

Internal Revenue Service

Department of the Treasury
Washington, DC 20224

Number: **2012-0019**

Release Date: 3/30/2012

Third Party Communication: None
Date of Communication: Not Applicable
Person To Contact:

Index Number: 61.00-00, 108.01-02, 108.02-00

, ID No.

Telephone Number:

Refer Reply To:
CC:ITA:B04
PLR-141357-11
Date:
March 01, 2012

Dear :

This is in reply to your request for a private letter ruling under §§ 61 and 108 of the Internal Revenue Code regarding a planned reduction in the principal balance of, and waiver of accrued interest on, a debt secured by stock in a company that you purchased from your .

While the Internal Revenue Service strives to be responsive to taxpayers' inquiries regarding the tax treatment of transactions, there are certain areas in which we are precluded from issuing letter rulings. In a telephone conversation on February 8, 2012, with Paul Lundberg, your authorized representative, Shareen Pflanz and I and representatives of the Office of Associate Chief Counsel (Financial Instruments and Products) explained that we cannot issue the requested rulings because they involve either issues clearly and adequately addressed by statute, regulations, decisions of a court, or other authority published in the Internal Revenue Bulletin or determinations that are primarily factual. See § 6.11 of Rev. Proc. 2012-1, 2012-1 I.R.B. 1, 17, and § 4.02(1) of Rev. Proc. 2012-3, 2012-1 I.R.B. 113, 121.

Because we cannot issue the requested private letter ruling, we are closing our file on this case. We will return the user fee you submitted in a separate correspondence.

Although we cannot issue a private letter ruling, we hope that the following general information explaining the rules regarding discharge of indebtedness income under §§ 61, 108, and 1001 is helpful to you.

You specifically asked if a reduction of the principal amount of an installment note and a waiver of accrued interest on the installment note should be treated as a repurchase of a debt instrument under § 1.61-12(c) of the Income Tax Regulations, generating cancellation of debt income. You also asked whether any cancellation of indebtedness income may be excluded from your income under the insolvency exception of § 108(a)(1)(B).

Section 61(a)(12) of the Code provides that gross income includes income from discharge of indebtedness. Section 1.61-12 provides that income from the discharge of indebtedness may result from the repurchase of a debt instrument. The repurchase of a debt instrument can come from the exchange (under § 1001) of a newly issued debt instrument for an existing debt instrument (see § 1.61-12(c)(2)).

Section 1001 and the regulations thereunder apply to the exchange of a debt instrument for a modified debt instrument. Gain or loss is realized under § 1.1001-1(a) when a debt instrument is exchanged for an instrument that is materially different either in kind or in extent. The amount realized on this disposition does not include amounts that are (or would be if realized and recognized) income from the discharge of indebtedness under § 61(a)(12) if the disposition is of property that secures a recourse liability (see § 1.1001-2(a)(2)). A significant modification to a debt instrument results in an exchange of the debt instrument for an instrument that differs materially either in kind or in extent (see § 1.1001-3(b)). Section 1.1001-3(e)(2) provides the rule for when a change in yield on a debt instrument that provides for only fixed payments is considered a significant modification. Several examples of significant modifications are provided in § 1.1001-3(g) including the following example of when a change in yield results from a change in principal:

§ 1.1001-3(g), Example (3):

- (i) A debt instrument issued at par has an original maturity of ten years and provides for the payment of \$100,000 at maturity with interest payments at the rate of 10 percent payable at the end of each year. At the end of the fifth year, and after the annual payment of interest, the issuer and holder agree to reduce the amount payable at maturity to \$80,000. The annual interest rate remains at 10 percent but is payable on the reduced principal.
- (ii) In applying the change in yield rule of § 1.1001-3(e)(2), the yield of the instrument after the modification (measured from the date that the parties agree to the modification to its final maturity date) is computed using the adjusted issue price of \$100,000. With four annual payments of \$8,000, and a payment of \$88,000 at maturity, the yield on the instrument after the modification for purposes of determining if there has been a significant modification under § 1.1001-3(e)(2)(i) is 4.332 percent. Thus, the reduction in principal is a significant modification.

If a modification of a debt instrument results in discharge of indebtedness income under § 61(a)(12), then the amount of income recognized is calculated in accordance with § 108(e)(10). Under § 108(e)(10), for purposes of determining income from discharge of indebtedness, if a debtor issues a debt instrument in satisfaction of indebtedness, the debtor is treated as having satisfied the indebtedness with an amount of money equal to the issue price of the instrument.

Section 108(a)(1)(B) provides that discharge of indebtedness income will be excluded from gross income if the discharge occurs when the taxpayer is insolvent. The amount excluded from gross income by reason of the insolvency exclusion may not exceed the amount by which the taxpayer is insolvent. (see § 108(a)(3)). For purposes of the insolvency exception, the Code defines “insolvent” as the excess of liabilities over the fair market value of assets. (see § 108(d)(3)). In addition, whether the taxpayer is insolvent and the amount of insolvency is determined on the basis of the taxpayer’s assets and liabilities immediately before the discharge.

Section 108(b)(1) provides that if income from the discharge of indebtedness is excluded from gross income under § 108(a)(1)(B), the amount excluded from income is applied to reduce the tax attributes of the taxpayer as provided in § 108(b)(2).

Section 108(b)(2) requires the reduction of tax attributes to be made in the following order: (A) net operating losses, (B) general business credits, (C) minimum tax credits, (D) capital loss carryovers, (E) basis reduction, (F) passive activity losses and credit carryovers, and (G) foreign tax credit carryovers. Under § 108(b)(5), however, a taxpayer, subject to certain limitations, may elect to apply the reduction in tax attributes to the reduction under § 1017 of the basis of the taxpayer’s depreciable property.

Finally, § 108(e)(2) provides that no income is realized from the discharge of indebtedness if payment of the liability would have given rise to a deduction.

We hope this general information is helpful to you. This general information letter does not constitute a ruling. See § 2.04 of Rev. Proc. 2012-1.

If you have any questions, please contact _____ or me at () _____. In accordance with the Power of Attorney on file with this office, a copy of this letter is being sent to your authorized representative.

Sincerely,

Michael J. Montemurro
Chief, Branch 4
Office of Associate Chief Counsel
(Income Tax & Accounting)

cc: