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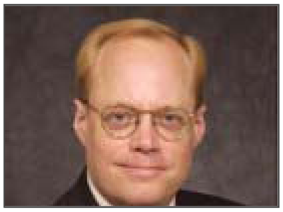

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THE TAX LAWYER

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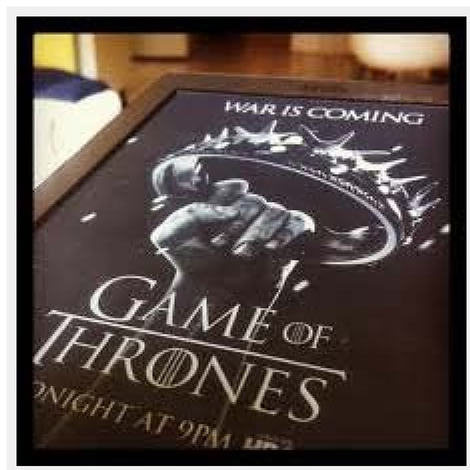
A Lannister Always Pays His Debts (Or IRS Would Tax Them)



As the third season of Game of Thrones unfolds, it is worthwhile to remember the House Lannister aphorism, "A Lannister Always Pays His Debts." That's a good thing, since paying one's debts is smarter tax-wise than having them forgiven. Why?

The IRS doesn't count loans as income, but the borrower does have cancellation of debt income or ***COD*** income when a loan is forgiven. You don't have to pay back the debt but must pay the IRS. The tax code generally taxes you when you are relieved of paying back a debt, treating it like cash paid to you. See 10 Things About COD Income.

This rule might seem easy to ignore, but when a loan is forgiven, you'll generally receive a Form 1099-C telling the IRS. If you receive one and disagree with the amount shown, write the lender requesting a corrected Form 1099-C showing the proper amount of canceled debt. Don't ignore Forms 1099.

In some cases discussed here, COD income isn't taxed. See Short Sale Tax Problems. If you believe the canceled debt isn't income to you because you're insolvent or for any other reason, you'll need to address this on your return. See Beware Each Form 1099! and The Truth About IRS Forms 1099. As if all this isn't frightening enough, can the IRS come along and claim that a "loan" you received—that is still outstanding and hasn't been forgiven—isn't a loan at all and was actually a sale?

In other words, can the IRS assert that some "loan" proceeds are really sales proceeds and therefore taxable? Yes, and that's what happened to Jonathan Landow in Tax Court. Landow took out a 90% loan against securities he put up as collateral. The loan was non-recourse—meaning that Landow could not be sued personally if he defaulted. Yet the securities were pledged as collateral.

In fact, the lender had the ability to sell off the securities in ways that were unusual for garden-variety loans. That's just what the lender did, despite the fact that Landow later claimed he had no idea his securities would be sold. Landow didn't pay off ***any*** of the $13.5 million principal amount of the loan and didn't report the "loan proceeds" as income. The IRS claimed the loan transaction really wasn't a loan at all and instead was a sale.

The Tax Court agreed with the IRS, treating this putative loan deal as a highly orchestrated transaction in which everyone knew the transaction would be documented as a loan but really amounted to a sale. Of course, Landow's deal was part of a controversial tax shelter. See *Shao v. Commissioner* and *Kurata v. Commissioner*. In that sense, the result in Landow's case was no surprise.

How you structure the transaction is important, as is how the transaction actually plays out. In general, courts look to indicators such as whether legal title passes, how the parties treat the transaction and the parties' intent. Get some independent advice and be careful.

Robert W. Wood practices law with Wood LLP, in San Francisco. The author of more than 30 books, including Taxation of Damage Awards & Settlement Payments (4th Ed. 2009 with 2012 Supplement, Tax Institute), he can be reached at Wood@WoodLLP.com. This discussion is not intended as legal advice, and cannot be relied upon for any purpose without the services of a qualified professional.