MORTGAGE FORGIVENESS DEBT RELIEF ACT OF 2007

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I. INTRODUCTION

Owning a home has transformed from being part of the "American Dream" to what many people, including our legislators, see as the "American Right." Throughout the 1990s and early 2000s, America's housing market experienced an unprecedented boom fueled largely by a decrease in the regulations of lending agencies.[1] The decrease in regulations caused an increase in loans given to borrowers whose job status, financial status, and credit rating traditionally would have prevented them from obtaining a mortgage or at least one as large as they received.[2] Moreover, lenders, in an effort to provide more people with the "American Dream," began providing adjustable rate mortgages (ARMs) and interest only mortgages.[3] These mortgages reduced the monthly payment for borrowers, so they could afford bigger, more expensive homes in nicer neighborhoods.[4] By 2006, the market reached its peak, and the interest rates on ARMs began adjusting, causing higher prices for borrowers who were already stretched thin making payments at the lower interest rate.[5]

Since 2006, America has seen its real estate and financial markets spiral out of control, bringing the highest rates of foreclosure since the

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[1] *See The Housing Decline: Extent of the Problem and Potential Remedies: Hearing Before S. Comm. on Finance*, 110th Cong. 5–6 (2007) [hereinafter *Housing Decline Hearing*] (testimony of Morris A. Davis, Professor of Economics, University of Wisconsin).

[2] *Id.*

[3] *See id.* at 3–4 (testimony of Jack Kemp, Principal, Kemp Partners).

[4] *Evolution of an Economic Crisis?: The Subprime Lending Disaster and the Threat to the Broader Economy: Hearing Before Joint Economic Comm.*, 110th Cong. 77–79 (2007) [hereinafter *Subprime Lending Hearing*] (statement of Robert J. Shiller, Professor of Economics and Finance, Yale University) (discussing the "social epidemic of optimism for real estate").

[5] *Housing Decline Hearing*, *supra* note 2, at 3–4 (testimony of Jack Kemp, Principal, Kemp Partners).

Great Depression.[6] In response to rising home foreclosures and sinking home and land values, seemingly with no end in sight, Congress passed the Mortgage Forgiveness Debt Relief Act of 2007 (Debt Relief Act).[7] The Debt Relief Act forgives the debt owed on a mortgage and excludes the forgiven debt from income under the tax code for homeowners who are involved in a short sale, foreclosure, or who want to refinance to a principal amount more reflective of the current market value.[8] Specifically, the Debt Relief Act amended § 108 of the tax code, Income from the Discharge of Indebtedness.[9] It provides, "Gross income does not include any amount which (but for this subsection) would be includible in gross income by reason of discharge (in whole or in part) of indebtedness of the taxpayer if—the indebtedness discharged is qualified principal residence indebtedness which is discharged before January 1, 2010."[10]

The exclusions under § 108 were originally created by the courts, and later codified by Congress, to ensure that taxpayers trying to emerge from the financial distress of bankruptcy and insolvency would actually get a "fresh start."[11] In other words, those taxpayers who are in such financial distress that they do not have assets sufficient to pay an immediate tax liability should be granted some relief. Thus, assessing an immediate tax bill against those taxpayers was determined to be contrary to public policy.[12] Rather, qualifying taxpayers are offered a tax deferral under § 108 allowing them to exclude the amount gained on discharge from the current year, but requiring that other tax attributes be reduced so the tax is "recaptured" in the future.[13] The exclusions are meant to help taxpayers in the worst financial condition get back to a point where their financial situation is secure and they can afford to pay taxes.

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[6] Peter G. Gosselin, *Bailout Is No Simple Matter*, L.A. TIMES, Sept. 7, 2008, at A1.

[7] Mortgage Forgiveness Debt Relief Act of 2007, Pub. L. No. 110-142, § 1, 121 Stat. 1803, 1803 (codified as amended in scattered sections of I.R.C.).

[8] *See* Mortgage Forgiveness Debt Relief Act, § 2, 121 Stat. at 1803–04.

[9] I.R.C. § 108(a)(1)(E) (2006).

[10] *Id.* There has already been an amendment extending the sunset date of the provision to Jan. 1, 2013. *See* Emergency Economic Stabilization Act of 2008, Pub. L. No. 110-343, § 303(a), 122 Stat. 3765, 3807 (codified as amended in scattered sections of 5, 12, 15, 31 U.S.C.).

[11] *See* Adam M. Leamon, Note, *Section 108 of the I.R.C. and Inclusion of Tufts Gain: A Proposal for Reform*, 50 B.C. L. REV. 1243, 1267–68 (2009).

[12] *Id.*

[13] *Id.* at 1266–67.

Adding an exclusion that applies to solvent homeowners who wish to refinance their mortgage because money is a little short expands the exclusions allowed under § 108 well beyond the original policy goals of helping bankrupts and insolvents get a "fresh start." In fact, when codifying the exclusions, the Treasury Department expressed great concern that solvent taxpayers would take advantage of the laws.[14] For that reason, Congress redrafted the language to specifically exclude solvent taxpayers from taking full advantage of § 108.[15]

Part II of this article discusses the history of including cancelled debt as income and the exclusions created by the courts. Part III discusses the Bankruptcy Tax Act of 1980,[16] which codified the judicial exclusions, and also discusses the policy reasons that justify the exclusions. Part IV discusses the real estate boom and subsequent downturn that led to the exclusion for qualified mortgage indebtedness. Part V compares the policy considerations behind the Bankruptcy Act of 1980 and the Mortgage Forgiveness Debt Relief Act of 2007.

II. THE IRS'S HISTORY OF TREATING DEBT CANCELLATION AS INCOME

A. Income as Defined by the IRS

The Internal Revenue Code defines gross income as any income "*from whatever source derived* . . . ."[17] "[T]he Court has given a liberal construction to this broad phraseology in recognition of the intention of Congress to tax all gains except those specifically exempted."[18] Thus, the Court held that any accession to wealth, other than those specifically

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[14] *See The Bankruptcy Tax Act and Minor Tax Bill*: *Hearing on H.R. 5043 Before the Subcomm. on Select Revenue Measures of the H. Comm. on Ways and Means*, 96th Cong. 9 (1979) [hereinafter *Bankruptcy Tax Act Hearing*] (statement of Daniel I. Halperin, Deputy Assistant Secretary for Tax Policy, Department of the Treasury).

[15] S. REP. No. 96-1035, at 10 (1980), *reprinted in* 1980 U.S.C.C.A.N. 7017, 7025.

[16] Pub. L. No. 96-589, 94 Stat. 3389 (1980) (codified as amended in scattered sections of 11, 26 U.S.C.).

[17] I.R.C. § 61(a) (2006) ("Except as otherwise provided in this subtitle, gross income means all income *from whatever source derived*, including (but not limited to) the following items: . . . (12) Income from discharge of indebtedness . . . ." (emphasis added)). *See also* United States v. Kirby Lumber Co., 284 U.S. 1, 3 (1931); Comm'r v. Glenshaw Glass Co., 348 U.S. 426, 430 (1955) (noting that this language first appeared in the Revenue Act of 1913).

[18] *Glenshaw Glass Co.*, 348 U.S. at 430 (requiring a taxpayer to include in gross income amounts gained through punitive damages awarded in a civil trial).

exempted by Congress, is to be included in a taxpayer's income.[19] This means a taxpayer does not have to actually receive cash to experience an accession to wealth; rather, if a taxpayer's assets are freed that otherwise were subject to the claims of creditors, the taxpayer gains by owing less.[20] Congress, the Commissioner, and the courts generally consider wealth created through the discharge of indebtedness as an accession to wealth.[21] As such, it must be added to the taxpayer's gross income in the year the debt is cancelled.[22] The "freed assets" theory, as it is now known, was expounded by Justice Holmes in *United States v. Kirby Lumber Co.*[23]

B. Rational for Treating Discharged Debt as an Accession to Wealth for Which Taxpayers Should Incur Tax Liability

In *Kirby Lumber*, a corporation issued bonds for $12,126,800 to raise capital.[24] Later that year, the corporation bought back some of the bonds for $137,521.30, which was less than their issuing value.[25] The Court found the corporation realized a "clear gain" by freeing assets that once would have been used to pay off the owners of the bonds.[26] This case set the precedent that cancelled debt (freed assets) must be included in a taxpayer's gross income.[27]

When a taxpayer obtains a loan from a lender, it is not counted as income because the taxpayer is required to repay not only the principal amount borrowed, but also interest.[28] Therefore, the taxpayer has not received a gain that can or should be taxed.[29] However, when the taxpayer's obligation to repay (part or all of the loan) is forgiven, assets that once would have been used to repay the loan are now free for the

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[19] *Id.* at 431.

[20] Bryan Camp, *Proceduralist Reflections on Home Mortgage Foreclosures*, 117 TAX NOTES 483, 484 (2007). Camp's article has an interesting discussion on why § 108(a)(1)(E) will not be effective because of procedural shortfalls rather than failed tax policy. *See generally id.*

[21] *See id.*

[22] *Id.*

[23] 284 U.S. 1 (1931).

[24] *Id.* at 2.

[25] *Id.*

[26] *Id.* at 3.

[27] Camp, *supra* note 20, at 484 ("[T]he burden on the taxpayer's remaining assets has been relieved, so the taxpayer is truly wealthier.").

[28] *Id.* at 483–84.

[29] *Id.* at 483.

taxpayer to put towards other obligations or to use as collateral to secure a new debt.[30] Thus, the taxpayer has gained wealth by not having to repay the forgiven obligation.[31]

For example, consider a taxpayer who borrows $100,000 for a mortgage on a principal residence (for simplicity we will consider the homeowner was able to obtain 100% financing, which is not unrealistic for the home buyers suffering in the current mortgage crisis).[32] If the fair market value of the property falls to $80,000 and the homeowner stops making the payments on the $100,000 loan, the bank can either short sell the house or initiate foreclosure proceedings and take the property to auction it off.[33] In either case, if the bank agrees not to hold the homeowner liable for the outstanding $20,000, the homeowner has freed $20,000 in assets that otherwise would have paid for the loan.[34] Now the homeowner can apply that $20,000 however he or she sees fit.[35] Let us further assume the taxpayer takes the freed $20,000 in assets and uses it to secure another loan to purchase a different asset that will appreciate in value. Clearly the taxpayer has gained wealth by this series of events (i.e., by reallocating the outstanding $20,000 to an income-producing asset) and under § 61, the taxpayer should be required to pay tax on that gain.[36]

However, if the lender sells the property for $80,000 and the taxpayer remains liable for the outstanding $20,000, there is clearly no gain. In fact, there would be a loss, and the taxpayer should not be taxed. The loss, however, will not be deductible under § 165(c) because it is from the sale

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[30] *Id.* at 484.

[31] *Id.*

[32] *See Subprime Lending Hearing*, *supra* note 4, at 144 (statement of Alex J. Pollock, Resident Fellow, American Enterprise Institute) (explaining that during the recent housing-market bubble, many lenders initiated mortgages with little or no down payment from borrowers).

[33] *Cf. Housing Decline Hearing*, *supra* note 1, at 41–43 (statement of Deborah A. Geier, Professor of Law, Cleveland-Marshall College of Law) (using a similar hypothetical to explain the dynamics of cancellation of debt income).

[34] *Id.*

[35] One argument against this analysis is that the homeowner does not receive cash, and thus, did not actually increase in wealth. This argument is discussed below in the section regarding the exclusion of cancellation of indebtedness income on a principal residence from income under the Debt Relief Act. *See* I.R.C § 108(a)(1)(E) (LexisNexis 2008).

[36] I.R.C. § 61(a)(12) (2006).

of a personal residence.[37] Under § 165(c), the only allowable deduction for losing personal property is a loss arising from, "fire, storm, shipwreck, or other casualty, or from theft" that is not compensated through insurance.[38]

Thus, where debt has been forgiven, the taxpayer experiences an increase in wealth due to a decrease in obligations owed. Although this realization of wealth may not be what we typically think of as income (an influx of cash), the taxpayer has fewer liabilities on his or her personal balance sheet, which increases the taxpayer's net worth. As long as this decrease in liabilities actually creates a positive net worth, the taxpayer is deemed to have income from the cancellation of debt that must be included in the taxpayer's gross income.[39] Thus, not all cancellations of debt result in an accession to wealth; § 108 defines when the cancellation results in income and when it does not.[40]

1. Cancelled Debt by Which the Taxpayer Gains Wealth

Although § 61(a)(12) provides a very broad definition making it seem as though all cancelled debt is treated as income,[41] the scope of the inclusion is limited by § 108(d)(1).[42] Under § 108(d)(1), indebtedness is defined as "any indebtedness—(A) for which the taxpayer is liable, or (B) subject to which the taxpayer holds property."[43] The Third Circuit further explained this definition in *Zarin v. Commissioner*.[44]

In *Zarin*, the taxpayer was a compulsive gambler who amassed $3,435,000 in credit debt with the Resorts International Hotel (Resorts)

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[37] § 165(c). In the case of an individual, the deduction under subsection (a) shall be limited to—

(1) losses incurred in a trade or business;

(2) losses incurred in any transaction entered into for profit, though not connected with a trade or business; and

(3) except as provided in subsection (h), losses of property not connected with a trade or business or a transaction entered into for profit, if such losses arise from fire, storm, shipwreck, or other casualty, or from theft.

[38] § 165(a), (c)(3).

[39] *See id.*; § 61(a)(12).

[40] § 108(a)(1).

[41] *Id.*; § 61(a)(12) ("[G]ross income means all income from whatever source derived, including . . . [i]ncome from discharge of indebtedness.").

[42] § 108(d)(1).

[43] § 108(d)(1)(A)–(B).

[44] 916 F.2d 110 (3d Cir. 1990).

casino in Atlantic City, New Jersey.[45] Zarin, a professional engineer, enjoyed gambling.[46] To facilitate his habit, Zarin applied for and received a $10,000 credit line from Resorts.[47] The credit allowed Zarin to "write a check called a marker, and in return receive chips," which were used at Resorts' tables.[48] Within one year of receiving his line of credit from Resorts, Zarin obtained a limit of $200,000, but managed to lose $2.5 million.[49] Zarin paid all of the $2.5 million he owed and continued to gamble at Resorts, which continued to raise Zarin's line of credit.[50] Despite a ruling by the New Jersey Casino Control Commission declaring many of Resorts' lending practices illegal, and an Emergency Order making it illegal for Resorts to make any further extensions of credit to Zarin, Resorts continued extending Zarin's line of credit.[51] By 1980, Resorts loaned Zarin $3,435,000, which he unsuccessfully attempted to repay via checks drawn against insufficient funds.[52] Resorts commenced an action to recover the debt, and Zarin defended on the premise that the debt issued by Resorts was illegal, and therefore, could not be collected.[53] Resorts and Zarin reached a settlement of $500,000, and Zarin was forgiven $2,935,000, which he did not claim on his tax return.[54] The Commissioner assessed a deficiency against Zarin, and the Tax Court upheld the deficiency.[55]

In reversing the judgment of the Tax Court, the Third Circuit relied on the definition of indebtedness given in § 108(d)(1).[56] The court determined that because the line of credit extended to Zarin was illegal under the Emergency Order of the New Jersey Casino Control Commission, the forgiven debt did not fall under § 108(d)(1)(A) and Zarin was not liable for the debt.[57] The court defined liability as "a legally enforceable obligation

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[45] *See id.* at 112.
[46] *See id.* at 111.
[47] *Id.*
[48] *Id.*
[49] *See id.* at 111–12.
[50] *Id.* at 112.
[51] *Id.*
[52] *See id.*
[53] *Id.*
[54] *See id.*
[55] *Id.*
[56] *Id.* at 113.
[57] *Id.*

to repay."[58] Because the debt was unenforceable, Zarin did not have a legal obligation to repay the loan and could not be assessed as a deficiency.[59]

The Third Circuit agreed with the Tax Court that Zarin's debt did not fit into the 108(d)(1)(B) category because it was not related to property he owned.[60] Under 108(d)(1)(B), a taxpayer must claim as income any forgiven indebtedness "subject to which the taxpayer holds property."[61] Although Zarin exchanged "markers" for chips,[62] which seems to be "property" under 108(d)(1)(B), the chips could be used only within Resorts to gamble and buy services, and thus, were worthless everywhere else.[63] The chips were simply an accounting mechanism that evidenced the debt Zarin owed Resorts.[64] Therefore, the court held that the chips could not be considered property because they "had no economic substance."[65] Thus, to have a debt that must be claimed in accordance with § 108(d)(1), the taxpayer must have a legal obligation to repay the debt or possess "property" (something with economic substance) subject to the debt.

Generally, mortgagors fit both of these definitions: they are personally responsible for paying the loan and the property is subject to the debt owed. Under the first definition, so long as the loan is a recourse loan, which most mortgages on a single family home are, the mortgagor will be responsible for paying it.[66] As to the second definition, the property occupied by the homeowner, which includes the land and the house, is subject to the debt owed by the homeowner.[67] Because the land and the house have economic substance, they qualify as property owned that is subject to the debt.[68] There are times when a person owns property that is

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[58] *Id.*
[59] *Id.*
[60] *Id.*
[61] *Id.*
[62] *See id.* at 114.
[63] *Id.*
[64] *Id.*
[65] *Id.*
[66] *Housing Decline Hearing*, *supra* note 2, at 42 n.8 (statement of Deborah A. Geier, Professor of Law, Cleveland State University).
[67] *Id.*
[68] *See id.*

worth less than what is owed on the mortgage.[69] When this is the case, the courts created an exclusion for taxpayers whose debt was cancelled but who received no value or income from the cancellation.[70]

2. *Judicially Created Exceptions to the Rule in* Kirby Lumber*—COD on Real Property—Pre § 121 and § 108*

a. Allen v. Courts[71]

Allen involved a situation very similar to the current economic state of affairs. However, in the 1940s, the Code had no exclusions for the discharge of indebtedness,[72] and income was defined simply as gains from whatever source derived.[73] There was also no exemption for real estate from capital gains tax as there is today in § 121.[74]

In *Allen*, the taxpayer wanted to purchase a seat on the New York Stock Exchange.[75] To purchase the seat, the taxpayer, Courts, entered into an agreement in 1929 with Eaton, whereby Eaton loaned Courts $402,000, to purchase a seat on the Exchange.[76] Under the terms of the agreement, the loan carried 6% interest and was to be repaid from time to time at the wish of Courts.[77] Eaton's right to be repaid was subordinate to all the claims against Courts that arose out of business transacted as a member of the Exchange, and Eaton was prohibited from maintaining any suit for the debt while Courts was a member of the Exchange and until all claims to which the loan was subordinate were fully paid.[78]

By 1934, the value of the seat fell to $125,000.[79] Courts not only owed Eaton at the time, but also had many other debts.[80] Including the debt

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[69] *See, e.g.*, Hirsch v. Comm'r, 115 F.2d 656, 657 (7th Cir. 1940) (concerning a taxpayer who paid $10,000 in cash and undertook mortgage indebtedness of $19,000 for property worth only $8000).

[70] *See* discussion *infra* Part II.A.1.b.

[71] 127 F.2d 127 (5th Cir. 1942).

[72] *See* Gary B. Wilcox, *Issuing Mixed Consideration in Troubled Debt Restructurings*, 10 VA. TAX REV. 357, 365 (1990) (noting that discharge of indebtedness income was not codified until 1954).

[73] United States v. Kirby Lumber Co., 284 U.S. 1, 3 (1931).

[74] *See* I.R.C. § 121 (2006) (listing 1964 as first year of codification for exclusion of gain from sale of principal residence).

[75] 127 F.2d at 127.

[76] *Id.*

[77] *Id.*

[78] *Id.*

[79] *Id.* at 128.

owed to Eaton, Courts was insolvent in the amount of $169,328.[81] The two came to a compromise and settled the debt owed to Eaton for a sum total of $213,625, which is $188,375 less than the original face value of the loan for the seat on the Exchange.[82] The compromise rendered Courts solvent in the amount of $103,671, which the Commissioner assessed as a realized gain against Courts.[83]

The Fifth Circuit determined that Courts did not realize a taxable gain because he had no legal obligation to repay.[84] Because the loan by Eaton was subordinate to all of Courts' other creditors and Eaton could not bring an action to recover the value of the loan so long as Courts remained a member of the Exchange, Courts had no legal obligation to repay the loan until he gave up his seat on the Exchange.[85] Moreover, the Fifth Circuit held that Courts' basis (the cost) in the seat had become $213,625 and no gain or loss would be realized until Courts disposed of the seat.[86]

Although this case arose many years before *Zarin*,[87] it is analyzed under the same concepts as those codified in § 108 and explained in *Zarin*. The Fifth Circuit in *Allen* allowed the income from the debt to be excluded from income because the taxpayer had no legal obligation to repay the loan.[88] However, if the taxpayer had been obligated to repay the loan within a certain number of years instead of when he disposed of the seat, then he may have been required to include the forgiven debt as income because there would have been a legal obligation to repay.[89] Under the current § 108, the taxpayer would also be entitled to an exclusion.[90]

b. Hirsch v. Commissioner[91]

Although *Allen* created an exception for taxpayers with no legal obligation to repay the loan,[92] the court in *Hirsch* created an exception

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[80] *Id.*
[81] *Id.*
[82] *Id.*
[83] *Id.*
[84] *Id.*
[85] *Id.*
[86] *Id.*
[87] Zarin v. Comm'r, 916 F.2d 110 (3d Cir. 1990).
[88] *Allen*, 127 F.2d at 128.
[89] *See id.*
[90] *See* I.R.C. § 108(a)(1)(B) (2006) (excluding from gross income a discharge of indebtedness that "occurs when the taxpayer is insolvent").
[91] 115 F.2d 656 (7th Cir. 1940).

where the taxpayer's debt was not subject to something with "economic substance."[93] In *Hirsch*, the taxpayer acquired real estate for $29,000 by putting down $10,000 and taking out a mortgage for $19,000 in 1928.[94] By 1936, Hirsch still owed $15,000 on the mortgage.[95] However, due to the Great Depression, the value of the property depreciated to $8000.[96] Hirsch negotiated with the lender to forgive the $15,000 for a payment of $8000.[97] Hirsch also retained possession of the property.[98] Thus, the petitioner gained the asset for $7000 less than original purchase agreement.[99]

The court reasoned that Hirsch did not receive anything of value when the $15,000 was forgiven for $8000.[100] The court determined that Hirsch now owned a piece of real estate worth $8000, which was at least $21,000 less than he thought it was worth when he agreed to purchase it for $29,000.[101] The court reasoned further that the property was worth $16,000 less than he paid for it because, until the work-out with the lender, Hirsch had paid $10,000 down at closing, had paid down $4000 on the principal of the loan, and made a final payment of $8000 to gain clear title to the property, for a sum total of $22,000.[102]

The court held, "The fact that after the transaction the plaintiff's balance sheet had improved was not sufficient to constitute 'a gain derived from capital.'"[103] For there to be a gain, the taxpayer must receive something of value.[104] The court reasoned that nothing of value was transferred to Hirsch in the transaction.[105] Instead, the transaction was merely a reduction of purchase price from $29,000 to $22,000.[106]

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[92] 127 F.2d at 128.

[93] 115 F.2d at 657.

[94] *Id.*

[95] *Id.*

[96] *Id.* at 658.

[97] *Id.* at 657.

[98] *Id.*

[99] *Id.*

[100] *Id.* at 658–59.

[101] *Id.* at 657.

[102] *See id.*

[103] *Id.* (quoting Kerbaugh-Empire Co. v. Bowers, 300 F. 938, 944 (S.D.N.Y. 1924), *aff'd*, 271 U.S. 170 (1926)).

[104] *Id.* at 657–58.

[105] *Id.*

[106] *Id.* at 658.

Therefore, the gain or loss would be realized once the taxpayer effected a disposition of the property, and that is when the taxes for any gain or loss would become due.[107]

Even though the cancellation of debt was excluded from income in the year of the forgiveness, theoretically, the value of the property would increase. Because of the reduction in basis, the taxpayer would pay taxes on the gain realized in the future when the property is sold. The consequence is a tax deferral rather than an outright exclusion.

Although the facts of *Hirsch* did not state whether the building purchased was a principal residence or a business-related building,[108] assume for the purposes of this discussion that it was a principal residence. The court allowed for a reduction in the purchase price between the buyer and seller which allowed the taxpayer to exclude the discharge of indebtedness as income.[109] The theory is that the taxpayer will eventually pay the taxes on that income because his or her basis in the property is reduced and the taxes are based on the taxpayer's gain when the property is sold.[110]

However, under the current tax code, unless Hirsch makes a profit in excess of $250,000 (again, this assumes the building is a principal residence), he will not be taxed on the gain made from the sale.[111] Thus, the concept of deferring taxation until a later date is more fiction than reality.

c. Commissioner v. Sherman[112]

Sherman is another case where the court found that the property transferred did not fit the definition of a "gain" for which he should be taxed.[113] In *Sherman*, the taxpayer purchased real estate in Dayton, Ohio for $25,000 and assumed a $175,000 mortgage.[114] When the bank tried to foreclose on the property, the taxpayer argued that the purchase was induced by fraud because the property was an investment property and the

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[107] *Id.* at 659. This is not the case today because the gain on a principal residence is excluded and no deductions are allowed for losses. *See* 21 U.S.C. § 121 (2006).

[108] *See Hirsch*, 115 F.2d at 657.

[109] *Id.* at 659.

[110] *Id.* at 658.

[111] I.R.C. § 121 (2006).

[112] 135 F.2d 68 (6th Cir. 1943).

[113] *Id.* at 70–71 ("[T]he transaction, as a whole, had resulted in loss and not in gain.").

[114] *Id.* at 68.

original seller fraudulently misrepresented its income potential.[115] The taxpayer compromised with the bank and agreed to pay $64,465.92 in cash and to assign certificates of claim with a face value of $109,972.55 and a fair market value of $60,484.90.[116] The taxpayer had a basis of $46,194.80 in the certificates of claim.[117] In the original assessment of deficiency, the Commissioner sought recovery of the difference between the face value of the mortgage and the face value of the certificates of claim.[118] On appeal, the Commissioner changed his argument to a difference between the fair market value of the certificates and the taxpayer's basis in the certificates ($14,290.10).[119]

The court found that the difference between the original purchase price and the amount of the settlement was a reduction in purchase price and not a gain from the discharge of indebtedness.[120] The court looked at the transaction as a whole and viewed the transfer of the certificates of claim merely as a means to pay the final determined debt.[121] The Commissioner viewed the transfer of the certificates as a *disposition* of the certificates resulting in gain for the taxpayer.[122] Because the court held that the transaction must be viewed as a whole, it held that the taxpayer did not receive something of value when the property value was actually lower than the amount that was paid.[123]

3. *Treatment of These Cases Under the Current Tax Code—§ 108(e)(5)*

The preceding cases characterized the taxpayer's transactions as purchase price reductions, which reduced his or her basis in the property and thereby increased the gain or decreased the loss on the disposition of the property in the future.[124] The key fact for analytical purposes is that, under all three cases, the lender was not also the seller.[125]

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[115] *Id.* at 68–69.
[116] *Id.* at 69.
[117] *Id.*
[118] *Id.*
[119] *Id.*
[120] *Id.* at 70–71.
[121] *Id.* at 70.
[122] *Id.*
[123] *Id.*
[124] *See* Comm'r v. Sherman, 135 F.2d 68 (6th Cir. 1943); Allen v. Courts, 127 F.2d 127 (5th Cir. 1942); Hirsch v. Comm'r, 115 F.2d 656 (7th Cir. 1940).
[125] *Sherman*, 135 F.2d at 70; *Courts*, 127 F.2d at 128; *Hirsch*, 115 F.2d at 659.

Under the current code, if the debtor is solvent, he or she can treat the debt forgiveness as a purchase price reduction only if:

> (A) the debt of a purchaser of property to the seller of such property which arose out of the purchase of such property is reduced, (B) such reduction does not occur—(i) in a title 11 case, or (ii) when the purchaser is insolvent, and (C) but for this paragraph, such reduction would be treated as income to the purchaser from the discharge of indebtedness, then such reduction shall be treated as a purchase price adjustment.[126]

Under subsection (A), the code requires the original *seller* to make the forgiveness of debt.[127] It further requires that the reduction not occur because the taxpayer is in a title 11 case or is insolvent, and the discharge would otherwise be treated as income.[128] If all the § 108(e)(5) criteria are met, the taxpayer may treat the transaction as a purchase price reduction and simply reduce his or her basis in the property to however much was paid. The key difference between § 108(e)(5) and the preceding three cases is that, in those cases, the reduction was made by a *lender* and not the original seller.[129] Thus, the seller has received the original purchase price, but the buyer repays the lender the lower, agreed upon amount. Therefore, under § 108(e)(5), the buyer has experienced a gain that should be treated as income because the lender has paid the seller the full purchase amount and the buyer is settling his debt with the lender for less than the amount already paid to the seller. Even if such a transaction on a home mortgage was considered purchase price reduction and not income derived from the discharge of the debt, § 121 would potentially allow the taxpayer to avoid

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[126] I.R.C. § 108(e)(5) (2000).

[127] § 108(e)(5)(A).

[128] § 108(e)(5)(B)–(C).

[129] *Compare* § 108(e)(5), *with Courts*, 127 F.2d at 128 ("[Borrower] bought a seat on the Exchange . . . for $402,000 nominally, but which . . . had really a much less exchangeable value. [Lender] considered his claim worth not more than $213,625 . . . . They settled for $213,625, and that became the cost to [borrower] of the seat."), *Hirsch*, 115 F.2d at 658 ("[Purchaser's] asset shrunk [from a purchase price of $29,000] to $8,000 . . . . [Purchaser] negotiated for and secured a reduction of $7,000. . . . [I]t was in its essence a reduction in purchase price from $29,000 to $22,000."), *and Sherman*, 135 F.2d at 70 ("The final payment of cash and certificates of claim completed the transaction and . . . there was no gain, since the property . . . was worth less than the unpaid amount of the mortgage. The effect of the whole transaction was a reduction in the purchase price of the property.").

paying taxes on the income despite experiencing a "freeing up" of assets through the transaction.[130]

4. Treatment of COD on Real Estate Post § 121 and § 108

In 1964, Congress added § 121, which allows a taxpayer to exclude from gross income the gain on a sale of a principal residence.[131] Originally, the exclusion only applied to taxpayers who were sixty-five years-old.[132] Currently, this exclusion applies to all homeowners who sell their principal residence.[133] A single taxpayer can exclude the first $250,000, and a married taxpayer filing jointly can exclude the first $500,000 of gain realized on the sale of a principal residence.[134] A principal residence is defined as a residence the taxpayer has owned and used for at least two of the five years preceding the sale.[135]

The exclusion amount ($250,000 or $500,000, respectively) is important. Although the policy behind § 108 is to provide taxpayers with a deferral, rather than an outright exemption, of the tax liability resulting from the income made on the cancellation of debt,[136] the likely result is an outright exclusion. To incur a taxable gain on the sale of a principal residence under § 121, a single homeowner would have to sell the house for $250,000 above the purchase price of the home.[137] Therefore, it seems unlikely that the liability will be "recaptured." However, the new

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[130] *See* I.R.C. § 121 (2000) ("Gross income shall not include gain from the sale or exchange of property if, during the 5–year period ending on the date of the sale or exchange, such property has been owned and used by the taxpayer as the taxpayer's principal residence for periods aggregating 2 years or more.").

[131] Revenue Act of 1964, P.L. No. 88-272, § 206, 78 Stat. 19, 38 (1964) (current version at I.R.C. § 121 (2000)).

[132] *Id.*

[133] *See* I.R.C. § 121(a) (2000) (offering the exclusion for "the taxpayer's principal residence" without setting an age restriction).

[134] § 121(b).

[135] § 121(a).

[136] *See* Note, *supra* note 11, at 1266 ("Congress enacted § 108 of the Code to benefit financially troubled taxpayers by providing temporary relief from the recognition of discharged debt.").

[137] *See* § 121(b)(1) (2000). The gain on the disposition of property is the amount realized in the disposition (the sale price) less the adjusted basis (which will be the amount the homeowner originally paid for the home). § 1001(a) (2000). Thus, a home purchased for $250,000 will have to sell for more than $500,000 for a single taxpayer to incur a taxable gain, therefore the likelihood of ever "recapturing" COD income that is excluded under § 108(a)(1)(E) is very low.

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exclusion created in the Debt Relief Act requires the taxpayer to reduce the basis of the home.[138] Reducing the basis necessarily results in the liability being "recaptured" on the gain when the home is sold.[139]

III. CODIFICATION OF EXCLUSIONS AND HOW THEY WORK—26 U.S.C. § 108

In 1980, Congress codified the judicially created exclusions for including cancellation of debt in a taxpayer's gross income in the Bankruptcy Tax Act of 1980.[140] The amendment added the first three exceptions for taxpayers who are bankrupt, insolvent, or who have qualified business indebtedness.[141] The fourth exclusion for qualified farm indebtedness (§ 108(a)(1)(C)) was codified in 1988 in response to decreasing land values that had a detrimental effect on the agricultural industry.[142] The codified exclusions, much like the judicially created exclusions, are meant to help taxpayers who are financially distressed.[143] A close reading of the statute, legislative history, and case law interpreting the provisions reveals that the exclusions are meant to benefit insolvent and not benefit solvent taxpayers.[144]

A. Bankruptcy—Government Should Not Step in Front of Creditors

Under § 108(a)(1)(A), "Gross income does not include any amount which . . . would be includible in gross income by reasons of the discharge . . . of indebtedness of the taxpayer if—(A)the discharge occurs in a title 11 case."[145] A title 11 case is "a case under title 11 of the United States Code (relating to bankruptcy), but only if the taxpayer is under the jurisdiction of the court in such case and the discharge of indebtedness is granted by the court or is pursuant to a plan approved by the court."[146]

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[138] *See* PAMELA J. JACKSON & ERIKA LUNDER, CONG. RESEARCH SERV., ANALYSIS OF THE PROPOSED TAX EXCLUSION FOR CANCELED MORTGAGE DEBT INCOME 3–4 (2007).

[139] *Id.*

[140] Bankruptcy Tax Act of 1980, Pub. L. 96-589, § 2, 94 Stat. 3389, 3389 (1980).

[141] *Id.*

[142] Technical and Miscellaneous Revenue Act of 1988, Pub. L. 100-647, § 1004, 102 Stat. 3342, 3385 (1988).

[143] Merkel v. Comm'r, 109 T.C. 463, 466-72 (1997).

[144] *See* discussion *infra* Part III.A–B.

[145] I.R.C. § 108(a)(1)(A) (2000).

[146] § 108(d)(2).

This section, as introduced in the Bankruptcy Tax Act of 1979[147] and amended in the Bankruptcy Tax Act of 1980, is meant to "revise[] and modernize[] the substantive law of bankruptcy court procedures."[148] The purpose of the bill is to help rehabilitate bankrupts by easing the tax burdens and administrative processes that were once affiliated with bankruptcy.[149] This facilitates their turnaround and gives them the "fresh start" that is meant to be given through bankruptcy.[150] However, the "fresh start" does not grant absolute forgiveness of tax liability; rather, the amount forgiven is used to reduce the taxpayer's basis in depreciable property or to reduce "other tax attributes."[151] Thus, the taxpayer will incur the liability in the future because the deductions used to offset liability (i.e., depreciation, net operating losses, etc.) will not be as large as they would have been had the debtor not been forgiven a debt. A similar exclusion exists for insolvent taxpayers, although the bill was amended specifically to limit the availability of the exclusions to solvent taxpayers.[152]

B. Insolvency—Insolvents Outside of Bankruptcy Deserve the Same "Fresh Start" Afforded to Bankrupts

Under § 108(a)(1)(B), a taxpayer's "gross income does not include any amount which . . . would be includible in gross income by reasons of the discharge . . . of indebtedness of the taxpayer if—the discharge occurs when the taxpayer is insolvent."[153] Insolvency is the "excess of liabilities over the fair market value of assets."[154] In other words, a taxpayer's insolvency is determined by the value of the taxpayer's assets and liabilities immediately before the discharge of the debt.[155]

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[147] *See* 2 BERNARD D. REAMS, JR., TAX REFORM 1980, A LEGISLATIVE HISTORY OF PUBLIC LAW 96-613: TAX LAWS, MISCELLANEOUS CHANGES 1 (1995).

[148] *Id.* at 1–2.

[149] *Bankruptcy Tax Act Hearing*, *supra* note 14, at 4 (statement of Daniel I. Halperin, Deputy Assistant Secretary for Tax Policy, Department of the Treasury).

[150] S. REP. No. 96-1035, *supra* note 15, at 10.

[151] *Id.*

[152] *Id.* Such an amendment was also recommended by Department of the Treasury. *See Bankruptcy Tax Act Hearing*, *supra* note 14, at 4 (statement of Daniel I. Halperin, Deputy Assistant Secretary for Tax Policy, Department of the Treasury).

[153] I.R.C. § 108(a)(1) (2000).

[154] § 108(d)(3).

[155] *Id.*

The insolvency calculation is based on the "freeing of assets theory" explained in *Kirby*.[156] According to the court in *Merkel v. Commissioner*,[157] Congress intended that the insolvency exclusion require solvent debtors to pay an immediate tax liability and not allow them to take advantage of the deferral given to bankrupts and insolvents outside of bankruptcy (insolvents).[158] The purpose of allowing the exclusion to bankrupts and insolvent debtors is to provide horizontal equity, similar treatment to taxpayers in similar situations.[159] Both bankrupts and insolvents are re-organizing their finances because their liabilities currently exceed their assets, and they cannot afford to incur an immediate tax liability.[160] Solvent debtors, by definition, have assets that exceed their liabilities and are in a better position to incur immediate tax liabilities.[161] The court in *Merkel* took note that this does not mean solvent debtors have sufficient cash on hand to pay the tax bill; rather, it means solvent debtors' overall assets exceed their overall liabilities.[162]

Moreover, the legislative history of the bill indicates Congress's intent to amend the previous law to limit the exclusions available to solvent debtors.[163] Prior to this bill, solvent corporate debtors were able to take advantage of poor drafting and avail themselves of all the potential reductions available to bankrupts and insolvents.[164] Although bankrupts and insolvents can reduce their net operating losses, take advantage of certain tax credits, carry over capital losses, or reduce their basis in depreciable property, solvents are limited to a reduction in basis of depreciable property.[165] The rationale is that the solvent debtor will sell the depreciable property eventually and the reduced-basis will be subject to "recapture"; thus, the exclusion still only applies as a deferral.[166]

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[156] Cozzi v. Comm'r, 88 T.C. 435, 445 (1987) (citing United States v. Kirby Lumber Co., 284 U.S. 1, 1 (1931)).

[157] 109 T.C. 463 (1997).

[158] *Id.* at 475.

[159] *Id.* at 476.

[160] *Id.*

[161] *Id.* at 474.

[162] *Id.*

[163] *See* S. REP. No. 96-1035, *supra* note 15, at 3.

[164] *Bankruptcy Tax Act Hearing*, *supra* note 14, at 4 (statement of Daniel I. Halperin, Deputy Assistant Secretary for Tax Policy, Department of the Treasury).

[165] S. REP. No. 96-1035, *supra* note 15, at 2–3.

[166] *See id.* at 3.

Even allowing an exclusion for depreciable property to solvent debtors who have a debt discharged, the spirit of § 108 remains intact because, theoretically, the excluded tax liability is paid in the future based on a large gain on the sale of the property. This is not the case for a homeowner who reduces his or her basis in a house. Despite that § 108 did not originally allow a reduction in non-depreciable property (a personal residence),[167] the foregone tax liability is not likely "recaptured" when the property is sold. Section 121 allows the homeowner to exclude gains of $250,000 for individuals and $500,000 for married taxpayers.[168] Therefore, barring a remarkable rebound in land and home prices, the taxpayer is receiving an outright exclusion of tax liability instead of a deferral of tax liability.

C. Farm Indebtedness—Congress Does Not Want the Taxpayer to Sell the Farm to Pay a Tax Bill[169]

In the early 1980s, the United States entered a recession causing "massive defaults on farm loans"[170] similar to the defaults on mortgages in the current crisis.[171] To prevent farmers from needing to sell the farm to pay taxes, Congress added an exclusion for qualified farm indebtedness to § 108(a)(1).[172] For this exclusion to apply to the taxpayer, the person forgiving the debt must be "engaged in the business of lending money" and unrelated to the taxpayer, the person from whom the farm was acquired, or someone receiving a fee related to the investment in the farm.[173] Moreover, for the debt to qualify, it must have been "incurred directly in connection with the operation . . . of the trade or business of farming"[174] and at least 50% of the taxpayer's "gross receipts" for the previous three years must have been from the "trade or business of farming."[175] The amount excluded from income cannot exceed the sum of the taxpayer's adjusted tax attributes and the adjusted bases of qualified property held by

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[167] *See* Internal Revenue Code of 1954, ch. 1, § 108, 68A Stat. 32, 32 (1954) (current version at I.R.C. § 108 (LexisNexis 2010).

[168] I.R.C. § 121(b) (2006).

[169] *See* JACKSON & LUNDER, *supra* note 138, at 1.

[170] NEIL HARL, THE FARM DEBT CRISIS OF THE 1980S 17 (1990).

[171] *See* E. Scott Reckard & Ronald D. White, *Foreclosures Strike Prime Borrowers*, L.A. TIMES, Aug. 21, 2009, at A1 (noting 13% of the nation's mortgages were either delinquent or in foreclosure).

[172] § 108(a)(1)(C).

[173] §§ 49(a)(1)(D)(iv), 108(g)(1)(B).

[174] § 108(g)(2)(A).

[175] § 108(g)(2)(B).

the taxpayer in the year following the exclusion.[176] Qualified property is any property used in a trade or business for the production of income.[177]

Thus, for discharged debt to qualify under the farm exclusion, the taxpayer must have acquired the debt from a qualified lender and for purposes consistent with operating a farm. Once the taxpayer makes the election to exclude the discharged debt from income, the taxpayer must reduce the basis of tax attributes listed in § 108(b)(2), including the basis in any property the taxpayer holds that is used for the production of income.[178] However, this does not include the basis of the taxpayer's personal residence.[179]

Although the farm exclusion does apply to solvent farmers,[180] the farmer must reduce tax attributes, which again will result in the "recapture" of the excluded tax liability in the future.[181] The exclusion currently given to solvent homeowners is not likely "recaptured" because the homeowner will not have the same tax attributes as a farmer or business owner to reduce (i.e., net operating losses or depreciable property).

D. Qualified Business Indebtedness—§ 108(a)(1)(D)

The fourth exclusion listed in § 108(a)(1) is an exclusion for qualified business indebtedness.[182] This particular exclusion does not apply to C corporations,[183] but the policy behind it still comports with the other exclusions in § 108. In *United States v. Centennial Savings Bank*,[184] the Supreme Court held that the policy behind the exclusion is not aimed at discouraging businesses from making advantageous business decisions, such as that in *Kirby* where the company repurchased stock at a lower price than it was issued for, because it may incur adverse tax consequences that it cannot afford.[185] The Court compared this exclusion to the others in

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[176] § 108(g)(3)(A)(i)–(ii).

[177] § 108(g)(3)(C).

[178] § 108(b)(2), (g)(3)(A)–(C).

[179] *See* § 108(g)(3)(C).

[180] §§ 49 (a)(1)(D)(iv), 108(a)(1)(B)–(C).

[181] SEN. REP. No. 100-445, at 29–30 (1988), *reprinted in* 1988 U.S.C.C.A.N. 4515, 4553–54.

[182] *Id.*

[183] *Id.*

[184] 499 U.S. 573 (1991).

[185] *Id.* at 582–83.

§ 108 and ultimately held that § 108 is a tax deferral system rather than a tax forgiveness system.[186]

In *Centennial Savings*, the taxpayer, a bank, charged its customers an early withdrawal fee when they "prematurely terminated their CD accounts."[187] In 1981, the taxpayer collected $258,019 in early withdrawal fees and then excluded the same amount from its taxable income claiming that the amount was properly excludable under § 108(a)(1)(D) as qualified business indebtedness.[188] Then, pursuant to § 108(c), the taxpayer reduced its basis in the CDs as though they were depreciable property.[189] The IRS determined that the fees were not income from the discharge of a debt, and thus, were not subject to the exclusion under § 108.[190] As a result, the IRS assessed a deficiency against the taxpayer.[191] The taxpayer paid the deficiency and then commenced an action for a refund.[192] The district court found in favor of the taxpayer, and the Fifth Circuit affirmed.[193] The Fifth Circuit determined that "the characterization of income as income from the discharge of indebtedness depends purely on the spread between the amount received by the debtor and the amount paid by him to satisfy his obligation."[194] This determination was based on the premise that the bank owed a debt of the principal and interest to customers who deposited money in a CD.[195] When the depositor chose to make an early withdrawal and pay the resulting fees, the bank's debt was reduced by the amount of the fee.[196] Thus, the bank was discharged from its debt and the resulting income was subject to the exclusion in § 108(a)(1)(D).[197]

The Supreme Court reversed the decision, reasoning that a debtor is only "discharged" from a debt when the creditor agrees to accept less than what is owed on the debt as full payment of the debt.[198] The Court defined discharge as used in § 108 as "forgiveness of, or release from, an

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[186] *See id.* at 583–84.
[187] *Id.* at 576.
[188] *Id.*
[189] *See id.*
[190] *Id.* at 577.
[191] *Id.*
[192] *Id.*
[193] *Id.*
[194] *Id.*
[195] *Id.* at 577–78.
[196] *See id.* at 578.
[197] *See id.*
[198] *Id.* at 580–81.

obligation to repay."[199] In this case, the Court determined that the depositor-creditor was aware that if an early withdrawal from the CD program was made, the bank's only legal obligation was to repay the principal and interest, less the stated fees.[200] Therefore, there is no "discharge" of a debt as contemplated in § 108.[201] The fees collected by the bank are regular income, and therefore, are not subject to exclusion under § 108.[202]

In coming to this conclusion, the Court explained the policy goals of § 108. "[T]he effect of § 108 is not genuinely to exempt such income from taxation, but rather to defer the payment of the tax by reducing the taxpayer's annual depreciation deductions or by increasing the size of taxable gains upon ultimate disposition of the reduced-basis property."[203] The Court further explained that § 108 is a "tax-deferral mechanism . . . designed to mitigate the effect of treating the discharge of indebtedness of income" because, "while the cancellation of the obligation to repay increases the taxpayer's assets, it does not necessarily generate cash with which the taxpayer can pay the resulting income tax."[204] Thus, Congress created the § 108 exclusions to allow taxpayers without sufficient cash to defer tax liability and not to discourage business from ceasing opportunities to repurchase debt obligations at lower than face value.[205] The Court relied on House and Senate reports from 1939 and 1942 in determining the intent of § 108,[206] but it also said that a "common sense" reading of the statute brings the reader to the same conclusion.[207]

In this opinion, the Supreme Court held that the purpose of excluding forgiveness of debt as income is to help taxpayers who do not currently have the ability to pay a tax bill, but will be able to pay the tax liability in the future.[208] The intent is not to allow a taxpayer to escape tax liability on a gain altogether simply because the taxpayer's actual cash holdings did not increase as a result of the transaction.[209] The Court also stated that the

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[199] *Id.* at 580.
[200] *Id.* at 581.
[201] *Id.*
[202] *Id.*
[203] *Id.* at 580.
[204] *Id.* at 582.
[205] *Id.* at 582–83.
[206] *See id.* at 583.
[207] *Id.* at 581–82.
[208] *See id.* at 580.
[209] *Id.*

policy of § 108(a)(1)(D) is to create a mechanism that eventually captures the tax liability without discouraging businesses from making advantageous business transactions.[210]

IV. RECENT DEVELOPMENTS—THE CURRENT FORECLOSURE CRISIS AND CONGRESS'S ATTEMPTS TO HELP INDIVIDUAL TAXPAYERS

A. The Subprime Mortgage Crisis

Between 1960 and 1994 the rate of homeownership in America was around 65%.[211] Between 1995 and 2005 the American rate of homeownership grew to 69%.[212] This translates into 4.5 million homeowners who otherwise would have been renters.[213] Between 2001 and 2005, the number of new single family homes being built per year increased from 1.3 million to 1.7 million.[214] With the influx of new buyers, the median home prices skyrocketed at rates never before seen in the housing market.[215] Land values became overvalued by 26%, and home prices were overvalued by 12% during this time period.[216] Around the end of 2005, the housing-boom began to end, and recently, the overvalued homes have declined in value, leaving homeowners with little to no equity in their homes.[217] This, in turn, had a very negative impact on the overall economy, which helped further stifle demand for new housing and new mortgages.[218] It has also caused less spending in the broader market place because many people borrow against their home equity to make those purchases.[219]

The growth and overvaluation that occurred during this period was spurred by a Federal Reserve initiative to bolster the country's GDP and provide access to mortgages and homeownership to a class of citizens who

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[210] *See id.* at 582–83.

[211] *Subprime Lending Hearing*, *supra* note 4, at 49–50 (statement of Peter R. Orszag, Director of the Cong. Budget Office).

[212] *Id.* at 50.

[213] *Id.*

[214] NAT'L ASS'N OF HOME BUILDERS, ANNUAL HOUSING STARTS (1978–2008) (2010), http://www.nahb.org/generic.aspx?sectionid=819&genericcontentid=554&channelID=311.

[215] *Housing Decline Hearing*, *supra* note 2, at 5–6 (testimony of Morris A. Davis, Professor of Economics, University of Wisconsin).

[216] *Id.*

[217] *Subprime Lending Hearing*, *supra* note 4, at 52 (statement of Peter R. Orszag, Director of the Cong. Budget Office).

[218] *Id.*

[219] *Id.*

have never before had the opportunity to own their own home.[220] To accomplish this goal, the Federal Reserve uncharacteristically kept interest rates at historic lows.[221] As the interest rates sank, demand for home loans increased.[222] As the demand for homes increased, the supply of housing decreased, which caused extreme inflation in the price of homes.[223] With low interest rates and high demand, lenders were able to provide credit to people who otherwise could not have afforded homes.[224] These borrowers are called subprime because the borrower does not qualify for a conventional type of loan due to bad credit, little to no cash for a down payment, or lack of proof of income.[225] In other words, these borrowers do not meet the underwriting guidelines to qualify for traditional or "prime rate" mortgages.[226] However, this is the group of Americans that the federal government wanted to see achieve the "American Dream" of homeownership.[227]

Subprime mortgages include "fixed rate mortgages, adjustable-rate mortgages, and combinations of the two," such as mortgages with a fixed "teaser" rate for the first few years and then an interest rate that varies, sometimes by the month or even day, for the remainder of the term.[228] The subprime mortgage market also includes "interest-only loans[] and negative amortization loans, in which the principal can actually grow during the initial years."[229] The common theme behind a subprime loan is to entice borrowers who could not otherwise obtain mortgage financing (especially at the height of the housing-boom) with low monthly payments

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[220] *Id.* at 52.

[221] *See id.* Although mortgage rates from 1995–2000 were already remarkably low at 7.6% (compare this with rates nearing 17% and 18% in the 1980s), the rates continued to drop below 6% through 2005. *Id.*

[222] *Id.*

[223] *Id.*

[224] *Housing Decline Hearing*, *supra* note 2, at 32–33 (statement of Michael Decker, Senior Managing Director, Research and Public Policy for Securities Industry and Financial Markets Association (SIFMA)).

[225] *Subprime Lending Hearing*, *supra* note 4, at 50 (statement of Peter R. Orszag, Director of the Cong. Budget Office).

[226] *Id.*

[227] *Housing Decline Hearing*, *supra* note 2, at 34 (statement of Michael Decker, Senior Managing Director, Research and Public Policy for SIFMA).

[228] *Subprime Lending Hearing*, *supra* note 4, at 50 (statement of Peter R. Orszag, Director of the Cong. Budget Office).

[229] *Id.*

for the first few years (so low that it seems too good to be true) and much higher payments in the last years of the loan.[230]

The problem with subprime loans is that many of the consumers receiving these types of loans are unsophisticated borrowers.[231] They were enticed into buying a house by the strong economy, the promise of available and affordable mortgages, and the false assumption that their home value would continue to grow.[232] Additionally, the terms of the subprime loans, especially the ARMs, are very complicated and confusing.[233] The unwitting consumer is lured in with the promise of low interest rates, but the lender fails to inform the borrower of the reality of the loan's terms: the potential size of the increase when the rate adjusts or the pre-payment penalty that can make it extremely expensive for a borrower to refinance the mortgage.[234]

Although subprime mortgages are not the sole cause of the housing downturn, they are particularly troublesome in trying to turn the market around.[235] By the end of 2006, lenders provided more than $1.2 trillion in subprime mortgages.[236] At that time, the subprime mortgages accounted for 13% of all home mortgages.[237] Subprime mortgages accounted for over 20% of the total number of home loans originated in 2005 and 2006.[238] However, nearly 60% of the homes in foreclosure at that time were homes financed by subprime mortgages.[239] Moreover, only 15% of the outstanding subprime mortgages are accounted for in that 60% figure.[240] That means that nearly 85% of the subprime borrowers are still current on their mortgage payments and many of the outstanding adjustable rate loans

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[230] *Id.* at 50–51.

[231] *Id.* at 51.

[232] *Id.* at 50.

[233] *Id.* at 51.

[234] *Id.* at 51. In regard to subprime mortgages one expert was prompted to ask, "Why are the most risky loan products sold to the least sophisticated borrowers?" *Id.*

[235] *Id.* at 52.

[236] *Id.* at 50.

[237] *Id.*

[238] *Id.*

[239] *Housing Decline Hearing*, *supra* note 2, at 3–4 (testimony of Jack Kemp, Principal, Kemp Partners).

[240] *Subprime Lending Hearing*, *supra* note 4, at 51 (statement of Peter R. Orszag, Director of the Cong. Budget Office).

have not yet reset, but will do so before the end of 2010.[241] Many of these mortgage payments will reset to monthly payments far exceeding the borrower's ability to pay.[242] The borrower will also have trouble refinancing the mortgage because the borrower will have little to no equity in the home and its value has declined, rather than increased.[243] If the borrower cannot afford the mortgage without refinancing, the borrower may be forced into a short sale or foreclosure.[244] Once the property is sold, through the short sale or a foreclosure auction, the bank may choose to release the borrower from the remaining debt.[245] In either case, the homeowner ends up with taxable income from the forgiveness of debt—provided the homeowner is not bankrupt or insolvent—and will therefore qualify for an exclusion under § 108.[246]

This begs the question: should the government intervene and create a new, temporary exclusion from income for homeowners who have received income through mortgage forgiveness?

B. Congressional Help for Homeowners?—108(a)(1)(E)

By early 2007, the mortgage crisis was so far out of hand that the average home price was decreasing by approximately 4% per year.[247] Compare this to an average increase of 10%, or more, per year, which is it where it once was.[248] By mid-2007, consumer and trade groups were calling for Congress to step in and ease the pressure on the market.[249] One

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[241] *Id.* at 52. It is not until the interest rates reset and the monthly mortgage payments increase that borrowers begin to default on mortgages. However, with the current rate of job loss and the souring economy, borrowers who were already stretched thin by the lower mortgage payment may be in trouble even before their mortgage resets. *See id.*

[242] *Id.*

[243] *See id.*

[244] *See id.* at 52–53.

[245] *Id.* at 58.

[246] *Id.*; I.R.C. § 108(a)(1)(D) (2006). The lack of equity is a result of the above discussion on how a subprime loan is issued. Without a substantial down payment, and with the type of loan taken (e.g., interest only), the homeowner has barely decreased the original principal of the loan if at all. Combined with the falling prices, this often results in the homeowner owing more on the loan than the house is actually worth.

[247] *Housing Decline Hearing*, *supra* note 2, at 35 (statement of Michael Decker, Senior Managing Director, Research and Public Policy for SIFMA).

[248] *Id.*

[249] *See,* e.g., Letters from Joseph M. Stanton, Chief Lobbyist National Association of Home Builders, John M. Robbins, Chairman of the Mortgage Bankers Association, and Pat V. Combs, President, National Association of Realtors, to Rep. Charles Rangel, Chairman,

(*continued*)

of the measures passed by Congress was the Mortgage Forgiveness Debt Relief Act of 2007, which amended § 108 of the tax code to include an exclusion for income derived through the discharge of qualified mortgage indebtedness.[250] The exclusion was added as § 108(a)(1)(E) and § 108(h).[251] Sections 108(a)(1)(E) and (h) read:

> (a)(1) Gross income does not include any amount which (but for this subsection) would be includible in gross income by reason of the discharge (in whole or in part) of indebtedness of the taxpayer if—(E) the indebtedness discharged is qualified residence indebtedness which is discharged before January 1, 2013.[252]
>
> (h) Special rules relating to qualified principal residence indebtedness. (1) Basis reduction. The amount excluded from gross income by reason of subsection (a)(1)(E) shall be applied to reduce (but not below zero) the basis of the principal residence of the taxpayer. (2) Qualified principal residence indebtedness. For purposes of this section, the term "qualified principal residence indebtedness" means acquisition indebtedness (within the meaning of section 163(h)(3)(B) . . . , applied by substituting "$2,000,000/ $1,000,000" for $1,000,000/$500,000" in clause (ii) thereof) with respect to the principal residence of the taxpayer. (3) Exception for certain discharges not related to taxpayer's financial condition. Subsection (a)(1)(E) shall not apply to the discharge of a loan if the discharge is no account of services performed for the lender or any other factor not directly related to a decline in the value of the residence or to the financial condition of the taxpayer. (4) Ordering rule. If any loan is discharged, in whole or in part, and only a portion of such loan is qualified principal

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H. Comm. on Ways and Means, and Rep. Jim McCrery, Ranking Member, H. Comm. on Ways and Means (Sept. 25, 2007), *available at* http://waysandmeans.house.gov/media/pdf/110/09%2026%2007%20Combined%20letters.pdf.

[250] Mortgage Forgiveness Debt Relief Act of 2007, Pub. L. No. 110-142, §2, 121 Stat. 1803, 1803–04 (2007).

[251] *Id.*

[252] I.R.C. § 108(a)(1)(E) (LexisNexis 2008). There has already been an amendment extending the sunset date of the provision to Jan. 1, 2013. *See* Pub. L. No. 110-343, § 303(a), 122 Stat. 3765, 3807 (2008).

> residence indebtedness, subsection (a)(1)(E) shall apply only to so much of the amount discharged as exceeds the amount of the loan (as determined immediately before such discharge) which is not qualified principal residence indebtedness. (5) Principal residence. For purposes of this subsection, the term "principal residence" has the same meaning as when used in section 121.[253]

This section extends the exclusions that were once limited to taxpayers who were bankrupt, insolvent,[254] or had farm indebtedness.[255] The exclusions now also apply to debtors who are potentially solvent, but whose finances are stretched thin—so thin that it could cause them to default on their mortgage.[256] On one hand, the other exclusions are aimed at preventing the government from stepping in front of other creditors or getting in the way of a former debtor working his or her way out of debt.[257] On the other hand, this bill is aimed at helping the taxpayer retain a home that he or she could not afford under ordinary circumstances.[258]

The original policy behind the exclusions in § 108 is based on a tax deferral, not a tax exemption.[259] Although § 108(h) requires a basis reduction,[260] it is very likely that many of the homeowners receiving a refinancing discharge will not be re-selling the house at a net gain of $250,000 or $500,000.[261] Thus, under § 121, a homeowner's tax liability on the discharge will not be deferred, but will be cancelled.[262] In fact, the government will be likely subsidizing taxpayers receiving an exempt-gain on the sale of their home (through tax incentives), where they would have otherwise suffered a loss if they were not able to refinance.[263] Moreover, if

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[253] § 108(a)(1)(E).

[254] § 108(a)(1)(A)–(B).

[255] § 108(a)(1)(C).

[256] § 108(a)(1)(E).

[257] *See* S. REP. No. 96-1035, *supra* note 15, at 10.

[258] *Housing Decline Hearing*, *supra* note 2, at 2 (2007) (statement of Sen. Max Baucus, Chairman, S. Comm. on Finance). Senator Baucus admits that taxing income from the cancellation of indebtedness is sound tax policy, but still determines that "when so many homeowners are losing their homes, and face a large tax bill to boot, it's time for us to provide temporary relief." *Id.*

[259] *See* United States v. Centennial Sav. Bank, 499 U.S. 573, 582 (1991).

[260] § 108(h)(1).

[261] *See* JACKSON & LUNDER, *supra* note 138, at 13.

[262] § 121(a).

[263] *See* JACKSON & LUNDER, *supra* note 138, at 7.

the homeowner stays in the home long enough to pay off the mortgage and then sells the home for more than the threshold amounts in § 121, the horizontal equity that was discussed in *Merkel* is not achieved.[264] Although some taxpayers will escape liability through this program, others will be forced to pay their deferred taxes in the future.[265]

V. ANALYSIS

The exclusion added by Congress does not prevent people from needing to sell their houses to pay taxes. Instead, it transfers the risk of falling home values to the bank while providing homeowners with a tax exemption that many taxpayers before 2008 had to pay and many taxpayers after 2013 will have to pay. The current situation is very similar to *Allen v. Courts* and the other real property cases that arose during the Great Depression.[266] However, during that time period, the courts allowed exclusions for bankrupt and insolvent taxpayers and taxpayers who negotiated a lower price with the original seller.[267] The new exclusion is for solvent taxpayers who are renegotiating with a third party lender either through refinancing, short selling, or foreclosure.[268] Although the original exclusions effectively work as tax deferrals,[269] the exclusion in the Debt Relief Act will work as a complete tax exception.[270]

The purpose of requiring a reduction in the basis of residential property is to defer the tax liability to when the owner disposes of the property.[271] This purpose may have been effected anytime before the 1960s and prior to the addition of § 121,[272] but that is no longer the case for most taxpayers. Because of § 121, a taxpayer must realize $250,000 or $500,000 above the purchase price before incurring a taxable gain.[273] Thus, it is unlikely that section 108(a)(1)(E) will work to defer tax liability; rather, it will exclude any liability from the cancellation of debt on the mortgage.

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[264] *See id.* at 7–8.

[265] *Id.*

[266] *See* Comm'r v. Sherman,135 F.2d 68 (6th Cir. 1943); Allen v. Courts, 127 F.2d 127 (5th Cir. 1942); Hirsch v. Comm'r, 115 F.2d 656 (7th Cir. 1940).

[267] *Sherman*, 135 F.2d at 70; *Courts*, 127 F.2d at 128; *Hirsch*, 115 F.2d at 659.

[268] *See* JACKSON & LUNDER, *supra* note 138, at 4.

[269] *See* United States v. Centennial Sav. Bank, 499 U.S. 573, 582 (1991).

[270] *See* JACKSON & LUNDER, *supra* note 138, at 4.

[271] *See Hirsch*, 115 F.2d at 658–59.

[272] I.R.C. § 121 (2006).

[273] §§ 121, 1001.

Senators and Representatives are concerned that without the new exemption, taxpayers will pay taxes on phantom income.[274] But it is not phantom income. If a taxpayer has a mortgage of $1000 per month and the house is foreclosed on because he or she cannot afford the $1000 per month payment, the taxpayer may move into an apartment and pay $500 per month. That is $500 less per month than what the taxpayer owed on the mortgage, which is $500 more the taxpayer can keep or spend on other things. Moreover, it has long been the policy of the tax code that where a taxpayer's assets are freed from the obligation to secure a debt, the taxpayer has incurred taxable income.[275]

Additionally, the policy behind § 108 was to help people in such severe financial trouble that they were filing for bankruptcy or were insolvent and seeking forgiveness to climb out of insolvency.[276] The original exclusions in the Bankruptcy Tax Act are the government's attempt to help these taxpayers regain their financial footing by deferring tax liability until a time when they could more easily afford it.[277]

However, the Debt Relief Act applies to homeowners who are technically solvent because of their retirement investments (such as 401(k)s, IRAs, and Roth IRAs).[278] Although many of these taxpayers would be insolvent without these retirement accounts,[279] they are still technically solvent—a status that is specifically denied access to the exclusions under the Bankruptcy Tax Act.[280] The concern is that these taxpayers will suffer negative tax consequences if they are forced to liquidate those assets.[281] When did government become a guarantor of taxpayers' personal retirement investments (other than social security, of course)? Moreover, the lender probably considered the taxpayer's retirement investments when determining if and how much to lend. Thus, the assets probably were used to secure the debt. Now, the assets are freed from the obligation to pay the debt; yet, the taxpayer is not required to recognize the resulting accession to wealth in accordance with § 61 and our tax policy.

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[274] Rachel Carlton, Comment, *Mortgage Forgiveness Debt Relief Act of 2007*, 45 HARV. J. ON LEGIS. 601, 609 (2008).

[275] *See* Camp, *supra* note 20, at 2.

[276] Leamon, *supra* note 11, at 1268.

[277] *See* S. REP. No. 96-1035, *supra* note 15, at 10.

[278] *Housing Decline Hearing*, *supra* note 2, at 8 (testimony of Deborah A. Geier, Professor of Law, Cleveland-Marshall College of Law).

[279] *Id.*

[280] S. REP. No. 96-1035, *supra* note 15, at 10.

[281] *See id.* at 11.

The original policy goals of § 108 are violated by the addition of this exclusion. If a homeowner is insolvent or is facing bankruptcy, then he or she should not face a tax bill at that time. However, tying the tax bill to the basis of the home is most likely going to be an insufficient way to recover the tax from the taxpayer. It is for this reason that the current addition to the tax code does not comport with the intent of § 108 nor is it an effective way to defer tax liability.

VI. CONCLUSION

The Mortgage Forgiveness Debt Relief Act has been supported with rhetoric such as, "It is just not right or fair that families struggling through a foreclosure would then face a tax bill in addition to losing their homes when they have seen no increase in their net worth,"[282] and "When your home is losing value and your family is under financial stress, the last thing you need is to be hit with higher taxes."[283] Although these are understandable sentiments, they support a law that ignores what has been established as sound tax policy.

Under § 61, when a taxpayer gains wealth (no matter how abstract), he or she is subject to taxation on that wealth.[284] Section 108 allows very limited exclusions for taxpayers who have debt forgiven but whose finances leave them unable to pay the resulting tax immediately, even after the discharge of the debt.[285] However, the bankrupt or insolvent taxpayer is not relieved of the tax liability forever. Rather, it is only deferred until a time when the taxpayer is better able to pay the tax.[286]

The Debt Relief Act's amendment of § 108 provides an exclusion to solvent taxpayers who have recognized a gain through the forgiveness of a debt.[287] Moreover, because of the workings of § 121, the taxpayer will most likely be provided with a complete exoneration from paying the tax liability.

Taxpayers who purchase homes are taking the risk that one day they may not be able to afford their mortgage, that the value of their home may

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[282] 2007 TAX NOTES TODAY 194-1 (statement of Rep. Charles Rangel, Chairman of H. Comm. on Ways and Means).

[283] Press Release, George W. Bush, President of the United States, *Fact Sheet: The Mortgage Forgiveness Debt Relief Act of 2007*, (Dec. 20, 2007), http://georgewbush-whitehouse.archives.gov/news/releases/2007/12/20071220-6.html.

[284] *See* I.R.C. § 61 (2006).

[285] *See* § 108.

[286] *See* United States v. Centennial Sav. Bank, 499 U.S. 573, 583–85 (1991).

[287] *See* § 108(a)(1)(E).

decrease (however unlikely this may be), and that if both occur, the taxpayer may get less back on the sale of the house while remaining personally liable to the bank for the outstanding debt. However, where the bank releases the taxpayer from liability, the taxpayer realizes a gain in assets that otherwise would be used to secure the debt. If the taxpayer is not bankrupt nor insolvent, then he or she should have to pay the resulting tax liability immediately because, by definition, he or she can afford to do so. Simply because "so many homeowners are losing their homes" does not mean that the government should provide "temporary relief" by excusing the homeowners from their tax liabilities.[288] Such a provision does not comport with a "common sense" reading of § 108.

[288] *See Housing Decline Hearing*, *supra* note 2, at 2 (statement of Sen. Max Baucus, Chairman, S. Comm. on Finance). The author disagrees with Senator Baucus's testimony. He supported the amendment to § 108 as "temporary relief" because "so many homeowners are losing their homes . . . ." *Id.*