CARLSON v. COMMISSIONER: NOT ALL IS FORGIVEN

An abstract concept of the Internal Revenue Code is the recognition of income upon the discharge of debt. The forgiveness creates a taxable event for ***solvent*** taxpayers.[1] Insolvent taxpayers have no tax recognition as permitted under 26 U.S.C. ' 108(a)(1)(B)[2]. Discharge of debt arises when a creditor waives collection or demand for full payment of a legally enforceable obligation. Creditors often Awork things out@ by accepting less than full invoice. This creates a taxable event for the debtor, but only if the debtor is solvent.[3] Calculating solvency is not black and white accounting. Where significant assets are exempt from creditors, the solvency calculation becomes problematic. The courts are split on the issue of: ADo you include or exclude the exempt assets to determine solvency?@ A 2001 tax court decision has answered the above question by including the exempt assets in calculating the solvency of a debtor prior to the discharge of debt. In re Carlson, 116

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[1] ' 108(d)(3) defines Ainsolvent@ as the excess of liabilities over the fair market value immediately before debt discharge.

[2] Similarly, bankrupt debtors do not recognize income under 26 U.S.C. ' 108(a)(1)(A).

[3] Interestingly, nonlawyers or accountants cannot fathom this entire concept. For instance, if a debt of $100.00 is forgiven for $35.00 the real effect on the economy is merely a reduction of $35.00 to the economy as a whole as two parties concluded C after making reasonable inquiry C that the Adeal had gone sour@ and the depreciation of the assets or lessening of the value of the exchange is a loss to the lender. But, lawyers and accountants look at financial transactions as ledger items C each debit has a credit. Each tax deduction has income. Each write off to one entity is income to the another. Whether or not the whole concept is in error is or another author as Congress has legislated the lawyer/accountant concept to be law.

T.C. No. 9 (2001). Because of the Carlson ruling, debtors with significant exempt assets must think twice about the recognition of income upon the discharge of the debt. If the discharge of debt appears imminent, the taxpayer should review the possibility of filing bankruptcy to avoid a taxable event.[4]

[4] Nuances exist. Below, a footnote will show some of the nuances. But, amazingly, many states have legislated that the exemptions in bankruptcy are the same as those in bankruptcy. But, many others have legislated that debtors can use the exemptions provided under federal law. The facts of the individual case make it very important for the bankruptcy practitioner to know how each is distinguishable and how the exemptions of bankruptcy may or may not protect his client from trustee or creditor attack after the client files for bankruptcy protection.

In February of 2001, the Carlson tax court determined that solvency=s calculation included a large exempt asset. The discharge of indebtednessbecame a taxable event to Carlson only because the court included exempt assets in quantifying his asset ledger. Carlson, who did not receive money from the discharge of indebtedness, received a taxable benefit and became obligated to pay taxes affiliated with the Aphantom income.@[5] In short, although Carlson neither received money or money equivalent for the bank=s decision to cease collecting on an obligation, Carlson became obligated to pay federal taxes.[6]

[5] A term used to describe the income recognized by the taxpayer even though the taxpayer neither received cash or cash equivalent in the transaction.

[6] At first blush, one may ponder how paying approximately 25% to 35% of the debt is a Abad deal@ to the taxpayer. But, very often the amount of tax is beyong the fungible resources of the debtor, and in a case like Carlson, the tax obligation may compel the taxpayer/debtor to liquidate the exempt asset to satisfy the tax obligation.

The amount of forgiven debt in Carlson was approximately $42,142.00.[7] The bank=s decision not to collect (or its Adeal@) was influenced by the fact that the bank was prohibited by state law from seizing the valuable asset of Carlson C a fishing permit claimed to have a fair market value of $393,400.00. After walking away from collection of that debt, the bank appropriately filed a 1099-A C a form declaring forgiveness of indebtedness.[8] Carlson attached the 1099-A to his 1040 return, but also included the following clause ATaxpayer Was Insolvent - No Tax Consequences.@[9] Carlson and his accountant thought this statement would avoid forgiveness of indebtedness recognition of income. The IRS and the tax court disagreed.

The term insolvent is a term of art defined in the Internal Revenue Code as:

> **Insolvent**. - - for purposes of this section [108], the term >insolvent= means the excess of liabilities over the fair market

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[7] In re Carlson, 116 T.C. No. 9 (2001) at 4

[8] Acquisition or Abandonment of Secured Property form filed at the end of the tax year to the Internal Revenue Service from which the discharge of indebtedness is received by the IRS=s computer from which a matching or corresponding entry should be included on the 1040 of the taxpayer. 1099-A is for abandonment of its secured interest. An unsecured creditor files a 1099-C form.

[9] The filing of this form starts the credit/debit mindset described in footnote 2 above. Since the bank has delivered a statement to the IRS indicating income to a party, the party=s return must match that with inclusion of income in the 1040. Of course, the Internal Revenue Code provides exclusion from income for the very reason recited succinctly by the accountant for Carlson.

> value of assets. With respect to any discharge, whether or not the taxpayer is insolvent, and the amount by which the taxpayer is insolvent, shall be determined on the basis of the taxpayer=s assets and liabilities immediately before the discharge.
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> 26 U.S.C. ' 108(d)(3).

Within the definition of insolvent is the term Aasset.@ AAssets@ as used in the insolvency definitional clause of '108(d)(3) is not defined by the Internal Revenue Code. Hence, jurisprudence has evolved with different conclusions as to whether or not the term Aassets= in '108(d)(3) includes exempt assets. Carlson, not surprisingly, argued that the term Aassets@ of '108(d)(3) excluded exempt assets as such were exempted from claims of creditors under applicable state law.[10] By excluding that asset, he argued he was insolvent under ' 108(a)(1)(B) and exempted from recognizing income.

[10] This was not an illogical conclusion because of the following rulings: Cole v. Commissioner, 42 B.T.A. 1110 (1940) and Hunt v. Commissioner, T.C. Memo 1989-335.

The only dispute in Carlson was whether or not '108(d)=s[11] Aassets@ included Aexempt assets.@ The insolvency exception of 26 U.S.C. '108(a)(1)(B) was intended to allow people a Afresh start@ when they were either insolvent or bankrupt.[12] Congress did not want to burden insolvent or bankrupt taxpayers.[13] After reviewing three pertinent cases on the issue, the tax court determined that the three provident cases relied upon by Carlson did not definitively answer the issue.[14]

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[11] 26 U.S.C. '108(a)(1)(B) entitles people to exempt discharge of indebtedness income, if the taxpayer is insolvent as defined in 108(d)(3) as recited above. That section states:

26 U.S.C. SECTION 108
a)Exclusion from gross income

> **(1)** In general
> Gross income does not include any amount which (but for this subsection) would be includible in gross income by reason of the discharge (in whole or in part) of indebtedness of the taxpayer if -
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> > **(A**) a discharge occurs in a title 11 case,
> > **(B)** the discharge occurs when the taxpayer is insolvent,

[12] Interestingly, Congress does not want to bother solvent bankrupt debtors, even if they are solvent when including their nonexempt assets. Also, subsequently, Congress created a bankruptcy exception to the discharge of indebtedness with ' 108(a)(1)(A).

[13] But, we now know Congress definitely does not want to burden bankrupt taxpayers, whether or not they are solvent; but, will not bother nonbankruptcy taxpayers only if they are proven to be definitionally insolvent.

[14] Lakeland Grocery Co. v. Commissioner, 36 B.T.A. 289 (1937); Dallas Transfer & Terminal Warehouse Co. v. Commissioner, 70 F.2d 95 (5th Cir. 1934); United States v. Kirby Lumber Co., 284 U.S. 1 (1931).

The three cases were: Lakeland Grocery Company v. Commissioner, 36 B.T.A. 289 (1937); Dallas Transfer & Terminal Warehouse Co. v. Commissioner, 70 F.2d 95 (5th Cir. 1934); and United States v. Kirby Lumber Co., 284 U.S. 1 (1931).

In Lakeland Grocery Company v. Commissioner, 36 B.T.A. 289 (1937), the bankruptcy petitioner delivered a plan to the bankruptcy court where $15,472.61 was tendered to the creditors in exchange for their cancellation of $89,237.55 of debt. At the conclusion of the bankruptcy, the debtor had assets worth $39,596.93. The issue became: If Lakeland received the forgiveness of indebtedness while insolvent, would Lakeland have a taxable event as Lakeland became solvent at the conclusion of the forgiveness? This case was handled before bankruptcy discharge of debt was excluded from income C the new 26 U.S.C. '108(a)(1)(A) and 11 U.S.C. '101(26) C the latter denying any income recognition. The court concluded, without the appreciation of either of the above-recited codified sections, that there was a gain to the debtor of $39,596.93 and a taxable event for the same. Today, outside of bankruptcy, this ruling may be followed. However, in a bankruptcy context, this case no longer is valid as the above-recited provisions have statutorily mandated no recognition of income.

In Dallas Transfer & Terminal Warehouse Co. v. Commissioner, 70 F.2d 95 (5th Cir. 1934), the insolvent debtor remained insolvent after the discharge of the indebtedness. Because the debtor received nothing at the end of the transaction

which it did not have at the beginning, the Court concluded:

> There is a reduction or extinguishment of liabilities without any increase of assets. There is an absence of such a gain or profit as is required to come within the accepted definition of income. (Citations omitted). It hardly would be contended that a discharged insolvent or bankrupt receives taxable income in the amount by which his provable debts exceed the value of the surrendered assets. The income tax statute does not purport to treat as income what did not come within the meaning of that word before the statute was enacted.
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> Dallas Transfer at 96.

The Court concluded, Aa transaction whereby nothing of exchangeable value comes to or is received by a taxpayer, does not give rise to or create taxable income.@ Dallas Transfer at 96.

Dallas Transfer came to its conclusion after reviewing United States v. Kirby Lumber Co., 284 U.S. 1 (1931). In Kirby Lumber, the lower court determined there may be no taxable event when a corporation purchases its own bonds at less than par value. The Supreme Court summarily reversed. The Court of Claims referred to a specific section regarding a sale and retirement of corporate bonds [15] and concluded that there was enough in that particular federal statute which prohibited the inclusion of income. Interestingly, the parties at this time (the decisions were respectively rendered in 1930 and 1931) did not review the debtor=s insolvency. Rather, the issue was whether or not a forgiveness of indebtedness, whether the

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[15] ' 545.

debtor be solvent or insolvent, was a transaction which created a taxable event.[16] Buying bonds at less than value was determined to be a recognizable taxable event for the difference between par value and the purchase price.

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[16]The Court of Claims wrote:

> The question is whether such gain is taxable as income. In our opinion, the question whether **the person engaging in such transaction is solvent or insolvent**, or whether he made a profit or suffered a loss through the use of the money for which the obligations were issued **is wholly immaterial**. (Emphasis added).
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> U.S. v. Kirby Lumber at 44 F.2d 885,887 (Ct. Claims 1930)

The above cases basically determined that if the debtor is insolvent before and after the forgiving act, then no taxable event arises. But, if the debtor is solvent only after, then there may be a taxable event outside of bankruptcy. And, all courts agree there is always a taxable event if the debtor is solvent before the forgiving act when outside of bankruptcy.[17] Hence, a determination of excluding the exempt assets in the debtor=s solvency analysis is critical if the forgiveness of indebtedness occurs without the protections of bankruptcy.

The case having facts most similar to those of Carlson was Cole v.

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	Solvent Before	Insolvent Before
Solvent After	No exclusion C ***Carlson***	No Exclusion ***Lakeland Grocery Co. v. Commissioner***
Insolvent After	Never will occur	***Dallas Transfer***C Exclusion also 108(a)(1)(B)

Commissioner, 42 B.T.A. 1110 (1940). The Cole court did not include insurance assets in calculating the insolvency of the Debtor in regard to discharge of indebtedness recognition of income. The Cole court wrote:

> In determining the amount in which petitioner=s net assets were increased as result of the cancellation of petitioner=s indebtedness by his creditor, i.e., the amount of petitioner=s assets which ceased to be offset by claims of creditors, there should be, and has been, omitted from the value of petitioner=s assets the value of his equity in ten life insurance policies.
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> Cole v. Commissioner at 1113.

The insurance proceeds were excluded in determining the insolvency of the debtor because applicable New York law prohibited creditors from reaching the insurance. The state law prohibition in collecting the insurance asset delivered grounds to exclude the insurance asset for calculating solvency in a discharge of indebtedness issue. Cole made this determination irrespective of whether the debtor was solvent before or after the forgiving event. The court in Cole absolutely prohibited inclusion of the exempt asset either before or after the forgiving event.[18]

The Texas silver baron Hunt family encountered the same issue as Cole and the tax court determined:

> In these cases the Hunt children [forgiven parties] did not file bankruptcy. Therefore, whether they are insolvent is determined by exempting only those assets which are exempt from the claims of

[18]Being insolvent before and after the forgiving event allows one to follow Dallas Transfer and avoid taxation.

creditors under state law.

Hunt v. Commissioner, T.C. Memo 1989-335 at 124.

Cole and Hunt were specifically rejected by the Carlson Tax Court. The Carlson court, rather than following Cole or Hunt, determined that 26 U.S.C. ' 108(e)(1)[19] precludes the application of Cole or any other judicially created exception to discharge of indebtedness income.[20] The insolvency exception of 26 U.S.C. ' 108(a)(1)(B) is now limited to statutory review, according to the Carlson court.[21] The language of 26 U.S.C. ' 108(e)(1) states that, Athere shall be no insolvency exception from the general rule that gross income includes income from

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[19] 108
(e) General rules for discharge of indebtedness.
For purposes of this title -
(1) No other insolvency except as provided in this section, there shall be no insolvency exceptions from the general rule that gross Income includes income from the discharge of indebtedness.

[20] Carlson at 116 T.C. No. 9 (2001), page 27.

[21] The Carlson court wrote:

> As Congress enacted the insolvency exclusion [Section 108(a)(1)(B)], it eliminated the net assets test as a judicially created exception to the general rule of income from the discharge of indebtedness. See sec.108(e). The fundamental difference between the insolvency exclusion [in section 108(a)(1)(B)] and the judicially developed] net assets test is that the Insolvency exclusion is applicable only if there exists income from the discharge of indebtedness, whereas the net assets test engages in the threshold inquiry.
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> Carlson at 27

the discharge of indebtedness@ except as provided in section 108(a)(1)(B). In short, the Carlson court concluded there cannot be a Ajudicial insolvency exception which was not codified in '108.@ Citing Gitlitz v. Commissioner, 531 U.S. at 206; 148 L.Ed. 2d 613; 121 S.Ct. 701; 69 U.S.L.W. at 4063 (2001).

By prohibiting the judicially created exclusion of exempt assets in calculating solvency, the Carlson court concluded:

> . . .the intention of Congress in enacting section 108(d)(3) that assets exempt from the claims of creditors under applicable State law are not to be excluded in determining the fair market value of a taxpayer=s assets for purposes of ascertaining whether the taxpayer is insolvent within the meaning of section 108(d)(3). Congress= intention is disclosed by an examination of section 108(d)(3) together with the 1978 Bankruptcy Reform Act and its legislative history and the 1980 Bankruptcy Tax Act and its legislative history. One of the stated policies of the 1978 Bankruptcy Reform Act was to >provide a fresh start=, S. Rept. 95-989, at 6 (1978), for the debtors coming out of bankruptcy. The principal mechanism adopted by Congress in the 1978 Bankruptcy Reform Act for providing such a >fresh start= in the Federal bankruptcy laws is through the discharge of debts.
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> Carlson at 28-29.

After proclaiming that the judicially developed insolvency exemption is trumped by a new statute[22], the Carlson court understood that Congress= failure to define Aasset@ in 26 U.S.C. '108 compelled further statutory review. Statutory review, the Carlson court determined, commences with the interpretation of the

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[22] 26 U.S.C. 108(e)

employed language. The Carlson court first interpreted the Internal Revenue Code to analyze the intent of Congress.[23] Because the term Aassets@ is not defined by the Internal Revenue Code, the court sought the ordinary meaning of the word.[24] The plain meaning of the word Aassets@ means items on the balance sheet showing the book value of the property. By looking at various definitions in various dictionaries, the court concluded:

> We conclude that the common and ordinary meaning of the word >assets= as reflected in the dictionary definition of that word does not support only one construction. We next turn to pertinent legislative history for the guidance in interpreting what Congress intended by its use of the word >assets= in the definition of the term >insolvent= in section 108(d)(3).
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> Carlson at 12.

The Carlson court looked to the Bankruptcy Tax Act of 1980 to help determine the congressional intent for the term Aassets.@ The Bankruptcy Reform Act of 1978 significantly changed the Bankruptcy Act to become the Bankruptcy Code. Tax aspects of bankruptcy were extremely affected by that legislative act

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[23] As done in Merkel v. Commissioner, 109 T.C. 463, 468 (1997)

[24] Court referred to the analysis of the term as done in Merkel v. Commissioner, 192 F.3rd 844, 848 (9th Cir. 1999).

and the Bankruptcy Tax Act of 1980. After looking at both acts, the Carlson court concluded a few meanings for the term Aassets.@

The Carlson court recognized how congressional legislation is able to create other insolvency definitions. Most specifically, the Carlson court looked to the insolvency definition of the Bankruptcy Code and found that Congress specifically excluded exempt assets in the calculation of assets against liabilities for bankrupts. Likely, the court reviewed 11 U.S.C. ' 101(26) which states in pertinent part

> (26) @insolvent@ means - -
> (A) with reference to an entity other than a partnership, financial condition such that the sum of such entity=s=s debts is greater than all of such entity=s property, at a fair valuation, exclusive of - -
> (ii) property that may be exempted from property of the [bankruptcy] estate under section 522 of this title.

Section 522 of the of title 11 specifically exempts property as defined under ' 541. Therefore, exempt assets are not included in the formula. Congress, when it chooses[25], excludes exempt assets when calculating solvency.

[25] Or when someone brings the issue to its attention whether by lobbyist of constituency concern.

The Carlson court determined that 26 U.S.C. ' 108(d) could have included the formula requested by the petitioner as Congress is capable of enacting legislation which unambiguously excludes exempt assets for determining solvency.[26] But, the Carlson court argues, Congressional omission of a clause similar to that of Bankruptcy Code=s definition of insolvent in title 26 is not coincidental.[27] The Carlson court, in short, concluded that Congressional failure to write a definition of insolvency identical to that requested by Carlson is not by misfortune.[28] The Carlson court found it obvious that Congress did not write a definition of insolvency in the title 26 like that written in title 11 so as to deliver a different result.[29]

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[26]Carlson=s insolvency test was literally what the Bankruptcy Code permitted.

[27]Section 101(26) of the Bankruptcy Code specifically excludes exempt property in the formula. Section 108 of the IRC unfortunately is not specific.

[28]11 U.S.C. ' 101(26)

[29]Carlson at 31. In fact, the Carlson court followed the ***expressio unius est exclusio alterius*** concept when concluding:

> We conclude that the decision of Congress not to define the term >insolvent= in section 108(d)(3) to exclude specifically such exempt asset in determining whether a debtor is insolvent for purposes of section 108 was intentional.

The Carlson court=s footnote 13 then refers to Myron M. Sheinfeld=s comment to Congress at the hearings for HR 5043, 96th Cong. 1st Sess (1979) that, Athe differing definitions of insolvent will, unless made consistent, cause substantial trouble and litigation.@ Hearing in HR. 5043 before Subcommission on Select Revenue Measures of the House Commission on Ways and Means.

Carlson at 32

Forgiveness of indebtedness income outside of bankruptcy is different from forgiveness inside of bankruptcy.[30]

[30] The following two boxes show how outside of bankruptcy there is only an exclusion when the debtor is insolvent before and after the event. While inside of bankruptcy, there is no recognition, even when the debtor is solvent before and after the event.

OUTSIDE OF BANKRUPTCY

	Solvent Before	Insolvent Before
Solvent After	No exclusion C *Carlson*	No Exclusion *Lakeland Grocery Co. v. Commissioner*
Insolvent After	Never will occur	*Dallas Transfer* C Exclusion also 108(a)(1)(B)

INSIDE OF BANKRUPTCY

	Solvent Before	Insolvent Before
Solvent After	Exclusion C 108(a)(1)(A)	Exclusion C 108(a)(1)(A)
Insolvent After	Never will occur	*Dallas Transfer* C Exclusion also 108(a)(1)(A)

The Carlson court has made the task of calculating insolvency more necessary. Calculating insolvency has always been extremely troubling for numerous professionals. Certain assets are very difficult to assess or evaluate. The definition of insolvency may be reasonably relied upon by taxpayer=s appraised value, but may be reasonably challenged by the Internal Revenue Service.

When confronted with a situation of having to appraise a unique asset, the taxpayer cannot always obtain an answer which he or she may desire. Unfortunately, the real world does not permit the taxpayer to go to the Commissioner of the Internal Revenue Service and ask that the Commissioner to be like the all and powerful Oz and tell the taxpayer, prior to his or her attempt to avoid discharge indebtedness recognition of income, whether he or she is definitively insolvent under ' 108 of title 26.[31] The utilization of a professional to appraise the assets of the debtor/taxpayer is the most prudent and efficient manner in handling the issue of whether or not the debtor is insolvent. But, the appraiser=s statement is not absolutely accepted by the Commissioner.

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[31]Remember, solvency is not an issue if a debtor is bankrupt. Solvency is only an issue outside of bankruptcy. ' 108(b)(1)(A) vs. ' 108(b)(1)(B) of title 26.

Until recently, numerous parties throughout the United States did not think there was even an issue about their client=s solvency.[32] Carlson=s accountant was one such party. Now, if non-exempt assets are marginally valuable, the non-exempt assets must be appraised. More importantly, in those states where tremendous amounts of exemption are allowed, the taxpayer must realize he or she is solvent in the eyes of a court that agrees with Carlson. Numerous states have laws not dissimilar to that of Alaska which prohibit creditors from attacking certain types of licenses or assets which the state deems to be important to its constituency. Large exempt assets include: homestead exemptions; IRA accounts; 401(k) accounts, and other retirement plans are statutorily exempt in the majority of jurisdictions; prepaid tuition plans ; and, licenses. Quite often, if not more often than not, dollar value of exempt assets exceeds the dollar amount of the scheduled liabilities. Chapter 7 debtors often are definitionally insolvent under 11 U.S.C. ' 101, but are definitionally solvent under 26 U.S.C. ' 108.

If the Carlson ruling is followed by the tax courts of the United States of America, a debtor taxpayer should seriously think about the tax ramifications of settling debts with third parties. Many taxpayers cannot afford the tax recognition associated with forgiveness of income which is revealed to the IRS with the filing of the 1099-A form.

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[32] Everyone relied on Cole.

Before counsel handles the settlement for creditors on behalf of his or her client, that party will equally be responsible or liable to the client if tax consequences occur which could have been avoided. Most obviously, the question becomes can the client afford to encounter a bankruptcy without losing assets of significant value and thereby relieve himself or herself of any and all discharge of indebtedness income as permitted by the definitions of 11 U.S.C. ' 101(26) combined with ' ' 522 and 541 of title 11.

Mr. Carlson was an easy candidate for a bankruptcy[33]. Had Carlson filed a bankruptcy instead of making the deal with the bank, the tax consequences would not have existed. In short, the tax practitioner and bankruptcy practitioner in such circumstances must work together when dealing with discharge of indebtedness income. Most likely, the commercial litigator, combined with the bankruptcy and tax practitioner, can form a powerful threesome to determine what legal strategies to use in regard to the common client. If the tax practitioner ignores bankruptcy law, or the bankruptcy lawyer ignores tax law, problems can arise. However, if the bankruptcy lawyer ignores tax law under the facts and circumstances of the topic contained in this article, the bankruptcy practitioner will luckily have avoided a substantial debt to the client. In the alternative, if a tax practitioner ignores bankruptcy law for a matter similar to the topic of this article, the tax practitioner

[33] This is assuming that he could use the state exemption in a bankruptcy filing.

may have harmed the client greatly. The complexity of the practice of law, especially in codified practices such as tax and bankruptcy, prohibit one person from knowing all of the nuances of each code. Therefore coordinationof practitioners in their respective fields is highly recommended. The team work of the attorneys representing the parties can overcome the abstractions of confounding issues like discharge of indebtedness.

Y:\Clients\11111\Articles\Carlson Not all is forgiven.wpd