***Merkel v. Commissioner, 109 T. C. 463 (1997)***

To qualify as liabilities for the insolvency exclusion under IRC §108(a)(1)(B), taxpayers must prove it is more probable than not that they will be called upon to pay the claimed obligations.

**Summary**

In Merkel v. Commissioner, the Tax Court denied the Merkels and Hepburns the insolvency exclusion under IRC §108(a)(1)(B) for discharge of indebtedness income. The taxpayers claimed insolvency based on contingent liabilities from personal guarantees and potential sales tax liability. The court held that for liabilities to be included in the insolvency calculation, taxpayers must prove it is more likely than not they will have to pay these obligations. The court found the taxpayers failed to meet this burden for both their guarantees and the potential tax liability, thus sustaining the IRS's deficiency determinations.

**Facts**

The Merkels and Hepburns were partners in a business that realized discharge of indebtedness income. They claimed insolvency to exclude this income from their taxable income. Their claimed liabilities included guarantees on a corporate loan and potential personal liability for the corporation's unpaid sales and use taxes. The loan guarantee was contingent on the corporation or the guarantors filing for bankruptcy within 400 days after a settlement date. The sales tax assessment against the corporation was later abated, and no personal assessment was made against the taxpayers.

**Procedural History**

The IRS determined deficiencies against the Merkels and Hepburns for excluding discharge of indebtedness income from their taxable income. The taxpayers petitioned the Tax Court, which consolidated their cases. The court's decision focused on whether the taxpayers were insolvent under IRC §108(a)(1)(B) and whether their claimed liabilities could be included in the insolvency calculation.

**Issue(s)**

1. Whether the taxpayers were insolvent under IRC §108(a)(1)(B) immediately before the discharge of indebtedness.
2. Whether contingent liabilities, specifically the taxpayers' guarantees and potential sales tax liability, can be included in the insolvency calculation under IRC §108(d)(3).

**Holding**

1. No, because the taxpayers failed to prove their insolvency by demonstrating that

© 2025 SCOTUSreports.com. All rights reserved. 

their liabilities exceeded the fair market value of their assets.
2. No, because the taxpayers failed to prove it was more probable than not that they would be called upon to pay the amounts claimed under their guarantees and the potential sales tax liability.

**Court's Reasoning**

The court analyzed the insolvency exclusion under IRC §108(a)(1)(B) and the statutory insolvency calculation under IRC §108(d)(3). It determined that the term "liabilities" in §108(d)(3) requires taxpayers to prove, with respect to any obligation claimed as a liability, that it is more probable than not they will be called upon to pay that obligation in the claimed amount. The court rejected the taxpayers' argument that contingent liabilities should be included based on their likelihood of occurrence. The court found the taxpayers failed to prove the likelihood of a demand for payment under their guarantees due to the low probability of bankruptcy. Additionally, the court found no evidence that the taxpayers knew or should have known of the corporation's failure to collect sales taxes, and no assessment was made against them personally. Therefore, neither the guarantees nor the potential sales tax liability were considered liabilities for the insolvency calculation.

**Practical Implications**

This decision clarifies that contingent liabilities must meet a high threshold to be included in the insolvency calculation for the purpose of the insolvency exclusion. Taxpayers must prove it is more likely than not that they will have to pay the claimed liabilities. This ruling impacts how taxpayers should analyze their financial situation before claiming the insolvency exclusion, emphasizing the need for concrete evidence of potential liability. Legal practitioners must advise clients carefully on documenting and proving potential liabilities. Businesses and individuals should be cautious in relying on contingent liabilities for tax planning. Subsequent cases have applied this ruling to various types of contingent liabilities, reinforcing the need for clear evidence of potential payment obligations.

© 2025 SCOTUSreports.com. All rights reserved. 