

## **PERSONAL INCOME TAX BULLETIN 2009-04**

**Issued: April 30, 2009**

### **Cancellation of Business<sup>1</sup> Indebtedness**

#### **I. Introduction.**

The purpose of this bulletin is to explain the extent to which cancellation of business 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 business 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 rents and royalties property.

Including these loan proceeds in the basis of rents and royalties property is a benefit to the taxpayer. For example, the taxpayer uses his or her basis when calculating the amount of gain or income realized upon a subsequent disposition of the rents and royalties property; the greater the taxpayer's basis, the less his or her gain upon disposition. In addition, a taxpayer reaps a benefit from including loan proceeds in the cost basis of property to the extent he or she depreciates that property.

A taxpayer realizes a benefit from the loan because the tax law allows an interest expense deduction associated with business indebtedness. By deducting the interest expense, the taxpayer is averring that the interest is connected to loan proceeds used for expenses ordinarily and necessarily incurred in business, profession, or farming activities.

The tax law allows the taxpayer to use the proceeds on a tax-free basis on the understanding that the taxpayer has an obligation to repay the lender. To accurately reflect cost basis and income when the obligation disappears, the taxpayer is required to recognize income as explained in this bulletin. If the taxpayer retains the business property connected with the business indebtedness, then the taxpayer must reduce the basis of that property.

Please note that Pennsylvania law does not contain an equivalent to the federal exclusionary rule for "qualified real property business indebtedness." Therefore, you treat qualified real property business indebtedness the same as any other business indebtedness under this bulletin. Likewise, Pennsylvania law does not contain an

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<sup>1</sup> For purposes of this bulletin, the term "business" refers to the Pennsylvania class of income commonly referred to as "net profits" or income from a "business, profession or other activity."

equivalent to the federal exclusionary rule for “qualified farm indebtedness.” Therefore, you treat qualified farm indebtedness the same as any other business indebtedness under this bulletin.

Further, please note that the Department does not allow deferral of income realized upon “reacquisition of an applicable debt instrument,” as allowed in the American Recovery and Reinvestment Act of 2009. Under federal law, taxpayers are allowed to defer recognition of income from such reacquisitions over a period of several years. However, for Pennsylvania personal income tax purposes, all of the income from reacquisition of an applicable debt instrument is immediately taxable in the year of reacquisition.

## **II. How to use this bulletin.**

1. The rules in this bulletin will apply to you when “business indebtedness” of yours is cancelled. The term business indebtedness is defined in Section III of this bulletin. Please refer to the definitions before proceeding.
2. If business 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 in an S corporation.
3. To the extent an obligation is not business indebtedness, please refer to Personal Income Tax (“PIT”) Bulletin 2009-2 (personal indebtedness), PIT Bulletin 2009-3 (indebtedness secured by a principal residence), PIT bulletin 2009-5 (investment indebtedness), or PIT Bulletin 2009-6 (rents and royalties indebtedness).
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.

**Business<sup>2</sup> indebtedness:** An obligation is business indebtedness to the extent it is any of the following:

1. An obligation incurred with respect to business activity or the proceeds of which are used for business purposes.
2. An obligation secured wholly or in part by business property.
3. An obligation for which a deduction or other offset against business income was made for costs associated therewith.
4. An obligation included in the basis of business property.

An obligation used in part for personal purposes and in part for business purposes is subject to the rules in this bulletin to the extent it is a business indebtedness described in sections (1) – (3) of this definition.

**Example 1:** A taxpayer business owner borrows \$10,000 and uses the proceeds to purchase a vehicle used 40% for business purposes and 60% for personal use purposes. He or she (inappropriately) has deducted 100% of the interest expenses associated with the loan. If the indebtedness is cancelled when the outstanding balance is \$8,000, he or she must report the entire \$8,000 as income. Under this definition, the indebtedness is treated 100% as business indebtedness because this is the extent to which the borrower deducted the interest expense from income. The taxpayer must treat the obligation consistently with the manner of treatment from previous tax years.

**Example 2:** Assume the business owner in Example 1 deducts only 40% of the interest expense associated with the loan. If the indebtedness is cancelled when the outstanding balance is \$8,000, he or she must report \$3,200 as income ( $\$8,000 * .40$ ). The indebtedness is treated 40% as business indebtedness because this is the extent to which the borrower deducted the interest expense from income.

Business indebtedness, as defined above, includes the amount of the principal obligation plus the amount of interest, penalties, fees, administrative costs, and fines associated with the obligation.

**Business property:** Real property, tangible personal property, or intangible personal property used in the conduct of a business activity.

For an explanation of how the Pennsylvania personal income tax rules apply to investment property, please refer to PIT Bulletin 2009-5. For an explanation of how the

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<sup>2</sup> Please recall that for purposes of this bulletin, the term “business” refers to the Pennsylvania class of income commonly referred to as “net profits” or income from a “business, profession or other activity.”

Pennsylvania personal income tax rules apply to rents, royalties, patents or copyrights property, please refer to PIT Bulletin 2009-6.

**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. An indebtedness 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 during which there has been no payment made expires, the 36-month period provides a rebuttable presumption that the indebtedness has been discharged.

If a debtor is partially discharged of a liability and retains the property subject to the liability, he or she must reduce the adjusted basis of the property to the extent the discharged amount was not included in income.

If an individual partner is relieved of a liability but the partnership remains liable, the liability is reallocated. Please refer to PIT 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.

#### **IV. Calculating the amount of reportable income.**

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

If business indebtedness is secured by business property, and if the business property is relinquished in connection with cancellation, the taxpayer must recognize income

from disposition of business 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**.

\* 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 secured business indebtedness.**

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

**Example:** A sole proprietor borrows \$10,000 secured by business property. Several years later, the bank discharges the loan when the outstanding balance is \$7,500, but the sole proprietor retains the business property. The sole proprietor must reduce his or her basis in the property by \$7,500.

### **C. Income from cancellation of unsecured business indebtedness.**

If unsecured business indebtedness is cancelled, taxable income is equal to the amount of discharged principal plus the amount of discharged interest, penalties, fees, administrative costs, and fines.

### **V. Classifying the reportable income.**

A taxpayer reports income from cancellation of business indebtedness in the class for which the income is a substitute, applying the rules in Sections V.A & V.B depending upon whether the indebtedness is secured or unsecured.

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.

The Department requires a taxpayer to treat income from cancellation of indebtedness consistently with how he or she treated the indebtedness over the term of the indebtedness, in the manner which most clearly reflects income.

#### **A. Unsecured business indebtedness.**

If the cancelled business indebtedness is unsecured, the cancellation income is reported in the same class of income from which any interest expenses or costs associated with the loan were deducted.

**Example:** A sole proprietor borrows \$10,000 on an unsecured basis. He or she uses the funds for payroll and utilities expenses. He or she has deducted the interest expense from net profits. The lender cancels the indebtedness when the outstanding obligation is \$8,000. The sole proprietor must report the \$8,000 as net profits.

#### **B. Secured business indebtedness.**

If the cancelled business indebtedness is secured by property and the property is relinquished in the cancellation, the cancellation results in income from disposition of the property securing the indebtedness.

The income arising from such transfer must be reported as income in accordance with Pennsylvania rules as explained in the Personal Income Tax Guide, found at

[www.revenue.pa.gov](http://www.revenue.pa.gov). If the property is not relinquished, a basis reduction is required as described in section IV.B.

**Example 1:** A taxpayer owns a building in Pennsylvania he or she uses for business purposes. The taxpayer uses the building to secure financing of \$250,000. The lender forecloses on the property at a time when the building has a basis of \$200,000. The building is relinquished to the lender in conjunction with abandonment of the taxpayer's business. Taxpayer recognizes gain of \$50,000, which is net gain from the disposition of property.

**Example 2:** A taxpayer owns royalty rights worth \$50,000. Taxpayer uses the royalty rights as collateral to secure indebtedness of \$50,000. He or she uses the proceeds of the indebtedness for overhead expenses associated with running his or her tree removal business. The taxpayer deducts the interest expense associated with the loan on Schedule C as a business expense. The bank subsequently cancels the \$50,000 indebtedness and keeps the collateral for the loan (the royalty rights). Taxpayer's adjusted basis in the royalty rights is \$10,000. Taxpayer recognizes income of \$40,000 (amount of indebtedness cancelled – taxpayer's adjusted basis). This income arises from a transfer of intangible property used in the taxpayer's business, and therefore, the income is reportable as business income.

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

An individual, sole proprietor or owner determines the amount of cancellation of indebtedness income under Section IV, and determines the classification of that income under Section V.

### **A. Individual, sole proprietor or owner recognition of income.**

**Example 1:** A taxpayer owns equipment used in his or her business with a basis of \$5,000. The equipment is encumbered by business indebtedness of \$25,000 and the taxpayer discontinues business operations. If the business indebtedness is discharged, he or she must recognize income of \$20,000 of Schedule D gain, applying the formula in Section IV.

**Example 2:** Taxpayer H buys a house in 1998. For 10 years, H uses a portion of the property as his or her principal residence and a portion of the property for business purposes. H claims depreciation deductions of \$15,000 for the business use of the property. The lender forecloses on H's property in 2008. H realizes a gain of \$50,000. H had no other Schedule D gains or losses for 2008. H determines that \$15,000 of the gain is allocable to the business-use portion of the property and that \$35,000 of the gain is allocable to the portion of the property used as his or her residence. H must recognize \$15,000 of the gain allocable to the business-use portion of the property. The income is reported on Schedule D as a disposition of property in accordance with the rules in Section VI.

## **B. Loans from owners to businesses.**

An owner of a disregarded entity or sole proprietorship is not allowed to deduct any interest or other costs associated with a loan to the business. Therefore, the owner is not required to include cancellation of the indebtedness as income from the business. Further, the owner must not recognize a loss on the cancelled business indebtedness.

**Example:** The owner of a single-member LLC loans \$1,000 to the LLC. The LLC has inadequate funds to pay the indebtedness and the owner cancels the indebtedness of the LLC. The LLC does not recognize cancellation of indebtedness income, and the owner does not recognize a loss for the bad debt. The owner may increase his or her cost basis in the business if the loan was not previously included in the basis of the business.

## **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, using the funds for payroll expenses and other overhead expenses. The partnership deducts interest expenses associated with the indebtedness. In Year 2, 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.

The partnership reports \$50,000 on each partner's RK-1 or NRK-1 as business income. Each partner must recognize \$50,000 as business income 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. See Section V for rules on classifying this income.

**Example:** A partnership owned by taxpayers A & B borrows \$100,000 on an unsecured basis, using the funds for payroll expenses and other overhead expenses. The partnership deducts from business income the interest expenses associated with the indebtedness. A & B share profits 50/50. In Year 2, the lender cancels the \$100,000 indebtedness. Each partner must recognize \$50,000 as business income from operations in the year of cancellation.

#### **B. Effect on outside basis.**

Each partner must **increase** his or her outside basis in the 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 the 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 business income of \$50 to each partner. Each partner must increase his or her outside basis by the \$50 of 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 \$15,000. The partnership recognizes cancellation of indebtedness income in Year 1. The partner's share of this cancellation of business indebtedness income is \$10,000. In the cancellation of indebtedness transaction, the partner is relieved of his or her share of \$15,000 in partnership liabilities. The partner's basis is increased to \$10,000 by the income recognized, and is then decreased by \$15,000 on account of the relief from liability. The partner must recognize business income from operations equal to \$10,000 from cancellation of indebtedness, and must recognize net gain arising from his or her intangible ownership interest (Schedule D) equal to \$5,000.

## 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. Please refer to PIT Bulletin 2009-5, "Cancellation of Investment Indebtedness," for rules regarding shareholder loans to the S corporation.

### 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; this business indebtedness is later cancelled by the lender. The S corporation realizes business 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 business 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 debt 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 debt basis before he or she may increase the basis of his or her S corporation stock.

**Example 1:** An S corporation recognizes \$30,000 of cancellation of indebtedness income. The S corporation realizes business 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 debt basis of \$0. The \$0 shareholder debt 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 debt 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 debt basis are now each \$5,000.

## **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.