

Rev. Rul. 91-31

ISSUE

If the principal amount of an undersecured nonrecourse debt is reduced by the holder of the debt who was not the seller of the property securing the debt, does this debt reduction result in the realization of discharge of indebtedness income for the year of the reduction under section 61(a)(12) of the Internal Revenue Code or in the reduction of the basis in the property securing the debt?

FACTS

In 1988, individual A borrowed \$1,000,000 from C and signed a note payable to C for \$1,000,000 that bore interest at a fixed market rate payable annually. A had no personal liability with respect to the note, which was secured by an office building valued at \$1,000,000 that A acquired from B with the proceeds of the nonrecourse financing. In 1989, when the value of the office building was \$800,000 and the outstanding principal on the note was \$1,000,000, C agreed to modify the terms of the note by reducing the note's principal amount to \$800,000. The modified note bore adequate stated interest within the meaning of section 1274(c)(2).

The facts here do not involve the bankruptcy, insolvency, or qualified farm indebtedness of the taxpayer. Thus, the specific exclusions provided by section 108(a) do not apply.

LAW AND ANALYSIS

Section 61(a)(12) of the Code provides that gross income includes income from the discharge of indebtedness. Section 1.61-12(a) of the Income Tax Regulations provides that the discharge of indebtedness, in whole or in part, may result in the realization of income.

In Rev. Rul. 82-202, 1982-2 C.B. 35, a taxpayer prepaid the mortgage held by a third party lender on the taxpayer's residence for less than the principal balance of the mortgage. At the time of the prepayment, the fair market value of the residence was greater than the principal balance of the mortgage. The revenue ruling holds that the taxpayer realizes discharge of indebtedness income under section 61(a)(12) of the Code, whether the mortgage is recourse or nonrecourse and whether it is partially or fully prepaid. Rev. Rul. 82-202 relies on *United States v. Kirby Lumber Co.*, 284 U.S. 1 (1931), X-2 C.B. 356 (1931), in which the United States Supreme Court held that a taxpayer realized ordinary income upon the purchase of its own bonds in an arm's length transaction at less than their face amount.

In *Commissioner v. Tufts*, 461 U.S. 300 (1983), 1983-1 C.B. 120, the Supreme Court held that when a taxpayer sold property encumbered by a nonrecourse obligation that exceeded the fair market value of the property sold, the amount realized included the amount of the obligation discharged. The Court reasoned that because a nonrecourse note is treated as a true debt upon

inception (so that the loan proceeds are not taken into income at that time), a taxpayer is bound to treat the nonrecourse note as a true debt when the taxpayer is discharged from the liability upon disposition of the collateral, notwithstanding the lesser fair market value of the collateral. See section 1.1001-2(c), Example 7, of the Income Tax Regulations.

In *Gershkowitz v. Commissioner*, 88 T.C. 984 (1987), the Tax Court, in a reviewed opinion, concluded, in part, that the settlement of a nonrecourse debt of \$250,000 for a \$40,000 cash payment (rather than surrender of the \$2,500 collateral) resulted in \$210,000 of discharge of indebtedness income. The court, following the Tufts holding that income results when a taxpayer is discharged from liability for an undersecured nonrecourse obligation upon the disposition of the collateral, held that the discharge from a portion of the liability for an undersecured nonrecourse obligation through a cash settlement must also result in income.

The Service will follow the holding in *Gershkowitz* where a taxpayer is discharged from all or a portion of a nonrecourse liability when there is no disposition of the collateral. Thus, in the present case, A realizes \$200,000 of discharge of indebtedness income in 1989 as a result of the modification of A's note payable to C.

In an earlier Board of Tax Appeals decision, *Fulton Gold Corp. v. Commissioner*, <Page 20>31 B.T.A. 519 (1934), a taxpayer purchased property without assuming an outstanding mortgage and subsequently satisfied the mortgage for less than its face amount. In a decision based on unclear facts, the Board of Tax Appeals, for purposes of determining the taxpayer's gain or loss upon the sale of the property in a later year, held that the taxpayer's basis in the property should have been reduced by the amount of the mortgage debt forgiven in the earlier year.

The Tufts and *Gershkowitz* decisions implicitly reject any interpretation of *Fulton Gold* that a reduction in the amount of a nonrecourse liability by the holder of the debt who was not the seller of the property securing the liability results in a reduction of the basis in that property, rather than discharge of indebtedness income for the year of the reduction. *Fulton Gold*, interpreted in this manner, is inconsistent with Tufts and *Gershkowitz*. Therefore, that interpretation is rejected and will not be followed.

HOLDING

The reduction of the principal amount of an undersecured nonrecourse debt by the holder of a debt who was not the seller of the property securing the debt results in the realization of discharge of indebtedness income under section 61(a)(12) of the Code.

EFFECT ON OTHER REVENUE RULINGS

Rev. Rul. 82-202 is amplified to apply whether the fair market value of the residence is greater or less than the principal balance of the mortgage at the time of the refinancing.