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SOLIDIFYING THE EXCLUSION FOR CANCELLATION OF INDEBTEDNESS INCOME RELATED TO HOME LOAN REDUCTIONS: A PETITION TO MAKE PERMANENT IRC SECTION 108(a)(1)(E) [1,2,3]

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[2] Although the authors and/or presenters of this paper might have clients affected by the rules applicable to the subject matter of this paper and have advised such clients on applicable law, no such participant has been engaged by a client to participate on this paper. No author has a direct personal or financial interest in the issue addressed in this paper.

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EXECUTIVE SUMMARY

In 2009, foreclosure threatened millions of American homeowners in what was the biggest housing crisis since the Great Depression. Although the climate of bankruptcies and mortgage foreclosures improved during much of the following decade, the current COVID-19 pandemic has thrust many homeowners back into a state of financial uncertainty. Despite mortgage relief programs, such as foreclosure moratoriums, designed to protect homeowners during such unprecedented times, the fears of bankruptcy and foreclosure still loom for many Americans. Preventing the recognition of discharged debt as income through section 108 of the Internal Revenue Code[4] is one particularly effective avenue for addressing the issues of bankruptcy and foreclosure. Specifically, section 108(a)(1)(E), created through the Mortgage Forgiveness Debt Relief Act of 2007 and the Emergency Economic Stabilization Act of 2008 and discussed in greater detail below, allows taxpayers to exclude from taxable income cancellation of "qualified principal residence indebtedness" through January 1, 2026.[5]

Although section 108(a)(1)(E) was initially authorized to last until January 1, 2010, the United States Congress ("Congress") has repeatedly extended 108(a)(1)(E) due to its recognition of the lasting effect of the mortgage crisis and the fact that taxpayers with mortgages higher than the value of their home—i.e., homes with "negative equity"—still require relief from the potential CODI when forced to restructure mortgage debts or when facing home foreclosure. Congress has voted to extend the applicability of Section 108(a)(1)(E) each time the provision is set to expire.

Accordingly, as explained in greater detail below, this proposal recommends that Congress consider making section 108(a)(1)(E) a permanent provision. This proposal recognizes that section 108(a)(1)(E) is a crucial tool that may help protect taxpayers who are facing potential foreclosure and, as noted in *Babin v. Commissioner*, "is premised on the belief that it is inequitable 'to kick someone when he is down.'"[6] Finally, this proposal will attempt to demonstrate how making section 108(a)(1)(E) permanent is consistent with the policies inherent to section 108's exceptions, as well as the general policy considerations contained in the code.

[4] All "section" references herein are to the Internal Revenue Code unless otherwise provided.

[5] Congress enacted Public Law No. 116-260 on December 27, 2020, which extends the expiration of IRC § 108(a)(1)(E) to January 1, 2026.

[6] *Babin v. C.I.R*, 23 F.3d 1032 (T.C. 1984)

DISCUSSION

I. INTRODUCTION

As noted above, this proposal recommends that Congress consider making Section 108(a)(1)(E) a permanent provision. This proposal will first explore the background and rationale for cancellation of indebtedness income ("CODI"), as well as the history of Section 108(a)(1). Next, the proposal will demonstrate the need to make Section 108(a)(1)(E) permanent, noting that: (1) the housing market conditions indicate an immediate and future need for Section 108(a)(1)(E); (2) COVID-19 has increased the need for relief for American mortgage holders; (3) making Section 108(a)(1)(E) permanent is consistent with and furthers already existing policies established by Section 108 generally as well as the provisions of the IRC that encourage home ownership; and (4) the need for constant renewal poses a danger to taxpayers. This proposal will also discuss potential challenges to enacting Section 108(a)(1)(E) permanently.

II. BACKGROUND OF CODI AND SECTION IRC SECTION 108

A. The Tax Treatment of Loans and Cancellation of Debt Income Generally

As a preliminary matter, Section 61 of the IRC requires individuals to recognize all income from whatever source derived, including income from discharge of indebtedness.[7] This principle comes from the idea that gross income is based on the presence of some accession to wealth or economic benefit to the taxpayer.[8] In keeping with this tenet of tax law, taxpayers do not generally recognize the proceeds from a loan as income.[9] Instead, gross income excludes borrowed funds because the obligation to repay the loan offsets the accession of wealth despite the fact that the taxpayer immediately increases his or her assets and can use the loan amount without restriction.[10] Thus, analyzing a borrowing transaction in its totality, the wealth of taxpayers who take loans to purchase their homes is not increased when the taxpayer takes the loan because these taxpayers have a corresponding obligation to repay said loan. Additionally, the taxpayer may not deduct its principal payments from income,[11] which means the repayment of such a loan has no effect on the taxpayer's tax liability.

With respect to funds borrowed by taxpayers for the purpose of purchasing property, and specifically in the context of home loans for principal residences, the taxpayer's basis in the property is generally equal to the full purchase price, which includes within it any loan amounts used towards the purchase.[12] Full ownership requires repayment of the loan and therefore the full loan amount is included as the cost of the property.[13] On the sale of the property, the

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[7] IRC § 61(a)(12) (2013).

[8] Martin McMahon and Daniel Simmons, *A Field Guide to Cancellation of Debt Income*, 63 TAX LAW. 415 (2010).

[9] Comm'r v. Tufts, 461 U.S. 300, 307 (1983).

[10] *Id*.

[11] *Id*.

[12] IRC § 1012 (2013); *Woodsam Assocs. v. Comm'r*, 198 F.2d 357, 359 (2d Cir. 1952).

[13] McMahon & Simmons, *supra* note 29, at 418; *see also* Crane v. Comm'r, 331 U.S. 1 (1947);

borrower's gain is calculated as the sales proceeds minus the basis as defined above.[14] Therefore, because taking a loan does not result in a realization event[15] and property bought with borrowed funds takes a basis equal to "the full value of the consideration provided," debtors must face the tax consequences after discharging a portion of their debt obligation for less than full payment.[16,17] These consequences arise under Section 61(a)(12), which holds that if debt owed is renegotiated or a portion is otherwise canceled for less than its original amount, the taxpayer generally must recognize gross income equal to the amount of debt canceled.[18]

While the general rule holds that canceled debt is recognizable income,[19] Section 108 lists a number of exceptions that allow taxpayers to prevent recognition of income derived from this discharge of indebtedness.[20]

B. IRC Section 108(a)(1)(E): Background and Current Permutation

Section 108(a)(1)(E) emerged primarily as a result of the sub-prime mortgage loan crisis in the mid to late 2000's.[21] Congress was concerned that taxpayers forced to restructure mortgage debts or facing home foreclosures would also recognize income from the cancellation of indebtedness.[22] Thus, through the Mortgage Forgiveness Debt Relief Act of 2007 (which was amended by the Emergency Economic Stabilization Act of 2008), Congress created 108(a)(1)(E), which originally excluded from gross income the cancellation of "qualified principal residence indebtedness" if the cancellation occurred on or after January 1, 2007 and before January 1, 2010.[23] For these purposes, "qualified principal residence indebtedness" was limited to acquisition indebtedness—indebtedness incurred in acquiring, constructing, or substantially improving any

[14] *Id*. (citing *Crane v. Comm'r*, 331 U.S. 1, 11 (1947); *Tufts*, 461 U.S. at 308-09; *Brons Hotels, Inc. v. Comm'r*, 34 B.T.A. 376, 381 (1936)).

[15] A realization event occurs under IRC section 1001 when there is an exchange where the taxpayer receives money or other property in the transaction. See *Helvering v. Bruun*, 309 U.S. 461 (1940). The Supreme Court said a "gain may occur as a result of exchange of property, payment of the taxpayer's indebtedness, relief from a liability, or other profit realized from the completion of a transaction." *Id.* at 469.

[16] McMahon & Simmons, *supra* note 29, at 418-19.

[17] There are other theories regarding CODI, including the transactional approach, however it is the authors' opinion that the theories discussed in this proposal are most relevant to the current inquiry.

[18] Section 61(a)(12) reflects the codification of the Supreme Court's decision in *United States v. Kirby Lumber Co.*, 284 U.S. 1 (1931). IRC § 61(a)(12) (2013). There the Court held that the taxpayer has realized a clear gain from the offset of their obligation to repay once their bonds were extinguished. *Kirby*, 284 U.S. at 2.

[19] IRC § 61(a)(12) (2013).

[20] *See generally* IRC § 108 (2013).

[21] *See* H.R. Rep. No. 110-356, at 4-5 (2007).

[22] *Id*. ("The recent unrest in the housing market has prompted concern over the tax consequences associated with discharges of indebtedness in connection with restructuring acquisition indebtedness and home foreclosures… The Committee believes that where taxpayers restructure their acquisition debt on a principal residence or lose their principal residence in a foreclosure, that it is inappropriate to treat discharges of acquisition indebtedness as income.").

[23] IRC § 108(a)(1)(E) (2013). Pursuant to section 108(a)(2)(C) the qualified principal residence indebtedness exclusion applies over the insolvency exclusion, unless the taxpayer elects otherwise.

qualified residence of the taxpayer, secured by such residence[24]—considered with respect to a taxpayer's principal residence[25] and not exceeding $1,000,000.[26]

Although Section 108(a)(1)(E) was a new provision at the time it was enacted, the concepts underlying it were not. Instead, Section 108(a)(1)(E) was created upon a preexisting framework of beneficial tax rules regarding principal residences constructed by Section 121.[27] Moreover, Section 108(a)(1)(E) does not apply to indebtedness on a home that is not the taxpayer's principal residence, nor does it apply to home equity indebtedness.[28] Indeed, this provision applies only if the debt cancellation is due to a decline in (1) the value of the home, or (2) the taxpayer's financial condition.[29] When a taxpayer uses the section 108(a)(1)(E) exclusion, instead of recognizing the CODI in the year of the event, the basis in the qualifying property is reduced by the excluded amount.[30]

Since its inception in 2007, Section 108(a)(1)(E) has been renewed and extended eight times—in 2008, 2010, 2013, 2014, 2015, 2018, 2019, and 2020.[31] Each time, these extensions served to protect taxpayers from recognizing CODI when seeking out a loan modification. The current permutation of Section 108(a)(1)(E) is provided in pertinent part below:

> **(1) In general.** Gross income does not include any amount which (but for this subsection) would be includible in gross income by reason of the discharge (in whole or in part) of indebtedness of the taxpayer if—
>
> **(E)** the indebtedness discharged is qualified principal residence indebtedness which is discharged—
>
> **(i)** before January 1, 2026, or
> **(ii)** subject to an arrangement that is entered into and evidenced in writing before January 1, 2026.

As provided, the law extends this taxpayer protection through the end of 2025, unless further extended.

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[24] IRC § 163(h)(3)(B) (2013); IRC §108(h)(2).

[25] Treas. Reg. § 1.121-1(b)(2) provides a nonexclusive list of factors that are relevant in identifying a property as a taxpayer's principal residence. Treas. Reg. § 1.121-1(b)(2) No particular factor is conclusive.

[26] IRC § 108(h)(2) (2013); It should be noted that the Tax Cuts and Jobs Act of 2017 ("TCJA") reduces the limit to $750,000 (or $375,000 if you are married filing separately) (see Pub. L. 115–97, 131 Stat. 2054 (2017).

[27] Section 121 imposes a $250,000 limit on gains excludable from gross income pursuant to the sale of a principal residence (or $500,000 for certain married couples filing jointly) (IRC § 121(b) (2013)).

[28] It should be noted that the TCJA disqualified "home equity indebtedness" as "qualified residence interest" for purposes of Section 163 for taxable years 2018 through 2025. Pub. L. 115–97, 131 Stat. 2054 (2017).

[29] IRC § 108(h)(3) (2013); *see also*, McMahon & Simmons, *supra*, at 467.

[30] IRC § 108(a)(1)(E) (2013). This basis reduction will not necessarily result in any subsequent income recognition if, for instance, the taxpayer does not sell the residence or if the gain is excludable under Section 121.

[31] Unlike previous extensions that were typically one to two years in length, the most recent extension now spans an additional five years, through January 1, 2026.

III. THE PROBLEM AND PROPOSAL: MAKE IRC SECTION 108(a)(1)(E) PERMANENT

This proposal recommends that Congress consider making IRC Section 108(a)(1)(E) a permanent provision by removing the expiration date contained in subparagraphs (i) and (ii). Such an action seeks to address one simple problem: taxpayers with mortgages higher than the value of their home—i.e., homes with "negative equity"—still require relief from the potential CODI if they restructure mortgage debts or are facing home foreclosure. Making this provision permanent would acknowledge that, like other provisions in Section 108 (*e.g.*, those addressing bankruptcy and insolvency), those facing the threat of losing their home warrants protection from an additional, and potentially crippling, tax burden. Further, allowing this provision provides an alternative to those taxpayers who would not otherwise qualify under the insolvency exemption for CODI or who are unable or do not wish to use the bankruptcy exemption.

IV. RATIONALE FOR MAKING SECTION 108(a)(1)(E) PERMANENT

As discussed in further detail below, we recommend Congress consider making Section 108(a)(1)(E) a permanent provision because doing so: (1) fulfills the current needs of taxpayers engaged in the housing and mortgage markets; (2) is consistent with the policies underlying the other paragraphs of Section 108(a)(1)—*i.e.*, recognizing that there are certain contexts in which the IRC should be flexible regarding CODI and offering relief for certain taxpayers with an inability to pay or that suffer a serious economic difficulty; (3) furthers and supports the policy of encouraging taxpayers to purchase a home, which underlies many IRC sections; and (4) puts a stop to the need to constantly renew a provision that serves a need in the U.S. housing market currently and in the foreseeable future.

A. The Current Housing/Mortgage Market Conditions Demonstrate a Need for Making Section 108(a)(1)(E) a Permanent Provision

i. Covid-19 Has Increased the Need for Certainty

As the COVID-19 pandemic continues to impact homeowners across the country, the need for financial stability is intensified for those with outstanding mortgage balances. In response to the unprecedented financial turbulence caused by the global pandemic, the Biden administration extended a federal moratorium on home foreclosures, which was first implemented by the Trump administration in 2020,[32] through June 30, 2021 and deferred payment requirements

[32] Neil Haggerty and Hannah Lang, *Trump Administration to halt foreclosures as pandemic worsens*, AMERICAN BANKER (Last visited February 26, 2021) https://www.americanbanker.com/news/trump-announces-foreclosure-halt-through-april-for-hud-backed-loans.

for Americans behind on their mortgages.[33] By one estimate, some 2.7 million homeowners who are in active mortgage forbearance plans stand to benefit from the moratorium extension alone.[34]

According to Black Knight, a mortgage data firm, properties with foreclosure filings in 2020 represented 0.16 percent of all U.S. homes.[35] Although foreclosures fell to record lows in 2020, as of January 2021, Black Knight estimated some 2.15 million American homeowners were at least 90 days past due on their mortgage payments.[36] These figures suggest that moratoriums and payment deferral programs have helped prevent a number of foreclosures. However, as these programs end, a significant increase in the number of foreclosures could potentially occur. Accordingly, due to the current uncertainty regarding both the global economy and pandemic, some observers believe we may be in store for another housing crisis.[37]

ii. Even Absent the COVID-19 Pandemic, Many Americans are Still Feeling the Effects of the 2009 Housing Crisis

While the rate of bankruptcies and mortgage foreclosures has improved since 2009, bankruptcy and foreclosure still affect homeowners across America. As of Q3 2020, approximately 1.6 million homeowners in the United States owned homes with negative equity, which amounted to approximately 2.9 percent of all mortgaged homeowner properties.[38] Although these figures are a marked improvement from 2009–2012, they are not insignificant.

To the extent taxpayers are taking part in home loan modification programs, which assist Americans facing the consequences of negative equity, the assistance can be somewhat negated by the potential tax implications from the discharge of indebtedness. If Section 108(a)(1)(E) is allowed to expire such taxpayers will not be protected from CODI. As discussed below, the continued existence and creation of new loan modification programs signals the importance of a more permanent solution.

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[33] Ken Thomas and Andrew Ackerman, *Biden Administration Extends Covid-19 Mortgage Relief*, THE WALL STREET JOURNAL (Last visited February 19, 2021) https://www.wsj.com/articles/biden-administration-extends-covid-19-mortgage-relief-11613485250.

[34] *Id.*

[35] Jeff Ostrowski, Foreclosures Fell to Record Low in 2020 – With a Huge Asterisk, BANKRATE (Last visited February 19, 2021) https://www.bankrate.com/mortgages/foreclosures-fell-to-record-low-in-2020/#:~:text=Properties%20with%20foreclosure%20filings%20in,was%202.23%20percent%2C%20in%202010.

[36] *Id.*

[37] Emily Benfer, et al., *The COVID-19 Eviction Crisis: An Estimated 30-40 Million People in America Are at Risk*, THE ASPEN INSTITUTE, (last visited February 26, 2021) https://www.aspeninstitute.org/blog-posts/the-covid-19-eviction-crisis-an-estimated-30-40-million-people-in-america-are-at-risk/.

[38] *Home Equity Reaches Record Highs: Homeowners Gained Over $1 Trillion In Equity in Q3 2020, CoreLogic Reports*, CORELOGIC PRESS RELEASE, (last visited Feb. 26, 2021) https://www.corelogic.com/news/home-equity-reaches-record-highs-homeowners-gained-over-1-trillion-in-equity-in-q3-2020-corelogic-reports.aspx.

iii. Continued Existence, Creation, and Utilization of Loan Modification Programs Supports the Need for Permanent Protection From CODI

The Home Affordable Modification Program ("HAMP") first launched in 2009 and served to provide relief to those affected by the housing crisis by allowing borrowers to lower their monthly payments and, as a result, avoid foreclosure.[39] HAMP provided modifications that allowed borrowers significant payment reductions tied to their income.[40] Like Section 108(a)(1)(E), HAMP was repeatedly extended as the need to assist taxpayers with the burdens of a home with negative equity continued long past the original need.[41] As the Director of the Federal Housing Financing Agency remarked at the Annual Economic Summit in 2015:

> Although the number of new borrowers entering [HAMP and the Home Affordable Refinance Program ("HARP")] continues to decline, in part because many eligible borrowers have already taken advantage of them and in part because of recovering house prices, lenders and servicers are continuing to approve new HAMP modifications and HARP refinances. Extending HAMP and HARP through the end of 2016 will provide real relief for borrowers who continue to face challenges either paying their mortgage or refinancing their loan.[42]

Although HAMP has now expired, programs such as the FHA Home Affordable Modification Program[43] and the Fannie Mae/Freddie Mac Flex Modification Program[44] address borrowers with negative equity.

iv. To the Extent the Housing Market Conditions Stagnate or Regress Section 108(a)(1)(E)'s Protections Will Be Necessary for Taxpayers

As noted above, as of Q3 2020, approximately 2.9 percent of all mortgaged homeowner properties had negative equity, which represents a significant number but also marks an improvement from years prior. However, there is no guarantee that this trend will continue, and in fact, there are several signals that suggest it may not. First, home prices are rapidly rising. The

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[39] *See Prepared Remarks of Melvin L. Watt Director of FHFA*, Greenlining Institute 22nd Annual Economic Summit (May 8, 2015).

[40] Home Affordable Modification Program authorized by the Emergency Economic Stabilization Act of 2008, Pub.L. 110–343, Div. A, 122 Stat. 3765 (2008).

[41] *See Prepared Remarks of Melvin L. Watt Director of FHFA*, Greenlining Institute 22nd Annual Economic Summit (May 8, 2015).

[42] *Id*.

[43] FHA-Home Affordable Modification Program (FHA-HAMP), Programs of HUD available at https://www.hud.gov/hudprograms/fhahamp. This program helps struggling homeowners modify their mortgage by reducing their interest rate, extending their loan term, or adding late payments to the principal mortgage balance.

[44] *See Fannie Mae Flex Modification Fact Sheet*, FANNIE MAE, (last visited Feb. 11, 2020) https://singlefamily.fanniemae.com/media/9016/display. This program allows homeowners to reduce mortgage payments by 20% and, depending on how long a homeowner is delinquent, get to a 40% front-end debt-to-income ratio, which is the percentage of gross monthly income used to make mortgage payments.

national average home price hit $397,800 in Q3 2020, which was 23 percent higher than the previous record high in Q1 2007 of $322,100.[45] Similarly, the S&P Homebuilders Select Industry Index, which tracks the stock prices of homebuilders, has risen 14.47 percent from January 2011 to January 2021, which is another indicator of rising home prices.[46]

Second, there has been an increase in the prevalence of unregulated mortgage brokers. As of 2018, 53.6% of U.S. mortgages were originated by unregulated mortgage brokers and five of the ten largest mortgage lenders were not banks.[47] By comparison, in 2010, just three banks (Wells Fargo, Bank of America, and Chase) originated 56% of all mortgages.[48] Notably, unregulated mortgage brokers are not subject to the same regulations as banks.

Third, despite being much lower than it was in 2007, the average debt-to-income ratio for loans issued to homebuyers increased to 35.1 percent in 2017 from 34 percent in 2016.[49] Additionally, as of 2019, the average unpaid balance of a new mortgage equaled approximately $285,434 according to data from the Consumer Financial Protection Bureau.[50]

Accordingly, although the percentage of homeowners with negative equity has been improving the past few quarters, there is no guarantee this trend will continue. Further, regardless of which direction this trend goes, the facts remain that: (1) a significant number of homeowners still have negative equity today; (2) that number is even greater if you include those with effective negative equity; (3) loan modification programs are still necessary, and continue to be created and used by taxpayers; and (4) these programs may result in CODI for homeowners already facing financial hardship potentially caused by the conditions just described. In short, although the housing/mortgage market is objectively healthier than it was during the housing crisis, the conditions Section 108(a)(1)(E) was created to address are still present today and could potentially last into the foreseeable future. Thus, making Section 108(a)(1)(E) permanent could help alleviate the problems created by these factors.

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[45] According to the Case Shiller home Price Index, *S&P/Case-Shiller U.S. National Home Price Index*, FEDERAL RESERVE OF ST. LOUIS (last visited Apr. 1, 2021) https://fred.stlouisfed.org/series/ASPUS.

[46] *See S&P Homebuilders Index*, S&P DOW JONES INDICES (last visited April 1, 2021) https://us.spindices.com/indices/equity/sp-homebuilders-select-industry-index.

[47] *Data Point: 2018 Mortgage Market Activity and Trends*, CONSUMER FINANCIAL PROTECTION BUREAU (last visited Dec. 24, 2019) https://files.consumerfinance.gov/f/documents/cfpb_2018-mortgage-market-activity-trends_report.pdf; *Here Are the Top 10 Mortgage lenders of 2018*, HOUSINGWIRE (last visited Nov. 6, 2018) https://www.housingwire.com/articles/50103-here-are-the-top-10-mortgage-lenders-of-2018/; *see Is the Real Estate Market Going to Crash?,* THE BALANCE (last visited 2020) https://www.thebalance.com/is-the-real-estate-market-going-to-crash-4153139.

[48] *3 Biggest Lenders Close over Half of U.S. Mortgages*, MORTGAGE DAILY (last visited 2021) https://www.prnewswire.com/news-releases/3-biggest-lenders-close-over-half-of-us-mortgages-116219989.html

[49] *U.S. Mortgage Market Statistics:* 2018, MAGNIFYMONEY (last visited Feb. 10, 2020) https://www.magnifymoney.com/blog/mortgage/u-s-mortgage-market-statistics-2018/ (citing Fannie Mae and Freddie Mac).

[50] U.S. Mortgage Market Statistics: 2020, LENDING TREE (last visited April 1, 2021) https://www.lendingtree.com/home/mortgage/u-s-mortgage-market-statistics/.

B. Making Section 108(a)(1)(E) a Permanent Provision is Consistent With Policies Already Established by the IRC

Making Section 108(a)(1)(E) a permanent provision is also recommended because doing so: (1) is consistent with the policies underlying the other provisions of Section—*i.e.*, the recognition that there are certain contexts in which the IRC should be flexible regarding CODI and the desire to offer relief to certain taxpayers with an inability to pay or that suffer financial hardship; and (2) furthers the policy of encouraging taxpayers to purchase a home, which underlies many IRC sections.[51]

i. Making Section 108(a)(1)(E) Permanent is Consistent with the Policies Underlying the Exceptions for Discharge in Bankruptcy and Insolvency

Section 108(a)(1)(A) excludes from the debtor's gross income any CODI and discharge of taxpayer indebtedness due to bankruptcy.[52] Similarly, section 108(a)(1)(B) excludes cancellation of debt income realized while the debtor is insolvent.[53] Generally, loan proceeds are not included in a taxpayer's gross income because there is a corresponding obligation for the taxpayer to repay that amount, which means the taxpayer has not experienced an accession of wealth. If that obligation is discharged, however, then the taxpayer has experienced an accession of wealth that should be taxed. In other words, these rules codify the policy that a taxpayer should be taxed only on an actual accession to wealth. Along those same lines, Sections 108(a)(1)(A) and (B) exclude CODI from gross income when a taxpayer is bankrupt or insolvent because "no accession to income has occurred if after the debt cancellation, the taxpayer remains insolvent since no assets have been freed."[54] Further, the attribute reduction mechanism of Sections 108(a)(1)(A) and (B) demonstrate the importance of considering a taxpayer's economic reality and offering relief to certain taxpayers with an inability to pay or that suffer a serious financial hardship because once a taxpayer has no remaining basis to reduce, the otherwise includible CODI simply disappears.

Accordingly, the existence and operation of Sections 108(a)(1)(A) and (B) make several things clear as it relates to policy and intent in this area. First, a taxpayer should only be taxed on its gain/accession to wealth. Second, a taxpayer's economic reality should be considered when determining whether there has been an accession of wealth. Third, there is an active interest in offering relief to taxpayers with an inability or difficulty to pay due to an economic event such as bankruptcy or insolvency. Fourth, the IRC should be flexible enough to offer relief to such a taxpayer. As more eloquently provided in *Babin v. Commissioner*, "the insolvency exception,

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[51] *See e.g.* IRC § 163(h)(2)(D) (2018).

[52] IRC § 108(a)(1)(A) (2013).

[53] IRC § 108(a)(1)(B) (2013). Insolvency is defined by section 108(d)(3) as "the excess of liabilities over the fair market value of assets." IRC § 108(d)(3) (2013). With respect to any discharge, whether or not the taxpayer is insolvent, and the amount by which the taxpayer is insolvent, is determined on the basis of the taxpayer's assets and liabilities immediately before the discharge.

[54] *Babin v. Comm'r*, 23 F.3d 1032, 1035 (6th Cir. 1984); *see* Lakeland Grocery Co., 36 B.T.A. at 292.

among other things, is premised on the belief that it is inequitable 'to kick someone when he is down.'"[55]

Making Section 108(a)(1)(E) permanent conforms with the policies prescribed above. The provision applies only if the debt cancellation is due to a decline in the value of the home or the taxpayer's financial condition. In other words, just like Sections 108(a)(1)(A) and (B), Section 108(a)(1)(E) operates to only tax a taxpayer on its accession to wealth while simultaneously considering the taxpayer's economic reality, *i.e.*, its home equity in this context. Further, when a taxpayer uses the Section 108(a)(1)(E) exclusion, the basis in the qualifying property is reduced by the excluded amount. Again, like Sections 108(a)(1)(A) and (B), this feature demonstrates Section 108(a)(1)(E)'s ability to be flexible. Not only does this mechanism offer immediate relief to taxpayers with an inability to pay, such as homeowners with an underwater mortgage, by allowing for attribute reduction as opposed to income inclusion, it also preserves the gain to be taxed later when the taxpayer should have more liquidity. Further, it provides taxpayers an alternative exemption to CODI, which does not necessitate meeting the stringent requirements of the insolvency exemption and does not require them to declare bankruptcy to avoid CODI.

ii. Exception for Reduction of Certain Purchase Price Debt Obligations and its Underlying Policies Support the Permanence of Section 108(a)(1)(E)

Another rationale supporting the permanence of Section 108(a)(1)(E) is that it uniquely relates to home mortgages, which differ greatly from other debt obligations. Consider Section 108(e)(5),[56] which provides that CODI is not recognized as a result of the reduction of an obligation from the purchaser to the seller of a property.[57] Instead, this reduction or cancellation of purchase money debt is treated as a reduction of the purchase price, which in turn reduces the basis of the property.[58] This would function in a similar manner to section 108(a)(1)(E) in converting an event that would be taxable currently into one which instead affects basis and thus could create additional income only when the home is later transferred.

Section 108(a)(1)(E) allows taxpayers to modify the loans on their primary residence through bargaining and restructuring loan agreements with banking institutions.[59] If Section 108(a)(1)(E) did not exist, reductions of primary mortgage loans would instead be

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[55] *Id.*

[56] The purchase price reduction exception is unavailable when the reduction occurs due to bankruptcy or insolvency.

[57] IRC § 108(e)(5) (2013).

[58] McMahon & Simmons, *supra* note 29, at 452.

[59] Banks are now encouraged to work with homeowners to make efforts in reducing eligible participants mortgage obligations; see *Principal Reduction Alternative (PRA)*, MAKING HOME AFFORDABLE http://www.makinghomeaffordable.gov/programs/lower-payments/Pages/pra.aspx (last updated March 21, 2013, 10:52 A.M.) ("HUD-approved housing counselors will help [taxpayers] understand [their] options, design a plan to suit [their] individual situation, and prepare [their] application[s]. Research shows that homeowners who work with housing experts… are more successful and have better long-term outcomes.").

recognized as income, and ultimately tax liability.[60] Indeed, bargaining for a loan reduction or modification would be a less attractive option without Section 108(a)(1)(E) due to the possibility of immediate tax liability that may negate much of the benefit of loan modification. Accordingly, Section 108(a)(1)(E) increases the desirability of bargaining by eliminating the risk of immediate recognition of CODI.

Section 108(a)(1)(E) also encourages lending institutions to bargain for the reduction of loans by allowing for greater recuperation of the loan amount. Lending institutions are better able to recover taxpayer debt because bargaining between parties under Section 108(a)(1)(E) can lead to tax-minimizing results (as seen above), providing taxpayers with an increased ability to repay a greater portion of the incurred debt. This may in many cases lead to a better return than liquidation of the collateral through foreclosure. Additionally, having a Section 108 exclusion specific to the housing/mortgage context aligns with the fact that this area is distinct from other types of debt and deserves due consideration. As such, making Section 108(a)(1)(E) permanent acknowledges the need to address the unique nature of a home mortgage as a constant, rather than something solely linked to variability in the housing market.

iii. Making Section 108(a)(1)(E) Permanent is Consistent with IRC Provisions That Encourage Homeownership

In 2007, Rep. Charles Rangel, Chairman of the House Committee on Ways and Means, said "[i]t's just not right or fair that families struggling through a foreclosure would then face a tax bill in addition to losing their homes when they have seen no increase in their net worth."[61] This perspective informs the design of today's Tax Code, which encourages home ownership. For instance, homeowners enjoy tax incentives for housing unavailable to renters, such as the ability to deduct home mortgage interest and property taxes, while renters may not deduct rent payments. Similarly, homeowners receive a mortgage interest deduction under Section 163(h)(2)(D), which permits taxpayers to deduct the interest payments made on a mortgage loan.[62] Congress acknowledged the mortgage interest deduction as benefiting home ownership and has maintained the deduction for precisely that reason.[63] In addition to the mortgage interest deduction, home ownership provides for similar benefits in the form of the property tax deduction,[64] a deduction for interest paid on home equity debt,[65] and other credits and expenses.[66] Thus, the Code can be viewed as encouraging homeownership.

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[60] *See generally* 2007 Tax Notes Today 194-1 (2013) (statement of Rep. Charles Rangel, Chairman of H. Comm. on Ways and Means).

[61] 2007 Tax Notes Today 194-1 (statement of Rep. Charles Rangel, Chairman of H. Comm. on Ways and Means).

[62] *Id* (citing MARK P. KEIGHTLEY, CONG. RESEARCH SERV. ,R41596, SELECT TAX BENEFITS FOR HOMEOWNERS: ANALYSIS AND OPTIONS.

[63] *Id*; *see also* IRC § 163(h) (2013); Roger Lowenstein, *Who needs the Mortgage-Interest Deduction?*, NY Times (March 5, 2006) http://www.nytimes.com/2006/03/05/magazine/305deduction.1.html.

[64] 26 U.S.C.S. § 164(3).

[65] 26 U.S.C.S. § 163(a).

[66] Two examples include a deduction for expenses for a home office per 26 U.S.C. § 280A(c) and tax credits for buying and installing renewable energy sources in one's home. 26 U.S.C. § 48.

C. Section 108(a)(1)(E) has Now Been Extended Eight Separate Times

Lastly, Section 108(a)(1)(E) was created through the Mortgage Forgiveness Debt Relief Act of 2007 and the Emergency Economic Stabilization Act of 2008 with an initial expiration date of January 1, 2010.[67] Since its inception, it has been extended eight times, most recently through P.L. 116-260, which extended the expiration date to January 1, 2026.[68] The repeated extension of Section 108(a)(1)(E) clearly demonstrates that Congress believes it is needed, effects a material beneficial impact, and will continue to do so for the foreseeable future. Moreover, in the uncertain economic climate of a pandemic-altered housing market, the extension codified in P.L. 116-260 signals Congressional intent to provide prolonged relief and assistance to America's most impacted homeowners. Thus, after almost 14 years of existence and repeated extensions, Section 108(a)(1)(E) should be made permanent.

V. CHALLENGES TO MAKING SECTION 108(a)(1)(E) PERMANENT

A. Potential Effects to Revenue

While the authors do not believe there are significant drawbacks to making Section 108(a)(1)(E) permanent, we nevertheless will attempt to address potential concerns interest parties can raise. First, while this paper does not attempt to address the numerical impact of permanently adopting this provision, there is a potential for some possible negative revenue impact, as Congress will not collect tax on amounts recognized by the discharge of this form of indebtedness. However, as a preliminary matter, this exemption has been and will be in place for a 17-year period, and therefore this is not a current source of revenue for the U.S. and will not be for some time. Second, Congress should consider whether this is a source of revenue it wishes to cultivate, specifically when it is triggered only when a U.S. taxpayer is in a position to qualify for one of the relevant home loan modification relief provisions (*e.g.,* when the taxpayer is on the brink of foreclosure on their primary residence). This necessarily is tax imposed on income earned by taxpayers in their worst moments. Third, application of Section 108(a)(1)(E) causes a reduction in basis; thus, tax is deferred, not necessarily erased.[69] Lastly, the revenue impact may be somewhat muted, as fewer modifications are occurring after the termination of HAMP. Thus, the authors anticipate any fiscal impact to be minimal.

B. Relief Provisions Were Thought to be Temporary

A second challenge to permanently enacting Section 108(a)(1)(E) is the idea that the provision was meant to only be temporary and that a permanent extension goes beyond the original mandate of the provision. As noted above, Section 108(a)(1)(E) was created through the

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[67] Pub.L. 110–142, 121 Stat. 1803 (2007); Pub.L. 110–343, Div. A, 122 Stat. 3765 (2008).

[68] Pub.L. 110–142, 121 Stat. 1803 (2007); Pub.L. 110–343, Div. A, 122 Stat. 3765 (2008); Pub.L. 112-240, 126 Stat. 2313 (2012); Pub.L. 113-295, 128 Stat. 4010.(2014); Pub.L. 114-113, 129 Stat. 2242 (2016); Pub.L. 115-123, 132 Stat. 64 (2018); Pub. L. 116-94, 133 Stat. 3227 (2019); Pub. L. 116-260, 134 Stat. 1182 (2020).

[69] The authors acknowledge that, to the extent the property is passed intestate, that there may be an intergenerational step-up in basis; however, this (1) does not apply in all instances and (2) goes beyond the scope of this Article.

Mortgage Forgiveness Debt Relief Act of 2007 and the Emergency Economic Stabilization Act of 2008 with an initial expiration date of January 1, 2010.[70] While the presence of this initial expiration date suggests an intent that Section 108(a)(1)(E) be temporary, Section 108(a)(1)(E) was created to address unrest in the housing market and to help American homeowners forced to restructure mortgage debts or facing home foreclosures—a goal which is not, in and of itself, a temporary one.

In other words, there may always be a need for Section 108(a)(1)(E). Furthermore, the fact that Congress has extended Section 108(a)(1)(E) eight times since its inception, keeping it in existence for nearly 17 years, evidences that it may agree. Notably, these extensions did not always occur during a state of emergency or crisis. Rather, there is a recognition that such an exclusion might be necessary, even in the best of times, to prevent significant ill effects to those taxpayers facing a large burden imposed on the privilege of receiving much needed assistance. Accordingly, the fact that Section 108(a)(1)(E) initially had an expiration date should not, in and of itself, have any bearing on whether it should apply indefinitely.

VI. CONCLUSION

In conclusion, since the 2009 Housing Crisis, there has been and continues to be a need for Section 108(a)(1)(E)'s exclusion of income earned from the discharge of principal home mortgage indebtedness. Further, making Section 108(a)(1)(E) a permanent provision is consistent with policies already established by Congress and the IRC, both with respect to the rationales employed for the exemptions for discharge in bankruptcy and insolvency—and other sub-provisions in Section 108—as well as with those provisions in the IRC that encourage home ownership. Congress has acknowledged the importance of this provision by extending Section 108(a)(1)(E) eight times since 2008, keeping it effective through January 1, 2026. Given the significance of this provision for those taxpayers who utilize it, as well as the lack of significant rationales in opposition, Congress should consider making Section 108(a)(1)(E) permanent.

[70] Pub.L. 110–142, 121 Stat. 1803 (2007); Pub.L. 110–343, Div. A, 122 Stat. 3765 (2008).