

A person wearing a light blue dress shirt is seen from the chest down, sitting at a wooden desk. They are looking at several tax forms, some of which have the word "TAX" printed on them. The forms are spread out on the desk, and the person's hands are visible as they handle the papers.

# General Rules of IRC Section 108: *Income From Discharge Of Indebtedness*

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A person wearing a grey pinstriped suit jacket and a light-colored shirt is seen from the chest down, sitting at a wooden desk. They are holding a black pen in their right hand and pointing it at a tax form. Their left hand is holding the form steady. A silver laptop is open to the right of the person. Several other tax forms are scattered on the desk, some with the word "TAX" printed on them.

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## **General Rules of IRC Section 108 - Income From Discharge Of Indebtedness**

A. General Rule. Reduction of indebtedness through compromise, negotiation, release, forgiveness or otherwise gives rise to cancellation of indebtedness income ("COI income" or "COD income"). IRC §61(a)(12); Reg. §1.61-12(a); U.S. v. Kirby Lumber Co., 284 U.S. 1, 52 S.Ct. 4, 76 L.Ed. 131 (1931).

B. Exceptions to General Rule. Gross income does not include COD income if:

- (a) the discharge occurs in a title 11 case;
- (b) the discharge occurs when the taxpayer is insolvent;
- (c) the indebtedness discharged is qualified farm indebtedness; or
- (d) In the case of a taxpayer other than a C corporation, the indebtedness discharged is qualified real property business indebtedness.
- (e) The discharged indebtedness is a qualified principle indebtedness which was either discharged or subject to an arrangement evidenced in writing, prior to January 1, 2018.<sup>1</sup>

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<sup>1</sup> IRC § 108(a)(1)(E)

C. Consequences of Exclusion. The exclusion from gross income under §108 of COD income is generally considered to operate as a deferral of the income because the taxpayer is required to reduce certain tax attributes. Theoretically, the taxpayer will recognize this income at a later date<sup>2</sup>.

(a) Unless the taxpayer elects to first reduce the basis of depreciable property under §108(b)(5), the order of reduction of tax attributes is as follows<sup>3</sup>:

- i) Any NOL of the taxable year of discharge, or carried over to the taxable year of discharge;
- ii) Any carryovers to or from the taxable year of discharge of an amount for purposes for determining the amount allowable as the general business credit under IRC §38;
- iii) The amount of the minimum tax credit available under IRC §53(b) as of the beginning of the taxable year immediately following the taxable year of the discharge;
- iv) Any net capital loss of the taxable year of discharge, or carried over to the taxable year of discharge;
- iv) Reduction in basis of the property of the taxpayer;

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<sup>2</sup> IRC § (b)(1)

<sup>3</sup> IRC §(b)(2)

- v) Any passive activity loss and credit carryovers of the taxpayer;
- vi) Any foreign tax credits from, or carried over to the taxable year of discharge.

D. Complexity of Rules Dictates Extreme Caution. The rules under §108 include intricate provisions which must be followed carefully in attempting to steer clear of any COD income in representing the insolvent taxpayer. Examples of some of the provisions which should be kept in mind are the following:

- (a) Special rules for S Corporations and partnerships provide generally that §108 rules for insolvency exclusion apply at the corporate level for S corporations but at the partner level for purposes of determining insolvency of taxpayer.<sup>4</sup>
- (b) Purchase money debt may be treated as a reduction of basis of property acquired if reduction does not occur in a title 11 case or while debtor is insolvent, but debt must be held by original seller at time of reduction for these rules to apply.<sup>5</sup>
- (c) If debt is contributed to capital of a corporation by a stockholder to whom the debt is owed, IRC §118 does not apply and it is treated as if the

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<sup>4</sup> IRC §108(d)(6) and (d)(7)

<sup>5</sup> IRC §108(e)(5)



corporation satisfied the debt with money equal to the shareholder's adjusted basis in the debt.<sup>6</sup>

(d) Acquisition of debt by a person related to the debtor may result in COD income being triggered, whereupon taxpayer has to look to §108 rules to determine whether it may be excluded from gross income.<sup>7</sup>

(e) Although formerly (prior to 1993) exchange of stock of debtor corporation or partnership interest in debtor partnership for outstanding debt was not considered to be a discharge of indebtedness to the corporation, under the current rules, an exchange of stock for debt outside of a Title 11 proceeding is treated as though the debt is being canceled in return for the fair market value of the stock received. If property in addition to stock is received, it is treated as if the FMV of the property paid down the debt. IRC §108(e)(8)

EXAMPLE: X Corp. owes Y \$1,000. X and Y agree to exchange stock worth \$500 and property worth \$200 for the debt. The result is \$300 of COD income.

- E. Attribute Reduction Applies To Estate In Bankruptcy.  
In any case under Chapter 7 or 11, where the bankrupt is an individual, the reduction of tax

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<sup>6</sup> IRC §108(e)(6)

<sup>7</sup> IRC §108(e)(4)

attributes required under §108 apply to the estate. Thus, in cases where §1398 applies, the tax attributes reduced are those of the estate and not the debtor/taxpayer. Although the debtor will succeed to the tax attributes of the estate upon termination of the estate, they will be reduced to the extent of any debt which has been discharged in the bankruptcy case.

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