

An Overview of the Rules Regarding the Realization and Recognition of Debt Cancellation Income

Related Practice Areas

- Tax

This paper describes how the income tax rules relating to debt cancellation income (COD income) work. The COD income rules sweep broadly across the whole range of business transactions and apply across all types of business entities. Their approach is not uniform, however. Some of the rules are applicable only to corporate debtors and some only to business entities taxed as partnerships. Because of the breadth of their reach, and the idiosyncratic application of some of the rules, taxpayers must take great care when trying to parse the income tax effect of restructuring debt, or discharging debt at a discount, where the restructuring or discharge could result in COD income. Previously, we released two papers that deal with tax issues related to restructuring debts of borrowers and modifying the terms of leases.

Our discussion is organized into two parts. Part I focuses on the general COD income rules and points out some of the decisions and judgments that must be made in navigating these rules. Part II will focus more precisely on the COD income rules that apply to real estate indebtedness. This paper was prepared in conjunction with the other papers that address certain related topics that arise in connection with restructurings of economically distressed business entities. For an overview of the income tax issues involved in the acquisition, restructuring, and disposition of so-called “distressed debt”, see our paper on [Tax Issues to Consider in Buying or Holding Distressed Debt](#).

part i — the basic principles applicable to the taxation of debt cancellation income

Realizing and recognizing COD income, and its collateral consequences, have become hot topics, politically, as a result of the IRS pronouncement regarding the deductibility of expenses of taxpayers funded from the proceeds of a Paycheck Protection Program loan (a PPP loan). The PPP loan is loan program enacted as part of the CARES Act that provides loan proceeds to eligible businesses to be used generally for payroll costs, including health care premiums, mortgage interest, rent, utilities, and other related expenses. Not more than 25 percent of the proceeds can be used for non-qualified costs. For businesses meeting the conditions, the amount of the PPP loan can be forgiven and the CARES Act exempts the amount of the loan forgiven from being included in the income of the borrower, to the extent that no other COD income exclusion applies.

The IRS analyzed the provisions of the CARES Act and the Code Sec. 108 rules relating to the exclusion of COD income from the borrower’s gross income and determined that, to the extent the”

CARES Act operates to exclude from gross income the amount of a covered loan forgiven under section 1106(b) of the CARES Act, [the forgiveness] results in a “class of exempt income” under § 1.265-1(b)(1) of the Regulations. Accordingly, section 265(a)(1) of the Code disallows any otherwise allowable deduction under any provision of the Code, including sections 162 and 163, for the amount of any payment of an eligible section 1106 expense to the extent of the resulting covered loan forgiveness (up to the aggregate amount forgiven) because such payment is allocable to tax-exempt income. Consistent with the purpose of section 265, this treatment prevents a double tax benefit.

This interpretation, which is consistent with the statute, the Code, prior case law, and fundamental tax policy, has been the subject of much critical political comment. Whatever the ultimate outcome, the IRS analysis focuses attention on how the COD income rules apply across broad categories of income and this paper will discuss those rules and address why the IRS interpretation is a correct application of the rules.

Background — The COD income rules attempt to impose symmetry on the rules dealing with income and deductions as they relate to debt discharges

This paper discusses when COD income is realized for income tax purposes, what are the circumstances in which COD income is not included in the taxpayer's gross income, what are the elections available to taxpayers to defer the recognition of COD income, and how is COD income measured in common circumstances. The COD income rules apply to a vast number of transactions and circumstances. This paper will provide a high-level view of these rules and their application to common transactions. It is no substitute for tax and legal advice addressed to your specific circumstances.

COD income, or income from the discharge of indebtedness, is one of the 14 separate categories of taxable income enumerated in Section 61 of the Code. Simply stated, a borrower realizes gross income to the extent that the borrower is relieved of a liability or obligation to repay a debt that it incurred or that encumbers property owned by the borrower. That income, COD income, is taxable to the borrower as ordinary taxable income.

The requirement that a borrower recognize gross income from the discharge of a debt or liability is simply a corollary of the income tax principle that no taxable income is recognized to a borrower from the receipt of proceeds of a bona fide loan. That is, if the loan proceeds are not recognized as income, the borrower must recognize gross income when the obligation to repay that amount is cancelled or terminated and the borrower recognizes an accession to wealth from the forgiveness. It is like a child's seesaw. The realization of taxable income restores the tax system to equilibrium and eliminates what would otherwise be an imbalance in the tax system. The recognition of the COD income is another thing entirely. Code Sec. 108 has a series of complex rules that address when COD income that has been realized by the borrower must be recognized as gross taxable income by the borrower. Taxpayers' advisers can mine diamonds within the fissures and cavities of the COD income recognition rules.

Thus, if the creditor forgives or cancels some or all of the outstanding indebtedness of the borrower, the borrower generally realizes gross taxable income in the amount of the debt forgiven or cancelled. That simple COD income rule is made more complicated, as is often the case with simple rules in the Code, by provisions that defer the recognition of, or exclude from gross income entirely, amounts that would otherwise be COD income. These rules also take into account actions by related parties in determining whether COD income has been realized by borrowers. Finally, as the guidance regarding the PPP loan payments illustrates, the COD income rules are also affected by the long-standing rules in the Code that deny taxpayers deductions for otherwise deductible expenses that are allocable to tax-exempt income. As a result, our path through the COD income rules will be somewhat more roundabout.

COD income results when a debt obligation or liability of the borrower is cancelled or discharged, in whole or in part, by the holder of the obligation or liability or by the operation of law

Example One: Corporation M, an accrual method taxpayer, is solvent but is struggling to pay its bills because of a cash flow issue involving the lag in payments received from its customers. The cash flow question is unlikely to be resolved quickly. M outsourced its maintenance and security services to Q, Inc. M and Q negotiated for a reduction in the outstanding balance that M owes to Q for the services provided by Q. In exchange for the immediate payment on account of its outstanding accounts payable and a discount on future invoices, M will pay 75 percent of its currently outstanding accounts payable and Q will cancel the remaining 25 percent. M will realize COD income on account of the 25 percent of its accounts payable that are cancelled by Q, although the recognition of that amount of gross income could be subject to one or more special rules under the Code.

Suppose that M formed a single-member LLC, wholly owned by M, and had the LLC make the payment equal to 75 percent of the outstanding accounts payable to the vendor in exchange for the assignment to the LLC by the vendor of 100 percent of the accounts payable. Post-acquisition, the accounts payable were not cancelled or forgiven but, because they are owned by a DRE of M, they have been extinguished as a matter of economics. Because the separate existence of the LLC is

ignored for federal income tax purposes, M is treated as having acquired the accounts payable at a discount and realizes COD income. The result is the same as in the immediately preceding example.

The two previous cases in Example One deal with debt acquired directly and indirectly through a DRE by the borrower. Suppose instead that a person or entity that is part of the same economic unit as the borrower, but is not the borrower, acquires the debt? For example, assume that M checked the box for the LLC as part of its initial classification election so that it was taxable as a corporation rather than a disregarded entity. M and the LLC do not expect to file a consolidated return in the year that the accounts payable are acquired. Nevertheless, because the accounts payable are acquired by a person or entity that is “related” to M through ownership, COD income is realized by M under the so-called related party acquisition rules. The result in that case is fair because M and its subsidiary, the LLC taxed as a corporation, are effectively a single economic unit even though they file separate income tax returns.

Example One illustrates some of the intricacies of the COD income rules. Taxpayers and their counsel need to focus not only on changes in the underlying debt or liability, but also acquisitions of the debt by related parties and whether the COD income, if realized, needs to be recognized as gross income by the borrower. In the first case in Example One, the purchase at a discount of the accounts payable for services rendered, the result could be different if the accounts payable were for **property** purchased by the borrower. In that case, the borrower might have treated the discounted repayment as a “purchase price” reduction, not included as gross income, provided that the borrower was solvent and the accounts payable continued to be held by the vendor at the time of payment (but not if the vendor has assigned the receivable to a factor, however). Depending on the circumstances, the borrower may not be confident the vendor continued to hold the accounts receivable. A reasonably well advised taxpayer would button that down, however.

COD income can result when the borrower’s indebtedness is acquired by a person that is related to the borrower or anticipates becoming related to the borrower and the test of related party status can be deceptive

In Example One above, COD income is realized when the accounts payable are acquired by a member of the M Corporation economic unit. Basically, the Code is making a determination that, in the case of certain ownership arrangements, the parties should be treated as a single taxpayer for the purpose of determining COD income. That principle is incorporated more broadly in the related party debt acquisition rules of Section 108(e)(4) of the Code. Under that provision of the Code, the acquisition of debt from an unrelated holder by a person or entity “related” to the borrower is treated as the acquisition of the debt by the borrower. Therefore, as in the case above, COD income cannot be avoided by having a person or entity within the same economic unit as the borrower acquire the borrower’s debt at a discount from an unrelated holder.

Although stated simply in concept, the details are more complicated and, as in any rule-based system of attribution, provide a map that can be followed to structure the acquisition of the borrower’s debt obligation by a cooperative person or entity that is unrelated under these rules. The related party determination is based on two sets of rules in the Code that are designed to identify groups of relationships where it is appropriate to view the members of the group as acting within the same economic unit so that transactions between or among members of the group are presumed to take place between or among persons with common economic interests. These related party rules are just that: rules. Where a person is related because they own more than 50 percent of the stock of a corporation, that relationship can be broken if the individual transfers enough stock to an unrelated person to reduce their ownership position to 50 percent or less. Close is not enough to be related. The rules are a cliff. Break the plane and you fall. Creep up to the edge, but not over, and you are safe. Of course, this assumes there are no undisclosed arrangements or “side letters” between the parties that could lead to the conclusion that the parties were related, taking into account the understandings or arrangements.

Common circumstances in which persons or entities are treated as related for these purposes include the following:

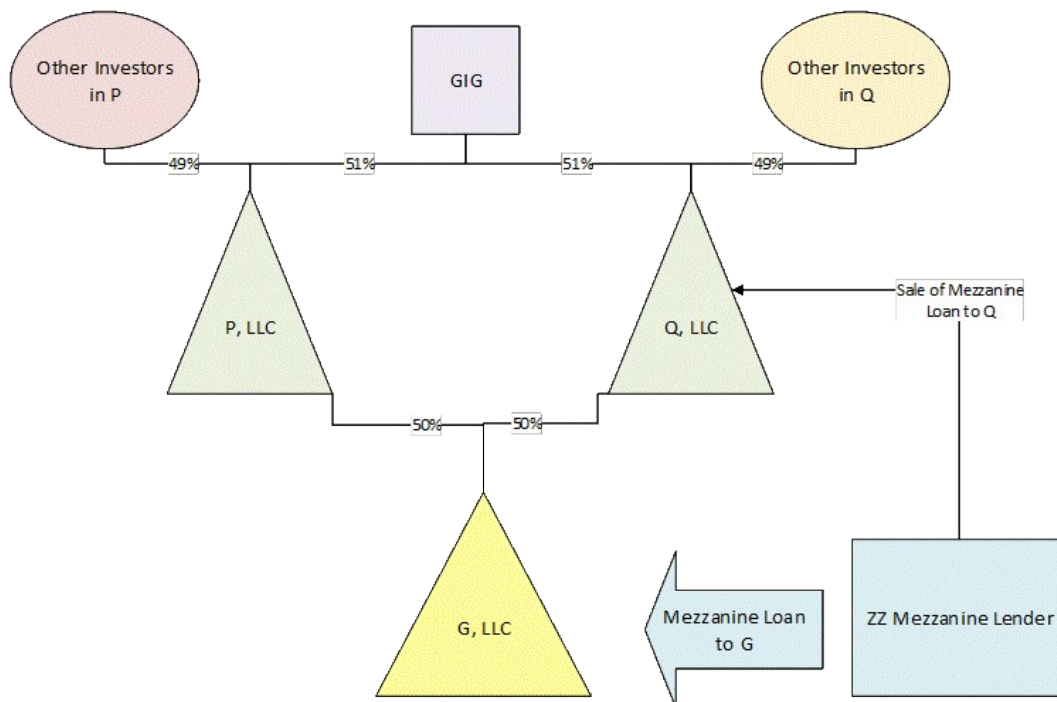
- Members of a family are treated as related persons. The term family includes a taxpayer’s spouse, ancestors, lineal descendent, and siblings.

- Corporations that would be members of a Section 1563(a) “controlled group” if the common ownership threshold were more than 50 percent are treated as related. Shareholders, partners, and beneficiaries are treated as owning interests owned by corporations, partnerships, and trusts, in proportion to their ownership of the entities.
- An individual and a corporation in which the individual owns greater than a 50 percent interest (by value) are related.
- Corporations and partnerships where the same persons own more than 50 percent of the value of the corporation’s stock and more than 50 percent of the capital or profits interests in the partnership are related.

Those are but a few of the related person relationships. In addition, there is a constructive ownership rule that, under certain circumstances, reattributes interests owned constructively by a person to certain other persons or entities related to that person. Determining whether and to what extent persons or entities are related for this purpose usually requires a granular analysis of the ownership of the entities and underlying beneficial owners. In many cases, borrowers and their advisers will be aware of the interrelationships among the parties. That is not always the case, however, particularly where the ownership of a business entity is divided among separate, independent entities or persons that act in their separate economic interests.

Example Two: G LLC, a joint venture between two separate LLCs, P and Q, operates a chain of retail stores specializing in home furnishings. G LLC has several outstanding liabilities, including a liability to ZZ Lender, Inc., a mezzanine lender. P and Q are each investment funds and each owns a 50 percent interest in the profits and capital of G LLC. GIG, a foreign wealth fund organized as an entity taxed as a C corporation for U.S. income tax purposes, owns a 25 percent interest in the profits and capital of both P and Q.

The ownership and relationships are shown in the diagram below:



ZZ approaches Q and offers to sell its mezzanine loan position owed by G for \$.50 on the dollar, i.e., a discount of 50 percent to the amount outstanding. Because the mezzanine loan documents give the holder certain rights in the event of a default by G, Q purchases the loan.

On its face, the acquisition by Q does not appear to be an acquisition by a person related to G because Q’s interest in both the profits and capital of G is **not more than 50 percent**. On its face, the acquisition of the mezzanine loan position does not appear to run afoul of the related party debt acquisition rules. A more granular analysis shows that looks can be deceiving. The P and Q ownership interests in G are attributed to their members in proportion to their ownership of

P and Q. Therefore, GIG is treated as owning a 25.5 percent interest (51 percent × 50 percent) in G attributed from P and a 25.5 percent ownership interest in G attributed from Q (51 percent × 50 percent), totaling a 51 percent interest in the profits and capital of G in the aggregate. There is no attribution of that 51 percent interest back into Q, however. On the other hand, Q and G are treated as related under the Code Sec. 707(b) rules because the same persons (the owners of GIG) are treated as owning more than 50 percent of the capital or profits of each entity. As a result, the acquisition by Q generates COD income to G that is allocated among its members in accordance with the LLC agreement.

The takeaway from Example Two is that this type of granular analysis is required in any debt or liability acquisition where there is a possibility that the borrower could be related to the transferee of the debt.

The related party acquisition regulations were adopted in 1992. As a result, the regulations do not have the type of “anti-avoidance” proscriptions that became more common in regulations adopted after that time. See, e.g., Treas. Reg. § 1.702-2. Thus, there are opportunities available to complete debt acquisitions that take advantage of the roadmap set forth in the rules that might not be available if taxpayers and their advisers needed to account for an overall anti-avoidance rule in the regulations, e.g., a proscription against transactions undertaken “with a view to” avoiding the related party rules.

Debt acquisitions by related persons are divided into two categories: direct acquisitions and indirect acquisitions.

Direct acquisitions occur when the debt obligation of the borrower is acquired at a discount by a person who is related to the borrower at the time of the acquisition **from a person unrelated to the borrower**. For example, if a more than 50 percent owner of partnership capital or profits acquires a promissory note of the borrower-partnership from a third party, that acquisition would be an acquisition by a related person, creating the possibility of COD income to the borrower. On the other hand, if the owner of a more than 50 percent interest in the profits of the partnership acquired the note from a person that owned a more than 50 percent interest in the capital of the partnership that would be an acquisition from a related person and would not run afoul of the related party rules.

Indirect acquisitions occur where a person not related to the borrower acquires debt of the borrower in anticipation of becoming related. In a sense, this is a regulatory step-transaction rule that establishes a relationship (and, possibly COD income) in cases where the debt acquisition is carried out as part of a plan. If the debt holder acquired the debt fewer than six months before the date on which the debt holder moves into a relationship with the borrower, the debt is presumed to have been acquired in anticipation of becoming related to the borrower and the related-party debt acquisition rules of the Code will apply. If the related party status is entered into between six and 24 months following the acquisition of the debt, the debt holder either must treat the debt as having been acquired in anticipation of becoming related or the borrower must file a disclosure on its tax return. In the absence of a disclosure, the acquisition is presumed to have been “made in anticipation” of becoming related. Disclosure is also required if, on the date on which the holder becomes related to the borrower, the debt represented more than 25 percent of the fair market value of the total gross assets of the holder.

In the case of both a direct and indirect acquisition, the COD income arises only where the debt is acquired at a discount to its amount outstanding.

Mechanism for calculating the amount of COD income and the so-called “correlative adjustments” when debt is acquired by a related person to the borrower.

In the “plain vanilla” case in the first portion of Example One, Corporation M’s indebtedness is extinguished in exchange for a payment of cash. Because the obligation or liability is satisfied by the transfer of money or property from the borrower to the holder of the obligation, there is no need to take into account any future tax items from the obligation. It has been extinguished for income tax purposes.

Where the debt is acquired by a related person, or by a person in anticipation of becoming related,

the analysis is more complicated. The complication arises because the debt or liability remains outstanding for income tax purposes subsequent to its acquisition and the realization by the borrower of the COD income. This is the difference between the second case in Example One (acquisition by a disregarded entity subsidiary of the borrower) and the third case (acquisition by a wholly owned subsidiary taxable as a corporation). In the third case, the purchased indebtedness is held by a separate taxable entity that is a related person to the borrower. Because it has not been modified, the amount required to be paid under the obligation remains the same, although its adjusted basis in the hands of the purchaser reflects the discounted purchase price for the payable.

In both cases, the amount of the COD income realized by the borrower generally is equal to the excess of the outstanding amount of the debt over the related person's adjusted tax basis in the debt on the acquisition date of the debt, where the holder was related or became related within six months of the acquisition date. There is a special rule applicable where the debt was incurred *in anticipation of becoming related* and the relationship did not come into being until more than six months following the acquisition date. In that case, the amount of the COD income is measured by the excess of the outstanding amount of the debt over the fair market value (FMV) of the debt in the hands of the holder on the acquisition date. Under the indirect acquisition rules, the term "acquisition date" means the date on which the holder of the debt that was acquired in anticipation of becoming related, in fact, becomes related to the debtor.

Under the regulations, when a person related to a borrower acquires debt of the borrower, whether directly or indirectly, the borrower's indebtedness is treated as constructively retired in exchange for new indebtedness of the borrower deemed to have been issued on the acquisition date. The issue price for the newly issued debt is the amount of the holder's adjusted income tax basis (unless the alternate FMV rule noted above applies, in which case the issue price is the FMV of the debt on the date the relationship come into being). The reissued debt is then tested under the original issue discount (OID) rules to determine if there is OID. In most cases, that formula will create OID in the hands of the holder (assuming that the debt is not immediately modified), which would accrue over the remaining term of the debt as ordinary taxable income in the hands of the holder. Conversely, the borrower would be entitled to additional deductions for the amount of the OID as it accrues, subject, however, to any Code provisions that limit or affect the ability of the borrower to deduct the interest, e.g., the limitations on the deductibility of interest under Code Sec. 163(j). This deemed issuance of a new debt instrument results in the correlative adjustments referred to above. Because the debt remains outstanding, but the amount of the debt as to the borrower is reduced by the COD income realized, adjustments must be made between the borrower and the holder so that the amount of the discount results in additional interest deductions and interest income over the remaining term of the debt. Therefore, if the debt is repaid at its stated amount upon its maturity, no additional income or loss need be accounted for.

The related holder of the debt does not recognize gain or loss on the deemed issuance of the new debt by the borrower. Where the alternate rule for determining the issue price, i.e., FMV on acquisition date, applies and the issue price is based on FMV on the acquisition date, the difference between the FMV and the holder's adjusted tax basis is accounted for as an acquisition premium or market discount item. No gain or loss is recognized at the time of the acquisition. The holder would be treated as having acquired debt with "market discount," however. *As described in our paper regarding distressed debt*, the amount of the market discount with respect to the debt will accrete as ordinary taxable income over the remaining term of the debt.

There is additional complexity in the treatment of the transaction where the borrower's debt is acquired in a transaction in which gain or loss is not otherwise recognized.

The consequence of these rules is that the borrower realizes COD income, which may or may not be taxable immediately, and additional interest deductions over the remaining term of the debt, and the holder recognizes additional ordinary taxable income over the remaining term of the debt. If the amount ultimately paid by the borrower to retire the debt is less than the purchaser's acquisition cost, plus OID accretions, the holder will have a capital loss.

Under what circumstances can COD income be deferred or excluded from gross income, in whole or in part, and at what tax cost?

The previous discussion focused on **when** COD income is **realized** by the borrower. The **amount** of COD income required to be included in the borrower's gross income is a separate question and requires the application of several rules that determine the amount of COD income required to be recognized.

The code provides a number of special COD income exclusions or deferral opportunities. The price for the deferral or exclusion is usually a reduction in the adjusted tax basis of certain assets or tax attributes, e.g., NOL carryovers, of the taxpayer. Although an in-depth discussion of the specific assets or tax attributes required to be reduced, and the order of their reduction, is beyond the scope of this paper, some of the more important rules that come up frequently are summarized below.

The first, and most important, rule is that no COD income is recognized by a borrower to the extent the borrower is insolvent and is not rendered solvent as a result of the discharge. If the borrower is rendered solvent, the amount of the COD income recognized is limited to the amount by which the borrower is rendered solvent. Because this is such an important and powerful rule of COD income absolutism, its application is circumscribed.

No COD income is recognized as a result of a discharge of the debt obligation or liability under a Bankruptcy Title 11 proceeding.

If the debt discharged is "qualified real property business indebtedness" **and the borrower is not a C corporation**, the borrower can elect not to recognize the COD income, to the extent of the outstanding amount of the discharged debt in excess of the FMV of the property securing the debt, provided that the borrower reduces its adjusted basis in certain assets.

Generally, a taxpayer that is able to exclude COD income from its gross income is required to reduce tax attributes, e.g., NOLs, business credits, capital loss carryovers, and passive activity carryovers, by the amount excluded from gross income. What these related tax attribute reductions accomplish is tax symmetry. To the extent that the debt or liability did not result in taxable income, the taxpayer is required to reduce its tax attributes in order to avoid a "double-dip."

There is an important qualification to these exclusions and attribute reductions in the case of partners and partnerships. In the case of partnerships, meaning all domestic, multi-member, unincorporated business entities that have not elected to be classified as corporations for tax purposes, the bankruptcy and insolvency exclusions, the qualified real property business indebtedness exclusion, and the tax attribute reductions required when the taxpayer excludes COD income from its gross income, are determined and applied **at the partner level and not the partnership level**. This recognizes the fact that the partners rather than the partnership are the taxpayers. This is reflected in the fact that the COD income is reported as gross income at the partnership level and carried through and stated separately on the partners' K-1s (in Box 11 on the Form K-1), and the exclusions that might be otherwise available are determined on a partner-by-partner basis.

The IRS issued a Revenue Procedure in which it determined that it would not challenge a partnership's treatment of a reduction of an indebtedness owed by such partnership as a purchase price adjustment (thereby excluded from the borrower's income), provided that the purchase price adjustment would otherwise qualify as a purchase price adjustment under Section 108(e)(5) but for the bankruptcy or insolvency of the partnership.

Some partnerships might try to allocate COD income to partners better able to exclude the amount of COD income from their gross taxable income, e.g., partners that are insolvent. The IRS addressed this technique in a published Revenue Ruling in which it concluded that an allocation to a partner of a share of the partnership's COD income that differs from the partner's share of the cancelled debt under Code Sec. 752(b) has substantial economic effect only if: (1) the partnership has deficit restoration obligations covering any negative capital account balances resulting from the COD income allocations that can be invoked to satisfy other partners' positive capital account balances, (2) the requirements of the economic effect test are otherwise met, and (3) substantiality is established independently. Applying the substantiality rule, the IRS concluded that partnership special allocations **lacked substantiality** when the partners amended the partnership agreement to specially allocate COD income and book items from a related revaluation after the events

creating such items have occurred where the overall economic effect of the special allocations on the partners' capital accounts did not differ substantially from the economic effect of the original allocations in the partnership agreement. In the ruling, the COD income was allocated to a partner that was insolvent.

In another published ruling, the IRS concluded that a partnership's discharged excess nonrecourse debt should be treated as allocable to the partner who, in the absence of the insolvency or other Code Sec. 108 exclusion, would be required to pay the tax liability arising from the discharge of that debt. Therefore, a partnership's discharged excess nonrecourse debt was treated as a liability of the partners for purposes of measuring the partners' insolvency under Code Sec. 108(d)(3) based upon how the COD income with respect to that portion of the debt would be allocated among the partners under Code Sec. 704(b) and the regulations.

Where state or local income taxes at the partnership level are determined based on the federal taxable income or gross income of a partnership, care should be taken in dealing with COD income for which a partner-level exclusion is available. The gross income would be reported on the partnership's Schedule K, and could be subject to state or local taxation, even though each partner could have one or more partner-level exclusions available to offset the income on their individual federal income tax return. Therefore, the partnership could be subject to state or local taxes notwithstanding the COD income would be excluded from the net income of the partners. Because the COD income is a partner-specific item reported on Schedules K and K-1, rather than line 1 of the Form 1065, care needs to be taken in the reporting of this item of gross income. A state or local income tax form that calculates tax liability by reference to the entity's "net income" as reported to the IRS might fail to add-back the amount of the separately reported COD Income.

It is the position of the IRS that a partner's share of COD income excluded by a partner under the insolvency exception still increases the adjusted basis of the partner for her partnership interest. Provided that the COD gross income matches the reduction in the partner's share of the discharged liability, the discharge should not result in a constructive cash distribution under Code Sec. 752.

The important takeaway is that dealing with COD income in the case of partnerships is not straightforward. Some of the approaches commonly thought to apply by business people will not produce the desired tax result. Only careful planning before the COD income is realized will allow for the successful navigation of the COD income and partnership allocation rules.

In the case of S corporations, the COD income is recognized **by the corporation** and allocated as an item of income to the shareholders under the usual S corporation rules. Even though partnerships and S corporations are treated as pass-through entities for income tax purposes, the COD income exclusion and attribute reduction rules are not the same. Insolvency or bankruptcy is determined at the S corporation level rather than at the shareholder level (which would be the case for partners in a partnership). COD income amounts that are excluded from the S corporation's income may reduce the losses that are suspended for a particular shareholder, but only in the immediately succeeding year. To the extent that the COD income is excluded from the S corporation's income because the corporation is in bankruptcy or is insolvent, the shareholders do not increase their bases for the excluded COD income.

In the real estate context, an important tool for dealing with COD income is the exclusion for COD income attributable to qualified real property business indebtedness. The exclusion of COD income attributable to qualified real property business indebtedness is discussed in [Part II of our papers dealing with debt cancellation income](#).

Some of the other important exclusions available to taxpayers to avoid recognizing COD income include the following:

For cash method taxpayers, to the extent that the payment of the liability or obligation would have given rise to a deduction, e.g., rental expense for property used in a trade or business, the discharge of that liability does not give rise to COD income.

In the case of a **solvent taxpayer**, a reduction in the amount of a payment obligation owed to the seller of property, i.e., purchase money debt or an account payable owed to a vendor, does not generate COD income to the buyer and the amount of the reduction is treated, instead, as an

adjustment to the purchase price of the asset acquired. (It reduces the adjusted basis of the asset in the hands of the purchaser.) Note that this exception applies only to debt owed to the seller and not debt owed to a third party (other than the seller) that was incurred in connection with the purchase of an asset. In Example One, the final variation in the facts involved an account payable that was generated by a sale of property to M and was held by the vendor at the time of the discharge at a discount. The discounted payment should be treated as a purchase price reduction. That assumes, of course, the borrower continues to own the asset. Further, if the vendor had sold its accounts receivable to its factor, a discounted satisfaction of the receivables owned by the factor, rather than by the vendor, would not qualify for the purchase money debt reduction exclusion.

There is a body of case law involving indebtedness where either the amount of the debt, or the fact of liability, is in dispute. In these cases, the courts have held that if a taxpayer, in good faith, disputed the amount of a debt, a subsequent settlement of the dispute would be treated as the amount of debt cognizable for tax purposes. The excess of the original debt over the amount determined to have been due is disregarded for both loss and debt accounting purposes.

Finally, there are three important rules dealing with contributions of debt to the capital of the borrower that borrowers and their counsel should be mindful of:

If a borrower-corporation acquires its debt obligation as a capital contribution from a shareholder (as opposed to in exchange for the issuance of stock), the corporation is treated as having satisfied the debt in exchange for cash equal to the shareholder's adjusted basis in the debt. Assuming that the shareholder acquired the debt at a discount (and was not a related person), or was a shareholder of the S corporation that was allocated losses that reduced her adjusted basis in the loan to the S corporation, COD income is triggered at that point. If the shareholder was treated as a related person, the COD income would likely have been triggered already.

If the debt is debt of a corporate or partnership borrower and the debt is satisfied in exchange for the issuance of stock or an interest in the partnership, the corporation/partnership borrower is treated as having satisfied its indebtedness with an amount of money equal to the FMV of the stock or partnership interest transferred to the holder of the debt. This rule is applicable where the holder of the debt is not a related person because, if the holder was a related person, the acquisition of the debt would have triggered COD income under the rules described above. This rule most often arises where a distressed corporation or partnership issues an interest in itself to unrelated creditors in satisfaction of their claims. In accordance with the rules noted above, COD income is recognized by the partnership and is required to be allocated to the partners who were members of the partnership immediately before the debt discharge. In the case of an S corporation, care must be taken that the holders of the debt or other obligation are qualified to be S corporation shareholders on the date of the issuance of the shares in exchange for the debt.

If the borrower (corporation or partnership) issues a debt instrument in satisfaction of its indebtedness, the borrower is treated as having satisfied the discharged obligation for an amount of cash equal to the issue price of the debt instrument. This means that the partnership/corporation borrower recognizes debt-discharge income to the extent that the value of the partnership interest/stock is less than the outstanding debt. Obviously, the rule in the regulations regarding the issue price of the debt instrument issued in the deemed exchange in the case of a related party acquisition supersedes this rule that is applicable to an actual exchange.

This completes Part I of the paper. As you may have observed, the recognition of COD income fundamentally is premised on a tax symmetry principle. That is, if the receipt of an amount is not includible in the taxpayer's income because the taxpayer has an obligation to repay the amount, a termination of discharge of that repayment obligation has debt cancellation income consequences to the borrower. That is the case with the PPP loans described in the introduction to this discussion. The amounts were treated as loan proceeds and, when the loan was forgiven the tax system needed to be made symmetrical. Therefore, the deductions funded by the proceeds of the loans were disallowed in the IRS guidance because, otherwise, the taxpayers receiving the PPP loans would h
