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Office of Chief Counsel
Internal Revenue Service

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memorandum

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date: April 1, 1998

to: Associate District Counsel, Salt Lake City

from: Assistant Chief Counsel, Income Tax & Accounting

subject: Significant Service Center Advice

This responds to your request for Significant Advice dated March 7, 1997, in connection with questions posed by the Underreporter Branch and Examination Branch of the Compliance division of the Ogden Service Center.

DISCLOSURE STATEMENT

Unless specifically marked "Acknowledged Significant Advice, May Be Disseminated" above, this memorandum is NOT to be circulated or disseminated except as provided in CCDM (35)2(13)3:(4)(d) and (35)2(13)4:(1)(e). This document may contain confidential information subject to the attorney-client and deliberative process privileges. Therefore, this document shall not be disclosed beyond the office or individual(s) who originated the question discussed. In no event shall it be disclosed to taxpayers or their representatives.

ISSUES

(1) When the IRS receives duplicate Forms 1099-C reporting cancellation of indebtedness for each person with joint and several liability on an indebtedness, should the IRS treat the full amount of the indebtedness cancelled as income to each separate taxpayer? Should the IRS treat this situation in a manner similar to the way the IRS deals with responsible persons under § 6672 of the Internal Revenue Code? Should the IRS change its instructions to third parties who provide the IRS with Form 1099-C information?

(2) When the IRS receives Forms 1099-C reporting cancellation of indebtedness for guarantors or sureties of a debt, must the IRS treat the full amount of the debt cancelled as income to each surety or guarantor? Should the IRS treat this situation in a manner similar to the way the IRS deals with responsible persons under § 6672? Should the IRS change its instructions to third parties who provide the IRS with Form 1099-C information?

(3) When applying the insolvency test of § 108(d), should a taxpayer's interest in a pension plan that is exempt from

creditor’s claims be included as an asset, and if so, how should that interest be valued?

(4) Under the particular facts described below, is issuance of a Form 1099-C appropriate?

(5) Should the IRS issue Forms 1099-C when cancelling tax debt of individuals discharged in a bankruptcy case or as a result of an offer in compromise under § 7122?

(6) Should an entity required to report under § 6050P subtract the proceeds of a foreclosure sale, settlement, etc. from the total debt in arriving at the amount of debt cancelled for Box 2 of Form 1099-C?

CONCLUSIONS

(1) When the IRS receives Forms 1099-C reporting cancellation of indebtedness for each person with joint and several liability on an indebtedness, the IRS should not treat the full amount of the indebtedness cancelled as income to each separate taxpayer. Instead, a determination should be made as to the appropriate amount of discharged debt allocable to each taxpayer that is jointly and severally liable, taking into account all the facts and circumstances.

(2) Reporting of cancellation of indebtedness is not required with respect to guarantors and sureties on an indebtedness. How the discharged indebtedness should be treated as to each surety or guarantor, if reported, will be addressed in a separate memorandum.

(3) When applying the insolvency test of § 108(d), a taxpayer's interest in a pension plan or other assets that are exempt from creditor's claims should be included as assets of the taxpayer. An interest in a pension plan should be valued in accordance with the principles described below.

(4) Under the particular facts described below in (4), issuance of a Form 1099-C is not appropriate.

(5) The IRS should not issue Forms 1099-C when cancelling tax debt of individuals discharged in a bankruptcy case or as a result of an offer in compromise under § 7122.

(6) An entity required to report under § 6050P should subtract the proceeds of a foreclosure sale, settlement, etc. from the total debt in arriving at the amount of debt cancelled to be reported in Box 2 of Form 1099-C.

FACTS

(1) The IRS receives separate Forms 1099-C for obligors with joint and several liability on an indebtedness that is discharged (for example, when spouses sign a note on a home mortgage and the home goes into foreclosure).

(2) The IRS receives Forms 1099-C for guarantors or sureties on an indebtedness.

(3) A taxpayer that realizes income from discharge of indebtedness claims the insolvency exception described in § 108(b) and has assets that are exempt from creditor's claims under state or other relevant law.

(4) A debtor incurs an indebtedness to purchase an automobile. In connection with that indebtedness, the lender obtains an expensive insurance policy pursuant to terms of the loan that states that a lender may obtain insurance when the borrower fails to provide proof of insurance. When debtors have judicially challenged the insurance policies, lending institutions have been required to remove the charge for the insurance policies. The lender then issues a Form 1099-C showing the removed cost of the insurance as cancellation of indebtedness income.

(5) The IRS cancels debt in a number of situations, including tax debt of individuals discharged in a bankruptcy case and debt cancelled through an offer in compromise under I.R.C. § 7122.

(6) The Service Center has received Forms 1099-C in which the reporting entity has failed to subtract the proceeds of a foreclosure sale, settlement, etc. from the total debt in arriving at the amount of debt cancelled for Box 2 of Form 1099-C.

DISCUSSION

(1) Joint obligors. Section 6050P requires certain entities to report discharges of indebtedness. Final regulations issued under § 6050P address the treatment of joint obligors. In general, a reporting entity must report discharges of indebtedness for each debtor discharged from such indebtedness (§ 1.6050P-1(e)(1)). In addition, in the case of multiple debtors that are jointly and severally liable on an indebtedness, the amount of discharged indebtedness required to be reported is the total amount of indebtedness discharged. (§ 1.6050P-1(e)(1)(ii)). When the reporting requirement of § 6050P was enacted, Congress indicated in the legislative history that it did not expect the reporting institutions to determine whether or not the debtor has income from the discharge of indebtedness.

H.R. Conf. Rep. No. 213, 103d Cong. 1st Sess. 1, 671 (1993). Accordingly, multiple reporting of the discharged debt is consistent with § 6050P(a)(1) which requires reporting for each person whose indebtedness was discharged.

A joint and several obligation creates a legal relationship between the creditor and the co-obligors under which the creditor may sue one or more of the parties to the liability separately, or all of them together at the creditor's option. Black's Law Dictionary, at 972 (1968). At common law, an obligor who is required to satisfy more than that obligor's proportionate share of a common obligation generally is entitled to seek pro rata contribution from each of the other co-obligors. Restatement of Restitution § 81 (1936). However, the right of contribution is an equitable doctrine, and depends upon a determination of the facts and circumstances, including whether the co-obligors equally enjoyed the use of the proceeds of the indebtedness. Because a taxpayer has a pro rata right of contribution from each of the co-obligors under certain circumstances, discharge of all of the co-obligors of the full amount of a joint and several obligation by a creditor should not be treated as income to each co-obligor in the full amount of the discharged obligation under § 61(a)(12). See, Kahle v. Commissioner, T.C. Memo 1997-91, 73 T.C.M. 2080, 2082, which suggests that the amount of cancellation of indebtedness income to a debtor in bankruptcy that gives rise to attribute reduction may be reduced because certain of the discharged debts were joint liabilities; Bressi v. Commissioner, 1991-651, 62 T.C.M. 1668 (1991), amount of discharge of indebtedness income for two taxpayers with joint and several liability for indebtedness was equal to the total amount of the indebtedness discharged; Rev. Rul. 92-97, 1992-2 C.B. 124, amount of discharge of indebtedness income for partnership and two jointly and severally liable partners equal to total amount of indebtedness discharged. Rather, an appropriate allocation of the discharged indebtedness should be made between the co-obligors, based on all the facts and circumstances.

In addition, in response to your question whether the IRS should change its instructions to third parties who provide the IRS with Form 1099-C information, we note that reporting for multiple debtors was modified in the final regulations under § 6050P. While the general requirement for reporting the full amount of the debt for multiple debtors was retained, several important exceptions were provided. The decision to retain the general requirement for reporting the full amount of the debt for multiple debtors is explained in the preamble to the final regulations as follows: "The IRS and Treasury believe, however, that requiring reporting for multiple debtors is consistent with § 6050P(a)(1), which provides that the reporting of a name, address, and TIN is required for each person whose indebtedness

was discharged." The exceptions are described in § 1.6050P-1(e)(1)(i), which states:

> In the case of indebtedness of $10,000 or more incurred on or after January 1, 1995, that involves more than one debtor, a reporting entity is subject to the requirements of paragraph (a) of this section for each debtor discharged from such indebtedness. In the case of indebtedness incurred prior to January 1, 1995, and indebtedness of less than $10,000 incurred on or after January 1, 1995, involving multiple debtors, reporting under this section is required only with respect to the primary (or first-named) debtor. Additionally, only one return of information is required under this section if the reporting entity knows, or has reason to know, that co-obligors were husband and wife living at the same address when an indebtedness was incurred, and does not know or have reason to know that such circumstances have changed at the date of a discharge of the indebtedness. This paragraph (e)(1) applies to discharges of indebtedness after December 31, 1994.

(2) Guarantors and sureties. The final regulations under § 6050P do not require reporting of discharges of indebtedness with respect to guarantors or sureties. Section 1.6050P-1(d)(7) states "Solely for purposes of the reporting requirements of this section, a guarantor is not a debtor. Thus, in the case of guaranteed indebtedness, reporting under this section is not required with respect to a guarantor, whether or not there has been a default and demand for payment made upon the guarantor." The treatment of a reported discharge of indebtedness to each surety or guarantor will be addressed in a separate memorandum.

(3) Determination of insolvency and exempt assets. Section 108(d)(3) defines "insolvent" as "the excess of liabilities over the fair market value of assets." Although case law interpreting the judicial insolvency exclusion that was in effect prior to the enactment of the Bankruptcy Tax Act of 1980 excluded assets exempt from creditors under state law (see, Cole v. Commissioner, 42 B.T.A. 1110 (1940), Marcus Estate v. Commissioner, T.C.M. 1975-9, AOD April 16, 1975), the statutory language places no limitation on assets that are taken into account in determining a taxpayer's solvency. The plain meaning of the term "asset" in § 108(d)(3) would include all of the taxpayer's assets in the insolvency calculation. Generally, where the language of a statute is clear and unambiguous, no further inquiry into the meaning of the statute is needed. 1 Mertens Law of Federal Taxation §3.05 (1991). Further, § 108, as an exclusion from income, is to be construed narrowly. U.S. v. Centennial Savings Bank FSB, 499 U.S. 573, 583 (1991). Excluding exempt assets from the measure of insolvency would provide taxpayers who are economically solvent, i.e., whose total assets exceed their

liabilities, the opportunity to defer a current tax in instances where they have the ability to pay the tax. Therefore, a debtor's interest in a pension plan should be taken into account in determining the debtor's solvency, even though the assets may be exempt from the reach of creditors under state law.

Regarding the valuation of the pension assets, we note that there are generally two categories of deferred compensation plans: defined contribution plans and defined benefit plans. In the case of a defined contribution plan, the actual earnings of the trust assets are allocated among the accounts of the participants at least annually. Therefore the value of the benefits of an individual under a defined contribution plan is simply the value of the individual's account or accounts under the plan.

Defined benefit plans generally provide for a benefit that is defined by the plan with respect to factors such as the individual's compensation, length of service and age at benefit commencement. Thus, there is no individual account, but a promise of a pension benefit that would usually be for the life of the individual with further payments possible to a survivor after the individual's death. In most cases, an individual has the ability to elect to have the pension benefits paid in one or more optional forms of benefit.

In a case where an individual has commenced the receipt of benefits under a defined benefit plan and, accordingly, has elected a form of benefit payment that includes an annuity or installment payments, we believe that value of the benefit should be the actuarial present value of the payments that are to be made under the annuity or series of installments on or after the relevant date (that is, the date as of which the insolvency determination is made). We suggest that the actuarial present value be determined using the interest rate and the mortality tables set forth in § 20.2031-7 of the regulations (which are used to value annuities for Federal estate tax purposes). This would appear to be consistent with the valuation requirements of § 7520 of the Code.

In the case where an individual has not commenced the receipt of retirement benefits under the plan, and, accordingly, has not elected a form of benefit payment, we suggest that the value of the benefit should be the greater of (1) the actuarial present value of the accrued benefit payable at the plan's normal retirement age or (2) the amount of any single-sum distribution that the participant could receive under the plan on the date as of the relevant date. The suggested approach would ignore optional forms of benefits that could be chosen, except that it would take into account any option that provides for an immediate cash payment.

There are certain types of defined benefit plans that base the individual's benefit, in part, upon the separate account of an individual (see § 414(k) of the Code) that may be contained in the plan. For example, a defined benefit plan could provide for a voluntary contribution account, or for a rollover account, for an individual. In such a case, we suggest that the value of the individual's benefit be the sum of (1) the value of the separate account, treating the separate account as a defined contribution plan, plus (2) the actuarial present value of the part of the benefit that does not depend upon the separate account as described above.[1]

Currently, the actuarial factors used to value annuities under § 20.2031.7 can be found in Internal Revenue Publication 1457 entitled Actuarial Values, Alpha Volume. Note, however, we understand that, during the coming year, the regulations will likely be changed to use a new mortality table (based on the United States Life Tables for 1990) for estate and gift tax purposes. Once this takes place, Publication 1457 will be revised to reflect the new table.

(4) No liability. Under the facts described above, we agree with your conclusion that issuance of the Form 1099-C is improper. In the fact situation you present, the debtor has established that there was no debt. Therefore, because the debtor owed nothing, there was no cancellation of a debt and no resulting income from cancellation of any indebtedness.

(5) Cancellation of debt by IRS. Cancellation of a tax debt by means of an offer in compromise does not give rise to discharge of indebtedness income. Eagle Asbestos & Packing Co. v. United States, 348 F.2d 528 (Ct. Cl. 1965). The court in Eagle Asbestos concluded that a compromise of the interest portion of a tax debt did not give rise to income from the discharge of indebtedness because "[t]he effect of the compromise settlement itself and the intentions of the parties in entering into it was to extinguish all tax liabilities included in the items making up the compromise." Such an intent could not be fulfilled if taxable income arose from the agreement. This rationale applies equally

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[1]Under some plans, the separate account may be an account that is in a separate defined contribution plan, rather than in the defined benefit plan itself. An example of this type is a so-called "floor-offset" plan. Under a floor-offset plan, the benefit otherwise payable under the defined benefit plan is reduced, or offset, by the actuarial equivalent of the account balance in the defined contribution plan. In such a case, the net benefit (after application of the offset) is the benefit payable from the defined benefit plan, and can be valued under the suggested approach for defined benefit plans generally.

to cancellation of a tax debt itself, as well as interest on a tax debt. Therefore, no Form 1099-C is required to be issued. However, we note that if the IRS cancels a debt that is not a tax debt, the amount cancelled is includible in discharge of indebtedness income and a Form 1099-C should be issued.

With respect to tax debts of individuals discharged in bankruptcy, regulations under § 1.6050P-1(d)(1)(i) state: "Reporting is required under this section in the case of a discharge of indebtedness in bankruptcy only if the creditor knows from information included in the reporting entity's books and records pertaining to the indebtedness that the debt was incurred for business or investment purposes ... ". Further, § 1.6050P-1(d)(1)(ii) states: "Indebtedness is considered incurred for business purposes if it is incurred in connection with the conduct of any trade or business other than the trade or business of performing services as an employee. Indebtedness is considered incurred for investment purposes if it is incurred to purchase property held for investment, as defined in section 163(d)(5)." An indebtedness arising as a result of nonpayment of an individual income tax liability is not incurred for business or investment purposes. See § 1.163-9T(b)(2)(i)(A) and Miller v. United States, 65 F.3d 687 (8th Cir. 1995). But see Redlark v. Commissioner, 106 T.C. 31 (1996). Therefore, a cancellation of such an indebtedness in bankruptcy would not give rise to a reporting requirement under § 1.6050P-1(d)(1)(i).

(6) Amount of indebtedness discharged when lender receives foreclosure proceeds or other settlement proceeds. Rev. Rul. 90-16, 1990-1 C.B. 12, citing Helvering v. Hammel, 311 U.S. 504 (1941), indicates that a mortgage foreclosure is a "disposition" within the scope of § 1001 of the Code. Section 1.1001-2(a)(1) of the Income Tax Regulations provides that the amount realized from the disposition of property includes the amount of liabilities from which the transferor is discharged as a result of the disposition. Therefore, to the extent that an amount of a debt is satisfied by the transfer of property in foreclosure, there is a § 1001 disposition event, and there is no cancellation of indebtedness income. The regulations make clear that, in the case of a transfer to a creditor of an asset encumbered by indebtedness for which the debtor is personally liable, combined with a discharge by the creditor of the full amount of the debt, there is a cancellation of indebtedness only to the extent the indebtedness exceeds the fair market value of the property. Section 1.1001-2(c), Example 8. Because the debt is being partially satisfied by the transfer of the property, it is cancelled only to the extent the debt exceeds the value of the property. Consequently, the amount of the debt satisfied should not be reported as discharged debt under § 6050P. Entities required to report under § 6050P should subtract the proceeds of a foreclosure sale, settlement, etc. from the total debt in

arriving at the amount of debt cancelled for Box 2 of Form 1099-C. The instructions to the Form will be reviewed to consider whether a clarification in the instructions is appropriate.

Thank you for your questions concerning these matters.

Sincerely,

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by /s/
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