



DEPARTMENT OF THE TREASURY  
INTERNAL REVENUE SERVICE  
WASHINGTON, D.C. 20224

May 13, 2010

Number: **INFO 2010-0141**  
Release Date: 6/25/2010

CC:ITA:B04:  
CONEX-117022-10

UIL: 61.00-00

The Honorable Bill Nelson  
United States Senate  
Washington, DC 20510

Attention:

Dear Senator Nelson:

I am responding to your inquiry dated April 16, 2010, on behalf of students who attended a vocational school that closed before providing the education for which the students paid. You requested information on the possible tax treatment to the students for certain loan restructurings and debt forgiveness. I hope the following general information about the possible tax treatment to the students is helpful.

Facts

was a private vocational school marketed private loans to students of to finance their education. originated and funded the loans to students. After funding the loans, sold its interest in the loans to an unaffiliated third-party loan servicer, serviced the loans for . In , abruptly closed

Other students and their cosigners filed suit in various jurisdictions across the country against several defendants. In their complaints, the plaintiffs alleged fraud, aiding and abetting fraud, negligent misrepresentation, and violations of state and federal consumer protection acts, and sought, among other things, to rescind the contracts and to prohibit lenders and holders of the student loans from enforcing or collecting on the loans.

The court preliminarily approved the settlement of a class action filed in the United States District Court for the \_\_\_\_\_, \_\_\_\_\_, to settle the various suits. As part of the settlement agreement, in exchange for the release of the plaintiffs various claims against \_\_\_\_\_, \_\_\_\_\_, and \_\_\_\_\_, the settlement class will receive certain student loan restructuring or debt forgiveness. In addition, as part of the settlement agreement, \_\_\_\_\_ will receive an assignment of the settlement class' claims against \_\_\_\_\_.

### Law

Generally, a taxpayer realizes income when a creditor discharges all or a portion of the taxpayer's debt (section 61(a)(12) of the Internal Revenue Code (Code)). Courts have concluded that the discharge of a debt accords the debtor an economic benefit equivalent to income.

### Purchase Price Adjustment

Section 108 provides certain exclusions from income for certain discharge of indebtedness income. Section 108(e)(5) provides that a debt reduction may be excludable as a purchase price adjustment under certain circumstances. This section provides that if (A) the debt of the purchaser of property to the seller arising out of the purchase is reduced, (B) the debt reduction does not occur in a Title 11 bankruptcy case or when the purchaser is insolvent, and (C) the reduction would be treated as income to the purchaser from the discharge of indebtedness but for section 108(e)(5), then such reduction will be treated as a purchase price adjustment.

In third-party lender cases, the IRS may treat a debt reduction as a purchase price adjustment to the extent that the debt reduction by the third-party lender is based on an infirmity that clearly relates back to the original sale (e.g., the seller's inducement of a higher purchase price by misrepresentation of a material fact or by fraud). Rev. Rul. 92-99, 1992-2 C.B. 34.

In the present situation, the loan restructurings and debt forgiveness may represent a compromise of the numerous claims against several defendants, including fraud, aiding and abetting fraud, negligent misrepresentations, and violations of stated and federal consumer protection. Therefore, the debt restructurings and debt forgiveness could be viewed as a purchase price adjustment based on an infirmity that relates back to the agreement to purchase educational services, and any discharge of indebtedness income could be excludable from gross income under section 108(e)(5) of the Code.

### Medium of Payment

Not every cancellation of indebtedness results in gross income under section 61(a)(12) of the Code. If a cancellation of indebtedness is merely a medium for payment of some other form of income, section 61(a)(12) and the exclusion under 108 do not apply. *United States v. Centennial Savings Bank, FSB*, 499 U.S. 573, 581 n.7 (1991). The IRS has concluded that the amount owed by the taxpayer under a contract that is forgiven by the seller, in return for a release of a contract counterclaim, is not income

from the discharge of indebtedness within section 61(a)(12) and, therefore, the exclusion provided by section 108 does not apply. Rev. Rul. 84-176, 1984-2 C.B. 34.

In the present situation, when \_\_\_\_\_ closed \_\_\_\_\_, the class members filed claims against \_\_\_\_\_, \_\_\_\_\_, \_\_\_\_\_, and other entities and alleged fraud, aiding and abetting fraud, negligent misrepresentation, and violations of state and federal consumer protection acts. At the same time, the class members owed amounts to \_\_\_\_\_ for the unpaid portions of the student loans. Therefore, the loan restructurings and debt forgiveness could be viewed as a medium for paying damages owed to the settlement class by the defendants and may constitute taxable income not excludable under section 108, or may be viewed as a medium of payment for a nontaxable recovery of a previously paid expense (assuming the class member did not previously deduct the tuition paid or receive an education tax credit for the tuition previously paid), depending on the nature of the claim that was settled.

This letter has called your attention to certain general principles of the law for informational purposes only. It does not constitute a ruling. In addition, section 4.02(10) of Rev. Proc. 2010-3, 2010-1 I.R.B. 115, 119, provides that the IRS ordinarily will not rule on the proper allocation of amounts received in settlement of a legal action.

I hope this information is helpful. If you have any additional questions, please contact me or \_\_\_\_\_, Identification Number \_\_\_\_\_ at \_\_\_\_\_.

Sincerely,

Michael J. Montemurro  
Chief, Branch 4  
Office of Associate Chief Counsel  
(Income Tax and Accounting)