pennsylvania
DEPARTMENT OF REVENUE

PERSONAL INCOME TAX BULLETIN 2009-06

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Cancellation of Rents, Royalties, Patents and Copyrights[1] Indebtedness

I. Introduction.

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

A taxpayer realizes a benefit from the loan because the tax law allows an interest expense deduction associated with rents and royalties 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 production, collection, conservation, or maintenance of rents and royalties property.

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 in the amount of the cancellation of indebtedness. If the taxpayer retains the rents and royalties property securing the rents and royalties 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 rents and royalties indebtedness under this bulletin.

II. How to use this bulletin.

1. The rules in this bulletin will apply to you when "rents and royalties debt" of yours is cancelled. The term rents and royalties debt is defined in Section III of this bulletin. Please refer to the definitions before proceeding.

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[1] The term "rents, royalties, patents and copyrights" is referred to throughout this bulletin as "rents and royalties."

2. If rents and royalties indebtedness was cancelled:

   a. First, calculate the amount of income or the basis reduction 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 rents and royalties indebtedness, please refer to Personal Income Tax ("PIT") Bulletin 2009-2 (personal indebtedness), PIT Bulletin 2009-3 (debt secured by a principal residence), PIT bulletin 2009-4 (business indebtedness), or PIT Bulletin 2009-5 (investment 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.

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 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 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.

Rents and royalties indebtedness: An obligation is rents and royalties indebtedness to the extent it is any of the following:

1. An obligation incurred with respect to production, collection, conservation, or maintenance of rents and royalties property.
2. An obligation for which a deduction or other offset against rents and royalties income was made for costs associated therewith.
3. An obligation secured wholly or in part by rents and royalties property.
4. An obligation included in the basis of rents and royalties property.

Rents and royalties property: Rents and royalties property is a taxpayer's property rights in rents, royalties, patents, copyrights, and similar property. The term does not include such property used in the conduct of a business, profession, or farm. 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 2009-4.

Please note that rents and royalties property is a specific type of investment property. For more detailed rules applying to all investment property, please refer to PIT Bulletin 2009-5.

IV. Calculating the amount of reportable income.

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

If rents and royalties indebtedness is secured by rents and royalties property, and if the rents and royalties 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 rents and royalties indebtedness.

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

C. Income from cancellation of unsecured rents and royalties indebtedness.

If unsecured rents and royalties indebtedness is written down, the 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 rents and royalties 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.

Recall that 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 as rents and royalties income.

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

B. Loan proceeds secured by rents and royalties indebtedness.

If the cancelled rents and royalties indebtedness is secured by property, and the property is relinquished in the cancellation, then the cancellation results in income from disposition of the property securing the indebtedness. The income arising from such transfer must be reported as net gain or income from the disposition of property, in accordance with Pennsylvania rules as explained in the Personal Income Tax Guide, found at www.revenue.pa.gov. If the property is not relinquished, a basis reduction is required as described in section IV.B.

> **Example:** A taxpayer owns a building in Pennsylvania he or she uses for rents and royalties 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. Taxpayer recognizes income of $50,000, which is classified as net gain or income from the disposition of property.

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. A common example of income from cancellation of rents and royalties indebtedness occurs when a taxpayer owning rental property relinquishes the property to the lender in return for cancellation of rents and royalties indebtedness.

A taxpayer who has owned a property for several years may have income or loss to report depending upon the depreciation taken and the amount of principal balance paid on the mortgage. A taxpayer who owned a property for a number of years and refinanced the mortgage or used the rental property as collateral for a second mortgage or loan most likely will have gain to report on their tax return.

> **Example:** Taxpayer buys a house in 1998 for $200,000. For 10 years, taxpayer uses half of the property as his or her principal residence and rents out the other half of the property and yields rental income therefrom. Half of the indebtedness is considered rents and royalties indebtedness.
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> The lender forecloses on taxpayer's property in 2008. Taxpayer realizes a gain of $50,000. Taxpayer had no other Schedule D gains or losses for 2008. Taxpayer determines that $25,000 of the gain is allocable to the investment-use portion of the property and that $25,000 of the gain is allocable to the portion of the property used as his or her residence. Taxpayer must recognize $25,000 of the gain allocable to the investment-use portion of the property. The income is net gain from the disposition of property.

VII. Partnerships.

After the partnership determines the amount of cancellation of 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 rents and royalties property. 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 net gain from the disposition of the rents and royalties property. Each partner must recognize $50,000 as rents and royalties 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 rents and royalties 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 rents and royalties income 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 rents and royalties 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 $150. The partnership recognizes cancellation of indebtedness income in Year 1. The partner's share of this cancellation of rents and royalties 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 rents and royalties income equal to $100 from cancellation of indebtedness, and must recognize net gain arising from his or her intangible ownership interest (Schedule D) 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. 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 rents and royalties indebtedness is later cancelled by the lender. The S corporation realizes rents and royalties 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 rents and royalties 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 rents and royalties 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.

C. Shareholder loans to the S corporation.

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

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.