PERSONAL INCOME TAX BULLETIN 2009-05

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Cancellation of Investment Indebtedness

I. Introduction.

The purpose of this bulletin is to explain the extent to which cancellation of investment indebtedness is reportable and taxable income for personal income tax purposes. This bulletin applies to individuals, sole proprietors, owners of disregarded entities, partnerships, and S corporations realizing cancellation of investment indebtedness.

When a taxpayer borrows money, he or she is not required to include the loan proceeds in income because he or she has an obligation to repay the lender. Because the taxpayer has an obligation to repay the lender, he or she is allowed to include loan proceeds in his or her cost basis of investment property.

This is a benefit to the taxpayer for many reasons. For example, the taxpayer uses his basis when calculating the amount of gain or income realized upon a subsequent disposition of the investment property; the greater the taxpayer's basis, the less his income from a disposition of that property. In addition, he has the benefit of including the loan proceeds in the basis in his investment in a partnership ("outside basis"). The taxpayer is able to deduct losses from the partnership to the extent of his outside basis.

When an obligation is subsequently forgiven, the obligation to repay the lender disappears. Therefore, if a taxpayer relinquishes investment property in connection with cancellation of investment indebtedness, the taxpayer must recognize net gain or income from the sale, exchange or disposition of property in accordance with the rules explained in this bulletin.

II. How to use this bulletin.

1. The rules in this bulletin apply when "investment indebtedness" is cancelled. The term 'investment indebtedness" generally refers to any indebtedness secured by investment property. The terms "investment indebtedness" and "investment property" are defined in Section III of this bulletin. Please refer to these definitions before proceeding.
2. If investment indebtedness is cancelled:
    a. First, calculate the amount of income resulting from cancellation of indebtedness. Refer to Section IV.
    b. Next, determine the class in which the cancellation of indebtedness income must be reported. Refer to Section V.
    c. Finally:

   i. Apply the rules in Section VI if you are a sole proprietor or owner of a disregarded entity.
   ii. Apply the rules in Section VII if you are a partner in a partnership or a member of an LLC taxed as a partnership.
   iii. Apply the rules in Section VIII if you are a shareholder of an S corporation.
3. To the extent an obligation is not investment indebtedness, please refer to Personal Income Tax ("PIT") Bulletin 2009-02 (personal indebtedness), PIT Bulletin 2009-03 (indebtedness secured by a principal residence), or PIT Bulletin 2009-04 (business indebtedness). For rules applicable to rents, royalties, patents or copyrights, please refer to PIT Bulletin 2009-06.
4. If you are in bankruptcy or think you may be insolvent, please refer to PIT Bulletin 2009-__ (forthcoming).
5. Please refer to Section IX for exceptions.

III. Definitions.

Cancellation: Cancellation occurs when a debtor is legally discharged from primary liability for an indebtedness and it is probable that the debtor will not be required to make future payments as guarantor of the indebtedness. A debtor is legally discharged on the occurrence of one of the following identifiable events:

1. Discharge of indebtedness in bankruptcy.
2. Discharge of indebtedness in receivership.
3. Expiration of the statute of limitations for collecting the indebtedness.
4. Discharge of indebtedness arising from the creditor's election to pursue foreclosure which statutorily extinguishes its right to pursue further collection.
5. Extinguishment of an indebtedness under a probate proceeding.
6. Discharge pursuant to an agreement between the creditor and debtor for less than full consideration.
7. Discharge according to a decision by the creditor, and under a defined policy of the creditor, to discontinue collection activity and to cancel the indebtedness.

A liability is not forgiven or discharged merely because it is temporarily uncollectible or unenforceable as a matter of fact. However, it is the position of the Department that, when a 36-month testing period expires during which there has been no payment made, the 36-month period provides a rebuttable presumption that the indebtedness has been discharged.

If an individual partner is relieved of a liability but the partnership remains liable, the liability is reallocated. Please refer to Personal Income Tax Guide Chapter 16 for an explanation of partnership rules.

Indebtedness: An obligation, absolute and not contingent, to pay on demand or within a given time, in cash or another medium, a fixed amount. The term includes principal, interest, penalties, fines, and administrative fees.

Investment indebtedness: An obligation is investment indebtedness to the extent it is secured wholly or in part by investment property.

Investment indebtedness includes the amount of the principal obligation plus the amount of outstanding interest, penalties, fees, administrative costs, and fines associated with the obligation.

Investment property: Real property, tangible personal property, or intangible personal property, including but not limited to the following:

1. Land and buildings.
2. Stocks, bonds, securities, options, and similar property.
3. Intangible ownership interest in an LLC, S corporation, or partnership.
4. Artwork.
5. Collectibles.

The term does not include property used in the conduct of a business, profession, or farm activity. For an explanation of how the Pennsylvania personal income tax rules apply to property used in the conduct of a business, profession, or farm activity, please refer to PIT Bulletin 2009-04. For an explanation of how the Pennsylvania personal income tax rules apply to property generating rents, royalties, patents or copyrights income, please refer to PIT Bulletin 2009-06.

IV. Calculating the amount of reportable income or basis reduction.

A. Income from the sale, exchange, or disposition of investment property in conjunction with cancellation of investment indebtedness.

A taxpayer must recognize income from the sale, exchange or disposition of investment property. Apply steps 1 – 3 below to calculate the amount of reportable income.

Step 1: Add the following items:

i. The amount of discharged principal*, plus
ii. The amount of discharged interest**, penalties, fees, administrative costs, and fines, plus
iii. The amount of any additional consideration received, including cash or other property.

The sum of (i)-(iii) is your **amount realized**. (The amount realized is reported as the “gross sales price” on PA Schedule D, Line 1, Column (d)).

* If you received a Form 1099-A or 1099-C, the amount in Box 2 of either form is the amount of discharged principal. If you are jointly and severally liable on the obligation, the discharged indebtedness must be allocated among the co-obligors

based on the facts and circumstances, including the extent to which each co-obligor equally enjoyed the use of the indebtedness proceeds.

** If you received a Form 1099-C and an amount is included in Box 3, this amount is included in discharged interest.

Step 2: From the amount realized as calculated in Step 1 above, subtract your **adjusted basis** in any property securing the indebtedness or in which the indebtedness was included in basis.

Your adjusted basis is equal to the amount you paid to purchase the property, including closing costs, realty transfer taxes, and one-time costs incurred to finance the property. The adjusted basis also includes the cost of any permanent improvements made to the property after purchase. You should not add property taxes, periodic interest expenses, or other recurring expenses not properly chargeable to the basis of the property.

Step 3: If you are an **individual, sole proprietor** or **owner of a disregarded entity,** the result of the amount realized in Step 1 above, minus the adjusted basis in Step 2 above, is the amount of gain that you must report on your Form PA-40. If you are a **partner,** please refer to Section VII to determine your share of the income from cancellation of indebtedness. If you are a **shareholder in an S corporation,** please refer to Section VIII to determine your share of the income from cancellation of indebtedness.

B. Mandatory basis adjustment in conjunction with cancellation of investment indebtedness.

If investment indebtedness is written down and if the investment property is not relinquished, the debtor-taxpayer must reduce the basis in the investment property by the amount of cancelled indebtedness.

V. Classifying the reportable income.

A taxpayer reports income from cancellation of investment indebtedness as net gain or income from the sale, exchange, or disposition of property. The same rule applies to all taxpayers for personal income tax purposes, including individuals, sole proprietors, partnerships, LLCs, and S corporations.

If partnership or S corporation indebtedness is discharged, the income is classified at the entity level; the partner, shareholder, member, or other owner reports the income in the class as determined at the entity level.

VI. Individuals, sole proprietors and owners of a disregarded entity.

An individual, sole proprietor or owner reports the entire amount of cancellation of indebtedness income as determined under Section IV. This amount is reported on

Schedule D and Form PA-40, Line 5. If a basis reduction is required, the newly reduced basis must be used in the future.

VII. Partnerships.

After the partnership determines the amount of cancellation of business indebtedness income under Section IV, and determines the classification of that income under Section V, the partnership next calculates each partner's share of the income applying the rules set forth in Section A, below. In addition, each partner must adjust his or her outside basis applying the rules set forth in Section B, below.

A. Rules for calculating each partner's share of income.

As a general rule, if a partnership borrows money on a **recourse** basis, the partner must include the cancelled indebtedness in income to the extent he or she bears the economic risk of loss for the indebtedness. For administrative convenience, the Department applies an economic risk of loss analysis similar to the analysis under I.R.C. § 752 and the regulations and rules thereunder, if the partnership has consistently allocated liabilities this way and if the allocations clearly reflect income. The partners must include the cancellation in income in the same proportion it is includible for federal income tax purposes.

> **Example:** A partnership owned 50/50 by taxpayers A & B borrows $100,000 on a recourse basis and secured by investment property. In Year 2, the partnership relinquishes the investment property and the lender cancels the $100,000 indebtedness. Under I.R.C. § 752 and the regulations thereunder, each partner bears the economic risk of loss equally, and therefore each partner is allocated $50,000 of the obligation.
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> The partnership reports $50,000 on each partner's RK-1 or NRK-1 as net gain from the disposition of the investment property. Each partner must recognize $50,000 as net gain on their PA-40. In addition, each partner realizes a deemed distribution equal to the amount of indebtedness cancelled, and must reduce his or her outside basis accordingly.

If a partnership borrows money on a **nonrecourse** basis, each partner must include the cancelled indebtedness in income to the extent he or she shares in the profits of the partnership.

> **Example:** A partnership owned by taxpayers A & B borrows $100,000, secured by investment property. The indebtedness is nonrecourse to the partnership. A & B share profits 50/50. In Year 2, the lender cancels the $100,000 indebtedness and the partnership turns over the property to the lender. Each partner must recognize $50,000 as income from operations in the year of cancellation.

B. Effect on outside basis.

Each partner must **increase** his or her outside basis in his or her partnership ownership interest to the extent of his or her share of partnership income from cancellation of indebtedness, including any minimum gain chargeback.

Each partner must **decrease** his or her outside basis in his or her partnership ownership interest to the extent he or she or she is relieved of indebtedness, consistent with his or her allocation of liabilities.

> **Example**: Two partners bear the economic risk of loss for $100 of recourse partnership obligations on a 50/50 basis. This recourse obligation is cancelled, resulting in net gain or income of $100. Each partner must increase his or her outside basis by the $50 share of the income. In addition, the partner must decrease his or her outside basis by $50, which is his or her share of indebtedness relief.

To the extent a partner's share of partnership liabilities exceeds that partner's share of partnership income, the partner will recognize gain as follows:

> **Example:** Partner has an outside basis of $0 at the start of Year 1 (on account of losses taken in previous years). The partner's share of partnership liabilities is $150. The partnership recognizes cancellation of indebtedness income in Year 1. The partner's share of this cancellation of investment indebtedness income is $100. In the cancellation of indebtedness transaction, the partner is relieved of his or her share of $150 in partnership liabilities. The partner's basis is increased to $100 by the income recognized, and is then decreased by $150 on account of the relief from liability. The partner must recognize income equal to $100 from cancellation of indebtedness, and must recognize additional net gain arising from his or her intangible ownership interest (reported on Schedule D Form PA-40) equal to $50.

VIII. S corporations.

After the S corporation determines the amount of cancellation of indebtedness income under Section IV, and determines the classification of that income under Section V, the S corporation must next calculate each shareholder's share of the income applying the rules set forth in Section A, below. In addition, each shareholder must determine the effects of the cancellation of indebtedness on the shareholder's outside basis, applying the rules set forth in Section B, below. Finally, any shareholder lending money to the S corporation must apply the rules set forth in Section C, below.

A. Calculating each shareholder's share of income.

Each shareholder must report cancellation of indebtedness income in accordance with the shareholder's pro rata share of S corporation income.

> **Example:** An S corporation borrows $100,000 secured by investment property; this investment indebtedness is later cancelled by the lender. The S corporation

realizes net gain or income from the cancellation in the amount of $100,000. Shareholder A's pro rata share of S corporation income is 50%. A must report $50,000 of the cancellation of indebtedness income as Schedule D net gain or income.

B. Basis increase equal to each shareholder's pro rata share of income from cancellation.

Each shareholder increases his or her basis of the stock of the S corporation or in his or her shareholder indebtedness basis by an amount equal to the shareholder's pro rata share of cancellation of indebtedness income. The shareholder must increase his or her shareholder indebtedness basis before he or she may increase the basis of his or her S corporation stock.

Example 1: An S corporation realizes income from the cancellation in the amount of $30,000. Shareholder A's pro rata share of this income is $10,000. Shareholder A has a stock basis of $5,000. He or she increases his or her stock basis to $15,000 by the income recognized.

Example 2: Assume that under the facts in Example 1, Shareholder A had a stock basis of $0 and had a shareholder indebtedness basis of $0. The $0 shareholder indebtedness basis reflects a reduction by $5,000 on account of losses taken in previous tax years. Recall that shareholder A's pro rata share of the cancellation of indebtedness income is $10,000. Shareholder A first increases his or her shareholder indebtedness basis to $5,000. Next, Shareholder A increases his or her stock basis by the remaining $5,000. His or her stock basis and shareholder indebtedness basis are now each $5,000.

C. Shareholder loans to the S corporation.

If an S corporation shareholder lends money to the S corporation, this amount is included in his shareholder debt basis. If the shareholder-lender cancels the debt to the S corporation, the S corporation must recognize income in the amount as determined under Section IV and the class as determined under Section V. This amount is reported on the S corporation PA-20S/PA-65 and the S corporation reports each shareholder's pro rata share of the income on the RK-1 or NRK-1 distributed to the shareholder.

The shareholder-lender must report the amount on the RK-1/NRK-1 as income on his or her PA-40 *in the same class* as reported on the PA-20S/PA-65 and RK-1/NRK-1.

In addition, the shareholder-lender may recognize a loss on account of the bad debt made to the entity to the extent of his remaining shareholder debt basis attributable to that debt. This loss *must be reported as a Schedule D loss*. If and only if the shareholder-lender is in the business of regularly lending money may the shareholder-lender report the loss as a Schedule C loss.

If the shareholder-lender has reduced his entire shareholder debt basis due to losses taken against the shareholder debt basis in prior years, the amount of the shareholder's loss necessarily has been reduced. This is because the shareholder has used the shareholder debt basis as a means to take losses over the years and he has benefited from the shareholder debt basis to that extent. Therefore, the shareholder may recognize a loss only to the extent of his remaining shareholder debt basis.

> **Example:** A shareholder-lender lends $60,000 to his S corporation. His pro rata share of income is 50%. His shareholder debt basis is $60,000 on account of the loan to the S corporation. After several years of losses, the shareholder-lender's remaining shareholder debt basis is $10,000.
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> The shareholder-lender agrees to cancel the loan to the S corporation when the outstanding principal is $50,000. The S corporation recognizes income of $50,000, which the S corporation determines is business, profession, or other activity income.
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> The shareholder-lender must report Schedule C income of $25,000, which is his pro rata share of S corporation income from cancellation of indebtedness.
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> In addition, the shareholder-lender recognizes a Schedule D loss on account of the debt which is now uncollectible. If the shareholder-lender received nothing from the S corporation upon cancellation, the loss is equal to the shareholder-lender's remaining shareholder debt basis, increased by the gain recognized on the cancellation of indebtedness. In this example, the total Schedule D loss is $35,000. This is the sum of the $10,000 shareholder debt basis increased by the $25,000 of cancellation of debt income recognized upon the cancellation. At the end of the tax year, the shareholder no longer has any shareholder debt basis.

IX. Exceptions.

A. Disputed indebtedness.

If the amount of indebtedness is genuinely in dispute, a settlement of a claim for less than the creditor seeks is not income if the debtor disputes the claim. This is because the amount payable is not a "fixed amount." Examples include:

1. Indebtedness which is not enforceable under state law; or
2. Indebtedness settled for less than the face amount on account of a dispute between the lender and borrower. If a lender agrees to accept less than the face amount of an obligation because of the borrower's potentially meritorious claim arising from the lender charging usurious interest rates, the lender's agreement to cancel the borrower's liability for all accrued interest is not income because the amount of indebtedness is genuinely in dispute.

B. Cancellation of purchase-money indebtedness.

If indebtedness arising in a sale on credit is cancelled or reduced, the amount cancelled is usually treated as an adjustment of the purchase price, to be applied in reduction of the buyer's adjusted basis for the property, rather than included in gross income as cancellation of indebtedness income.

An indebtedness reduction is treated as a reduction of purchase price, rather than indebtedness cancellation income, if:

(1) The cancelled or reduced obligation is indebtedness of a purchaser of property to the seller of such property, arising out of the purchase of such property;
(2) The taxpayer is not insolvent or in bankruptcy when the reduction occurs; and
(3) The reduction would, apart from this rule, be cancellation of indebtedness income.

This rule applies only to reductions by agreement between buyer and seller and not, for example, to a cancellation resulting when an obligation is unenforceable on account of the running of the statute of limitations on enforcement.

This rule does not apply when the indebtedness has been transferred by the seller to a third party or when the property has been transferred by the buyer to a third party.

This rule does not apply if the indebtedness was never owed to the person from whom the taxpayer purchased the property. For example, if A buys property from B, financing the purchase with a loan from C, the purchase-price reduction rule is inapplicable to any reduction of the liability.