FROM THE GREAT DEPRESSION TO THE CURRENT HOUSING CRISIS: WHAT CODE SECTION 108 TELLS US ABOUT CONGRESS'S RESPONSE TO ECONOMIC CRISIS

Monica D. Armstrong[*]

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* Associate Professor of Law, Walter F. George School of Law, Mercer University. I would like to thank Professor Leandra Lederman, Indiana University School of Law-Bloomington, IN, for helping me with this article. Her comments and suggestions were not only extremely helpful, but gave me the confidence that I needed throughout the writing process.

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I. INTRODUCTION

On December 20, 2007, President George W. Bush signed the Mortgage Forgiveness Debt Relief Act of 2007 ("Mortgage Debt Relief Act" or "MDRA") into law.[1] As the title suggests, the Mortgage Debt Relief Act assists homeowners affected by the housing mortgage crisis that first hit the United States in 2005.[2] The most significant part of the legislation provides tax relief to homeowners who received a discharge of their mortgage obligation from the banks after a loan modification or foreclosure.[3]

It has been a long-established principle that debt forgiveness constitutes gross income.[4] The rationale for taxing discharged indebtedness is that borrowed money is excluded from gross income due to the borrower's offsetting obligation to repay his lender. In other words, the loan proceeds increase the borrower's assets, but such increase is entirely offset by the borrower's repayment obligation. However, to the extent that any of the debt is forgiven, the rationale for the initial exclusion disappears. Now, the borrower has received an "accession to wealth" equal to the amount of cancelled debt.[5]

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1. Pub. L. No. 110-142, 121 Stat. 1803 (2007).

2. "The Committee believes that where taxpayers restructure their acquisition debt on a principal residence or [lost] their principal residence in a foreclosure, that it is inappropriate to treat discharges of acquisition indebtedness as income." H.R. REP. NO. 110-356, at 4 (2007).

3. *See* I.R.C. § 108 (2006).

4. *See, e.g.*, United States v. Kirby Lumber Co., 284 U.S. 1, 3 (1931) and I.R.C. § 61(a)(12) (2006).

5. *See*, Yishai Beer, *Unpacking the Cancellation of Indebtedness Doctrine*: *Toward Economic Reality-Based Taxation*, 19 VA. TAX REV. 457, 460 (2000). For a detailed discussion of the concept of discharge of indebtedness income see, e.g., Boris I. Bittker & Barton H. Thompson, *Income From the Discharge of Indebtedness*: *The Progeny of* United States v. Kirby Lumber Co., 66 Cal. L. Rev. 1159 (1978); Alice Welt Cunningham, *Payment of Debt With Property—The Two-Step Analysis after* Commissioner v. Tufts, 38 TAX LAW. 575 (1985); James S. Eustice, *Cancellation of Indebtedness and the Federal Income Tax*: *A Problem of Creeping Confusion*, 14 TAX L. REV. 225 (1959); Stanley S. Surrey, *The Revenue Act of 1939 and the Income Tax Treatment of Cancellation of Indebtedness*, 49 YALE L.J. 1153 (1940).

Despite what seems an obvious and logical conclusion—that discharge of debt produces an accession to wealth—this does not necessarily translate into actual receipt of money from which the taxpayer can pay the consequential income tax.[6] The Supreme Court first addressed this tax paradox in the business context in *Bowers v. Kerbaugh-Empire Co*.[7] The Court's ruling, that an insolvent business who repays a loan for less than the amount borrowed does not have gross income, became the prototype for the judicially-created insolvency exception.[8] Congress modified the tax relief developed by the courts in the Revenue Act of 1939.[9] However, rather than exclude the discharged indebtedness, the Revenue Act of 1939 instituted a tax *deferral* method. It allowed financially struggling businesses to reduce their debts without incurring an immediate tax.[10] However, the deferred tax was preserved through a basis reduction in the businesses' assets, equal to the amount of the debt relief.[11] This tax deferral provision, whose underlying policy was designed to alleviate the sometimes harsh effect of treating discharged indebtedness as gross income, eventually became section 108 of the Internal Revenue Code.

Following the policy of section 108, Congress, through the Mortgage Forgiveness Debt Relief Act,[12] amended section 108(a)(1) by adding subparagraph (E).[13] The new Code provision relieves the tax burden faced by homeowners whose mortgage debts were discharged following a loan modification or foreclosure. In other words, Code section 108(a)(1)(E) precludes the imposition of a federal income tax on a homeowner after the discharge of mortgage debt on the home.[14]

The fact that Congress took action to help homeowners avoid the unexpected tax consequences of a discharged debt following a major

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6. *See* H.R. REP. NO. 76-855, at 23 (1939); S. REP. NO. 77-1631, at 77-78 (1942).

7. 271 U.S. 170, 175 (1926).

8. *Id*.

9. Pub. L. No. 76-155, 53 Stat. 862, 875 (1939) (to be codified at I.R.C. § 22(b)(9) (1939)).

10. I.R.C. § 22(b)(9) (1939). "This provision will materially aid . . . corporations whose bonds can be purchased at the present time at less than their face value, giving them an incentive to liquidate their indebtedness." H.R. REP. NO. 76-855, at 4-5, *reprinted in* 1 J.S. SEIDMAN, SEIDMAN'S LEGISLATIVE HISTORY OF FEDERAL INCOME AND EXCESS PROFITS TAX LAWS 1236 (1954).

11. Treas. Reg. § 19.113(b)(3)-1 (Supp. 1940).

12. Pub. L. No. 110-142, 121 Stat. 1803.

13. Section 108(a) provides a number of exceptions to section 61(a)(12).

14. I.R.C. § 108(a)(1)(E) provides that "[g]ross 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 the indebtedness discharged is qualified principal residence indebtedness which is discharged before January 1, 2013."

economic crisis is not a new phenomenon. In the Revenue Act of 1939, Congress offered tax relief to financially strapped businesses—victims of the Great Depression—whose creditors discharged all or part of their debt obligations.[15] In the Farm Credit Relief Act of 1980, Congress added section 108(a)(1)(C) to the 1954 Internal Revenue Code to prevent farmers affected by the credit crisis from incurring income tax on the discharge of farm indebtedness. In other words, out of the Great Depression came both the insolvency exception to discharge of indebtedness income and section 108(a)(1)(B); out of the credit crisis of 1980 came section 108(a)(1)(C), which excludes qualified farm indebtedness from gross income; and out of the current housing crisis came section 108(a)(1)(E).

This article will explore the development of section 108, using the three major economic crises mentioned above as a timeline. Part II discusses the judicial debate of whether gross income should include discharge of indebtedness. Part III discusses the development of the insolvency exception following the Supreme Court's decision in *Kirby Lumber*, which held that gross income includes discharge of indebtedness. More specifically, it provides a discussion of court decisions that carved out exceptions to *Kirby Lumber* to provide tax relief to struggling businesses impacted by the Great Depression. This part closes with a discussion of the codification of the insolvency exception, under the Bankruptcy Tax Act of 1980. Part IV will discuss the history of the Farm Credit Crisis, its impact on farmers, and the amendment to section 108, which offered tax relief to solvent farmers whose debts were cancelled. Also, included in this part is a discussion of some of the criticisms of the amended provision. Finally, Part V will focus on the housing crisis, which led to the latest amendment to section 108. This part will explain the situation leading up to the housing collapse, followed by a critique of its overall effectiveness.

II. DISCHARGE OF INDEBTEDNESS: GROSS INCOME OR NOT—ITS COMPLICATED HISTORY

As referenced earlier, the issue of whether discharge of indebtedness created gross income was first addressed by the United

15. The 1939 Revenue Act added paragraph (9) to section 22(b) of the 1939 Internal Revenue Code allowing corporations in an "unsound financial condition" to settle their debts, in many cases for pennies on the dollar, without incurring an income tax. Revenue Act of 1939, Pub. L. No. 76-155, 53 Stat. 862, 875 (to be codified at I.R.C. § 22(b)(9) (1939)).

States Supreme Court in *Bowers v. Kerbaugh-Empire Co.*[16] In *Kerbaugh-Empire*, the taxpayer borrowed money from a German bank,[17] receiving $1,983,000.[18] The taxpayer agreed to the bank's condition to repay the loan in German marks or its equivalent in gold.[19] Over the course of several years, the taxpayer made payments on the loan. When the taxpayer made its final payment on the loan of 284,220.56 marks, that amount was worth $570,767.95 (American dollars) less than at the time of the loan.[20] The Commissioner of Internal Revenue took the position that the extent to which the German marks decreased in value, $570,767.95, constituted gross income. The Supreme Court, taking note that the taxpayer lost the money that it borrowed in its business operations and that the business operations, as a whole, resulted in a loss, determined that repayment of the entire amount of the loan at a reduced amount did not result in income to the taxpayer.[21]

The tax laws in effect, at the time of the *Kerbaugh-Empire* decision, were broad enough for the Court to hold the debt reduction as gross income.[22] However, the Court declined to make such a finding. Rather, the Court determined that in light of the company's poor financial condition before and after the discharge, the discharge of indebtedness did not meet the definition of income as articulated in one of its earlier cases, *Eisner v. Macomber*.[23] By making the company's poor financial status the basis of its decision, the *Kerbaugh-Empire* court

16. 271 U.S. 170, 173 (1926).

17. *Id*. at 171. The taxpayer borrowed the funds from Deutsche Bank in Berlin, Germany. *Id*.

18. *Id*. at 172. In 1913, $1,983,000 equaled 8,341,337.50 German marks (approximately 4.206 marks equaled 1 dollars or 1 mark equaled .23 dollars). *Id*.

19. *Id.* at 172.

20. *Id.* at 173. German marks that were worth over 4 cents per mark in 1911, were worth 2 ½ cents per mark in 1921. The amount, 284,220.56 marks, depreciated in value from $798,144.41 at the time of the loan, to $113,688.23. (This figure can be determined through the process of deduction. The case states that the difference between the amount borrowed at the time the loan was made and the amount paid was $684,456.18. The taxpayer paid $113,688.23. So the combined amounts, $793,144.41, equal the value of the marks in 1911, when the taxpayer first borrowed the funds). *Id*.

21. *Id*. at 175 ("When the loans were made and notes given, the assets and liabilities of [the taxpayer] were increased alike. The loss of the money borrowed wiped out the increase of assets, but the liability remained. The assets were further diminished by payment of the debt. The loss was less than it would have been if marks had not declined in value, but the mere diminution of loss is not gain, profit, or income.").

22. Revenue Act of 1921 § 213, Pub. L. No. 98, 42 Stat. 227, 237-38. The Act provided that gross income "includes gains, profits, and income derived from salaries, wages, or compensation for personal service . . . *of whatever kind and in whatever form paid*. . . ." *Id*. (emphasis added).

23. Eisner v. Macomber, 252 U.S. 189, 193 (1920) (overruled).

carved out an exception to what, a few years later, would become the general rule that gross income includes discharge of indebtedness.

On the heels of the Supreme Court's decision in *Kerbaugh-Empire* came *Appeal of Meyer Jewelry Co.*[24] As in *Kerbaugh-Empire*, the Board of Tax Appeals ("BTA")[25] determined that the definition of income did not include a taxpayer's discharge of indebtedness.[26] *Meyer Jewelry* also involved a taxpayer-business experiencing financial hardship. As a result of the company's financial downturn, its creditors agreed to reduce their claims against the company by $52,817.03. On audit, the Bureau of Internal Revenue[27] determined the company to be liable for the tax, based on the amount of the discharged debt.

The BTA, after a thorough discussion of Congress' intent "to exercise its power to the full extent granted by the Constitution[,]"[28] held that such "cancellation of the taxpayer's indebtedness [did] not constitute income."[29] It reasoned:

> It is true the taxpayer has been relieved from paying an amount to its creditors by their common consent, an amount which the evidence shows it could not have in fact paid whether voluntarily relieved of payment or not. Its balance sheet will disclose a more favorable financial condition, but 'enrichment through increase in value of capital investment is not income in any property meaning of the term.' That the taxpayer received a benefit in the sense of being able to continue its business may be conceded, but such an opportunity can not constitute gain or income, within the meaning of the Constitution and the Revenue Acts. It is not believed that relief from paying an obligation, under the circumstances set forth in this case, constitutes income, and it is our opinion that it is not taxable under the statute.[30]

The court noted that the taxpayer had been relieved of a debt "it could not have in fact paid."[31] The statement shows that the court considered the taxpayer's poor financial condition to be a compelling

24. 3 B.T.A. 1319 (1926).

25. The Board of Tax Appeals was the predecessor of the current Tax Court. BTA cases were published in *Reports of the United States Board of Tax Appeals* (1924-1942) and *Board of Tax Appeals Memorandum Decisions* (1928-1942).

26. *Meyer Jewelry Co.*, 3 B.T.A. at 1323.

27. The Bureau of Internal Revenue is the former name of the Internal Revenue Service.

28. *Meyer Jewelry Co.*, 3 B.T.A. at 1321.

29. *Id.*

30. *Id.* at 1322-23 (noting the taxpayer's debt relief did not add anything to his worth) (internal citation omitted). *See also* John F. Campbell Co. v. Comm'r, 15 B.T.A. 458, 459-60 (1929) and Senner v. Comm'r, 22 B.T.A. 655, 657-58 (1931).

31. *Meyer Jewelry Co.*, 3 B.T.A. at 1322.

factor in deciding that the discharge of indebtedness did not result in gross income.[32]

The courts' refusal to impose an income tax liability on the discharge of indebtedness for businesses struggling financially continued in *Appeal of Independent Brewing Company of Pittsburgh*[33] where the BTA addressed the issue of whether the taxpayer had taxable income from the purchase of its own mortgage bonds[34] for less than what the company owed.

The BTA found *Kerbaugh-Empire* controlling and held that the amounts discharged were not income due to the financial condition of the taxpayer at the time of the discharge. It stated: "The facts are simply that during the taxable year[,] the taxpayer used a portion of its cash on hand to pay a portion of its debts. *Whether it will ever be able to pay the balance of them is uncertain*."[35] While the court did not use the phrase "poor" or "unsound" financial condition, the phrase, "whether it will ever be able to pay the balance,"[36] implies that it considered the company to be struggling financially, for only a taxpayer who is in a poor financial condition would be able to pay only part of its debt, leaving uncertain its ability to pay the balance.

By 1926, a rule had formed regarding the taxability of discharge of indebtedness with respect to companies in an unsound financial condition: the discharge of indebtedness of a financially struggling business is not income. Many subsequent debt discharge cases followed this general rule.[37] The establishment of the general rule could not have been timelier. More businesses would come to rely on this rule in only a few short years as America entered into the worst economic climate of all time—the Great Depression.

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32. *See also* Simmons Gin Co. v. Comm'r, 16 B.T.A. 793, 797 (1929) ("We held in the *Appeal of Meyer Jewelry Co.* . . . that the amount of indebtedness canceled by the creditors of an insolvent person did not constitute income to the debtor.").

33. Appeal of Indep. Brewing Co. of Pittsburgh, 4 B.T.A. 870, 873 (1926).

34. A mortgage bond is a bond secured by a mortgage on one or more assets. These bonds are typically backed by real estate holdings and/or real property, such as equipment. In a default situation, mortgage bondholders have a claim to the underlying property and could sell it off to compensate for the default. *Mortgage Bond*, INVESTOPEDIA.COM, http://www.investopedia.com/terms/m/mortgage_bond.asp (last visited Oct. 29, 2010).

35. *Indep. Brewing Co. of Pittsburgh*, 4 B.T.A. at 873-74 (emphasis added).

36. *Id*. at 874.

37. *See* Nat'l Sugar Mfg. Co. v. Comm'r, 7 B.T.A. 577, 578 (1927) (holding that the purchase of second mortgage bonds for less than face value was not taxable income to an insolvent taxpayer); *Simmons Gin Co.,* 16 B.T.A. at 798 (concluding that the forgiveness of $119,927.24 for an insolvent person should not be included in gross income); John F. Campbell Co. v. Comm'r, 15 B.T.A. 458, 460 (1929) (holding that $50,087.51 in debt relief was not income, finding facts indistinguishable from *Meyer Jewelry Co.*); Progress Paper Co. v. Comm'r, 20 B.T.A. 234 (1930).

III. THE GREAT DEPRESSION, *KIRBY* DOCTRINE, AND THE JUDICIALLY-CREATED INSOLVENCY EXCEPTION

The Great Depression was the result of numerous factors, not just the Stock Market Crash, which occurred on Tuesday, November 29, 1929. One scholar lists: "the adherence to the gold standard; the raising of interest rates by the Federal Reserve at an inopportune time in an attempt to stem the stock market speculation prior to the Great Depression; a decline in consumption that caused decline in the stock market; and a series of banking crises,"[38] as major causes of the Great Depression.

Among the casualties of the Great Depression were businesses. Many businesses went bankrupt. Those businesses that managed to stay afloat were provided lifelines by their creditors, who cancelled part or all of the businesses' debts. Discharging a part of the businesses' debt obligations kept the companies out of bankruptcy and offered creditors the prospect of recouping some of their money.[39] However, during 1931, while America continued to suffer from the dreadful effects of the Great Depression, the Supreme Court reversed the lower court's decision in *United States v. Kirby Lumber Co*,[40] holding that discharge of indebtedness constituted gross income.[41] The decision threatened to overturn *Kerbaugh-Empire* and its progeny,[42] thereby affecting those surviving businesses whose debts were reduced or cancelled by their creditors.

In *Kirby Lumber*, the taxpayer distributed its own bonds and received more than $12 million from bondholders, thereby making it obligated to those bondholders for the same amount. In the same year,

38. Darren M. Springer, *Reimaging the WTO*: *Applications of the New Deal as a Means of Remedying Emerging Global Issues*, 29 VT. L. REV. 1067, 1075 (2005) (citing Christina D. Romer, *The Nation in Depression,* 7 J. ECON. PERSP. 19, 28 (1993)).

39. There were other reasons creditors found it beneficial to discharge all or a part of the debt: "A bank in receivership anxious to terminate its affairs may prefer to accept sixty to seventy-five cents on the dollar rather than institute litigation or foreclosure [or] a creditor may hope to induce future purchases from his debtor by canceling an obligation of the latter." Surrey, *supra* note 5, at 1156.

40. United States v. Kirby Lumber Co., 284 U.S. 1, 2 (1931).

41. Kirby Lumber Co. v. United States, 44 F.2d 885, 887 (Ct. Cl. 1930), *rev'd*, United States v. Kirby Lumber Co., 284 U.S. 1 (1931).

42. *See* Simmons Gin Co. v. Comm'r, 16 B.T.A. 793, 798 (1929) (holding reduction in debt was not income to the company because the taxpayer was insolvent); *Progress Paper Co*., 20 B.T.A. at 235. In *Progress Paper*, the taxpayer experiencing financial problems had his debts reduced by his creditors (a reduction of $49,886). The BTA held that "the forgiveness or cancellation of a debt, in whole or in part, by a creditor does not result in income to the debtor." *Id.* at 236.

1923, Kirby Lumber repurchased those bonds for roughly $137,000 less than what the bondholders paid. Upon repurchasing the bonds, Kirby Lumber had no further financial obligation to the bondholders. The Court of Claims disregarded the taxpayer's financial condition before and after the discharge, finding its financial status to be immaterial.[43] It then determined that no gross income resulted from the forgiveness of the debt.[44] However, the Supreme Court found the taxpayer's financial position after the discharge a compelling factor, and found that Kirby Lumber had income from the discharge of indebtedness in the amount $137,000. It reasoned:

> Here there was no *shrinkage of assets* and the taxpayer made a clear gain. As a result of its dealings, it made available $137,521.30 assets previously offset by the obligation of bonds now extinct. We see nothing to be gained by the discussion of judicial definitions. The defendant in error has realized within the year *an accession to income*, if we take words in their plain popular meaning as they should be taken here.[45]

In finding that the taxpayer's discharge of indebtedness resulted in taxable income, the court created what is today an established principle: gross income includes discharge of indebtedness. However, it did not overturn *Kerbaugh-Empire*. In fact, a closer reading of *Kirby Lumber* shows that the Court actually followed the reasoning in *Kerbaugh-Empire*, focusing on the company's financial position after the discharge. With *Kirby* now standing for the proposition that gross income includes discharge of indebtedness, it relegated the rule set out in *Kerbaugh-Empire* to an exception.

By the late 1930s, it was well-established that taxpayers who were insolvent before being discharged of a debt and remained insolvent subsequent to the discharge could exclude the discharged amount from gross income. [46] At the same time, taxpayers who were solvent before

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43. *Kirby Lumber Co.*, 44 F.2d at 887 ("In our opinion, the question whether the person engaging in such transaction is solvent or insolvent, or whether he made a profit or suffered a loss, through the use of the money for which the obligations were issued, is wholly immaterial.").

44. *Id*.

45. *Kirby Lumber Co.*, 284 U.S. at 3 (emphasis added).

46. *See* Appeal of Meyer Jewelry Co., 3 B.T.A. 1319, 1323 (1926); Burnet v. John F. Campbell Co., 50 F.2d 487, 488 (D.C. Cir. 1931); E.B. Higley & Co. v. Comm'r, 25 B.T.A. 127 (1932); Towers & Sullivan Mfg. Co. v. Comm'r, 25 B.T.A. 922, 924 (1932); Quinn v. Comm'r, 31 B.T.A. 142, 145 (1934); *Simmons Gin Co.*, 16 B.T.A. at 797, Eastside Mfg. Co. v. Comm'r, 18 B.T.A. 461, 465 (1929); *Progress Paper Co.*, 20 B.T.A. at 236; Madison Rys. Co. v. Comm'r, 36 B.T.A. 1106, 1109 (1937) ("[W]here an insolvent debtor satisfies a portion of his debts without thereby becoming solvent, he has likewise realized no taxable income. He has not by such

and after the discharge were required to include in their gross income the amount of the discharge.[47] What remained unclear was whether *Kirby Lumber* or *Kerbaugh-Empire* applied in cases where creditors cancelled the indebtedness of a taxpayer, who were insolvent before the discharge and who became solvent immediately upon the discharge. The issue was addressed in *Lakeland Grocery Co. v. Commissioner*.[48]

In *Lakeland Grocery*, the insolvent taxpayer had assets worth approximately $55,000, but liabilities exceeding $100,000. The taxpayer's creditors, "to permit [it] to remain in business,"[49] agreed to accept $15,472.61 in complete cancellation of its debt, leaving the taxpayer with $39,596.93 of assets free and clear from the claims of creditors. While noting that the taxpayer "was hopelessly insolvent," before the discharge, the BTA viewed the once encumbered, but now freed assets, as gross income.[50] In other words, the taxpayer was solvent to the extent that its assets were not subject to the claim of creditors ($39,596.93), thereby making *Kirby Lumber* applicable.[51]

Just when it appeared that *Lakeland Grocery* put the nail in the coffin for solvent, but struggling, businesses, Congress finally stepped in. In 1939, Congress enacted the Revenue Act of 1939 to provide tax relief to insolvent *and* solvent-but-struggling businesses.[52] The Act amended then section 22(b) by adding paragraph 9.[53] It stated the following:

> A corporation which establishes to the satisfaction of the Commissioner that it is in an unsound financial condition may redeem its bonds, notes, or other evidence of indebtedness . . . at less than their face value without recognition of gain if such redemption occurs. . . .[54]

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satisfaction of his debt realized 'something of exchangeable value,' something 'for his separate use, benefit, and disposal.'"); Transylvania R.R. v. Comm'r, 99 F.2d 69, 72 (4th Cir. 1938).

47. B. F. Avery & Sons, Inc. v. Comm'r, 26 B.T.A. 1393, 1400 (1932); White v. Comm'r, 34 B.T.A. 424, 428 (1936), *aff'd sub nom.*, Walker v. Comm'r, 88 F.2d 170, 171 (5th Cir. 1937).

48. 36 B.T.A. 289, 290 (1937).

49. *Id*.

50. *Id.* at 292.

51. *Id*. "The Board in Madison Railways, thereafter applied its insolvency rule to the case of a purchaser of bonds which was insolvent, both before and after the purchase, to hold that no income resulted from the purchase." Surrey, *supra* note 5, at 1160.

52. Revenue Act of 1939, Pub. L. No. 76-155, 53 Stat. 862, 875 (to be codified at I.R.C. § 22(b)(9) (1939)).

53. Revenue Act of 1939, I.R.C. § 215(a).

54. H.R. REP. NO. 76-855, at 5 (1939).

Based on section 22(b)(9), corporations did not have to establish insolvency before or after the discharge of debt.[55] So long as the corporation found itself in an "unsound financial condition," it could exclude the cancelled debt from gross income. A corporation could establish that it was in an "unsound financial condition" simply by showing that its encumbered property had greatly depreciated in value from the date the debt was incurred to the time of the discharge.[56]

Even with the new tax provision extending relief to taxpayers who otherwise would have income from discharge of indebtedness under *Kirby Lumber*, some businesses still did not meet the standards. This is because section 22(b)(9) applied only where the debt was evidenced by a security. Struggling businesses whose unsecured debts were forgiven could not benefit from the newly added tax provision. Courts trying to help these struggling businesses get around *Kirby Lumber*, or at least reduce the amount of discharge of indebtedness income, created new theories designed to exclude discharges of indebtedness from gross income. The theories included: (1) the net assets test; (2) purchase price debt reduction theory; and (3) the gift theory.

A. Net Assets Test: Defining Insolvency

Trying to determine whether *Kerbaugh-Empire* or *Kirby Lumber* applied depended, in large part, on the insolvency of the taxpayer. A taxpayer was considered solvent if he had "net assets" after the debt cancellation (assets that were no longer subject to the claims of creditors). Conversely, a taxpayer was considered insolvent if he had "net liabilities" (liabilities in excess of assets). However, in the case of *Cole v. Commissioner*,[57] the BTA helped struggling businesses reduce the amount of discharge of indebtedness income by holding that items

55. "It is not necessary . . . that a corporation must establish that its liabilities exceed its assets or it is unable to meet its current obligations as they fall due." *Id.* at 23-24.

56. By 1942, Congress removed the requirement that the corporation had to be in an unsound financial condition at the time of discharge. "Your committee believes these restrictions unnecessarily strict and that they deny the benefits of this section in many meritorious cases." S. REP. NO. 77-1631, at 46 (1942), *reprinted in* 108 BERNARD D. REAMS, JR., INTERNAL REVENUE ACTS OF THE UNITED STATES 1909-1950 LEGISLATIVE HISTORIES, LAWS, AND ADMINISTRATIVE DOCUMENTS 46 (1979). The change permitted both financially sound and unsound corporations to exclude discharges of debts from being included in the calculation of their gross income. By 1954, section 22(b)(9) became section 108 of the Internal Revenue Code of 1954. Section 108 abolished the requirement that a security evidence the note and extended it to individuals. *See* I.R.C. § 108 (1954).

57. 42 B.T.A. 1110, 1113 (1940), *superseded by statute*, I.R.C. § 108(d)(3) (1986), *as recognized in* Carlson v. Comm'r, 116 T.C. 87 (T.C. 2001). *See infra* note 86.

exempt from the claims of creditors in bankruptcy proceedings would also be excluded from the assets used to determine a taxpayer's solvency.[58]

In *Cole*, the taxpayer's employer advanced him over $100,000 so that he could pay off a very significant debt. By 1935, the taxpayer owed $62,000 on the advance. The taxpayer's employer offered to discharge the remaining balance on the debt obligation, if he resigned from the company. Immediately before the debt cancellation, the taxpayer had assets totaling $29,559.57, consisting of cash, stock, securities, equity in his home, and net equity in ten life insurance policies. The taxpayer's liabilities immediately before the debt cancellation totaled $68,013.50, which included the $62,000 of debt owed to his creditor.[59]

In determining the taxpayer's net assets after the cancellation of debt, i.e., "the amount of [taxpayer's] assets which ceased to be offset by claims of creditors,"[60] the BTA excluded the taxpayer's net equity in his ten life insurance policies totaling $19,515.62 because under New York law, as applicable at the time of the debt cancellation, the equity in the policies was exempt from the claims of creditors. Accordingly, the court determined that, immediately before the taxpayer's discharged indebtedness, his assets totaled $10,043.95 and his liabilities totaled $68,013.50. Immediately after the discharge, the taxpayer's liabilities decreased to $5,526.38. Applying the *Kirby Lumber* rule, the Board of Tax Appeals held that the taxpayer was solvent to the amount of $4,517.57, the difference between his $10,043.95 of assets and the $5,526.38 of liabilities.[61] Had the $19,515.62 of equity in the taxpayer's life insurance policies been included in his assets, the taxpayer would have been determined solvent to the extent of $24,033.19, which would have constituted discharge of indebtedness income.[62]

B. Purchase Price Reduction Exception

Under this theory, when the debtor borrows money to purchase property and the lender subsequently reduces the debt obligation to reflect the property's reduced value, the reduction in the debt obligation

58. *Cole*, 42 B.T.A. at 1113.
59. *Id.* at 1110-11.
60. *Id.* at 1113.
61. *Id.* at 1114.
62. *See also* Marcus Estate v. Comm'r., 34 T.C.M. (CCH) 38 (1975).

does not generate gross income.[63] Rather, the debt reduction will result in a price reduction on the property equal to the decreased debt.[64] The taxpayer would have discharge of indebtedness income only to the extent that the debt reduction exceeded the property's value.[65] The purchase price reduction exception was first articulated in *Hirsch v. Commissioner*.[66]

In *Hirsch*, the taxpayer purchased property in 1922 for $29,000, using $10,000 of his own funds and borrowing $19,000. The $19,000 loan was secured by the property, so the taxpayer had a mortgage debt of $19,000. From the time of the property's purchase, it declined in value, and by 1929 had a value of $8,000. Between 1922 and 1929, the taxpayer paid a total of $4,000 on the loan, still owing the creditor $15,000. The creditor rejected the taxpayer's offer to satisfy the remaining balance by conveying the $8,000 property in return for full satisfaction of the indebtedness. However, the creditor counter-offered, stating that it would accept $8,000 in satisfaction of the $15,000 outstanding balance. Hirsch accepted the counter-offer with the result being that he was able to keep the property, for which he paid a total of $22,000 ($10,000 of his own cash plus $12,000 payment to his creditor), after forgiveness of the $7,000 balance of the loan. The BTA sided with the Commissioner, agreeing that such forgiveness of indebtedness was gross income.[67]

On appeal, it was apparent from the third paragraph of the Seventh Circuit's opinion as to how it would view the forgiveness of the $7,000. It quoted a prior case that commented on the current condition of the economy: "It being apparent . . . that instead of being a harvest time of profits for the taxpayer, the year 1929 . . . was just the opposite, and to say that anything moved to him by way of gains, profits, or income was 'simply paradoxical.'"[68] Thus, BTA viewed the facts in the following

63. "The reduction in purchase price exception reflects a tendency to consider a transaction in its entirety and not exclusively on the debt reduction feature. In effect, this exception permits the decline in value of the debtor's property to offset and eliminate the benefit resulting from the partial discharge of the obligation." TMFEDPORT No. 540 § II, p. 25 (BNA) (2008).

64. The tax effect of reducing the basis in the property is that the taxpayer on a subsequent of sale of the property will realize a larger gain, if the sales price exceeded the price of the reduced basis, or a smaller loss if the taxpayer were unable to sell the property for more than the basis.

65. *See, e.g.*, Comm'r v. Coastwise Transp. Corp., 71 F.2d 104, 106 (1st Cir. 1934); L.D. Coddon & Bros. Inc. v. Comm'r, 37 B.T.A. 393, 398-99 (1938).

66. 115 F.2d 656, 658 (7th Cir. 1940).

67. *Id.* at 657-58.

68. *Id.* at 657.

way: The taxpayer paid $29,000 for the property. Of that amount, the taxpayer borrowed $19,000, which he was under an obligation to repay.

> Then came the depression; the value of his purchased asset shrunk to $8,000. It was not yet fully paid for; it was not worth paying for; it could not be sold for enough to satisfy the balance remaining unpaid on the purchase price. Caught in this dilemma he negotiated for and secured a reduction of $7,000. True, this was a forgiveness of indebtedness, but more than that, it was in essence a reduction in purchase price from $29,000 to $22,000.[69]

Thus, the court held that the Board of Tax Appeals decision to be "reversed and remanded, with directions to compute the tax upon the basis of exclusion of $7,000, representing the voluntary reduction in the purchase price."[70]

C. Gift Exception

In another move by the courts to avoid the income tax consequences from the discharge of indebtedness during hard economic times, the courts held that such forgiveness of indebtedness could be a gift. Gifts have been held to be excluded from gross income, since the income tax was first imposed.[71] *Helvering v. American Dental Co.*[72] was the first case to apply the gift exclusion in the discharge of indebtedness context arising in a business setting.

In *American Dental*, the taxpayer-corporation owed accrued interest and back rent. The taxpayer's creditors reduced both the interest, which had been accruing since 1933, and the back rent. A total of $25,219.65 was discharged. There was no indication that the taxpayer was insolvent at or before the debt cancellation, nor was there an indication that the taxpayer was insolvent afterwards. Because of the absence of the taxpayer's insolvency, the Commissioner included the $25,219.65 as income on the taxpayer's 1937 income tax return.[73]

The taxpayer disputed the asserted deficiency, arguing that the discharges were gifts that were exempt from tax. The BTA found that

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69. *Id.* at 658.

70. *Id.* at 659. Cases following *Hirsch* included Allen v. Courts, 127 F.2d 127, 128 (5th Cir. 1942); Helvering v. A.L. Killian Co., 128 F.2d 433, 434 (8th Cir. 1942); Gehring Publ'g Co. v. Comm'r, 1 T.C. 345, 354 (1942); Comm'r v. Sherman, 135 F.2d 68, 70 (6th Cir. 1943); Fifth Ave.-Fourteenth St. Corp. v. Comm'r, 147 F.2d 453, 456 (2d Cir. 1944).

71. *See* II(B) of the 1913 Revenue Act, 38 Stat. 114 at 167. Gross income does not include "the value of property acquired by gift." *Id.*

72. Helvering v. Am. Dental Co., 318 U.S. 322, 330-31 (1943).

73. *Id*. at 323-24.

the cancellations were not gifts and held in favor of the Commissioner.[74] The appellate court reversed the Board's holding, finding that such debt forgiveness was in fact a gift.[75] The Commissioner appealed the decision, and the Supreme Court granted certiorari. The Court held the debt forgiveness to be "gratuitous, a release of something to the debtor for nothing, and sufficient to make the cancellation here gifts within the statute."[76]

D. *Codification of the Judicially-Created Exceptions*: *Bankruptcy Tax Act of 1980*

By 1980, one thing was clear: a taxpayer realized income from the discharge of indebtedness. However, what remained unclear were the circumstances in which a taxpayer could exclude discharge of indebtedness from gross income. Courts continued to apply the insolvency exception, which had been codified in 1954, as Code section 108 of the Internal Revenue Code.[77] However, other judicially-created exceptions to *Kirby Lumber* had not been codified and continued to be applied on a case-by-case basis.

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74. *See* Am. Dental Co. v. Comm'r, 44 B.T.A. 425, 428-29 (1941), *rev'd*, 128 F.2d 254 (7th Cir. 1942). The Board held: "No evidence was introduced to show a donative intent upon the part of any creditor. The evidence indicates, on the contrary, that the creditors acted for purely business reasons and did not forgive the debts for altruistic reasons or out of pure generosity." *Am. Dental Co.*, 44 B.T.A. at 428.

75. *See Am. Dental Co.*, 128 F.2d at 256. "[T]he indebtedness was cancelled for the benefit of the debtor and without consideration, and was not taxable." *Id*.

76. *Am. Dental Co.*, 318 U.S. at 331. "The application of the gift exclusion in the case of debt cancellations arising in a business setting has been extremely rare." Nicolas J. Bakatsias & Keith A. Wood, *The Increased Relevance of the Cancellation of Indebtedness Rules in Today's Economic Environment*, http://www.tiny.cc/l8wui. *See also* Capitol Coal Corp. v. Comm'r, 250 F.2d 361, 363 (2d Cir. 1957); Denman Tire & Rubber Co. v. Comm'r, 192 F.2d 261, 263 (6th Cir. 1951) (holding no gift where a solvent debtor settled federal excise claims and the amounts due on bonds); Spear Box Co. v. Comm'r, 182 F.2d 844, 846 (2d Cir. 1950) (holding no gift where notes were purchased at discount); Marshall Drug Co. v. United States, 95 F. Supp. 820, 822 (Ct. Cl. 1951) (holding no gift where trade creditors cancelled indebtedness of accrual basis corporation for less than amount due). *But see* Reynolds v. Boos, 188 F.2d 322, 326 (8th Cir. 1951) (finding that the cancellation of previously deducted back rent in connection with the renewal of a lease was a gift is not clearly erroneous). Bakatsias & Wood, *supra*, at 8 ("Nevertheless, it remains at least a possible contention by a debtor seeking to avoid discharge of indebtedness income, particularly in view of the Supreme Court's stated willingness in alleged "gift" cases to accept the findings of the triers of fact with respect to the element of donative intent, even as to transactions which occur in the commercial sphere."). Section 108 contains no statutory language prohibiting the gift exclusion in the case of debt cancellations. Nevertheless, both the House and the Senate Reports contain the following language: "it is intended that there will not be any gift exception in a commercial context to the general rule that income is realized on discharge of indebtedness." H.R. REP. NO. 96-833, at 15 n.21 (1980) and S. REP. NO. 96-1035, at 19 n.22 (1980).

77. *See* Revenue Act of 1954, Pub. L. No. 83-591, 68 Stat. 730.

An attempt to clear up the confusion concerning the exceptions came about in the Bankruptcy Tax Act of 1980 ("BTA 1980").[78] BTA 1980 substantially amended Code section 108 of the 1954 Internal Revenue Code. The "new" section 108 provided that taxpayers would not realize gross income from the discharge of indebtedness during bankruptcy,[79] insolvency,[80] or where the indebtedness was "qualified business debt."[81] BTA 1980 also codified the purchase price reduction exception[82] and the definition of insolvency for purposes of the net assets test.[83] The gift exception, however, was neither codified nor overturned.[84]

BTA 1980 also added a very significant provision, code section 108(e)(1). It provided, in part that "there shall be no insolvency exception from the general rule that gross income results from discharge of indebtedness."[85] This halted further expansion of the *Kirby Lumber* exceptions by the courts. No longer could courts get around *Kirby Lumber* by creating more exceptions as they did during the Great Depression. Therefore, if a taxpayer received a discharge of indebtedness and was not bankrupt or insolvent at the time of the discharge, such indebtedness did not constitute "qualified business indebtedness," or result in a purchase price reduction, the taxpayer had gross income under Code section 61(a)(12).[86]

As with the timing of the Supreme Court's decision in *Kirby Lumber*, the Bankruptcy Tax Act of 1980 came about at the worst time for farmers. Due to the limitation created under Code section 108(e)(1), solvent farmers would be subjected to taxation under *Kirby Lumber* as they faced the Farm Credit Crisis of the 1980s.

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78. Pub. L. No. 96-589 § 2(a), 94 Stat. 3389 (1980).

79. I.R.C. § 108(a)(1)(A) (1986).

80. *Id.* § 108(a)(1)(B).

81. *Id.* § 108(a)(1)(C). This provision was identical to the old section 108, allowing solvent individuals to exclude from gross income discharges of indebtedness income, if the indebtedness was incurred in connection with property used in the taxpayer's trade or business.

82. *Id.* § 108(e)(5). However, it limited it only to instances where the seller of the property reduced the purchase price. Thus, a debtor had discharge of indebtedness income when third-party lenders, i.e., banks and other lending institutions, reduced the purchase price.

83. *Id.* § 108(d)(3). However, it was not until a few years later that a court decision held assets exempt from the claims of creditors were included for purposes of determining insolvency, thus overruling *Cole v. Comm'r*, 42 B.T.A. 1110 (1940).

84. However, the 1960 Supreme Court case, *Commissioner v. Duberstein*, would make it nearly impossible for a business to use the gift exception to exclude discharge of indebtedness from gross income. 363 U.S. 278, 289 (1960).

85. I.R.C. § 108(e)(1).

86. I.R.C. § 61(a)(12) (2006).

IV. ECONOMIC CRISIS: THE FARM CREDIT CRISIS OF THE 1980S. RESPONSE: SECTION 108(A)(1)(C)

To understand what caused the farm credit crisis in the 1980s is to understand the events of the previous decade. The 1970s were profitable years for the American farmer. This was, in large part, due to inflation and an increased demand by foreign countries for United States agricultural products.[87] With the increased demand, farm prices and farm incomes skyrocketed.[88] With the soaring prices and incomes, the value of farmland significantly appreciated. However, part of the land appreciation was artificial, due to relaxed banking standards and an increase in the loans offered by numerous lending institutions.[89]

Many farmers expanded production to profit from the record farm prices. They took out loans to purchase additional land—highly-appreciated land.[90] In most cases, the farmers used the equity in their existing land to secure the loans. Low interest rates made borrowing an easy choice for the farmers.[91] In addition, the deregulation of the banking industry by Congress made it very easy for farmers to qualify for the loans. The deregulation resulted in an increase in lenders who, in turn, competed with one another for farm customers.[92] Vying for the farmer's business, agricultural lenders loaned money to the farmer for far more than what the farmer needed or requested.[93] Most farmers had no difficulty obtaining a loan, as the lenders made qualifying very easy, basing it on the property's future appreciation, rather than the farmer's income.[94] As a result of this over-borrowing and liberal lending, total farm indebtedness increased from $52,755 million to $178,708 million

87. Countries like India, China, and the Soviet Union were purchasing United States farm products to make up for their own agricultural shortages. "People in foreign countries wanted American food and they had the money to pay for it, so foreign markets became important to the farmers." CRISIS IN AGRICULTURE, http://www.nebraskastudies.org/1000/stories/1001_0100.html (last visited Oct. 29, 2010).

88. Net farm income doubled in just a matter of three years, from 1970 to 1973, from $14.4 billion to $34.4 billion. CLIFTON B. LUTTRELL, THE HIGH COST OF FARM WELFARE 58 (1989). Farm prices soared from $7 billion in 1970 to $43.8 billion in 1981. George J. Church, *Real Trouble on the Farm*, TIME, Feb. 18, 1985, at 24, 28.

89. Relaxed standards on Federal Land Bank lending and an increase in loans by other lending institutions also contributed to the increased land values. Jason Manning, *The Midwest Farm Crisis of the 1980s*, http://eightiesclub.tripod.com/id395.htm.

90. JAMES SCHWAB, THE FARM CREDIT CRISIS IN IOWA (1985).

91. LUTTRELL, *supra* note 88, at 82.

92. MARK FRIEDBERGER, SHAKE OUT: IOWA FARM FAMILIES IN THE 1980S, at 30 (1989).

93. *Id.* at 45.

94. *Id.*

from 1970 to 1980.[95] Neither the farmers nor the lenders concerned themselves about the mounting debt, expecting the proceeds from the export sales, coupled with the rising property values, to enable the farmers to make timely payments.[96]

However, the agricultural boon of the 1970s would not continue into the next decade. By 1980, the indebted farmer faced excessively high interest rates[97] and "tight money."[98] The high interest rates translated into higher payments for the farmer, who received a variable interest rate. Further, the restrictions on lending made it difficult for the farmers to borrow additional money to cover the higher payments. This one-two punch burst the agriculture bubble.[99] By 1984, overproduction and increased foreign competition caused farm commodities prices to drop significantly.[100] When it seemed like things could not get any worse, it did, farm-operating costs, such as fuel and fertilizer, jumped due to a spike in oil prices.[101]

As a result of these rather unfortunate events, farm income dropped, to be followed by land values. Those farmers who borrowed heavily in the 1970s, found themselves unable to make their loan payments as their incomes decreased due to a decrease in farm prices. The option to sell off part of their land to pay off their loans was not available either, since the land values decreased to an amount less than their outstanding debt.[102] It was not long before lenders began foreclosure proceedings against the delinquent farmers.

Responding to the crisis the American farmers faced, Congress passed legislation to create federal farming programs[103] designed to aid

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95. NEIL E. HARL, THE FARM DEBT CRISIS OF THE 1980S, at 28 (1990).

96. The value of farm real estate rose an average of 8.1% per year, between 1940 and 1982. LUTTRELL, *supra* note 88.

97. The interest rates were as high as 21.5%. Stewart E. Bland, *Insolvencies in Farming and Agribusiness*, 73 KY. L.J. 795, 796 (1984).

98. The Federal Reserve Board made an effort to end inflation by reducing the credit supply. HARL, *supra* note 95, at 14-15.

99. Manning, *supra* note 89.

100. "American farm products were still costlier than those of competitors on the international market; federal price supports kept prices artificially high enough so that farmers in Argentina, Australia, Canada, and Europe were able to seize more of the market than ever before." *Id. See also* Heather Ball & Leland Beatty, *Blowing Away the Family Farmer*: *The Debt Tornado,* THE NATION, Nov. 3, 1984, at 442-44.

101. Bland, *supra* note 97, at 796.

102. David Harrington & Thomas A. Carlin, *The U.S. Farm Sector*: *How Is It Weathering the 1980's?*, Econ. Research Serv., U.S. Dep't of Agriculture, Agriculture Information Bulletin No. 506, 12-17, *available at* http://tiny.cc/8dn7s.

103. The Farmers Home Administration (FmHA) was one of the main agricultural lenders participating in the program.

the farmers to avoid foreclosure and continue their farming operations. The federal programs were generally an agreement between the Federal government and the farm lending institution. If the lender agreed to reduce a part of the farmer's indebtedness, the federal government would guarantee a portion of the farmer's remaining balance.[104]

While the farm programs would most likely help the farmer save his agricultural business, under the current income tax laws, the indebted solvent farmer, eligible to participate in the program, would have discharge of indebtedness income. Because of the Bankruptcy Tax Act of 1980 and section 108(e)(1), the solvent farmer would not be able to find protection under section 108 or the judicially-created exceptions.

Concerned that the potential tax consequences would prevent otherwise eligible farmers from participating in the Federal farm programs, thus resulting in the forfeiture of their land, Congress included a provision in the Tax Reform Act of 1986 ("TRA 86"),[105] specifically intended to address the dilemma solvent farmers faced.[106] TRA 86 provided, in part, that "certain solvent [farmers] realizing income from the discharge of certain farming-related indebtedness may reduce tax attributes, including basis in property, under rules similar to those applicable to insolvent taxpayers."[107] The special provision for discharges of "certain farm indebtedness" in TRA 86, became section 108(a)(1)(C) of the 1986 Internal Revenue Code, and provided that gross income shall not include discharge of indebtedness if "the indebtedness discharged is qualified farm indebtedness ("QFI")."[108]

A. *Definition of QFI*

Section 108(g), as enacted in 1986, provided that discharged indebtedness would be considered QFI if: (1) the indebtedness was

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104. *General Explanations*, H.R. 3838, 99th Cong., 2d Sess. 161 (1986).

105. Pub. L. No. 99-514, 100 Stat. 2085 (1986).

106. STAFF OF S. COMM. ON THE BUDGET, 109TH CONG., TAX EXPENDITURES: COMPENDIUM OF BACKGROUND MATERIAL ON INDIVIDUAL PROVISIONS 220 (Comm. Print 2006) ("Congress was concerned that pending legislation providing Federal guarantees for lenders participating in farm-loan write-downs would cause some farmers to recognize large amounts of income when farm loans were canceled. As a result, these farmers might be forced to sell their farmland to pay the taxes on the canceled debt. This tax provision was adopted to mitigate that problem.").

107. Tax Reform Act of 1986 § 405(a), Pub. L. No. 99-514, 100 Stat. 2085.

108. *Id.* TRA 86 also repealed the "qualified business indebtedness" exclusion originally under I.R.C. § 108(a)(1)(C), replacing it with "qualified farm indebtedness." Pub. L. No. 99-514, § 822, 9A U.S.C.C.A.N. (100 Stat.) 289 (1986) (repealing I.R.C. § 108(a)(1)(C)). "Congress believed that the prior law treatment of discharge of qualified business indebtedness was too generous . . . . [and] produced disparate results among taxpayers depending upon the makeup of their depreciable assets." *Id.*

discharged by a "qualified person,"[109] defined under I.R.C. § 46(c)(8)(D)(iv) of the Internal Revenue Code;[110] (2) the "indebtedness was incurred directly in connection with the operation by the taxpayer of the trade or business of farming"[111] and; (3) at least 50% of the taxpayer's average annual "gross receipts" for the three years prior to the year in which the discharge of such indebtedness occurs, is attributable to the trade or business of farming.[112] Upon meeting all three requirements under section 108(g), the farmer is required to reduce his tax attributes and the basis in his properties to the extent of the amount of the discharged debt.[113] Not surprisingly, the qualified farm indebtedness exception had its critics. Those criticizing the QFI exception, among other things, found some of the requirements restricting, some of the terms ambiguous or limiting, or the overall effect of the provision contrary to legislative intent.

B. *Criticisms of the Section 108(a)(1)(C): Tax Attribute Limitation Contrary to Legislative Intent*

One criticism of newly enacted section 108(a)(1)(C) was that it only excluded discharge of indebtedness income to the extent of the taxpayer's "tax attributes and properties" bases. In other words, a farmer's discharged indebtedness could qualify as QFI, but to the extent that the discharged amount exceeded his tax attributes and bases in his properties, he had gross income. Such limitation was deemed "contrary to the congressional intent of the 1986 act."[114]

As noted by one critic, when section 108(a)(1)(C) was enacted, so long as the farmer met all three requirements under section 108(g), he could exclude the debt discharged from gross income, even where the amount discharged exceeded the tax attributes and bases.[115] The Conference Committee Report published in conjunction with TRA 86 supported this finding.[116] Ignoring the legislative history, the Staff of the

109. I.R.C. § 108(g)(1) (1986).

110. *Id.* § 108(g)(3).

111. *Id.* § 108(g)(2)(A).

112. *Id.* § 108(g)(2)(B).

113. I.R.C. § 1017(b)(4), Pub. L. No. 99-514, 100 Stat. 2085, 2224.

114. *The Utility Ratepayer Refund Act of 1989*, 135 CONG. REC. 3033 (1989) (statement of Hon. Byron L. Dorgan).

115. Stephan Garelis, *Problems Remain in Handling Discharge of Farm Debt by Solvent Farmers*, 67 J. TAX'N 230 (1987). "As enacted, Section 108(g), on its face, is limited only by the amount of qualified farm debt cancelled." *Id.*

116. *Id.* (citing H.R. REP. NO. 99-841, at 116 (1986), *reprinted in* 1986 U.S.C.C.A.N. 4203-04). *The Utility Ratepayer Refund Act of 1989*, *supra* note 114. *See also Extension of Remarks,*

Joint Committee on Taxation's General Explanation of the Tax Reform Act of 1986 ("Blue Book")[117] and the Technical and Miscellaneous Revenue Act of 1988 ("TAMRA")[118] concluded that "[t]o the extent there is unabsorbed discharge of indebtedness income after the reduction of tax attributes and the basis of qualified property, the taxpayer will recognize income."[119]

C. *Insolvent Farmers Excluded*

An additional, albeit easily fixable, issue with section 108(g) concerned the disparate treatment of insolvent farmers. Section 108(g), as enacted, was limited to farmers who were solvent at the time of the discharge. Insolvent farmers were not eligible for the exclusion and could, theoretically, have discharge of indebtedness income.[120] For example, Farmer A has $1,000 of QFI and $2,000 in assets. Farmer A's creditor discharges $700 of QFI. Farmer A remains solvent after the discharge, to the extent of $1,700 and may exclude the $700 of discharged debt (assuming his tax attributes equaled or exceeded $700).[121] On the other hand, Farmer B has $1,000 QFI and $500 in assets. Farmer B's creditor discharges $600 of QFI. If Farmer B's tax attributes equal $500, then his QFI may be excluded to that extent. The remaining $100 of discharged QFI is gross income because Farmer B is insolvent, to that extent and section 108(a)(1)(C) does not apply to insolvent farmers.[122]

This contrary result did not last long, as it was resolved in the Technical Corrections Bill with an ordering rule, providing that the insolvency exception applies first, and that the section 108(g) applies

Proceedings and Debates of the 101st Congress, First Session Material in Extension of Remarks was not spoken by a Member on the floor, 135 CONG. REC. E2887-03, E2888 (1989) (statement of Hon. Byron L. Dorgan, North Dakota) ("It is my understanding that a controversy has arisen concerning the solvent farmer provision due to the passage of the Technical and Miscellaneous Revenue Act of 1988 [TAMRA]. Within TAMRA, a technical correction limited the tax-free discharge of indebtedness under the solvent farmer provision to the amount the basis and the tax attributes remaining in the farm property. Any write-down in excess of that amount is treated as income . . . [T]his so-called technical correction runs contrary to the congressional intent of the 1986 act.").

117. H.R. 3838, 99th Cong., 100 Stat. 2085 (1987).

118. Section 1004(a)(4) of the Technical and Miscellaneous Revenue Act of 1988 (TAMRA). Pub. L. No. 100-647, 102 Stat. 3342, 3385 (1988).

119. *Id.* § 1004(a)(5) (amending I.R.C. § 1017(b)(4) (1986)).

120. *See* Garelis, *supra* note 115.

121. *See id.* for a similar example.

122. *See id.* for a similar example.

once the farmer becomes solvent.[123] So in the above example, Farmer B's debt discharge of $600 would be excluded entirely—$500 would be excluded under the insolvency exception (because Farmer B's liabilities exceed his assets by $500), and the remaining $100 will be excluded under the QFI exception.

D. "Trade or Business of Farming"

Section 108(g) only applies in the case of indebtedness incurred in connection with the operation by the taxpayer of the trade or business of farming, by a qualified unrelated party. Congress failed either expressly or by reference, to define the term "trade or business of farming." As one critic noted:

> Congress' failure to define the phrase "trade or business of farming" for purposes of the QFI exception either expressly or by reference, sowed fertile seeds for litigation. Taxpayers are likely to raise creative arguments to establish their debt as incurred in connection with their operation of a trade or business of farming, thereby satisfying the first element of the QFI exception[124]

Surprisingly, the reasonable prediction did not come true; however, subsequent cases, Internal Revenue Service rulings, and Treasury regulations would embrace a broad definition.[125]

E. Gross Receipts Test

Critics found the gross receipts test to be very limiting, only providing tax relief to those farmers "who derive at least 50 percent of their average annual gross receipts for the proceeding 3 years from farming."[126] It "precluded relief for farmers . . . forced to sell assets to satisfy farm debts, denied crop financing, or are otherwise forced to scale down their farm operations."[127] A proposal by a United States Representative was made to redefine gross receipts to income attributable to both, the trade or business of farming or the sale or lease of assets used in such trade or business, so that a farmer who "cash

123. *Id.*

124. Dirk A. Williams, *The Qualified Farm Indebtedness Exception to Taxation of Discharged Debt*: *Making Hay Under TRA*, 50 MONT. L. REV. 279, 287 (1989). For a further discussion of the various definitions of "trade or business of farming" provided in the Code, see *id.*

125. *See* IRS FSA, 1993 WL 1469706; Treas. Reg. §1.61-4(d) (2010) states: "The term 'farm' embraces the farm in the ordinarily accepted sense, and includes . . . poultry . . . farms."

126. *The Utility Ratepayer Refund Act of 1989, supra* note 114.

127. *Id.*

rents" his land during that three-year period would be able to meet the gross receipts test.[128] Congress failed to accept the proposed legislation. The concern expressed by the representative became an actual issue a few years later, in *Lawinger v. Commissioner*.[129]

In *Lawinger*, the taxpayer operated a beef farm until 1986, when she sold the cattle and farm equipment and rented the land to another farmer. In 1989, the taxpayer restructured her $242,453 debt with FmHA, which discharged $199,701 of the debt and gave the taxpayer a new note reflecting the non-discharged debt of $42,752. The discharged debt resulted in the taxpayer becoming solvent. The taxpayer treated the $199,701 of discharged debt as QFI and excluded it from gross income, pursuant to section 108(a)(1)(C). The Internal Revenue Service determined that none of the discharged debt qualified as QFI because the taxpayer failed the gross receipts test.[130]

Both parties agreed that the taxpayer's aggregate gross receipts for the three years prior to the year of debt discharge (1986 through 1988) totaled $165,383, requiring at least $82,691.50 of that amount to be attributable to the trade or business of farming. The taxpayer contended that her aggregate gross receipts attributable to her farming business totaled $87,753. She included:

1986: Gross income from farming	$29,319
1986: Sales price from sale of livestock	$12,868
1987: Farm rental income	$ 8,000
1987: Proceeds from the sale of farm machinery	$37,566
Total gross receipts attributable to farming:	$87,753.[131]

The government asserted that the taxpayer's farm rental income and the sale of the farm equipment were not attributable to the trade or business of farming, thus, total gross receipts attributable to the trade or business of farming was $42,187 ($12,868 from sale of livestock and $29,319 from 1986 farm income), therefore, it determined that the taxpayer did not satisfy the aggregate gross receipts test of section 108(g)(2)(B).[132]

While finding that the sale of the farm equipment was attributable to the trade or business of farming,[133] the court held that the gross rental

128. *Id.*
129. 103 T.C. 428, 429 (1994).
130. *Id.* at 431-32.
131. *Id.* at 433.
132. *Id.* at 434.
133. *Id.* at 437.

income in 1987 is "not attributable to petitioner's trade or business of farming because the amounts of the rent collected were not dependent upon farm production, and if any trade or business of farming occurred, it was carried on by the lessee, not by petitioner."[134] Thus, only $79,753 of the taxpayer's aggregate gross receipts were attributable to farming—less than $3,000 shy of the 50% mark. The court found the taxpayer's situation to be a "sympathetic yet difficult case,"[135] for, had petitioner restructured her debt a year earlier, she would have met the gross receipts test.[136]

V. ECONOMIC CRISIS: HOUSING/MORTGAGE CRISIS. CONGRESSIONAL RESPONSE: SECTION 108(A)(1)(E)

A. Collapse of the Housing Market

Some argue that the root cause of today's housing crisis was federal legislation enacted to provide everyone the opportunity to own a home.[137] However, there is no argument that the Federal Reserve's decision to lower interest rates—and to keep them low for six years—and the lending industry's relaxed lending practices with respect to high-risk homeowners, significantly contributed to the collapse of the housing market in 2006 (or 2007).[138]

In 2001, the Federal Reserve Board lowered interest rates in an effort to boost the economy, which had declined due to the 2000 recession, and later the September 11 terrorist attacks. The interest rates, which were at 6% at the beginning of 2001, were lowered to 1.75% by the end of the year.[139] For the housing market, the low interest rates

134. *Id.*

135. *Id.* at 436.

136. *Id.*

137. The idea can be traced to the Community Reinvestment Act ("CRA"), a program enacted during the Carter Administration that urged lenders to approve loans to borrowers traditionally found unqualified. Banks that did not ease credit restrictions risked being fined or penalized, under the Home Mortgage Disclosure Act ("HMDA") or Equal Credit Opportunity Act ("ECOA"). *See* Eamonn K. Moran, *Wall Street Meets Main Street*: *Understanding the Financial Crisis*, 13 N.C. BANKING INST. 5, 26 (2009). "National Homeownership Strategy: Partners in an American Dream," was another program touting homeownership "as both patriotic and an easy win for all," created under the Clinton administration. *See id.* at 26. *See also* Yaron Brook, *The Government Did It*, FORBES.COM (July 18, 2008, 11:30 AM), http://www.forbes.com/2008/07/18/fannie-freddie-regulation-oped-cx_yb_0718brook.html.

138. Moran, *supra* note 137, at 14.

139. Entering 2001, the country was entering a recession, caused by a decline in the stock market the previous year and the fall of the dot-com industry. To prevent deflation and to cushion

translated into lower monthly payments for those taking out mortgage loans. Lower monthly mortgage payments allowed more people to purchase homes, which in turn, increased demand.[140] As housing demand increased, so did home prices, increasing by 5.7% each year between 2000 and 2006.[141]

Lenders enjoyed the robust real estate market and wanted it to continue and grow. As such, lenders sought out a new group of perspective homebuyers to enter the housing market—subprime borrowers.[142] By 2003, subprime lending, virtually unheard of in 1994 and used primarily by the heavily regulated banking industry, had increased ten-fold.[143] However, it was independent mortgage firms and other non-banking industries—which were not regulated—that provided most of the subprime loans. The unregulated subprime lenders, with their lax lending standards, "crafted creative loans to provide money to the high-risk borrowers [which allowed them] to purchase more expensive homes."[144] Rather than considering the borrower's credit history, down payment contribution, or future income as qualifiers for

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the collapse of the dot-com bubble, the Federal Reserve reduced interest rates to historic lows, hoping to spur the economy. *Id.* at 13-14.

140. "Homeownership rose to 67.4% . . . in 2000 from 64% in 1994, and peaked in 2004, with an all-time high of about 69%." *Id.* at 19 (internal citation omitted).

141. Manav Tanneeru, *How a 'Perfect Storm' Led to the Economic Crisis*, CNN.COM, http://www.cnn.com/2009/US/01/29/economic.crisis.explainer/index.html (last visited Oct. 30, 2010). *See also The Housing Decline*: *The Extent of the Problem and Potential Remedies*: *Hearing Before the S. Comm. on Finance*, 110th Cong. 1 (2007) (testimony of Morris A. Davis, Assistant Professor in Real Estate and Urban Land Economics, School of Business, University of Wisconsin—Madison). Prior to 1997, housing prices increased by about 0.6% per year. *Id.* "Since 2006, real house prices have been flat." *Id.*

142. Subprime borrowers generally did not qualify for mortgage loans for a number of reasons, including poor credit histories, inadequate incomes, and high debt-to-equity ratios. However, in 1994, Housing and Urban Development (HUD) secretary, Henry Cisneros, eased mortgage restrictions to allow subprime borrowers to qualify for mortgage loans. Still, the subprime borrower remained a credit risk, thus, lenders charged them a higher interest rate than their credit-worthy prime borrowers. While the higher interest rate meant that the subprime borrower's monthly mortgage payments would be higher than the prime borrower who borrowed the same amount, it did not discourage the subprime borrower from seeking a mortgage or loan. *See* Moran, *supra* note 137, at 20, 25-26. Among other things, HUD modified existing regulations and allowed borrowers to qualify for a mortgage loan without proof of an income history or a steady source of future income; eliminated the requirement that lenders use third-party appraisers, allowing instead for the lenders to handpick them; and allowed lenders to approve borrowers based on their application alone, no longer requiring them to interview the borrowers in person. Subprime lending was used frequently by the banking industry, during the 1990s. While profitable, it was not considered risky, because the banking industry was subject to strict regulations. *Id.* at 26.

143. *Id.* at 29. "Subprime mortgage origination volume increased for less than five percent, or $35 billion, of total mortgage origination volume in 1994 to nearly twenty percent, or $625 billion, in 2005." *Id.* at 23.

144. *Id.* at 16.

the loan, subprime lenders based the loan approval on an expectation that the already increasing home values would continue to increase.[145] This irresponsible lending practice allowed otherwise unqualified borrowers to enter the housing market, thereby increasing demand and further increasing home values.

The most common type of loan offered to subprime borrowers was the adjustable rate mortgage ("ARM"). The ARM was attractive because it offered very low interest rates to the subprime borrower for the first two or three years. However, at the end of the period, the interest rate would reset to a much higher rate, sometimes doubling the monthly mortgage payments.[146] Take, for example, a subprime customer who received a $200,000 ARM at an interest of 2% for the first three years increasing to 12% thereafter. His monthly payment for years 1 through 3 would be $1030.[147] However, in year 4 and subsequent years, when the interest rate jumped to 12%, the mortgage payment jumps to $2348.89.[148] An amount he would most likely not be able to pay.

However, both the homeowner and the subprime lender did not concern themselves with year 4, the date the interest rate would reset. Both believed the home's value would have increased by that time, allowing the homeowner to borrow from the equity in the home to make the higher payments. Or, they believed that interest rates would remain low and refinancing for a low, fixed-interest rate would be available three years later. Such assumptions were very wrong and very costly.

By 2006, job losses and rising interest rates led to depreciating home values. These three factors caused the housing bubble to burst and affected the homeowner's ability to keep his home. Homeowners who lost their jobs could not make their current mortgage payments, and they lost their homes through bank foreclosures. Homeowners who were employed, but whose low-interest "teaser" rates increased, could not afford the higher monthly mortgage payments. They defaulted on their loans, and the lenders foreclosed on the homes.

By the end of 2006, nearly 1.2 million homes were in foreclosure.[149] The number of foreclosures continued to rise each year,

145. *Id.* at 22.

146. *Id.*

147. *See* Mortgage Calculator, WWW.BANKRATE.COM, http://www.bankrate.com/calculators/mortgages/mortgage-calculator.aspx (last visited Oct. 30, 2010). The monthly payment also includes property taxes of 1.5%.

148. *See id.*

149. *See* http://www.realtytrac.com (2005 foreclosure numbers were 547,000 and increased by 45% in 2006).

with 2,824,674 foreclosures in 2009.[150] The significant amount of foreclosures resulted in an oversupply of homes. The large inventory of homes caused home values to plummet. Homes were now worth less than the outstanding loan balance. The sinking values barred any chances of homeowners with ARMs to refinance their loan at a lower interest rate.

B. Foreclosures, Debt Discharges and MDRA 2007

In the case of foreclosures, with home values at rock bottom, sales proceeds received from the foreclosure sale did not cover the outstanding loan balance. If the loan was recourse, the lender had the option to go after the homeowner personally to collect the balance.[151] However, where the homeowner had no assets—which was usually the case—the lender chose to discharge the debt, viewing as imprudent the decision to sue the former homeowner. Upon discharge of the debt, if the homeowner was not insolvent, he had gross income under section 61(a)(12) of the Internal Revenue Code.[152]

When Congress passed the MDRA to add section 108(a)(1)(E) to the Internal Revenue Code, it intended to help both the foreclosed homeowner—in particular the subprime borrower. For the foreclosed homeowner, the MDRA would prevent the "double whammy" that would have otherwise occurred: the loss of the home through foreclosure followed by an income tax upon discharge of the mortgage indebtedness. The following hypothetical illustrates the tax burden foreclosed homeowners faced upon discharge of their mortgage indebtedness, and the tax relief section 108(a)(1)(E) is designed to offer them.

Married homeowners Henry and Gina borrowed $140,000 from Bank XYZ to purchase a home. Two years after purchasing their home, Henry lost his job. Gina made the $1000 monthly mortgage payment until the interest rate on their loan skyrocketed to 12.5%, increasing the payment to $1500 a month. Gina could not make the increased mortgage payments, and Henry and Gina eventually found themselves more than four months behind. As a consequence of nonpayment, Bank XYZ foreclosed on the couple's home. The foreclosure sale brought in only $40,000. There still remained a balance (deficiency) of $95,000

150. *See id.* The projected number of foreclosures in 2010 does not look too promising.

151. Compare recourse mortgage with a non-recourse mortgage, which means that the lender's only recourse is the mortgaged property.

152. I.R.C. § 61(a)(12) (2006).

owed to the bank. However, because Henry and Gina lost their only asset, Bank XYZ made the business decision to discharge the deficiency balance. Bank XYZ's discharge of Henry and Gina's mortgage liability triggered "discharge of indebtedness income," to them equal to the $95,000 of the cancelled debt.

Prior to the Mortgage Debt Relief Act, the $95,000 of discharged indebtedness would have subjected Henry and Gina to federal income tax based on the discharged amount.[153] So the devastation Henry and Gina felt after losing their home to foreclosure would be exacerbated upon learning of the income tax liability on the phantom income, resulting from the discharged debt. Congressional response to such unexpected tax consequences, through the enactment of the Mortgage Debt Relief Act, attempts to protect homeowners in situations similar to Henry and Gina, allowing them to rebuild their financial futures without the added burden of an income tax that, in most cases, they would be unable to pay.

Section 108(a)(1)(E) excludes from gross income discharges of "qualified principal residence indebtedness." On the surface, the provision seems to do that which Congress intended, provide tax relief to the foreclosed homeowner whose debt was discharged. However, the actual effect of section 108(a)(1)(E) does not fully reflect Congress's intentions and/or concerns for the distressed homeowner.[154] A closer examination of section 108(a)(1)(E) reveals that, in spite of its deceptively simple requirements, not all foreclosed homeowners will benefit from the tax relief provision. The reasons include the provision's: (1) short deadline; (2) narrow definition of qualified principal residence indebtedness ("QPRI"); and (3) disparate treatment of similarly situated homeowners.

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153. *See id.* It provides that gross income includes discharge of indebtedness, "Where a recourse mortgage has been discharged, cancellation of indebtedness income arises to the extent the amount of the debt exceeds the fair market value of the property." Johnson v. Comm'r, 77 T.C.M. (CCH) 2005, at *2 (1999); *see also* Treas. Reg. § 1.1001-2(c), Example (8); Gehl v. Comm'r, 102 T.C. 784, 786 (1994), *aff'd by*, No. 94-3111, 1995 WL 115589 (8th Cir. Mar. 20, 1995); Bialock v. Comm'r, 35 T.C. 649, 660 (1961).

154. "[I]f you are unfortunate enough to lose your home to foreclosure because you are struggling, you have suffered enough. You shouldn't be punished further by being taxed on what you no longer own." 153 CONG. REC. H11, 256 (daily ed. Oct. 4, 2007) (statement of Rep. Dennis Cardoza).

C. *Temporary Deadline*

The tax relief available to homeowners under section 108(a)(1)(E) is temporary, available until December 31, 2012.[155] Solvent taxpayers whose mortgage debts are discharged after December 31, 2012, will have discharge of indebtedness income. Given the concern that Congress expressed for foreclosed homeowners, it is puzzling as to why it made the provision not only temporary, but available for such a short period.

D. *Should It Be Permanent?*

History shows that foreclosures resulting from economic downturns are not new, as they have been occurring since the Great Depression. In 1932, approximately 250,000 homes were foreclosed.[156] By 1933, more than 1,000 homes were being foreclosed each day.[157] One could say that Congress was a little late to the party when they passed the MDRA in 2007; as such, legislation was warranted eighty years ago.

Originally, the insolvency exception under section 22(b)(9) of the 1939 Code was to last for only a short period of time.[158] Qualified farm indebtedness was also intended to be temporary. Both provisions are now permanent. The legislative history does not specify what Congress considered when they made both provisions permanent. However, such a decision makes sense considering the purpose of section 108—to minimize hardship—and the cyclical nature of a down-turned economy. In contrast, when Congress enacted tax relief for canceled debt with respect to Hurricane Katrina victims, such relief was temporary. Hurricanes, while common, do not occur in the same areas or on a regular basis. Nor do they cause the kind of devastation that Hurricane Katrina caused. Thus, the temporary relief is justified.

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155. The Emergency Economic Stabilization Act of 2008, Pub. L. No. 110-343, 122 Stat. 3765, Div. A. § 303, extended the exclusion's sunset date from January 1, 2010 to January 1, 2013.

156. *See* Fred Wright, *The Effect of New Deal Real Estate Residential Finance and Foreclosure Policies Made in Response to the Real Estate Conditions of the Great Depression*, 57 ALA. L. REV. 231, 240 (2005).

157. *Id.* at 239.

158. Originally, when Congress enacted the Revenue Act of 1939 to offer tax relief to corporations in an unsound financial condition, such businesses could redeem its indebtedness for less than face value without recognizing income if such cancellation occurred between January 1, 1939 and January 1, 1943. *See* H.R. REP. NO. 76-855, at 23 (1939). The exclusion for corporations was extended an additional three years in the Revenue Act of 1942. S. REP. NO. 77-1631, at 77-78 (1942). In the Revenue Act of 1951, Congress made the temporary provision permanent. *See* H.R. REP. 82-311 (1951).

Permanently excluding qualified principal mortgage indebtedness from gross income would fall in line with the many other tax incentives offered to homeowners as a means of encouraging home ownership. These tax benefits include: (1) Internal Revenue Code section 121, which excludes from gross income gains (profits) of up to $500,000 from the sale of a principal residence;[159] (2) Internal Revenue Code section 164, which allows a deduction for real estate taxes paid on mortgage loans; (3) Internal Revenue Code section 163, which entitles a homeowner to a deduction for the interest paid on their mortgage loan.[160]

A permanent exclusion for discharge of mortgage indebtedness would also have the effect of encouraging home ownership because it would allay the fear that may prevent people from making home purchases—the fear of foreclosure. While a permanent exclusion for the discharge of qualified principal residence indebtedness does not prevent foreclosure, it can provide a sense of comfort to prospective homeowners to know that in the event of their worst fear—foreclosure—they will not be subject to an income tax on the phantom income.

E. *Extension of Temporary Deadline*

Even if the temporary deadline can be justified for policy reasons,[161] there are a number of arguments to support extending it.

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159. I.R.C. § 121(a)-(b). The gain excluded is a maximum of $250,000 for single filers and married couples filing separate returns. The maximum of $500,000 excluded applies to married taxpayers who file joint returns. *Id.*

160. However, some proponents of the temporary exclusion use the three housing deductions mentioned as reasons for the mortgage debt relief exclusion to be temporary. *See* PAMELA J. JACKSON, CONG. RESEARCH SERV., RL 34212, ANALYSIS OF THE PROPOSED TAX EXCLUSION FOR CANCELED MORTGAGE DEBT INCOME 10 (2007).

> The deduction for mortgage interest is the most costly provision, with an estimate of $79.9 billion in revenue loss for FY2008. The exclusion of gain on the sales of homes is the second largest tax provision for homeowners, with an estimate of $29 billion in tax revenue loss for FY2008. The deduction of state and local real estate taxes is the third provision, with an estimate of $14.3 billion in tax revenue loss for FY2008.

Id. at 10-11 (internal citations omitted).

161. As one witness stated during a Senate Hearing concerning the Mortgage Forgiveness Debt Relief Act,

> I believe that H.R. 3648 should be made temporary. The current market conditions are unusual. Because most home value losses today are more likely due to these market conditions rather than due to personal consumption, it might be administrable "rough justice" to allow *all* such debt-discharge income to be excluded, without a specific showing that the home's loss in value was due solely to market conditions rather than personal consumption. But that will not be true forever; the home market will eventually revert to the historical norm where most well-maintained homes at least maintain their

First, the housing market crisis has not bottomed out. Foreclosures continue to be on the rise as people continue to lose their jobs.[162] It defeats the purpose of the mortgage indebtedness exclusion to have this impending deadline, when there have been no signs of an end to the housing market crisis—or even signs of an improving housing market.[163] The fact that the original deadline of December 31, 2010 was extended to December 31, 2012, indicates that the crisis will exist for a longer time than Congress originally believed.

Secondly, many homeowners who will lose their homes to foreclosure before January 1, 2013 will not be able to benefit from section 108(a)(1)(E), if the banks do not or cannot sell the homes before the deadline. This will likely be the case because banks are finding it difficult to dispose of their current inventory of homes.[164] A homeowner cannot incur discharge of indebtedness income until such indebtedness has been discharged. The banks cannot discharge the mortgage debt until they sell the homes. If banks do not sell the homes until after the deadline, then it follows that any discharge of indebtedness income will be past the deadline. Thus, under this scenario, homeowners forced out of their homes before the December 31, 2012, will not be able to exclude any discharge of indebtedness from gross income. To avoid this harsh result, the temporary deadline should be based on the date of the foreclosure and not the date of discharge.[165]

> nominal value (if not actually appreciate over time). When that happens, most value loss, if it occurs, will be due to personal consumption, and thus, any resulting realized debt-discharge income should be includable by the solvent taxpayer.

The Housing Decline: *The Extent of the Problem and Potential Remedies*: *Hearing Before the S. Comm. on Finance*, 110th Cong. 8 (2007) (testimony of Deborah A. Geier, Professor of Law, Cleveland-Marshall Coll. of Law, Cleveland State Univ.), *available at* http://finance.senate.gov/imo/media/doc/121307testdg.pdf.

162. Already, January's 315,716 foreclosures are 15% higher than in 2009 and February's 308,524 foreclosures are 6% higher than the previous year. www.realtytrac.com. *See also* Carolyn Kemp, *Delinquencies, Foreclosures Starts Fall in Latest MBA National Delinquency Survey*, MORTGAGEBANKERS.COM (Feb. 19, 2010), http://www.mortgagebankers.org/NewsandMedia/PressCenter/71891.htm. ("Foreclosure rates could continue to climb, however, based on the ability of borrowers 90 days or more delinquent to solve their problems.").

163. "It is too early to determine when the housing slump will end." JOINT CTR FOR HOUS. STUDIES, HARVARD UNIV. THE STATE OF THE NATION'S HOUSING 4 (2007), *available at* http://www.jchs.harvard.edu/publications/markets/son2007/son2007.pdf. "Recent studies have projected that the slump will continue, with no foreseeable relief for troubled homeowners." Rachel Carlton, *Mortgage Forgiveness Debt Relief Act of 2007*, 45 HARV. J. ON LEGIS 601, 601 (2008).

164. In 2007, 4.5 million existing homes for sale, a 10.8 month supply compared to 3.9 million or 7.4 months supply in 2006. In 2004, it was 2.2 million or 4.3 months. *See National Association of Realtors.*

165. From the time the bank forecloses on the home to the time it is sold takes approximately eighteen months. Amy Crews Cutts & Richard K. Green, *Innovative Servicing Technology*: *Smart*

F. *Definition of "Qualified Principal Residence Indebtedness"*

Only "qualified principal residence indebtedness ("QPRI")" will be excluded from discharge of indebtedness income. Section 108(h)(3) defines qualified principal residence indebtedness as: acquisition indebtedness ("AI"). The section then references section 163(h)(3)(B) to provide the definition for acquisition indebtedness, which it defines as indebtedness incurred in the acquisition, construction or substantial improvement of a qualified residence and is secured by the residence.[166] Stated simply, qualified principal residence indebtedness is indebtedness incurred in the acquisition, construction, or substantial improvement of a qualified residence.

The problem in using section 163(h)(3)(B) to define QPRI is that section 163(h)(3)(B) is a deduction-granting provision. Provisions allowing income tax deductions are narrowly construed. [167] It generally follows that any definition associated with a tax deduction will be narrow in scope. Using the tax-deduction provision to define QPRI will exclude certain types of mortgage indebtedness.

Two types of mortgage indebtedness that may fail to meet the definition of QPRI are home equity lines of credit ("HELOCs") and second mortgages. A homeowner, who takes out either of these types of loans, generally does not use the borrowed funds to acquire or construct a home. While he may use the funds to improve his residence substantially, he may also use the money to purchase a car, pay off credit card debt, or go on vacation. In such instances, the indebtedness, which is secured by his residence, does not qualify as QPRI. As such, any discharge of the liability will cause the homeowner to recognize discharge of indebtedness income. A result that seems contrary to the legislative intent because the homeowner who defaults on this type of

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Enough to Keep People in Their Houses? 16 (Freddie Mac, Working Paper No. 04-03, 2004), a*vailable at* http://www.freddiemac.com/news/pdf/fmwp_0403_servicing.pdf.

166. I.R.C. § 163(h)(3)(B) (2010). Refinancing of the indebtedness is also included in the definition of acquisition indebtedness. *Id.*

167. *See* INDOPCO, Inc. v. Comm'r, 503 U.S. 79, 84 (1992) (noting the familiar rule that deductions are to be strictly and narrowly construed, allowed only "as there is a clear provision therefore"); *In re* Harvard Indus. v. IRS, 568 F.3d 444, 454 (3d Cir. 2009) ("[T]he taxpayer has the burden of proving its eligibility for a deduction, and statutes authorizing deductions are a matter of legislative grace and are to be construed narrowly, unless the text of the statute authorizing the deduction reflects a different congressional intent."); Consol. Chollar Gould & Savage Min. Co. v. Comm'r, 133 F.2d 440, 441 (9th Cir. 1943) (holding that "the ambiguity arising from two possible rational interpretations must be resolved *against* the taxpayer seeking the deduction and which must bring itself clearly within the area of legislative grace." (emphasis added)).

loan still faces foreclosure, and will be further burdened with an income tax.

What makes the narrow definition of QPRI even more perplexing is that homeowners are allowed a mortgage interest deduction with respect to this type of indebtedness, which the Tax Code calls "home equity indebtedness."[168] This turns into an absurd result, in that the definition of QPRI for a tax provision designed to provide tax relief is narrower than the tax provision designed solely "as a matter of legislative grace."[169]

In contrast, when Congress amended section 108 to offer tax relief to farmers discharged of "qualified farm indebtedness ("QFI")," the term "farm" (or farming), was not given a restrictive definition. In fact, Congress did not define "farm," or any of its derivatives (which invited litigation). Instead, the definition was developed through case law and resulted in "farm" being broadly defined.[170]

It is noteworthy that the courts could have, but did not adopt the more restrictive definition of farming found under the tax deduction provision of section 464(e). Section 464(e) limits farming to "the cultivation of land or the raising or harvesting of any agricultural or horticultural commodity including the raising, shearing, feeding, caring for, training, and management of animals."[171] Such a limited definition would have prevented many farmers from qualifying for the tax relief offered under section 108(a)(1)(C).[172]

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168. I.R.C. §163(h)(3)(C)(i) ("'[H]ome equity indebtedness' means any indebtedness (other than acquisition indebtedness) secured by a qualified residence. . . .").

169. At least one scholar agrees with limiting the exclusion to indebtedness used substantially to improve the home, ". . . as such debt is tantamount to credit card debt that just happens to be secured by the home. If such debt is cancelled, the justification for exclusion . . . disappears." *The Housing Decline*: *The Extent of the Problem and Potential Remedies: Hearing Before the S. Comm. on Finance*, 110th Cong. 9 (2007) (testimony of Deborah A. Geier, Professor of Law, Cleveland-Marshall Coll. of Law, Cleveland State Univ.).

170. Poultry farms are considered farms for purposes of QFI. Treas. Reg. § 1.61-4(d); "[T]he operation of an integrated poultry processing business meets the definition of farm for QFI purposes." Maple Leaf Farms, Inc. v. Comm'r, 64 T.C. 438, 447 (1975). Further, the term "farmers" includes not just individuals, but any partnership or corporation that "cultivates, operates, or manages a farm for gain or profit, either as owner or tenant." Treas. Reg. §1.175-3 (2010). The broad definition "is in keeping with the purpose of the statute: assisting farmers to keep and continue operating their farms and to avoid bankruptcy." 135 CONG. REC. S5078-02 (daily ed. May 10, 1989) (statement of Sen. Chuck Grassley).

171. I.R.C. § 464(e) (1997).

172. For a more detailed discussion of the definition of "farms," see Williams, *supra* note 124.

G. *"Substantial Improvement of the Qualified Residence"*

If the homeowner uses the borrowed funds to *substantially improve* his personal residence (and the loan is secured by the residence), it is QPRI. However, determining what constitutes a substantial improvement to make the indebtedness QPRI may not be so easy. Will using the funds to paint the exterior and interior of the home be considered a substantial improvement? What about buying furniture for the home, putting in a new air conditioning, or heating unit? Consider the following scenario.

In 2002, homeowner purchased a principal residence for $150,000, taking out a $150,000 mortgage loan with no down payment. The loan was secured by the principal residence. In 2003, when the home was valued at $200,000, homeowner took out a second mortgage in the amount of $50,000 that she used to add a garage to her home ($35,000) and to make improvements to the landscaping ($15,000). The total amount borrowed was $200,000. In 2008, the homeowner could no longer make her mortgage payments. The bank foreclosed. After the sale of the home, the bank discharged the remaining balance of $50,000.

The Internal Revenue Service takes the position that $35,000 is QPRI, but $15,000 is not because it was not used to "acquire, construct, or substantially improve the property."[173] However, the taxpayer could reasonably take the opposite position and consider the entire $50,000 QPRI, believing that all expenses incurred substantially improved her home. These opposite positions will naturally lead to costly litigation, for both the government and the taxpayer.

So long as the home served as security for the loan, thereby giving the bank the right to foreclose on the property upon default, this should be sufficient for the indebtedness to qualify as QPRI. QPRI should not be restricted by what the homeowner does with the funds. Otherwise, it does exactly what the legislation seeks to prevent: taxation on the foreclosed homeowners. Surely, offering an exclusion to help the homeowners, but making it difficult for many of them to meet the requirements was not Congress's intentions.

173. *Id.*

H. Disparate Treatment of Homeowners with HEI that is not QPRI

"Tax policy does not favor dissimilar taxation of similarly situated taxpayers."[174] Not allowing home equity indebtedness to qualify as QPRI will result in discharge of indebtedness income for those homeowners if the debt is "recourse,"[175] while homeowners discharged of home equity "nonrecourse"[176] indebtedness will legally be able to avoid a tax. Consider the following scenarios.

In 2003, Mr. and Mrs. Smith purchased a residence for $200,000. They used $20,000 of their own funds and borrowing the remaining $180,000 from State Bank. Mr. and Mrs. Smith were personally liable for the loan, i.e., it was a recourse loan. In 2005, Mr. and Mrs. Smith took out a second mortgage in the amount of $30,000. They used the loan proceeds to pay off their student loans. In 2008, financial problems prevented Mr. and Mrs. Smith from making their mortgage payments. As a consequence of nonpayment, State Bank foreclosed on the loan. At the time of the foreclosure, Mr. and Mrs. Smith owed State Bank $190,000. The foreclosure sale brought in only $150,000, leaving a deficiency balance of $40,000. After unsuccessful collection attempts, State Bank discharged the $40,000 deficiency.

State Bank's discharge of the recourse liability results in discharge indebtedness income to Mr. and Mrs. Smith equal to the amount discharged, $40,000. Mr. and Mrs. Smith may find relief under section 108(a)(1)(E) only if the amount discharged is QPRI. Because Mr. and Mrs. Smith used only $10,000 of the $40,000 discharged to "acquire, construct, or substantially improve" only that amount constitutes QPRI and may be excluded from gross income. [177] The remaining $30,000 of

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174. DEP'T OF THE TREASURY, TAX REFORM FOR FAIRNESS, SIMPLICITY, AND ECONOMIC GROWTH: TREASURY DEP'T REPORT TO THE PRESIDENT 14 (1984). It states: a tax that places significantly different burdens on taxpayers in similar economic circumstances is not fair. For example, if two similar families have the same income, they should ordinarily pay roughly the same amount of income tax, regardless of the sources or use of that income. A fair tax system does not allow some taxpayers to avoid by legal means or evade them by illegal means. *Id.*

175. A "recourse" debt is a debt for which the debtor has personal liability. U.C.C. § 3-414(1) (1987). The lender may obtain a personal judgment against the debtor. For examples of tax effects of recourse liability see Treas. Reg. § 1.1001-2(a), (c) (1980).

176. "A nonrecourse liability means that the lender is not entitled to a personal judgment against the debtor, but can only recover the property which secures the loan; thus the debtor has no personal liability." *Id.* A nonrecourse debt is a "debt for which the debtor is not personally liable. The lender is barred from action against the borrower's other assets if the security value is insufficient to satisfy the loan." Deborah A Geier, Tufts *and the Evolution of Debt-Discharge Theory*, 1 FLA. TAX REV. 115, 119 n.9 (1992).

177. There could be an issue concerning the order in which the different types of debt qualify as being satisfied with the foreclosure sale. For instance, an argument could be made that the HEI

the discharged debt represents indebtedness incurred by Mr. and Mrs. Smith not used to "acquire, construct, or substantially improve" the residence. Therefore, it is not QPRI and Mr. and Mrs. Smith will be subject to an income tax on that amount.[178] Contrast these tax consequences to a situation in which Mr. and Mrs. Smith's debt is nonrecourse.

If given the same facts as above, except that Mr. and Mrs. Smith are not personally liable for the loan, the tax consequences are completely different. In this instance, Mr. and Mrs. Smith will not have discharge of indebtedness income. Rather, Mr. and Mrs. Smith will be deemed to have sold the home for $190,000. In other words, the entire debt is included in the "amount realized."[179] With an adjusted basis in the house of $200,000, the foreclosure sale results in a $10,000 non-deductible loss—but more importantly, it does not result in a taxable gain![180]

This absurd and inequitable result in the two nearly identical cases is perhaps the strongest argument as to why QPRI should be expanded to include any indebtedness, which is secured by the home, regardless of the use of those funds. Allowing second mortgages and HELOCs to count as QPRI, although the funds are not used towards the home, will prevent this type of inequity. If this hole is not filled, more homeowners may be forced to file bankruptcy due to their increased liability on the phantom income.

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was satisfied with the proceeds from the foreclosure sale, and that the deficiency balance represented QPRI. This argument is unlikely to be successful and will not be discussed beyond this footnote.

178. Mr. and Mrs. Smith must also determine their gain or loss from the foreclosure sale. In this case, the amount that they realize is $150,000, the fair market value of the house less their adjusted basis, resulting in a non-deductible personal loss. *See* I.R.C. § 262(a) (2010). *See also* Treas. Reg. §1.1001-2(a)(2).

179. "Except as [otherwise] provided . . . the amount realized from a sale or other disposition of property includes the amount of liabilities from which the transferor is discharged as a result of the sale or disposition." *Id.* § 1.1001-2(a)(1). *See also* I.R.C. § 7701(g) ("In determining the amount of gain or loss (or deemed gain or loss) with respect to any property, the fair market value of such property shall be treated as being not less than the amount of any nonrecourse indebtedness to which such property is subject.").

180. For an in depth look at the absurdity of the results between recourse and non-recourse loans (or an argument as to why recourse and non-recourse loans should be given the same treatment for purposes of sections 61(a)(12) and 108(a)), see *The Housing Decline*: *The Extent of the Problem and Potential Remedies: Hearing Before the S. Comm. on Finance*, *supra* note 169 (testimony of Deborah A. Geier). It can be noted here that disparate treatment can happen the other way around as well, with homeowners with a non-recourse having a gain after the foreclosure sale and not being subject to section 108 because it is not discharge of indebtedness income. Though, this is rare. In most instances, as indicated in the example, it will usually result in a non-deductible capital loss.

VI. CONCLUSION

When the nation is going through hard economic times, taxpayers become delinquent in their debts, resulting in debt cancellation by their creditors. Congress appropriately responds through section 108 to extend tax relief to the taxpayers who have been hit the hardest by the down-turned economy: businesses during the Great Depression; farmers during the 1980s credit crisis; and foreclosed homeowners in the housing crisis. To the farmer, amending section 108 to exclude from gross income discharge of "qualified farm indebtedness," allowed him to restructure his debt and keep his farm. For the foreclosed homeowner, amending section 108 to exclude from gross income discharges of "qualified principal residence indebtedness" allowed him to deal with the devastation of losing his home without the added burden of an income tax.

However, as this article demonstrates, Congress did not go far enough to ensure that all of the intended beneficiaries of section 108 are actually helped. Limitations with respect to "qualified farm indebtedness" and "qualified principal residence indebtedness" leave some farmers and foreclosed homeowners out in the cold. As we saw in *Lawinger*, a taxpayer who restructured her debt to save her farm nonetheless faced income tax consequences from the discharge of part of her indebtedness because she failed the "gross receipts test," which she would have met had she sold her farm a year earlier.

Foreclosed homeowners whose homes are not sold before 2013 or who used part of the borrowed funds for something other than substantially improving the home, will have discharge of indebtedness income. They will be hit by the "double whammy" Congress tried to prevent when they passed MDRA.

Congress should take another look at section 108, in particular the most recent provision, and make the necessary changes so that it comports with the policy of section 108. Further, Congress should learn through these provisions so that it can be ready to help the next taxpayer not currently covered under section 108. As this article has shown, history does repeat itself.