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**Is Debt Relief Really Just a Debtor’s Prison? Federal Tax Consequences of Debt Relief**

**By Jasen D. Hanson, Esq. and John W. Hackney, Esq.**

Covid-19 continues to wreak havoc on the world and slows efforts to reopen economies. Businesses and individuals have seen limited relief through expanded Small Business Association (SBA) loan programs, Paycheck Protection Program (PPP) loans, payroll tax deferral, and $1,200 stimulus checks. Despite efforts to quell the impact of the nearly six-month lockdown, businesses and individuals still face a number of obstacles to regain the benefits of the vibrant economy that marked the start of 2020. Debt relief in the form of restructured loans, foreclosures, and outright loan forgiveness programs may provide additional help to struggling taxpayers.

But is debt relief any relief at all? While relief from payments, stalled foreclosures and other forms of debt relief may provide immediate assistance, such programs may result in negative tax consequences. Imagine your bank reduces the balance of your mortgage by $40,000 only to find out you now have to pay taxes on that $40,000. Unwary taxpayers may find themselves in that unenviable position of having taxable income without the cash to pay the resulting tax. Taxpayers will go from owing commercial lenders to owing the federal government—a creditor with far superior rights and abilities to collect outstanding debts.

Without proper guidance, debt relief can become a debtor’s prison. However, Section 108 provides important exceptions that may bail out underwater taxpayers. Taxpayers need to consult with experienced tax professionals to analyze the tax consequences of debt relief.

# Debt Relief Creates Taxable Income

Tracing back to the U.S. Supreme Court decision in [*United States v. Kirby Lumber Co.*](https://www.bloomberglaw.com/public/document/UnitedStatesvKirbyLumberCo284US152SCt476LEd1311931CourtOpinion?doc_id=X5BUF9?jcsearch=284+us+1), the inclusion of discharged debt as income derives from the realization that the discharge of debt frees up assets previously subject to that debt. In *Kirby Lumber* the Supreme Court addressed the consequences of a corporation purchasing its own bonds in the open market at a discount. In an opinion written by Justice Holmes, the Supreme Court recognized that by satisfying its debt for less than the principal of that debt, the corporation recognized an economic gain. That is, it freed up additional assets that would, theoretically at least, been used to satisfy the full principal of the debt. This “freeing of assets” theory has underpinned the federal tax consequences of debt relief ever since.

Congress and the IRS later codified the *Kirby Lumber* principle in two provisions of federal tax law: (1) Section 61(a)(11); and (2) Treasury Regulation 1.1001-2(a)(1). Under Section 61(a)(11), the gross income of a taxpayer includes “income from discharge of indebtedness” or cancellation of debt (COD) income. Treas. Reg. 1.1001-2(a)(1) states that the amount realized from the sale or exchange of property includes the amount of liabilities from which the seller/transferor is discharged as a result of the sale or disposition of the property. While both provisions treat discharged liabilities as an income, the effects of those two provisions can be drastically different. Section 61(a)(11) treats income from the discharge of indebtedness as ordinary income. Treas. Reg. 1.1001-2(a)(1) may result in capital gain treatment in certain situations. Moreover, the taxable income exclusions found in Section 108 only apply to Section 61(a)(11) COD income. So, what is the difference between Section 61(a)(11) and Treas. Reg. 1.1001-2(a)(1)?

# Discharged Debts versus Deemed Sales

The distinction between Section 61(a)(11) and Treas. Reg. 1.1001-2(a)(1) derives from the mechanism discharging the debt. Section 61(a)(11) covers the general spectrum of debt discharging events—*i.e.* loan forgiveness, bankruptcy, etc. The recognition event involves the creditor forgiving the debt owed to it by the debtor-taxpayer without consideration and results in ordinary income.

On the other hand, Treas. Reg. 1.1001-2(a)(1) applies to debt discharged as the result of a sale, exchange, or other disposition of property. These amounts may result in capital gains or losses, not ordinary income. The exclusions found in Section 108 do not apply to this form of debt relief.

On the surface, that distinction seems easy to navigate. However, like most areas of federal tax law, the practical application of Treas. Reg. 1.1001-2(a)(1) remains convoluted. For starters, any transaction that results in the discharge of debt may constitute a sale or exchange under Treas. Reg. 1.1001-2(a)(1). This includes foreclosures (*see* [*Estate of Delman v. Commissioner*](https://www.bloomberglaw.com/public/document/EstateofDelmanvCommissioner73TC151979CourtOpinion?doc_id=XE6QVT?jcsearch=73+tc+15)) and sales that, while not expressly referencing the discharge of debt, contemplate the debt discharge as a condition of the sale transaction (*see* [*2925 Briarpark, Ltd. V. Commissioner*](https://www.bloomberglaw.com/public/document/2925BriarparkLtdvCommissioner163F3d3135thCir1999CourtOpinion?doc_id=X40TDV?jcsearch=163+f+3d+313).

A sale or other disposition of property for purposes of Treas. Reg. 1.1001-2(a)(1) goes beyond simple sales or other disposition transactions to include a wide variety of transactions that result in the release of assets otherwise encumbered by debt. For nonrecourse debts, Treas. Reg. 1.1001-2(a)(4)(i) provides that the sale or other disposition of the property securing a nonrecourse liability discharges the transferor from the liability. For recourse debts, Treas. Reg. 1.1001-2(a)(4)(ii), the sale or disposition of property securing that recourse liability results in a discharge if another person assumes the liability, regardless of whether the transferor is relieved from the liability.

Additionally, Treas. Reg. 1.1001-2(a)(2) treats recourse and nonrecourse debt differently for purposes of determining whether the discharge of those debts results in the inclusion of income under Treas. Reg. 1.1001-2(a)(1). In [*Commissioner v. Tufts*](https://www.bloomberglaw.com/public/document/Commr_v_Tufts_461_US_300_103_S_Ct_1826_75_L_Ed_2d_863_1_EXC_160_1/2?doc_id=X5CAF7?jcsearch=461+us+300), the Supreme Court held that the amount realized on the sale or disposition of property includes the total value of the nonrecourse indebtedness discharged as a result of the sale. There, the taxpayer partnership sold property with a fair market value of $1,400,000 and basis of $1,455,740 to a third party who agreed to assume responsibility for a $1,851,400 nonrecourse mortgage. The Supreme Court held that the amount realized was the total value of the nonrecourse mortgage ($1,851,400) and not limited to the fair market value ($1,400,000) of the property. Thus, the taxpayer recognized a $451,400 capital gain on the disposition of the property.

However, Treas. Reg. 1.1001-2(a)(2) bifurcates the amount realized on the sale or disposition of property “that secures a recourse liability” into (1) a sale or exchange resulting from the difference in fair market value of the property and its basis and (2) a COD income event to the extent the value of the recourse debt exceeds the fair market value of the property. *See* [*Gehl v. Commissioner*](https://www.bloomberglaw.com/public/document/GehlvCommr102TC7841994CourtOpinion?doc_id=X17P3RQNB5G0?jcsearch=102+tc+784). Recourse debt—even in a sale or exchange (foreclosure, etc.) – may qualify for partial exclusions under Section 108.

# Navigating Section 108

Absent a gracious creditor, most debt relief transactions will likely result in partial sale or exchange treatment. But whether through a gracious bank or the discharge of recourse debt, Section 108 provides pathways for taxpayers to forego being saddled with phantom income.

Section 108 provides a series of exceptions to Section 61(a)(11) COD income recognition. Most notably, Section 108(a)(1)(A) excludes from income debts discharged pursuant to a bankruptcy action under Title 11—which covers traditional Chapter 7, Chapter 11, and Chapter 13 bankruptcies. Section 108(a)(1)(B) excludes from income debts discharged to the extent of the taxpayer’s insolvency. For example, if a taxpayer has a positive net worth of $200,000 before accounting for a nonrecourse debt of $500,000 and that $500,000 debt is forgiven, the taxpayer only recognizes $300,000 in taxable income ($500,000 - $200,000 = $300,000 excluded).

Section 108 applies to other forms of debt relief, including:

* The discharge of qualified farm indebtedness. Section 108(a)(1)(C). Section 108(g)(2) defines qualified farm indebtedness as debts incurred in connection with operation of a farming business by taxpayers with 50% (or more) of gross receipts from farming activities, in aggregate, for the three previous tax years.
* The discharge of qualified real property indebtedness where the taxpayer is not a C Corporation. Section 108(a)(1)(D). Section 108(c)(3) defines qualified real property indebtedness as indebtedness incurred or assumed in connection with the acquisition, construction, reconstruction, or substantial improvement of real property used in a trade or business (and secured by such property).
* The discharge of qualified principal residence indebtedness that occurs before Jan. 1, 2021 or is subject to an arrangement entered into and evidenced by writing before Jan. 1, 2021. Section 108(a)(1)(E).

The relief provided by Section 108 does not come without pain. Under Section 108(b), a taxpayer must reduce certain tax attributes by the amount income excluded by reason of Section 108. Those tax attributes include: (1) net operating losses under Section 172; (2) the Section 38 general business credit; (3) the Section 53(b) minimum tax credit; (4) capital loss carryover under Section 1212; (5) the basis of property held by the taxpayer; (6) suspended passive activity losses or credits; and (7) foreign tax credit carryovers under Section 27. These attribute reductions will certainly impact future tax years. In addition, certain tax attributes can impact the ability to utilize Section 108. For example, under Section 108(c)(2)(B) a taxpayer can only use the qualified real property Indebtedness exclusion to the extent of the taxpayer’s aggregate adjusted basis in depreciable real property.

As businesses and families continue to navigate the fallout from the coronavirus pandemic, they could obtain short-term debt relief that generates long-term federal tax pain. Taxpayers should consider the potential tax impact of various debt relief programs and consult with qualified tax advisors when determining the best form of debt relief.

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