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November 20, 2012

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## Re: Report on Insolvency under Section 108: the Treatment of Contingent Liabilities

Dear Messrs. Mazur, Miller and Wilkins:

I am pleased to submit the attached report of the Tax Section of the New York State Bar Association, which provides recommendations for additional guidance regarding the treatment of contingent liabilities in the determination of insolvency for purposes of Section 108(a)(1)(B).

By way of background, when a taxpayer's debt is forgiven in whole or in part, Section 61(a)(12) requires that the taxpayer recognize gross income from cancellation of indebtedness. Under the "insolvency exception" of Section 108(a)(1)(B), however, income from cancellation of indebtedness is excludible from gross income to the extent that a taxpayer is insolvent. Whether a taxpayer is insolvent, and the extent to which a taxpayer is insolvent, is determined by calculating the excess of the taxpayer's liabilities

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over the fair market value of the taxpayer's assets immediately before the debt discharge.

Neither the Code nor the Treasury Regulations provide any guidance regarding the treatment of contingent liabilities for purposes of the insolvency exception. In *Merkel v. Commissioner*, the Tax Court concluded that contingent liabilities may be included in the insolvency determination, but only if "it is more probable than not that [the taxpayer] will be called upon to pay that obligation in the amount claimed . . . ." The Ninth Circuit affirmed.

Because we believe this "all-or-nothing" approach is inherently flawed, we do not recommend that Treasury and the IRS adopt the *Merkel* approach in future guidance. Under *Merkel*, a taxpayer with a contingent liability that has a 49% probability of being paid is not permitted to include any portion of the contingent liability in the insolvency determination, while a taxpayer with a contingent liability that has a 51% probability of being paid may include the entire liability. In both cases, the result does not accurately reflect the true economic impact of a contingent liability on a taxpayer's net worth.

We therefore recommend that contingent liabilities (without regard to whether they are "more probable than not") should generally be included in the insolvency determination under Section 108(d)(3), but not in excess of their actual fair market values, as determined on the same basis as the valuation of contingent liabilities under Treas. Reg. § 1.752-7(b)(3)(ii). To minimize the complexity associated with any future guidance that adopts this approach and to ensure that the insolvency exception of Section 108(a)(1)(B) remains a viable alternative to filing for bankruptcy protection, we also recommend that contingent liabilities that are remote (*e.g.*, a less than 20% probability of payment) should be ignored in the insolvency determination.

Finally, we recommend an optional safe harbor for valuing contingent liabilities in the insolvency determination in the case of corporate taxpayers that discharge debt by issuing stock to creditors, which we believe will simplify the determination in many out-of-court debt restructurings.

The report also includes a number of other technical comments and recommendations.

Respectfully submitted



Andrew W. Needham  
Chair

Enclosures

cc: William D. Alexander  
Associate Chief Counsel (Corporate)  
Internal Revenue Service

Messrs. Mazur, Miller and Wilkins

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