A REVIEW OF SOME TAX ISSUES
THAT YOU MIGHT SEE FROM TIME TO TIME

GREENSBORO BAR ASSOCIATION

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Recognized by the NCACPA with Outstanding Presenter Awards, Keith commonly speaks on tax planning, transition planning, and state and federal tax updates. He has developed and delivered courses in partnership taxation and authored a curriculum on basic tax law issues for North Carolina Superior Court Judges.

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Introduction

This manuscript contains a survey of selected tax issues of interest to many attorneys.

You will note that this manuscript is subdivided into six (6) parts.

Part One discusses taxable cancellation of debt income and certain possible exclusions from taxable income. Part Two provides an overview of the tax treatment of settlement and judgment awards. Part Three discusses income tax basis issues for inherited property and for gifted property. Part Four discusses federal tax collection procedure and discusses various strategies for representing clients faced with IRS collection activities. Part Five of the manuscript discusses innocent spouse relief protection afforded under the federal tax system.

Finally, Part Six of the manuscript discusses a new IRS Audit Guide for IRS auditors to follow when performing IRS audits of attorneys.

PART ONE

Internal Revenue Code Section 108 and Cancellation of Indebtedness Income

Written by Nicholas J. Bakatsias and Keith A. Wood

I. Introduction.

In today’s depressed economic conditions, foreclosures and defaults on loans are becoming more and more commonplace. The U.S. credit and housing markets are in their worst shape in a generation. Real estate values are down and, as a result, the refinancing of existing variable-rate or adjustable rate loans has been curtailed. The fallout is a massive increase in the number of foreclosures and, to an increasing extent, a mortgage workout environment in which mortgage lenders realize they will not fully recoup the loan funds and accrued interest and, therefore, are open to "workouts" in which either principal or interest on existing loans is reduced.

There are tax consequences to borrowers in these situations, tempered somewhat but not entirely by recent Congressional legislation. While the prospects of losing one’s home or commercial investment property are frightening to many of our clients, it appears few are cognizant of the potentially adverse tax consequences that could result in connection with forgiven or discharged debt.

This paper looks at the tax consequences to borrowers who receive "discharge of indebtedness" income as a result of these voluntary "workouts" and involuntary foreclosures and aims to highlight possible planning opportunities applicable to clients who are facing or are likely to face financial difficulties.
II. General Rules.

A debtor's release from the obligation to repay a loan will generally constitute taxable income to the debtor. U.S. vs. Kirby Lumber 284 U.S. 1 (1931). Indeed, IRC Section 61(a)(12) states that the taxpayer will be required to recognize ordinary income as a result of "discharge of indebtedness" income ("COD Income"). The rationale is that the taxpayer will realize an accession in wealth due to the discharged debt.

This discharge from indebtedness income can result from formal action taken by the creditor (such as a formal discharge or a loan compromise) or by operation of law (such as in a bankruptcy discharge or by virtue of the statute of limitations expiring for enforcement of a loan).

Example: John and 9 other individuals form a limited liability company to develop real property. The land purchase is financed with a $2 million loan that is personally guaranteed by the 10 individual members. When the LLC then defaults on the note, the bank purchases the property at foreclosure for $1.2 million. The LLC (and the guarantors) still owe the bank $800,000 on the note. The bank sues the LLC members, and John settles his share of the deficiency for $40,000 instead of his $80,000 share of the liability. John has $40,000 of discharge-of-indebtedness income.

III. Character of Taxable Income and Calculating the Amount of the Debt Discharge Income.

When debt is cancelled, the "character" of the taxable income recognized by the debtor may be (i) capital gain (or loss), (ii) ordinary income (or loss) or (iii) non-taxable income, depending upon the debtor’s specific circumstances.

When property is foreclosed upon, the taxpayer will be concerned as to whether the foreclosure will generate (i) income from discharge of indebtedness or (ii) gain from the sale of that property. This will be very important to the taxpayer if capital gains tax rates are lower than ordinary income rates, or if income from the discharge of indebtedness may be eligible for exclusion from gross income under Section 108.

Different rules apply, depending upon whether the property is subject to non-recourse debt or recourse debt.

A. Non-Recourse Debt.

(1) Transfer of Property in Full Satisfaction of Nonrecourse Debt: Gain or Loss on Deemed Sale. In general, debt-discharge income does not arise on a transfer of property where non-recourse debt exceeds the fair market value of the property transferred. Instead, the taxpayer must recognize gain or loss from the sale or exchange of the property to the extent that (i) the non-recourse indebtedness exceeds (or is less than) (ii) the taxpayer’s tax basis in the property. Reg. Section 1.1001-2(a)(2). As a result, the taxpayer cannot utilize the
cancellation of debt exclusions contained in Section 108(a) to avoid income inclusion on account of the transfer of property in satisfaction of a non-recourse debt. See Commissioner v. Tufts, 461 US 300 (1983) and Gershowitz v. Commissioner, 88 TC 984 (1987). So, in the case of a foreclosure of property subject to a non-recourse debt, the entire gain is treated as a gain from the sale or exchange, to the extent that the debt exceeds the taxpayer’s tax basis in the property. The gain from the deemed sale may be ordinary or capital.

(2) Reduction of Nonrecourse Debt in Absence of Property Transfer or Foreclosure. However, in the event non-recourse debt is simply reduced and there is no property disposition (i.e., no foreclosure or deed in lieu transaction), the taxpayer will likely recognize COD income.

B. Recourse Debt. Different rules apply in the case of recourse debt.

(1) Recourse Debt Partially or Fully Satisfied by Deed in Lieu or by Foreclosure. In the case of recourse debt, where property subject to a recourse debt is disposed of in satisfaction of the debt, then the IRS regulations bifurcate the transaction and provide that:

(a) gain from the sale or exchange of property arises to the extent that (a) fair market value of the property exceeds (b) his tax basis in the property (or loss from the sale or exchange of property arises to the extent that his tax basis exceeds the fair market value of the property); and

(b) debt discharge income arises to the extent of the excess of (a) the debt over (b) the fair market value of the property.


This will be a bad result for many taxpayers who dispose of property subject to a recourse mortgage in excess of the fair market value of the property who otherwise would be eligible for relief provisions under Section 108, since they would prefer to have discharge of indebtedness income, rather than gain from the sale or exchange of the property.

Example 1: In 2008, Bob transfers to a creditor an asset with a fair market value of $7,000 and a tax basis of $6,000 in full satisfaction of a $8,500 recourse debt for which Bob is personally liable. The amount realized on the disposition of the asset is its fair market value of $7,000, so Bob realizes a taxable gain on the sale of $1,000 (FMV of $7,000 minus tax basis of $6,000). In addition, Bob also realizes ordinary income from discharge of indebtedness of $1,500 ($8,500 debt - $7,000 FMV). Regs. 1.1001-2(c), Example 8.

Also, a taxpayer can realize cancellation of indebtedness income even if the property is sold or transferred at a loss.
**Example 2:** Thus, under the facts contained in the example above, if Bob's tax basis in the property is $8,000, Bob realizes a loss of $1,000 (Basis of $8,000 minus $7,000 FMV = $1,000 loss which may be capital or ordinary loss) when transferring the land to the creditor, but (to the surprise of Bob) still realizes ordinary cancellation of debt income equal to $1,500 (Debt of $8,500 minus FMV of $7,000).

(2) **What if Bank Reduces Debt Without Property Transfer?**

Note, however, in the event there is a reduction in a taxpayer's recourse liability by the creditor without an accompanying transfer of the encumbered property to the creditor, the taxpayer will realize cancellation of indebtedness income to the extent of the debt reduction. In such cases, the taxpayer may qualify for one or more of the Section 108 cancellation of debt exclusions to avoid COD income recognition as discussed in more depth below.

IV. **Creditor Reporting Requirements: Comparison of IRS Forms 1099-A and 1099-C.**

Section 6050P of the Internal Revenue Code requires that an information return be filed by "an applicable entity" that discharges indebtedness of any person if the amount discharged is $600 or more. Under §6050P(c)(2), an "applicable entity" includes a financial institution (such as a bank or credit union) and organizations significantly engaged in the trade or business of lending money. Generally, the Form 1099-C must be issued on or before February 28 of the year following the year of the discharge and a statement must be provided to the debtor by January 31 of that year. Regs. § 1.6050P-1(a)(4).

Generally, any other entities are not required to issue Forms 1099-C if they do not fall within the type of entities described in § 6050P(2). Thus, service providers or sellers of goods on credit are not legally obligated to issue Forms 1099-C to report cancellation of indebtedness income.

Of course, as we all know, in some cases, creditors will issue a Form 1099-C even if they are not legally required to do so. Perhaps some such sellers/providers of goods and services file a Form 1099-C under a mistaken belief that they are required to do so, and perhaps other service/goods sellers or providers file a Form 1099-C as a matter of spite.

A. **Issuance of Form 1099-A.** IRS guidelines to Forms 1099-A provide that a Form 1099-A should be delivered by a creditor to a borrower if the creditor lent the borrower money in connection with a trade or business and, in full or partial satisfaction of the debt, the creditor acquires an interest in the property that is security for the debt (e.g., through foreclosure).

Form 1099-A requests the following information:

(a) the date of the lender's acquisition or knowledge of abandonment;
(b) the balance of principal outstanding;
(c) the fair market value of the property;
(d) whether the borrower was personally liable for repayment of the debt; and
(e) a description of the property.

The Form 1099-A Instructions to the borrower instruct the borrower to report gain or loss on the transaction so it is important for the taxpayer-borrower to establish the fair market value of the property at the time of the foreclosure or issuance of the deed in lieu to the creditor in order to measure that gain or loss by the difference of the fair market value and the income tax basis of the property. The Instructions seem to suggest that the fair market value of the property will be presumed to be the sale proceeds upon foreclosure.

B. Issuance of Form 1099-C. However, if and when the creditor cancels the debt (in connection with a foreclosure or an abandonment of secured property or otherwise), the creditor should issue the debtor the Form 1099-C in lieu of Form 1099-A.

Form 1099-C requests the following information:

(a) the date of debt cancellation;
(b) the amount of debt cancelled;
(c) the amount of any interest included in the amount of debt cancelled;
(d) a description of the origin of the debt;
(e) whether the borrower was personally liable for repayment of the debt;
(f) whether the debtor is reporting debt discharge in bankruptcy; and
(g) the fair market value of the property.

Again, the debtor will be taxed on the COD income to the extent that the debt exceeds the fair market value of the property unless one of the COD exclusions applies.

C. Issuance of Form 1099-A May Precede Issuance of Form 1099-C. The IRS instructions seem to suggest that a Form 1099-A is issued by a lender when there remains debt outstanding owed by the debtor to the lender for which the lender has not yet released the debtor. In other words, the issuance of a Form 1099-A may indicate that the lender may decide to pursue a deficiency action against the debtor for any remaining debt owed by the debtor to the lender beyond the principal amount of the debt secured by the foreclosed property. On the other hand, a lender who decides to write-off or forgive any excess indebtedness in excess of the fair market value of the property would issue the debtor a Form 1099-C.

V. When is Cancellation of Indebtedness Income Realized?

COD income arises at the date that the debt is satisfied by less than the full amount owed. If a debt satisfaction/cancellation occurs for a reason other than partial payment, taxable income is recognized upon any of the following dates:

1. When it becomes clear that the debt will not be repaid;
2. Upon execution of an agreement between the debtor and a creditor effecting a satisfaction of the debt;

3. On the date of judicial approval of a settlement;

4. On the date a court determines that the statute of limitations has run as a bar against collection;

5. Other events making it clear that the debt will not be repaid;

6. Where indebtedness is forgiven conditional upon the happening of a future event, in the year in which the future event takes place;

7. When encumbered property is foreclosed upon for less than the full amount owed; or

8. Where encumbered property is abandoned.

Note: The point here is that the COD event can in fact occur after the encumbered property is foreclosed upon.

VI. Distinguishing Sale or Exchange Transactions and Timing of COD Event.

A. General Overview.

As discussed above, there are many factors to consider when analyzing whether and to what extent the discharge of recourse or nonrecourse debt will result in taxable income to the debtor. Obviously, the “character” of the income to be recognized is significant if capital gains and ordinary income are taxed at different rates or if the debtor can take advantage of one of the §108 exclusions.

B. Non-Recourse Debt.

1. Gain or Loss Recognized When Property Transferred to Satisfy Nonrecourse Debt. As a general rule, debt-discharge income does not arise on a transfer of property where nonrecourse debt exceeds the fair market value of the property transferred. Instead, the taxpayer must recognize gain from the sale or exchange of the property to the extent (a) the indebtedness exceeds (b) the taxpayer's basis in the property. This means that the taxpayer cannot utilize the exclusions contained in §108(a) to avoid income inclusion on account of the transfer of the property.

Under Section 506(a) of the Bankruptcy Code, the value of property securing a secured claim limits the amount of such claim to the value of the secured property, with the amount in excess of the secured property’s value characterized as an unsecured claim. PLR 8918016 involved a debtor in a title 11 bankruptcy case who owned real property subject to a mortgage
that was greater than the fair market value of the property. The IRS ruling provided that §506 of the Bankruptcy Code treats the difference in the fair market value of the property and the mortgage amount as an unsecured claim based on the taxpayer's personal liability. That amount was discharged in the bankruptcy. The mortgagee foreclosed on the property after it was abandoned by the trustee. The IRS limited the gain required to be recognized to the amount of secured portion of the mortgage determined after applying §506 of the Bankruptcy Code (i.e., the fair market value of the property). This ruling arguably supports the position that in bankruptcy, the excess of the nonrecourse mortgage over the fair market value of the mortgaged property will be deemed a recourse mortgage. Arguably, the taxpayer can exclude the recourse portion of the mortgage from gross income under §108.

2. **COD Income Can Arise When Nonrecourse Debt is Reduced.** Note that, as discussed in more detail below, cancellation of debt income can arise when a nonrecourse liability is reduced without an accompanying disposition of the property securing such liability.

C. **Tax Consequences of Recourse Debt Discharge in Connection with Transfer of Property.**

When recourse debt is discharged in connection with the conveyance of property, whether voluntary or involuntarily, special rules apply.

1. **Tax Consequences When Amount of Debt Exceeds Fair Market Value of the Property.** If the amount of the debt exceeds the property's fair market value at the time of discharge, a bifurcation of the disposition occurs as follows:

   (a) there is gain or loss from the sale or exchange of property that arises to the extent the fair market of the property is greater/less than tax basis; and

   (b) there is debt-discharge income to the extent of the excess of the debt over fair market value. Regs. §1.1001-2(c). The COD event occurs (and COD income is taxable) when the debt is ultimately discharged.

2. **Tax Consequences When Debt is Less Than Fair Market Value.** Debt-discharge income does not arise where the debt is less than the fair market value of the property because the debt is satisfied by virtue of the value of the property that is transferred. Note, however, taxable gain or loss from the sale or exchange of the property can arise to the extent the fair market of the property is greater or less than tax basis.

   A taxpayer who qualifies for the relief exclusions under §108 would prefer COD income to gain from the sale or exchange of property when transferring property encumbered by a mortgage in excess of the fair market value of the property.

   It is important to remember that COD income is realized in the case of a recourse mortgage foreclosure only when the foreclosure proceeding discharges the mortgage. In Aizawa v. Comr., 99 T.C. 197 (1992), aff'd, 29 F.3d 630 (9th Cir. 1994), the mortgagee of a recourse
mortgage foreclosed on the encumbered property. The taxpayer-mortgagor then purchased the property at a foreclosure sale for $72,700 when the mortgagor's adjusted basis in the property was approximately $100,091, and the taxpayer was still indebted to the mortgagee in the amount of $133,506. A deficiency judgment in the amount by which the remaining debt exceed the sales proceeds was awarded by the court. The court held that the mortgagor realized a capital loss of $27,391 on the sale based in the difference between the taxpayer's adjusted basis ($100,091) and the sale proceeds ($72,700). There was no cancellation of debt income since a portion of the debt remained outstanding as a result the deficiency judgment.

D. **Disposition of Property To Satisfy Recourse Debt and Timing of COD Events.**

1. **In General.** The issue of whether the property subject to recourse debt is disposed in satisfaction of the debt raises several practical considerations for the client.

2. **Disposition of Property in Complete Satisfaction of Recourse Debt.** Basically, if the taxpayer disposes of the encumbered property in complete satisfaction of the recourse debt (e.g., via a deed in lieu of foreclosure), there has been a dispositive event which will result in (a) cancellation of debt income to the extent of the excess of (i) the debt over (ii) the fair market value of the property and (b) gain or loss from the deemed sale to the extent (i) the fair market value of the property over (ii) the debtor's income tax basis in the property.

3. **Disposition of Property Without Full Debt Release.** On the other hand, if a creditor simply forecloses on the encumbered property in a recourse debt situation, the taxpayer may have gain or loss on the deemed sale, but there is great uncertainty as to when the discharge of indebtedness income will arise since the possibility of a deficiency judgment remains outstanding and there is no certainty as to when the creditor may pursue that deficiency judgment. This has implications for the taxpayer with respect to the taxpayer's ability to utilize the permitted exceptions for discharge of indebtedness income (as discussed below).

Essentially, there is no resolution for the taxpayer until the creditor decides not to pursue the deficiency judgment (or until the applicable statute of limitations has run its course).

E. **Creditor Reporting Requirements: Comparison of IRS Forms 1099-A and 1099-C**

1. **Issuance of Form 1099-A.** IRS guidelines to Forms 1099-A provide that a Form 1099-A should be delivered by a creditor to a borrower if the creditor lent the borrower money in connection with a trade or business and, in full or partial satisfaction of the debt, the creditor acquires an interest in the property that is security for the debt (e.g., through foreclosure).

Form 1099-A requests the following information:

(a) the date of the lender's acquisition or knowledge of abandonment;
(b) the balance of principal outstanding;
The Form 1099-A Instructions to the borrower instruct the borrower to report gain or loss on the transaction so it is important for the taxpayer-borrower to establish the fair market value of the property at the time of the foreclosure or issuance of the deed in lieu to the creditor in order to measure that gain or loss by the difference of the fair market value and the income tax basis of the property. The Instructions seem to suggest that the fair market value of the property will be presumed to be the sale proceeds upon foreclosure.

2. **Issuance of Form 1099-C.** However, if and when the creditor cancels the debt (in connection with a foreclosure or an abandonment of secured property or otherwise), the creditor should issue the debtor the Form 1099-C in lieu of Form 1099-A.

Form 1099-C (an example of which is attached hereto as Exhibit B), requests the following information:

(a) the date of debt cancellation;
(b) the amount of debt cancelled;
(c) the amount of any interest included in the amount of debt cancelled;
(d) a description of the origin of the debt;
(e) whether the borrower was personally liable for repayment of the debt;
(f) whether the debtor is reporting debt discharge in bankruptcy; and
(g) the fair market value of the property.

Again, the debtor will be taxed on the COD income to the extent that the debt exceeds the fair market value of the property unless one of the COD exclusions applies.

3. **Issuance of Form 1099-A May Precede Issuance of Form 1099-C.** These IRS instructions seem to suggest that a Form 1099-A is issued by a lender when there remains debt outstanding owed by the debtor to the lender for which the lender has not yet released the debtor. In other words, the issuance of a Form 1099-A may indicate that the lender may decide to pursue a deficiency action against the debtor for any remaining debt owed by the debtor to the lender beyond the principal amount of the debt secured by the foreclosed property. On the other hand, a lender who decides to write-off or forgive any excess indebtedness in excess of the fair market value of the property would issue the debtor a Form 1099-C.

F. **Importance of Appraisals and Property Values.**

1. **General Discussion.** In order to calculate the gain or loss and/or COD income that may arise upon disposition of the property in full or partial satisfaction of the debt, it is imperative that the parties establish the fair market value of the subject property at the time of foreclosure or upon issuance of a deed in lieu of transfer. The taxpayer recognizes gain or loss on the foreclosure or deed in lieu of transfer date to the extent (a) the fair market value of the
property is (b) greater or less than the taxpayer’s income tax basis in the property. Then later, when the debt has been discharged, the taxpayer will realize COD income to the extent that (a) the debt exceeds (b) the fair market value of the property.

2. **How to Determine the Fair Market Value of Property Foreclosed Upon or Transferred to the Creditor in a Deed In Lieu Transaction.** In a foreclosure proceeding, generally the foreclosure bid price is considered to be the fair market value of the property. See Temporary Regulations 1.6050J-1T.

   However, if a voluntary conveyance by the taxpayer to the creditor occurs through a deed in lieu of foreclosure transaction, the Instructions to Forms 1099-A and 1099-C instruct the creditor to enter the “appraised value” of the property.

   Accordingly, it may be wise for the debtor-taxpayer to obtain an appraisal of the value of the property at the time of conveyance to the creditor in order to establish the agreed upon fair market value of the property for 1099-C or 1099-A reporting purposes. This will directly implicate the amount of gain and/or COD income, if any, that the taxpayer will realize.

3. **Why Would the Debtor-Taxpayer Care About the Fair Market Value Determinations in Deed In Lieu Transactions?** Establishing the fair market value of the property in connection with a deed in lieu of foreclosure transaction is critical to the taxpayer-debtor when capital gains and ordinary income tax rates differ and when the taxpayer-debtor may be in a position to utilize one or more of the Section 108 COD exclusions to avoid COD income recognition.

   Also, the debtor-taxpayer may desire to establish the fair market value of real estate that has declined in value (as is currently the case for many taxpayers) in order to claim a capital loss on the deed in lieu transfer to the extent that the taxpayer’s income tax basis in the property exceeds the depressed market value of the property.

   In addition, a taxpayer who qualifies as a “dealer” of real property may be able to claim an ordinary loss in such deed in lieu of foreclosure transactions where the subject real estate has substantially declined in value.

4. **Now, Let’s Look at Some Examples of These Rules.**

   **Example 1.** Assume the Debtor (D) transfers capital gain property with a fair market value of $7,000 and an income tax basis of $6,000 to the Lender (L) in full satisfaction of $9,000 recourse debt. Here D recognizes gain of $1,000 ($7,000 FMV minus a basis of $6,000) on the deemed sale. In addition, D will realize COD income of $2,000 ($9,000 debt minus $7,000 FMV of the property). Here we see that the $1,000 capital gain may be a favorable tax result to D, especially if the $2,000 of COD income can be excluded under one of the COD exclusions.
Example 2. Now we assume D transfers capital gain property with a fair market value of $12,000 and an income tax basis of $20,000 to L in full satisfaction of a $20,000 recourse debt. Here D recognizes (i) an $8,000 loss ($12,000 FMV - $20,000 Basis) and (ii) COD income of $8,000 ($20,000 Debt minus $12,000 FMV).

VII. Exceptions from Cancellation of Indebtedness Income.

As indicated above, cancellation of indebtedness income can arise in many situations such as: (1) when a debt is forgiven; or (2) when a debt is satisfied for less than the full amount owed. Fortunately, there are limited circumstances in which no cancellation of indebtedness income will arise, such as in the following circumstances:

1. Where the debt discharge is a gift of the donor/creditor. This situation most frequently arises in the case of inter-family debts.

2. Where the taxpayer/debtor may file an election to reduce his tax basis in trade or business property by the amount of reduced "qualified real property business debt." IRC § 108(c)(3).

3. No cancellation of indebtedness income arises for contingent obligations. If the taxpayer's repayment obligations are contingent upon the happening of a future event, no COD income arises if the contingent event does not occur.

4. No COD income arises where there is no increase in the debtor's assets. Although this exception appears to be very limited in application, consider whether a taxpayer has no increase in his assets by virtue of the provision of services by the creditor.

5. No COD income for debt discharged in bankruptcy.

6. Partial or total COD exclusion for insolvent debtors.

VIII. Exclusions from COD Income Where the Debtor Is Insolvent or Is In Bankruptcy.

A. General Overview. The general rule is that a debtor recognizes ordinary income equal to the amount of the debt discharged over the amount of cash and the fair market of any property paid to the creditor. However, there is an important exception to this rule where the debtor is bankrupt or insolvent.

Under Section 108(a)(1), if the debtor is in bankruptcy, no debt discharge income is realized. If the debtor is insolvent, income must be recognized to the extent that the cancelled debt exceeds the amount by which the debtor was insolvent before the discharge. Section 108(a)(3).
Example: Bob has assets worth $1 Million and debts of $1.3 Million. So, Bob is "insolvent" to the extent of $300,000. If Bob's creditors forgive $400,000 of debt, then Bob must recognize $100,000 of COD income. However, if Bob was in bankruptcy at the time of the debt forgiveness, Bob would not have any taxable COD income.

Accordingly, there are instances where it may be appropriate to encourage a client to declare bankruptcy, as opposed to relying on the insolvency exception, where there will be a significant amount of discharge of debt.

The taxpayer must be insolvent at the time of the foreclosure or debt cancellation, or the foreclosure or debt cancellation must occur during bankruptcy to qualify for the exclusions. Thus, if the bankruptcy is filed too late or if the taxpayer has retirement funds or other assets available to satisfy the foreclosure, there can still be enormous and unexpected tax liability arising from the foreclosure.

The application of the bankruptcy and insolvency exclusions is automatic and not elective to the taxpayer. In addition, the exceptions are inapplicable where the income is not characterized as income from the discharge of indebtedness, despite emanating from the cancellation of debt. Thus, it has been held that debt cancellation in exchange for the settlement of a damage claim does not give rise to income from the cancellation of indebtedness for purposes of §108 (OKC Corp. v. Comr., 82 T.C. 638 (1984)).

Note: The cost to the taxpayer of avoiding COD income by virtue of the bankruptcy or insolvency exclusion is the reduction in certain tax attributes of the taxpayer (such as loss carryforwards and asset basis). Section 108(b); Regs. 1.108-4(a).

B. The Bankruptcy Exception.

Under Section 108(a)(1)(A), a taxpayer in a title 11 case can exclude cancellation of debt income arising at the time the taxpayer is bankrupt. Section 108(d)(2) provides that the term “title 11 case” means a case under the Bankruptcy Code if: (i) the title 11 court as jurisdiction over the taxpayer; and (ii) the court approves a plan which discharges the cancelled debt income. Note that the foreclosure or debt cancellation must occur during bankruptcy to qualify for the exclusions. Thus, if the bankruptcy is filed too late or if the taxpayer has retirement funds or other assets available to satisfy the foreclosure, there can still be enormous and unexpected tax liability arising from the foreclosure.

Also, as mentioned above, Section 108(b) requires that the taxpayer must reduce certain tax attributes when taking advantage of the bankruptcy exception.

C. The Insolvency Exception.

Section 108(a)(1)(B) allows an insolvent taxpayer to exclude discharge of debt income if the discharge occurs at a time in which the taxpayer is insolvent. Section 108(a)(2)(A) provides that the insolvency exclusion is inapplicable in a discharge resulting from bankruptcy.
1. Calculating the Amount of Insolvency.

Section 108(a)(3) provides that the excluded amount is limited to the extent of the taxpayer’s insolvency. Similar to the bankruptcy exclusion rules, the taxpayer must reduce certain tax attributes as a result of benefitting from the insolvency exception. Under Section 108(d)(3), “insolvency” is defined as the excess of the taxpayer’s liabilities over the fair market value of its assets, as calculated immediately before the discharge.

Example: ABC, a debtor corporation, has assets of $175 and liabilities of $200. ABC's creditors agree to cancel their indebtedness for ABC's stock worth $175. ABC has therefore satisfied $175 of its debt with stock and had $25 of debt cancelled for no consideration by its creditors. ABC does not realize discharge of indebtedness income because the amount of debt that has been forgiven ($25) does not exceed the amount by which ABC was insolvent ($25). If the stock that ABC issued to its creditors were valued at $150, ABC would realize $25 of gross income, since the amount of forgiven debt ($50) exceeds the amount by which it was insolvent ($25) by $25.

2. Assets Exempt from Creditors Are Counted to Determine Insolvency.

Section 108(d)(3) does not identify which assets and which liabilities are included in the determination of a taxpayer’s solvency. Prior to the promulgation of the Bankruptcy Tax Act, assets exempt from creditor claims were not included in the analysis of a taxpayer’s solvency. Cole v. Comr., 42 B.T.A. 1110 (1940). However, the Tax Court in Carlson v. Comr., 116 T.C. 87 (2001), held that, following the passage of the Bankruptcy Tax Act, assets exempt from creditor claims are in fact included in the determination of the taxpayer’s solvency for purposes of the insolvency exception of §108(a)(1)(B).

Likewise, in TAM 199935002, the IRS Chief Counsel stated that exempt assets for bankruptcy purposes should be included as "assets" for insolvency calculation. Therefore, it is quite likely that the IRS will argue that certain assets of the taxpayer which are exempt from creditor claims (such as IRAs, tenants by the entirety real property and 401(k) plan balances) must be included as countable assets for purposes of determining the insolvency exception.

However, in PLR 8920019, the Internal Revenue Service found that, despite filing a joint return, the separate assets of a spouse are not factored into the insolvency calculation for the purpose of §108.

Therefore, even though an asset of the debtor may be exempt from claims of creditors under state law, the value of that asset must be counted for purposes of determining the extent (or existence) of a person’s insolvency.

The following is a non-exclusive list of assets which, although exempt from claims of creditors, still must be considered when determining whether the debtor is insolvent:
1. ERISA Qualified Retirement Plan Assets.
2. IRA’s.
3. Life insurance policies.
4. Tenancy by the entirety real estate.

**Note:** Because exempt assets must be considered when determining whether a taxpayer is insolvent for purposes of Section 108, some taxpayers, who own exempt assets, should file bankruptcy before the debt discharge so they can:

1. Avoid Section 108 COD income; and
2. Protect the exempt assets from claims of creditors - including the IRS and North Carolina Department of Revenue.

Hence, it is risky to rely upon the insolvency exception when trying to avoid § 108 cancellation of indebtedness income. In many cases, a better practice is to go ahead and file a bankruptcy court petition before the debt discharge to make sure that § 108 cancellation of indebtedness income does not arise.

3. **When Are Contingent Liabilities Considered Under the Insolvency Exception?**

Another factor to consider when evaluating the insolvency exception is the extent to which contingent liabilities reduce the solvency of the taxpayer. In *Merkel v. Comr.*, 192 F.3d 844 (9th Cir. 1999), the Ninth Circuit held that it is the taxpayer’s burden to prove by a preponderance of the evidence that the taxpayer will in fact be called upon by the contingent creditor to satisfy the liability.

Another issue that often arises in the analysis of a taxpayer’s solvency is the extent to which nonrecourse debt affects the calculation. The IRS ruled in Rev. Rul. 92-53 that the excess of the amount of the nonrecourse debt over the fair market value of the property securing the debt is included in the analysis, but only to the extent that such excess nonrecourse debt is discharged in determining the taxpayer’s insolvency. Let’s take a look at the following examples borrowed from William Tatlock, BNA-540 3rd, Discharge of Indebtedness, Bankruptcy, and Insolvency, Tax Management, Inc. (2009):

**Example (1):** Dan borrows $1 million from Craig and signs a nonrecourse note to repay that amount plus interest at a fixed market rate, payable annually. The note is secured by an office building valued in excess of $1 million. Dan uses the $1 million loan proceeds to purchase the building from someone other than Craig. Dan is not personally liable on the nonrecourse note payable to Craig. One year later, when the value of the office building is $800,000 and the outstanding principal on the note is $1 million, Craig agrees to modify the terms of the note by reducing the note’s principal amount to $825,000. The modified note bears adequate sated interest within the meaning of §1274(c)(2). At the time of the modification, Dan’s only other assets have an aggregate fair market value of $100,000, and Dan is personally liable to Bob on other indebtedness of $50,000.
Under these facts, the excess nonrecourse debt is $200,000. Since $175,000 of the $200,000 excess nonrecourse debt is discharged, $175,000 of the excess nonrecourse debt is taken into account in determining whether Dan is insolvent under §108(d)(3). Dan has liabilities of $1,025,000, i.e., $50,000 owed to Bob plus a portion of the nonrecourse debt that is discharged ($175,000) plus a portion of the nonrecourse debt up to the fair market value of the property securing the debt ($800,000). Dan's assets total $900,000. Since Dan's liabilities ($1,025,000) exceed Dan's assets ($900,000) by $125,000 immediately before the indebtedness is discharged, Dan is insolvent to the extent of $125,000. Thus, Dan must include $50,000 as income from discharge of indebtedness under §61(a)(12), i.e., the $175,000 that is discharged less the $125,000 by which Dan is insolvent.

Example (2): The facts are the same as in Example (1), except that Bob agrees to accept assets from Dan with a fair market value (and basis to Dan) of $40,000 to settle the $50,000 recourse debt and that Craig does not reduce Dan's nonrecourse note. Under these facts, the excess nonrecourse debt is not considered in determining whether Dan is insolvent under §108(d)(3). As a result, Dan is solvent immediately before the discharge because Dan's total liabilities — $800,000 of nonrecourse debt not in excess of the property's fair market value securing the debt plus $50,000 of recourse debt — do not exceed the $900,000 fair market value of assets. Accordingly, Dan must include the entire $10,000 of discharged indebtedness in income under §61(a)(12).

D. Corporations, Partnerships and LLCs: Who Must Be Insolvent or in Bankruptcy?

Different rules apply depending upon whether the taxpayer is a partnership (including an LLC) or a corporation. If the debtor is a corporation, the cancellation of indebtedness income issue is determined based upon whether the corporation is solvent or insolvent, and the solvency or insolvency or bankruptcy status of the corporation's shareholders is irrelevant. Section 108(d)(7). In that case, the corporation must reduce its basis in its assets by the amount of the cancelled debt. Section 108(d)(7)(A). Or, in the case of S corporations, the S corporation shareholders may be required to reduce any suspended losses in excess of their tax basis in their S corporation stock. Section 108(d)(7)(B).

A different rule applies where the taxpayer is a partnership or an LLC. Where the taxpayer-debtor is a partnership or LLC, the cancellation of indebtedness income is passed through to the partners and LLC members and the availability of the bankruptcy or insolvency exception is determined at the partner or member level. Section 108(d)(6).

Let's look at some examples:

1. **S Corporations.** Let's assume Allen and Barry form an S Corporation as a 50/50 S Corporation. The S Corporation files bankruptcy and has COD income. Here, the indebtedness discharged is determined by the corporate bankruptcy at the corporate bankruptcy level. This means that, under IRC §108(d)(7), Allen and Barry do not have any COD income to
recognize since their S corporation was insolvent or bankrupt. However, Allen and Barry must reduce their tax attributes by the excluded COD income, such as by reducing their basis in S corporation assets or by reducing any suspended loss carryovers to the extent that they have loss carryovers in excess of their available tax basis in their S corporation stock or their loans to the S Corporation.

2. **A Bankrupt Disregarded Entity.** Let’s now assume that Steve is the sole owner of an LLC which is a disregarded entity for federal income tax purposes under Section 301.7701-2(a). Here, the single-member LLC is bankrupt, but Steve is solvent or has not declared bankruptcy himself. Under PLR 200652017, the IRS takes the position that Steve must recognize COD income since he is not bankrupt or insolvent.

3. **Limited Liability Company Example.** Let’s assume that Tom and Bob create an equal 50/50 limited liability company which files a bankruptcy petition and obtains a discharge of LLC liability. Let’s also assume that Tom is bankrupt or insolvent, but that Bob is solvent. In this case, under Section 108(d)(6), qualification for the exclusion of COD income is determined at the LLC member and not the LLC entity level. Therefore, Tom’s COD income is not taxable since he is bankrupt, but Bob’s share of taxable income must be recognized as ordinary income unless he can avail himself of another Section 108 exclusion, such as the exclusion for discharge of qualified real property business debt under Section 108(a)(1)(D), which is made at the individual LLC member level as discussed below.

IX. **Qualified Real Property Business Indebtedness: Making the Election to Reduce a Taxpayer's Basis in Business Real Property Instead of Recognizing Debt Discharge Income.**

A. **General Overview.** Under the tax rules, a taxpayer, other than a C corporation, may elect to exclude the discharge of indebtedness income from gross income to the extent that the discharged debt is "qualified real property business indebtedness." Section 108(c)(3). Qualified real property business indebtedness (QRPBI) is indebtedness which:

(a) was incurred or assumed by the taxpayer in connection with real property used in a trade or business and which debt is secured by such real property;

(b) was incurred or assumed before January 1, 1993, or if incurred or assumed on or after January 1, 1993, is "qualified acquisition indebtedness"; and

(c) with respect to which the taxpayer files the required election with the IRS.

Section 108(c)(3).

“Qualified acquisition indebtedness” means indebtedness incurred or assumed to acquire, construct, re-construct or substantially improve the property securing the debt. IRC §108(c)(4). The amount of QRPBI debt that can be excluded from gross income is limited to the excess of the outstanding principal amount of all QRPBI debt secured by the property (immediately before the discharge) over the fair market value of the property immediately before the discharge. Section 108(c)(2)(A); Regs. 1.108-6(b).
Note the QRPBI is especially beneficial to taxpayers heavily invested in real estate, as it permits such taxpayers to modify or restructure their recourse real estate loans or dispose of the property in satisfaction of the recourse loans without recognizing COD income. Note also that this election is not available for foreclosures or “deeds in lieu” with respect to nonrecourse debts, since these transactions do not give rise to COD income.

**B. Reducing Tax Attributes.**

In those cases, where the taxpayer makes an election to exclude the discharged QRPBI from gross income, the taxpayer must reduce its basis in depreciable real property which can include reducing the portion of the taxpayer's basis in his partnership interest attributable to the partnership's depreciable real property and making a corresponding reduction in his share of the partnership's basis in a depreciable real property. Section 1017(b); Regs. 1.1017-1(a) and (g).

The reduction in basis is treated as additional depreciation for purposes of Section 1250. IRC §1017(b). This means that the excluded discharge of indebtedness will be offset by some combination of (1) foregone depreciation deductions, (2) ordinary income on the sale or disposition, and (3) reduced Section 1231 loss treatment on a sale. Of course, if a taxpayer dies while holding the qualified real property, his heirs will receive an income tax basis step-up on death under Section 1014.

**C. Partnership Treatment.**

Unlike the case with individuals or S corporations, in the case of a partnership, the determination as to whether the discharged indebtedness is QRPBI (and the amount by which the principal amount of the QRPBI exceeded the fair market value of the property) would have to be determined at the partnership level. However, the election to exclude QRPBI debt is made by an individual partner. IRC §108(d)(6). With S corporations, the election is made by the S corporation.

**D. Making the Election to Reduce Basis.**

In order to make an election to reduce basis, the taxpayer must file with the IRS a completed Form 982 which must be made on a timely-filed income tax return for the taxable year in which the taxpayer has discharge of indebtedness income that is excludable under Section 108(a), including extensions. If the taxpayer fails to make the election on that return, the taxpayer must request the Commissioner's consent to file late election under Reg. §301.9100-1 through -3; Reg. §1.108-5.

**E. Foreclosure or Deed in Lieu of Foreclosure.**

It is important to keep in mind that these rules apply even where the taxpayer does not retain the property securing the qualified real property business indebtedness. In fact, Section 108(c) can also apply where the taxpayer disposes of the property giving rise to COD income in a foreclosure or via a deed in lieu of foreclosure.
Generally, as discussed above, the taxpayer utilizing the QRPBI exception must reduce its basis in its depreciable property which it owns in the year following the year in which the debt discharge occurs. However the 108(c) legislative history indicates that, where the property is disposed of in a foreclosure or deed in lieu transaction, the reduction in basis such property occurs immediately before the foreclosure or deed in lieu exchange. Accordingly, the basis reduction to the property giving rise to the QRPBI will serve to increase gain (or decrease loss) on the disposition of such property. See I.R.C. Sec. 1017(b)(3)(F)(iii).

Example: Assume Bob is neither bankrupt nor insolvent and he owns an office building with a fair market value of $800,000 and a basis of $1,000,000 which is subject to a $900,000 recourse debt. Bob negotiates with the lender to transfer the property back to the lender in return for the lender’s cancellation of the recourse debt. If Bob does not make the 108(c) election, then Bob will recognize a $200,000 Section 1231 loss ($1,000,000 basis - $800,000 FMV) and $100,000 of COD income ($900,000 debt - $800,000 basis). However, if Bob makes the 108(c) election to exclude the COD income and reduce his basis in the office building immediately prior to transfer to the lender, Bob will recognize $0 COD income and $100,000 Section 1231 loss since his $1,000,000 basis in the property will be reduced by the $100,000 of excluded COD income ($900,000 108(c) adjusted basis - $800,000 FMV). Accordingly, at the cost of losing $100,000 in Section 1231 losses, Bob avoids recognizing $100,000 of ordinary income.

Therefore, in recourse debt situations in which the fair market value of the qualified business real property is less than the taxpayer’s income tax basis in that property, the taxpayer may prefer to dispose of the property in a foreclosure or deed in lieu transaction in order to allow the taxpayer to recognize a Section 1231 ordinary loss while also avoiding COD ordinary income. This can be a real tax benefit to a recourse debtor when the sale or exchange prong of the bifurcated recourse COD analysis results in a capital loss.

X. New Tax Relief for Residential Foreclosures

In recent years, with the escalating value of homes, many people have bought more "house" than they could afford and others have sought to refinance their homes in order to "pull out" attractive equity.

On December 20, 2007, the Mortgage Forgiveness Debt Relief Act of 2007 became law. Before this new law, cancellation of debt from foreclosure of homes or from short sales of homes (sale of a home for less than the amount of the debt owed) generally resulted in additional tax liability equal to the difference between what the home was sold for and the amount of the total debt. Short sales have been particularly troublesome to taxpayers. With a short sale, the homeowner makes arrangements to sell the house for less than the actual mortgage amount.

In these cases, the taxpayer has a terrible credit rating problem and, in addition, the taxpayer is left with a tax bill arising from the COD income by virtue of the short sale or foreclosure.
Under the new Mortgage Forgiveness Debt Relief Act of 2007 (PL 110-142), up to $2 Million ($1 Million for married individuals filing separately) of cancellation of indebtedness income is not taxed if the indebtedness is "qualified principal residence" debt that is discharged in 2007, 2008 or 2009. Section 108(a)(1)(E), added by PL 110-142. **Note this relief has been extended through December 31, 2012 by the Emergency Economic Stabilization Act of 2008.** This is great news for many homeowners caught in the sub-prime market trap.

The new rules provide that relief from debt stemming from foreclosure of a personal residence, to the extent that the debt was incurred to **buy or improve** a home, will now be excluded from taxable income if the foreclosure occurs between January 1, 2007 and December 31, 2012. Note, however, that the new law only provides relief for debt incurred to buy or improve a property or to refinance debt that previously was used to buy or improve a home. **So, home equity loans will not be protected from the new relief rules.**

Note that the Section 108(a)(1)(E) exclusion applies regardless of whether there is a foreclosure or a short sale of the principal residence, or simply a reduction or restructuring of the acquisition debt encumbering the principal residence.

Under Section 108(a)(1)(E), the excluded debt will reduce the income tax basis of the taxpayer’s principal residence. However, the basis reduction rule only applies in instances where the taxpayer retains ownership of the principal residence. In the event of a short sale or foreclosure of the residence, no basis reduction is required by the taxpayer since the taxpayer no longer owns the home. See IRS Pub. No. 4681 (2008).

Note that this exception does not apply to a loan that is discharged because of services performed for the lender or for any other reason not directly related to a decline in the residence's value or to the worsening of the taxpayer's financial condition. §108(h)(3). When a discharged loan is comprised only partially of qualified principal residence indebtedness, the exception only applies to that portion. §108(h)(4). The insolvency exception may not apply in lieu of the qualified principal residence indebtedness exception, unless the taxpayer so elects. §108(a)(2)(C).

**XI. Exceptions to New IRC Section 108(a)(1)(E) Residential Foreclosure Rules.**

However, there are many exceptions to the new laws.

**A. Exclusion Limit.** First of all, the limits are $2 Million for joint taxpayers and $1 Million for married taxpayers filing separately.

Note, however, that no period of ownership or use is needed to use the principal gain exclusion of debt forgiveness income under Section 108(a)(1)(E), in contrast to the Section 121 rule for gain exclusion on the sale of a principal residence.

**Example:** Eve purchased her main home in 2006 and has a $310,000 mortgage debt. Eve is unable to make her mortgage payments and her lender ultimately
forecloses in early 2008 when her mortgage debt has been paid down to $300,000. The lender sells the home for $240,000 in satisfaction of the debt later that year. Eve has $60,000 in income from the discharge of indebtedness. Eve may exclude this $60,000 under Section 108(a)(1)(E).

**Example:** The Smiths have a $2.2 million mortgage taken on a home that was worth $2.3 million at closing, but now has a fair market value of only $1.95 million. The mortgagee forecloses and forgives the $150,000 mortgage amount in excess of the fair market value (at foreclosure, the Smith had already paid the debt down to $2.1 million). The Smiths may exclude only $50,000 of the forgiveness amount under the new law. Because the existing mortgage of $2.1 million is $100,000 over the $2 million limit, that $100,000 cannot be excluded by the qualified residence exclusion.

**Example:** The Smiths find themselves unable to keep up with their $4,000 per month mortgage payments on their principal residence. They had been paying $2,200 a month on an adjustable rate mortgage that they had planned to refinance before the higher interest rate kicked in. Unfortunately, their home is now worth less than the remaining mortgage total and thus they cannot refinance. Nevertheless, their current mortgage holder is willing to drop the mortgage amount by $100,000 (which would reduce payments to $3,000 per month) rather than face holding a house it cannot sell. If the Smiths had purchased the home for $400,000 which was their basis in the property, they must reduce their basis by $100,000, the amount of debt forgiveness income excluded under the principal residence exclusion. Assume further that five years from now, Mrs. Smith, who is now the sole owner because of a divorce settlement, sells the home for $825,000. With a basis of $300,000, she will realize $525,000 in gain, of which $250,000 is excluded under Section 121.

**B. Only Debt to Purchase or Improve a Home Will Qualify For Exclusion.** Second, the new law only provides relief for debt incurred to buy or improve a property or to refinance debt that previously was used to buy or improve a home. So, home equity loans will not be protected from the new relief rules. So, when calculating the amount of forgiven debt that is covered by the new exclusion rules, any debt not used to buy or improve the principal residence will continue to be considered as income to the foreclosed homeowner. This means that forgiven equity lines and many second mortgages will still be subject to the taxable income rules. However, any second mortgage debt secured by the principal residence which is used to acquire, construct or substantially improve the principal resident will qualify for the Section 108(a)(1)(E) exclusion. So if a taxpayer obtained a second mortgage in order to construct a garage for his principal residence, the second mortgage debt will qualify for the Section 108(a)(1)(E) exclusion.

**C. Second Homes, Vacation Homes and Business and Investment Property Are Not Eligible for the Exclusion.** Finally, second homes, vacation homes and business and investment property are not included in the forgiveness rules. Instead, the new rules only apply to debts secured against the **qualified principal residence** of the taxpayer. If a taxpayer has two
homes, only the home that is used the majority of the time will qualify for the new forgiveness
debt rules.

D. Bankruptcy and Insolvency Exception Still May Be Available. Of course, the
bankruptcy and insolvency exceptions to the COD income rules are still available. However, the
taxpayer must be insolvent at the time of the foreclosure, or the foreclosure must occur after or
during bankruptcy to qualify for the exclusions. Thus, if the bankruptcy is filed too late or if the
taxpayer has retirement funds or other assets available to satisfy the foreclosure, there can still be
enormous and unexpected tax liability arising from the foreclosure.

E. Creditor and Debtor Reporting Requirements.

As discussed below, the creditor will send the homeowner and the IRS a Form 1099-C,
Cancellation of Debt Form, to report the amount of the forgiven debt. In order to exclude the
COD income from taxable income, the taxpayer-homeowner must file a Form 982, Reduction of
Tax Attributes Due to Discharge of Indebtedness, with the IRS to claim the exclusion of
forgiveness of debt income.

F. Reduction of Tax Attributes.

If debt is discharged under new Section 108(a)(1)(E) and the taxpayer keeps his home,
the taxpayer must reduce his tax basis in the home by the amount of the released debt. Note,
however, this basis reduction does not usually hurt the homeowner at all because any gain
realized on the sale of the residence is typically sheltered by the Code Section 121 home sale
exclusion of $250,000 ($500,000 for joint filers).

As mentioned above, the basis reduction rule only applies in instances where the taxpayer
retains ownership of the principal residence. In the event of a short sale or foreclosure of the
residence, no basis reduction is required by the taxpayer since the taxpayer no longer owns the

XII. Debtor Reporting Requirements. Debtors, who exclude amounts from gross income
under § 108, are required to attach a Form 982 to their tax returns to report the cancellation of
indebtedness income.
PART TWO
SO YOU THINK YOU'VE WON?
THE TAXATION OF SETTLEMENTS AND JUDGMENTS
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INTRODUCTION

Today's discussion provides a basic review of the taxation of tort-type damages awarded by court decision or agreed upon pursuant to a settlement agreement, including a chart summarizing the tax treatment of various damages arising from different torts. We will discuss briefly structured settlements and qualified assignments.

I. EXECUTIVE SUMMARY

Generally, under Internal Revenue Code Section 104 (“Section 104”), an individual who receives damage awards or settlements for physical sickness or physical injury arising from a physical injury tort claim will not be subject to income taxes on those damages. Prior to 1996, damage awards resulting from emotional distress claims, even absent any physical-type tort claim, were also tax-exempt. Due to 1996 legislation changes to Section 104, however, damages now must result from a physical injury tort claim to escape taxation.

II. ANALYSIS

Pursuant to Internal Revenue Code Section 61 (“Section 61”), the term taxable “gross income” is defined as “all income from whatever source derived,” with some limited exceptions. Thus, Section 61 provides the overriding general rule that any damage award or settlement payment will be taxable income, unless the income is subject to some statutory exemption from taxable income.

One of the exceptions from taxable gross income is compensation received as a result of personal physical injuries or physical sickness, as provided for in Section 104. Subsection 104(a)(2) exempts from taxable gross income: the amount of any damages (other than punitive damages) received (whether by suit or agreement and whether as lump sums or as periodic payments) on account of personal physical injuries or physical sickness. Note that this subsection was amended in 1996 to add the word “physical” before the words “injuries” and “sickness.” Also in 1996, Proposed Regulation Section 1.104-1(c) was added to address this “physical” requirement.1 This proposed regulation, included in part below, requires damages to arise from physical injury or physical sickness to be excluded from gross income:

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1 While not technically binding, the Internal Revenue Service views proposed regulations as the Treasury's interpretation of the Internal Revenue Code. As such, the Internal Revenue Service will use a regulation as a “sword” in enforcing the Internal Revenue Code. In contrast, a taxpayer can use a regulation as a “shield” because reliance upon a proposed regulation constitutes the taxpayer’s “reasonable basis” for taking a certain tax position.
Section 104(a)(2) excludes from gross income the amount of any damages (other than punitive damages) received (whether by suit or agreement and whether as lump sums or as periodic payments) on account of personal physical injuries or physical sickness. **Emotional distress is not considered a physical injury or physical sickness. However, damages for emotional distress attributable to a physical injury or physical sickness are excluded from income under section 104(a)(2).** Section 104(a)(2) also excludes damages not in excess of the amount paid for medical care (described in section 213(d)(1)(A) or (B)) for emotional distress. For purposes of this paragraph (c), the term damages means an amount received (other than workers' compensation) through prosecution of a legal suit or action, or through a settlement agreement entered into in lieu of prosecution.

(Emphasis added.) Prop. Reg. Sec. 1.104-1(c).

**A. Section 104 Exclusion Only Applies to Tort Claims**

Section 104(a)(2) requires damages to be “received (other than workmen’s compensation) through prosecution of a legal suit or action based upon tort or tort type rights, or through a settlement agreement entered into in lieu of such prosecution.”\(^2\) State law generally determines whether a cause of action is a tort.\(^3\)

Proposed Regulation Section 1.104-1(c)(2), supra, would apply the Section 104(a)(2) exclusion to “damages recovered for a physical personal injury or sickness under a statute, even if that statute does not provide for a broad range of remedies. The injury need not be defined as a tort under state or common law.”

**B. The “On Account Of Personal Physical Injuries or Physical Sickness” Requirements**

In light of the changes discussed above in 1996, this memorandum discusses the two requirements necessary for a damage award to escape inclusion in taxable gross income under Section 104: (1) the “on account of” requirement and (2) the “personal physical injury or physical sickness” requirement.

1. **The “On Account Of” Requirement**

First, damages must have been received “on account of” a personal injury to escape inclusion in taxable gross income under Section 104. In Comm. v. Schleier, a case involving age discrimination, the United States Supreme Court determined that the award a taxpayer received in a settlement was taxable because the award was not “on account of” personal injury or

\(^2\) I.R.C. Section 104(a)(2).

\(^3\) Greer v. U.S., 207 F.3d 322, 327 (6th Cir. 2000), citing Burnet v. Harmel, 287 U.S. 103, 110, 53 S.Ct. 74 (1932) ("[S]tate law creates legal interests, but the federal statute determines when and how they shall be taxed.").
sickness.4 The Court explained in this case of employment discrimination that the genesis of the back wages awarded to the taxpayer, whether his 60th birthday or his being laid off due to his age, cannot "fairly be described as a 'personal injury' or 'sickness.'"5

Another person aggrieved due to the physical injury or sickness of another may be able to receive damage awards or settlement payments free from income taxation. For example, in Private Letter Ruling 200121031, the IRS decided that a widow could receive settlement proceeds tax-free because her underlying causes of action, which included loss of consortium, were based on her husband’s exposure to asbestos and asbestos products, which proximately caused his subsequent diseases and death.6 Such a result is not surprising given the language of the Joint Committee on Taxation in its discussion of Section 104(a)(2):

If an action has its origin in a physical injury or physical sickness, then all damages (other than punitive damages) that flow therefrom are treated as damages received on account of personal physical injuries or physical sickness whether or not the recipient of the damages is the injured party. For example, damages (other than punitive damages) received by an individual on account of a claim of loss of consortium due to the physical injury or physical sickness of such individual's spouse are excludable from gross income. In addition, damages (other than punitive damages) received on account of a claim of wrongful death continue to be excludable from gross income as under prior law.7

(Emphasis added).

The logic of the IRS in the private letter ruling mentioned above, as buffered by the language of the Joint Committee on Taxation, can be extended to a number of various physical injury situations such that persons other than the person physically harmed may receive tax-free damages, such as damages resulting from wrongful death.8 Likewise, if a parent suffers emotional distress as a result of witnessing an accident involving the parent’s child, then the parent’s damages arguably should be exempt from taxation.

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6 See also Private Letter Ruling 199952080 (1/03/2000). Please note that private letter rulings ("PLRs") may neither be cited as precedent as they are written in response to individual requests for guidance, nor can they be relied upon by any party other than the parties to whom they are issued.
7 Comm. Report. JCS 12-96 (Joint Committee on Taxation, General Explanation of Tax Legislation Enacted in the 104th Congress), Part Four (Revenue Provisions of the Small Business Job Protection Act of 1996 (H.R. 3448)), Article V (Revenue Offsets), Section 5 ("Taxation of Punitive Damages Received on Account of Personal Injury or Sickness (Sec. 1605 of the Small Business Act and Sec. 104(a)(2) of the Code), pp. 223-24 (herein after, this source shall be cited as the "Joint Committee Report"). See also PLR 200121031, supra.
8 See, e.g., PLR 200492017 (10/16/2009), where the Service states that to the extent an award received by a taxpayer represented compensatory damages for wrongful death and associated emotional distress, that award was excludable from the taxpayer’s income under Section 104(a)(2).
2. The “Physical Injuries or Physical Sickness” Requirement

Second, Section 104(a)(2), as well as Proposed Regulation Section 1.104-1(c), require that an injury must be “physical” in nature in order for the resulting damages to be tax-free under Section 104.

For example, damages received on account of harm to one’s personal or professional reputation are not considered to be received “on account of personal physical injuries or physical sickness.” Before 1996, such damages were considered to have arisen from personal injury and were thus excluded from gross income. After 1996, however, damages resulting from injury to professional and personal reputation are taxable. Indeed, the Joint Committee on Taxation states, “[T]he exclusion from gross income does not apply to any damages received ... based on a claim of employment discrimination or injury to reputation accompanied by a claim of emotional distress.”9

3. Punitive Damages

Punitive damages are generally taxable because they are imposed to punish and thus do not arise “on account of” personal injury.10 In general, taxpayers who receive punitive damages must include these damages in their gross income even if, as suggested by the language of the statute and Joint Committee Report, the punitive damages result from physical injury or physical sickness.11 The major exception to this rule is limited to punitive damages awarded on account of a wrongful death claim with respect to which applicable State law provides that only punitive damages may be awarded in such an action.12

4. Emotional Distress

Proposed Regulation Section 1.104-1(c) also demonstrates that Congress does not consider “emotional distress”13 to be a physical injury or physical sickness.14 As a result, Congress decided that damages for emotional distress are includable in gross income.15 However, if the emotional distress is attributable to a physical injury or physical sickness, then the damages for the emotional distress also are excluded from gross income.16 Please note that one may also exclude any portion of a damage award that is a reimbursement of medical care

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9 Joint Committee Report, supra, p. 224.
11 See Joint Committee Report, supra, p. 223.
12 Punitive damages will not be taxable if they are awarded in wrongful death actions “with respect to which applicable State law (as in effect on September 13, 1995 and without regard to any modification after such date) provides, or has been construed to provide by a court of competent jurisdiction pursuant to a decision issued on or before September 13, 1995, that only punitive damages may be awarded in such an action.” I.R.C. Section 104(c).
13 Intended by the House Committee to include physical symptoms such as insomnia, headaches and stomach disorders which may result from such emotional distress. Joint Committee Report, supra, n. 171.
14 Id.; I.R.C. Section 104(a); Proposed Regulation Section 1.104-1(c)(1).
15 Proposed Regulation Section 1.104-1(c)(1).
16 Id.
costs relating to emotional distress, even if the emotional distress does not arise from physical injury.  


In his article, “Tax-Free Physical Sickness Recoveries in 2010 and Beyond,” Robert W. Wood discusses the impact the elusive differences between physical sickness and emotional sickness have on emerging case law. Also, a 2010 Tax Court case, Domeny v. C.I.R., further illustrates the gray area between physical injury and emotional distress and the circular logic that applies when determining which type of injury — physical or emotional — causes the other. In that Tax Court case, the taxpayer and the IRS disagreed over whether the taxpayer had received damages on account of physical injury or sickness. The Tax Court ultimately determined that the taxpayer received non-taxable damages on account of physical injury or sickness because the "hostile and stressful work environment" in which the taxpayer worked exacerbated her multiple sclerosis, thus causing physical injury. Such case law suggests that if damages for emotional distress are attributable to physical injury or physical sickness, the damages may avoid taxation even if the underlying claim is not based upon a traditional physical injury tort claim.

III. ATTORNEY FEES

Much confusion exists with respect to the treatment of attorneys fees. An example may be helpful. Consider a non-physical injury claim in which the plaintiff has agreed to pay his or her attorney 30% of any damages awarded at the end of the case. If the plaintiff is awarded $1,000 in damages, the plaintiff will pay the attorney $300. The plaintiff will then seek to deduct the $300 paid in attorneys fees on his or her income tax return.

Even if the amount paid is deductible, both the amount and effect of the deduction are limited in several ways. First, the deduction is categorized as a miscellaneous itemized deduction, which means the deduction is limited to the amount by which it exceeds two percent of the Plaintiff’s adjusted gross income. Second, the deduction is subject to the itemized deduction “phase-out” rules, which means that if the Plaintiff’s adjusted gross income exceeds a

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17 Id.
19 T.C. Memo 2010-9.
20 Id.
21 For example, if the source of the claim is purely personal in nature and not related to the Plaintiff’s business, the related attorneys’ fees may not be deductible. See, generally, I.R.C. Section 212. Moreover, if the award was based on physical injury and so is tax-free to the Plaintiff, then the attorneys’ fees are not deductible. See, I.R.C. Section 265. See also Bent v. C.I.R., (1986), 87 TC 236, aff’d (1987, CA3) 61 AFTR 2d 88-301, 835 F2d 67, 88-1 USTC ¶ 9101.
22 I.R.C. Section 67. Note, however, that in some cases, the legal expenses may be deductible as a business expense, if the claim at issue originates from the taxpayer’s business. See, e.g., Guill v. C.I.R., 112 T.C. 325, 329 (1999). Such a deduction may only be available as a miscellaneous itemized deduction from adjusted gross income, however, for legal expenses incurred by an employee in a wrongful termination claim due to a lack of a “business connection.” See, e.g., Biehl v. C.I.R., 118 T.C. 467, 472, 478-79 (2002).
specific amount, the deduction will be further limited.\textsuperscript{23} Third, if the Plaintiff is subject to the Alternative Minimum Tax, the deduction will not be allowed at all.\textsuperscript{24}

In effect, the plaintiff, in our example above, now owes taxes on the full $1,000, even though a substantial portion of this amount was paid to an attorney. Note, however, that the American Jobs Creation Act of 2004, P.L. 108-357, provides that, if the party received the damages due to certain types of unlawful discrimination, the legal fees will not be categorized as a miscellaneous itemized deduction and, as a result, will not be subject to the above limitations.

Some taxpayers have attempted to avoid these limitations on deductions by assigning a portion of their rights in their lawsuits to their attorneys. This maneuver, however, will not be successful. Discussing two instances of employment discrimination, the United States Supreme Court held, “as a general rule, when a litigant’s recovery constitutes income, the litigant’s income includes the portion of the recovery paid to the attorney as a contingent fee.” \textit{C.I.R. v. Banks}, 543 U.S. 426, 430, 125 S.Ct. 826, 829 (2005). Viewing the case in the context of an anticipatory assignment of income, the Court held that the taxpayer’s “income-generating asset” is the cause of action deriving from the plaintiff’s legal injury, an asset over which the taxpayer “retains ultimate dominion and control.” \textit{Banks} at 436, 125 S.Ct. at 832. The Court declined to address claims involving statutory attorney fees. \textit{Banks} at 438, 125 S.Ct. at 834.

Please note that the deductibility of the plaintiff’s attorneys fees in a structured settlement based on a non-physical injury is a complex issue, a thorough analysis of this specific issue is outside the scope of this memorandum.

\textbf{IV. SUMMARY CHART}

Based on the preceding analysis, the following chart provides a general summary of the tax treatment of damages resulting from various tort claims:

\begin{itemize}
  \item[A. Slander/Libel]
    \begin{enumerate}
      \item Injury to Reputation \hspace{1cm} Taxable
      \item Emotional Distress \hspace{1cm} Taxable
      \item Punitive Damages \hspace{1cm} Taxable
    \end{enumerate}
  
  \item[B. Employment Discrimination/Hostile Work Environment/Americans with Disability Act]
    \begin{enumerate}
      \item Lost Wage Income \hspace{1cm} Taxable
      \item Emotional Distress \hspace{1cm} Taxable\textsuperscript{25}
      \item Punitive Damages \hspace{1cm} Taxable
    \end{enumerate}
\end{itemize}

\textsuperscript{23} I.R.C. Section 68.

\textsuperscript{24} I.R.C. Section 56(b)(1)(A)(i).

\textsuperscript{25} Generally, but see \textit{Domeny}, supra.
C. Personal Injury: Medical Malpractice/ Assault and Battery/ Slip and Fall/Auto Accidents

1. Physical Injury
   1. Pain and Suffering Exempt
   2. Medical Expenses Exempt
   3. Lost Income Exempt
   4. Wrongful Death Exempt

2. Emotional Distress Arising from Physical Injury Exempt

3. Punitive Damages Taxable

V. SETTLEMENT AGREEMENTS

A. Generally

Payments received pursuant to settlement agreements, in contrast from severance agreements, may be excluded from taxable gross income under Section 104. To benefit from the Section 104 taxable income exclusion rules, a taxpayer should ensure that his or her settlement agreement properly allocates the damage settlement between taxable and nontaxable settlement amounts.

If the parties to a settlement agreement draft the agreement to “expressly allocate[] the settlement between tort type personal injury damages and other damages, it will be respected for tax purposes to the extent that the parties entered into the agreement in an adversarial context at arm’s length and in good faith.” Moulton v. C.I.R., T.C. Memo. 2009-38.

Absent such allocation, the entire amount of the damages awarded under the settlement agreement may “result[] in the entire amount’s being presumed not to be excludable.” Pipitone v. United States, 180 F.3d 859, 864 (7th Cir. 1999), citing Wise v. C.I.R., T.C. Memo. 1998-4.

Not surprisingly, the IRS may make “a reasonable attempt ... to allocate the proceeds between nonexcludable income and personal injury damages.” Field Service Advisory 2187, 1997 WL 33106702 (Sept. 23, 1997).

The major question the IRS and the courts will try to determine is “in lieu of what was the amount paid.” Bagley v. C.I.R., 105 T.C. 396, 406 (1995). The answer to such a question necessarily must emerge from “all of the facts surrounding the settlement.” Id. If, however, “there is no evidence on which to predicate an allocation,” a court will not make such an apportionment, presumably resulting in full taxation of the settlement proceeds.

26 See, generally, Rev. Rul. 85-97, 1985-2 C.B. 50 (“The exclusion provided by section 104(a)(2) extends to personal injury damages allocable to lost wages.”).
27 Punitive damages are generally taxable. As discussed, supra, punitive damages are excluded from income in the rare case that punitive are awarded in a wrongful death action in which applicable state law only provides for punitive damage awards. See n. 12, supra.
28 See Greer, supra, 207 F.3d at 327, quoting Lubart v. Commissioner, 154 F.3d 539, 542 (5th Cir. 1998) (stating “[P]arties must be prohibited from creating contrived ‘settlement agreements’ to avoid taxation of the proceeds.”).
When considering the factual context of a settlement, the Tax Court has stated, “When damages are received pursuant to a settlement agreement, the nature of the claim that was the actual basis for settlement controls whether such damages are excludable under section 104(a)(2).” 30 That said, the most important factor to be considered is “the payor’s intent in making the payment.” 31 Indeed, “Although the belief of the payee is relevant...the character of the settlement payment hinges ultimately on the dominant reason of the payor in making the payment.” 32 Determination of the payor’s intent may include consideration of the joint stipulation of the settlement agreement and the allegations made in the underlying complaint. 33 Indeed, some commentators have suggested that a discrepancy in the manner in which the payor and recipient taxpayer record the settlement payment for tax purposes will trigger investigation by the IRS. 34

B. Reporting and Withholding Requirements

Internal Revenue Code Instructions for Form 1099 indicate that a defendant-payor will be obliged to determine the taxable nature of payments made to the plaintiff. If these payments are taxable to the plaintiff, for example, punitive damages and damages not arising from physical injury, then the defendant-payor must report such payments via Form 1099.

Under certain circumstances, for example, if the plaintiff refuses to provide his or her tax identification number to the defendant, then the defendant may also be required to “deduct and withhold from such payment a tax equal to the product of the fourth lowest rate of tax applicable under section 1(c) and such payment.” 35

C. Structured Settlements

Instead of making and receiving a lump-sum payment based on a tort resulting in personal injury, the parties in a settlement may agree to “structure” the settlement such that payments are made over a period of time. Each payment would be tax-free to the recipient, including the hypothetical interest within each payment. In contrast, had the recipient received a lump sum and then invested this amount, the recipient would be taxed on the income resulting from that investment. The parties to a structured settlement agreement should also be sure to not

31 T.C. Memo. 2009-38; see also T.C. Memo. 1998-357.
33 T.C. Memo. 1998-357. See also Alexander v. IRS, 77 AFTR 2d 96-201 (72 F3d 938) (CA1, 1995) (“[W]e take into consideration the well-settled rule that the classification of amounts received in settlement of litigation is to be determined by the nature and basis of the action settled, and the amounts received in compromise of a claim must be considered as having the same nature as the right compromised.”); Save v. C.I.R., T.C. Memo. 2009-209 at *3 (“In the absence of any express language in the agreement, the intent of the payor is the most important factor in determining the purpose of the payment.”). In Knevelbaard v. Commissioner, the Tax Court considered testimony in determining the basis of a settlement agreement. T.C. Memo. 1997-330, 11-13.
35 I.R.C. Section 3406(a).
label any payment or portion thereof as interest, even if the payment would otherwise be tax-free under Section 104 as the IRS may tax the interest as ordinary income.36

D. Qualified Assignments

If a party (the “Defendant”) becomes liable to make periodic payments as damages under a suit or a settlement agreement (the “Liability”), the Defendant can pay a third party (the “Assignee”) to assume this Liability (the “Assignment”). This payment to the Assignee (the “Payment”) will be tax-free to the Assignee if the Assignment is “qualified,” meaning that it meets certain conditions.37 An Assignment is “qualified” if, among other conditions, the underlying liability arises from a personal injury,38 and the recipient of the periodic payments (the “Plaintiff”) can exclude the payments from his or her gross income.39 However, the Payment to the Assignee will not be tax-free to the Assignee to the extent the Payment exceeds the Assignee’s cost of obtaining an annuity contract that is used to fund the periodic payments to the Plaintiff.40

Economic performance will occur when payments are made to the Plaintiff, which means that the Assignee may deduct payments as they are made to the Plaintiff.41 Similarly, the Defendant will deduct the amount paid to the Assignee in the year in which it so pays the Assignee.42

VI. Settlement Payments For Trade Secret Misappropriation Treated as Ordinary Income, and Not Capital Gain; Freda v. Commissioner, 108 AFTR 2d 2011-5985 (7th Cir. Ct. of Appeals August 26, 2011).

In this case, C&F Packing Company sued Pizza Hut, Inc. for "trade secret misappropriation." Ultimately, C&F agreed to dismiss all of its claims against Pizza Hut in exchange for payment of $15.3 Million. C&F reported the entire payment as proceeds from the sale of a capital asset, generating capital gain. Since C&F was an S corporation, the reported capital gain was passed-through, and taxed to, the individual S corporation shareholders of C&F.

Later, the IRS contended that the settlement payments should be treated as ordinary income, since the lawsuit Complaint, originally filed by C&F against Pizza Hut, alleged that trade secret misappropriation, by Pizza Hut, had caused C&F to incur substantial losses of potential profits.

37 I.R.C. Section 130(a).
38 I.R.C. Section 130(c).
39 I.R.C. Section 130(c)(2)(D).
40 See I.R.C. Sections 130(a), (d).
41 I.R.C. Section 461(h)(2)(C); I.R.C. Regulation Section 1.461-4(g)(2).
A. Fact Summary. C&F was a sausage producer. Years earlier, Pizza Hut had approached C&F about allowing Pizza Hut to use C&F's meat processing procedures in connection with Pizza Hut's business. In 1985, Pizza Hut agreed to sign a Confidentiality Agreement under which Pizza Hut agreed that it would not disclose C&F's confidential information about its sausage processing procedures.

Later, C&F sued Pizza Hut for "trade secret misappropriation" and contended that Pizza Hut violated the terms of the Confidentiality Agreement. In the original lawsuit Complaint, C&F requested a damage award, claiming in its Complaint that "C&F has been damaged, and has suffered, among other things, lost profits, lost opportunities, operating losses and expenditures."

Ultimately, Pizza Hut and C&F entered into a Settlement Agreement, and in exchange for a $15 Million settlement payment, C&F agreed to release all of its claims against Pizza Hut. The Settlement Agreement provided for "a lump sum payment in full and complete discharge and settlement of the Lawsuit and other past, present and future claims that could be asserted now or in the future by C&F".

C&F characterized $6.12 Million from the settlement as gain from a "trade secret sale" and reported the entire amount as long-term capital gain on its 2002 federal income tax return. Since C&F was an S corporation, the reported capital gain was passed-through, and taxed to, the individual S corporation shareholders of C&F.

B. The Tax Court Proceedings. During the Tax Court proceedings, the IRS argued that, in its very own Complaint, C&F had never argued that it had suffered damages to a capital gain asset. Instead, the Complaint only alleged damages for lost profits. And, in the Settlement Agreement, the terms of the Settlement Agreement never purported that C&F was exchanging its trade secrets information in exchange for a lump sum settlement payment.

C&F, however, presented three arguments in support of its position that the settlement proceeds should be taxed as long term capital gain:

1. Relying on Inco Electroenergy Corp vs. Commissioner, TCM 1987-437, which held that funds received for damages to a capital asset are taxable as capital gain, the shareholders of C&F argued that the settlement payments by Pizza Hut were payments for damage to C&F trade secrets, which were capital assets.

2. Second, the C&F shareholders argued that since long-term capital gain is defined in terms of the "sale or exchange" of capital assets, the settlement payment represented the culmination of a "sale or exchange" of the trade secrets relating to the C&F process.

3. Third, since Section 1234A treats, as capital gain, income attributable to the termination of certain rights or obligations, the shareholders contended that Pizza Hut made the settlement payment to terminate C&F's rights under the Confidentiality Agreement the parties had signed in 1985.
The Tax Court rejected all three arguments and held that all the settlement payment proceeds should be taxed as ordinary income. The Tax Court held that, based upon the "origin of the claim" doctrine, since C&F had never alleged that it received payments as compensation for a lost or transferred capital asset, but instead had simply alleged that it suffered "loss of profits", the language in the original Complaint and in the Settlement Agreement bound C&F to recognize the entire amount as ordinary income, and not as capital gain.

C. The 7th Circuit Court of Appeals. The C&F shareholders then appealed to the 7th Circuit Court of Appeals. In agreement with the Tax Court, the Appeals Court noted that, in the earlier case of Sager Glove, 36 TC 1173 (September 29, 1961), aff'd 11 A.F.T.R. 2d 325 (7th Cir. 1962), the Seventh Circuit Court of Appeals had held that, under the "origin of the claim" doctrine where:

"the recovery represents damages for lost profits, it is taxable as ordinary income. However, if it represents a replacement of capital destroyed or injured, the money received ... is a return of capital and not taxable."

Here in Freda, in the original Complaint, C&F sought damages for loss of profits and in nowhere in the Complaint did C&F focus on any type of damage to or destruction of its capital asset. In addition, the Settlement Agreement gave no indication that Pizza Hut believed that it was compensating C&F for the sale or the use of its trade secrets. Instead, the Settlement Agreement only stated that $15.3 Million was tendered "in consideration of the dismissal with prejudice of the lawsuit." And, nowhere did the Settlement Agreement mention anything about the settlement payment being in exchange for any type of transfer of a capital asset that Pizza Hut previously received, or was receiving, by virtue of the Settlement Agreement.

Thus, based upon a direct and plain reading of the original Complaint and Settlement Agreement, the Court of Appeals ruled that C&F was bound by its prior demand for judicial award for "lost profits."

Note: This case is the classic case where C&F's litigation attorneys drafted an initial Complaint, and even the Settlement Agreement, without considering the possible tax consequences of the judicial award or settlement. Perhaps C&F's litigation attorneys believed that they would have an easier time in proving lost profits, as opposed to being able to prove diminishing value of C&F's capital assets, i.e., its trade secrets or proprietary meat processing process.

Presumably, with even a small amount of foresight or tax planning, C&F's litigation attorneys easily could have alleged alternative damages to its capital asset in the original Complaint. Likewise, in the Settlement Agreement, the litigation attorneys easily could have "couched" the Settlement Agreement in terms of payment for damages to, or transfer of, a capital asset from C&F to Pizza Hut.

Also Note: One judge dissented with the 7th Circuit Court of Appeals' decision, and indeed the end result seems particularly harsh in light of the fact that C&F never would have incurred lost profits without the corresponding loss or destruction of its capital asset. Indeed, if Pizza Hut had negligently or intentionally destroyed a building belonging to C&F, then it is obvious that C&F's
damages would have related to the loss of the building itself (a capital asset), rather than the mere loss of potential rental income (ordinary income) the building could have generated.
PART THREE
INCOME TAX ISSUES FOR GIFTED PROPERTY

I. Introduction. On occasion, individuals transfer their interest in real property to a related party, often for no consideration. This type of transfer is most common in estate, asset protection and Medicaid planning. Given the emotional nature of these types of planning, the tax implications of such transfers are easily overlooked. The following is a brief overview of the tax considerations of such transfers and two techniques for minimizing capital gains taxes upon the sale of the real property.

II. Cost Basis of Gifted Property. Gifted property is generally subject to carry-over basis rules under the Internal Revenue Code. Essentially, a recipient's cost basis in gifted property equals the donor's cost basis in such property.\(^{43}\) For instance, if a parent gifts his or her property outright to his or her adult child, the child will generally take the property subject to the parent's cost basis, which is typically lower than current fair market value (although this is not always the case, especially in recent years). If the child subsequently sells the property, he or she could be subject to significant capital gains tax on the difference between the sales price and the property's cost basis.

III. Cost Basis of Inherited Property. The cost basis rules associated with inherited property, however, are in stark contrast to the carry-over basis rules. With respect to inherited property, the beneficiary-recipient generally receives the property with a step-up in cost basis equal to its fair market value as of the date of the decedent's death.\(^{44}\) As a result, if a child inherits property, his or her basis in such property is generally stepped-up to fair market value. This means that the beneficiary-recipient can immediately sell the property and potentially recognize little or no capital gain. For a variety of reasons, however, it is not always ideal for real property to stay in one's name until death. Fortunately, with proper planning an individual can transfer property out of his or her name and still permit the recipient to take advantage of a step-up in basis upon the donor's death. The following transfer techniques remove the real property from the donor's probate estate but retain the benefits of step-up in basis:

A. Retained Life Estate. One option for consideration is for the donor to transfer the real property subject to a retained life estate.

1. Retained life estates, in general. In a retained "life estate," the donor possesses the property and practically serves as owner, paying all taxes, insurance, and regular maintenance of the property, but the remainderman, not the donor, has legal title to the underlying real property.\(^{45}\) Thus, the donor may continue to use the property he or she gifted yet it will be excluded from the donor's assets subject to determining Medicaid eligibility under current law.\(^{46}\) Importantly, however, a gratuitous transfer of property and retention of a life

\(^{43}\) I.R.C. § 1015(a).
\(^{44}\) I.R.C. § 1014(a)(1).
\(^{46}\) "Estate," for purposes of North Carolina's Medicaid Recovery Plan, "means all the real and personal property considered assets of the estate available for the discharge of debt pursuant to G.S. 28A-15-1." N.C. Gen. Stat. §
estate is a Medicaid sanctionable transfer that will trigger a penalty if it occurred during the applicable Medicaid look-back period. 47

2. Tax implications of retained life estate. One benefit of a retained life estate is that it provides the remaindermen with a step-up in basis for income tax purposes upon the life tenant-donor's death because the property is treated as being received via inheritance from the life tenant. 48 Specifically, under Section 1014(b)(9) of the Internal Revenue Code, any property which is included in the value of a decedent's gross estate for federal estate tax purposes is entitled to a step-up in basis upon the decedent's death. Moreover, Section 2036 of the Internal Revenue Code makes the full value of land subject to a retained life estate subject to inclusion in the decedent's gross estate. Thus, at the death of the life tenant-donor, the remaindermen will be entitled to a full step-up in basis to fair market value.

Unfortunately, the conveyance of property with a retained life estate also may cause a current gift for federal gift tax purposes. 49 For federal gift tax purposes, when property is gifted with a retained life estate, the conveyance is treated as a taxable gift equal to the value of the remainder interest passing to the donee. Also, because the gift is a gift of a future interest in real property, the gift will not qualify for the $13,000 federal gift tax exclusion. 50

B. Retained Limited Power of Appointment. Another option for consideration when gifting real property is to retain a "limited power of appointment."

1. Retained powers of appointment, in general. Powers of appointment are often used in estate planning to add flexibility and reduce tax liability. In general, a power of appointment is a right that one confers on another (or retains for themselves) to designate those who are to receive property after the occurrence of some event. Such powers can drafted to be exercisable in favor of anyone, including the power-holder, the power-holder's creditors, the power-holder's estate, or creditors of the power-holder's estate (referred to as a general power of appointment) or a more limited group of persons that does not include the power-holder or his or her creditors or creditors of his or her estate (referred to as a "limited" power of appointment). 51 Thus, the limited power of appointment precludes the donor-power-holder (or his or her creditors) from exercising the power for his or her benefit. Thus, by gifting the property and retaining a limited power of appointment over the property, the donor divests

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47 See Deficit Reduction Act of 2005, enacted on February 8, 2006 and made effective in North Carolina for Medicaid applications made on or after October 1, 2007.

48 I.R.C. §§ 1014, 2036.

49 I.R.C. § 2501(a).

50 I.R.C. § 2503(b)(1).

51 See I.R.C. § 2041.
him or herself of any ownership interest but, as discussed below, avoids the downside of the carry-over basis rules.

As with retained life estates, gifts of property with a retained limited power of appointment are a Medicaid sanctionable transfers that will trigger a penalty if they occurred during the applicable Medicaid look-back period. 52

2. Tax implications of retained limited powers of appointment.

General powers of appointment are includible in the power-holder's estate for federal estate tax purposes. 53 Limited powers of appointment, on the other hand, typically escape inclusion in the power-holder's estate for federal estate tax purposes. Where the donor retains a limited power of appointment, and thereby is both the donor and power-holder, however, the gift is deemed incomplete. Under the Internal Revenue Code, when a donor transfers property but retains the power to "name new beneficiaries or to change the interest of the beneficiaries as between themselves unless the power is a fiduciary power limited by an ascertainable standard," the property is includible in the donor's estate for federal estate tax purposes. 54

As a result, if a person gives property to another but retains a power of appointment over such property, the gift will be considered incomplete. Consequently, upon the power-holder's death, the appointee (or original donee if the power-holder fails to exercise the power of appointment) acquires the property with a cost basis equal to its fair market value at the time of the power-holder's death. 55 The mere existence of a power of appointment exercisable by will is sufficient to cause the property to includible in the estate of the power-holder, whether or not the power was exercised.

Conclusion.

By transferring real property and retaining a life estate or special power of appointment, the donor removes title to the underlying property from his or her name. These techniques may protect the underlying property from the donor's creditor claims and/or Medicaid estate recovery. Where the underlying property is the donor's principal residence, retaining a life estate may be the more appropriate of the two techniques. This is because the donor-life tenant can continue to live in the property after the transfer and, if the donor moves to a nursing home, as long as the donor intends to return home, it is unlikely that Medicaid could successfully require the donor-life tenant to make the property productive or rent out the underlying property.

On the other hand, where the underlying property is not the donor's personal residence, retaining a special power of appointment over the property may be more appropriate. For instance, if the donor retained a life estate over farm land there is a greater likelihood that the donor's creditors (or Medicaid) could successfully require that the donor make the property

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52 See supra note 4.
53 I.R.C. § 2041(a)(2).
54 Treas. Reg. § 25.2511-2(c). Moreover, where a donor retains the right to designate who shall possess or enjoy the property, the property is includible in his or her estate under Section 2036 of the Internal Revenue Code.
55 IRC § 1014(b)(9); see also Banker's Trust Co. v. United States, 156 F. Supp. 930 (1957) (holding basis step-up was allowed where grantor reserved the right to revoke the trust without the right to revest corpus in himself).
productive or rent out the property and use the proceeds to pay creditor claims or for his or her care. Whereas if the donor merely retained a special power of appointment, the donor would not have the legal right to access the property, charge rent or make the property productive. Thus, where the underlying property is not the donor's personal residence, the donor should consider retaining a special power of appointment rather than retaining a life estate.

Whether an individual that transfers his or her interest in real property to a family member for no consideration should retain a life estate of limited power of appointment depends on a number of factors. If done properly, however, either transfer should result in a step-up in basis upon the death of the donor, minimizing capital gains taxes upon the sale of the real property. Importantly, these transfers must still be viewed as part of a comprehensive estate plan, as they may result in adverse estate tax consequences or cause the donor to violate fraudulent transfer of Medicaid eligibility rules.
PART FOUR
Federal Tax Collection Procedure

I. Overview of IRS Tax Collection Procedures in General.

A. Introduction. The Collection Division of the Internal Revenue Service ("IRS") is charged with the primary responsibility for monitoring the unpaid taxes due to the IRS and for collecting those receivables as diligently and quickly as possible. The Collection Division's goal is to collect any unpaid tax liability in full or to collect the maximum reasonable amount as quickly as possible. Collection Principle Number 6 states in part:

All Taxpayers are expected to pay in full. If that is not possible, they should pay the amount which is reasonable...

B. Collection Division Sections. Most districts have a separate Collection Division which is organized into an Automated Collection System, a Field Office and a Special Procedures Staff. IRM 11(15)6, MT 1100-370 (Sept. 6, 1989).

1. The Automated Collection System or "ACS" is the computerized system on which most delinquent accounts and collection investigations are maintained at least initially. ACS is a computerized telephone collection system which attempts to collect unpaid tax liabilities through telephone contact with the taxpayer. ACS call sites (1-800 numbers) are located in each service center and in many districts. If a delinquency is not paid within the time period covered by the computerized collection notice cycle, that account will usually be transferred to ACS for appropriate follow-up. Using information that the IRS has about a delinquent taxpayer, ACS personnel will contact taxpayers to demand full payment of the delinquency, conduct investigations by tactics such as contacting third parties and by other means in order to locate taxpayers and their assets, handle incoming calls and taxpayer correspondence, make adjustments to accounts, and provide support to district offices.

2. The Field Office is staffed by one or more groups of collection personnel who receive delinquent accounts from service centers and other sources which require field work or particular expertise not available in ACS. The local field office is generally organized into three categories of employees:

(1) Collection Support Staff or Taxpayer Service Personnel - limited authority

(2) Revenue Representatives small dollar investigation

(3) Revenue Officers - broad powers
3. **The Special Procedures Staff** provides advice and assistance on technical matters to the Collection Division and performs litigation related work for the Division. The Special Procedures Staff reviews and processes applications for discharge of property from a federal tax lien, applications for certificates of non-attachment of federal tax liens, applications for subordination, and releases of liens.

C. **The Collection Process.**

1. Once a tax liability has been “assessed”, the Collection Division will enter the picture unless the liability is paid in full or litigation concerning the liability is commenced.

2. After the initial assessment notice or bill is sent, a taxpayer can normally expect to receive a series of notices or letters from the IRS concerning the unpaid liability over a period of several months culminating in the issuance of a Notice of Intent to Levy. The types of "notices" that can be expected are as follows:

   a. Notice and Demand - requests payment within 10 days "10 day notice"

   b. Second Notice of Taxpayer Delinquent Account - five weeks after first notice not sent if withholding taxes due or corporate income taxes due

   c. Request for Immediate Payment - five weeks after second notice

   d. Final Notice - five weeks after third notice

   e. Notice of Intent to Levy - six weeks after Final Notice 30 days after issue, IRS may levy wages or seize assets

   [**NOTE:** Total anticipated time before seizure or levy - approximately five and one-half months (absent jeopardy assessment)]

3. After receipt of a notice, the next step of the taxpayer could be critical to a successful solution of the problem with the Collection Division.

   a. Procrastination is the worst possible action which can be taken by a Taxpayer trying to deal with a collection problem. It is important
to establish a record, if possible, of the Taxpayer's good faith intention to pay by such actions as early contact with the IRS about a collection problem, making voluntary payments toward the liability (even small payments), being prompt and making diligent responses to IRS correspondence and inquiries.

b. Never lie to the IRS or intentionally mislead its employees.

c. Meet or beat all IRS deadlines.

d. Keep promises. If a taxpayer promises to supply information or take an action by a specific date, do it by, or prior to, the deadline. Let the IRS know if you cannot keep your promise and arrange for an alternative deadline if possible.

e. Never give away assets or hide assets during the pendency of an IRS collection matter. In addition to destroying a taxpayer's credibility with the IRS and adversely affecting the deal which is being negotiated, such actions can form the basis for criminal prosecution for evasion of payment, willful failure to pay, or false statements.

f. Make sure the taxpayer is complying with all of its filing and payment obligations prospectively.

4. The first notice will ask the Taxpayer to contact the ACS office at the Service Center which issued the notice. Although the ACS personnel have very limited authority or discretion, the ACS sometimes will agree to a favorable installment payment arrangement or may even agree to put an account in “uncollectible status” if significant financial hardship is present, but these results often simply depend on who answers the phone at ACS.

D. Tax Collection Powers.

1. The Federal Tax Lien [IRC Sections 6321-6326]

a. General Discussion. Once a tax assessment has been made, the IRS must notify the Taxpayer of the assessment and demand payment within 60 days. If the Taxpayer fails to pay the assessed amount, a general tax lien is statutorily imposed by Section 6321. Section 6321 provides that, if any person neglects or refuses to pay a tax which he owes after a demand has been made for payment, the amount due, including interest, penalties and costs, shall be a lien in favor of the United States upon all property and rights to property belonging to such person. Under Section 6321, a “secret”
federal tax lien is created on the tax, interest and penalties. This tax lien attaches to all property of the Taxpayer owned at the time of the assessment, or acquired after the assessment. Section 6321; Reg 301.6321-1. The federal tax lien is called a “secret” lien, because the tax lien attaches to all property, even if the tax lien has not been recorded on the public record.

Thus, in any tax collection case, the first issue to address is a determination of what property of the Taxpayer will be subject to a federal tax lien. This is an extremely complicated area of the tax law. Section 6321 provides that unpaid tax, interest and penalties “shall be a lien in favor of the United States upon all property and rights of property, whether real or personal belongings” to the Taxpayer. Also, the tax lien attaches to any property subsequently acquired by the Taxpayer. Property transferred by the Taxpayer before assessment of the tax is not subject to the lien, as long as the transfer is legitimate. Also, some types of property interests are exempt from the federal tax lien.

b. **Duration of Federal Tax Lien; 10-year Statute of Limitation on Collection.** Section 6322 provides that the federal tax lien arises at the time of the assessment and continues until the liability is satisfied or becomes unenforceable due to the lapse of time. Under Section 6502, an assessment may be collected by levy or a court proceeding only if the levy or proceeding is begun within 10 years after the date of the assessment. Since the only means for enforcing the lien are by levy or judgment, Section 6502 effectively requires the IRS to collect under a tax lien within 10 years.

Under pre-1998 tax law, the IRS and taxpayer could agree to extend the 10-year statute of limitation on collection by agreement in connection with an Offer in Compromise or installment agreement.

However, under Section 6502(a) as amended by the 1998 Tax Act, the IRS may no longer extend the 10-year statute of limitation on collection in connection with an Offer in Compromise. The IRS may, however, agree to extend the 10-year statute of limitation in connection with an installment payment agreement, but the extension can only extend for up to 90 days after pre-agreed-upon extension ends. Thus, the IRS must levy or proceed in court within 90 days after the expiration of the agreed-upon extension.
Thus, the tax lien is extended for the following periods:

(1) Extension by a waiver in connection with an installment agreement;

(2) Beginning with the commencement of a suit to reduce the lien to judgment and continuing until any resulting judgment is unenforceable;

(3) The period (plus six months) during which the automatic stay in a bankruptcy case is in effect;

(4) The period (plus 60 days) during which a deficiency related to the tax liability is pending before the Tax Court.

c. **New Section 6320 - Notice and Opportunity for Hearing Before Filing Notice of Lien.** Under the 1998 Tax Act, the IRS must now give advance written notice of its intention to file a Notice of Tax Lien. In addition, the taxpayer may request a hearing before an IRS Appeals Officer to request review of the substantive tax matters at issue as well as whether other collection alternatives are more appropriate. The rules surrounding the pre-notice hearing are the same as the rules applicable to the pre-levy hearings under new Section 6330. See below.

2. **The IRS' Right to Levy and Sell Property [IRC Sections 6331-6343]**

a. The federal tax lien and the federal tax levy are the two principal administrative collection devices of the IRS. As discussed above, the federal tax lien encumbers and maintains the IRS’s interest in the Taxpayer’s property. However, the mere existence of a perfected federal tax lien does not execute the lien on any of the Taxpayer’s property. Thus, a party who owes the Taxpayer money, and who is aware of the existence of the federal tax lien, is under no obligation to pay the money to the IRS absent from collection action by the IRS. The administrative collection device which typically compels a third party to pay the money to the IRS is the **federal tax levy**. Once the general tax lien arises and attaches to a taxpayer's property, Section 6331 authorizes the IRS to levy upon and seize property to collect assessed taxes **30 days after notice and demand for payment have been given to the taxpayer (and immediately if collection is in jeopardy).**
Note: Under Section 6331, the IRS must not seize property until it first determines that net proceeds of sale would exceed expenses of levy and sale. Also, the IRS must thoroughly consider other alternative collection methods.

b. The term "levy" includes the power of distraint and seizure by any means. IRC Section 6331(b). A levy reaches only that property which is possessed by the taxpayer and existing at the time of the levy. Successive levies may be made until the amount due plus expenses is paid in full.

c. Under IRC Section 6331(d), the Service must notify the taxpayer of its intention to levy no less than 30 days before the levy is made unless collection is in jeopardy. IRC Section 6331(d). The notice must be given to the taxpayer in person, left at the taxpayer's residence or usual place of business, or mailed by certified or registered mail to the taxpayer's last known address. IRC Section 6331(d)(2). The notice must include a brief statement which sets forth in simple and nontechnical terms information regarding procedure.

Under the new 1998 Act, before levy, the IRS must warn the taxpayer in writing at least thirty days in advance of a levy and, in addition, the IRS must advise the taxpayer of a right to hearing before an Appeals officer. New Section 6330(b). The taxpayer, upon request, is entitled to a hearing before an Appeals officer who has had no prior involvement in the matter.

The Appeals Officer is responsible for confirming that all of the administrative and tax collection procedural requirements before the levy have been met. Section 6330(c)(1). The Appeals officer is also required to address substantive issues concerning the tax liability itself, but not if they have been meaningfully addressed before. Thus, under new Section 6330(c), the substantive issues to be reviewed by the Appeals Officer include, but are not limited to:

- Appropriate spousal defenses, such as innocent spouse relief.
- Other collection alternatives, such as the substitution of other assets for seizure, offers in compromise, an installment agreement;
- Other substantive challenges to the existence of the amount of the tax liability if the taxpayer did not otherwise have the ability to dispute, such tax liability (such as where the taxpayer fails to request an IRS Appeals Conference after issuance of a 30-day letter), or whether the taxpayer fails to file a Tax Court Petition (after issuance of a 90-day Notice of Deficiency).
Finally, if the taxpayer is not satisfied with the Appeals officer’s decision, the taxpayer can file a petition with the United States Tax Court within thirty days of the Appeals officer’s determination. Section 6330(d).

**Note:** The taxpayer is entitled to only one hearing under Section 6330 with respect to the tax period involved.

**Observation:** Arguably, this new provision, which allows the taxpayer to receive a hearing before an Appeals officer, more than any other in the Act, will present a tremendous practical defense to taxpayers subject to collection action. Whereas, in the past, there was very little that could be done about pending collection actions, the use of Appeals and Tax Court petitions is likely to give taxpayers the ability to at least significantly delay collection action. During the delay, the taxpayer may be able to make arrangements for payment.

d. **Federal Tax Levy Procedural Requirements.** Thus, a federal tax levy commands the third party to pay directly to the IRS all amounts which the third party owes to the Taxpayer. With respect to third parties, the IRS will typically levy on:

1. Wages of the Taxpayer.
2. Bank accounts.
3. Property sold by the Taxpayer to a purchaser or subsequent creditor after Notice of The Federal Tax Lien has been filed with the local register of deeds.

There are two notices required in order for a levy by the IRS to be considered valid. First, under Section 6331(a), the IRS cannot proceed to collect a tax liability until 10 days after the IRS serves notice and demand on the Taxpayer for payment of the tax liability. In addition to the 10-day waiting period after notice and demand, Section 6331(d) requires that the IRS notify the Taxpayer in writing of its intention to levy on the Taxpayer’s salary, wages, or other property at least 30 days before the date of the levy. Both the 10-day and 30-day notices can be issued simultaneously.

Once the 10-day and 30-day notices are sent to the Taxpayer, there is very little the Taxpayer can do to forestall IRS collection. If possible, it is advisable to contact the IRS Collection Officer to see if an installment payment arrangement may be instituted in lieu of the levy. Another option is the Offer in Compromise process discussed below. In some extreme
cases, as discussed below, bankruptcy may be another option to forestall collection.

e. **Certain property is exempt from levy.** See IRC Section 6334.

II. **Hardship and Taxpayer Advocate Assistance Orders; Uncollectible Account Status.**

A. The IRS Problem Resolution Program (PRP) is a special program instituted by the IRS to handle taxpayer complaints and to represent the interests and concerns of taxpayers within the IRS. It is designed to resolve problems that were not resolved through normal procedures.

B. The PRP is managed by the Taxpayer Ombudsman in the IRS National Office. Each service center, regional and district office has a Problem Resolution Officer ("PRO").

C. To protect taxpayer's rights, under the 1998 Tax Act, at least one Taxpayer Advocate will be located in each state who will report to the National Taxpayer Advocate. The Taxpayer Advocates will have the power to issue "Taxpayer Assistance Orders" ("TAO"). A TAO can require the IRS to release levies or liens, cease collection or audit actions or cease any other activity.

(i) The PRP is extremely useful in the collection area (i.e. release of salary levy where it creates significant hardship).

(ii) The key to using the PRP is to prove that there has been a failure to receive reasonable treatment through normal channels. Document all telephone conversations with a follow up letter to the IRS.

(iii) As under pre-1998 tax law, a TAO can be issued if the taxpayer is suffering or about to suffer a "significant hardship" as a result of the manner in which the IRS is administering the tax laws. They will not deal with the technical aspects of tax accounts (i.e. change the determination of an audit deficiency).

Although Code Section 7811(a) always has provided for “Taxpayer Assistance Orders” for some time, there was no definition of the situations where an order could be issued; that is, where “significant hardship” existed.
Fortunately, under the new Act, Significant Hardship can now be any of the following non-exclusive list:

1. A threatened adverse action by the IRS;
2. A delay of more than thirty days in resolving problems;
3. The incurring of significant costs by the taxpayer (including professional fees) if relief is not granted;
4. Irreparable injury or long-term adverse impact to the taxpayer if relief is not granted.

(iv) In evaluating an Application for TAO based on “significant hardship,” the IRS will consider whether the proposed action will interfere with the taxpayer's ability to obtain or retain any of the following:

(1) Housing or other necessities (i.e. food, clothes, electricity for taxpayer or the family);
(2) Transportation to and from work;
(3) Employment;
(4) Essential medical treatment or medication;
(5) Avoidable loss of a education;
(6) Risk that normal procedure would not take effect in time to avoid personal harm to the taxpayer (i.e. threats of personal harm).

Observation: As a result of the new Act, Taxpayer Assistance Orders will now be used much more heavily in collection cases. It seems it may be relatively easier to meet the requirement of “significant hardship” when collection action is threatened. Use of the Taxpayer Assistance Order should at least be considered when collection action is about to occur.
III. Installment Payment Arrangements.

A. Generally. Prior to the enactment of the Taxpayer Bill of Rights in 1988, the Service would enter into installment payment agreements with taxpayers who were unable to pay, but the decision to do so was solely within the Service's discretion. However, as part of the Taxpayer Bill of Rights, Section 6159 was added to the Code. Section 6159 directs the Service to enter into installment payment agreements if the Service determines that such agreements will facilitate the collection of tax. IRC Section 6159(a).

B. Automatic and Streamlined Installment Agreements. Under IRC Section 6159(c), taxpayers are automatically entitled to installment payment agreements if the tax liability is $10,000 or less, not including interest and penalties. Under amended Section 6159(c), the taxpayer is automatically entitled to an installment agreement where the tax liability is $10,000 or less, if the taxpayer has not failed to file any tax return; entered into any other installment payment agreement. However, the taxpayer first must establish that the full amount of tax can be paid within three years.

If a taxpayer has unpaid tax liabilities of $50,000 or less (of tax, penalties and interest), the taxpayer may qualify for a "streamlined" installment payment agreement. IRM 5.14.5.2

The key benefit of a streamlined installment payment agreement is that they can be processed without financial disclosures and without IRS managerial approval. To qualify for the streamlined installment agreement arrangement, the taxpayer must be able to full pay the unpaid balance of the assessment within 72 months or before the expiration of the collection statute of limitations, whichever comes first. Also, all prior tax returns must have been filed.

If the balance of the unpaid assessment is more than $25,000, then all payments must be made as "direct debit" installment payments.

Only individuals and out-of-business sole proprietors will qualify for a streamlined installment payment agreement if the unpaid balance of the assessment is between $25,000 and $50,000. Individuals and businesses that are out-of-business can qualify for a streamlined installment agreement only if their unpaid assessment is $25,000 or less.
C. **Term of Agreement.** An Installment Agreement accepted by the IRS remains in effect for the term of the agreement. Section 6159(b) provides that the Service may alter, modify or terminate the agreement if:

a. Information provided to the IRS prior to the agreement was inaccurate or incomplete or the Service believes that collection of a tax covered by such an agreement is in jeopardy; or

b. The Service determines that the taxpayer's financial condition has changed significantly. However, such action can be taken only if:

   (1) notice is given to the taxpayer of the determination no later than 30 days prior to the action; and

   (2) the notice states the reasons why the Service believes a significant change has occurred.

c. Taxpayer fails to pay any installment when due; or

d. Taxpayer fails to pay any other tax liability when due; or

e. Taxpayer fails to provide updated financial information when requested. IRC Section 6519(b)(4).

f. If IRS elects to terminate, they must provide to Taxpayer an administrative review of the termination if requested by the Taxpayer.

D. **Negotiating and Finalizing an Installment Payment Agreement.**

An installment payment agreement is ordinarily finalized using Form 433-D (Installment Agreement). However, the Service will also use Form 2159 (Payroll Deduction Agreement) and Form 433-G (Direct Debit Installment Agreement). See, IRM 5331.1, MT 5300-28 (Mar. 14, 1988); IRM 5337.1, MT 5300-32 (Nov. 15, 1985); and IRM 5337.41, MT 5300-42 (July 9, 1990). Before an agreement is finalized, the taxpayer must submit complete and accurate financial data bearing upon the taxpayer's ability to pay. This information is most often submitted using Forms 433-A and/or 433-B.

The IRS has issued new guidelines concerning national and local allowable expense standards to determine a taxpayer's present ability to pay the liabilities for both negotiating Installment Payment Agreements and Offers in Compromise.
E. **Pros and Cons of an Installment Agreement.**

a. Installment Agreements do not operate to forgive the indebtedness, therefore, it is the only option other than bankruptcy if the IRS will not accept an Offer in Compromise.

b. The acceptance of an Installment Agreement grants the Taxpayer temporary and conditional relief from enforced debt collection measures (Treas. Reg. 301.6159-1(d)) so long as the agreement is in force.

   (1) A temporary reprieve from forced collection is all some taxpayers require in order to get back on their feet and settle the liability (i.e. time to close a loan or sell assets).

   (2) Sometimes an Installment Agreement is used as an interim measure to avoid forced collection measures while planning and preparing for an offer in compromise or bankruptcy filing.

c. Interest and penalties (i.e. failure to pay) continue to accrue during the payment period. However, under Section 6651(h) as amended by the 1998 Tax Act, the late payment penalty is reduced from .5% per month to .25% per month for any month during which an installment payment agreement is in effect. The maximum late payment penalty of 25% has not been changed.

d. Under an Installment Agreement, the IRS will allocate payments to its best advantage. For example, if a Taxpayer has employment and income tax liabilities, the IRS will allocate payment to income and non-trust fund taxes first, then to trust fund taxes. Trust fund taxes are not dischargeable in a bankruptcy.

e. IRS may force the taxpayer to suspend running of 10-year statute of limitations on collection.
IV. **Offers in Compromise.**

A. **General.** If the Taxpayer is concerned only about tax liabilities in general, the Offer in Compromise will be the solution of first choices assuming that the Taxpayer can meet the rigorous guidelines established by the IRS.

1. **Advantages.**
   a. A successful Offer in Compromise operates as a conclusive settlement of all federal tax obligations (whether dischargeable in bankruptcy or not) for the years covered by the Offer.
   b. It is only option available other than payment in full if tax debt is nondischargeable in bankruptcy.
   c. The submission of an Offer in Compromise stays forced collection activity so long as the collection of the liability will not be jeopardized (IRM 57 (10)(9).3) or it does not delay or interfere with the Service’s ability to collect the tax.

   (1) It is prudent to ask IRS to suspend collection activity.
   (2) The submission of an offer by a joint obligor (i.e. other “responsible persons” in the case of delinquent employment taxes) will not suspend collection against other “responsible persons.”

2. **Disadvantages.**

   a. An Offer in Compromise does not affect the rights of other creditors who may still force the taxpayer into bankruptcy or otherwise attach his assets.

   b. An Offer in Compromise should not be filed if bankruptcy appears inevitable:

   Federal taxes assessed within 240 days of the bankruptcy filing are not discharged. The 240 day period is extended by the time any Offer in Compromise is under consideration.

   c. The ten (10) year collection limitation period for the collection of a tax is suspended while an offer is pending until one year after the last to occur:

   (1) Offer is rejected;
   (2) Offer being accepted;
Offer is voluntarily withdrawn; or

Taxpayer satisfies the terms and conditions of the Offer, including the filing of all returns and payment of all taxes for a period of five (5) years following acceptance of the Offer.

d. An Offer in Compromise is legally enforceable against both the IRS and the taxpayer; however, if the taxpayer defaults, the tax liability is reinstated with penalties and interest that would have been imposed if the Offer in Compromise had not been put into effect.

Even if the accepted Offer in Compromise provides for immediate payment of the offered amount, a taxpayer can default and cause a reinstatement of the tax by filing a delinquent return or by accruing a new tax liability within the five (5) year period following acceptance of the Offer in Compromise.

If Taxpayer cannot make deferred payment installment due under the terms of the Offer in Compromise, the IRS has power to reduce or extend the payment schedule temporarily without “defaulting” the Offer in Compromise Agreement. IRM 57(10)(19.22(4)

B. Overview. In 1995, the Service issued new Internal Revenue Manual provisions with regard to the evaluation of Installment Agreements and Offers in Compromise. The new policies and procedures were developed, at least in part, in response to criticism directed at the Service's evaluation and collection of its accounts receivables. The new policies and procedures were supposed to reflect a new era in the Service's attitude and approach to Offers in Compromise. The "new" offer policy provides (IRM 57(10).1).1 that:

1. An Offer in Compromise will be considered "when it is unlikely that the tax liability can be collected in full and the amount offered reasonably reflects collection potential."

2. An Offer in Compromise is a "legitimate alternative" to declaring an account currently uncollectible or to an extended installment pay arrangement.

3. The success of the program depends upon taxpayers making adequate offers consistent with their ability to pay and the Service making "prompt and reasonable decisions."
4. Taxpayers are "expected to provide reasonable documentation to verify their ability to pay."

5. The best candidate for an Offer in Compromise is one for more than a nominal amount. The IRS’s position has been that it will not compromise a tax liability for nominal sums.

   **Note:** When the taxpayer has no assets and cannot offer to settle for more than a nominal sum, then the best route may be to convince the IRS to designate the account as “currently not collectible and wait for the statute of limitation to expire.”

6. If the taxpayer cannot pay the tax immediately, but does have enough disposable income to pay it within a five (5) year period, then under the new “income and expense” guidelines discussed below, the taxpayer will not be eligible for an Offer in Compromise.
   
   a. An Installment Agreement or bankruptcy may be the only alternatives.
   
   b. If the statute of limitations will expire within five (5) years or the taxpayer is in poor health, an offer may be considered even if tax would be paid within the five (5) year period. IRM 57(10)(10.1(4)

7. An Offer in Compromise must represent the taxpayer’s maximum capacity to pay and must offer the IRS at least as much as could be recovered from the levy of nonexempt assets.

   **Note:** Best offer is one which is in excess of the amount the IRS could get if levied and sold nonexempt assets.

8. If a deferred payment offer (pay offer amount in installments) is contemplated, the shorter the time, the more acceptable it is likely to be viewed by the IRS. The maximum period allowable is generally two years.
C. **Prerequisites for Acceptance of an Offer in Compromise.**

1. **Grounds for an Offer in Compromise.** An Offer in Compromise may be accepted by the Service only for one of the following reasons (an offer can be based on both reasons, but collectibility will be investigated first):
   
   a. Doubt as to whether the taxpayer owes the liability ("doubt as to liability"); or
   
   b. Doubt that the liability can be collected in full ("doubt as to collectibility").

2. **Tax Obligations.** As a prerequisite for an Offer in Compromise being accepted, the Taxpayer must be current with all outstanding tax filing and payment obligations. IRM 57(10)(10).2.

   **Comment:** If a taxpayer has a long history of delinquent returns and/or failure to pay his taxes and the pattern is likely to continue in the future, then an Offer in Compromise may not be the solution. Even if the offer is accepted, any failure to file or any accrual of an unpaid tax in the five (5) year period following acceptance will result in all the tax, interest and penalties being reinstated (less any amount paid with the offer).

3. **Civil/Criminal Proceedings.** No Offer in Compromise will be entertained where:
   
   a. Criminal proceedings have been recommended or where the issue is being litigated civilly (IRM 57(10)(13)); or
   
   b. Public policy would require rejection of an offer (i.e., taxpayer is a convicted criminal or a notorious organized crime figure). IRM 57(10)(1.3)

4. **Application.** The taxpayers must submit an original and fully executed Offer in Compromise, Form 656, and a Form 433-A, Collection Information Statement for Individuals, and/or Form 433-B in the case of a business.
   
   a. The Form 656 must be the current version or if a duplicated copy, it must be certified that it contains all the provisions of the original current version.
   
   b. If the tax liability is a joint liability of a husband and wife, the taxpayers must only file one Form 656 for both spouses.
   
   c. If there is a joint tax liability and also a separate tax liability for one of the spouses, a Form 656 must be filed for the joint liability and another Form 656 must be filed for the separate tax liability. Only one Form 433-A covering the financial information for both taxpayers must be filed.
5. **New IRS Guidelines.** Under Section 7122(c), the IRS is required to make sure its guidelines allow taxpayers a means to provide for basic living expenses. Of course, the IRS believes this is already the case in the existing guidelines. The IRS cannot reject an offer from a “low income” taxpayer solely on the basis of the amount. Low income taxpayer is undefined.

In addition, under the new rules, the IRS is prohibited from levy while an Offer in Compromise is pending. This has long been the IRS’s administrative practice.

### D. Procedure

1. **Filing.** An Offer in Compromise is made by submitting a fully executed Form 656 and Form 433-A and/or 433-B to the Internal Revenue Service. The Offer in Compromise should be filed with the Special Procedures Branch in the district office of the Internal Revenue Service for the district in which the taxpayer resides or has its principal office.

   a. If the taxpayer is already working with a Revenue officer, a copy of the Offer in Compromise should be filed with the revenue officer in order for him or her to take immediate steps to stay any forced collection activity while the Offer in Compromise is being processed.

   b. The success or failure of your Offer in Compromise will depend on how you prepare and reflect the requested information. In preparing the Offer in Compromise, the following should be kept in mind:

      (1) Practitioners and taxpayers alike should keep in mind that an Offer in Compromise must be approached realistically and reasonably. The Service will not compromise a liability simply because it is old or for nuisance value or for a nominal amount.

      (2) No Offer in Compromise can be accepted unless the taxpayer is current in all of his tax filings and tax payments (i.e. not continuing to accrue an unpaid liability).

      (3) Know the Offer in Compromise policies and procedures (including the new policies regarding offers) and use that knowledge in negotiating the terms of the offer.

Comment: Do not submit an offer unless it is in an amount at least equal to, and preferably in excess of, the taxpayer’s net realizable equity (i.e., the quick sale value of assets less the amount of any encumbrances having priority over the tax lien(s)), plus the present discounted value of the taxpayer’s estimated disposable income for a five (5) year period determined under the new guidelines.
Otherwise, the offer will be returned immediately as "unprocessable." IRM 57(10)9.1(3).

(4) Market your Offer in Compromise by demonstrating that it is serious and reasonable. It should include:

(a) appraisals, bank statements and other documentation or information on assets and liabilities that will support your offer amount;

(b) a statement of any special circumstances that may impact the "doubt of liability," or "doubt as to collectibility" issue (i.e. age, health concerns, change in employment).

(c) Know the offer in compromise policies and procedures (including the new policies regarding allowable expenses) and use that knowledge in negotiating the terms of the offer. The offer specialist should respond to a knowledgeable practitioner favorably in the negotiating process.

(d) Evaluate the adequacy of the offer using the Manual provisions before you submit it.

(e) Work with the taxpayer to do some tax planning in anticipation of the offer. Keep in mind that, under the terms of the offer, any overpayments that a taxpayer would be entitled to receive for periods that end before, within, or as the end of the calendar year in which the offer is accepted or remains unpaid are waived and are applied against the compromised liability. If an offer is anticipated, a taxpayer's withholding, estimated tax payments and any other payments should be carefully reviewed, planned and monitored before and during the offer process to keep the potential refunds to a minimum consistent with required tax compliance.
E. **Processing and Evaluation of Offer.**

1. **“Unprocessable” Offers.** An “IRS Advisor” in the Special Procedures Branch of the IRS can immediately return to the taxpayer as “unprocessable” any Offer in Compromise in the following circumstances (IRM 57(10)(9.1):

   a. The “net realizable equity” of the assets shown on Form 433-A and/or Form 433-B exceeds the tax due or the offer amount;

   b. The taxpayers can pay the tax within five years from their disposable income determined under the guidelines and based on information shown on the Form 433-A and/or Form 433-B;

   c. The required forms are unsigned, incomplete or have been modified;

   d. There is substantial doubt about the taxpayer’s ability to fund the offer amount; or

   e. Where the Taxpayer is delinquent with respect to current tax filing and payment obligations.

F. **Consequences of Acceptance or Rejection of Offer.**

1. **Acceptance of Offer.**

   a. The acceptance of an offer creates a binding agreement between the taxpayer and the IRS. It can only be terminated for mutual mistake or fraudulent misrepresentations.

   b. The accepted compromise is conclusive of all tax issues for the periods to which the compromise applies. Treas. Reg. 301.7122-1(c). The taxpayer waives all right to apply for a refund or otherwise challenge the liabilities. Likewise IRS is prevented from asserting a new claim, including an audit assessment for a year in which there is a compromised liability.

   c. Offer settles all interest and penalties. Interest will accrue, however, on the offer amount until paid. IRM 57(10)1.41.

   d. The taxpayers waive any right to refunds to which they may be entitled arising out of periods up to the end of the year in which the Offer in Compromise is accepted. IRM 57(10)(6).7.

   e. The federal tax lien will be released only upon the taxpayer paying the offer amount in full.
f. If the taxpayer subsequently defaults under the offer agreement (i.e. fails to file return timely or accrues new tax liability), the tax liability and lien are reinstated with all penalties and interest.

2. Rejection of Offer in Compromise.

(1) If the offer amount is not acceptable, the taxpayer will be given an opportunity to increase or modify the offer based on the evaluation of the IRS as to what may constitute a minimum acceptable offer.

(2) If the taxpayer is unable to pay what the IRS believes is a minimum acceptable offer, there are only four options:

(a) Request that the matter be referred to the Regional Office of Appeals. The basis for the appeal will be that the agent overvalued taxpayer’s assets or did not allow the correct “necessary” expenses in computing the future income portion of the offer. IRM 57(10)(1).(10).

(b) Negotiate an Installment Agreement.

(c) Do nothing. The IRS typically will not levy on a personal residence. If the taxpayer can avoid a levy on wages by pleading “hardship” with the problem resolution officer and therefore, stay enforced collection, the IRS may mark the account as “currently not collectible.” If the taxpayer waits until the statute of limitation for collection (10 years) has run, the liability goes away.

(d) When all else fails, bankruptcy should be considered.

V. Bankruptcy.

A. Generally. There are generally three types of voluntary bankruptcy proceedings available to a taxpayer:

(a) Chapter 7 bankruptcy consists of a liquidation of assets and liabilities. A trustee is appointed to administer the liquidation of the taxpayer’s estate for the benefit of all creditors, including the IRS.

(b) Chapter 11 and 13 are reorganizational bankruptcies. The objective underlying a reorganization is that the interests of the creditors, particularly unsecured creditors may best be served if the debtor’s assets are not liquidated.
(1) If the taxpayer is a business, the reorganization plan may permit
the taxpayer to emerge from bankruptcy by paying only a portion
of his obligation, including the IRS obligations.

(2) Creditors have a voice in the reorganization process and may vote
to accept or reject any plan.

(3) A bankruptcy court may not confirm a Plan of Reorganization if
the principal purpose of the plan is the avoidance of taxes (11
U.S.C. Section 1129(d)).

B. **Advantages of a Bankruptcy Filing.**

a. Bankruptcy results in an automatic stay of any collection activity. The
IRS can, however, conduct a tax audit, make demand for unfiled tax
returns and assess an uncollected tax that arose prior to the bankruptcy.

b. The IRS will apply proceeds of a levy outside of bankruptcy to non-trust
fund taxes or other taxes dischargeable in bankruptcy. In a bankruptcy
reorganization (not a Chapter 7), the Court is empowered to order tax
payments be applied to nondischargeable taxes. There is no guarantee,
however, that a court in every case will so order such an application.

c. Funds paid to the IRS shortly before bankruptcy to nondischargeable taxes
do not constitute a preference avoidable by the trustee. If funds are used
to pay dischargeable taxes within ninety (90) days of bankruptcy, the
Trustee may be able to recover the payments for the benefit of all the
creditors. Timing of the bankruptcy filing is critical to avoid a tax
preference.

d. A Chapter 7, 11 or 13 bankruptcy may discharge a taxpayer’s entire tax
liability.

(1) Dischargeability of taxes is dependent on the type of tax, when the
taxes were assessed or when the return was due. See Exhibit B
attached.

(2) Trust fund and certain penalties (i.e. trust fund recovery penalty
taxes) are not dischargeable.

(3) If a Notice of Federal Tax Lien was filed prior to bankruptcy, the
lien will continue to encumber any property held by the Taxpayer
after bankruptcy to which the lien attached even if tax was
"discharged in the bankruptcy." The IRS can enforce its lien
against the asset after bankruptcy.
(4) Unassessed taxes and taxes assessed within 240 days of bankruptcy filing are not discharged.

C. **Disadvantages with a Bankruptcy Filing**

a. Bankruptcy is a matter of public record and will adversely affect business reputations, credit ratings and ability to purchase personal (i.e. cars, home) or business assets on credit.

b. Nondischargeable tax liabilities will survive the bankruptcy and can only then be satisfied either through forced collection of or sale of exempt assets (assets that survived the bankruptcy) or through an Installment Agreement or Offer in Compromise.

c. The collection statute of limitation period of ten (10) years is tolled for the period of time during the bankruptcy stay plus six (6) months as to nondischarged taxes.

d. The bankrupt estate includes all assets of the taxpayer, other than certain limited exempt property, and includes certain property and rights to property acquired by the taxpayer within 180 days after the filing of bankruptcy:

   (1) Bequest, device and inheritance.
   (2) Property settlement with bankrupt’s spouse.
   (3) Life insurance proceeds or proceeds for a death benefit plan (11 USC Section 541(a)).
PART FIVE
Federal and North Carolina Innocent Spouse Relief Rules

I. Introduction. Married couples are permitted to file jointly - which ordinarily produces the lowest combined tax as a result of lower income tax brackets available to taxpayers who file joint tax returns. The primary disadvantage of filing a joint tax return is that taxpayers who file a joint tax return are "jointly and severally" liable for any income tax, related penalties and interest arising out of that return, including any later determined deficiency - regardless of the separate taxable income of each spouse. IRC § 6013(d)(3).

Note: In some cases, a spouse who files a joint return will not be deemed to have filed a joint return where the joint return was filed under duress or where the other spouse forged the signature of the innocent spouse. In these cases, there has been no joint return filed. Of course, it can often be very difficult, if not impossible, to prove that the joint return was filed under duress.

Fortunately, Section 6015 contains three exceptions to joint and several liability for taxes on a joint return: (1) general innocent spouse relief, (2) election for a separate liability, and (3) equitable tax relief. Prior to the 1998 IRS Tax Reform Act, innocent spouse relief was severely limited. However, in 1998, Congress substantially amended the innocent spouse relief rules. It is important to note that the new innocent spouse relief rules apply to tax liabilities arising before, as well as after, 1998. Thus, the new innocent spouse rules are retroactive in their application.

II. The General Innocent Spouse Relief Rule. The first exception to joint and several liability is known as the "general" innocent spouse rule of § 6015(b). If a 6015(b) election is made by a qualifying spouse, that spouse will be relieved of liability for tax attributable to an understatement of tax (but not underpayment of tax) to the extent that the understatement is attributable to the erroneous items of the other spouse.

A. General Requirements. To qualify for the general innocent spouse relief, the requesting spouse must satisfy each of the following requirements:

1. There is an understatement of tax due to erroneous items of the other spouse;
2. The requesting spouse did not know of, and had no reason to know of, the understatement when the return was signed;
3. Taking into account all the facts and circumstances, holding the requesting spouse liable for additional tax would be inequitable; and
4. The requesting spouse makes a valid election for § 6015(b) relief.

The term "erroneous item" is defined to include unreported gross income, an erroneous deduction or credit or improperly reported tax basis in sold assets. Reg. 1.6015-1(h)(4). Thus, an understatement occurs when income is omitted or
understated, or where reported expenses are overstated. Thus, the Section 6015(b) election will not protect a spouse from a tax "underpayment" where the reported tax is not paid in full.

B. **No Constructive or Actual Knowledge of the Understatement.** The most difficult hurdle in the first innocent spouse relief exception is to prove that the innocent spouse did not know of, and did not have reason to know of, the tax understatement.

C. **Equity Considerations.** In addition, even if the spouse can prove that she did not have actual or constructive knowledge of the understatement, the innocent spouse must still prove that it would be unfair to hold her liable for the tax. One of the most important factors determining "equity" is whether or not the innocent spouse significantly benefitted, directly or indirectly, from the understatement. Thus, a requesting spouse, whose standard of living improved significantly in the years of the understatement, would have a substantial hurdle to overcome.

Fortunately, it is also possible to achieve proportionate innocent spouse relief under the first exception where, for example, a spouse had reason to know of only a portion of the understated tax.

D. **The § 6015(b) Election.** The timing and form of electing innocent spouse relief under § 6015(b) is the same for the other relief provisions discussed below.

**III. Separate Tax Liability Election for Divorced and Separated Taxpayers.** The 1998 Tax Reform Act added a major new liability relief provision under § 6015(c) for qualifying divorced and separated spouses filing joint returns. Section 6015(c) allows a spouse to elect to limit his or her liability for any understatement deficiency arising with respect to a joint return to that portion of the understatement deficiency attributable to erroneous items allocable to that spouse.

**Note:** Section 6015(c) only applies to deficiencies of tax on a joint return and does not apply to liabilities for unpaid taxes reported on the joint return. Relief for liability for tax underpayments is available only under § 6015(f) discussed below.

A. **General Requirements.** To elect separate liability relief under § 6015(c), a requesting spouse must satisfy all of the following requirements:

1. At the time of making the election, the requesting spouse is either no longer married to, or is legally separate from, or for the previous twelve months has not been a member of the same household, as the other spouse;

2. Prior to making the election, the requesting spouse and the other spouse had not transferred assets between themselves as part of a fraudulent scheme;
3. At the time of signing the joint return, the requesting spouse had no actual
acknowledge of the item giving rise to the understatement deficiency; and

4. The requesting spouse makes a timely election for § 6015(c) relief.

B. The Divorced/Separated Requirement. The Tax Court has held that married
individuals are considered to be legally separated if they are under a state court
judgment or decree that expressly provides that the parties live apart in the future.
Also, separate liability election relief may also be available for spouses who are
not legally separated but who have not been a member of the same household for
the last twelve months before the election is made. Of course, if the spouses are
not legally separated, then temporary co-habitation within the last twelve-month
period may be problematic.

C. Actual Knowledge Versus Constructive Knowledge. Section 6015(c) separate
liability election may not be made where the requesting spouse had actual
knowledge of the item giving rise to the deficiency. Note that there is no
constructive knowledge component of the separate liability election relief. Thus,
in the case of Michael Culver, 116 TC NO 15 (April 2, 2001), the U.S. Tax Court
ruled that Section 6015(c) separate liability election available to an innocent
spouse where the IRS failed to prove that the innocent spouse had actual
knowledge of embezzlement income. In that case, Mr. Culver filed a separate
liability election under Section 6015(c) in order to seek relief for certain tax
liabilities arising from his former wife’s embezzlement. In this case, the IRS
contended that Mr. Culver did not qualify for the separate liability election under
Section 6015(c) because he should have known of his wife’s unreported
embezzlement income. According to the IRS, Mr. Culver should have taken
notice that the lavish lifestyle provided by his wife’s income was not adequately
supported by their two separate incomes as reported on their joint tax return for
the tax year at issue.

The Tax Court, however, concluded that the IRS failed to prove that Mr. Culver
had “actual knowledge” of the unreported embezzlement income. It is critically
important to note that, consistent with the statutory provisions of Section 6015(c),
the Tax Court dispensed with the “should-have-known” concept and instead
placed the burden upon the IRS to show, by a preponderance of the evidence, that
Mr. Culver had actual knowledge of the unreported embezzlement income.

D. Allocation of the Tax Understatement Deficiency Between Spouses. Section
6015(d)(1) states the general rule for allocating erroneous items of the deficiency
between spouses for purposes of § 6015(c). Thus, a requesting spouse's separate
liability will be determined by multiplying the total deficiency by a fraction, the
denominator being the net amount of all items taken into account in computing
the deficiency, and the numerator being the net amount of all such items allocable
to that spouse. Furthermore, § 6015(d)(3)(A) provides that erroneous items are
generally allocated to the spouses as those items would have been allocated if
separate returns had been filed. The burden of proof is on the requesting spouse to prove and establish the allocation formula. This is one of the principal disadvantages of § 6015(c) relief.

Note: The Separate Liability election relief has no "equitable" component.

IV. Equitable Relief. The 1998 IRS Tax Reform Act added a third new liability relief provision under § 6015(f) called "equitable relief." Section 6015(f) authorizes the IRS to relieve a spouse from liability for a deficiency arising on a joint return for any unpaid tax if, taking into account all the facts and circumstances, it is inequitable to hold the individual liable for all or a portion of the deficiency for unpaid tax, and if relief is not available under either § 6015(b) or § 6015(c).

Note: In contrast to § 6015(b) and (c), § 6015(f) authorizes relief for underpayment of tax properly reported on the joint return that is not paid, as well as understatements of tax.

A. General Requirements. In order to be considered for relief from tax for a joint return under § 6015(f), the following requirements must be met:

1. Relief is not available to a requesting spouse under § 6015(b) or (c);
2. The requesting spouse makes valid election for § 6015(f) relief; and
3. No assets were transferred between the spouses as part of a fraudulent scheme.

B. Revenue Procedures 2000-15. According to Revenue Procedure 2000-15, a spouse who meets the foregoing threshold requirements and also meets the following criteria will ordinarily obtain relief:

1. The tax due that was reported on the return was unpaid at the time the return was filed;
2. At the time relief was requested, the requesting spouse is no longer married to, is legally separated from the non-requesting spouse, or for the previous twelve months has not been a member of the same household as the non-requesting spouse;
3. At the time the return was signed, the requesting spouse did not know of, and had no reason to know of, that the tax would not be paid, and such spouse establishes it was reasonable to believe the non-requesting spouse would not pay the reported liability;
4. The requesting spouse would suffer economic hardship if relief from liability was not granted; and
5. The tax liability for which relief is sought is attributable to the non-requesting spouse.

If the foregoing requirements of Revenue Procedure 2000-15 are not met, Revenue Procedure sets forth other facts and circumstances which will weigh in favor of, or against, the requesting spouse. The factoring weighing in favor of relief include the following:

1. The requesting spouse is legally separated from, living separate and apart from, or divorced from, the non-requesting spouse;
2. The requesting spouse would suffer economic hardship if relief is not granted; or
3. The requesting spouse was abused by his or her spouse but such abuse did not constitute duress.

Factors weighing against relief would include:

1. The liability for which relief is sought is attributable to the requesting spouse;
2. The requesting spouse knew or had reason to know of the unpaid deficiency;
3. The requesting spouse received a significant benefit from the unpaid liability;
4. The requesting spouse will not experience economic hardship if relief is not granted.
5. The requesting spouse has not made a good faith effort to comply with federal income tax laws in the tax years following the year to which the request for relief is made.

V. Domestic Abuse Cases. Under the innocent spouse relief rules, an individual requesting innocent spouse relief should submit a Form 8857 with the Internal Revenue Service claiming innocent spouse relief under Section 6015 of the Internal Revenue Code. However, the law requires that the IRS tell a taxpayer's spouse (or former spouse) that the innocent spouse relief has been requested. In this case, the non-innocent spouse (or former spouse) has the right to provide the IRS with information and receive limited information from the IRS about that request.
Not surprisingly, many victims of domestic abuse have worried that requesting innocent spouse relief could result in retaliation by the "non-innocent" spouse. Internal Revenue News Release IR-2001-23 provides a mechanism to alert the IRS of these concerns.

In Internal Revenue News Release IR 2001-23 (February 20, 2001), the IRS stated that it has initiated a series of steps to protect victims of domestic abuse who apply for innocent spouse relief. These taxpayers, who are victims of domestic violence, and fear that filing a claim for innocent spouse relief would result in retaliation, should write the term "Potential Domestic Abuse Case" at the top of their Form 8857. These taxpayers should also explain their concerns in a statement attached to the Form 8857, in addition to explaining why they should qualify for innocent spouse relief.

Unfortunately, the News Release does not enumerate the specifics steps the IRS proposes to take in order to protect a petitioning spouse from retaliation.

VI. Making a Section 6015 Election. An election for innocent spouse relief must be made by filing Form 8857.

VII. Time for Making the Election. If collection activities began before July 1998, the last date for filing an election is two years after the date of the first collection activity occurring after July 1998. For liabilities arising after July 1998, the last date for filing an election is two years after the date that the IRS commenced collection activities against the innocent spouse. For purposes of these rules, the term "IRS collection activity" are defined as those which "have the effect of giving the spouse notice of the IRS's intention to collect the joint liability from such spouse." HR Conference Report No. 599, 105th Cong., 2d Sess. @ 250-51 (1998).

VIII. Innocent Spouse Relief Available for North Carolina Purposes. Under I.R.C. Section 6015, innocent spouse relief is available to certain "innocent" spouses. Under N.C.G.S. 105-G152(e), if a taxpayer receives innocent spouse treatment for federal tax purposes, this innocent spouse is also automatically eligible for innocent spouse relief for North Carolina income tax purposes. This innocent spouse relief provision under North Carolina law has become more significant in the last couple of tax years as the result of the expansion of federal innocent spouse relief tax rules.

If you have a client who has received innocent spouse treatment from the Internal Revenue Service, you should submit a request to the North Carolina Individual Income Tax Division in Raleigh (or to the Revenue Collection Officer assigned to the collection case) to receive comparative relief from North Carolina tax liabilities.

Moreover, we also understand that, if a taxpayer has filed an innocent spouse relief request with the IRS, then the North Carolina Department of Revenue will automatically suspend any further collection efforts pending resolution of the IRS innocent spouse relief application.
PART SIX
IRS Issues New Audit Technique Guide For Attorney Audits.

On July 13, 2011, the IRS published its new Audit Technique Guide to be used by IRS Auditors when performing audits on attorneys. The Audit Guide advises IRS Auditors to look at the following potential tax issues involving attorneys:

1. Whether upfront fee payments by clients should be taken into taxable income by the attorneys;
2. Whether attorneys properly report cash receipts for criminal and immigration matters as taxable income;
3. "Personal Service Corporation" tax issues for C corporations;
4. Constructive dividend issues for C corporations that pay personal expenses of the attorneys;
5. Loans to shareholders or the personal use of corporate assets;
6. Inadequate compensation issues for S corporations; and
7. Whether attorneys are claiming non-deductible deductions for client advances.