Rev. Rul. 92-92

How is discharge of indebtedness income (also referred to as cancellation of debt (COD) income) characterized for purposes of section 469 of the Internal Revenue Code?

FACTS

A, an individual, defaults on a recourse loan from an unrelated bank when the outstanding balance of the loan is $1 million. A transfers property with an adjusted basis of $700,000 and a fair market value of $800,000 to the bank in full satisfaction of A's $1 million debt. As a result A has $100,000 of gain on the sale ($800,000 value of property transferred less $700,000 of basis) and $200,000 of COD income ($1,000,000 liability discharged less $800,000 value of property transferred). Section 108 of the Code does not exclude the COD income from A's gross income. At the time the indebtedness is discharged, under the rules of section 1.163-8T of the temporary Income Tax Regulations, 60 percent of the debt is allocated to passive activity expenditures and 40 percent of the debt is allocated to other expenditures.

LAW AND ANALYSIS

Section 469(a) of the Code disallows passive activity losses for the taxable year for individuals and certain other taxpayers. A passive activity is defined generally in section 469(c)(1) as any activity that involves the conduct of a trade or business in which the taxpayer does not materially participate. Any rental activity, regardless of whether the taxpayer materially participates, is a passive activity under section 469(c)(2). A passive activity loss is defined in section 469(d)(1) as the amount (if any) by which the aggregate losses from all passive activities for the taxable year exceed the aggregate income from all passive activities for such year.

Section 1.163-8T of the temporary regulations prescribes rules for allocating interest expense for purposes of applying the passive loss limitation of section 469 of the Code. Under these rules, interest expense is generally allocated in the same manner as the debt to which the interest expense relates is allocated. Debt is allocated by tracing disbursements of the debt proceeds to specific expenditures. These interest tracing rules provide that the allocation is not affected by the use of an interest in any property to secure the repayment of the debt or interest.

Section 1.469-2T(c)(1) of the temporary regulations provides generally that passive activity gross income for a taxable year includes an item of gross income if and on1y if such income is from a passive activity.

In determining whether COD income is from a passive activity, it is generally appropriate to allocate the income in the manner in which section 1.163-8T of the temporary regulations allocates the debt at the time of the discharge and to treat the income allocated to an expenditure as income from the activity to which the expenditure relates. However, traditional substance over form and step transaction principles will apply to prevent taxpayers from attempting to manipulate the character of the COD income.

At the time A's loan is discharged, 60 percent of the debt is allocated to passive activity expenditures, and 40 percent is allocated to other expenditures. Thus, $120,000 (60 percent of the $200,000 COD income) is characterized as income from a passive activity, and $80,000 (40 percent of the $200,000 COD income) is characterized as income from a nonpassive activity.

HOLDING

For purposes of section 469 of the Code, COD income is characterized as income from a passive activity to the extent that, at the time the indebtedness is discharged, the debt is allocated to passive activity expenditures and as income from a nonpassive activity to the extent that, at the time indebtedness is discharged, the debt is not allocated to passive activity expenditures.

DRAFTING INFORMATION

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