

Tax Alert: Determination of taxable and exempted income attributable to the discharge of indebtedness

On November 7, 2016, the Puerto Rico Treasury Department (“PRTD”) issued Administrative Determination No. 16-14 (“AD 16-14”) to discuss what constitute taxable and exempt income when there is a discharge of indebtedness related to mortgage loans or when the debtor is insolvent. Moreover, AD 16-14 institutes a mechanism for the latter case (i.e. when there is discharge of indebtedness to an insolvent debtor), whereby both the creditor and debtor will be able determine the amount of taxable and exempt income in those particular instances.

What does the forgiveness of debts mean?

The forgiveness (or cancellation) of debts results when the creditor totally or partially releases the debtor from the fulfillment of an obligation through a written agreement.

Income from discharge of indebtedness under the PR Internal Revenue Code

Pursuant to Section 1031.01(a)(6) of the 2011 PR Internal Revenue Code, as amended (“PR Code”), income derived from the discharge of indebtedness must be included as gross income for tax purposes.

Nonetheless, if the discharge of indebtedness is attributable to any of the following circumstances, the amount so derived will not be considered taxable income:

- Debt discharged under Title 11 of the United States Code;
- Debt discharged when the taxpayer is insolvent;

- Student loans forgiveness, if the discharge is allowed under the terms of the loan after the Taxpayer has worked during a determined period of time;
- The discharged indebtedness occurs as a result of the reorganization of a mortgage loan guaranteed by the qualified residence of the taxpayer.

For its part, pursuant to Section 1063.14 of the PR Code, the creditor who condones the indebtedness may claim a deduction for the loss on said discharge by issuing an Informative Declaration to the debtor.

In order to determine the exempted amount from a discharge of indebtedness transaction due to insolvency, the debtor must submit evidence of the insolvency status to the creditor. As a requirement, the debtor must submit to the creditor an *Agreed Upon Procedures Report* prepared by a *Certified Public Accountant* authorized to practice in Puerto Rico and who belongs to a *Peer Review Program*. This report must contain the required information by AD 16-14 and must be submitted within thirty (30) days after the transaction that resulted in the indebtedness discharge. However, in the case of transactions that occurred during calendar year 2016, the debtor will have until January 31, 2017 to submit to the creditor the aforementioned report.



Contact us

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December 16, 2016

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The amount of discharge that constitutes exempt income to the debtor will be disclosed on *Form 480.6D, Informative Return – Exempt Income and Exempt Income Subject to Alternate Basic Tax*, while taxable income will be evidenced on *Form 480.6A, Informative Return – Income Not Subject to Withholding*.

What is a Mortgage Loan reorganization?

The PRTD has determined that a mortgage loan has been subject to reorganization when the mortgagee relinquishes his right to collect part or the entire owed amount. Examples of reorganized mortgage loans are:

- Short sales;
- Short pay-offs;
- Discharges; and
- Payment instead of performance

Exclusion of income derived from the cancellation of indebtedness by restructuring a mortgage loan

As noted above, Section 1031.01(b)(10)(A)(iv) of the PR Code states that indebtedness discharged as a result of the reorganization of a mortgage loan guaranteed by the qualified principal residence of the taxpayer will be excluded from gross income, so long as original mortgage loan debt does not exceed \$1,000,000. Therefore, the gross income exclusion under Sec. 1031.01(b)(10)(A)(iv) will only apply to the that mortgage loans that do not exceed \$1,000,000.

AD 16-14 provides an illustrative example - if the original debt related to the principal residence was \$1,250,000, the amount of exempted income will be 80%. ($\$1,000,000 / \$1,250,000$). In this example, if the balance to be discharged was \$900,000, the exempted amount would be 80%, that is, \$720,000 ($\$900,000 \times 80\%$) and the difference of \$180,000 ($\$900,000 - \$720,000$) would be taxable amount.

Exclusion of income from discharge of indebtedness due to insolvency of the debtor

In transactions where the discharge of indebtedness is due to debtor's insolvency, Section 1031.01(b)(10)(A)(ii) of the PR Code provides that the amount excluded cannot exceed the amount by which the taxpayer is insolvent. The aforesaid Code section defines *insolvency* as the excess of liabilities over the fair market value of assets determined immediately before the discharge of debt.

For example, let assume that X's assets are \$100,000, while her liabilities amount to \$150,000. After various fruitless collection efforts, Creditor A decides to forgive X's \$40,000 outstanding loan. Since the forgiven amount (\$40,000) does not exceed the insolvency amount (\$50,000), the whole \$40,000 is excluded from gross income.

On the other hand, assuming the same facts as above, but with the amount of the outstanding loan forgiven being \$60,000. In this case the forgiven amount (\$60,000) exceeds the insolvency amount (\$50,000). Since the debt discharge positions X from insolvency to solvency, only the amount that brings the taxpayer to a break-even position (i.e. \$50K) will be excluded from gross income, while the remaining amount (i.e. \$10K) will be considered taxable income.

To recap: if the discharge of indebtedness amount is lesser than the insolvency of the debtor, the total amount will be exempted. However, if the discharge from indebtedness pushed the insolvent debtor into a solvency status, only the break-even amount (that is, when the total assets equal total liabilities) shall be exempted. Any excess shall be classified as taxable income.

Please contact our Tax Department should you require additional information regarding this or any other tax issue. We will glad to assist you.