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Did the IRS Forget Non-PPP Debt?

Tax Implications of Debt Forgiveness

by Lou Pizzileo, CPA, Partner, Grassi

Alice Varisano, CPA, Tax Partner, Grassi

with Sean Murray, President, deBanked

May 2020

Available online at grassicpas.com

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Typically, debt that has been canceled, forgiven or discharged for less than the amount owed is taxable income and must be reported as such in the tax year the cancellation occurs.

In the course of responding to the major losses of the COVID-19 crisis, many businesses may have significant amounts of debt forgiven or discharged as they work through creditor negotiations, corporate restructuring, bankruptcy filings or other financial strategies. Understanding how this will impact tax obligations is an important part of any crisis response and recovery plan.

Under the CARES Act, Paycheck Protection Program debt forgiveness is not taxable income. The Treasury designed the program this way to provide significant relief to small businesses. Subsequently, the IRS diluted that relief by ruling that the expenses claimed against loan forgiveness will no longer be deductible, but there is a dialogue in the legislature to undo this ruling.

With so much focus on PPP forgiveness, has discharge of other non-PPP debt been forgotten?

If a business owner makes it through this crisis, successfully restructures its debt with creditors, and gets some of the debt discharged to keep their business operating, it appears punitive that such cancellation of debt will be taxable income and require cash outflow in the form of income taxes.

Excluding Cancellation of Debt (COD) from Gross Income

The taxation of COD income makes sense under normal circumstances when you consider the tax deductions that taxpayers can claim on the expenses paid by the full amount of the loan proceeds, including the forgiven amount.

Normally, the only time a taxpayer can avoid taxation on COD income is when the law specifically allows it to be excluded from gross income. These instances include:

- Debt canceled in a Title 11 bankruptcy case
- Debt canceled to the extent insolvent
- Cancellation of qualified farm indebtedness
- Cancellation of qualified real property business indebtedness
- Cancellation of qualified principal residence indebtedness that is discharged subject to an arrangement that is entered into and evidenced in writing before January 1, 2021

Generally, if a taxpayer excludes COD from gross income under one of the exclusions listed above, they must reduce certain tax attributes (i.e.,

credits and carryovers, losses and carryovers, basis of assets) – but not below zero – by the amount excluded. This is done by attaching Form 982, Reduction of Tax Attributes Due to Discharge of Indebtedness (and Section 1082 Basis Adjustment) to the tax return to report the COD amount qualifying for exclusion and any corresponding reduction of those tax attributes. For cancellation of qualified principal residence indebtedness that is excluded from income, the taxpayer must only reduce their basis in the principal residence.

Recourse and Nonrecourse Debt

In some cases, COD income may also be excluded from gross income when the property that secured the debt is sold to the creditor in exchange for full or partial satisfaction of the debt. The tax treatment will depend on whether the taxpayer was personally liable for the debt (recourse debt) or not personally liable for the debt (nonrecourse debt).

If the property was subject to a nonrecourse debt, the amount realized by the sale would be the entire amount of the nonrecourse debt plus the amount of cash and the fair market value (FMV) of any property the taxpayer received. Ordinary income will not result from this COD.

On the other hand, if the property was subject to a recourse debt, the seller would realize the fair market value (FMV) of the property. Ordinary income from the COD would be the amount of the debt in excess of that FMV. This COD must be included in the taxpayer's income in most cases. The difference between the FMV and the adjusted basis (i.e. taxpayer's cost) will be considered gain or loss on the disposition of the property.

Treatment of COD During the COVID-19 Crisis

On face value, it would appear that taxpayers who have non-PPP debt canceled, forgiven or discharged during the COVID-19 crisis and do not meet any of the exclusions above, would be subject to tax on the COD income.

For example, assume a business hopes to "hang on" through the crisis and chooses not to formally file for Chapter 11 bankruptcy. The company is not necessarily insolvent but has stopped making its loan payments due to government-mandated closures. The business somehow survives but will never be able to repay its debt due to the devastating impact of COVID-19 losses. The business discontinues making loan payments, and the lender writes the debt off rather than pursue the outstanding balance. (This may be in part because the lender needs or wants to expense the losses now, rather than chase down a business that defaulted due to factors outside of their control). Under current law, the business – not completely insolvent or in Chapter 11 – has to report the canceled amount as gross income.

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Given the severity and duration of the COVID-19 crisis, we're hopeful that the IRS and regulators will relax these rules and offer some form of relief to taxpayers who have non-PPP debt canceled as a result of the pandemic. In the meantime, it is crucial for business owners to consider possible tax implications as they plan the financial recovery and future of their companies.

For more information:

Lou Pizzileo, CPA
Partner, Grassi Advisors & Accountants
516.336.2455
lpizzileo@grassicpas.com

Alice H. Varisano, CPA
Tax Partner, Grassi Advisors & Accountants
516.336.2430
avarisano@grassicpas.com

Sean Murray
President, deBanked
212.220.9084
sean@debanked.com