

Cancellation of Indebtedness as Income under Pennsylvania Law, Part III.

This post will continue the discussion of the Commonwealth's decision in *Marshall v. Commonwealth*, No. 933 F.R. 2008 (Pa. Commw. Jan. 3, 2012) with a focus on the statutory construction issues presented by Mr. Marshall's predicament.

The treatment of income from cancellation of indebtedness in *Marshall* represented an issue of first impression, leading the court to look at federal law for guidance. As a consequence, a brief review of some basic federal principles is in order.

First, in *Crane v. Commissioner*, 331 U.S. 1 (1947), the Supreme Court held that where real estate is sold subject to a non-recourse mortgage loan that did not exceed the property's value, the seller has to include the balance of the non-recourse loan in calculating the amount realized from the disposition of the property when it is sold subject to the mortgage.

Second, in *Tufts v. Commissioner*, 461 U.S. 300 (1983), the Supreme Court held that when the unpaid balance of a non-recourse mortgage loan exceeded the value of the real estate, the seller still must include the unpaid balance of the mortgage in calculating the amount realized from a disposition of the property. The Court offered several reasons for this conclusion:

- When a taxpayer borrows on a non-recourse basis, he incurs an obligation to repay the loan and that obligation is why the loan proceeds are not income subject to tax, 461 U.S. at 307;
- When the proceeds of a non-recourse loan are used to acquire or improve real estate, the taxpayer includes them in calculating his basis in the property, because of the obligation to repay, 461 U.S. at 307-08;
- Unless the outstanding amount of the loan is included in determining the amount realized upon disposition of the property, the taxpayer will effectively have received untaxed income when the loan was made and received an inappropriate increase in basis, 461 U.S. at 309-10.

Under the Pennsylvania personal income tax, there are a series of different classes of income, one of which includes "[n]et gains or income from disposition of property." 72 P.S. § 7303(a)(3). A regulation issued under the statute indicates that a gain occurs on disposition of property if "the amount realized from the conversion of the property into cash or other property exceeds the adjusted basis of the property." 61 Pa. Code § 103.13(a).

Marshall's first line of attack on the statutory construction front was to argue that he received no cash or property, and therefore he had no income, based upon the plain language of the regulation. The majority rejected Marshall's contention, noting that the Department of Revenue had a practice of construing its regulation to include the amount of any debt that was discharged through foreclosure, which the court concluded was reasonable in light of the similarity between the language of the regulation and the language of Section 1001 of the Internal Revenue Code, which also references money and other property in defining the amount realized. *Marshall*, slip op. at 15.

The problem, however, as the dissenters note, is that Section 61(a)(12) of the Internal Revenue Code explicitly includes cancellation of indebtedness in the definition of income and the Pennsylvania statute does not. And if the statute does not treat cancellation of indebtedness as income, the validity of the Department of Revenue's interpretation of its regulation to include

cancellation of indebtedness in calculating gain is questionable, particularly since Pennsylvania has a statute that calls for the strict construction of any provision imposing a tax. 1 Pa. C.S.A. § 1928(b)(3).

Marshall also made a series of arguments designed to limit the amount of cancellation of indebtedness income. He argued that the amount of cancellation of the indebtedness income should be limited, since only 308 million dollars of the debt went into basis. This argument rested on one of the reasons that the Supreme Court offered in support of its holding in *Tufts*, the fact that loan proceeds had been included in the taxpayer's basis. While this argument has some surface appeal, I think it breaks down when carefully scrutinized. First, *Tufts* was decided on the basis of *Crane*, and the mortgage obligation at issue there included unpaid interest accruals not just acquisition debt. Second, the Court in *Tufts* explicitly indicated that its holding was not based primarily on tax benefits that the taxpayers had received, it was focused upon the fact that there was an obligation to repay the loan, not the tax benefits that accrued to the borrower. 461 U.S. at 310 n.8. Thus, to the extent that the majority decision to consider the federal approach to cancellation of indebtedness was appropriate, its analysis of how *Tufts* would apply was correct.

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