

January 2008

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Recommended Citation

Richard C. Beck, *The Tax Treatment of Cancelled Interest and Penalties on Consumer Debt*, 53 N.Y.L. SCH. L. REV. 1025 (2008-2009).

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RICHARD C.E. BECK

The Tax Treatment of Cancelled Interest and Penalties on Consumer Debt

ABOUT THE AUTHOR: Richard C.E. Beck is a professor of law at New York Law School. I wish to thank Professors Daniel Halperin, Adam Chodorow, and Diane Fahey for their valuable comments on an earlier version of the article. Errors of course remain my own. This work was supported by a generous research grant from New York Law School. A shorter version of this article was published in *Tax Notes: Richard C.E. Beck, Payne v. CIR and the Tax Treatment of Defaulted Credit Card Debt*, 121 TAX NOTES 1315 (Dec. 15, 2008).

As of this writing, foreclosure threatens millions of American homeowners in the biggest housing crisis since the Great Depression of the 1930s. In addition, a second financial bubble of defaulting credit card debt appears about to burst. Both are likely to result in the renegotiation and discharge of large amounts of non-business debt.

This means that both groups of distressed debtors face additional hardship from taxes, or perhaps more accurately, taxes on their hardship. Under U.S. law, unlike that of any other country, debt discharge is treated as taxable income. When a lender gives up hope of collection and forgives part of a debt, the discharged amount gives rise to a new debt—a tax debt. The greater the amount of relief, the greater the new tax debt for cancellation of indebtedness (“COD”), almost as if the IRS were stepping into the lender’s shoes and demanding payment of a portion of the very debt that was just forgiven.

No other country’s tax system appears to tax COD, at least to individuals. This is probably because COD resembles loss more than it does gain, and trying to tax it seems both perverse and futile. Perverse because it undercuts the relief provided by the lender, and futile because distressed taxpayers who are unable to pay their original creditors would seem unlikely to be able to pay the government either.

For these reasons, and many others, the seventy-seven year history of COD law in the United States is and always has been controversial, constantly changing, replete with exceptions, and despite its complexity, uncertain to the point where even the simplest questions cannot be answered with assurance.

The current credit crisis has brought an urgent example of this confusion to the fore, namely whether forgiven debts for defaulted credit card interest and penalties are includible under current law as COD income.

Many studies, including one by the General Accounting Office,¹ show that credit card issuers have been steadily increasing interest and penalty rates, causing these to add up to significant amounts that are often greater than the original principal borrowed.² Punitive interest rates as high as thirty-six percent may apply if the borrower has made a single late payment. These excessive amounts make it more likely that borrowers will default. Furthermore, after default, issuers continue to charge high-rate interest and penalties so that many borrowers, even those still

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1. See U.S. GOV’T ACCOUNTABILITY OFFICE, GAO-06-929, CREDIT CARDS: INCREASED COMPLEXITY IN RATES AND FEES HEIGHTENS NEED FOR MORE EFFECTIVE DISCLOSURE TO CONSUMERS (2006), available at <http://www.gao.gov/new.items/d06929.pdf>; Martin H. Bowsworth, *Credit Card Fees Rise, Disclosure Statements Inadequate*, CONSUMERAFFAIRS.COM, Oct. 12, 2006, http://www.consumeraffairs.com/news04/2006/10/gao_credit_cards.html; Press Release, Consumer Action News, Consumer Action Releases 2008 Credit Card Survey: Credit Card Traps Can Catch Even Good Customers (July 23, 2008), available at http://www.consumer-action.org/news/articles/2008_credit_card_survey/ (providing highlights of the survey and information on how to access the survey).
 2. See Joseph S. Enoch, *Credit Card Executives Tough Out Senate Hearing*, CONSUMERAFFAIRS.COM, Mar. 7, 2007, http://www.consumeraffairs.com/news04/2007/03/senate_credit_cards02.html (reporting that “[t]he woes of millions of Americans who are slaves to hidden fees, compounding interest and cryptic terms” were heard in a Senate Permanent Subcommittee on Investigations hearing March 7, 2007, chaired by Sen. Carl Levin (D-Mich.)). One of the witnesses was Wesley Wannemacher, a former Chase Bank credit card holder who placed \$3200 of wedding expenses in late 2001 on his card. He never spent another cent on that card, yet his debt to Chase ballooned to \$10,700—that is until Chase saw his name on the witness list last week and forgave his debt. *Id.*

making regular payments, can never catch up again. At some point, the risk of total loss of its unsecured claims in a cardholder's bankruptcy will induce the issuing bank (or debt collectors who buy the issuer's defaulted accounts) to offer a settlement for some partial payment and forgive the balance. It is this forgiveness which triggers the tax question.

The Tax Court recently held in *Payne v. CIR* that the forgiveness of defaulted interest is taxable to the borrower,³ and in *Hahn v. CIR* that forgiven penalties are taxable.⁴ This article argues that these decisions are clearly erroneous under current law. Because these judicial errors will potentially injure millions of taxpayers, it is important that the errors be corrected. *Payne* is currently on appeal before the Eighth Circuit and should be reversed.

I. WHY COD? THE LOAN PROCEEDS THEORY

The leading explanation of why COD income should be taxed in the first place is the "loan proceeds" theory, now to be found in every casebook and treatise. Borrowed money (i.e., loan proceeds) is not taxed when received because it does not belong to the borrower. The loan proceeds are supposed to be returned to the lender, and so they do not increase the borrower's net worth. If that supposition is later contradicted by forgiveness of the debt, the original reason for tax-free receipt is negated, so the theory goes, and the forgiveness should be taxed, if not by reopening the loan year, then in the year of forgiveness *nunc pro tunc*.⁵ This justification for taxing COD is generally accepted, and I have never seen it challenged.⁶

3. *Payne v. Comm'r*, 95 T.C.M. (CCH) 1253 (2008) (holding that a MBNA credit card account balance of \$21,270 settled in full by payment of \$4592 resulted in taxable income of \$16,678, despite the undisputed fact the taxpayer repaid all borrowed principal in full). This case is now on appeal to the Eighth Circuit.
4. *See Hahn v. Comm'r*, 93 T.C.M. (CCH) 1055 (2007) (concluding that a compromised bank line of credit resulted in taxable income not only from cancelled principal of loan, but from cancelled interest, late fees, and attorney's fees as well).
5. *See, e.g.*, Boris I. Bittker & Barton H. Thompson, Jr., *Income from the Discharge of Indebtedness: The Progeny of United States v. Kirby Lumber Co.*, 66 CAL. L. REV. 1159 (1978) (articulating the classic expression of this view). The loan proceeds theory has generally replaced an earlier "freeing of assets" theory, now largely discredited because (among other defects) it can lead to the problems addressed here: cancellation of a penalty, for example, can "free up" assets, but it provides no gain. *See id.* at 1165.
6. Despite this unanimity of opinion, however, the loan proceeds theory is surprisingly weak, and seems little more than a post hoc rationalization of nearly fifty years of dubious law. Debt forgiveness of the sort in *Payne* and *Hahn* bears no resemblance whatsoever to the open market cash repurchases of corporate debt securities at a discount as was present in *Kirby Lumber*. It was an unaccountable error for the courts and the tax bar to accept without serious discussion the government's over-generalization of *Kirby Lumber's* limited holding, which involved only bond repurchases that were voluntary, to situations of face-to-face debt forgiveness dictated by inability to pay. It remains obscure how and why this came about, and why *Kirby Lumber* is still cited in support of taxing such utterly diverse transactions. In my view, distress COD should not be taxed (whether or not *Kirby Lumber*-type repurchases are taxed), if only because the forgiveness provides no liquidity out of which taxes might realistically be paid. Non-distress cases can almost always be taxed through the tax benefit rule (see the discussion of *Schlifke v. CIR*, *infra* note 49) or under another more fitting classification in cases where it is appropriate to tax them at all. The term "COD" is so large a tent as to be an entire circus, and if the law is ever to be

THE TAX TREATMENT OF CANCELLED INTEREST AND PENALTIES ON CONSUMER DEBT

A. Non-cash Loan Proceeds

The Internal Revenue Code (the “Code” or “IRC”) does not specify what kinds of obligations are subject to income treatment when cancelled, and it speaks ambiguously of “indebtedness” at IRC section 61(a)(12) without any further limitation at all.⁷ The definition of indebtedness at IRC section 108(d)(1) is hardly any more helpful. There, “indebtedness” is defined as “any indebtedness (A) for which the taxpayer is liable, or (B) subject to which the taxpayer holds property”⁸—a characterization so broad as to be nearly useless. The Treasury has never promulgated any regulations in this all-important area, and taxpayers have been essentially without guidance for seventy-five years.⁹

The loan proceeds theory of debt forgiveness would seem to limit income treatment to borrowings of cash and to have no effect upon the cancellation of obligations incurred for other reasons.¹⁰ As an economic matter, without the receipt of borrowed money, or at least of valuable property or services purchased on credit, the taxpayer can have no gain when the obligation is cancelled. It is the *loan proceeds* which constitute the postulated gain, and without gain there can be no taxable income.

It has always been clear that if an obligation is incurred without receipt of economic consideration, its cancellation is not taxable. For example, the courts have held since the decision in *Landreth v. CIR* that cancellation of a guarantor’s debt is tax free because it was the primary borrower who received the money, not the guarantor.¹¹ The *Landreth* court’s reasoning is worth repeating:

The situation of a guarantor is not like that of a debtor who as a result of the original loan obtains a nontaxable increase in assets. The guarantor obtains nothing except perhaps a taxable consideration for his promise. Where a debtor is relieved of his obligation to repay the loan, his net worth is increased over what it would have been if the original transaction had never occurred. This real increase in wealth may be properly taxable. However, where the guarantor is relieved of his contingent liability, either because of payment by the debtor to the creditor or because of a release given him by the creditor, no previously untaxed accretion in assets thereby results in an increase in net worth. Payment by the principal debtor does not increase the guarantor’s net worth; it merely prevents it, pro tanto, from being decreased. The guarantor no more realizes income from the transaction than he would if a tornado,

clarified, we will have to get rid of the term and examine each species separately. All this will be the subject of another article, and is beyond the scope of this one.

7. See I.R.C. § 61(a)(12) (2006) (“[G]ross income means all income from whatever source derived, including . . . [i]ncome from discharge of indebtedness.”).
8. I.R.C. § 108(d)(1) (2006).
9. Except for a few almost random exceptions, such as certain seller-financed purchases of property subject to IRC section 108(e)(5) discussed below and cancelled expenses which would have been deductible, the Treasury has provided no guidance. See I.R.C. § 108(e)(5) (2006).
10. The law would have been far less confusing if the COD rules applied only to cash loans.
11. *Landreth v. Comm’r*, 50 T.C. 803 (1968).

bearing down on his home and threatening a loss, changes course and leaves the house intact.¹²

Similarly, although the case law is sparse, it seems agreed, even by the most literal-minded, that cancelled debts do not give rise to income if they were originally incurred without loan proceeds—for example, such obligations as for fines or penalties, tort judgments, alimony, child support, taxes, or pledges to make a gift to charity.¹³ Although there are few actual decisions in this area, the courts have often expressed the principle in dictum that the cancellation of such obligations amounts to the mere avoidance of a loss, and avoidance of loss is not a gain and not taxable.¹⁴

1. *Purchase Money Debt for Property*

Where the economic consideration for a debt is in the form of property rather than cash, that is to say a purchase of property on credit, the law is plentiful if not entirely rational. Under IRC section 108(e)(5), a reduction of purchase-money debt from property is exempt from taxation and treated instead as a retroactive reduction of the purchase price of the property.¹⁵ However, the provision is unreasonably narrow. It is limited to seller-financing¹⁶ and limited further to situations where the lender-seller still holds the debt and the purchaser-borrower still holds the property.¹⁷ These limitations lack support in prior case law, and they seem to have no rational basis. There is no economic difference to the buyer whether he owes the purchase price to the seller or to a third party; in both cases he has received not money, but property on credit.

When IRC section 108(e)(5) applies, the basis of the purchased property securing the debt must be reduced by the amount of forgiven debt in order to prevent

12. *Id.* at 812–13 (internal citations omitted). This same passage was quoted with approval in *Hunt v. Comm’r*, 59 T.C.M. (CCH) 635 (1990).

13. *See Comm’r v. Rail Joint Co.*, 61 F.2d 751 (2d Cir. 1932) (finding that a corporation which repurchased its own bonds for less than face amount does not have income because bonds were issued not for cash as in *Kirby Lumber*, but as dividends without receiving any loan proceeds in return). The court explained in dictum:

Suppose that a taxpayer validly contracts in 1930 to give \$1000 to a charity in 1931, and in the latter year compromises the obligation by paying \$500 in full settlement. If the taxpayer returns his income on a cash basis, this transaction cannot possibly increase his income. The giving of the obligation certainly added nothing to income in 1930, and the payment of it in 1931 will appear only as a deduction of the sum actually paid in that year to the use of a charitable corporation.

Id. at 752.

14. *See, e.g., Eagle Asbestos & Packing Co. v. United States*, 348 F.2d 528, 531 (Ct. Cl. 1965) (stating that the difference between the actual payment of a settlement claim and the amount of the claim is not income).

15. *See* I.R.C. § 108(e)(5) (2006).

16. I.R.C. § 108(e)(5)(A) (2006).

17. I.R.C. § 108(e)(5).

unwarranted tax benefits. This insures that an appropriate amount of gain will eventually be taxed and prevents excessive depreciation and/or loss deductions.¹⁸

In effect, the back-end price adjustment rule created in IRC section 108(e)(5) operates just like the front-end rule for bargain purchases. Our tax rules do not tax bargain purchases at the time they are made, but instead preserve the spread between basis and value as unrealized gain for later taxation.¹⁹ An after-the-fact basis adjustment for purchase money debt relief has exactly the same effect.

Note too that a cash refund of part of a fully paid purchase price of property also has the identical tax effect. If the purchaser of a computer or a car collects a refund, say by mailing in a cash-back rebate voucher or complaining to the vendor that the same item can be purchased elsewhere for less, the cash rebate is of course a tax-free return of the buyer's own capital and the buyer's basis in the property for tax purposes would be appropriately revised downward to reflect its final net purchase price.²⁰ Thus, a bargain purchase, a reduction of purchase money debt, and a cash rebate of part of a purchase price of property are all economic equivalents and should be treated similarly for tax purposes.²¹

2. *The Mortgage Forgiveness Debt Relief Act of 2007*

The new Mortgage Forgiveness Debt Relief Act of 2007 (the 2007 Act),²² now codified at IRC section 108(h), in effect extends the tax relief of IRC section 108(e)(5) to homeowners who have bank mortgages, but leaves open the issues of whether cancellation of consumer debt for interest and penalties are taxable. Thus the problem in *Payne* and *Hahn* will also affect homeowners, though perhaps to a lesser extent than credit card borrowers. The 2007 Act provides very limited relief and does not mention the issues of interest and penalties.²³

18. These issues have little or no urgency with respect to personal-use property which, unlike business property, cannot be depreciated and does not permit any deduction for losses. See I.R.C. § 179(d)(1)(C) (2006). Even on the gain side, the issue is less urgent than for business property, because up to \$500,000 of gain from the sale of a primary residence is exempt. See I.R.C. § 121(b)(2)(A) (2006). These dramatically different effects illustrate why it is far less important to account for and police consumer debt cancellation than business COD.

19. See I.R.C. § 1011(a) (2006) (noting that taxable gains are determined, in part, by the original cost to the taxpayer).

20. See generally I.R.C. § 1012 (2006).

21. This observation highlights the unreasonableness of the limitations in IRC section 108(e)(5) criticized above. For example, a cash rebate would be tax free whether it came from the seller or from a corporation affiliated with the seller, but if the rebate were in the form of a reduction of purchase money debt, IRC section 108(e)(5) would not apply by its terms. See *supra* text accompanying note 16.

22. I.R.C. § 108 (2006).

23. A homeowner who takes a mortgage directly from the seller has no income under the general rule of IRC section 108(e)(5) if the mortgage is later reduced. Only if the mortgage is from a bank or other third party (as most mortgages are) does the buyer need the (temporary) mercy of the 2007 Act to obtain the same result. In short, the 2007 Act would have been wholly unnecessary if IRC section 108(e)(5) had been drafted without its arbitrary limitations.

IRC section 108(h) is applicable only to the years 2007 through 2012, and it forgives tax on discharge of mortgage debt for homeowners, but only for the principal of a purchase money mortgage up to the purchase price of a single owner-occupied primary residence (and even then with an arbitrary \$1 million limitation on principal amount, \$2 million for a married couple).²⁴

Neither IRC section 108(h) nor section 108(e)(5) excludes tax on forgiveness of “money-out” mortgages in excess of the purchase price to the extent of that excess, nor forgiveness of refinancing to the extent such mortgages exceed the original purchase price, nor forgiveness of second mortgages and home equity lines of credit. In short, all borrowings against home equity are still subject to tax when cancelled.²⁵ The ink was still wet on the 2007 Act when estimates began to appear that millions of additional taxpayers would be exposed to foreclosure risk and risk of tax on COD from discharge of home equity indebtedness.

Home equity debts often represent a refinancing of credit card debt or withdrawals of cash for living expenses. The advantage to the borrower of such loans over unsecured credit card debt is that the homeowner can often borrow a larger amount at a lower rate and, in addition, can deduct the interest on up to \$100,000 of such borrowing.²⁶ Congress may believe such debtors are less deserving of relief than people whose foreclosures are caused by purchase money home mortgages.²⁷ On the other hand, Congress may have thought that exempting home equity debt would simply be too long a stretch from existing rules.²⁸ Relief from purchase-money mortgage forgiveness required only some tweaking of the longstanding IRC section 108(e)(5) price-adjustment rule in order to provide similar relief for bank mortgages.

Because IRC section 108(h) protects only cancelled purchase money principal, cancelled obligations for mortgage interest and penalties will apparently be governed by the same rules as for other consumer loans. Some cancelled interest undoubtedly

24. I.R.C. § 108(h) (2006).

25. Unless the borrowing is reinvested in the home and qualifies as acquisition indebtedness, or the taxpayer is insolvent or bankrupt, IRC section 108(a) generally protects all taxpayers from tax COD income. *See* I.R.C. § 108(a) (2006).

26. The disadvantage, of course, is that this is a tempting formula for losing one’s home. The interest deduction is unjust for a different reason as well: those who had home equity could (and can) deduct interest on loans to buy a car or take a vacation or go to school, a privilege denied to the less affluent who do not own a home.

27. Much home equity borrowing is no doubt for self-indulgences, but much is also due to unavoidable expenses for health and education or simply to make ends meet for those who are temporarily out of work. The same is of course also true for credit card indebtedness which is incurred by taxpayers who are not fortunate enough to own a home with equity.

28. Many consumer groups are now actively lobbying for expansion of tax relief to include home equity debt, but it seems unlikely they will be successful, and even less likely that statutory relief will be enacted for income from credit card COD. Some tax experts are likely to oppose further relaxation of COD rules they regard as necessary to safeguard the taxability of “consumption.” In their view, even the carefully limited relief under the 2007 Act is a dangerous departure from COD rules which they think are necessary to protect the fundamental logic of tax. *See, e.g.,* Deborah Geier, *Another Take on the Mortgage Debt Relief Situation*, 117 TAX NOTES 389 (Oct. 23, 2007).

will be protected by IRC section 108(e)(2), which exempts from tax cancelled obligations that which would have been deductible if paid.²⁹ Much mortgage interest would fall into this category because, within certain limits, home mortgage interest, including interest on home equity indebtedness, is deductible under IRC sections 163(h)(2)(D) and 163(h)(3).³⁰ On the other hand, much interest will fall outside these exemptions. Approximately half of all homeowners claim the standard deduction and do not itemize their deductions. The IRS may well decide to deny these taxpayers the protection of IRC section 108(e)(2).³¹ Unfortunately, non-itemizing taxpayers probably represent a much higher percent of homeowners threatened by foreclosure because the incidence of itemization rise with income.³²

3. *Purchase Money Debt for Services*

There seems to be no law at all on the question of purchase money debt relief for consumer services, whether the services are in the form of the right to use the creditor's property or enjoyment of the creditor's personal efforts. For example, if a landlord reduces an obligation for past due rent there is apparently no reported authority as to whether the reduction is taxable as COD.³³ Neither does there seem to be any authority for taxing reduction of a doctor's or lawyer's bill, an obligation to pay for tuition or travel, or any other sort of consumer services.

The most likely reason for this gap is that these debt reductions are apparently just after-the-fact price adjustments and it simply has not occurred to anyone to tax them. After all, the school could have provided tuition at a discount or even for free as a tax-exempt scholarship in the first place, the doctor can charge whatever price he wants for his services, and the landlord can ask for any rent he likes, including

29. See I.R.C. § 108(e)(2) (2006) ("No income shall be realized from the discharge of indebtedness to the extent that payment of the liability would have given rise to a deduction.")

30. See I.R.C. § 163(h)(2) (2006) (providing a deduction on qualified residence interest); I.R.C. § 163(h)(3) (2006) (defining qualified residence interest to include either acquisition indebtedness or home equity indebtedness).

31. IRC section 108(e)(2) seems intended to give the taxpayer the benefit of lost deductions in this situation on the same principle of the tax benefit rule. If the homeowner has lost no tax benefit because he would still have claimed the standard deduction even if he had paid the cancelled interest, presumably IRC section 108(e)(2) would not apply, or at least the IRS may be expected to take this position.

32. See Gerald Prante, *Most Americans Don't Itemize on Their Tax Returns*, TAX FOUND., July 23, 2007, available at <http://www.taxfoundation.org/files/ff95.pdf> (providing state-by-state data that indicates the itemization rates rise as income rise).

33. This example not applicable if the tax benefit rule applied. A recovery of previously deducted rent under IRC section 111 could only apply to business rent that is deductible in advance of payment by an accrual method taxpayer. See I.R.C. § 111 (2006) (requiring the conversion of a recovery of the taxpayer's own capital, which would otherwise be tax free, such as repayment of a loan, into taxable income if the taxpayer deducted it in a prior year). It could not apply to tax a recovery of consumer rent, first because it is not deductible, and also because consumers are always on the cash method and cannot claim deductions of any kind before actual payment. The same is true of consumer interest. See *infra* Part I.B.

none at all (say offering the first six months free) as long as the transaction is not a disguised barter of some sort. Because the services cannot be depreciated or resold, there is no basis to adjust as there would be for a purchase of property. Also, the taxpayer has consumed the services and retains nothing of value that could be converted into cash to realize liquidity. If debt reduction for property purchased on credit is tax free, a similar reduction for services purchased on credit must *a fortiori* be excludible as well.

Comparison with a cash rebate is once again instructive. If a landlord refunds rent that a tenant already paid for a prior period, say because the rent turned out to exceed a rent control limitation or because the tenant threatens to move where he can rent a similar apartment for less, it is clear that the refund would simply be a tax-free return of the tenant's capital. The same would be true for any other services. If a doctor refused to cash a patient's check upon learning the patient or his family were medical colleagues, or if a school credited tuition paid for one semester to an entire year on learning the student was a full-blooded Cherokee, no income would result.

Given the lack of any apparent tax issue that can or should arise from cancellation of debts for consumer services, it seems quite natural that there is no reported administrative or judicial authority addressing such matters. It is thus surprising that the IRS took the position in *Hahn* and *Payne* that cancelled consumer interest is taxable as COD and even more surprising that the Tax Court agreed. There is no principled difference between a landlord's service of providing the use of real property for rent and a lender's service of providing the use of money for interest. If the receipt of one at a reduced price is taxable, then the other should be as well.

B. Cash Loan Proceeds

There are only two reported decisions regarding taxability of forgiven interest and/or penalties with respect to consumer loans; both are Tax Court memorandum decisions and are quite recent (one from 2007 and the other 2008). In *Hahn*, the loan principal was apparently cash drawn down on a bank line of credit.³⁴ In *Payne*, the principal of the debts was incurred on a credit card both for cash advances and to pay hospital bills.³⁵ Both decisions held for the government, and both are erroneous.

1. Hahn v. CIR, Penalties, and the Miracle of Income Without Gain

In *Hahn v. CIR*, the court considered, on motion for summary judgment, whether the taxpayer had realized income from discharge of indebtedness on a \$2 million line of credit from a bank. The main issue concerned a large non-principal amount of the cancelled debt that the court termed "related items" consisting of "interest, late charges, attorney's fees and other costs." The court barely distinguished these very different "related items" from one another.

34. *Hahn v. Comm'r*, 93 T.C.M. (CCH) 1055 (2007).

35. *Payne v. Comm'r*, 95 T.C.M. (CCH) 1253 (2008).

THE TAX TREATMENT OF CANCELLED INTEREST AND PENALTIES ON CONSUMER DEBT

In answer to the taxpayer's plea that he received no cash or other value in exchange for these "related items,"³⁶ the Tax Court asserted that income may be realized without any such receipt of cash or other property, citing as authority (inappropriately) *Old Colony Trust Co. v. CIR*,³⁷ together with a list of earlier Tax Court decisions.³⁸ In the cited Tax Court decisions it does in fact appear that cancelled obligations for interest, penalties, and other items were taxed along with cancelled principal, but in none of them did the taxpayer raise the issue of an absence of loan proceeds that was raised in *Hahn*. These earlier decisions did not even mention this issue much less brief, argue, or decide it. Because the loan proceeds issue was completely overlooked in the earlier cases, the *Hahn* court should have treated the cancellation of non-principal items as an issue of first impression rather than making it appear to be a matter of settled law.

The *Hahn* decision is also vitiated by its failure to make any distinction between the cancelled interest and the cancelled penalties. The Tax Court asserted that "the right to use money is a valuable property interest,"³⁹ but it is not clear whether the court was referring to interest alone or treating the late fees, legal collection costs, and other "related items" collectively, as if all these items involved the same issue. The court went on to explain its conclusion by reference to the now largely discredited "freeing of assets" theory:⁴⁰

[T]he facts indicate that petitioner had use of the borrowed funds beyond the time specified in the note. Consequently, petitioner incurred a liability for the related items. When petitioner was released from the liability, he realized and accession to income due to the freeing of assets previously offset by the liability.⁴¹

The above-quoted passage seems to confirm that the court saw no meaningful difference between interest and penalties. It is inconceivable, however, that a penalty assessed to the borrower, or the cost of the bank's legal services used for collection against him, could be regarded as valuable receipts to the borrower. Like the merciful

36. *Hahn v. Comm'r*, 93 T.C.M. (CCH) 1055 (2007). The taxpayer also argued that because the borrowed funds were used in his business of breeding and training horses, they were exempt from COD income treatment under IRC section 108(e)(2), asserting that the funds would have been deductible as business expenses if they had been paid. The court denied this part of the taxpayer's motion for summary judgment on the ground that it was a contested matter of fact whether his activities amounted to a business.

37. *Id.* (citing *Old Colony Trust Co. v. Comm'r*, 279 U.S. 716 (1929), where the Court held an employer's payment of taxpayer employee's income taxes as additional taxable compensation). *Old Colony*, however, is irrelevant because it is not a debt cancellation case; it involved, in substance, an indirect payment of salary directly to the taxpayer's creditor.

38. *Hahn v. Comm'r*, 93 T.C.M. (CCH) 1055 (2007) (citing *Harris v. Comm'r*, 34 T.C.M. (CCH) 597 (1975); *Jelle v. Comm'r*, 116 T.C. 63 (2001); *Earnshaw v. Comm'r*, 84 T.C.M. (CCH) 146 (2002); *Seay v. Comm'r*, 33 T.C.M. (CCH) 1406 (1974)).

39. *Hahn v. Comm'r*, 93 T.C.M. (CCH) 1055 (2007).

40. *See supra* note 5.

41. *Hahn v. Comm'r*, 93 T.C.M. (CCH) 1055 (2007).

tornado in *Landreth*, forgiveness of penalties, collection fees, and interest on such penalties involve not gain, but avoidance of loss. That avoidance of loss is not taxable is obvious and universally accepted.⁴² The Hahn court's freeing-of-assets theory would just as well require taxing the cancellation of a parking ticket, a miracle of income without gain.

2. *Payne v. CIR: Cancelled Interest Is Not Income*

In *Payne v. CIR*, the taxpayer settled a credit card debt of \$21,407 by paying MBNA America Bank the sum of \$4592 as payment in full. The entire amount forgiven, some \$16,678, was apparently interest.⁴³ MBNA reported this amount on a Form 1099-C, which the taxpayer contested on the ground that the forgiven interest was not taxable because it was simply a retroactive reduction of the rate of interest, or "purchase price" of the loans under IRC section 108(e)(5). In addition, the taxpayer argued that cancelled interest is not taxable in any event, whether or not IRC section 108(e)(5) applies by its terms. The Tax Court refused to apply IRC section 108(e)(5) on the ground there was no sale of property, and it also rejected the taxpayer's other arguments. But the court cited no authority for the proposition that the cancelled interest was taxable, not even *Hahn* which was decided less than a year earlier by the same court.⁴⁴ Nor did the court bolster its decision by any explanation. Its only authority was a literal and wooden reading of the Code: a debt was cancelled, a 1099-C was issued, and the taxpayer could cite no explicit statutory exception. The Court's opinion would have applied equally well (or poorly) to cancelled penalties.

The *Payne* decision is erroneous. The privilege of using borrowed money does of course have economic value. It does not follow, however, that cancellation or reduction of an unpaid interest obligation should be taxable. One immediate difficulty is how to determine that value. The stated amount of the cancelled obligation cannot be assumed to be its value. It would be very questionable to maintain that the value of borrowed money triples just because the borrower mails in a credit card payment a day late. Moreover, it is common knowledge that a good customer at least can usually reverse such a rate jump (and related penalties) with a telephone call.⁴⁵ The economic effect of cancellation is the exact equivalent of a bargain price for the use of the principal, and the bargain should be non-taxable for the same reasons that any other bargain purchase of goods or services is not taxed. The taxpayer's price adjustment argument was correct, irrespective of whether IRC section 108(e)(5) applies literally by its terms.

42. See *Landreth*, 50 T.C. 803.

43. *Payne v. Comm'r*, 95 T.C.M. (CCH) 1253 (2008).

44. See *id.* (failing to cite any authority for the proposition that cancelled debt attributable to interest charges is taxable).

45. Such courtesies on the part of the bank would arguably be taxable if *Payne* and *Hahn* are correct. Apart from its absurdity, the issue is unlikely ever to arise because the amounts fall below the threshold of the 1099 reporting requirement. See discussion *infra* Part II.

THE TAX TREATMENT OF CANCELLED INTEREST AND PENALTIES ON CONSUMER DEBT

A lender may charge any amount of interest, or none at all, without creating taxable income.⁴⁶ Open any newspaper and you will find advertisements to buy a car with a zero percent interest rate loan. Our mailboxes are filled with offers from banks to loan money at zero percent interest for limited periods of time. By rolling over from one bank to the next as each offer expires, one might borrow for years with no interest obligation, and with no tax obligation. Cancelling an obligation to pay interest has the same effect as a front-end discount, and neither discount should be taxable unless it is a disguised payment of some sort.⁴⁷

As with other varieties of COD, it is instructive to compare cancellation of an IOU with a cash refund. If a lender refunds interest already paid, say because the interest rate violated a consumer protection statute, there can be no doubt that the refund would be a tax free return of the borrower's capital. Such a refund would be taxable only if the tax benefit rule applied.⁴⁸

The IRS has apparently never published its position regarding the taxation of cancelled consumer interest in any regulations or rulings. Somewhat bizarrely, its position seems to be published only in its instructions to taxpayers. For example, IRS Publication 525 "Taxable and Non-taxable Income" states that cancelled interest for a cash-method taxpayer is taxable unless the interest would have been deductible.⁴⁹ The Instructions for Forms 1099-C repeat the same rule as if it were clear and settled law.⁵⁰

The IRS's position seems to be based upon IRC section 108(e)(2) which provides that no income is realized from discharge of a debt if payment of the debt would have given rise to a deduction.⁵¹ The IRS seems to have read into this provision its converse, that if no deduction would have been allowed, income must result. This backwards reading of IRC section 108(e)(2) has no basis in history or logic and leads to absurdities. If this IRS reading were applied consistently, cancellation of a fine or

46. This assumes that IRC section 7872 does not apply. *See infra* note 47.

47. *See, e.g.*, I.R.C. § 7872 (2006). This provision explicitly taxes below-market interest only when it is offered from employer to employee or corporation to shareholder. In other words, it is taxed only when it is offered as a disguised payment of salary or dividends (or in certain other situations involving deliberate tax abuse that is not relevant to the discussion in this article).

48. *See Schlifke v. Comm'r*, 61 T.C.M. (CCH) 1697 (1991). The taxpayer in this case exercised his right to rescind a second mortgage bank loan on his home under the Truth in Lending Act (TILA), after having paid and deducted some \$140,625 in interest. Under the TILA, the taxpayer was entitled to credit that interest toward the original loan principal of \$225,000 which was still outstanding in full. The taxpayer paid the remaining \$84,375 principal which ended his obligation. The IRS claimed the taxpayer had income of \$140,625 either as COD (the amount of principal cancelled) or under the tax benefit rule (that same amount of previously deducted interest was "recovered" within the meaning of IRC section 111 when it was applied to pay off the principal). Judge Tannenwald chose to apply the tax benefit rule and held for the government.

49. INTERNAL REVENUE SERV., PUBLICATION 525: TAXABLE AND NONTAXABLE INCOME 19 (2008).

50. *See* IRS Instructions for Forms 1099-A and 1099-C (2008), <http://www.irs.gov/pub/irs-pdf/i109ac.pdf>.

51. *See* I.R.C. § 108(e)(2) (2006).

penalty would give rise to taxable income simply because it is non-deductible,⁵² and even the compromise of a federal tax would result in income.⁵³

II. THE CONUNDRUMS OF INFORMATION REPORTING

It appears that the only reason taxing cancelled consumer interest has become an issue is the government's ill-advised decision to force lenders to report cancelled consumer debt on Form 1099-C. This in turn raised difficult (or impossible) compliance questions of what exactly must be included on the required forms. None of these questions would have arisen without the reporting requirement and, as a result, we find ourselves in the strange position that information reported on Form 1099 now de facto determines the substantive law.

If cancelled interest is taxable, one might expect reporting it to be obligatory. It seems therefore somewhat odd to find that the Form 1099-C Instructions state that the lender is not required to report cancelled interest. If the lender chooses to report cancelled interest, however, it must be separately stated on the Form 1099-C.⁵⁴

Recently ACA International ("ACA"), a trade organization claiming to represent debt collectors in fifty states and sixty countries, published a letter requesting guidance from the IRS about the Form 1099-C reporting requirements for discharges of credit card debt.⁵⁵ One of the many perplexing issues discussed there concerns an alleged impossibility of meeting the current requirement that discharged principal must be reported separately from discharged interest. Many debt collectors are in the business of buying delinquent credit card debt in bulk from the originating banks at a substantial discount from face value, collecting what they can, and then discharging the balance. The discharged balance must be reported, for tax purposes, to the debtor and to the government on Form 1099-C. By the time of the ultimate discharge, however, the underlying breakdown between principal and interest is often lost and, according to the ACA at least, may be irrecoverable. Delinquent debt may be sold as many as five or six times before it is ultimately discharged.⁵⁶

The ACA recommended that the full face amount of purchased debt receivables of this sort be considered principal for reporting purposes and only interest accruing afterwards would be required to be separately stated. In the alternative, the ACA requested a best efforts rule that would come to the same result if the debt buyer

52. See I.R.C. § 162(f) (2006).

53. See Richard C.E. Beck, *Is Compromise of a Tax Liability Itself Taxable? A Problem of Circularity in the Logic of Taxation*, 14 VA. TAX REV. 153 (1994).

54. Even more oddly, the lender may, but is not required to, report other non-principal amounts such as cancelled "penalties, fines, fees, and administrative costs," but unlike interest, there is no apparent way to separate them on the Form 1099-C from the principal. See *supra* note 52. The Instructions go on to state that for "nonlending" transactions, such non-principal amounts are "included in the debt," but that there is no penalty for failing to report non-principal amounts until further guidance is issued. *Id.* at 3-4. To date, no such guidance has been issued.

55. Rozanne Andersen & Valerie Hayes, *Credit and Collection Group Seeks Guidance on Discharge of Indebtedness Reporting Rules*, 2008 TNT 96-23, May 16, 2008.

56. *Id.*

THE TAX TREATMENT OF CANCELLED INTEREST AND PENALTIES ON CONSUMER DEBT

could not locate the breakdown information. The ACA reasoned that the breakdown has no tax effect in most cases because only discharged interest which could have been deducted by the debtor is tax exempt, such as certain home mortgage interest or certain student loan interest, and very little discharged credit card interest would qualify for this exemption. The IRS has not yet responded to the ACA's request for guidance.

The position taken in this article is that all discharged interest (and of course penalties) is non-taxable, whether it could have been deducted or not. Under this view, if the IRS accepted the ACA's recommendation, the result would be highly unfair to vast numbers of taxpayers. Defaulted debt sold in bulk probably has a higher ratio of interest and penalties to principal than accounts still held by the issuing banks. It follows that in many, if not most, instances at least half or more of the purchased debt is likely to consist of penalties and interest.⁵⁷ Under these circumstances, it would be unconscionable to enforce payment of taxes that the IRS knows are not actually owed. Until the IRS can obtain accurate 1099-C reports which show only cancelled principal, the IRS should stop enforcement altogether.⁵⁸

III. CONCLUSION

Cancelled interest and penalties for non-business consumer debts such as credit card and home equity (and home mortgage) indebtedness is not taxable as COD. The Tax Court's decision in *Payne* is wrongly decided and should be reversed on appeal. A Form 1099-C should not be issued by lenders or their successors except for cancelled principal, and until and unless the principal can be separately stated, such information forms should not be issued or enforced.

57. In *Payne*, where the debt was still held by the issuing bank, more than seventy-five percent of the debt consisted of interest. *Payne v. Comm'r*, 95 T.C.M. (CCH) 1253 (2008).

58. Even this will not solve all problems because it is not entirely clear when debt is forgiven in a final settlement whether a partial payment should be allocated first to interest or first to principal or pro rata. It is also not clear whether an explicit allocation agreement between debtor and creditor ought always to be respected. See GORDON HENDERSON & STUART GOLDRING, *TAX PLANNING FOR TROUBLE CORPORATIONS* § 401.1 (2004).