

No Exclusion of Discharge of Indebtedness Income for Insolvent Disregarded Entities

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April 2011

On April 13, 2011, proposed Treasury Regulations Section 1.108-9 was issued in which it was made clear that the insolvency of a disregarded entity will not in itself result in the exclusion from gross income under Sections 108(a)(1)(A) and (B) of the Internal Revenue Code of the amount of debt discharged.

Disregarded Entities

Certain entities are treated as not in existence (disregarded) for income tax purposes and their owner or owners are treated as carrying on the activity of the entity directly and owning its property directly. (The entity nevertheless retains its separate attributes for purposes other than income tax; as such, a single-member limited liability company continues to insulate its member from liability.) Such disregarded entities include:

- Limited liability companies formed in the United States with a single member (unless an election is made to treat the entity as a corporation)
- Certain subsidiaries of real estate investment trusts and S corporations
- Grantor trusts which are created in such a way that the grantor retains certain powers or benefits that result in the grantor's being treated as the owner of the trust assets (for example, a corporation that is the sole member of a domestic limited liability company would ignore the limited liability company and treat its business as being carried on directly by the corporation as a division)

Application of Insolvency Rules

For federal income tax purposes a taxpayer is insolvent if it (a) has liabilities in excess of the value of its assets or (b) is in a bankruptcy proceeding. A taxpayer in a bankruptcy proceeding does not recognize income from indebtedness discharged in the proceeding. An insolvent taxpayer, outside of bankruptcy, recognizes no income from discharge of indebtedness up to the point that "solvency" is achieved; that is, at the point that liabilities and the value of the taxpayer's assets are equal. Additional discharge of debt would result in the recognition of income to the extent of such additional discharged debt.

Proposed Regulation

The proposed Regulation simply holds that the disregarded entity is not the "taxpayer" for purposes of the exclusion applicable to insolvent taxpayers. In other words, the circumstances upon which the benefits of Sections 108(a)(1)(A) and (B) may be invoked must exist as to the taxpayer that is the owner of the disregarded entity and not merely as to the disregarded entity. This is the logical result of the income tax treatment of an entity as being nonexistent.