INTERNAL REVENUE SERVICE
NATIONAL OFFICE TECHNICAL ADVICE MEMORANDUM

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District Director

Taxpayers' Names:

Taxpayers' Address:

Taxpayer's Id. Nos.:

Year:

LEGEND

x:
STATE:

ISSUE

For purposes of § 108(d)(3) of the Internal Revenue Code, which, if any, of the taxpayers' assets are not included in a determination of whether the taxpayers are insolvent.

CONCLUSION

The fair market value of any assets exempt from a creditor's claims under state law is included in determining a taxpayer's insolvency under § 108(d) of the Internal Revenue Code. The contrary conclusion reached in technical advice memorandum 9130005 (TR-32-191-90) has been reconsidered, and this technical advice memorandum revokes technical advice memorandum 9130005.

FACTS

On October 9, 1984, the taxpayers purchased their residence for 130x dollars. On October 7, 1987, the mortgagee foreclosed on the residence using a non-judicial foreclosure proceeding. At the time of the foreclosure, the residence had a fair market value of 100x dollars and was subject to a mortgage with an outstanding balance of 122x dollars. Due to the State anti-deficiency statute, the mortgagee is barred from attempting to collect from the mortgagor a deficiency resulting from the non-judicial foreclosure of a residence whose fair market value has fallen below the outstanding mortgage balance. Under State law, a mortgagee has the option of foreclosing using a judicial procedure, under which a deficiency judgment can be enforced, or a non-judicial procedure, under which a deficiency judgment is prohibited. Therefore, the deficiency of 22x was discharged by the non-judicial foreclosure. It is represented that the taxpayers were insolvent on the date of the foreclosure if assets exempt from the claims of creditors under applicable state law are not included in the insolvency determination. The taxpayers have not filed bankruptcy.

APPLICABLE LAW AND RATIONALE

Under § 61(a)(12) of the Code, except as otherwise provided, gross income means all income including income from the discharge of indebtedness.

Example 8 of § 1.1001-2(c) of the Income Tax Regulations provides that when property subject to a recourse liability is transferred to a creditor in satisfaction of the liability, the taxpayer has capital gain or loss to the extent of the difference between the fair market value of the property and the taxpayer's basis in the property and discharge of indebtedness income to the extent of the difference between the outstanding amount of the indebtedness and the fair market value of the property.

Section 108(a)(1)(B) of the Code provides that discharge of indebtedness income is excluded from gross income if the discharge occurs when the taxpayer is insolvent. Section 108(a)(3) provides that the amount excluded by § 108(a)(1)(B) shall not exceed the amount by which the taxpayer is insolvent.

Section 108(d)(3) of the Code defines insolvent to mean the excess of liabilities over the fair market value of assets determined immediately before the discharge.

The Bankruptcy Tax Act of 1980, Pub. L. No. 96-589, 1980-2 C.B. 607, substantially amended § 108 of the Code, and (among other things) codified in § 108(a)(1)(B) the judicially developed insolvency exception to the general rule that income is realized upon the discharge of indebtedness. See S. Rep. No. 96-1035, 96th Cong., 2d Sess. 8 (1980), 1980-2 C.B. 623. The Bankruptcy Tax Act also added § 108(e)(1) of the Code, which provides that the insolvency exception in § 108(a)(1)(B) is the exclusive insolvency exception.

The statutory language of § 108(d)(3) of the Code does not specify which assets and which liabilities are taken into consideration for determining the definition of insolvent and the committee reports to the Bankruptcy Tax Act do not clarify this definition. Although case law interpreting the judicial insolvency exclusion that was in effect prior to the enactment of the Bankruptcy Tax Act of 1980 excluded assets exempt from creditors under state law (see, Cole v. Commissioner, 42 B.T.A. 1110 (1940), Marcus Estate v. Commissioner, T.C. Memo. 1975-9, AOD April 16, 1975), the statutory language places no limitation on assets that are taken into account in determining a taxpayer's solvency. The plain meaning of the term asset in § 108(d)(3) would include all of the taxpayer's assets in the insolvency calculation. Generally, where the language of a statute is clear and unambiguous, no further inquiry into the meaning of the statute is needed. 1 Mertens Law of Federal Taxation § 3.05 (1991). Further, § 108, as an exclusion from income, is to be construed narrowly. U.S. v. Centennial Savings Bank FSB, 499 U.S. 573, 583 (1991).

Further, the legislative history provides no clear guidance regarding the treatment of exempt assets for purposes of the insolvency definition. The legislative history specifically cites Dallas Transfer & Terminal Co. v. Commissioner, 70 F. 2d 95 (5th Cir. 1934), and Lakeland Grocery Co. v. Commissioner, 36 B.T.A. 289 (1937), which established the prior judicial insolvency exception. S. Rep. No. 96-1035, 96th Cong., 2d Sess. 8 (1980), 1980-2 C.B. 623. It does not cite the progeny of those cases that held, in applying the judicial insolvency exception, assets exempt under state law should not be included in the measure of insolvency. See, Cole v. Commissioner, 42 B.T.A. 1110 (1940), Marcus Estate v. Commissioner, T.C. Memo. 1975-9, AOD April 16, 1975). In United States v. Ron Pair Enterprises, Inc., 489 U.S. 235 (1989), the Supreme Court provided guidance as to when a judicial principle is so longstanding and well-established that it must be considered in statutory interpretation. If the Supreme Court has "never clearly acknowledged or relied upon" the exception in question, then it "counsels against concluding that the [exception] was well recognized." Ron Pair, 489 U.S. at 247. Since the judicial rule establishing the exclusion of exempt assets was never clearly acknowledged or relied upon by the Supreme Court, and in the absence of any specific citation to that rule in the legislative history, the rule should not be considered in interpreting the subsequent statutory rules dealing with insolvency.

In addition, in Bankruptcy Code §101(32), Congress defined insolvent to exclude, among other things, property that may be exempted from property of the estate under § 522 of the Bankruptcy Code, which includes assets exempt under state law. Thus, arguably, when Congress intended to exclude state exempt assets, it specifically provided such an exclusion.

The legislative history underlying § 108 indicates that a bankrupt debtor and an insolvent debtor should be provided with a fresh start in that they should not be burdened with current taxation on the discharge of indebtedness. S. Rep. No. 96-1035, 96th Cong., 2d Sess. 9-10 (1980), 1980-2 C.B. 624. This rationale was based upon the fact that such debtors would not have assets available to pay a tax liability that would arise upon the discharge of their debts. However, excluding exempt assets from the measure of insolvency would provide taxpayers who are economically solvent, i.e. whose total assets exceed their liabilities, the opportunity to defer a current tax in instances where they have the ability to pay the tax. Such taxpayers would have assets available to pay a tax liability (although the assets would be exempt from the reach of creditors under state law).

For the reasons discussed above, we conclude that assets exempt from creditor’s claims under state law should be included in determining a taxpayer's solvency for purposes of §§ 108(d) and 108(a)(1)(B).

In this case, the taxpayers have discharge of indebtedness income as a result of the mortgagee's non-judicial foreclosure on their residence since State's anti-deficiency statute relieved them of their liability for any deficiency on the mortgage note. The taxpayers in this case may not exclude assets exempt from the claims of their creditors under State law from the calculation of their total assets for purposes of determining whether they are insolvent under section 108 of the Code.

A copy of this technical advice memorandum is to be given to the taxpayer. Section 6110(j)(3) of the Code provides that it may not be used or cited as precedent.