***Cozzi v. Commissioner, 88 T. C. 435 (1987)***

Income from the discharge of indebtedness must be recognized when it becomes clear the debt will never be paid, based on a practical assessment of the circumstances.

**Summary**

John and Antoinette Cozzi, limited partners in Hap Production Co. , a film production partnership, were assessed additional income and penalties by the IRS for 1980 due to the discharge of a nonrecourse loan. Hap had reported a large loss in 1975 from the loan but failed to make any payments or report income from its cancellation until audited in 1981. The Tax Court upheld the IRS's determination that the income should be recognized in 1980, when the debt became clearly uncollectible, and imposed a negligence penalty for the Cozzis' failure to report the income.

**Facts**

In 1975, Hap Production Co. , formed to produce films, entered into agreements to produce a film titled 'Annie' for Map Films, Ltd. , with funding from a nonrecourse loan from Sargon Etablissement. Hap reported a significant loss in 1975 due to the loan but never received payments from Map or made payments to Sargon. The film never turned a profit. Hap ceased operations but did not report income from the loan's discharge until an IRS audit in 1981. The Cozzis, limited partners, did not report their share of this income until after the audit began.

**Procedural History**

The IRS commenced an audit of Hap in 1981, which led to a criminal investigation in 1982. In 1984, Hap settled with Map and Sargon, releasing all parties from obligations. The Cozzis filed a petition with the Tax Court challenging the IRS's determination of a 1980 deficiency and negligence penalty. The Tax Court upheld the IRS's decision.

**Issue(s)**

1. Whether the Cozzis realized ordinary income in 1980 from the discharge of Hap's nonrecourse debt.
2. Whether the Cozzis are liable for the negligence penalty under section 6653(a) of the Internal Revenue Code.

**Holding**

1. Yes, because by 1980, it was clear that Hap's debt to Sargon would never be paid, and Hap had effectively abandoned the film project.
2. Yes, because the Cozzis failed to report the income from the debt discharge before the IRS audit commenced, indicating negligence or intentional disregard of

tax obligations.

## Court's Reasoning

The Court applied the principle that income from debt discharge must be recognized when the debt becomes clearly uncollectible. It found that by 1980, Hap had ceased operations, the film had not turned a profit, and no payments were made on the loan, indicating abandonment of the project. The Court rejected the Cozzis' argument that the IRS's determination was arbitrary, stating that the notice of deficiency was based on evidence linking the Cozzis to the income-generating activity. The Court also noted the Cozzis' failure to report the income until after the audit began as evidence of negligence.

## Practical Implications

This decision clarifies that income from debt discharge must be reported in the year the debt becomes clearly uncollectible, even without a formal discharge agreement. It emphasizes the importance of timely reporting such income to avoid negligence penalties. The ruling impacts how tax shelters and similar arrangements should be analyzed for tax purposes, highlighting the need for careful monitoring of obligations and timely income recognition. Subsequent cases have applied this principle in determining the timing of income recognition from debt discharge.

 