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Tax Law's Insolvency Definition Not the Same as Bankruptcy's

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Gross income generally includes income from the discharge of indebtedness.[1] However, the Internal Revenue Code (the "Code") sometimes permits taxpayers to exclude income from the discharge of indebtedness from gross income.[2]

In the case of corporate taxpayers, such an exclusion is permitted if the discharge of indebtedness occurs in a case under title 11 of the United States Code (relating to bankruptcy, the "Bankruptcy Code") or if the discharge occurs when the taxpayer is "insolvent."[3] However, the amount excluded by reason of the taxpayer's insolvency may not exceed the amount by which the taxpayer is insolvent.[4] In the case of a discharge of indebtedness of a partnership, this "insolvency exclusion" is applied at the partner level,[5] so that an insolvent partner may take advantage of the exclusion to exclude the partner's distributive share of the partnership's income from the discharge of indebtedness, regardless of whether the partnership itself is solvent or insolvent. (Conversely, a *solvent* partner may not take advantage of the insolvency exclusion for discharge of indebtedness income flowing through to the partner from an *insolvent* partnership.)

The Code provides:

> [T]he term "insolvent" means the excess of liabilities over the fair market value of assets. With respect to any discharge, whether or not the taxpayer is insolvent, and the amount by which the taxpayer is insolvent, shall be determined on the basis of the taxpayer's assets and liabilities immediately before the discharge.[6]

However, the Code provides no further guidance in computing the amount of the taxpayer's liabilities.[7] In a recent decision, *Merkel v. Commissioner,*[8] the United States Court of Appeals for the Ninth Circuit addressed the question of how contingent liabilities are to be taken into account for this purpose. Although the decision happened to involve individual taxpayers, the same principles should be applicable to corporate taxpayers seeking to take advantage of the insolvency exclusion.

In 1986, Security Pacific Bank made a loan to Systems Leasing Corporation ("SLC"), a corporation the sole shareholders of which were Dudley and La Donna Merkel and David and Nancy Hepburn (collectively, the "taxpayers"). SLC was the sole maker of the note evidencing the loan, but the Merkels and the Hepburns personally guaranteed its repayment. On May 31, 1991, at a time when the balance of the SLC loan exceeded $3,000,000 and the loan was in default, the Bank agreed that, if SLC paid $1,100,000 on or before August 2, 1991, and if no bankruptcy petition were filed by (or against) SLC, the Merkels, and the Hepburns for 400 days after August 2, 1991, the Bank would not exercise its remedies under the guaranty against the Merkels and the Hepburns. No such bankruptcy petition was filed during the 400-day period.

The Merkels and the Hepburns had another investment in common. Each couple owned a 25% partnership interest in HMH partners, with a third party owning the remaining 50%. HMH had its own financial difficulties, and on September 1, 1991, Great Western Bank forgave a $1,439,000 note owed to it by HMH. The Merkels and the Hepburns were each allocated 25%, or approximately $360,000, of HMH's income from the discharge of this indebtedness.

In preparing their tax returns, the Merkels and the Hepburns took the position that they were insolvent and were thus entitled to exclude their distributive shares of HMH's income from the discharge of indebtedness. In computing their insolvency as of September 1, 1991, they treated their respective obligations under the SLC guaranty as a "liability." The Internal Revenue Service disagreed with this treatment and, revising the taxpayers' computations, determined that they were not insolvent—since their liabilities, without regard to the SLC guaranty, did not exceed their assets—and that they were accordingly not entitled to exclude their respective shares of HMH's income. The Tax Court agreed with the IRS,[9] the taxpayers appealed, and the Ninth Circuit has now affirmed the Tax Court's decision.

The Ninth Circuit began its analysis by describing the two lines of

thought that went into Congress's decision to add the insolvency exclusion to the Code. First, Congress was cognizant of a longstanding nonstatutory rule allowing the exclusion by insolvent taxpayers of income from the discharge of indebtedness, on the grounds that, so long as the taxpayer still has more liabilities than assets, no assets have been "freed" and the taxpayer's wealth has not been increased.[10] Second, Congress desired to ease the tax burden on bankrupt and insolvent debtors, by not imposing immediate tax liabilities on them, for reasons akin to the "fresh start" given to bankrupt debtors with respect to their liabilities generally. These two factors suggested to the Ninth Circuit that "only those liabilities in the amount that actually offsets assets [should] be considered in calculating insolvency" and that a "debtor's ability to pay an immediate tax ... [should be] the 'controlling factor' in determining whether the [insolvency] exclusion applies." These conclusions led the Ninth Circuit to articulate the following legal test: "Accordingly, a taxpayer claiming to be insolvent ... must prove by a preponderance of the evidence that he or she will be called upon to pay an obligation claimed to be a liability and that the total amount of liabilities so proved exceed the fair market value of his or her assets." Since the taxpayers had failed to prove that, as of August 31, 1991, a bankruptcy event was likely to occur and that they would be called upon to pay any amount on the SLC guarantees, they could not take those guarantees into account in computing their insolvency on that date.

In reaching its conclusion, the majority of the Ninth Circuit panel expressly rejected an alternative approach suggested by the taxpayers, and endorsed by Circuit Judge O'Scannlain in his dissent. Under this alternative approach, all liabilities, including contingent liabilities, such as guarantees, would be taken into account at their face amount "discounted by the probability of their occurrence." This test had previously been adopted by the Seventh Circuit in defining "insolvency" for purposes of the Bankruptcy Code.[11] While the majority agreed that this approach was "good economics" and, therefore, "as a general proposition ... good law," it was not the law that Congress had enacted as the insolvency exclusion.

Contingent liabilities of all sorts are frequently undertaken by taxpayers, but, perhaps owing to their indeterminate nature, their treatment for tax purposes has not always been clear. With respect to the insolvency exclusion at least, the Ninth Circuit has exchanged this lack of clarity for a bright-line rule. The Ninth Circuit's all-or-nothing "preponderance of the evidence" standard may lack the elegance of a more economically-grounded approach to the problem. Nevertheless, taxpayers will appreciate the certainty that has now been introduced in the law regarding the treatment of contingent liabilities for purposes of the insolvency exclusion.

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1 Internal Revenue Code ("Code") section 61(a)(12).

2 When income from the discharge of indebtedness is excluded, the taxpayer is required by Code section 108(b) to reduce certain favorable tax attributes.

3 Code section 108(a)(1)(A)-(B), (d)(2), (d)(3).

The "insolvency exclusion" was added to the Code in 1980. As discussed below, there was a similar nonstatutory rule applied by the courts before that time.

The "title 11 case" exclusion is available only if the taxpayer is under the jurisdiction of the court in such case and the discharge of indebtedness is granted by the court or is pursuant to a plan approved by the court. In certain circumstances, a corporate taxpayer may also exclude income from the discharge of "qualified farm indebtedness."

The "title 11 case" and "insolvency" exclusions are available to noncorporate taxpayers as well. In many cases, however, noncorporate taxpayers may also take advantage of an exclusion for income from the discharge of "qualified real property business indebtedness." This exclusion is not available to corporate taxpayers (except S corporations). Code section 108(a)(1)(D).

4 Code section 108(a)(3).

5 Code section 108(d)(6).

6 Code section 108(d)(3).

7 *See* Rev. Rul. 92-53, 1992-2 C.B. 48, in which the Service held that the amount by which a nonrecourse debt exceeds the fair market value of the property securing that debt is taken into account in determining whether the taxpayer is insolvent, if that same nonrecourse debt is being discharged; if some *other* debt is being discharged, however, the nonrecourse debt is taken into account in the insolvency computation only to the extent of the fair market value of the security.

8 ___ F.3d ___ (5th Cir. 1999), *aff'g* 109 T.C. 463 (1997).

9 Before the Tax Court, the taxpayers had argued that the plain meaning of the term "liabilities" under Code section 108(d)(3) encompasses all liabilities, whether contingent or otherwise, and that the extent (if any) to which particular liabilities are counted must be determined on a case-by-case basis.

10 This theory has its origin in *Dallas Transfer & Terminal Warehouse Co. v. Commissioner*, 70 F.2d 95 (5th Cir. 1934).

11 *Covey v. Commercial Nat'l Bank,* 960 F.2d 657 (7th Cir. 1992).

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