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May 4,1999

State =

Dear

On March 19, 1991, the Internal Revenue Service issued LTR 9125010 (TR-31-519-90) to you. The purpose of this letter is to inform you that LTR 9125010 is hereby revoked.

LTR 9125010 concluded that if all of your creditors are subject to the laws of State concerning the rights of creditors, then the value of the personal residence and other property exempt from the reach of creditors by the laws of State would not be included in the assets considered in determining whether you were insolvent under § 108(d)(3) of the Internal Revenue Code for purposes of § 108(a)(1)(B) of the Code. We now believe that this conclusion is inconsistent with the plain meaning of the statutory language of § 108.

Under § 61(a)(12) of the Code, except as otherwise provided, gross income means all income including income from the discharge of indebtedness.

Section 108(a)(1)(B) of the Code provides that discharge of indebtedness income is excluded from gross income if the discharge occurs when the taxpayer is insolvent. Section 108(a)(3) provides that the amount excluded by § 108(a)(1)(B) shall not exceed the amount by which the taxpayer is insolvent.

Section 108(d)(3) of the Code defines insolvent to mean the excess of liabilities over the fair market value of assets determined immediately before the discharge.

The Bankruptcy Tax Act of 1980, Pub. L. No. 96-589, 1980-2 C.B. 607 substantially amended § 108 of the Code, and (among other things) codified in § 108(a)(1)(B) the judicially developed insolvency exception to the general rule that income is realized upon the discharge of indebtedness. See S. Rep. No. 96-1035, 96th Cong., 2d Sess. 8 (1980), 1980-2 C.B. 623. The Bankruptcy Tax Act also added § 108(e)(1) of the Code, which provides that the insolvency exception in § 108(a)(1)(B) is the exclusive insolvency exception.

The statutory language of § 108(d)(3) of the Code does not specify which assets and which liabilities are taken into consideration for determining the definition of insolvent and the committee reports to the Bankruptcy Tax Act do not clarify this definition. Although case law interpreting the judicial insolvency exclusion that was in effect prior to the enactment of the Bankruptcy Tax Act of 1980 excluded assets exempt from creditors under state law (see, Cole v. Commissioner, 42 B.T.A. 1110 (1940), Marcus Estate v. Commissioner, T.C. Memo. 1975-9, AOD April 16, 1975), the statutory language places no limitation on assets that are taken into account in determining a taxpayer's solvency. The plain meaning of the term asset in § 108(d)(3) would include all of the taxpayer's assets in the insolvency calculation. Generally, where the language of a statute is clear and unambiguous, no further inquiry into the meaning of the statute is needed. 1 Mertens Law of Federal Taxation § 3.05 (1991). Further, § 108, as an exclusion from income, is to be construed narrowly. U.S. v. Centennial Savings Bank FSB, 499 U.S. 573, 583 (1991).

Further, the legislative history provides no clear guidance regarding the treatment of exempt assets for purposes of the insolvency definition. The legislative history specifically cites Dallas Transfer & Terminal Co. v. Commissioner, 70 F. 2d 95 (5th Cir. 1934), and Lakeland Grocery Co. v. Commissioner, 36 B.T.A. 289 (1937), which established the prior judicial insolvency exception. S. Rep. No. 96-1035, 96th Cong., 2d Sess. 8 (1980), 1980-2 C.B. 623. It does not cite the progeny of those cases that held, in applying the judicial insolvency exception, assets exempt under state law should not be included in the measure of insolvency. See, Cole v. Commissioner, 42 B.T.A. 1110 (1940), Marcus Estate v. Commissioner, T.C. Memo. 1975-9, AOD April 16, 1975). In United States v. Ron Pair Enterprises, Inc., 489 U.S. 235 (1989), the Supreme Court provided guidance as to when a judicial principle is so longstanding and well-established that it must be considered in statutory interpretation. If the Supreme Court has "never clearly acknowledged or relied upon" the exception in question, then it "counsels against concluding that the [exception] was well recognized." Ron Pair, 489 U.S. at 247. Since the judicial rule establishing the exclusion of exempt assets was never clearly acknowledged or relied upon by the Supreme Court, and in the absence of any specific citation to that rule in the legislative history, the rule should not be considered in interpreting the subsequent statutory rules dealing with insolvency.

In addition, in Bankruptcy Code § 101(32), Congress defined insolvent to exclude, among other things, property that may be exempted from property of the estate under § 522 of the Bankruptcy Code, which includes assets exempt under state law. Thus, arguably, when Congress intended to exclude state exempt assets, it specifically provided such an exclusion.

The legislative history underlying § 108 indicates that a bankrupt debtor and an insolvent debtor should be provided with a fresh start in that they should not be burdened with current taxation on the discharge of indebtedness. S. Rep. No. 96-1035, 96th Cong., 2d Sess. 9-10 (1980), 1980-2 C.B. 624. This rationale was based upon the fact that such debtors would not have assets available to pay a tax liability that would arise upon the discharge of their debts. However, excluding exempt assets from the measure of insolvency would provide taxpayers who are economically solvent, i.e. whose total assets exceed their liabilities, the opportunity to defer a current tax in instances where they have the ability to pay the tax. Such taxpayers would have assets available to pay a tax liability (although the assets would be exempt from the reach of creditors under state law). Accordingly, we revoke LTR 9125010.

Unless it was part of a closing agreement, a letter ruling found to be in error or not in accord with the current views of the Internal Revenue Service may be revoked. If a letter ruling is revoked, the revocation applies to all years open under the statute of limitations unless the Internal Revenue Service uses its discretionary authority under § 7805(b) to limit the retroactive effect of the revocation. Section 12.04 of Rev. Proc. 99-1, 1999-1 I.R.B. 47 (January 4, 1999).

This ruling is directed only to the taxpayer who requested it. Section 6110(j)(3) of the Code provides that this letter may not be used or cited as precedent.

Sincerely,

Assistant Chief Counsel
(Income Tax & Accounting)

by Christopher F. Kane
Christopher F. Kane
Assistant to the Chief, Br. 3

Enclosure:

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