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Congress, COVID, and COD

by Donald B. Susswein and Ryan P. McCormick

Donald B. Susswein

Ryan P. McCormick

Donald B. Susswein (don.susswein@rsmus.com) is a principal in the Washington National Tax office of RSM US LLP. Ryan P. McCormick (rmccormick@rer.org) is senior vice president and counsel to The Real Estate Roundtable. They appreciate the helpful comments and assistance of Kyle Brown, Nick Gruidl, Nick Passini, Stefan Gottschalk, Frank Creamer Jr., and Jeffrey DeBoer.

In this article, Susswein and McCormick explain why Congress should allow all distressed borrowers, even if solvent, to exclude cancellation of debt income to the extent that they reduce the basis of their depreciable and nondepreciable assets. They model their proposal after tax rules similar to those that applied before 1980, modifying them to more clearly reflect the borrower's overall net economic income or loss.

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In theory, the tax code treats debt forgiveness as a taxable event requiring the borrower to pay income taxes, at ordinary tax rates, on the amount of debt that is reduced, discharged, or canceled — generally referred to as income from the discharge of indebtedness, or cancellation of debt (COD). In practice, when economic conditions worsen, Congress has second thoughts. Members of the taxwriting committees are currently reconsidering rules that apply when lenders forgive all or a portion of a distressed borrower's indebtedness. Although the immediate impetus is the current economic downturn, Congress and the courts have long sensed that the case for taxing distressed borrowers — who are typically suffering an overall economic loss, not an overall gain — is questionable tax policy[1] and often even worse economic policy. That is why the tax policy pendulum seems to swing between harsh rules when times are good to more flexible rules in times of economic hardship. Ideally, Congress will consider and adopt COD reforms that, even if they are only temporary, will point the way toward a more sensible permanent regime.

The main contenders for a temporary remedy, perhaps applying to COD arising between March 13, 2020, and December 31, 2023, appear to be the following:

1. complete forgiveness of the tax on debt forgiveness income without any reduction in the borrower's tax deductions, losses, basis, or other tax attributes (this is the relief that Congress apparently intends to apply to loans forgiven under the Paycheck Protection Program (PPP));
2. allowing all taxpayers to defer COD for a certain period of time (for example, five years) and then include the deferred

[1] For more on this observation, see our postscript.

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amount in their taxable income over the next five years (this form of relief would be based on a temporary rule adopted in 2009 in response to the Great Recession[2]); or

3. allowing solvent taxpayers to exclude COD income to the extent that they reduce the basis of their assets (or possibly reduce other tax attributes) — this was the general approach that applied to business taxpayers for decades until the 1986 Tax Reform Act made it available only to insolvent taxpayers and some farmers; since then the attribute reduction approach has been selectively extended to specific borrowers that Congress determined were in need of temporary or permanent relief from the strict rules adopted in 1986.

We recommend the last option, not only as a temporary measure but as a model for permanent reform.

The basis reduction approach recognizes that the borrower has likely suffered an overall economic loss, not a net gain, from an unanticipated economic downturn. It tries to match the inclusion of the putative "gain" from the COD with the borrower's corresponding economic loss (even if not yet realized). By reducing asset basis, the forgiven COD income shows up either as increased gain (or reduced loss) on a later sale of the asset, or as a reduction in the borrower's future depreciation deductions if the asset is depreciable.

In some cases the borrower may not have enough basis in the assets securing a discharged loan, and the taxpayer would need to reduce the basis of other assets. For that reason, the general rules in effect before the 1980s included provisions specifying the order and manner in which the basis of the taxpayer's assets was reduced. Similar rules apply today under sections 108(b) and 1017 for insolvent taxpayers or others still permitted to exclude COD in exchange for a reduction in the basis of their assets or other tax attributes.

A pivotal part of our proposal is changing or clarifying the order in which the taxpayer's assets would be subject to basis reduction based on what we believe are the appropriate policy considerations as well as considerations of administrability. Indeed, identifying the assets or tax attributes that would most properly reflect the unrealized economic loss of a distressed borrower – the economic loss that caused the lender to forgive all or part of the loan – is the heart of the problem.

The issues we discuss concern debt forgiveness that arises when a creditor accepts less than the face amount of a debt because of doubts about the debtor's ability to pay in full. They do not apply to spurious COD, such as forgiveness of debt that occurs on account of services performed for the lender or any other factor not directly related to a decline in the value of the assets securing the loan or the earning power of the borrower. For example, if an employer loans an employee $100,000 and then forgives the loan in recognition of the employee's outstanding performance, that amount is a disguised bonus, not COD.[3] Loan forgiveness that is a disguised method of transferring value from the lender to the borrower should not be subject to any new ameliorative rules.

I. The Attribute Reduction Approach: A Proposal

In the case of COD arising from a decline in the borrower's ability to repay the loan, an ideal rule would allow the borrower to exclude an amount of COD and later include the same amount as the borrower's economic situation, liquidity, or ability to pay improves. It should also be practical and administrable. Congress should adopt the following approach:

1. Solvent taxpayers should be able to exclude COD to the extent that they agree to reduce the basis of their assets, and after that, in exchange for reducing any of the other tax attributes listed in section 108(b).
2. As currently provided in section 1017, priority for basis reduction should be given to (a) business and investment real property secured by the discharged debt (depreciable and nondepreciable but

[2] Section 108(i).

[3] *Denny v. Commissioner*, 33 B.T.A. 738 (1935) (*acq. and nonacq.* on other issues); Rev. Rul. 2004-37, 2004-1 C.B. 583.

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excluding inventory); (b) business and investment personal property secured by the discharged debt (tangible and intangible but excluding inventory or similar assets); (c) business or investment assets not securing the discharged debt (excluding inventory or similar assets); (d) inventory, accounts receivable, or similar assets; and finally (e) assets not used in business or held for investment (such as a taxpayer's personal residence or automobile). The tax consequences of these ordering rules should reasonably align with the economic losses of the borrower that caused the lender to reduce the principal of the debt, but see our discussion below for a possibly more exact method.

3. Within any of these five categories, including business or investment assets not securing the discharged debt, the basis reductions should be allocated among the assets according to their relative adjusted bases or any other reasonable method permitted by regulations. One approach that should be considered would generally allocate basis reductions in proportion to adjusted basis while minimizing the extent to which the basis of any asset would be reduced below its fair market value. This would minimize the potential need to retain a rule of current law that recaptures basis reductions as ordinary income if the asset is later sold.
4. The rules of section 1017, allowing for basis reduction in partnership interests and corporate subsidiaries but only to the extent that the bases of the underlying assets are reduced, should be applied. This ensures that the appropriate character, useful life, and ultimate use or disposition of the underlying assets controls the effects of the basis reduction.
5. If there is still COD after all asset bases have been reduced, the taxpayer should be permitted to select among the tax attributes listed in section 108(b), such as net operating losses, capital loss carryforwards, and general business credits.
6. Given these sensible asset allocation rules, the basis-reduction-recapture rule provided by section 1017 that applies to assets that are sold after their bases have been reduced may not be necessary. Such a rule should certainly not apply to any asset whose basis is not reduced below its FMV. If a recapture rule in other cases is necessary, any recapture income should itself be treated as COD that may then be run through these rules again.

There may be sympathetic cases in which a taxpayer has no asset basis and no tax attributes but is not insolvent. They may range from a family-owned restaurant to a student who is fortunate enough to have his student loan purchased and forgiven in troubled times by a wealthy alumnus. For those cases, Congress may wish to consider a modest amount of COD income that would be excluded by taxpayers with no tax attributes to give up in exchange. Those taxpayers may be the victims of harsh economic times and may be unable to bear the cost and complexity associated with an IRS bill (together with liens, judgements, garnishments, and other collection efforts that may hinder their personal economic recovery) for the tax on a form of phantom income that does not recognize that their own economic circumstances have worsened by an equal or greater amount.

II. The Underlying Problem With Current Law

Current law contains a variety of complex rules, some permanent and some temporary, that excuse or defer the taxation of COD. The exceptions reflect the insight that imposing an income tax on COD is questionable when a distressed borrower is suffering an overall economic loss and not an overall accretion to wealth. As the Supreme Court explained, "The mere diminution of loss is not gain, profit, or income."[4]

Although reducing debt economically benefits a borrower, it typically reflects, and is typically smaller than, the unrecognized loss to the borrower's assets or earning power that caused the lender to reduce the debt. Arm's-

[4] *Bowers v. Kerbaugh-Empire Co.*, 271 U.S. 170 (1926).

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length lenders do not typically reduce a borrower's debt out of the goodness of their hearts. They do so to salvage as much as they can when a borrower's economic distress may otherwise lead to an even greater loss if the lender does not make some concessions. Concessions are generally provided to give the borrower an incentive to continue to maintain or enhance the assets securing the debt and to repay as much of the original loan as is practicable.

For example, when a $60,000 loan is secured by business or investment property that was once worth $100,000 but is suddenly worth only $50,000, a prudent lender may realize that she is better off reducing the debt to $45,000 than foreclosing or forcing the borrower into bankruptcy. At the same time, it is shortsighted to view the borrower as enjoying a $15,000 taxable benefit from the reduction of his debt by $15,000. The borrower has also just experienced a $50,000 loss in the value of his business or investment property or his personal earning power. Overall, he is $35,000 poorer, not $15,000 richer, but the $50,000 loss may not be currently realized. Even if it is, it may be a $50,000 capital loss that cannot be used to offset the $15,000 of ordinary COD.

To visualize a typical workout under the "normal" tax rules generally applicable to COD, one might imagine three parties sitting around a negotiating table: the lender who is taking a $15,000 hit; the borrower, who is taking a $35,000 hit; and the government, which is seeking to burden the borrower with an ordinary income tax on a supposed $15,000 gain. The lender in this case may get a tax benefit from writing down the loan by $15,000. That amount, of course, is the lender's real economic loss. In this mini-economy, there is a total economic loss of $50,000, $15,000 of which is borne by the lender and $35,000 of which is borne by the borrower. There has been no net economic gain for either party.

Not surprisingly, the general rule imposing an ordinary income tax on a distressed borrower, who is actually suffering a net economic loss, is subject to a number of exceptions. Many are congressional responses to widespread economic hardship in a particular industry or region. But the fundamental problem with COD is the same whether the hardship of taxation without gain is suffered by hundreds of thousands of borrowers worldwide or by a dozen borrowers in one square city block who have been hurt by the city's unanticipated decision to close a nearby metro stop. As the saying goes, a recession is when your neighbor loses his job; a depression is when you lose yours.

III. Borrower Exceptions to Immediate COD Recognition

Over the years, Congress and the courts[5] have created exceptions to address the hardship of a tax rule that ignores economic reality by treating COD as an economic windfall to the borrower. In the real world, as Congress has increasingly come to recognize, COD arising from a borrower's economic distress is almost always the symptom of an overall economic loss for the borrower as well as the lender. The exceptions to the general rule include the following:

1. *Bankruptcy or insolvency*. Borrowers discharged from debt when insolvent or after having filed for bankruptcy or similar protection from creditors are generally allowed to exclude COD to the extent of their insolvency. Those rules are both statutory and judicial in origin. By statute, however, various unused potential tax benefits of the borrower, such as loss carryforwards and the tax basis of the borrower's assets, must be reduced by the amount of COD income excluded from income.
2. *Seller financing*. Under section 108(e)(5), as well as some court decisions, the discharge of seller-financed debt is excused from tax if the borrower elects to treat the debt reduction as if it were a reduction in his purchase price, reducing his basis in the purchased asset. Examples of seller financing would include a homebuilder who takes back a note from the buyer or a truck manufacturer who provides credit to his customers. If the buyer-borrower is a business and the purchased asset is depreciable, the basis reduction will reduce depreciation deductions going forward. The reduced future depreciation

[5] For more on this observation, see our postscript.

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deductions should correspond to the reduced stream of future gross income reflected in the asset's reduced FMV. That decline in the asset's value, of course, is what convinced the lender to reduce the principal amount of the loan – presumably in the belief that she will recover more of her investment than if she foreclosed or drove the borrower into bankruptcy court. If the borrower later sells the property for less than he originally paid, which would ordinarily trigger a tax loss, he will lose or reduce that future tax loss because the excluded COD will have reduced his basis. And if the asset is a depreciable asset that recovers its value and begins to generate periodic operating income at its previous level, the borrower will find that he has given up the periodic depreciation deductions he would have enjoyed if he had not reduced his basis by the amount of excluded COD.

3. *Some purchase-money debt*. Under some court decisions, but subject to constraints the IRS may seek to impose, the seller-financing rule will also apply to purchase-money debt provided by a third-party bank or lender. As with the statutory seller-financing rule, the purchase price of the asset is reduced by the amount of the COD. For example, the Fifth Circuit considered a case in which a third-party lender had loaned a borrower money to purchase a seat on the New York Stock Exchange. Because the loan was principally secured by the seat, the lender was willing to forgive a portion of the loan when the seat lost almost three-quarters of its original value. The court explained that the borrower had "bought a seat on the Exchange, which he still has, for which he gave an obligation for $402,000 nominally, but which fell far short of being an absolute one, and which had really a much less exchangeable value. When in 1934 he and [the lender] dealt with the situation, [the lender] considered his claim worth not more than $213,625, and the seat was worth only $125,000. They settled for $213,625, and that became the cost to [the borrower] of the seat. Not until he disposes of the seat will he realize loss or gain."[6] If the same asset were depreciable, the basis reduction would reduce the borrower's future periodic depreciation deductions – ideally corresponding to the anticipated reductions in the borrower's future periodic operating income reflected in the lender's reassessment of the asset's market value.

4. *Commercial real estate*. In 1993, in response to a commercial real estate depression that contributed to the economic recession of the early 1990s, Congress provided a rule similar to the one on seller financing for all debt incurred in the acquisition of real property. However, COD on qualified real property indebtedness was excludable only for individuals (including individuals who invest through a partnership) and only to the extent that they reduced their basis in the depreciable portion of the real property acquired with the forgiven debt (such as a building, but not the land on which it was built). Refinanced acquisition indebtedness is covered by this rule, but a cash-out refinancing is not.

5. *Farm indebtedness*. In 1986, in response to an economic crisis in U.S. agriculture caused by high interest rates, excessive borrowing, declining exports, and overproduction that was wiping out both farmers and agricultural banks, Congress exempted farmers from the strict new rules adopted that year. Section 108(a)(1)(C) allowed for the tax-free forgiveness of some types of farm-related

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[6] *Allen v. Courts*, 127 F.2d 127 (5th Cir. 1942). Today the IRS still recognizes that the borrower has suffered a loss in that situation, but it is willing to apply this rule to third-party loans only when the loss stems from an impairment in the property that was present at the time of the purchase, such as a hidden manufacturing defect or fraud by the seller. *See* Rev. Rul. 92-99, 1992-2 C.B. 35. This may reflect a theoretical critique of the development of the case law, but a distinction between seller financing and third-party financing does not seem to make much sense, as we explain below. Indeed, even COD arising from a cash-out refinancing may deserve a rule like the seller-financing rule when the lender is reducing the loan on account of a decline in the value of the collateral that occurred after the loan was underwritten.

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debt, as long as the basis of the farmer's depreciable and nondepreciable assets was reduced to the same extent.

6. *Home mortgage indebtedness*. In 2007, as it became increasingly clear that millions of Americans would fail or struggle to meet their mortgage obligations, Congress enacted a temporary provision excluding the discharge of some principal residence indebtedness from tax. Here too, the homeowner's tax basis in the residence is reduced by the amount of excluded COD. This temporary rule has been extended many times, most recently to discharges that occur before January 1, 2021, or that occur under a written arrangement entered into before that date.
7. *Financial crisis-era deferral*. At the height of the most recent financial crisis in 2008 and 2009, Congress adopted a much briefer temporary provision, this time effectively allowing businesses of all types to defer the recognition of COD arising in 2009 or 2010 for five years (or four years if the discharge occurred in 2010) with ratable recognition of the income over the following five years.
8. *PPP loans*. The COVID-19-era Coronavirus Aid, Recovery, and Economic Security (CARES) Act (P.L. 116-136) allows taxpayers to exclude from taxable income loan amounts forgiven under the $670 billion PPP. Moreover, although general tax principles would have eliminated the taxpayer's deductions for salaries or other expenses paid with the forgiven debt, Congress has moved to enact legislation that would preserve those deductions, without any other reduction in the borrower's tax attributes, such as a reduction in the borrower's basis in her business.
9. *Foreclosure on nonrecourse debt.* Economic gains comparable to COD may arise with the foreclosure of a nonrecourse loan if the value of the property taken in full satisfaction of the loan is less than the FMV of the property. To see the comparison, consider a recourse loan of $100 that is partially satisfied by foreclosing on property worth only $70. If the borrower had a basis of $70, he would have no gain or loss because only $70 of the $100 loan would be treated as satisfied by the transfer of the property to the lender. If the borrower were also allowed to walk away without satisfying the $30 deficiency, he would have COD of $30. When the loan is nonrecourse (under a series of judicial precedents notorious to generations of law students[7]), the borrower's amount realized on the foreclosure of the property (or sale in lieu of foreclosure) includes the full balance of the $100 loan, not just the $70 portion that does not exceed the value of the property. As a result, the borrower has $30 of gain, often capital gain, and no COD. The result is comparable to excluding the $30 COD of a recourse borrower in exchange for a $30 reduction in the basis of his foreclosed property (from $70 to $40) resulting in $30 of gain and no COD.

IV. The PPP Approach: Forgiveness on Forgiveness

In the recently enacted PPP loan program, Congress indicated its readiness to adopt a simple and generous approach that could be a model for COD arising more generally from the current economic crisis. The original program design provided that the forgiveness of PPP loans used for qualifying purposes would not be treated as COD income, but Congress later realized that general tax principles would have imposed a rule similar to the attribute reduction rule.[8] That is, the borrower would lose any deductions for expenses paid with the principal of the forgiven debt. That was because the taxpayer had never taken that cash into income and therefore could not claim to have incurred any real expense for tax purposes. Congress has indicated that it intends to pass

[7] *See, e.g.*, *Crane v. Commissioner*, 331 U.S. 1, 6 (1947).

[8] Notice 2020-32, 2020-21 IRB 837; *but see* letter from Senate Finance Committee Chair Chuck Grassley, R-Iowa, ranking member Ron Wyden, D-Ore., and House Ways and Means Committee Chair Richard E. Neal, D-Mass., to Treasury Secretary Steven Mnuchin on May 5, 2020 ("The position taken in the Notice ignores the overarching intent of the PPP, as well as the specific intent of Congress to allow deductions in the case of PPP loan recipients.").

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legislation ensuring that there is no reduction in those deductions, or in any other of the taxpayer's potential tax benefits or tax attributes.[9]

The effect of such a rule is to provide the borrower with a permanent accretion to his net worth equal to the principal amount forgiven without any subsequent tax on that gain, even if the borrower's economic fortunes totally recover. In a sense, it is almost like declaring the borrower to be a one-person Opportunity Zone. This may make sense as a matter of economic policy because the borrower may be suffering other economic losses and Congress wants to maintain incentives for further economic growth. If so, one may ask why the policy should not be extended to other pandemic-related debt forgiveness.

For example, why should the forgiveness of a $100,000 loan from the government, extended in May 2020 and forgiven in July 2020, be treated differently from the forgiveness in July 2020 of $100,000 out of a $200,000 arm's-length bank loan that was originally made in January 2020, just before the pandemic hit hard domestically? In both cases the loan might be to the same local tavern to pay its employees. In the case of the PPP, the loan was made and forgiven to keep the establishment afloat. The bank loan may have been made to finance the hiring of a well-known regional chef to expand the tavern's dining options. That may have seemed like a speculative investment for the tavern but a safe bet for the bank when the tavern's highly profitable bar business seemed bulletproof. When the lockdown decimated the tavern's liquor sales, even though it could remain marginally solvent selling carryout meals, the bank might have partially forgiven the loan to keep the tavern in business and salvage as much value for the bank as possible. If the parties were negotiating a workout, permanent forgiveness of any tax on the tavern's debt forgiveness income would make it easier to strike a deal. That would increase the chances that the tavern could stay in business until the lockdown was eased and its liquor sales resumed. With luck, the new chef would help the tavern's dining business and profitability soar. There would be no "recapture" of the forgiven tax on the tavern's debt forgiveness income, but Congress would still presumably be pleased with the overall outcome.

As this example illustrates, Congress may prefer a tax policy that prevents business closures by erring on the side of generosity to a more parsimonious tax policy that might encourage more bankruptcies. On the other hand, that approach may be troublesome to a student of the tax law. At best, it might be fitted into the exclusion that sometimes applies to government grants for the general welfare, although those generally have been limited to programs for low-income individuals.

V. Another Potential Solution: Deferring COD Income

In 2009, in response to the Great Recession, Congress temporarily allowed some borrowers to defer their inclusion of COD. Section 108(i) completely deferred the COD for approximately five years and then recaptured the excluded amount over the ensuing five years. That approach has the virtue of simplicity, but the timing of the payback is arbitrary and does not necessarily reflect any improvement in the borrower's economic situation, liquidity, or ability to pay after five years. The borrower could be sitting with the same illiquid and distressed asset she had before, perhaps with a value equal to the reduced balance of the loan. But she has no greater ability to pay a tax on the supposed gain realized from the reduction of the loan because she has not generated any cash from the sale of the property. Moreover, if she were to sell the property at a loss (the same unrecognized loss that persuaded the lender to forgive some of the debt), it might be treated as a capital loss that could not be used to offset the deferred, ordinary COD income.

The 2009 decision to adopt a temporary, short-term deferral may reflect the exigencies of the time. At the height of the financial crisis, Congress was concerned with the health and stability of the capital markets and the financial system. Some perceived the problem as more of a liquidity crisis than a problem of fundamentals. Here, the

[9] The Health and Economic Recovery Omnibus Emergency Solutions (HEROES) Act (H.R. 6800) (passed by the House on May 15) (allowing deduction for expenses paid with forgiven PPP loans); Small Business Expense Protection Act of 2020 (S. 3612) (introduced May 5) (cosponsored by Grassley and Wyden and would allow businesses to claim deductions for ordinary business expenses paid with forgiven PPP loans).

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economy may be facing more changes to fundamental values, or at least more long-lasting changes to market values. Even if valuations can be expected to come back through economic growth, a distressed borrower that is forced completely out of the game by the inability to structure a workout will not participate in that upswing. For that reason, a short, arbitrary deferral may be of little or no value to many distressed borrowers.

For some taxpayers, enough time will cure almost any problem. One could imagine a permanent rule that deferred all COD for five or 10 years, followed by a 15- or 20-year period in which the excluded amount might be recovered as ordinary income. However, it would be hard to determine a single period appropriate for the wide range of circumstances likely to arise in any particular economic slowdown.

VI. Attribute Reduction: Benefits and Challenges

In many cases, the basis reduction approach seems to work perfectly, both conceptually and practically. In others, determining the appropriate ordering of assets subject to basis reduction presents challenges.

A. Debt Secured by Single Property With Basis

When debt secured by a single piece of property is reduced by the lender because of a comparable reduction in the value of the property and the borrower has enough basis in the asset to absorb the COD, reducing asset basis by the amount of COD seems to give the government its due without unduly burdening the taxpayer. This is essentially the same as the seller-financing rule, but there is no reason to limit it to seller financing, or even to acquisition financing, although an example with acquisition financing makes it easier to see.

If a loan of $80 is originally secured by an asset worth $100, and the loan is reduced by $35 to $45 when the asset's value unexpectedly drops from $100 to $50 because of a disaster that hits the day after the asset is purchased, the asset can be expected to produce half as much future cash and gross income, generally at the same rate as before. If the asset is fully depreciable and its tax basis is reduced from $100 to $65 (in lieu of including $35 of COD), it will produce 65 percent of the originally scheduled depreciation deductions over the same period. That is, a $50 asset will be enjoying $65 of depreciation deductions, instead of a $100 asset enjoying $100 of depreciation deductions. This should be acceptable to the average taxpayer, assuming it generates a stream of cash and gross income commensurate with its depreciation deductions, which have been reduced in absolute terms by $35, but not by as much as the economic loss suffered by the borrower. If the asset is not depreciable and does not generate any current income, such as a gold ingot, any future sale of the asset (absent market movements) should generate cash of $50. With a tax basis of $65, that will produce a loss of $15. That is the right amount. Of the $50 cash proceeds, $45 will be paid to the lender, leaving $5 for the borrower. The buyer's original cash equity of $20 will thus have produced only $5 in the end. His $15 economic loss and $15 tax loss will match.

If the basis reduction causes the asset basis to be reduced below the asset's FMV, the analysis is similar. However, if the asset is later sold for a capital gain (derived from the portion of the basis reduction below FMV), current law would recapture all or a portion of the capital gain as ordinary income. Below we discuss how the recapture rule of current law should be modified to deal appropriately with that situation.

B. Debt Secured With Mix of Assets With Basis

If the loan is secured by a mix of assets, there may not be a direct correspondence between the assets whose basis is reduced and the assets whose decline in value led to the COD event. Assuming that identifying those assets would be difficult, this presents a policy decision. Should the rules governing the selection of assets be punitive or ameliorative? One could adopt a simple rule requiring that the taxpayer select the basis of assets with the shortest lives first or decide that the opposite approach makes more sense. The current asset-basis ordering rules under section 1017 for insolvent taxpayers seem to embody a reasonably administrable, reasonably ameliorative approach. First the borrower reduces the basis of business or investment real property (depreciable and nondepreciable but excluding inventory) secured by the discharged loan, and then she reduces the basis of business or

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investment personal property (tangible and intangible but excluding inventory and similar assets) secured by the discharged loan.

As under current law, our proposal would allocate basis reductions in each category in proportion to their relative bases or any other reasonable method permitted by regulations. This approach seems nearly impossible to game and seems fair in the sense that it would provide equal treatment to similarly situated taxpayers.

If one were looking for a theoretically purer approach for all the assets securing the debt, priority could be given to the assets whose values had declined since the time the loan was underwritten. Those would be the assets most like the single asset in the seller-financing case whose decline in value had caused the lender to reduce the loan balance. That would more closely match the excluded COD with the unrealized losses on the assets whose declining values had caused the COD. However, such a precise rule may be unnecessary in practice and could be difficult to administer.

C. Debt Secured by Assets Without Basis

In today's economy, a taxpayer may experience COD from the forgiveness of debt secured by an asset whose basis has been fully depreciated, or an asset that has no basis, such as the self-generated goodwill of a popular restaurant or other service business whose anticipated future revenues have been decimated by a pandemic. If there is not enough basis in the assets securing the debt, the ordering rules would simply mean that the taxpayer would next reduce the basis of other trade or business or investment assets (not including inventory or similar items) not securing the debt. Again, once one goes beyond the assets purchased with the debt or secured by the debt, one faces the larger question of economic policy: Should the assets be selected under a punitive rule that would apply the basis reduction to the assets with the shortest lives first, or should the approach be ameliorative and allow the taxpayer to use the longest-lived assets, or nondepreciable assets, first? The current rules, prioritizing real property secured by a discharged loan over personal property securing a discharged loan and skipping over inventory and similar assets, suggest an ameliorative approach.

Our proposal would allocate basis reductions among the taxpayer's trade or business assets not securing the loan (other than inventory or similar assets) in proportion to their relative adjusted bases or any other reasonable method authorized by regulations. We also offer an alternative, theoretically purer method based on the economic lives of the assets that secure the discharged debt whose decline in value led to the COD event, but that approach may be unnecessary and administratively infeasible.

When an asset securing a discharged loan has already been fully depreciated, some might observe that the borrower has enjoyed substantial tax benefits. They might argue that he should not complain about the inclusion of COD if a loan used to purchase that property, or secured by that property, is reduced or forgiven. The counter-argument is that those prior tax benefits reflected real economic depreciation or accelerated cost recovery allowances that were intentionally provided to accomplish a congressionally approved policy and used in good faith by a taxpayer who did not plan into, or anticipate, the economic loss leading to the COD. Indeed, an analogy could be drawn to the gain on the disposition of a low-basis asset when it is destroyed by a casualty.

D. Analogy: Casualty Loss and Insurance Proceeds

The unanticipated economic distress leading to forgiveness of a loan secured by a zero-basis asset might be compared to the situation of a valuable but fully depreciated asset being destroyed by a hurricane. If the asset is fully insured, the borrower will obtain cash equal to its value that he may then use to replace or rebuild it. In that case, section 1033 allows the insurance proceeds to be received tax free if they are reinvested in property "similar or related in service or use" to the property destroyed by the hurricane. Of course, that new property does not get a basis equal to its cash purchase price. The basis is reduced by the amount of insurance proceeds received tax free.

Section 1033 recognizes that the hurricane situation is different from one in which a taxpayer with fully depreciated property voluntarily decides to dispose of the property and must

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recognize gain if the amount realized exceeds his basis. The COD rules should reflect a similar insight. Borrowers do not plan to lose money in economic or environmental disasters to game the COD rules.

In a 21st-century economy, section 1033 is too strict in allowing this treatment only after the acquisition of property "similar or related in service or use," but the underlying concept is sound. Taxable gain has been accelerated through no fault of the taxpayer — there has been a casualty or unanticipated economic disaster — and it is simply the wrong time to tax the taxpayer. Certainly it makes no sense to tax the owner, for example, because he decides it is prudent to take the insurance proceeds paid for flood damage to a low-lying apartment complex and to reinvest that cash in a resort hotel that is more safely located on higher ground.[10] The same seems true of debt forgiveness income for a fully depreciated asset if the taxpayer has other assets whose basis can be reduced as an alternative to including the debt forgiveness in income currently. The other assets should not need to be "similar or related in service or use."

E. Guiding Policy Principle for Ordering: Punitive Or Flexible?

In all the scenarios discussed above, other than the simple case in which a single asset with sufficient basis is securing a discharged loan, the question remains: Should the rules governing the selection or ordering of assets and potentially other attributes be punitive or ameliorative? One can view COD income as something that, in the ideal tax system, should be subject to immediate taxation as ordinary income, with any exception viewed as reflecting an act of weakness by the policymakers – and with every exception carefully monitored to prevent further backsliding. That might be viewed as the law-and-order approach and was the mindset as Congress tightened the COD rules in 1980 (limiting the basis reduction approach to depreciable property) and again in 1986 (limiting it to insolvent taxpayers and some farmers). In fairness, the fiscal, economic, and tax policy environment was far different in that era of widespread individual tax shelters, high inflation, and high nominal interest rates, all of which made mere tax deferral a more pressing and costly problem for the government than it is today.

One can also view the technical gains from COD as something that, in the ideal tax system, are akin to the technical gains from the conversion of fully depreciated property into cash by a hurricane or other casualty, the gains from which can properly be reflected as reductions in the basis of replacement property held for the production of income or gain. From that perspective, given the unanticipated nature of COD, one might opt for the simplest possible rule, allowing the taxpayer the maximum flexibility to allocate the "price" among those assets, other than obviously abusive allocations (such as a corporation allocating basis reduction to the stock of its wholly owned subsidiary, a technique that was actually barred as far back as 1980).

Finally, it should be noted, current law requires insolvent taxpayers and solvent farmers to first reduce other tax attributes, such as NOLs, tax credit carryforwards, minimum tax credits, and capital loss carryovers, before reducing asset basis. However, current law allows an election to go directly to asset basis reduction and then return to NOLs and the other attributes only if there is not enough asset basis to absorb the taxpayer's COD. One can see that the basis-first election would be favorable to some taxpayers (if their assets have long lives and their NOLs, for example, would likely be used over a relatively short period). For others, who might have capital loss carryovers that they would not likely use soon and short-lived depreciable assets, the basis-first election would be unfavorable. A reasonable temporary or permanent COD rule usable by all solvent taxpayers could follow the same elective approach or require, as we propose, that asset basis reduction go first.

VII. Our Attribute Reduction Approach: Possible Refinements

The central challenge in implementing a basis reduction or attribution reduction approach is identifying the right assets, in cases other than the very simplest when the discharged loan is a

[10] *See Clifton Investment Co. v. Commissioner*, 312 F.2d 719 (6th Cir. 1963), *cert. denied*, 373 U.S. 921 (1963); Rev. Rul. 70-399, 1970-2 C.B. 164.

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single, recently purchased asset with sufficient basis, to absorb the COD arising from an unanticipated decline in the value of the asset.

When there are multiple assets that have been serving as collateral for the debt, the law has long-standing ordering rules described above that seem difficult to game but that may not always produce a theoretically correct result. Ideally, one might identify the assets responsible for the decline in value since the loan was underwritten that caused the lender to reduce the loan balance. In practice, one will know each asset's adjusted basis and could estimate each asset's FMV, but identifying their value when the loan was underwritten, other than for assets purchased with the loan proceeds, might be more difficult. Thus, using the broad categories provided by current law (real property, personal property, etc.) and allocating within those categories by relative adjusted basis or value should be an acceptable rule of convenience. In theory, allocating in proportion to the decline in value of the assets securing the discharged debt (from the time the loan was underwritten to the time it was reduced) to the extent of the adjusted basis in those assets, and then allocating in proportion to remaining adjusted basis might be closer to a theoretical ideal. That degree of precision may be possible, but it is probably unnecessary.

For assets not securing the debt, and with an eye toward administrative feasibility, we note that a theoretically more accurate method for those "other assets" might allocate remaining basis adjustments to one or more "other assets" whose useful lives most resembled the zero-basis assets that were securing the debt (reduced to zero because of the priority for assets securing the debt). For example, an asset securing a discharged loan — such as the self-generated goodwill of a restaurant chain or other service business with a presumed useful life of 15 years but no actual basis — would not have any actual basis that could be reduced commensurate with the decline in the asset's value that caused the lender to discharge the loan. However, Congress could allow the borrower to exclude the COD in exchange for his agreement to reduce the basis of a comparable asset with a comparable useful life (or a mix of assets whose weighted average useful life was close to that of the assets securing the debt). That would produce a reduction in future depreciation deductions or future losses on that other asset equal to the COD from the discharge of the loan secured by the zero-basis asset. The timing and character of the offsets would also seem to be reasonable. It would be as if some or all of the borrower's high basis in the other asset was moved to the zero-basis asset and that moved basis was then reduced to zero to pay for the COD exclusion, leaving the other asset with a reduced basis.

Interestingly, that seems to be what would have happened if a newly purchased but fully depreciated, zero-basis asset (determined before its value was reduced below its original purchase price by a sudden economic downturn) had been converted into cash insurance proceeds by a fire or casualty subject to section 1033. The cash might have been used to purchase from a third party an asset comparable to the asset destroyed by fire to serve as substituted collateral for the loan, and that third party might have purchased a comparable, newly purchased asset from the borrower, that would have a basis equal to its recent purchase price because the borrower did not use any accelerated or bonus depreciation, at no gain or loss to the borrower. When the economic downturn then caused a decline in the value of the newly purchased asset securing the loan, and the loan balance was reduced accordingly, producing COD, the borrower could exclude that COD by reducing the basis of the newly purchased, high-basis asset acting as substituted collateral. In sum, there would be an imaginary or deemed tax-free substitution of high-basis collateral from the borrower's portfolio of other assets (with a comparable useful life) for the low- or zero-basis collateral actually securing the loan, with that substitution of collateral deemed to occur just before the economic downturn and the loan balance was reduced.

Identifying "other assets" to match the economics of the assets securing the loan might be administratively difficult, particularly when there are multiple assets securing the loan. Thus, an allocation based on the relative adjusted bases of the "other assets" not securing the loan should be a reasonable substitute. Other possibilities might be to allocate in proportion to relative adjusted basis, except to the extent that that would result in a reduction of any particular asset's basis below its FMV, or to allocate in proportion to FMV, except

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to the extent an asset did not have sufficient adjusted basis.

VIII. Addressing the Curious Case of Recapture

Sometimes section 1017 recaptures gain in a subsequent asset sale that involves property whose basis was reduced in a COD event and recharacterizes the gain as ordinary income. A closer look at specific examples demonstrates why that result is inappropriate in many cases and is tantamount to requiring the borrower to pay tax twice, or at least pay extra, for the same COD exclusion merely because the borrower decided for economic or business reasons to dispose of an asset.

The point is that post-discharge appreciation has nothing to do with the COD or the basis reduction. If post-discharge gain arises because the basis of a depreciable asset was reduced below FMV at the time of the discharge, treating that gain as capital gain instead of ordinary income could be a legitimate concern. However, the remedy should be modified. Recapture income in that case should be treated as COD income that may be run through our proposed rules again.

Let's compare two cases. First assume that a $100 depreciable asset with a $90 basis that is securing an $80 loan declines in value to $50, causing the lender to reduce the loan by $40 and triggering $40 of COD, which the borrower excludes by reducing the basis of the asset from $90 to $50. Here the COD exclusion has been fully paid for, and any later gain or loss on a sale of the asset would be from post-discharge appreciation or depreciation having nothing to do with the COD or the basis reduction. There is no reason for recapture here.

If the asset had a basis of only $50, that basis was reduced to $10 to "pay for" the exclusion of the COD, and the asset was immediately sold for $50 producing a capital gain of $40, the case for recapture is plausible because the taxpayer arguably substituted $40 of capital gains for what, to a tax purist, should have been reduced depreciation deductions. That sanction, however, would be excessive and administratively burdensome for an asset that happens to be sold in the ordinary course for economic or business reasons.

Our proposed asset allocation rules may eliminate the likelihood of basis reductions below value, but if a recapture rule is still needed any recapture income (such as the $40 of capital gains in this example) should itself be treated as COD, which could then be excluded by running through our rules again.

IX. Summary of Suggestions for Congressional Action

Congress adopted a general rule in 1986 that taxes the COD of solvent taxpayers other than some farmers in the year a loan is discharged, but has repeatedly liberalized those rules, generally in favor of an asset or attribute reduction approach, whenever a large number of distressed borrowers has emerged. That is certainly the situation today, but it also suggests that the 1986 rules are not working properly.

Our suggested approach excludes the COD of all solvent borrowers that elect to reduce the basis of their assets, followed in some cases by other attributes listed in section 108(b). We believe that approach aligns closely with the actual economics of the COD event, in contrast with permanent tax forgiveness, as with the PPP loans, or a short and arbitrary tax deferral, as under section 108(i). It is our hope that the basis reduction approach could lead to permanent reform of the 1986 rules.

Our proposal largely relies on the current ordering rules to identify the assets whose bases should be reduced. We suggest some modest reforms to those rules. We also describe a more theoretically pure method of prioritizing assets for basis reduction, recognizing that such an approach may not be necessary and may be difficult to administer. Certainly, if a temporary rule is needed quickly, deferring to the current ordering rules would be a reasonable expedient.

If Congress follows this path in adopting a temporary rule, in a few years it can assess the rule's efficacy. That would include evaluating the allocation and ordering rules and deciding whether this temporary approach makes sense as a permanent rule.

Postscript: A Historical Perspective

Congress, the courts, and academics have all struggled with the same dilemma. They recognize, as one must, that a distressed borrower

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whose debt is reduced has typically suffered an unrealized economic loss greater than the amount of the debt reduction, but they have been unable to develop a rule or mechanism to appropriately match the borrower's undeniable economic gain (from the lender's agreement to reduce the debt) with the economic loss of the borrower (that caused the lender to agree to the debt reduction in the first place). *The difficulty of that challenge should not be minimized.*

As explained by Boris Bittker and Lawrence Lokken,[11] the 1926 decision of the Supreme Court in *Bowers v. Kerbaugh-Empire Co.* held that COD could not arise from debt forgiveness where "the whole transaction was a loss [taking into account the use of the original loan proceeds to acquire assets that had declined in value]."[12] In 1931 the Supreme Court imposed an income tax on debt forgiveness income in what is still considered the leading precedent for the taxation of COD, *United States v. Kirby Lumber Co.*[13] In that case, however, the Court did not reverse *Bowers v. Kerbaugh-Empire* but distinguished it, holding that the reduction of the taxpayer's debt was not accompanied by any corresponding loss.

While Bittker and Lokken (and many other commentators) applaud the result, they criticize the idea that one should ever analyze a debt discharge issue by looking at the "transaction as a whole." They soundly observe that such an approach, at least as a judicial construct, is unadministrable given the difficulty, indeed the irrelevance, of tracing borrowed funds to determine the nature and boundaries of "the transaction as a whole." In summary, they explain:

> Unfortunately, *Kerbaugh-Empire* linked the tax treatment of the debt discharge to the fate of the borrowed funds, and *Kirby Lumber* carried this idea forward by distinguishing rather than repudiating *Kerbaugh-Empire*, seeming thereby to invite an open-ended inquiry into the debtor's financial history in order to determine whether a debt discharge generates gain. In a tortuous series of later decisions . . . the courts have held that the nature of the obligation, the mode of discharge, the creditor's objective in agreeing to the settlement, the absence of prior tax benefits, and the debtor's financial condition may, in particular circumstances, shield the taxpayer from the result reached in *Kirby Lumber*.

Congress saw the same problem – that COD income was only one side of the equation. But Congress also found it difficult to solve with an administrable rule that was not subject to perceived abuse. From the 1930s to 1980, business borrowers were allowed by law and regulations to avoid COD in exchange for a reduction in the basis of their assets. In 1980, however, Congress began to see the potential for tax abuse if borrowers were allowed unfettered discretion in deciding which assets they would choose to be subject to basis reduction. As can be seen in the legislative history to the 1980 legislation that limited basis reduction to depreciable assets and imposed some other "antiabuse" rules, Congress seemed to be thinking that any approach that failed to result in the imposition of an ordinary income tax on COD was inherently abusive. Yet it is obviously not abusive to exclude COD, arising from the reduction of indebtedness used to acquire a nondepreciable asset like a seat on the New York Stock Exchange, as long as the borrower's basis in that nondepreciable asset is reduced by the amount of excluded COD. Nevetheless, with all the other problems occupying the tax-writing committees in the 1980s, Congress seems to have gone for the simplest possible approach in 1986, imposing an immediate ordinary income tax on the COD of solvent borrowers (other than certain farmers). As we have seen in the last 35 years, that approach has not proven to be viable or realistic when economic hardship is sufficiently widespread to attract congressional attention.

We believe that our proposal may solve, in a reasonably administrable way, this longstanding problem of identifying the assets whose basis should be reduced to appropriately reflect the borrower's gain from a reduction of his liabilities and his corresponding economic loss. ■

[11] Bittker and Lokken, *Federal Taxation of Income, Estates, and Gifts*, para. 7.1.

[12] *Bowers v. Kerbaugh-Empire Co.*, 271 U.S. 170 (1926).

[13] *United States v. Kirby Lumber Co.*, 284 U.S. 1 (1931).

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