Understanding and Reporting the Tax Consequences of Cancellation of Debt Income

Responsible Officials

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Definition of Problem

The National Taxpayer Advocate, in her 2007 Annual Report to Congress, identified the tax consequences of cancellation of debt income as one of the most serious problems encountered by taxpayers.1 The rules that determine whether cancellation of debt income is includible in gross income are complex. There are several exceptions to the general rule of includibility, such as the exception for debt canceled when a homeowner becomes unable to make payments on a loan secured by his or her principal residence under the Mortgage Forgiveness Debt Relief Act (MFDRA).2 The requirements for reporting excluded amounts are also complex, and taxpayers often do not receive reliable information about their tax reporting and payment obligations concerning cancellation of debt income.

For example, the New York Times described the operation of MFDRA as follows: “Suppose a buyer defaults on a $220,000 mortgage. The bank forecloses and sells the house in today’s battered market for $180,000. The $40,000 of remaining debt is discharged. Under previous law, the $40,000 was considered income and was subject to taxation. Under this law, the tax obligation is forgiven.”3 According to the Fort Worth Star-Telegram: “In tax law, the amount of forgiven debt is typically treated as income and is taxed. But to help people who are affected by the mortgage crisis, Congress excluded homeowners whose mortgage debt was forgiven in years 2007, 2008 and 2009. Keep good records, and keep track of the amount that the bank wrote off.”4

These newspaper accounts are not inaccurate, but they fail to mention two important points. First, even though “qualified principal residence indebtedness” under MFDRA includes most home loans whether they resulted from a refinancing transaction, a second mortgage, or a home equity line of credit, the fact that the canceled debt is a home loan does not mean the MFDRA exception applies. The exception does not cover loan proceeds used for any purpose other than to acquire or improve a principal residence.5 As described

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1 National Taxpayer Advocate 2007 Annual Report to Congress 13-34. This problem ranked second among the 26 most serious problems addressed.
below, many homeowners used a portion of their home loans to pay off medical bills, student loans, or other expenses. These canceled debts are not excludible from income under MFDRA (although they may be excludible under a different exception). Second, neither homeowners nor any other debtors who exclude cancellation of debt from income automatically receive the benefit of the exclusion. To claim the exclusion, taxpayers are required to file Form 982, Reduction of Tax Attributes Due to Discharge of Indebtedness (and Section 1082 Basis Adjustment) with their tax returns.\(^6\) If they fail to file Form 982, the IRS will assume the cancellation of indebtedness income is taxable.\(^7\)

In recognition of the seriousness of the problems taxpayers face in reporting cancellation of debt, the National Taxpayer Advocate makes a Legislative Recommendation in this year’s Annual Report to Congress suggesting three options that would make it easier for financially distressed taxpayers to exclude cancellation of debt from gross income.\(^8\)

### Analysis of Problem

#### Background

According to RealtyTrac, “one in every 475 U.S. housing units received a foreclosure filing in September [of 2008]. Foreclosure filings were reported on 765,558 U.S. properties during the third quarter, up more than three percent from the second quarter and up 71 percent from the third quarter of 2007.”\(^9\) In response to this foreclosure crisis, Congress extended MFDRA, which was originally set to terminate on December 31, 2010, through 2012.\(^10\) The rise in foreclosures has taken place against a backdrop of increasingly risky loan practices.

In recent decades, an increasing number of housing loans were made by lenders specializing in subprime lending.\(^11\) Subprime loan originations reached $160 billion in 1999, representing 12.5 percent of total originations.\(^12\) According to a Department of Housing and Urban Development and Department of Treasury Task Force on Predatory Lending report, “The primary purpose of over 50 percent of first lien subprime mortgages and up to 75 percent of second lien subprime mortgages is debt consolidation and/or general consumer credit, not home purchase, home improvement or refinancing the rates and terms

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7. Id. at 3 (2007). The IRS is notified that a debt has been canceled by means of Form 1099-C, Cancellation of Debt, issued by creditors who forgive a debt of $600 or more.
8. See Legislative Recommendation, Simplifying the Tax Treatment of Cancellation of Debt Income, infra.
12. Id. at 29.
of a mortgage.” Borrowers 65 years of age or older were three times more likely to hold subprime mortgage loans than borrowers under 35.

Of the subprime loans that were second lien mortgages, 45 percent of the loans were used for debt consolidation, 30 percent for medical, education and other expenses, and 25 percent for home improvement.

In the majority of loans, a portion of the proceeds was still being used to cover living expenses and pay other non-mortgage debt such as credit cards in 2001 and early 2002, as shown below:

**CHART 1.3.1, Use of Funds from Refinancings, 2001 and 2002**

![Chart](chart.png)

Percentages add up to more than 100 because each refinancing loan could have been used for multiple purposes.

Source: Federal Reserve System, Flow of Funds Accounts of the United States.

From 1992 to 2001, the level of credit card debt among seniors between 65 and 69 years old increased by 217 percent. “With virtually all medical expenses now payable by credit card, there is evidence to suggest that deductibles, co-pays, dental and vision care, prescription drugs and other uncovered costs played a significant role in the increased credit card balances of many older Americans.”

13 Id. at 26.
18 Id. at 6.
According to the New York Times, after years of “flooding Americans with credit card offers and sky-high credit lines, lenders wrote off an estimated $21 billion in bad credit card loans in the first half of 2008.”¹⁹ If unemployment continues to increase, debt cancellation could exceed historic norms.²⁰

Cancellation of this debt does not qualify for exclusion from income under MFDRA, and using home loan proceeds to pay this debt disqualifies canceled loans for exclusion under MFDRA. Taxpayers need to be able to determine whether their canceled debt is excludible from income under a different exception (such as the insolvency exception) and must file Form 982 to claim the benefit of that exception.

**Developments Since the 2007 Annual Report to Congress**

The 2007 Annual Report recommended changes to various aspects of the reporting process to make it easier for taxpayers to understand their obligations in reporting cancellation of indebtedness income. The report recommended that the IRS:

- Develop a comprehensive publication that would assist taxpayers in preparing returns;
- Provide in-person assistance to taxpayers who seek information or return preparation assistance;
- Improve the form used by lenders to report cancellation of indebtedness income and the form used by taxpayers to report reductions in tax attributes; and
- Improve its communications with taxpayers who it believes misreported cancellation of indebtedness income.

We commend the IRS for taking the steps described below that improved the availability of reliable information and assistance to taxpayers, and for working with the office of the National Taxpayer Advocate to address our concerns.

**New Publication 4681 Provides Better Information to Taxpayers**

The National Taxpayer Advocate strongly recommended “that the IRS develop a publication on the tax treatment and reporting of cancellation of indebtedness income that consolidates all relevant information in one place.”²¹ The IRS developed Publication 4681, *Canceled Debts, Foreclosures, Repossessions, and Abandonments*, in collaboration with the Taxpayer Advocate Service and released it in May 2008. The publication fills a critical

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²⁰ *Id.*
²¹ National Taxpayer Advocate 2007 Annual Report to Congress 31.
information gap, because it provides an exhaustive explanation of cancellation of indebtedness issues.22

**The Taxpayer Advocate Service (TAS) Raised Awareness about Cancellation of Debt**

As part of the 2008 IRS Nationwide Tax Forums, held in six major cities (Atlanta, Chicago, Orlando, Las Vegas, New York, and San Diego), TAS developed and presented a training session entitled *Cancellation of Debt – What You Need to Know*. The session was designed to raise awareness of the issue among practitioners and to provide guidance for them. It opened with a video podcast showing the National Taxpayer Advocate describing cancellation of debt income and how this issue affects taxpayers. The session proceeded in a panel format with a TAS executive serving as moderator, a TAS attorney or systemic advocacy analyst sharing the TAS perspective, a representative from the Wage and Investment (W&I) division Automated Underreporter (AUR) unit describing how the IRS handles Forms 1099-C, and a local Low Income Taxpayer Clinic (LITC) staff member discussing the impact of cancellation of debt income on taxpayers and practitioners.

This session proved extremely popular, attracting standing room only crowds at all of the first three Tax Forums. The Atlanta and Chicago presentations drew more than a thousand attendees. In each of the final three locations, the session was presented twice to accommodate everyone who wished to attend, and attendees were given the new Publication 4681 as a reference document.

**The IRS Revised Form 982**

The National Taxpayer Advocate noted in the 2007 Annual Report that "The IRS could substantially simplify the task of completing the form [Form 982] for non-business taxpayers by clarifying the instructions."23 In 2008, the IRS, in collaboration with TAS, revised Form 982 and the instructions to incorporate the MFDRA provisions (and other statutory provisions pertaining to Hurricane Katrina) and to provide clarification. The revised instructions include a detailed chart that guides taxpayers to the appropriate lines on the form. The taxpayer sees a column captioned "IF the discharged debt you are excluding is..." with a menu of different types of debt (qualified principal residence indebtedness, nonbusiness debt, or any other debt). Each category of debt on the menu corresponds to a column captioned "THEN follow these steps..." The steps explain exactly which lines on the form to complete.

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22 In July 2008, the National Taxpayer Advocate awarded the National Taxpayer Advocate award to TAS and other IRS and Chief Counsel employees who worked on the new Publication. The National Taxpayer Advocate Award is conferred on IRS employees who make extraordinary contributions in support of the following TAS strategic objectives: advocate changes in tax law or procedures that protect taxpayer rights, reduce taxpayer burden, and improve IRS effectiveness; improve TAS's ability to identify and respond to taxpayer concerns; identify significant sources of TAS casework and work with operating divisions on strategies to reduce inappropriate TAS workload; and ensure the human resources component of TAS is adequate to meet its workload demands.

23 National Taxpayer Advocate 2007 Annual Report to Congress 23.
The revised Form 982 is a substantial improvement over the previous version, although it does not reference Publication 4681 because the publication was issued later. As described below, further changes in Form 982 are desirable.

**The IRS Revised Form 1099-C**

Form 1099-C, *Cancellation of Debt*, is used by lenders to report cancellation of indebtedness.\(^{24}\) Lenders issued Forms 1099-C to over 1.4 million taxpayers in 2006 and to more than 1.6 million taxpayers in 2005.\(^{25}\) In 2006, over 15 percent of the taxpayers issued a 1099-C received more than one, but on only two percent of the Forms 1099-C did the issuer check the box to indicate the debt was discharged in bankruptcy.\(^{26}\)

The 2007 Annual Report to Congress noted that although taxable cancellation of indebtedness income does not arise if the underlying debt is nonrecourse, “there is no difference in the way canceled recourse debts and canceled nonrecourse debts are reported on Form 1099-C.”\(^ {27}\) Form 1099-C also did not instruct the issuer to provide its telephone number, which made it more difficult for a debtor who disagrees with the amount recorded by the issuer as the fair market value of the property (or with any other aspect of the form) to communicate with the issuer to resolve the problem. The IRS revised Form 1099-C in 2008 to include the field “Was borrower personally liable for repayment of the debt?” and to instruct the issuer to provide its telephone number. The reverse side of the 1099-C, which contains "Instructions for Debtor," was changed to incorporate references to Publication 4681. The National Taxpayer Advocate applauds the IRS for making these improvements and looks forward to continued collaboration with the IRS in further refining and developing Form 1099-C and instructions.

**The IRS Expanded Assistance to Taxpayers**

In her 2007 report, the National Taxpayer Advocate noted that the IRS designated the tax treatment of canceled debt a subject that is “out of scope” for tax return preparation assistance at Volunteer Income Tax Assistance (VITA) sites, Tax Counseling for the Elderly (TCE) sites, and at the IRS’s own Taxpayer Assistance Centers (TACs).\(^ {28}\) She recommended that the IRS designate the tax treatment of canceled debts as “in scope” for purposes of preparing returns and answering general questions at the TACs. She further recommended that the IRS provide specialized training on cancellation of indebtedness issues to a unit of telephone assistors and then route taxpayer calls on these issues to those assistors.\(^ {29}\)

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\(^{24}\) Treas. Reg. § 1.6050P-1(a)(1).


\(^{27}\) National Taxpayer Advocate 2007 Annual Report to Congress 18.

\(^{28}\) Id. at 24.

\(^{29}\) Id. at 33.
The IRS removed the “out of scope” designation at VITA and TCE sites with respect to the MFDRA exception for cancellation of debt income. Volunteers who staff these sites may now assist taxpayers in determining whether the MFDRA exception applies to them. However, training at VITA and TCE sites appears to incorporate Publication 4702, Mortgage Forgiveness Debt Relief Act of 2007, which is inadequate and out of date. We recommend that the IRS develop better training materials for VITA and TCE sites, confirm that VITA and TCE volunteers who staff these sites can spot potential application of other exceptions to cancellation of debt income, and refer taxpayers who visit VITA and TCE sites to TACs or LITCs, as appropriate.

The IRS also removed the “out of scope” designation at the TACs, and is providing more extensive training on cancellation of debt income for some TAC employees. Senior staff began training in November 2008 to be qualified to assist taxpayers with this issue by January 2, 2009, when the new filing season begins. As of December 15, 2008, 277 employees certified that they received such training. The printed training materials cover the insolvency and bankruptcy exceptions for cancellation of debt income, but not the exceptions for qualified farm indebtedness or qualified real property business indebtedness (these exceptions continue – we believe, appropriately – to be designated “out of scope”). The materials explain the meaning of insolvency and state “Note: Advise the taxpayer to attach a statement to their return explaining how they arrived at their insolvency amount. This could be done by listing all their assets in one column and liabilities in another.” The materials include several examples from the new Publication 4681, as well as a glossary of terms and training on how to complete Form 982.

The printed training materials will be used in conjunction with an interactive electronic assistance program that was also recently developed and is scheduled to be launched in January 2009. The software, referred to as ITLA (Interactive Tax Law Assistant), is organized as an interview in which the taxpayer (through the IRS employee) answers a series of questions that lead to a conclusion and a recommended course of action.

Although one of the ITLA questions is “Were you insolvent at the time the debt was canceled?” the assistor is cautioned, “Note to Assistor: do not assist taxpayer with the insolvency calculation.” Further, ITLA does not appear to distinguish between qualified principal residence indebtedness and home loan proceeds used to pay other types of debt. The relevant question, “Did you incur the debt in acquiring, constructing, or substantially improving your principal residence?” does not permit the taxpayer to respond that only
a portion of the debt was so used. Therefore, the assistor may incorrectly conclude that all (or none) of the taxpayer’s canceled debt is excludible from income.\textsuperscript{33} For this reason, only IRS employees who receive separate training on cancellation of debt income should use ITLA. Taxpayers who call the IRS toll-free number (1-800-829-1040) to inquire about cancellation of indebtedness issues will speak with a Customer Service Representative who has received training and will use the same interactive ITLA software described above. Moreover, the IRS should add a follow-up question to ITLA inquiring whether the taxpayer used the proceeds for another purpose such as debt consolidation.

**Continuing Challenges**

Since the National Taxpayer Advocate’s 2007 Annual Report to Congress, the IRS has dealt with several aspects of cancellation of indebtedness that pose difficulties for taxpayers. Particularly with respect to raising awareness of the issue and providing taxpayers with useful information, the IRS has been proactive. However, the difficulty of accurately describing this area of the law in terms that make sense to many taxpayers makes misreporting more likely. Misreporting will not, in many cases, result in an underpayment of tax, yet it may trigger an enforcement action by the IRS. The IRS needs to communicate with taxpayers who do not perfectly account for their cancellation of debt income before resorting to enforcement measures. As Commissioner Shulman has said, the IRS must show sensitivity in dealing with taxpayers buffeted by difficult economic times.\textsuperscript{34}

**Taxpayer Challenges in ReportingCanceled Debts on Form 982 Persist.**

Taxpayers who exclude cancellation of indebtedness from income are required to report a corresponding reduction in tax attributes by filing Form 982. As described below, the IRS matches this form (and the taxpayer’s tax return) with Forms 1099-C issued to the taxpayer to determine whether the taxpayer properly reported cancellation of indebtedness income. Taxpayers who exclude cancellation of debt from income entirely under MFDRA need only reduce their basis in their residence by the amount of the canceled debt.\textsuperscript{35}

As described above, however, many taxpayers cannot use the MFDRA exception to exclude all of the canceled debt because they used some of the debt proceeds for purposes other than the acquisition, construction, or improvement of their principal residences. These taxpayers may avail themselves of the insolvency exception. Form 982, which is used to claim insolvency, contains a definition of insolvency and an example that illustrates the concept, but the form does not include a worksheet for calculating insolvency, nor does it direct

\textsuperscript{33} The IRS has indicated that a revised version of the ITLA software will be available on Dec. 5, 2008, which will address these shortcomings in the current application. IRS response to TAS Nov. 21, 2008.

\textsuperscript{34} Martin Vaughan, *IRS Head: Tough Economic Times Call for Sensitive Approach*, Dow Jones Newswires, Oct. 27, 2008. See also Most Serious Problem, Customer Service within Compliance, infra; Most Serious Problem, The IRS Needs to More Fully Consider the Impact of Collection Enforcement Actions on Taxpayers Experience Economic Difficulties, infra.

\textsuperscript{35} Pub. L. No. 110-142 § 2(b); IRS Pub. 4681, Canceled Debts, Foreclosures, Repossessions, and Abandonments 7 (2007).
the taxpayer to submit any substantiation of insolvency with the completed Form 982. As described below, this lack of guidance may result in later enforcement action by the IRS.

Further, taxpayers who qualify for another exception (such as the insolvency exception) will have to contend with the ordering rules set out in Form 982, which direct them to reduce tax attributes (such as basis, net operating losses, general business credit carryovers, minimum tax credits, and capital losses) in relation to the amount of the canceled debt. Taxpayers who are not farmers or businesses will very likely not have tax attributes other than personal property. Therefore, they will face the requirement of reporting adjustments to personal property such as furniture, jewelry, and clothing.

The reduction in basis in personal property will increase the gain on any subsequent disposition of these items or reduce the (nondeductible) loss. Implicit in the logic of this statutory scheme is the supposition: (1) that the taxpayer can establish that he or she has basis in personal property in an amount greater than zero; (2) that the taxpayer who reduces his or her basis in personal property may later sell such personal property; and (3) in the event of such sale the taxpayer will accurately report the gain or (nondeductible) loss, having kept track of the basis in the sold property in the interim. Also implicit in this framework is the supposition that the IRS likewise keeps track of basis in taxpayers’ personal property as reported on Form 982. In a statutory environment such as this, to say nothing of the economic difficulty the taxpayer is likely facing, the importance of engaging in sensitive, proactive, and helpful communications with taxpayers, especially those whom the IRS identifies as having misreported collection of indebtedness income, is evident.

The IRS Is Too Quick to Take Enforcement Measures When Taxpayers Misreport Cancellation of Debt.

Taxpayers may first become aware they may need to report cancellation of indebtedness income when they receive a letter, Notice CP 2000, Notice Proposing Adjustments to Income, Payments, or Credits. The IRS issued 126,906 such notices in 2005.36 The Notice CP 2000 is the first step toward assessment of the tax and in this sense is an enforcement measure.

The IRS may issue Notice CP 2000 after an AUR analyst evaluates a discrepancy between amounts shown on a Form 1099-C and on the taxpayer’s return. It may be issued even if the taxpayer files a Form 982 claiming that he or she was insolvent, if the taxpayer does not also include a statement showing the amount of the insolvency. As described above, Form 982 does not direct the taxpayer to include such a statement. The Notice CP 2000 states that a discrepancy exists and instructs the taxpayer: “If you claimed insolvency, please provide us with a breakdown of your total assets and liabilities immediately before the cancellation of debt.”

Therefore, taxpayers who successfully navigate Form 982 and attest to their insolvency may nevertheless find themselves facing an IRS enforcement action when they receive a Notice CP 2000 instructing them to provide a breakdown of their assets and liabilities, without any guidance as to what form the report is to take. The IRS should develop tools and schedules, including an insolvency worksheet, to help taxpayers accurately and completely meet their reporting obligations for cancellation of debt income when they file their tax returns.

**The IRS Should Create a Single Unit Dedicated to Handling Cancellation of Debt Issues.**

The complexity of this area of the law, coupled with the frequency of the issue and the expectation, in view of continued economic difficulties, that the number of taxpayers affected by cancellation of debt will grow, warrants the creation of a specialized IRS unit to handle related questions. This approach is not unusual: the IRS set up a specialized unit in 1998 to handle claims for relief from joint liability under newly enacted IRC § 6015,\(^\text{37}\) and created procedures for accessing the “U.S. competent authority” in the early 1970s to help taxpayers deal with certain provisions of international tax treaties.\(^\text{38}\) Providing more in-depth training to fewer employees would lead to better quality control and consequent improvement in service on a more timely basis (or in real time), consistency in service, and greater ease in spotting and accommodating emerging trends. The centralized unit should be given authority to initiate communications with taxpayers who may have misreported their cancellation of debt income by writing to them at their last known addresses and attempting to ascertain their current addresses. The unit should be responsible for initiating communications that focus on helping taxpayers meet their reporting obligations, rather than establishing that they have not.

**Conclusion**

The rules pertaining to cancellation of indebtedness income are complex and, for most taxpayers, counterintuitive. In 2008, the IRS responded to several concerns raised by the National Taxpayer Advocate in her 2007 Annual Report to Congress, but needs to do more to inform taxpayers of the rules and simplify the reporting procedures. The IRS should update the materials it uses to train volunteers who staff the VITA and TCE sites and revise the new ITLA software to verify that it accurately reflects the statutory framework and complements the written training materials. To the extent the IRS requires taxpayers to furnish a breakdown of assets and liabilities in order to claim the insolvency exception, it should provide appropriate forms and instructions, and revise Form 982 to direct taxpayers to provide this information with their returns. The IRS should create a specialized unit to handle cancellation of debt issues. IRS communications to taxpayers who misreport their cancellation of debt should take into account the economic difficulty that these taxpayers are likely facing. By extending the term of MFDRA through 2012, Congress recognized that

\(^{37}\) See IRS Form 8857, Request for Innocent Spouse Relief (1998).

the economic distress that leads to debt cancellation is not likely to abate in the next few years. The tax treatment of debt cancellation will therefore require continued attention.

**IRS Comments**

As a result of the downturn in the economy and the increasing numbers of taxpayers affected by taxable debt forgiveness income, the IRS has taken, and will continue to take actions to help taxpayers better understand and comply with these very complex provisions of the Internal Revenue Code. Many of these actions were taken in close collaboration with the National Taxpayer Advocate, who timely identified this as an emerging issue and provided the IRS with a number of excellent suggestions. As outlined in more detail below, the IRS developed a new Publication 4681, clarified other related forms, instructions, and publications, and expanded the scope of the services offered at TACs and IRS-sponsored volunteer sites to address this issue. In addition, IRS compliance notices are being revised to reference the Mortgage Forgiveness Debt Relief Act of 2007 and to include the new Publication 4681. Finally, as an integral part of the planning for the 2009 filing season, the IRS is developing enhanced communications products, updating and expanding IRS.gov, and increasing outreach to taxpayers, partners, and tax practitioners on this important subject.

The IRS developed Publication 4681, *Canceled Debts, Foreclosures, Repossessions, and Abandonments*, in collaboration with TAS, to consolidate all relevant information in one document. The publication, which was released in May 2008, provides a thorough explanation of cancellation of debt (COD) issues. The National Taxpayer Advocate recognized this accomplishment by awarding the National Taxpayer Advocate award to IRS employees who worked on the new publication.

The IRS, in collaboration with TAS, also revised Form 982, *Reduction of Tax Attributes Due to Discharge of Indebtedness*, and the instructions to incorporate MFDRA provisions and simplify the task of completing the form for non-business taxpayers. A new table was also added to the instructions on *How to Complete the Form*, to clearly explain which lines on Form 982 must be completed in situations involving qualified principal residence debt, other non-business debt (such as car loan or credit card debt), and other debts.

Although the National Taxpayer Advocate states the revised Form 982 is a substantial improvement over the previous version, she also states taxpayers continue to face challenges in reporting canceled debts on Form 982. Specifically, the National Taxpayer Advocate mentions that Form 982, which is used to claim insolvency, does not include a worksheet for calculating insolvency, nor does it direct taxpayers to submit substantiation of insolvency. The IRS notes that, because of the vast numbers and types of assets and liabilities that can exist for taxpayers, it is impossible to develop a worksheet that would work for all taxpayers. The IRS believes it would be more beneficial to illustrate the calculation through the use of examples, such as those in Publication 4681. To this end, the IRS plans to add
a reference in Form 982 that directs taxpayers to the insolvency examples in Publication 4681. Further, the IRS is updating Publication 525, *Taxable and Nontaxable Income*, to include more specific guidelines on the types of assets and liabilities that must be included in the computation for taxpayers seeking to exclude income based on the insolvency exclusion.

With regard to the National Taxpayer Advocate’s recommendation that the IRS direct taxpayers to submit substantiation of insolvency with the completed Form 982, the IRS believes this would pose unnecessary burden on those taxpayers since most will not receive a CP 2000 notice from the IRS. The IRS further notes this information is not required during the processing of Form 982, but is normally requested only in connection with resolution of an information return document matching discrepancy, or when a return is selected for examination.

With respect to the VITA and TCE programs, the IRS expanded the scope at VITA/TCE sites to include COD issues relating to the MFDRA. Volunteers with advanced certification will be trained to assist taxpayers with tax return preparation for income excluded due to “discharge of qualified principal residence indebtedness.” A Screening Sheet will be available for volunteers to identify those taxpayers who can be assisted at the volunteer sites and those that need to be referred to TACs or Low Income Taxpayer Clinics. In addition, a training supplement to the 2008 Publication 4491, *Volunteer Student Guide*, is currently under development. The supplement, Publication 4491-X, will include information about the MFDRA, plus updates on other legislation that have become available since Publication 4491 was published. Two outreach products – Publication 4702, *Mortgage Forgiveness Debt Relief Act of 2007 Overview*, and Publication 4705, *Tax Relief for Struggling Homeowners and FAQs* – are also being updated to provide partners, volunteers, and employees with current information about the MFDRA.

With respect to TACs, the IRS has also expanded the scope of return preparation assistance to include COD issues related to MFDRA. Further, for tax law assistance, the IRS removed the “out of scope” designation and is providing extensive training on COD income for TAC employees who have received Intermediate Tax Law Training. The Interactive Tax Law Assistant (ITLA), an interactive electronic assistance program, will address insolvency, allowing trained assistors to help with a comparison of assets vs. liabilities. Additional probes were added to determine the portion of principal residence indebtedness that was used for a purpose other than acquiring, constructing, or substantially improving the taxpayer’s principal residence. The ITLA will also include a resulting response that will address the equity portion of the debt.

The IRS agrees that only IRS employees who receive separate training on COD income should use ITLA. Providing high quality service depends on employees knowing when and

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where to refer issues that are outside their training, certification and expertise. As such, referral procedures are in place to assist taxpayers when an employee encounters a question beyond their training or expertise. Taxpayer issues beyond these levels will be handled through a clearly defined referral process.40

The National Taxpayer Advocate asserts the IRS is too quick to take enforcement action when taxpayers misreport COD. For example, the National Taxpayer Advocate states taxpayers may first become aware that they may need to report COD income when they receive a letter, Notice CP 2000, Notice Proposing Adjustments to Income, Payments, or Credits. The IRS believes taxpayer’s first indication that they need to report COD income more often arises when they receive Form 1099-C, Cancellation of Debt, from the lender. Form 1099-C is required to be filed with the IRS and the taxpayer for cancellation of any debts of $600 or more. However, if the taxpayer fails to include this income on their return or to claim one of the applicable exceptions or exclusions on Form 982, they may receive a CP 2000 notice from the IRS. This notice includes a special paragraph that instructs the taxpayer that under certain conditions, cancelled or forgiven debt should be included on returns as income. This paragraph also informs taxpayers that if they claim insolvency, they should provide a breakdown of total assets and liability immediately before the cancellation of debt. Further, TY 2007 and future CP 2000 notices that involve COD income will include reference to the MFDRA and a copy of Publication 4681.

For COD cases selected for review by the Automated Underreporter (document matching) Program, if the taxpayer files Form 982 to claim the insolvency exception, a CP 2000 request for substantiation of insolvency is much like any other issue where the IRS is verifying the taxpayer’s claim. The practice of requesting additional information from the taxpayer, even though inclusion of that information is not required at the time of filing, is not unique to situations involving COD insolvency status.

Finally, the National Taxpayer Advocate recommends the IRS create a single unit dedicated to handling COD issues, similar to the current Innocent Spouse program or the U.S. competent authority procedures created in the early 1970s. It is important to understand that unlike Innocent Spouse or the recently centralized Identity Theft unit, where specialized handling is provided to address unique claims or uncommon issues, the requirement to report and pay tax on COD income is an integral part of IRS’ information, education, assistance, and compliance operations. In light of current economic conditions, the IRS believes the additional focus and attention to the COD income issue, as outlined above, is fully warranted. However, there are myriad complex provisions in the Code. At this time, the IRS does not believe the COD income issue is so unique as to justify creation of redundant, centralized operations dedicated solely to this particular tax provision.

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40 IRM 21.3.4.3.7, Referral Procedures.
Taxpayer Advocate Service Comments

The National Taxpayer Advocate applauds the IRS for recognizing the seriousness of this problem and taking appropriate action such as working with TAS to develop Publication 4681, Canceled Debts, Foreclosures, Repossessions, and Abandonments; revising Form 982, Reduction of Tax Attributes Due to Discharge of Indebtedness; and expanding assistance to taxpayers at TACs and IRS-sponsored volunteer sites. The National Taxpayer Advocate welcomes the IRS’s commitment to continue to enhance its training materials and communications products.

While the IRS and the National Taxpayer Advocate have worked together very effectively in addressing issues surrounding the problem of understanding and reporting the tax consequences of cancellation of debt income, some challenges remain where the IRS appears not to appreciate the uniqueness and long-term nature of the problem. For example, the IRS believes that a taxpayer first realizes he or she may have cancellation of indebtedness income upon receipt of the Form 1099-C. This assertion simply does not correspond to the realities taxpayers face when their homes are foreclosed, they are evicted, and their former residences sold. Taxpayers in this situation seek alternative living arrangements, such as with friends or family or in shelters, and they may move several times. It should come as no surprise that many taxpayers in this situation do not notify the lender that foreclosed on their home of their current whereabouts in order to ensure that they will receive a form they have never heard of which will permit them to meet a tax reporting obligation that they do not even suspect exists. This is a unique problem, and the IRS should find unique approaches to helping taxpayers understand and report the tax consequences of their debt cancellation. An AUR notice, as the likely first indication taxpayers receive that they may have a tax liability, should be explanatory and helpful, keeping in mind that many taxpayers will not in fact owe additional taxes. The outreach and communications products that the IRS is creating, described in its response, could be included with the initial letter AUR sends.

We are unconvinced that the IRS cannot produce an insolvency worksheet for taxpayers to submit with their tax returns when they claim the insolvency exception. The IRS is developing specific guidelines pertaining to insolvency for inclusion in Publication 525, Taxable and Nontaxable Income, which demonstrates that the capability exists. Designing a form with that information (including a line for “other” assets or liabilities if necessary), providing a general explanation for the form, and referencing Publication 525, would be helpful and appropriate.

As another example of the IRS’s underestimate of the significance of this issue, the IRS explains that it solicits substantiation from taxpayers claiming the insolvency exception “much like any other issue where the IRS is verifying the taxpayer’s claim.” It is true that the rules pertaining to cancellation of debt income have been in place for many years. As our statistics show, however, entire segments of the population, such as the elderly with
credit card debt used to pay for medical care, are now affected by these rules for the first time. Middle-class taxpayers whose jobs will be impacted by the economic downturn and the subprime lending spree of recent years will join the ranks of those with debt cancellation reporting obligations. These conditions will transform the problem of cancellation of debt reporting into a taxpayer crisis for the next five years at least. The IRS is short-sighted to resist immediate and fundamental accommodation of this reality.

**Recommendations**

In summary, the National Taxpayer Advocate recommends that the IRS:

1. Develop an insolvency worksheet for taxpayers claiming the insolvency exception;
2. Revise Form 982 to instruct taxpayers claiming the insolvency exception to attach an insolvency worksheet to their returns; and
3. Create a centralized unit dedicated to handling cancellation of debt issues.