Loans, Taxes And the Subprime Lending Flap

By Robert W. Wood

It is difficult to winnow the subprime lending controversy down to a single sentence, a single page or even down to a single discipline. Its effects are persuasive. It is almost impossible to pick up a newspaper or magazine touching on the financial markets without seeing references. Although it doubtless will mean skittish markets for some time, its impact with commercial, consumer and mortgage loans remains uncertain. About the only thing that does seem certain is that lending markets have tightened considerably.

Taxes Too?

In this milieu, few participants or observers are thinking about tax issues. However, as we weave through what will undoubtedly be a multiple-year process, professionals will be faced with multiple scenarios that have tax implications. Among the most significant arises when a mortgage is discharged, either in whole or in part.

As a tax lawyer, I've always found discharge of indebtedness income (sometimes called cancellation of indebtedness or COD income) difficult to explain. Clients almost invariably understand that they will have a tax liability when they receive cash, and even when they receive something of value in non-cash form, such as gold coins or land. However, most clients find it difficult to think of discharge or cancellation of debt as income. Nevertheless, the income tax laws are clear that a discharge of indebtedness usually produces gross income subject to tax.

Example:
Sam owes Tom $1,000. Tom eventually decides he is not likely to collect the debt, and decides to formally relieve Sam from paying back the $1,000. When Tom does so, Sam has income.

Note that in this simple example, it does not matter whether the debt is relinquished because of friendship, fear of litigation or virtually any other reason. When debt is discharged, it represents income to the person who will no longer have to repay the money.

Big Stakes

In the context of the subprime lending mess, it's likely we will see large tax problems over this seemingly simple rule. For example, many borrowers began paying on commercial or mortgage loans, but eventually defaulted. When there is a default, the loan generally remains outstanding, and typically grows substantially over time, because of added interest and penalties. If at some point the lender—under fear of litigation or otherwise—decides to cancel the mortgage loan, there will be discharge of indebtedness income to the borrower.

Many borrowers are surprised when they later find, either from their CPA when preparing their tax return, or even less happily, from the IRS on audit, that they have additional tax liabilities on account of such discharge.

There are a couple of important exceptions to this rule, and these can, but do not always, ameliorate the negative tax impact of the COD income.

Bankruptcy

Under Internal Revenue Code Sec. 108(a)(1)(A), discharge of indebtedness income is excluded from gross income if the discharge of the debt occurs while the taxpayer is under the jurisdiction of the Bankruptcy Court, and the discharge of indebtedness is granted by the Court or occurs pursuant to a bankruptcy plan approved by the court.

Example:
Ben Borrower borrows money from Clive Creditor to finance his personal business. Later, Ben experiences financial difficulty and enters Chapter 7 bankruptcy. If the Bankruptcy Court approves the discharge of Ben's debt to Clive, such a discharge should not be taxed as COD income.

Insolvency

One need not file for bankruptcy to avoid COD income. If the borrower is insolvent at the time of the discharge, the discharge may not be taxed as COD income. However, for this tax protection to apply, the amount of the discharge cannot exceed the amount by which the borrower is insolvent [See, e.g., Toberman v. Commissioner, 294 F.3d 985 (8th Cir. 2002)]. IRC Sec. 108(e)(1) defines “insolvent” as the excess of liabilities over the fair market value of assets, determined immediately before the discharge. Here are two examples:

• Bonnie Borrower has assets of $150 and liabilities of $200. Her creditors agree to cancel the indebtedness in exchange for all of Bonnie's assets. The amount of debt forgiven is $50. Bonnie should not realize COD income because the amount of the debt that has been forgiven ($50) does not exceed the amount by which Bonnie was insolvent ($50).

• Once again, Bonnie has assets of $150 and liabilities of $200. However, Bonnie's creditors agree to cancel their indebtedness in exchange for only $100 of Bonnies's assets. Bonnie should realize $50 of COD income, since the amount of the forgiven debt ($100) exceeds the amount by which Bonnie was insolvent ($50).

Rewritten Obligations

Under another rule, there should not be discharge of indebtedness income if the obligation is rewritten in some other way. This is a curious and terribly important rule. Generally, Treasury Regulations treat a “significant modification” in the terms of a debt instrument as a debt-for-debt exchange [Treas. Reg. Sec. 1.1001-3]. This generally does not give rise to taxable COD income, as long as the issue price of the new debt instrument is greater than or equal to the amount of the debt prior to the modification.

Example:
Dave Deadbeat owes Larry Lender $100, to be paid over a period of three months. If Dave renegotiates with Larry to pay the $100 over a period of 12 months, no COD income should be recognized. Why? The issue price of the new debt ($100) is equal to the amount that was owed prior to the modification.
However, if Dave Deadbeat renegotiates the debt with Larry Lender so that he only has

to pay $50 over a period of six months in full satisfaction of the former debt, Dave recognizes $50 in COD income. Why? Here, the issue price ($50) of the new debt instrument is less than the amount owed previously ($100).

As these examples make clear, precisely how you do something is very important to the tax result.

Foreclosure

We can't leave the topic of the subprime fiasco without noting that foreclosures also have tax effects. A debt can be eliminated in foreclosure, and as we've seen, eliminating (or “discharging”) a debt can trigger a tax. In forclosure, though, there's an extra factor: the property’s value.

Generally, COD income results when the mortgage loan eliminated through foreclosure exceeds the value of the foreclosed property. However, either the bankruptcy or insolvency rules noted above may help you and prevent you from having to pay tax. Notably, the IRS website now has a special section for individuals who have lost their homes through foreclosure (http://www.irs.gov/newsroom/article/0,,id=174022,00.html). It is worth checking out.

Conclusion

So far, there seems to be little mention of tax issues when discussing the subprime lending controversy. Perhaps this is understandable, since the tax issues inevitably arise primarily on the resolution of these items, and not before. In most cases, we are probably a long way from resolving these disputes.

Still, it is not too soon to note the tax issues that will arise as we untangle the vestiges of the easy credit that led to the subprime debt controversy.

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