Internal Revenue Service

Department of the Treasury

Washington, DC 20224

Number: **INFO 2002-0024**
Release Date: 3/29/2002
Index No.: 61.09-18

[redacted]

Person to Contact:
[redacted]
Telephone Number:
[redacted]
Refer Reply To:
CC:ITA:4 – GENIN-156710-01
Date: January 11, 2002

Taxpayers = [redacted]

Memorandum = [redacted]

Dear [redacted]:

You have asked our assistance and comments regarding whether the taxpayers realized cancellation of indebtedness income (COD income) under § 61(a)(12) of the Internal Revenue Code upon the cancellation of certain personal liability notes (deficiency notes). The deficiency notes were issued in exchange for original notes issued by the taxpayers' controlled entities. The taxpayers were not liable on the original notes.

A Memorandum addressing the cancellation of the deficiency notes concludes that the taxpayers will be liable for cancellation of indebtedness income because they executed personal liability notes in exchange for the original notes, even though they were not personally liable on the original notes when the indebtedness was incurred. On page 24, the Memorandum states as follows:

> [taxpayers] generally were individual guarantors on the initial debt incurred by the partnerships. To the extent that the initial debt was forgiven when the property was deeded back and the deficiency notes were issued, [taxpayers] would not have realized COD income individually as guarantors. However, when [taxpayers] issued the deficiency notes, they did so as individual debtors. Thus, when the deficiency notes were sold ... for less than the outstanding principal, [taxpayers] were relieved of debt, not as guarantors, but as debtors. Thus, they should have recognized COD income to the extent they were relieved of debt on the deficiency notes... ."

Rail Joint rationale

In general, we agree with this conclusion. However, the taxpayers may make the argument that they there is no COD income when the deficiency notes were sold for less than the outstanding principal, relying on the Commissioner v. Rail Joint, 61 F.2d 751 (2nd Cir. 1932) aff'g Rail Joint v. Commissioner, 22 B.T.A. 1277 (B.T.A. 1931), nonacq. 1931-2 C.B. 99; and Bradford v. Commissioner, 233 F.2d 935 (6th Cir. 1956) line of cases. Those cases hold that a taxpayer does not realize COD income if the taxpayer did not receive anything of value when the indebtedness was incurred.

In Bradford, the original debtor owed $100,000. The bank permitted his wife to substitute her note for his. Several years later, the bank settled the wife's debt for $50,000. The Service argued that the wife had COD income in the amount of $50,000, but the Court held that the wife did not have COD income, because "the taxpayer received nothing of value when the indebtedness was assumed."

In Rail Joint, a corporation issued bonds as a dividend. It then repurchased the bonds at a discount. The court held that, since the corporation received no increment to its assets at the time the indebtedness was incurred, no COD income was realized when the bonds were repurchased. Similarly, here, it could be argued that the taxpayers received nothing of value when the personal liability notes were executed, as the proceeds of the original borrowing went to entities controlled by the taxpayers, and not the taxpayers themselves.

The Tax Court has used a similar rationale in cases relating to whether a guarantor realizes cancellation of indebtedness income. As discussed in the Memorandum on page 21, in Landreth v. Commissioner, 50 T.C. 803 (1968), the Tax Court found that a guarantor does not realize cancellation of indebtedness income when the underlying debt is paid. The Landreth case also relies on the Rail Joint line of authority:

> However, where the guarantor is relieved of his contingent liability, either because of payment by the debtor to the creditor or because of a release given him by the creditor, no previously untaxed accretion in assets thereby results in an increase in net worth. Commissioner v. Rail Joint Co., 61 F.2d 751 (C.A. 2, 1932); Fashion Park, Inc., 21 T.C. 600, nonacq. (1954). Payment by the principal debtor does not increase the guarantor's net worth; it merely prevents it, pro tanto, from being decreased. Landreth at 813.

The Tax Court extended the Rail Joint rationale to a guarantor in a case in which the underlying obligation is unpaid and the guarantor becomes liable for the indebtedness. Whitmer v. Commissioner, T.C. Memo. 1996-83.

The Service has generally disagreed with the rationale in the Rail Joint case. Thus, the Service has generally taken the position that COD income must be recognized to the extent indebtedness has been cancelled, notwithstanding that nothing of value was received when the personal liability notes were executed. For example, in a recent Chief Counsel Advice memorandum, cancellation of a penalty imposed upon an individual for failure to perform a service obligation under a contract was determined to be cancellation of indebtedness income regardless of the fact that the debtor arguably obtained nothing of value when the indebtedness was incurred. IRS CCA 200038044, Sept 22, 2000.
However, while the Service rejects the Rail Joint rationale, we generally agree that a guarantor (whether or not the primary obligor has defaulted and the guarantor has become liable for the indebtedness) does not realize cancellation of indebtedness income on release of a liability, based upon § 108(e)(2).

Section 108(e)(2)

Section 108(e)(2) provides that no COD income is realized if payment of the obligation would have given rise to a deduction. A guarantor generally has a claim against the original debtor in an amount equal to the amount of the guarantee that is paid. Assuming such a claim is uncollectible, it would give rise to a bad debt deduction or capital loss for the guarantor if the guarantee were paid. Therefore, cancellation of an obligation that arises pursuant to a guarantee appears to be subject to § 108(e)(2). If the notes under which the taxpayers became personally liable on the indebtedness would entitle them to a claim against the original entity under applicable local law, which would give rise to a bad debt deduction, it could be argued that there is no COD on cancellation of the notes because of § 108(e)(2).

Thank you for inquiring regarding this matter. If we may be of further assistance, please contact [redacted].

Sincerely,

Associate Chief Counsel
(Income Tax & Accounting)

By: _____
Stephen J. Toomey
Assistant to Branch Chief