depreciated to \$80 million. Borrower negotiates with the lender to write down the loan principal to \$80 million and leave the other terms unchanged. The change to the loan terms is a significant modification and is treated as if the Borrower paid off the old note with the new note, creating immediate COD income for the \$20 million loan write down amount. If instead the Borrower had negotiated to reduce loan principal to \$85 million and receive a lower interest rate in the new loan, the COD income would only be \$15

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<sup>5</sup> Code § 61(a)(12); Reg. § 1.61-12.

<sup>6</sup> Code § 108(e)(4) (50% related party acquiring debt is treated as if debtor reacquired debt); Reg. § 1.61-12(c)(2) (debt acquisition at discount is COD for the discount).

<sup>7</sup> Code § 108(e)(10) (exchange of old note for new note can create COD income); Reg. § 1.1001-3 (significant modification is a deemed exchange)

<sup>8</sup> Code § 1273(b)(4) (use stated redemption price at maturity for non-traded debt); Code § 1274 (discount issue price if instrument doesn't pay minimum applicable federal rate). For simplicity this outline assumes all debt instruments discussed are not publicly traded.

<sup>9</sup> All interest rates used herein are assumed to be at least equal to the applicable federal rate unless otherwise stated.

million (assuming the new interest was at least the applicable federal rate (4.35% for long-term loans for March 2010)).<sup>10</sup>

## 2. Debt for Hope Note

A borrower may be able to exchange the underwater portion of a loan for a new loan with less priority in the capital structure (i.e., a “Hope Note” or a “B Note”). As long as the Hope Note is respected as debt for tax purposes and is not publicly traded, COD income should not result if the issue price of the Hope Note is at least equal to the AIP of the old note and the Hope Note pays at least the minimum AFR interest rate. However, the primary difficulty with a Hope Note is that it may not be respected as debt for income tax purposes as the principal is no longer fixed and would be missing a hallmark feature of debt. A Hope Note is different than a shared appreciation mortgage, where it is merely a portion of the interest that is not a sum certain. Moreover, in order to incentivize the borrower with underwater property, the Borrower may wish to receive a share of future profits on par or even before the principal of the Hope Note would be repaid, creating another equity type of characteristic for the Hope Note.

## 3. Debt for equity

COD income also results when a creditor contributes the debt to the capital of a corporation or a partnership and does not receive equity value equal to the AIP of the debt.<sup>11</sup> In 2004 Congress eliminated the potential for a partnership debt-for-equity exception and further

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<sup>10</sup> Rev. Rul. 2010-8 (setting AFR rates for March 2010).

<sup>11</sup> Code §108(e)(8).

specified that (1) the treatment does not change depending on whether the debt is recourse or nonrecourse and (2) any COD income is only allocated to the partners existing immediately before the contribution of the debt for equity. IRS regulatory guidance also creates a presumption that the fair market value of the equity received for the debt is the liquidation value of the equity the lender received for the debt making it more likely that the equity will be valued low and there will be more COD income.<sup>12</sup>

#### 4. Deed-in-lieu / foreclosure – recourse vs. nonrecourse debt

If the borrower forfeits property to the lender, the borrower can have COD if the loan is recourse to the borrower, but there is no COD income if the loan is nonrecourse. The answer does not change depending on whether the property transfer is from an official foreclosure or a deed in lieu of foreclosure. With a recourse debt, the COD income is the difference between the value of the property and the amount owed on the loan.<sup>13</sup> If the tax basis and value of the property differ, the borrower will also have a gain or loss on the deemed sale of the property to the lender for that difference. If the loan is nonrecourse, there is no COD income at all, but instead the borrower is treated as selling the property to the lender for relief of the debt, resulting

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<sup>12</sup> T.D. 9557, 76 Fed. Reg. 71255 (11/17/11). For example, if a borrower gives the equity equivalent of a “hope note” (a promise to repay if the property goes back up in value) the right to potential future profits is not generally valued in determining the value of the equity transferred to the lender. However, if the “hope note” is treated as debt for tax purposes, a very different result can occur because the presumption is that the face amount of non-publicly traded debt paying at least AFR is respected in determining whether there is debt relief.

<sup>13</sup> Rev. Rul. 90-16.

in gain or loss equal to the difference between the amount of the debt and the tax basis in the property.<sup>14</sup>

Example - COD computation on deed-in-lieu with built-in gain property.

Taxpayer has a recourse debt of \$100 and deeds property with a basis of \$50 and a value of \$60 in full satisfaction of the debt. Taxpayer has COD income of \$40, the difference between the value of the property and the amount of the debt. Taxpayer also has a \$10 gain from a deemed sale of the property (\$60 value less \$50 basis in the property). If the debt were nonrecourse, Taxpayer would not have any COD income but instead would have \$50 of gain from a deemed sale of the property for relief of the nonrecourse debt. In either instance the taxable income is \$50, but if the property gain were capital with favorable rates, the different character of the gain could result a different tax liability. Also, if Taxpayer was eligible for one of the statutory COD income exceptions, the COD income from the relief of recourse debt could result in less total taxable income.

Example - COD computation on deed-in-lieu with built-in loss property.

Taxpayer has a recourse debt of \$100 and deeds property with a basis of \$100 and a value of \$50 in full satisfaction of the debt. Taxpayer has COD income of \$50, the difference between the value of the property and the amount of the debt. Taxpayer has a \$50 tax loss from a deemed sale of the property (\$100 basis less \$50 value). Even though the COD income and tax loss net out in dollar terms, if the loss is capital and Taxpayer has

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<sup>14</sup> Commissioner v. Tufts, 461 U.S. 300 (1983); Reg. §1.1001-2(c) Example 7.

no other capital gain, Taxpayer has \$50 of taxable ordinary income and a \$50 capital loss carry forward. However, if the property were real property used in the trade or business for at least one year, the loss would be ordinary under the section 1231 rules and could be offset against the COD income (if not offset against other section 1231 gains). Alternatively, if the debt were nonrecourse instead of recourse, there would not have been any COD income or loss on the property since Taxpayer would be treated as selling the property for the \$100 of nonrecourse debt relief and would apply the \$100 of tax basis for no net gain or loss.

Despite the significant differences between recourse and nonrecourse debt, there is a surprising lack of clarity in the law as to what is a nonrecourse debt.<sup>15</sup> Technically nonrecourse debt is an obligation that is secured by and limited to the value of specified assets such that a taxpayer's other assets remain unburdened by the obligation.<sup>16</sup> However, with the advent of LLCs, such traditional nonrecourse debts are the exception. Many recent obligations tend to be "exculpatory" debts that are subject to 100% of the assets of the LLC, however, effective nonrecourse economics are achieved by using only special purpose LLCs. Thus, if A and B form LLC to hold a single parcel of real property and the LLC incurs a single exculpatory liability secured by all of its assets (i.e., the single parcel and perhaps some working capital), the debt is still arguably a recourse obligation to the LLC. This is true even though the debt is nonrecourse

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<sup>15</sup> See generally Sheppard, Walkaway: Forgiveness of Nonrecourse Debt and Other Problems 92 Tax Notes Today 34-5 (1992) ("[the IRS representative] suggested that exculpatory liabilities might be considered recourse liabilities for purposes of section 1001. In the case of a single-asset partnership, there may be no practical difference between a nonrecourse liability and an exculpatory liability. The tax law needs to decide whether section 1001 justifies looking through to the partners to determine whether the liability is recourse or not.").

<sup>16</sup> Reg. § 1.1001-2(a), -2(c).

to partners A and B under the section 752 rules that allocate debt basis among the partners. Conversely, if the debt inside the LLC were structured as a traditional nonrecourse debt secured only by the single parcel and excluding any other LLC assets, the debt would be nonrecourse for COD purposes even if one of the owners of the LLC guaranteed the debt. The recourse or nonrecourse nature is less clear when the obligation is by a tax-disregarded LLC that is wholly owned by a single taxpayer.<sup>17</sup>

## **B. Cancelled Debts That Do Not Create COD**

Certain debt cancellations do not create COD. These exceptions include the following:

1. Debt that would give rise to a future deduction.<sup>18</sup> The common examples include the forgiveness of unpaid interest or trade payables owed by a cash method taxpayer.
2. Reduction in seller-financing obligation by solvent debtor.<sup>19</sup> The reduction is treated as a purchase price reduction and is limited to direct debts owed to the seller.<sup>20</sup>
3. Corporate debtors acquiring debt from shareholders as a contribution to capital.<sup>21</sup> If a shareholder transfers a corporate obligation to the

<sup>17</sup> K. Burke, "Exculpatory Liabilities and Partnership Nonrecourse Allocations," 57 Tax Law. 33, 37 (2003) ("notwithstanding the nonrecourse characterization under the section 704(b)/752 regulations, most commentators agree that an exculpatory liability should be treated as recourse for purposes of section 1001").

<sup>18</sup> Code §108(e)(2).

<sup>19</sup> Code §108(e)(5).

<sup>20</sup> See Rev. Rul. 92-99 (reduction in debt by third-party lender is not purchase price adjustment).

corporation and does not receive any stock in return, the corporation is treated as repaying the debt with cash equal to the shareholder's basis in the debt and avoids COD income to the extent such basis equals the amount of the debt. For example, if the sole shareholder of a corporation loaned \$1 million to the corporation and transferred the debt to the corporation for no new stock at a time when the fair market value of the obligation was less than \$1 million, the corporation would not have COD income because the shareholder's basis in the debt was equal to the debt obligation.

### **C. Primary Statutory COD Exceptions**

#### **1. Bankruptcy Exception**

COD income is exempted from taxable income if the related debt discharge occurs as part of a Title 11 bankruptcy discharge (the "bankruptcy exception"). This exception takes priority over all other statutory COD exceptions and its result is mandated if there is a bankruptcy discharge. The cost of this exception is that the taxpayer must forfeit a corresponding number of valuable tax attributes, however, the exception still applies even if the excluded income exceeds the amount of available attribute reduction. This is especially important to a business that is trying to emerge from a Chapter 11. The reduction in these other tax attributes must follow the statutorily prescribed order of: net operating losses, general business credits, AMT credits,

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<sup>21</sup> Code §108(e)(6).

capital loss carryovers, basis reduction,<sup>22</sup> passive activity loss/credit carryovers, and foreign tax credit carryovers. However, a taxpayer can elect under section 108(b)(5) to first apply the attribution reduction to the basis of depreciable property, bypassing the general attribution reduction ordering rule. This election may be beneficial to the business, i.e., less future depreciation expense but save as much of the NOLs and tax credits as possible. This election needs to be reflected when the tax return is filed.

## 2. Insolvency Exception

The insolvency exception exempts COD income from tax to the extent of the taxpayer's insolvency, with tax attribute reduction identical to the bankruptcy exception. The exception applies after the bankruptcy exception but before the other exceptions. In determining the amount a taxpayer is insolvent there are special rules for nonrecourse debt and contingent debt. If a specific nonrecourse debt is being discharged, then the excess of that debt over the value of the related property is taken into account, but if other debt is being discharged, the underwater nature of the nonrecourse debt is ignored.

This limitation of the exception "to the extent the debtor is insolvent" requires a comparison between the amount of discharge of indebtedness income and the amount necessary to make the debtor insolvent. An example is as follows:

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<sup>22</sup> Generally speaking, this applies to reduce the basis of the depreciable property of a company in the year of discharge. The basis of the property would be measured as of the beginning of the year in which the discharge of indebtedness has occurred. The effect of this basis reduction would be that the business for income tax purposes would have less depreciation expense on a going forward basis coming out of the Chapter 11.

Example

Total Assets of business at FMV	\$125
Total Liabilities	<u>140</u>
Limitation	<u>(\$ 15)</u>

The above example reflects the fact pattern that up to \$15 of liabilities can be discharged for this business without recognition of any COD income. Any amount of discharge of indebtedness over the \$15 of liabilities would result in taxable income to the business entity. It should also be noted that the assets of the business need to be measured at fair market value. Generally accepted accounting principles (GAAP) are not the standard that is followed in order to determine the value of the assets being measured.

### 3. Qualified Principal Residence.

The personal residence exemption applies to discharges of debt from a qualified personal residence made before January 1, 2013.<sup>23</sup> The exemption applies to acquisition debt of up to \$2 million with respect to the principal residence of the taxpayer. The excluded income reduces the tax basis of the principal residence.

### 4. Section 108(c) Real Property Exception

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<sup>23</sup> Code §108(a)(1)(E) and (h).

Taxpayers that are not C corporations can elect to exclude COD income from Qualified Real Property Business Indebtedness (“QRPBI”). Under this QRPBI exception taxpayers can elect to reduce tax basis of depreciable real property in lieu of COD income. Because the basis reduction is treated as depreciation for recapture purposes, future gain on the sale of the property could be characterized as ordinary income (although for section 1250 property this recapture amount will reduce over time).

The primary requirements for the QRPBI exception are as follows:

- (a) **Trade or business.** Debt must have been incurred or assumed by the taxpayer in connection with real property used in a trade or business.<sup>24</sup>
- (b) **Secured by real property.** Debt must be “secured by” such real property (used in a trade or business).
- (c) **Acquisition debt.** Debt incurred or assumed after January 1, 1993 must be qualified acquisition indebtedness. Qualified acquisition indebtedness is debt incurred or assumed to acquire, construct, reconstruct, or substantially improve real property otherwise meeting the definition of QRPBI. Code §108(c)(4). If qualified acquisition debt is refinanced, the refinanced debt also qualifies to

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<sup>24</sup> Code §108(c)(3)(A).

the extent it does not exceed the amount of the debt being refinanced.

- (d) **Election.** Taxpayer must make an election to treat the discharged debt as QRPBI.
- (e) **Limited to amount under water.** Exclusion limited to amount the principal of the QRPBI exceeds the value of the underlying real property securing the debt (not just the depreciable portion of such real property).
- (f) **Limited to basis of depreciable real property.** Exclusion limited to the aggregate adjusted bases of depreciable real property held by the taxpayer immediately before the discharge (other than depreciable real property acquired in contemplation of such discharge). In determining the basis of depreciable real property, property other than property securing such QRPBI can be taken into account, including certain property held through partnerships, after reducing the basis of such property for current year depreciation and other COD-exclusion tax-basis reductions.

**D. Partnership versus Partner Application of Exceptions.**

For COD Income in a partnership, the bankruptcy, insolvency, and QRPBI exception exceptions are applied at the partner level.

**E. Like-kind exchanges as part of foreclosure**

Under the tax rules, real property is generally allowed to be exchanged tax-free for other real property. Although it is somewhat novel to do such an exchange through a foreclosure, the concept is that a foreclosure of property by a non-recourse lender is treated as a sale to the lender for tax purposes for relief of the debt. It is best if the lender can also include some net cash proceeds, even if just to encourage the borrower to be cooperative and avoid the costs and delay of a full foreclosure. If a Qualified Intermediary is used to facilitate such sale, replacement property can be identified within 45 days of the foreclosure and acquired within 180 days of the foreclosure. Various specialty companies also provide “triple net leased” real estate investments to be the replacement property if long-term property is not found in that time frame. Because there are no material net proceeds from the foreclosure and the replacement property must have at least as much debt as the old property to avoid tax, this requires the taxpayer to inject new equity to acquire replacement property. Some of the triple-net leased properties allow high debt-to-equity ratios (e.g., 90% leverage), but a more traditional investment would require more equity. For example, if the old property had \$80 of nonrecourse debt and the new lender requires at least an 80% loan-to-value ratio, an additional \$20 of equity would need to be invested for the taxpayer to acquire the replacement property (plus transaction costs).

**Conclusion**

COD income recognition can be complex and arise in surprising circumstances. The rules for when it is triggered and the exceptions require careful planning and often require specific timely elections to avail oneself of the exceptions. Perhaps Shakespeare was right after all when he said “neither a borrower nor a lender be.”

**Appendix**Example of Insolvency ExceptionMFS – Mr. Individual  
Schedule of Insolvency

<u>Assets at FV</u>	<u>At Date Immediately Before Forgiveness</u>	<u>At Date Immediately After Forgiveness</u>
Any Associates LP	(\$7,129)	(\$7,129)
Your Partners LLC	759,249	759,249
ABCD Family Partnership III Partners, LP	57,378	57,378
Partners, LP	3,053	3,053
Capital Investors I Managers I	46,498	46,498
Principal Investors I	7,407	7,407
Investment I	2,974	2,974
Investment II	110,669	110,669
Bank Accounts	203,519	203,519
Home	166,211	166,211
Car	1,250,000	1,250,000
Retirement Account	5,000	5,000
Household Furnishings	186,000	186,000
Suits and Clothing	25,000	25,000
	10,000	10,000
<u>Total</u>	<u>2,825,829</u>	<u>2,825,829</u>
<u>Liabilities at FMV</u>		
Credit Card Debt – Visa	4,782	4,782
Credit Card Debt – Dept. store	566	566
Loan (forgiven)	4,065,000	-
Loan 600	67,500	67,500
Avenue Loan	447,371	447,371
HELOC	356,433	356,433
<u>Total</u>	<u>4,941,652</u>	<u>876,652</u>
Net Over (Under)	(2,115,823)	<u>\$1,949,177</u>
<u>Discharge Per 1099-C</u>	<u>4,065,000</u>	

30TH ANNUAL SPRING MEETING

Total Taxable Discharge \$1,949,177

**Case Example of Scope of Bankruptcy Exclusion and Attribute Reduction**

The Fifth Circuit in *Johnson v. Comm'r* (2005-1 USTC ¶50396) dealt with the amount of debt discharge that would reduce a taxpayer's tax attributes in bankruptcy.

Subject to certain exceptions, when a taxpayer is discharged from all or part of a debt, the amount discharged is income for the discharge of indebtedness. One exception to this rule occurs in a bankruptcy proceeding. In bankruptcy cases, the debt discharge is not included in gross income, but the amount of debt discharged reduces certain tax attributes of the taxpayer, including net operating losses (NOLs). The amount of debt discharge in bankruptcy, therefore, reduces the amount of the net operating loss that will revert to the debtor upon termination of the bankruptcy estate.

In the Fifth Circuit case, an individual filed a petition under chapter 7 of the Bankruptcy Code. Certain assets that the individual transferred to the bankruptcy estate generated an NOL of \$153,000 for the estate. The bankruptcy estate also included two mortgaged pieces of real estate. The mortgagor was granted relief so it could foreclose on its mortgages. It sold the two properties, leaving a total unrecovered amount in excess of \$197,000 on the mortgages. The mortgagor did not file proofs of claims against the estate for these unrecovered amounts. Therefore, when the Bankruptcy Court accepted the trustee's final report, there was less than \$5,000 of allowed debts discharged and unpaid.

The individual taxpayer took the position that the amount of the NOL that reverted to him upon termination of the bankruptcy estate was the \$153,000 NOL reduced only by the \$5,000 of debts formally discharged by the Court. As a result, the taxpayer claimed this loss on his

individual income tax return. The Internal Revenue Service (IRS) disallowed the utilization of this NOL, claiming that the NOL (as a tax attribute) should be reduced by any debt discharged in bankruptcy. The IRS argued that the \$197,000 of discharged mortgages, as well as the \$5,000 in debts formally discharged in the bankruptcy proceeding must reduce the NOL. Consequently, the IRS argued that the NOL was reduced to zero by the debt discharge and no NOL remained to revert to the individual.

The Fifth Circuit agreed with the IRS. It stated that any debt discharge income excluded under the special rules of Section 108 of the Internal Revenue Code will reduce tax attributes. Therefore, the NOL that was assumed by the individual on the termination of the bankruptcy estate was actually zero.

The Fifth Circuit further noted that the mortgagor forfeited the right to seek recourse for further amounts of the outstanding debt after the foreclosure sales by not filing a proof of claim in the required period, so that debt was discharged as a result, regardless of whether that fact was mentioned in the bankruptcy court's final report.