LR #6

Simplify the Tax Treatment of Cancellation of Debt Income

Problem

At a time when the government is taking extraordinary steps to assist individuals who stand to lose their homes to foreclosure, there is surprisingly little recognition that many of these individuals will face federal income tax consequences as a result. The same is true for individuals who default on consumer debt.[1] Many taxpayers will be required to include the amount of any debts written off by the lender in gross income and pay the associated tax. Some taxpayers will be entitled to exclude the amount of canceled debt from gross income, but they will have to navigate extremely challenging tax reporting requirements to do it.

When a borrower becomes unable to repay a debt and the lender cancels some or all of it, the Internal Revenue Code (IRC) generally provides that the amount of debt cancellation must be included in the gross income of the borrower.[2] This amount is referred to as "cancellation of debt income" (CODI). The Code also provides that in certain situations, a taxpayer may exclude CODI from gross income, including where a taxpayer is "insolvent," (meaning that the taxpayer's total liabilities exceed the taxpayer's total assets)[3] or where "qualified" debt (also known as "qualified principal residence indebtedness") is canceled in the course of a mortgage foreclosure.[4] However, the rules for claiming one of these exclusions are so complex that many and probably most taxpayers who qualify to exclude CODI from gross income do not do so. As a result, some taxpayers unnecessarily include CODI in gross income. Other taxpayers fail to report CODI and fail to claim a corresponding exclusion because they do not realize that debt forgiveness is a taxable event. These taxpayers may unnecessarily face IRS examination and tax assessment.[5]

The following is a list of some of the obstacles that prevent taxpayers from claiming exclusions to which they are entitled:

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1 According to an article in the *New York Times*, lenders wrote off an estimated $21 billion in bad credit card loans during the first half of 2008. Eric Dash, *Consumers Feel the Next Crisis: It's Credit Cards*, New York Times, Oct. 29, 2008, at A1.

2 IRC § 61(a)(12).

3 IRC § 108(a)(1)(B).

4 IRC § 108(a)(1)(E). The exclusion applies to the extent that the principal balance of the loan does not exceed $2 million and the home is the taxpayer's principal residence.

5 The IRS receives Forms 1099-C, *Cancellation of Debt*, from lenders reporting the amount of each canceled debt. The IRS document-matching program compares each Form 1099-C it receives against the tax return of the taxpayer with the same taxpayer identification number. If a canceled debt is reported to the IRS on Form 1099-C and the amount is not reported on the taxpayer's return, the discrepancy will be flagged and the taxpayer may face IRS examination and tax assessment.

1. ***Requirement to File Form 982.*** A taxpayer who qualifies for an exclusion does not receive it automatically. To claim an exclusion, the taxpayer must file Form 982, *Reduction of Tax Attributes Due to Discharge of Indebtedness* (and *Section 1082 Basis Adjustment*). Form 982 is not simple. The IRS estimates that it takes business taxpayers ten hours and 43 minutes to complete it.[6] Moreover, many taxpayers and practitioners have never even encountered the form, which is not included in many tax software packages available to taxpayers.
2. ***Requirement to Adjust Tax Attributes.*** The main reason for the complexity of Form 982 is that taxpayers generally are required to reduce "tax attributes," in a specified sequence, by the amount of CODI they are entitled to exclude. Among the tax attributes listed on the form are net operating losses, general business credit carryovers, minimum tax credits, net capital losses, nondepreciable and depreciable property, passive activity loss and credit carryovers, and foreign tax credit carryovers. These terms are baffling to most taxpayers. Non-business taxpayers who do not have most of these tax attributes are generally required to reduce their basis in personal property like furniture, jewelry, and clothing, and keep track of it prospectively.[7] Taxpayers often have no idea what this means or how practically to do it.[8]
3. ***Qualified Principal Residence Indebtedness Exclusion.*** In December 2007, Congress added the "qualified principal residence indebtedness" exclusion that generally allows homeowners whose mortgage debts are canceled in the course of a foreclosure or loan restructuring to exclude the resulting CODI from gross income.[9] In practice, however, many homeowners whose debts are canceled in the course of a foreclosure or loan restructuring will *not* qualify to exclude CODI from gross income. That is because the exclusion only applies with respect to funds used to *acquire or improve* a principal residence.[10] It appears that a significant percentage of homeowners with subprime mortgages – probably a majority – used a portion of the loan proceeds for non-qualified purposes like paying off car loans, medical bills, student loans, or credit card balances.[11] In these cases, the taxpayer must reduce the amount of CODI eligible for exclusion by the amount of mortgage debt used for such non-qualified purposes. Thus,

6 The IRS does not provide a separate estimate of the amount of time individual taxpayers spend completing Form 982.

7 However, no basis adjustment is required upon cancellation of qualified principal residence indebtedness where a taxpayer loses his home in a foreclosure. *See* IRS Publication 4681, *Canceled Debts, Foreclosures, Repossessions, and Abandonments* 13, *Example 2 – Mortgage loan foreclosure* (2007). Where a taxpayer retains his residence and excludes CODI solely under the qualified principal residence indebtedness exclusion, the taxpayer is required to reduce the basis in his residence by the amount of the canceled debt. IRC § 108(h)(1); IRS Pub. 4681, *Canceled Debts, Foreclosures, Repossessions, and Abandonments* 7 (2007).

8 The reduction in the basis of these items of personal property is designed to increase any gain upon their disposition.

9 Mortgage Forgiveness Debt Relief Act, Pub. L. No. 110-142, § 2(b) (2007).

10 IRC § 108(h)(4) (providing that if only a portion of a mortgage loan constitutes "qualified principal residence indebtedness," the qualified principal residence indebtedness exclusion applies only to the extent that the amount of debt canceled exceeds the portion of the loan that does not constitute qualified principal residence indebtedness).

11 According to a federal government report issued in 2000: "The primary purpose of over 50 percent of first lien subprime mortgages and up to 75 percent of second lien subprime mortgages is debt consolidation and/or general consumer credit, not home purchase, home improvement or refinancing the rates and terms of a mortgage." Department of Housing and Urban Development and Department of the Treasury Task Force on Predatory Lending, *Curbing Predatory Home Mortgage Lending* 26 (2000). We have not located more recent government data on this point.

despite last year's legislation, tens of thousands of taxpayers who lose their homes to foreclosure are still required to pay tax on some or all of the canceled debt unless another exclusion applies.

4. ***Insolvency Exclusion.*** The insolvency exclusion is generally designed to allow financially distressed taxpayers to exclude CODI from gross income. However, many taxpayers who qualify for the insolvency exclusion fail to claim it because they do not know it exists, do not understand the meaning of the word "insolvency," or do not know how to claim it. In general, a taxpayer is considered insolvent if the sum of all of his liabilities exceeds the sum of all of his assets (including the value of such items as furniture, jewelry, and clothing). To claim the insolvency exclusion, it is not sufficient simply that the taxpayer know he is insolvent. Rather, the taxpayer is only entitled to claim an exclusion up to the amount of insolvency, so the taxpayer must compute the insolvent amount exactly. For example, if a taxpayer's liabilities are $60,000 and his assets are worth $56,500, the taxpayer is entitled to exclude up to $3,500 in CODI from gross income; if the taxpayer has $10,000 of CODI, he is taxable on the remaining $6,500.

5. ***Combining Exclusions.*** In the case of a home foreclosure where a portion of the mortgage proceeds was used for nonqualified purposes, a taxpayer may be eligible to exclude some CODI under the qualified principal residence indebtedness exclusion and other CODI under the insolvency exclusion. For example, if a taxpayer takes out a mortgage for $200,000 and uses $25,000 to pay off medical bills and student debt, he may exclude CODI under the qualified principal residence indebtedness exclusion only to the extent that the amount of CODI exceeds $25,000. If the taxpayer is also insolvent, he is generally entitled to exclude additional amounts up to the amount of the insolvency. Yet another provision entitles taxpayers to exclude canceled debts which would, if paid, have been deductible; for example, a taxpayer generally may exclude canceled medical bills from gross income to the extent they exceed 7.5 percent of adjusted gross income.[12] It is asking a lot to expect taxpayers to be cognizant of all these rules and the interaction among them.

6. ***Variation in Federal Tax Consequences Based on Taxpayer's Place of Residence.*** The federal tax treatment of CODI varies depending on the state in which the taxpayer resides. In most states, a borrower is personally liable for his debts, which means that the lender is entitled to pursue the borrower's other assets if the borrower defaults. This type of debt is referred to as "recourse" debt. In other states, including California, the lender's only remedy in case of default is generally to repossess the property that secures the debt.[13] This type of debt is referred to as "nonrecourse" debt. Because the lender has no right to pursue the borrower's other assets in the case of nonrecourse

12 IRC § 108(e)(2).

13 This result is achieved through anti-deficiency statutes. *See, e.g.*, Cal. Civ. Proc. § 580(b); Ariz. Rev. Stat. Ann. § 33-729(A); N.C. Gen. Stat. § 45-21.38; S.D. Codified Laws Ann. § 44-8-25. In some states with anti-deficiency statutes, a lender may be able to collect additional amounts if the matter is pursued through judicial proceedings.

debt, the lender is not considered to cancel any unpaid balance and the borrower has no CODI. Most taxpayers do not understand the differences between recourse and nonrecourse debt or the fact that the tax consequences of a debt default may differ depending on where they live.

The result of having to navigate this CODI minefield is that hundreds of thousands of taxpayers have cancellation of debt income each year, but very few claim exclusions. Overall, lenders send about two million Forms 1099-C, *Cancellation of Debt*, to the IRS each year reporting CODI.[14] Yet it appears that *less than one percent* of taxpayers with CODI may be filing Form 982 to claim the exclusion.[15] Taxpayers who default on their debts are generally experiencing significant financial problems, and almost by definition, their liabilities are high relative to their assets. The National Taxpayer Advocate believes that a significant percentage of taxpayers who qualify for exclusions, particularly the insolvency exclusion, do not make claims.[16]

Example

Taxpayers purchased a house for their family in 2003 for $200,000 and took out a 30 year, fixed-rate mortgage for $160,000 (*i.e.*, 80 percent of the purchase price). In 2005, at a time when the taxpayers had other debts of $50,000, including student loans and two car loan balances, a representative of a subprime lending company contacted them and urged them to refinance their mortgage so they could consolidate all of their debt at a lower interest rate. The subprime lender offered a mortgage product that required interest-only payments for three years. Because real estate values were then rising, the subprime lender offered them a mortgage for $210,000. The taxpayers refinanced and used $50,000 to pay off their student loans and car loans.

In 2008, the monthly mortgage payment increased to include payments on principal. At that time, the principal balance of the mortgage was still $210,000, but the value of the house had fallen to $170,000. The taxpayers could not make the higher payments, so the lender foreclosed and sold the house. The mortgage was considered recourse debt, and the lender canceled the remaining $40,000 balance. The borrowers received a Form 1099-C from the lender reporting $40,000 of CODI. Although Congress passed legislation generally

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14 IRS Document 6961, Table 2 (showing that the IRS expects to receive about 1.9 million Forms 1099-C in 2008 and about 2.1 million Forms 1099-C in 2009).

15 For tax year 2005, the IRS received 495,495 electronically filed returns from taxpayers who had cancellation of debt income reported on a Form 1099-C. IRS Compliance Data Warehouse, Information Returns Master File and Individual Returns Transaction File (Tax Year 2005). By comparison, the IRS received only 4,571 electronically filed Forms 982 for that time period. IRS E-File Reports (Processing Year 2006). Note that the number of electronically filed returns actually was greater than 495,495 because our data search only reflects Forms 1099-C issued to taxpayers listed with the primary taxpayer identification number (TIN) on a tax return. It does not reflect cases where a spouse or a person whose TIN was listed as other than the primary TIN received a Form 1099-C. Note, too, that the data excludes returns filed on paper, which represented slightly less than half of all individual income tax returns filed. We could not determine how many Forms 982 were submitted with paper-filed returns.

16 For a more detailed description of the complexity of the CODI rules and the tax administration problems arising from that complexity, *see* Most Serious Problem: *Understanding and Reporting the Tax Consequences of Cancellation of Debt Income, supra. See also* National Taxpayer Advocate 2007 Annual Report to Congress 13-34 (Most Serious Problem: *Tax Consequences of Cancellation of Debt Income*).

allowing taxpayers to exclude CODI arising from foreclosures, the exclusion provides that only CODI in excess of amounts borrowed for non-qualified purposes may be excluded. Since these taxpayers borrowed $50,000 for non-qualified purposes, they are not entitled to exclude any portion of the CODI under the qualified principal residence indebtedness exclusion.

The taxpayers may be able to exclude some or all of the CODI under the insolvency exclusion. To make that determination, the taxpayers must compute the value of all their assets and all their liabilities. The fair market value of many assets, including cars, furniture, and clothing, is not clear-cut, requiring them to make judgments and develop substantiation in case they are later audited. If they wish to claim an exclusion, they must file Form 982 and make adjustments to their tax attributes. This is a particularly challenging exercise if one of the taxpayers is engaged in a trade or business.

If the taxpayers do not realize they have CODI or are not familiar with the CODI rules (perhaps, for example, because they lost their home and the Form 1099-C never reached them), they may fail to report the income or claim the exclusion. In that case, the IRS's document-matching system will generally flag the CODI amount as unreported income, and the IRS may issue a notice proposing additional tax. Once this notice is issued, the taxpayers at best will have to spend time understanding and responding to the notice to avoid a tax assessment. At worst, the taxpayers will not respond or will not respond adequately, and the IRS will assess tax that the taxpayers may not owe.

Recommendation

The National Taxpayer Advocate recommends that Congress pass legislation to make it easier for financially distressed taxpayers to exclude CODI from gross income. As discussed above, Congress established a general rule that CODI is includible in gross income but also created certain exclusions that generally are geared toward providing relief for taxpayers who are experiencing financial difficulties.

We suggest three options for consideration:

1. ***Provide that CODI is not includable in gross income unless the total amount of CODI attributable to the taxpayer from all sources exceeds a certain threshold for the taxable year.*** This would be the simplest option for taxpayers, because they would be relieved of the burden of learning about and filing Form 982 to claim an exclusion. The IRS could automatically program its computers to ignore CODI if the sum of CODI reported on Forms 1099-C with respect to the taxpayer falls below the threshold. The threshold should be set at a level high enough to provide relief to a majority of the financially distressed taxpayers whom the proposal is designed to assist and low enough to prevent widespread abuses that could undermine the general rule that CODI is taxable.

2. ***Provide that taxpayers with CODI below a certain threshold do not need to make adjustments to their tax attributes.*** This option is less attractive in that taxpayers would still have to file Form 982, would still have to distinguish between "qualified" and "non-qualified" indebtedness for purposes of the qualified principal residence indebtedness exclusion, and would still have to compute insolvency.[17] But it would create a more limited exception to the general rule that CODI is taxable than would be the case under option 1, while alleviating some taxpayer burden and reducing record-keeping requirements.
3. ***Amend the definition of "qualified principal residence indebtedness" to provide that the full amount of canceled mortgage debt qualifies for exclusion, even if a portion of the proceeds was used to pay off non-residential debt like car loans, medical bills, student loans, or credit card balances.***[18] This option would provide complete relief from CODI tax liability attributable to mortgage debt cancellation for most homeowners or persons who have lost their homes. However, it would not relieve taxpayers of the burden of filing Form 982 to claim the exclusion or provide any relief to taxpayers who have CODI from canceled debts (*e.g.*, car loans, medical bills, student loans, or other consumer debt) that are not rolled into a mortgage.[19]

[17] If taxpayers are not required to adjust tax attributes, the National Taxpayer Advocate recommends that the IRS create a simplified Form 982-EZ for their use. The National Taxpayer Advocate also recommends that the IRS develop and provide a worksheet that taxpayers may use for purposes of computing whether and to what extent they are insolvent. For additional detail, see Most Serious Problem: *Understanding and Reporting the Tax Consequences of Cancellation of Debt Income*, *supra*.

[18] This could be accomplished by redefining "qualified principal residence indebtedness" in IRC § 108(h)(2) as acquisition indebtedness under IRC § 163(h)(3)(B)(i) *or* home equity indebtedness under IRC § 163(h)(3)(C)(i). Interest on amounts borrowed under home equity lines of credit is currently deductible, so this change would align the tax treatment of interest on the debt with the tax treatment of cancellation of the debt.

[19] Our understanding is that the majority of canceled debts are not mortgage-related, so it may be desirable to combine this option with option (1).