Insolvency Procedures under Section 108

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In the current prolonged recession, many industrial and commercial entities have had to restructure their outstanding debt. Many debtor entities have had to restructure their public bonds as well as their private mortgages and notes. In particular, many real estate-intensive debtor entities have had to restructure their commercial real estate mortgages. When any amount of debt repayment is forgiven in such a debt restructuring, that event causes the debtor entity to recognize cancellation of debt (COD) income for federal income tax purposes. However, the debtor taxpayer can exclude some, or all, of this COD income to the extent that the debtor entity is insolvent. This discussion summarizes the federal income tax requirements related to the debtor entity recognition of COD income. And, this discussion summarizes the federal income tax requirements for the exclusion of COD income recognition related to debtor entity insolvency. In particular, this discussion focuses on the generally accepted methods and procedures that the valuation analyst may use to measure debtor entity insolvency for COD income exclusion purposes.

Introduction

The 2008 credit crisis, the subsequent recession, and the sluggish recovery have negatively affected both individuals and businesses operating in most industries. The current economic downturn has affected businesses regardless of their business structure or income tax status (e.g., C corporation, S corporation, partnership, limited liability company, etc.).

During the last four years, many businesses have had to negotiate some discharge of indebtedness with their creditors. Recapitalization and restructuring of commercial mortgages and other corporate debt is often necessary in order for distressed businesses to continue operating.

Due to the prolonged economic downturn, many debtor entities have to:

1. renegotiate the terms of their debt or
2. restructure their debt.

The downside of debt restructuring is that the debtor entity may have to recognize cancellation of debt (COD) income for federal income tax purposes.

If the taxpayer entity is relieved of debt, that relief is taxable income. Internal Revenue Code Section ("Section") 61(a)(12) provides that gross income includes income from COD.

COD Income Recognition Exceptions

Section 108, however, provides exclusion provisions for the recognition of COD income. Such exclusions include:

1. the bankruptcy exception and
2. the insolvency exception.

This is an important income tax benefit to businesses seeking bankruptcy protection. Insolvent taxpayers are allowed to exclude COD income in order to:

1. preserve the debtor's "fresh start" and
2. not bear the burden of an immediate tax liability when the debt is forgiven.

With debt restructuring a common occurrence in the current economic environment, business taxpayers should:

1. be aware of the COD income recognition tax rules and
2. plan for the income tax effects of these debt restructuring transactions.

This discussion focuses on the income tax consequences of Section 108 related to debt restructuring and the exclusion of COD income due to insolvency.

This discussion summarizes the procedures that the valuation analyst should consider with respect to measuring debtor entity insolvency for COD income exclusion purposes.

Debt Restructuring Events That Cause Debtor Entity COD Income

A debt restructuring outside of bankruptcy generally occurs when:

1. an ownership change is not expected or
2. the parties do not want to pay the expense of a bankruptcy proceeding.

A company may repurchase its existing debt at a price discount by means of a debt restructuring or a debt recapitalization. A nonbankruptcy debt workout may involve the creditors' exchange of the debtor entity's recourse or nonrecourse debt for newly issued equity.

Individual business owners are often required to personally guarantee the business debt in many closely held and family-owned businesses. When the business becomes financially distressed, this debt is often partially or entirely discharged.

When debt is forgiven or partially discharged, under Section 61, COD income in the amount of the debt discharge is included in the entity's taxable income. This is because the taxpayer entity did not include the loan proceeds in income when the proceeds were received.

A reduction in liabilities without a corresponding reduction in assets is a discharge of indebtedness income. Essentially, COD income quantifies the economic improvement in the debtor entity's position after a restructuring event.

For example, if a creditor forgives a $200,000 debt, the taxpayer debtor will generally recognize $200,000 of taxable income, improving the entity's debt position by $200,000.

Lenders frequently require compensating securities, such as preferred stock or common stock warrants, as an incentive for restructuring debt.

The Exchange of Equity for Debt

Under Section 108, in debt restructuring that involves the exchange of equity for debt, the amount of COD income recognized is equal to:

the excess of the amount of the debt
that is forgiven

over

the fair market value of the equity
exchanged in order to cancel the debt

The more complex capital structure of the entity post-restructuring may require more complex calculations to estimate the amount of the COD income. In order to estimate the economic improvement in the entity's debt position following the debt restructuring, the equity securities issued as compensation to the creditor need to be valued.

Under Section 108(e)(2), the discharge of debt will not result in COD income to the extent that payment of the liability would have resulted in a tax deduction.

Debts owed to trade creditors and certain liability claims that are discharged will also not result in COD income.

COD income is considered ordinary income under Section 62(a)(12). At the time of the debt discharge, the COD is subject to federal income taxation.

COD Income Recognition Exceptions

However, Section 108 provides several exceptions to the COD income recognition rule, allowing exclusion of the COD income recognition in the following circumstances:

1. The taxpayer entity is in a Title 11 bankruptcy proceeding
2. The taxpayer entity is insolvent immediately prior to the forgiveness of debt

Congress reasoned that these exclusions allow the taxpayer entity to get a "fresh start." Also, Congress reasoned that burdening the taxpayer entity with a large income tax liability from the relief granted by the bankruptcy process or from the discharge of debt would tend to defeat that objective.

Other exclusion provisions under Section 108 that may be applied to COD income include the following:

1. The discharge of qualified farm indebtedness
2. In the case of a business taxpayer other than a C corporation, the discharge of qualified real property business indebtedness
3. The discharge of qualified principal residence indebtedness prior to January 1, 2012

Debtor Entity Insolvency Reduces the Recognition of COD Income

Section 108 determines what portion of the related COD income is excluded from gross income, based on the taxpayer entity's insolvency at the time of discharge.

Under Section 108(a)(3), if the debt discharge occurs when the taxpayer debtor is insolvent, then the amount of COD income excluded will not exceed the amount by which the taxpayer debtor is insolvent.

The amount of COD income excluded under this section is applied to reduce the tax attributes of the taxpayer entity.

The debtor entity's tax position is affected by the COD income whether or not any income is actually realized. The taxpayer entity may exclude the COD income under Section 108(a) at the cost of decreasing certain debtor entity tax attributes.

Income Tax Attributes

To the extent that the taxpayer entity excludes any COD income from gross income, a corresponding reduction is applied to the income tax attributes of the subject debtor entity in the following order:

1. Net operating losses (NOLs)
2. General business tax credits
3. Minimum tax credits
4. Capital loss carryovers
5. Income tax basis reduction
6. Passive activity loss and credit carryovers
7. Foreign tax credit carryovers

Under Section 108(b)(5), the debtor entity also has the option to elect to reduce the basis of its depreciable property prior to reducing any other entity tax attributes.

Illustrative Example

For example, let's consider the following illustrative scenario:

1. The debtor entity has a NOL balance of $200,000.
2. The debtor entity has an implied $200,000 COD income from debt restructuring.
3. No exclusion of COD income is available.

The debtor entity may use the NOL balance against the COD income. Thereby, the debtor entity will decrease the realized COD income to $0. As a result, the debtor entity's tax attributes are reduced by $200,000.

If the debtor entity in the above scenario is insolvent under Section 108(a)(1)(B) by $200,000, then the implied COD income and the realized COD income are $0. However, due to Section 108(b), the debtor entity's tax attributes are still reduced by $200,000.

The Section 108 COD income recognition exceptions are applied differently for partnerships and corporations.

Therefore, it is important to consider the type of the taxpayer business entity for purposes of the insolvency analysis.

COD Income Recognition for Different Business Structures

Under Section 61, COD income is considered ordinary income and is subject to federal income taxation at the time the debt is released. However, these tax repercussions are different for entities depending on whether the subject business is an S corporation, C corporation, or a partnership.

The tax effects further vary based on whether the debt is related to (1) a recourse loan or (2) a nonrecourse loan.

S Corporations

When an S corporation recognizes COD income, this causes a reduction in the entity's tax attributions at the corporation level. Since S corporations do not have NOLs, this affects each shareholder's distributive share of losses and deductions that have been excluded for the taxable year of the debt discharge.

The result of this calculation is a readjustment of each shareholder's excess losses that carry forward into the years following the year of debt discharge.

Further, if the S corporation's liabilities are cancelled, then the COD income will not be included in the S corporation's taxable income. In that case, the shareholder's financial status is not relevant.

C Corporations

When a C corporation recognizes COD income, this also results in a reduction of the entity's tax attributions at the corporation level. The difference here is that C corporations do have NOLs. Therefore, the taxpayer intent typically is to preserve those NOL tax attributes.

Partnerships

In the event that a partnership defaults on its debt obligations, and a portion or all of that debt is released from the creditor, then the partnership must recognize COD income. The COD income realized must be allocated among the partners based on their respective ownership percentages.

Even though the COD income is realized at the partnership level, the determination of whether or not that COD income should be recognized is made at the partner level.

The reason for this is because, if one partner is bankrupt or considered insolvent, then that partner would likely not recognize any COD income allocated by the partnership. On the other hand, if the other partner(s) are solvent, then the other partner(s) must recognize their respective portion of the realized COD income.

COD Income Recognition Requirements Related to Recourse Debt and Nonrecourse Debt

When there is a reduction in debt that is recourse debt, often times, such a reduction will result in taxable COD income. Recourse debt is debt that is personally guaranteed by the debt holder.

That is, in the event the debt holder defaults on its debt obligation to the lender, the lender has the right to bring legal case against the debt holder. When the debt is considered to be nonrecourse, the lender does not have right to pursue anything other than the collateral for that debt.

For example, often closely held businesses need outside capital for an expansion or for working capital needs. The business owner may personally guarantee the business loan.

That personal guarantee is because smaller businesses:

1. often have difficulty in accessing capital and
2. are likely to be forced to pay higher interest rates.

In the event the debtor entity defaults in its debt obligations, the lender has the right to bring legal action against not only the debtor entity, but against the business owner as well.

On the other hand, if a homeowner defaults on his home loan, the bank may collect the collateral (i.e., the home). However, the bank may not take further legal action against the homeowner.

When a lender forecloses on real estate as part of a settlement related to a recourse loan, the foreclosure is reflected as a property sale. The proceeds from the foreclosure sale are equal to the lesser of:

1. the amount of the debt or
2. the fair market value of the real estate.

If the debt related to the recourse loan is greater than the fair market value of the real estate, then the taxpayer entity will recognize COD income related to the sale of the real estate.

Since a foreclosure sale is treated as a property sale, the amount of any taxable gain or loss is determined in accordance with the Section 1221 and Section 1231 requirements.

In the event that the debt related to the recourse loan is less than the fair market value of the real estate, the proceeds from the foreclosure sale are considered to be equal to the amount of the recourse debt. As a result, the taxpayer entity does not recognize any COD income.

When a lender forecloses on real estate as part of a settlement related to a nonrecourse loan, the foreclosure sale is still reflected as a property sale. However, the difference is that the proceeds from the foreclosure sale are equal to the amount of the debt related to the nonrecourse loan.

In this case, the fair market value of the real estate is not relevant. It is also noteworthy that the taxpayer entity will not recognize any COD income.

In the event that the discharged debt is greater than the real estate cost basis, the taxpayer entity will recognize either capital gains income or ordinary income according to Section 1231. However, such income will not be treated as COD income.

Federal Income Tax Definition of Insolvency

Under the U.S. Bankruptcy Code Section 101(32)(A), the term "insolvency" is defined as a financial condition such that the sum of an entity's debts is greater than all of such entity's property, at a fair value valuation.

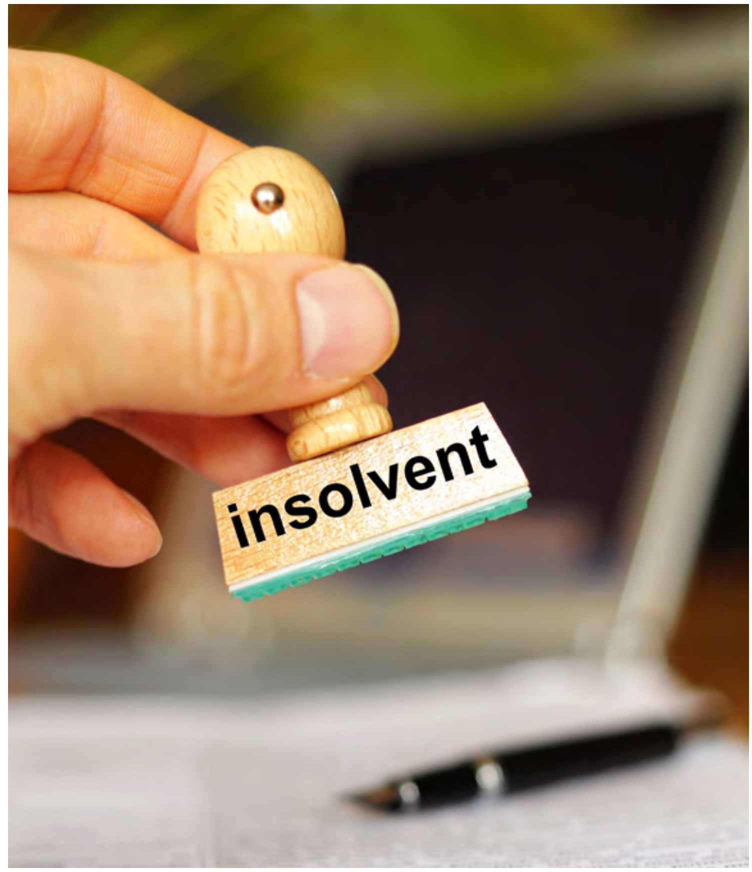
The term "insolvent" is defined in Section 108(d)(3), however, as the excess of liabilities over the fair market value of assets as determined immediately before the debt discharge. In comparison to the bankruptcy definition, the federal income tax definition of insolvency does not apply fair value or fair market value to liabilities.

Procedures to Quantify Debtor Entity Insolvency

Insolvency under Section 108 occurs when the taxpayer entity liabilities exceed the fair market value of the taxpayer entity assets. The amount by which the taxpayer entity is insolvent for Section 108(a)(1)(B) exclusion purposes is determined on the basis of the assets and liabilities immediately prior to the debt discharge.

The determination of insolvency (for income tax purposes) depends on the fair market value of the debtor entity's assets. Therefore, valuation of the debtor entity is an important element in the insolvency determination.

The valuation methods and procedures for measuring debtor entity insolvency for COD income exclusion purposes should consider the concept of "highest and best use" (i.e., is the value of the assets greater under a value in use basis or a value in exchange basis?).



Valuation Approaches

The three generally accepted valuation approaches used to estimate the fair market value of the debtor entity assets are:

1. the asset-based approach,
2. the income approach, and
3. the market approach.

Once the fair market value of the debtor entity's assets is estimated, the valuation analyst is able to measure the insolvency of the debtor entity. The amount of insolvency is then netted against the amount of the recognizable COD income.

Illustrative Example

For example, if a creditor forgives a $200,000 debt, the taxpayer entity will generally recognize $200,000 of taxable income. However, if the taxpayer entity is insolvent, the debtor entity would be able to exclude part or all of COD income realizable from the debt discharge.

To illustrate the process of measuring debtor entity insolvency and the effect of the insolvency exclusion on recognizable COD income, let's consider the simplified illustrative example presented in Exhibit 1.

In this example, a valuation is performed and the fair market value of the debtor entity's net assets is estimated at negative $100,000 (i.e., total assets of $200,000 less total liabilities of $300,000). Let's assume that the creditor forgives $200,000 of long-term debt. That debt forgiveness will result in $200,000 of taxable income to the debtor.

Illustrative Example Conclusion

This negative net asset value implies that the debtor entity is insolvent by $100,000. Therefore, the debtor entity may take advantage of the Section 108 insolvency exclusion.

The taxpayer's COD income of $200,000 will be partially offset by the taxpayer's insolvency amount of $1000,000.

Due to its eligibility for the insolvency exclusion, the debtor entity may net the insolvency amount against the COD income. Therefore, the taxpayer will only realize $100,000 of COD taxable income.

Exhibit 1
Illustrative Example
Insolvency Test Procedures

Original long-term debt balance:	$200,000	Restructured long-term debt balance:	$0

Taxpayer Solvency/Insolvency Analysis	At Fair Market Value
Total assets	$ 200,000
Current liabilities	100,000
Interest-bearing debt	200,000
Insolvency amount	**$(100,000)**
Total Implied COD income	200,000
Less: Taxpayer insolvency amount	(100,000)
Equals: Amount of COD income realized	**$ 100,000**

Tax Court Includes Exempt Assets in Insolvency Test for COD Income Recognition Purposes

Section 108 loosely defines the term "insolvent" as a debtor having liabilities that exceed the fair market value of the debtor assets. However, there are some uncertainties as to which assets should be included and which liabilities should be excluded in the insolvency formula.

Prior to 1999, Letter Ruling 9125010 concluded that if all creditors are subject to the laws of the state concerning the rights of creditors, then the value of the personal residence and other property (which is typically exempt from the reach of creditors by the laws of the state) would not be included in the assets considered in the Section 108 insolvency determination.

That is, assets which were out of reach from creditors under state law were not to be included in the insolvency determination.

In 1999, the Service issued Letter Ruling 9932013, effectively revoking Letter Ruling 9125010. In its new ruling, the Service concluded that all debtor assets should be included in the insolvency formula.

This is because the fundamental purpose of Section 108 indicates that a bankrupt debtor and an insolvent debtor should be provided with a fresh start.

The bankrupt or insolvent debtor should not be troubled with income taxes related to debt that has been previously released. This rationale was based on the fact that such debtors would not have assets available to pay income taxes related to debt that has been released.

However, excluding exempt assets (i.e., personal property or other assets that are typically exempt from the reach of creditors under state law) from the determination of insolvency would present taxpayers (who may be economically solvent) with the opportunity to defer a tax liability in cases where they have the ability to pay the tax liability.

Illustrative Example

To illustrate the effect of including all assets (i.e., assets that would otherwise be exempt from the reach of creditors) in the determination of whether a taxpayer debtor was insolvent, let's consider the two scenarios presented in Exhibit 2.

In scenario A, the taxpayer's personal property was not included in the insolvency formula. That is, the taxpayer held the personal property separate from the assets and liabilities of the business.

Therefore, the personal property was otherwise exempt from the reach of creditors under state law. And, the taxpayer's personal property was not included in the insolvency formula.

Under these assumptions, the taxpayer total liabilities of $500,000 exceed the fair market value of the taxpayer total assets of $400,000 and the taxpayer is deemed to be $100,000 insolvent. The $500,000 COD income will be reduced by this $100,000.

In scenario B, the taxpayer's personal property was included in the insolvency formula. Therefore, for purposes of determining the amount of COD income recognition, the taxpayer was not considered to be insolvent.

This is because the fair market value of the total assets ($500,000 in personal property plus $400,000 in business assets) exceeds the total liabilities of $500,000. Accordingly, the full amount of the $500,000 debt foregiveness was considered taxable COD income.

Exhibit 2
Consideration of Personally Owned Assets with Business Assets

Original long-term debt balance	$500,000	Restructured long-term deb balance	$0

Taxpayer Debtor Entity	Scenario A	Scenario B
Business-owned assets	$ 400,000	$ 400,000
Personal assets operated by business	500,000	500,000
Total debtor entity assets	900,000	900,000
Total business liabilities	500,000	500,000
Debtor solvency/(insolvency)	$ (100,000)	$ 400,000
Possible COD income	500,000	500,000
Amount of COD income realized	$ 400,000	$ 500,000

Illustrative Example Conclusion

Assets that would normally be exempt from the reach of creditors do not only include personal property or assets held under a separate business entity. In many instances, the Tax Court has included certain intangible assets that creditors are typically prohibited from seizing under state law.

Tax Court Includes Certain Intangible Assets in the Debtor Insolvency Analysis

In *Carlson v. Commissioner*,[1] the Tax Court concluded that the term "assets" in Section 108(d)(3) translates to all of the taxpayer assets, not just the assets that are within the reach of creditors.

The *Carlson* case is influential in the insolvency determination for purposes of recognizing COD income.

The Facts of the Case

In 1988, the Carlsons purchased a fishing vessel for commercial use. The purchase price of the boat was $202,451. They financed the purchase of the boat with a loan from Seattle First National Bank. In 1992, the Carlsons stopped making payments on the loan and they became delinquent.

In 1993, the Carlsons' loan had an unpaid principal balance of $137,142 and Seattle First National Bank foreclosed on the loan. The bank sold the boat for $95,000 and the full proceeds of the sale were applied to the outstanding balance of the loan. The remaining difference of $42,142 was discharged.

Immediately after the discharge of debt, the Carlsons had liabilities that totaled $515,930 and an aggregate fair market value of assets totaling $875,251. An Alaska limited entry fishing permit, which had a fair market value of $393,400, was included in those assets.

When the Carlsons filed their 1993 income tax return, they did not report the COD income as a result of the foreclosure sale of the boat. The bank filed the form 1099-A, Acquisition or Abandonment of Secured Property with the Service, and the bank also sent the Carlsons a copy.

The Carlsons attached a copy of the form 1099-A to their income tax return and noted at the bottom "Taxpayer was insolvent—no tax consequence."

The Service issued a notice of deficiency and stated that the Carlsons' income should be increased by the amount of COD income recognized, $42,142. The Service argued that in the determination of insolvency after the discharge of debt, all assets, even those that would not typically be within the reach of creditors, must be included in the determination of insolvency for purposes related to COD income recognition.

That is, in its solvency analysis, the Service included the fishing license, which was considered an intangible asset and which creditors were otherwise prohibited from seizing.

With the fair market value of the fishing permit intangible asset included, the Carlsons were considered solvent. Therefore, the Carlsons had to recognize the taxable COD income.

The Carlsons argued that as presented in Section 108(d)(3), the term "assets" should not include assets that are exempt from the claims of creditors under state law.

The Carlsons referenced *Cole v. Commissioner*[3] and *Hunt v. Commissioner*[4]; both of which concluded that according to Section 108(d)(3), the term "assets" only includes assets that are within the reach of creditors under state law for purposes of recognizing COD income.

The Tax Court Decision

The Tax Court first addressed whether the definition of the terms "assets" and "insolvent," as presented in Section 108, was clear. The Tax Court referenced the plain and ordinary meaning of the term "assets" used by Congress, since the statute does not define the term.

If the plain and ordinary meaning of the term supports only one construction, then the statutory language is considered unambiguous. When the term supports more than one construction, then the statutory language is considered ambiguous. In that case, legislative history can be referenced in order to understand the term.

After reviewing the legislative history, the Tax Court concluded that when Congress enacted Section 108(d)(3) and the related regulations, Congress intentionally adopted a different definition of the term "insolvent."

Unlike the definition of the term "insolvent" for purposes of the Bankruptcy Act, the term "insolvent" did not specifically exclude a taxpayer's assets that are not within the reach of creditors' claims.

The Tax Court further concluded that since Congress did not state that such assets should be excluded from the insolvency formula for purposes of recognizing COD income, Congress did not intend for such assets to be excluded.

Court Excludes Certain Contingent Liabilities in the Insolvency Analysis

In the same way that the Tax Court must decide which assets to include in the insolvency formula for purposes related to COD income recognition, often the Court is also presented with the question of which liabilities should be included.

In *Dudley B. Merkel*,[4] the Ninth Circuit was presented with the question of when a liability should be excluded from the insolvency formula for purposes related to COD income recognition.

The Facts of the Case

In 1979, Dudley B. Merkel and David Hepburn started Systems Leasing Corp. (SLC) for the purpose of leasing computers. SLC was owned equally by Merkel and Hepburn, and both men were officers in the company.

In 1986, SLC applied for a loan from Security Pacific Bank. In return, the bank was given a note. The note from SLC to Security Pacific Band was personally guaranteed by both Merkel and Hepburn

In April 1991, the unpaid balance of the note from SLC was approximately $3,100,000, and SLC was in default of its loan obligations to Security Pacific Bank.

In May 1991, Merkel and Hepburn (as guarantors), and the bank entered into an agreement of a structured workout related to the repayment of the SLC debt obligation to the bank.

The structured workout, agreed upon by all parties, provided for the following terms:

1. SLC agreed to pay the bank $1,100,000 on or before August 2, 1991.
2. The bank agreed to release its security interest in the remaining collateral upon payment of the payoff amount of $1,100,000 by the settlement date agreed to by both parties.
3. After the payment of $1,100,000 was made, Security Pacific Bank agreed to release Merkel and Hepburn as personal guarantors of the SLC note if bankruptcy was not filed by or for SLC or petitioners, within 400 days after the settlement date.

In an unrelated matter, the North Carolina Department of Revenue issued a notice of sales and use tax due to SLC on June 14, 1991. The notice identified the total amount of taxes, penalties, and interest due, of approximately $980,000.

Merkel and Hepburn later protested the sales and use tax assessment with the help of an attorney. As a result of the appeal, the North Carolina Department of Revenue released the tax assessment in full.

In relation to the proposed settlement between SLC and Security Pacific Bank, SLC made the payment by the settlement date. And, the bank released its security interests in the collateral of SLC. All other conditions of the agreement were met.

After August 2, 1991, the expiration of the 400-day period, the bank released SLC from its liability of the SLC note and Merkel and Hepburn from the petitioners' guarantees.

The Service's Position

Merkel and Hepburn also both operated partnerships with their wives. And, in a separate matter, the Service audited Merkel and Hepburn. The Service issued a notice of deficiency and stated that $360,000 of COD income should be included in the partnership income.

The Taxpayer's Position

Both Merkel and Hepburn made the argument that the following liabilities caused them to be insolent:

1. Their liability as guarantors on the SLC note to Security Pacific Bank
2. The liability of Merkel and Hepburn as officers of SLC for the unpaid sales and use tax assessment by the State of North Carolina against SLC caused them to be insolvent

The Court's Decision

The Ninth Circuit presented the reasoning that, in order for a liability to be considered in the determination of insolvency for purposes of recognizing COD income, such liabilities must be "ripe and in existence on the measurement date."

The Ninth Circuit decided that, since both liabilities were contingent, neither could be included in the insolvency formula for purposes of COD income recognition.

Merkel and Hepburn argued that as presented in Section 108(d)(3), the term "liabilities" translates to all liabilities, whether contingent or not. Merkel and Hepburn reasoned that even though the liabilities may have been contingent, such liabilities were still real.

Merkel and Hepburn suggested that since such liabilities were contingent, a proper way to measure such liabilities would be to lessen the full exposure amount of the liabilities.

Section 108 contains no definition of the term "liabilities." The regulations interpreting Section 108 neither add to the statutory definition of insolvency nor define the term "liabilities."

The Ninth Circuit declared that, in order for a contingent liability to be included in the insolvency formula, the taxpayer must prove that it is more likely than not that the taxpayer will be called upon to pay such a liability.

Summary and Conclusion

As a result of the 2008 credit crisis, many businesses have found the need to restructure their business debt.

The debt restructuring may include a renegotiation of the outstanding debt terms. Or, in many cases, the debt restructuring may include the partial forgiveness of debt, resulting in the debtor entity COD income.

Due to the current economic environment, many businesses would not be able to continue operating without restructuring their business debt. The disadvantage of the debt restructuring is that the debtor entity may have to recognize income related to the COD.

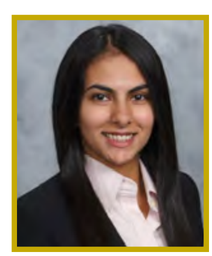
Section 108 and the related regulations determine what portion of the COD income should be excluded from taxable income, based on the determination of the debtor entity insolvency at the time of the release of debt.

In the current economic environment, debtor entities often find the need to restructure their debt. Section 108 and the related regulations provide guidance for valuation analysts and taxpayers related to the income tax consequences associated with COD income.

Judicial decisions also provide valuation analysts and taxpayers with professional guidance. The above-mentioned court cases provide examples of the COD income consequences that may occur when a debtor entity restructures its business debt.

Notes:

1. Carlson v. Commissioner, 116 TC No. 9 (2001).
2. Cole v. Commissioner, , 42 B.T.A. 1110 (1940).
3. Hunt v. Commissioner, T.C. Memo. 1989-335.
4. Dudley B. Merkel, 192 F.3d 844 (9th Cir. 1999), aff'g 109 TC 463 (1997).



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