

REPORT #692

TAX SECTION

New York State Bar Association

Treatment of Cancellation of Debt Income

June 10, 1991

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June 10, 1991

The Honorable Carol O'Cleireacain
 Commissioner
 New York City Department of
 Finance
 Municipal Building
 New York, New York

Dear Commissioner O'Cleireacain:

We understand that the New York City Department of Finance ("Department") is considering how cancellation of debt ("COD") income should be treated under the New York City General Corporation Tax ("GCT"). Specifically, the heretofore unaddressed issue is whether COD income should be classified as subsidiary, investment or business income. This letter sets forth the views of the Tax Section on this issue.¹

Since New York's trifurcated tax scheme is unique, there is little analogous authority from other states or from the Internal Revenue Code of 1986 ("Code") on which to rely.² Also, the

¹ This letter was prepared primarily by James Locke. A similar letter was sent to Commissioner Wetzler commenting on the treatment of COD income under substantially identical provisions of the franchise tax imposed by Article 9-A of the New York Tax Law.

² There are many unresolved issues under federal tax law concerning COD income and our comments here are directed only to the unique issues raised under the New York tax.

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existing statutes and regulations in New York do not provide a clear answer. We recommend that New York City take an approach which results in consistency between income and deductions and prevents whipsawing of both taxpayers and the Department. In our view, these goals can best be met by allocating COD income based on the historic allocation of the debt discharged.

Background.

The portion of the GCT imposed on income is based on a taxpayer's "entire net income" allocable to the City. Entire net income is defined as total net income from all sources and is presumptively the same as the taxpayer is required to report for federal income tax purposes, subject to many statutory adjustments. One of these adjustments provides that in computing entire net income, all dividends, interest and gains from "subsidiary capital" are excluded. Subsidiary capital is defined generally to include investments in the stock of, and any indebtedness from, subsidiaries.

Entire net income is composed of investment income and business income. Investment income is defined as "income, including capital gains in excess of capital losses, from investment capital." Investment capital is defined as investments in stocks, bonds and other securities, corporate and governmental, not held for sale to customers in the regular course of business, exclusive of subsidiary capital and stock issued by the taxpayer. Business income is all income included in entire net income which is not investment income.

Generally, income from subsidiary capital is the most tax-favored type of income for GCT purposes since it is excluded from entire net income. Allocated investment income and allocated business income are taxed at the same rate; however, the rules for allocating the two types of income differ. Thus, the classification of income as either investment or business income can make a substantial difference.

Generally, since a taxpayer has more control over the sources of its investment income than over the sources of its business income, classification of income as investment income would be preferred by taxpayers.

COD income arises when a liability of the taxpayer is cancelled or reduced. A taxpayer's own liabilities are not specifically included within the definition of subsidiary, investment or business capital but rather offset capital in those categories. Specifically, liabilities which are "directly or indirectly" attributable to subsidiary or investment capital are "deducted" from subsidiary or investment capital, respectively,³ and all other liabilities reduce business capital. Interest on indebtedness directly or indirectly attributable to subsidiary capital or to income, gains or losses from subsidiary capital that is deducted for federal income tax purposes is added back into income for GCT purposes. Interest on indebtedness directly or indirectly attributable to investment income is deducted in computing investment income. Interest on all other indebtedness, to the extent otherwise deductible, is deducted in computing business income. See Statement of Audit Procedure CAP/GCT, March 22, 1991 referencing General Corporation Tax Policy Bulletin 2-84 and TSB-M-88(5)C.

Recommendation.

We believe that COD income created by the cancellation of a liability should be classified in the same manner as the type of capital from which such liability is "deducted". In other words, if the liability is "attributable to" and reduces the taxpayer's subsidiary capital, and as a result, no New York tax benefit is claimed by the taxpayer with respect to interest paid on the indebtedness, any COD income with respect to such liability should likewise be attributable to subsidiary

³ In the case of indebtedness attributable to subsidiary or investment capital, the deduction of liabilities is subject to the discretion of the Commissioner.

capital and excluded from entire net income. If a liability is attributable to investment capital and the interest on such liability is deductible in computing investment income, COD income resulting from such liability should be investment income. All other COD income would become business income.

In order to prevent abuse, it may be necessary to allocate the COD income based upon the treatment of the liability over a longer period than merely the year of cancellation, perhaps by using the average allocation of the liability between the three types of capital over the preceding three to five years. This would discourage a taxpayer from increasing the allocation of the liability to subsidiary capital in the year the COD income is realized. In addition, since a corporation's investment allocation percentage can be planned, a look back method for determining the investment allocation percentage for the portion of the COD income allocable to investment capital might also be necessary.

Discussion.

We are aware of no direct authority on this question in New York and the statute and regulations provide no clear answer. One possible interpretation of the statute would be that since liabilities are not directly included in the definition of subsidiary or investment capital, all COD income must be business income. As pointed out by the examples which follow, such an interpretation leads to results which are contrary to rational tax policy.

We believe that our position can be supported by a careful reading of the statutes involved. Considering first subsidiary capital, income from subsidiary capital is defined to include all dividends, interest and gains from subsidiary capital. The definition of subsidiary capital provides that at the Commissioner's discretion certain liabilities directly or indirectly attributable to assets included in subsidiary capital are deductible from subsidiary capital. COD income is generally

treated as income on the ground that the discharge of debt frees up assets and, like other income, increases the taxpayer's net worth.⁴ To the extent a debt was deductible from subsidiary capital, the accretion of wealth resulting from a discharge of the debt will be reflected on the taxpayer's "tax balance sheet" as an increase in subsidiary capital. It should follow that COD income with respect to liabilities attributable to subsidiary capital is a "gain from subsidiary capital." Likewise, investment income is defined to mean all "income . . . from investment capital." Since at the Commissioner's discretion liabilities directly or indirectly attributable to assets included in investment capital are deducted in measuring investment capital, COD income arising with respect to such liabilities is "from" investment capital.

Our recommendation is supported by recent amendments to the regulations defining "investment capital" and "investment income." Those regulations made clear that futures and forward contracts are not investment capital. GCT Reg. Sec. 3-31(a)(4). However, gain or loss from closing a position in a futures or forward contract which diminishes the taxpayer's risk of loss from holding assets which constitute investment capital is treated as investment income or loss. Similarly, premium income from an unexercised option on an asset constituting investment capital is considered investment income. See GCT Reg. Sec. 4-52(a)(2) and (5). Thus, the regulations provide that gain or loss from a liability that economically offsets investment capital, even if the liability is not itself investment capital, is investment income

⁴ The seminal federal income tax case on the taxation of COD income is United States v. Kirby Lumber Co., 284 U.S. 1, which justifies the tax as follows (284 U.S. 3): "As a result of its dealings [the taxpayer] made available . . . assets previously offset by the obligation of bonds now extinct. We see nothing to be gained by the discussion of judicial definitions. The defendant in error has realized within the year an accession to income, if we take words in their plain popular meaning, as they should be taken here."

or loss. We believe that the position taken in these regulations is directly analogous to our suggested treatment for COD income.

Our position is also consistent with the basic tax principle, expressed at the federal level in Arrowsmith v. Commissioner, 344 U.S. 6 (1952), that an item that represents a reversal of an earlier item should have the same character as the earlier item. In effect, COD income either reverses previously accrued interest expense or offsets the tax effects of basis in the item financed with the debt. Cf. section 108(e)(5) of the Code (COD income attributable to cancellation of purchase money debt treated as reduction in purchase price).

Examples

We believe the following examples illustrate that our interpretation results in the correct tax policy result.

Example 1: Corporation A borrows \$1000 at an annual interest rate of 10% from Bank X to invest in \$1000 of publicly traded corporate bonds with a stated interest rate of 15% issued by an unaffiliated corporation. These bonds constitute Corporation A's only investment capital. The New York City allocation percentage of the issuer of the bonds is 1%. The difference between the income earned on the bonds and the interest expense incurred on the loan from Bank X would be investment income, 1% of which is allocable to New York City. In effect, 1% of the interest expense on the loan from Bank X is deductible for GCT purposes. Assume Corporation A's New York City business allocation percentage is 60%.

Corporation A accrues, but does not pay, the interest on the loan from Bank X and some or all of the accrued interest is later cancelled by Bank X.

Corporation A has income for federal tax purposes from the discharge of the accrued interest expense (assuming a federal tax benefit was received for the accrued interest). We believe that this COD income should be income from investment capital. Since only 1% of the accrued interest was deductible for GCT

purposes, only 1% of the income realized from the discharge of the accrued expense should be taxed. It would make no sense to treat the recovery of an item deducted only to the extent of 1% as business income, 60% of which is allocated to New York City.

Example 2: Corporation B issues a \$1000 bond bearing interest at 15% for \$1000 in cash. The bond has a term of 10 years and is publicly traded. The proceeds were invested in a wholly owned subsidiary of Corporation B. Corporation B treated all interest expense on the bonds as attributable to subsidiary capital and thus did not receive a New York tax benefit for such expense. Corporation B subsequently suffers financial problems and agrees to exchange new publicly traded bonds with the same principal amount and maturity with interest at 10% for its outstanding bonds. The fair market value of the new bonds is \$400. As a result of the changes made by the Revenue Reconciliation Act of 1990, Corporation B will have \$600 of COD income and original issue discount of \$600 (some or all of which may be deductible only when paid under section 163(e)(5) of the Code).

We believe that the \$600 of COD income should be income from subsidiary capital and thus excluded from entire net income. If a contrary conclusion were reached, the \$600 of COD income would be included in entire net income as business income but the \$600 of OID deductions in subsequent years would be disallowed since such deductions are from a liability directly attributable to subsidiary capital.

Example 3: Bank Y loans Corporation C \$1000 on a nonrecourse basis to acquire shares of Subsidiary D for which Corporation C pays \$1500. The loan is secured by the Subsidiary D shares. Corporation C is a holding company whose only assets are the shares of Subsidiaries D, E and F. Since the loan was directly attributable to the acquisition of the shares of a subsidiary, Corporation C cannot deduct the interest on the loan in computing entire net income. Subsequently, due to financial reverses, the value of the shares of Subsidiary D declines to \$500. Bank Y agrees to modify the terms of the loan by reducing the principal amount

of the note to \$500. Corporation C has COD income of \$500 as a result of the reduction of its nonrecourse loan. See Rev. Rul. 91-31 (May 20, 1991); Gershkowitz v. Commissioner, 88 T.C. 984 (1987). Corporation C subsequently sells Subsidiary D for \$500. C has a \$1000 loss from sale of the subsidiary. Corporation C's net economic loss is \$500 (\$500 of COD income less a \$1000 loss on the sale).

The loss on the sale of Subsidiary D would be a nondeductible loss from subsidiary capital. We believe that the COD income should similarly be treated as income from subsidiary capital resulting in a \$500 net loss from subsidiary capital. Note that this result is the same as if Bank Y had foreclosed on the loan, rather than modifying its terms. In that event Corporation C would have had no COD income but would have recognized a \$500 loss on the foreclosure that would be a loss from subsidiary capital. The tax consequences of these economically equivalent transactions should not differ. By contrast, if in the debt reduction/sale case, the \$500 of COD income were treated as business income, Y would have \$500 of business income and a \$1000 loss from subsidiary capital, which would not reflect the economics of the transaction to C, and would be a very different tax result from the economically equivalent foreclosure case.

We urge you to clarify the rules for COD income in accordance with our recommendations. We would of course be pleased to discuss the allocation issue and our recommendations with you or your staff.

Very truly yours,

James M. Peaslee
Chair