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THE TAX ADVISER

Debt Discharge Under Sec. 108: Partnerships vs. S Corps.

TAX CLINIC

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Gross Income

As tax liability for cancellation of debt (COD) income gives many taxpayers an unpleasant surprise in today's economy, its tax treatment continues to be a focal point for tax professionals in tax planning and preparation.

The primary difference regarding debt discharge between businesses that are organized as partnerships and those organized as S corporations is the application of Sec. 108 and its effect on the passthrough character of the debt discharge.

In a partnership, the partner recognizes a pro rata share of COD income in full and applies Sec. 108 at the partner level (Sec. 108(d)(6)). In contrast, COD income in an S corporation is recognized at the corporate level, where the taxable portion after the application of Sec. 108 is realized and passed through to the shareholders (Sec. 108(d)(7)(A)).

Sec. 108(a)(1) allows for exclusion of COD income from gross income where the debt discharge:

1. Occurs in a Title 11 case (bankruptcy);
2. Occurs when the taxpayer is insolvent;
3. Is qualified farm indebtedness;
4. Is qualified real property business indebtedness (other than for a C corporation); or
5. Is qualified principal residence indebtedness discharged prior to Jan. 1, 2013 (currently proposed legislation would extend this date by one year).

In addition, the ordering rules in Sec. 108(b)(2) for reducing tax attributes by the amount of excluded COD income applies differently to partnerships and S corporations. This item compares the tax results of debt discharge for partnerships and S corporations and the effect on the stakeholder in each entity.

Sec. 108(a)(1)(A): Bankruptcy

Because the Sec. 108 exclusion from gross income is determined at the partner level, partners qualify for the bankruptcy exclusion only if they are

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individually in bankruptcy. Partners that exclude COD income from gross income must file Form 982, *Reduction of Tax Attributes Due to Discharge of Indebtedness (and Section 1082 Basis Adjustment)*, with their tax return and reduce their tax attributes per the ordering rules of Sec. 108(b), as discussed later in this item.

For an S corporation, the bankruptcy exclusion applies if the S corporation is under the jurisdiction of a court in a bankruptcy case and the debt discharge is granted by the court or as part of a court-approved plan. Any taxable income after the application of Sec. 108 is passed on to the shareholders as taxable income, without any stock basis adjustment for the excluded income. The S corporation files Form 982 to claim the exclusion and is required to reduce its tax attributes.

Sec. 108(a)(1)(B): Insolvency

If the taxpayer is not in bankruptcy, the insolvency exclusion may apply. For a partnership, insolvency is determined at the partner level, rather than the partnership level, by measuring all the partner's assets, including assets that are exempt from bankruptcy creditors, such as retirement accounts and principal residence equity, against the partner's liabilities. (For more, see Sullivan, "Measuring Insolvency Under Sec. 108.") The partner files Form 982 to claim the exclusion, and the tax attributes of the partner, not of the partnership, are reduced.

Note that in the case of the bankruptcy exception, as well as the insolvency and qualified farm indebtedness exceptions discussed below, a partner can elect to reduce the basis of depreciable property before reducing tax attributes by electing to treat the partner's share of the partnership interest as depreciable property to the extent of the partner's interest in the depreciable property held by the partnership. This election requires the partnership to agree to make a corresponding reduction in the basis of the partnership property for that partner.

For an S corporation, the determination of any inclusion or exclusion of COD income, and the corresponding tax attribute reductions, are made at the S corporation level rather than the shareholder level. COD income that is excluded from gross income does not pass through to the shareholders for income recognition or shareholder basis considerations.

Sec. 108(a)(1)(C): Qualified Farm Debt

If the taxpayer is not in bankruptcy or insolvent, the qualified farm exclusion may apply if:

- The debt was incurred directly in the business of farming;
- At least 50% of the taxpayer's gross receipts for the preceding three tax years was attributable to farming; and
- The lender is unrelated to the taxpayer and is actively and regularly engaged in the business of lending money or is a government agency or instrumentality.

The amount of COD income excludable is limited to the total adjusted tax attributes plus the aggregate bases of business property and property held for the production of income.

For partnerships, the exclusion from gross income of qualified farm debt is made at the partner level rather than the partnership level and cannot exceed the sum of tax attributes and business and investment assets of the partner. The corresponding reduction in tax attributes occurs at the partner level.

For S corporations, the exclusion of qualified farm debt from gross income is made at the S corporation level for S corporations engaged in the business of farming. S corporations claim the qualified farm debt exclusion by filing Form 982. Because the excluded qualified farm debt does not pass through to the shareholders and does not adjust their stock bases, the S corporation does not report it on Schedule K or K-1.

Sec. 108(a)(1)(D): Qualified Real Property Business Debt

If the taxpayer is not a C corporation and is not in bankruptcy or insolvent, the qualified real property (QRP) business debt exclusion may apply. QRP business debt does not include qualified farm indebtedness and is:

- Incurred or assumed by the taxpayer in connection with real property used in a trade or business and is secured by such real property; and
- Incurred or assumed before Jan. 1, 1993, or if on or after that date, is qualified acquisition indebtedness, which is incurred or assumed to acquire, construct, reconstruct, or substantially improve the property.

The amount of COD income that can be excluded under this exception is subject to the lesser of:

- **Fair market value (FMV) limitation:** The excess of the principal amount of the outstanding debt over the FMV of the real property securing the debt; or
- **Overall limitation:** The aggregate adjusted bases of all depreciable real property held by the taxpayer immediately before the discharge (other than property acquired in contemplation of discharge). When applying the overall limitation, the adjusted bases of the taxpayer's depreciable real property must be determined after reductions in basis with respect to insolvency, bankruptcy, or discharge of qualified farm debt.

To exclude COD income from the discharge of QRP business debt, the taxpayer must make a timely filed election (including extensions) on a completed Form 982 for the tax year in which the discharge occurs. The amount of income excluded by a discharge of QRP business debt reduces the basis of the taxpayer's depreciable real property as determined under Sec. 1017. The basis reduction is deemed to occur at the beginning of the tax year following the year of discharge.

For a partnership, the partner, rather than the partnership, applies the QRP exclusion at the partner level and makes this election by completing Form 982 and attaching it to the partner's tax return. The amount of income excluded by a discharge of QRP business debt of a partner reduces the basis of the partner's depreciable real property. This basis reduction is not limited to the property secured by the debt. Further, any partnership interest of a partner can be treated as depreciable real property to the extent of the partner's interest in the depreciable real property held by the partnership if the partnership agrees to make a corresponding reduction in the basis of the partnership property for that partner.

For an S corporation, the QRP exclusion is applied at the S corporation level by attaching Form 982 to a timely filed (including extensions) Form 1120S, *U.S. Income Tax Return for an S Corporation*. The income excluded at the S corporation level reduces the basis in the depreciable real property of the S corporation. Shareholders cannot treat their interest in an S corporation as depreciable real property as a partner in a partnership can.

Sec. 108(b): Reduction of Tax Attributes

Although the ordering of the tax attributes that must be reduced by the amount of excluded COD income are the same for partnerships and S corporations, the application varies greatly.

For partnerships, a partner applies the reduction of tax attributes based on the amount of COD income excluded from gross income at the partner level, based on the partner's tax attributes. For S corporations, the attribute reduction is calculated at the S corporation level.

The reductions in tax attributes described are made after the determination of the tax imposed by this chapter for the tax year of the discharge. The tax attributes subject to reduction that are carryovers to the tax year of the discharge, or that may be carried back to tax years preceding the year of the discharge, are taken into account by the

taxpayer for the tax year of the discharge or the preceding years, before they are reduced.

The tax attributes are reduced in the following order:

- Net operating loss (NOL): For partnerships, the partner reduces the NOL generated in the year of the debt discharge and then any NOL carryforward of the partner. A special rule applies for S corporations with regard to NOLs. For S corporations, the NOL amount is the aggregate amount of the shareholders' losses or deductions disallowed for the year of the discharge under Sec. 1366(d)(1), including disallowed losses or deductions of shareholders that transferred all of their stock in the S corporation during the year of the discharge. C corporation NOL carryovers of an S corporation for preelection years are not reduced.
- General business credits.
- Minimum tax credits.
- Capital loss carryovers.
- Basis: The taxpayer's basis in property (including the taxpayer's share of partnership property) is reduced under Sec. 1017. Basis reduction occurs after calculating depreciation for the year of discharge.
- Passive activity losses and credits.
- Foreign tax credits.

For partnerships, the partner applies the debt discharge income against the partner's carryover tax attributes. For S corporations (other than in the case of NOLs), the S corporation applies the COD income against carryovers from previous C corporation years at the S corporation level.

For both entity types, the NOL, capital loss, basis, and passive activity loss attributes are reduced dollar for dollar. The reduction for the other credit attributes is reduced by 33 1/3 cents per dollar.

EditorNotes

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