

Leveraging New IRS Rules Eliminating 36-Month Testing Period for Cancellation of Debt Income

MONDAY, DECEMBER 15, 2014, 1:00-2:50 pm Eastern

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Dec. 15, 2014

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Updates in Cancellation of Debt Income Determinations

December 15, 2014

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What is cancellation of debt (COD) income?



If a debt is cancelled or forgiven, other than as a gift or bequest, the debtor must generally include the cancelled amount in gross income for tax purposes

Discharged debt must be reported regardless of whether debtor is subject to tax

- Over \$600
- Form 1099-C
- Due in February or March of the following year
- Bankruptcy discharge – different guidelines for timing

CORRECTED (if checked)

CREDITOR'S name, street address, city or town, state or province, country, ZIP or foreign postal code, and telephone no.		1 Date of identifiable event	OMB No. 1545-4204
		2 Amount of debt discharged	2015
		\$	
		3 Interest included in box 2	
		\$	Form 1099-C
4 Debtor's federal tax-processor number	DEBTOR'S identification number	4 Debt description	
CREDITOR'S name		5 If checked, the debtor was personally liable for repayment of the debt <input type="checkbox"/>	
Street address (including apt. no.)			
City or town, state or province, country, and ZIP or foreign postal code			
Account number (see instructions)		6 Identifiable event code	7 Fair market value of property
		\$	\$

Form **1099-C** (keep for your records) www.irs.gov/irm/1099c Department of the Treasury - Internal Revenue Service

Cancellation of Debt

Copy B For Debtor
This is important tax information and is being furnished to the Internal Revenue Service. If you are required to file a return, a negligence penalty or other sanction may be imposed on you if taxable income results from this transaction and the IRS determines that this info. has not been reported.

CORRECTED (if checked)

CREDITOR'S name, street address, city or town, state or province, country, ZIP or foreign postal code, and telephone no.		1 Date of identifiable event	OMB No. 1545-1424
		2 Amount of debt discharged	2015
		\$	
		3 Interest included in box 2	
		\$	Form 1099-C
4 Debtor's federal tax-processor number	DEBTOR'S identification number	4 Debt description	
CREDITOR'S name		5 If checked, the debtor was personally liable for repayment of the debt <input type="checkbox"/>	
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A discharge is deemed to have occurred if an identifiable event has occurred*

Such as:

- **Certain judicial proceedings**
- **Agreement between debtor and creditor**
- **Creditor's decision to stop collection activity**

Confusion over the last listed identifiable event:

- **The non-payment testing period of 36 months during which time the creditor has not received any payment on the indebtedness**

*Treas. Reg. § 1.6050P-1(b)(2)(i)(A-H)

Notice of Proposed Rulemaking

November 3, 2014



- Confusion about the 36 month non-payment testing period
- Removal of this as an identifiable event

Non-payment testing period

Originally implemented to:

- *Improve income reporting by third parties*
- *Improve taxpayer compliance*

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~~Treas. Reg. sec. 1.6050P-1(b)(2)(i)(h)~~

IRS and Taxpayers agree

It does neither

Internal Revenue Bulletin 2014-45

November 3, 2014

- Notice of Proposed Rulemaking
- Removal of the 36 month Non-payment Testing Period Rule for Discharge of Indebtedness

Rule as it Stood

- A rebuttable presumption arises that an identifiable event has occurred if a creditor does not receive a payment within a 36 month testing period
- A creditor may rebut the assumption if active collection efforts occurred within the 12 month period ending at the close of the year

BUT

- Even if a creditor does not rebut the presumption, the debt is not necessarily cancelled
- Creditors may file 1099-C, may continue to try to collect on the debt
- Confusion over when (year) the discharge may have actually occurred
- Taxpayers remain confused as to whether the receipt of Form 1099-C represents cancellation of debt includible in income

- Comment period runs to January 13, 2015
- No comments supporting this provision
- It anticipated that this will become final in early 2015

Other Identifiable Events

- A discharge of indebtedness under the bankruptcy code
- Cancellation of debt that renders a debt unenforceable in a receivership, foreclosure, or similar proceeding in state or federal court
- Cancellation of debt upon expiration of statute of limitations for collection of the debt, or upon expiration of the statutory period for filing a claim or commencing a deficiency judgment proceeding

- Cancellation of debt pursuant to election of foreclosure remedy by a creditor
- A probate proceeding that renders debt unenforceable
- A discharge of indebtedness pursuant to agreement between debtor and creditor for payment of less than full consideration
- A decision by the creditor to discontinue collection efforts and discharge the debt

Exclusions for COD Income

Examples:

- Section 108, Insolvency
- Cancelled debt is acquisition indebtedness on principal residence
- Bankruptcy
- Student loans where student is required to work for certain employer

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COD Income – Recognizing, Reporting and Planning Considerations

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Outline

- Recognizing and Reporting COD Income
 - Form 1099-C
 - Exclusions from Taxability
 - Reporting on federal tax returns
- Tax Planning Considerations

Form 1099-C

- What is reported to the debtor?
 - Date of the identifiable event that resulted in the cancellation of indebtedness;
 - The amount of debt discharged. The creditor is not required to, but may, include interest in the total amount discharged. If the amount of debt reported as discharged includes interest, the interest amount must be separately identified;

Form 1099-C Continued

- Description of the debt (e.g., mortgage, student loan, credit card);
- Whether the debt is recourse or nonrecourse;
- The type of identifiable event (e.g., foreclosure, bankruptcy); and
- If the Form 1099-C is filed in satisfaction of both the 1099-A and 1099-C requirements, the FMV also should be reported (see above).

Basic Concepts – Types of Debt

- Recourse Debt – transfer of property to lender does not necessarily release the obligor from liability
- Nonrecourse Debt – transfer of property to lender releases the obligor from liability
- Exculpatory Debt – similar to nonrecourse debt except that property does not specifically secure debt (such as debt of limited liability company)

Basic COD Concepts

- COD income is ordinary income taxable at maximum 35% rate but in some cases may be subject to exclusion. Treas. Reg. § 1.61-12
 - COD income reported by financial institutions and other lenders on Form 1099-C
- Capital gain income (including Section 1231 gain) is taxable at lower rate (currently 15% maximum)
 - Capital gain income (gross proceeds) reported on Form 1099-B (securities) and Form 1099-S (real estate)

Statutory Exclusions

- Bankruptcy
- Insolvency
- Qualified Real Property Business Indebtedness (“QRPBI”) (Noncorporate Taxpayers)
- Purchase Money Debt Reduction
- Lost Deductions Through Nonpayment
- Qualified Farm Indebtedness
- Others (generally no longer effective)
 - Qualified Personal Residence (before 2013)
 - Special Deferral Election for 2009 and 2010

Insolvency Exclusion

- Exclusion to the extent insolvent –excess of liabilities over FMV of assets
- All assets apparently included even those exempt from creditors. *Carlson*; TAM 199935002
- Contingent liabilities apparently subject to all or nothing approach
- Nonrecourse debt included in full only if it is being discharged. Rev. Rul. 92-53
- Uncertain application to partner's share of partnership liabilities
- Test applied at partner level but at S corporation level
- Test applied at owner level for grantor trusts and disregarded entities. Prop. Reg. Sec. 1.108-9 (April 12, 2011) (no inference as to current law)

Qualified Real Property Business Indebtedness

- Applies to solvent taxpayers
- Incurred or assumed in connection with real property used in trade or business
- Secured by real property
- Limit is **lesser** of (1) excess of pre-discharge principal amount over FMV of secured real property and (2) aggregate adjusted basis of depreciable real property held immediately before discharge. No “stuffing” rule.
- Incurred or assumed before 1993 or after 1993 for acquisition, construction or substantial improvement
- Elective

Purchase Money Reductions

- Reduction of debt of purchaser to seller, not of purchaser to subsequent holder of note
- Not elective – purchaser must lose basis even if it could shelter with NOLs
- Not available if purchaser bankrupt or insolvent
- *But see* Rev. Proc. 92-92 – bankruptcy or insolvency of partnership not relevant

Lost Deductions Through Nonpayment

- Matching principle or tax benefit rule
- Applies most often to cash basis taxpayers
- Applicability to amortizable capital expenditures doubtful

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Attribute Reduction General Rule – page 1

- Made after taxable income for COD year is determined
- NOLs for COD year and carryovers from prior years
- Business credits (33-1/3 cents for dollar of exclusion)
- Minimum tax credits (33-1/3 cents for dollar of exclusion)
- Net capital loss for COD year and carryovers from prior years

Attribute Reduction General Rule – page 2

- Basis in property to extent it exceeds undischarged liabilities
- Passive activity loss or credit carryovers from COD year (at 33-1/3 cents per dollar)
- Foreign tax credit carryovers from COD year (at 33-1/3 cents per dollar)
- No recognition of COD income that is not offset (not applicable to QRPBI) – “black hole” income

Attribute Reduction Election

- Elect to offset all or part of COD income against depreciable property first
- Any COD income not subject to election is thrown back to General Rule
- Depreciable property held as beginning of year following COD year
- Basis reduced without regard to undischarged liabilities

Attribute Reduction Election – Continued

- Portion of partnership interest treated as depreciable property
- Portion of stock of consolidated subsidiary treated as depreciable property
- Sub-election to treat real property inventory as depreciable property
- Personal property recapture under Section 1245 as if basis reductions were depreciation deductions
- Real property recapture under Section 1250 to the extent basis reduction exceeds SL depreciation of unreduced basis. Vanishing detriment.

Attribute Reduction (QRPBI)

- Mandatory reduction of **depreciable real property** (ONLY) held as of beginning of year following COD year
- **But** property disposed of in COD year treated as if basis has been reduced immediately before disposition
- Election to treat real property as inventory **unavailable**
- Basis of real property securing debt comes first
- Lookthrough to reduce basis of partnership interest
- Basis of interest in partnership with COD income reduced first
- Remaining COD income from partnership offset against other depreciable real property basis of taxpayer

Reporting of COD Income by Debtor

- Refer back to 1099-C
 - Instructions for Debtor
 - Box 6 Code – Reason for Filing
- IRS Form 982
 - Used to report the exclusion and the reduction of certain tax attributes
 - Filed with federal income tax return for a year a discharge of indebtedness is excluded from your income

Reporting on IRS Form 1040

- Must be reported whether or not excluded
- If you get a 1099-C, report as ordinary income then claim exclusion

Planning to Reduce Income

- Exclusions described above
 - Just because a 1099-C is issued does not mean there is income
- Other Possible Considerations Within Debtor's Control
 - Election (in many situations) to file for bankruptcy protection;
 - Ability to determine the timing of the discharge of indebtedness;
 - Election to claim the QRPBI exclusion;
 - Election to reduce the basis of the taxpayer's depreciable property before reducing other tax attributes; and
 - Potential opportunity to do tax planning for the year of the discharge of indebtedness.