United States Government Accountability Office

GAO

Report to Congressional Requesters

August 2010

TAX ADMINISTRATION

Expanded Information Reporting Could Help IRS Address Compliance Challenges with Forgiven Mortgage Debt

Accountability * Integrity * Reliability

GAO-10-997

Contents

United States Government Accountability Office
Washington, DC 20548

August 31, 2010

The Honorable Max Baucus
Chairman
The Honorable Charles E. Grassley
Ranking Member
Committee on Finance
United States Senate

The Honorable John Lewis
Chairman
The Honorable Charles W. Boustany, Jr.
Ranking Member
Subcommittee on Oversight
Committee on Ways and Means
House of Representatives

To assist the growing number of taxpayers facing foreclosure or mortgage restructuring, the Mortgage Forgiveness Debt Relief Act of 2007, and its 3-year extension as part of the Emergency Economic Stabilization Act of 2008, allows taxpayers to generally exclude from taxable income forgiven mortgage debt used to buy, build, or substantially improve a principal residence.[1]

Joint Committee on Taxation (JCT) estimates originally suggested that the exclusion of forgiven mortgage debt from taxable income may result in about $968 million in federal revenue losses from fiscal year (FY) 2008 through FY 2013 and more recent estimates suggest that the revenue losses could be closer to $1.9 billion.[2] The Department of Treasury

[1]Pub. L. No. 110-142, 121 Stat. 1803 (Dec. 20, 2007) and Pub. L. No. 110-343, 122 Stat. 3765 (Oct. 3, 2008).

[2]To calculate these revenue effects we added Joint Committee on Taxation estimates from: Joint Committee on Taxation, *Estimated Revenue Effects of H.R. 3648, The "Mortgage Forgiveness Debt Relief Act of 2007" as Amended and Passed by the Senate on December 14, 2007*, JCX-118-07 (Washington, D.C.: Dec. 18, 2007), *Estimated Budget Effects of the Tax Provisions Contained in an Amendment in the Nature of a Substitute to H.R. 1424, Scheduled for Consideration on the Senate Floor on October 1, 2008*, JCX-78-08 (Washington, D.C.: Oct. 1, 2008), and by adding estimated revenue effects from *Estimates of Federal Tax Expenditures for Fiscal Years 2008-2012*, JCS-2-08 (Washington, D.C.: Oct. 31, 2008), and *Estimates of Federal Tax Expenditures for Fiscal Years 2009-2013*, JCS-1-10 (Washington, D.C.: Jan. 11, 2010).

estimates suggest that the exclusion may result in federal revenue losses of about $1.4 billion from FY 2008 through FY 2013.[3] Some taxpayers with forgiven mortgage debts may be bankrupt or insolvent; however, others are not and therefore may have the ability to pay taxes on forgiven mortgage debts.

The briefing contained in appendix I, provided to your offices on July 28, 2010, and subsequently updated, summarizes our assessment of the Internal Revenue Service's (IRS) administration of this tax provision. In response to your request, our objectives were to identify

1. the number of taxpayers who have reported the exclusion of forgiven mortgage debt since the program's inception and the dollar amount excluded;
2. the challenges, if any, IRS faces in administering the exclusion and evaluate how effectively IRS is addressing the challenges; and
3. the challenges, if any, taxpayers could face in understanding whether forgiven mortgage debt can be excluded from taxable income and evaluate how to address these challenges.

To meet these objectives, we worked with IRS officials to determine the availability of information on the tax treatment of forgiven mortgage debt; analyzed IRS data on the number and dollar amounts of cancelled debts between 2007 and June 2010; analyzed related forms and publications, education and outreach materials, and actions taken by IRS to inform taxpayers, tax software companies, and paid preparers about the tax treatment of cancelled mortgage debt; reviewed a selected sample of tax preparation software packages from tax software providers that cover 90 percent of the market; and interviewed IRS officials and housing market experts familiar with the current condition of the housing market, including trends in foreclosure and debt cancellation. We interviewed IRS officials about how they produced estimates on the number and dollar amount of forgiven debts and the reliability of those estimates. We also interviewed housing market experts that we frequently consult about data such as foreclosures and home sales, and determined that the data included in this briefing were sufficiently reliable for our purposes.

[3] To calculate this number we added revenue loss estimates from the President's budget requests for fiscal years 2010 and 2011 dated February 26, 2009, and February 1, 2010, respectively.

We conducted this performance audit from July through August 2010 in accordance with generally accepted government auditing standards. Those standards require that we plan and perform the audit to obtain sufficient, appropriate evidence to provide a reasonable basis for our findings and conclusions based on our audit objectives. We believe that the evidence obtained provides a reasonable basis for our findings and conclusions based on our audit objectives.

Background

Taxpayers are to report all cancelled debt, including mortgage debt, excludable from taxable income by completing Form 982, "Reduction of Tax Attributes Due to Discharge of Indebtedness (and Section 1082 Basis Adjustment)." Taxpayers use Part 1 of this form to report reasons why cancelled debt can be excluded from taxable income. Taxpayers who are in bankruptcy or insolvent are to exclude their forgiven mortgage debt under the bankruptcy or insolvency category on the Form 982. Taxpayers with forgiven mortgage debt who are not bankrupt or insolvent are to exclude forgiven mortgage debt under the qualified principal residence category on the Form 982. Thus, these taxpayers may have the ability to pay taxes on forgiven debts because they are not in bankruptcy or insolvent. Lenders report all types of cancelled debts to IRS on Form 1099-C, "Cancellation of Debt."

With some exceptions, a cancelled or modified debt is considered taxable income for taxpayers who are not insolvent or in bankruptcy. Without the Mortgage Forgiveness Debt Relief Act and its extension, millions of homeowners currently facing foreclosure could be liable for income taxes on the discharge of debt on their principal residence.

Results

IRS estimates suggest the dollar amount of forgiven mortgage debt excluded from income could be significant. IRS Statistics of Income (SOI) officials estimate that for tax year 2008, the most current tax year for which data are available, about 126,000 to 169,000 returns included a Form 982, excluding a total of about $15.2 billion to $24.6 billion of forgiven debt from taxable income. IRS estimates suggest that for about 61,000 to 93,000 of the returns with a Form 982, forgiven debt for a qualified principal residence was the only type of forgiven debt, and taxpayers excluded about $6.4 billion to $11.8 billion from taxable income. Additionally, because taxpayers excluding multiple types of debt from income are only required to report the total amount being excluded and not the amount for each individual type, IRS lacks data to determine the dollar amount of forgiven mortgage debt excluded for these taxpayers.

IRS faces several compliance challenges in administering this complicated tax provision. IRS officials reported that it may be difficult to collect additional taxes on forgiven debts, particularly when taxpayers are already insolvent and defaulting on debts, and that this and other considerations, such as IRS's return on investment, would affect IRS's decisions about allocating resources for enforcing this provision. However, as noted above, there is evidence some taxpayers have the ability to pay additional tax if owed, and certain housing market data show that the potential for significant noncompliance with the exclusion of forgiven mortgage debt exists. For example, housing market experts who publish regular foreclosure and delinquency surveys confirmed to us that mortgages on vacation and investment homes may account for a substantial portion of current delinquencies and foreclosures. Over the last 5 years, vacation home and investment property purchases are estimated to have ranged from 40 percent (2005) to 27 percent (2009) of home sales.[4] Current IRS forms provide limited information on mortgage debt forgiveness and IRS is not making full use of all available data. For example,

- Form 982 does not contain enough information to allow IRS to check for compliance because the form cannot be easily matched against information received from lenders on Form 1099-C. Form 982, Part 1 uses check boxes instead of dollars to report the amount of forgiven debt being excluded. As a result, IRS cannot determine what dollar amounts are being excluded for each type of qualified cancelled debt.

- Form 1099-C instructions ask lenders to provide an open-ended description of the type of cancelled debt, but do not require the lender to uniformly identify the specific type of cancelled debt. For example, the form does not use a series of check boxes or apply codes so that lenders could select among a list of common cancelled debt types (e.g., mortgage, home equity line of credit, credit card, auto loan, etc.).

- Neither Form 982 nor Form 1099-C requires the taxpayer or lender to disclose the address of the property secured by the forgiven debt. According to IRS officials, collecting such information might not result in a perfect match in all cases across the two forms. However, it would allow IRS to better determine whether the forgiven debt is for a principal residence. Further, we previously recommended, that IRS consider collecting the address of the secured property on Form 1098, "Mortgage Interest Statement," for taxpayers deducting mortgage

[4]National Association of Realtors, *Investment and Vacation Home Buyers Survey, 2010.*

interest to help determine the home's use and eligibility for the deduction and improve compliance for taxpayers reporting rental real estate activity. IRS agreed to study the issue.[5]

- Without being able to systematically identify whether the forgiven debt is for a mortgage, IRS also cannot identify taxpayers who may be eligible for the provision, but are not taking advantage of it.

- IRS is not using available internal or third-party data to determine whether taxpayers with forgiven mortgage debt own multiple homes—also a potential indicator that the forgiven debt is not for a principal residence.

Without having an estimate of the extent of noncompliance, IRS is unable to determine whether additional resources should be dedicated to compliance monitoring for mortgage debt forgiveness or if automated compliance checks are needed.

At the same time, little concrete information exists to measure the extent to which paid preparers and taxpayers experience difficulty adhering to mortgage debt forgiveness provisions due to the complexity of the law, IRS forms, and instructions. However, anecdotal evidence suggests IRS's forms and instructions and the related tax laws are difficult to understand. For example, IRS officials acknowledged that the law is confusing and the National Taxpayer Advocate described Form 982 as "technically challenging."[6] As a result, IRS has taken actions to reduce the complexity associated with filing the Form 982, including revising the form's instructions and engaging in outreach to paid preparers and software providers on cancelled debt. Currently, the most frequently used commercial software packages provide varying degrees of support for Form 982. In addition, IRS has not explored several low-cost and easy-to-implement options that could help it clarify how to treat forgiven mortgage debt for tax purposes. These options include the following:

[5]GAO, *Home Mortgage Interest Deduction: Despite Challenges Presented by Complex Tax Rules, IRS Could Enhance Enforcement and Guidance*, GAO-09-769 (Washington, D.C.: July 29, 2009) and *Tax Gap: Actions that Could Improve Rental Real Estate Reporting Compliance*, GAO-08-956 (Washington, D.C.: Aug. 28, 2008).

[6]The National Taxpayer Advocate assists taxpayers in resolving problems with IRS, and is appointed by the Secretary of the Treasury and reports to the Commissioner of Internal Revenue, although her views do not necessarily reflect the position of IRS, the Treasury Department, or the Office of Management and Budget.

- Releasing to paid preparers, software companies, or taxpayers an existing interactive tool on cancellation of debt which is similar to tools already released for other tax laws in that it enables users to navigate a series of questions about taxpayers' particular cancelled debt circumstances. IRS officials reported that making this tool publicly available would introduce some additional costs. However, based on our observation of the tool, it may clarify the tax treatment of forgiven debt, including mortgage debt, for tax purposes.

- Using telephone software to analyze the reasons why taxpayers call IRS with questions about the tax treatment of forgiven mortgage debt.

- Encouraging software companies to provide more interactive features that would help taxpayers answer a series of questions about more complex cancelled debt situations, and, if applicable, subtract ineligible amounts of debt from the total being excluded from income.

Conclusions

IRS is responsible for enforcing complex tax laws and must consider trade-offs when allocating its enforcement resources, such as the ability to collect assessed taxes and return on investment. Deteriorating trends in the housing market have led to an increase in the number and amount of forgiven mortgage debts, which have complex tax consequences. However, IRS is missing opportunities to both identify noncompliance and assist eligible taxpayers in excluding forgiven mortgage debt before the provision expires at the end of 2012. Revising the forms, collecting more information from taxpayers and lenders, and using third-party data would help IRS determine whether taxpayers are correctly excluding mortgage debt from taxable income and whether IRS needs to dedicate additional resources to this issue. Further, providing greater assistance to taxpayers and expanding outreach to stakeholders are low-cost solutions that could help better highlight the potential tax consequences of cancelled debts.

Recommendations for Executive Action

We recommend that the Commissioner of Internal Revenue take the following nine actions.

To enhance IRS's ability to detect noncompliance with mortgage debt forgiveness provisions,

(1) modify Form 982, Part 1 to segregate the total dollar amount of forgiven debt by exclusion type and capture the information in IRS's databases;

(2) modify Form 1099-C to require lenders to identify in a more useable format (check boxes or coding, for example) the specific type of cancelled debt and capture the information in IRS's databases;

(3) modify the Form 982 and Form 1099-C so that filers disclose the address of the secured property for which the debt is being forgiven and capture the information in IRS's databases;

(4) determine if available data (including IRS and third-party data) would allow IRS to better identify whether the debt being excluded is for a principal residence; and

(5) use the additional data reported on the revised Form 982 and Form 1099-C to assess the extent to which taxpayers are compliant.

To provide better information for paid preparers and taxpayers to determine eligibility for excluding forgiven mortgage debt from taxable income, explore and implement readily available low-cost options to help clarify the tax treatment of forgiven debt, including options such as

(6) make IRS's interactive tool for cancelled debt publicly available for the 2011 filing season;

(7) use IRS's telephone software to obtain better information about why, if at all, taxpayers call IRS with questions about forgiven mortgage debt;

(8) work with software companies to more fully support complex debt cancellation issues, particularly those related to forgiven mortgage debts; and

(9) either send notices to taxpayers when a lender files a Form 1099-C indicating a forgiven mortgage and the taxpayer does not file a Form 982 or document that the costs of doing so would exceed the benefits.

Agency Comments

We provided a draft of this report to the Commissioner of Internal Revenue. We received written comments from the Deputy Commissioner, Services and Enforcement; his comments are reprinted in appendix II. He stated that IRS agreed with five of the nine recommendations and said that the other four, related to making changes to the Forms 982 and 1099-C and collecting the resulting data, have significant value. However, the Deputy Commissioner raised the question of whether the costs of making the changes would outweigh the benefits and said that before taking action on the four recommendations, IRS would ascertain the costs and benefits.

We agree that costs and benefits should be considered, but we are not sure a useful estimate is possible in this case. As our report states and IRS acknowledges, the lack of data presents challenges in estimating the extent of noncompliance and, therefore, the benefits of additional IRS action. The Deputy Commissioner stated that IRS will review a sample of tax returns filed with Form 982 and analyze available third-party data to determine the character of the cancelled debt. However, our report—based on interviews with IRS officials—said that the available third-party data reported on Form 1099-C do not contain information in a format that could help to systematically determine eligibility. Thus, IRS's review of a sample of tax returns using only currently available data risks understating the benefits of additional information reporting. To avoid the challenge of developing a complete benefit estimate, we recommended that IRS make relatively minor changes to the Forms 982 and 1099-C that would not impose significant additional burden on taxpayers or third parties. By collecting such additional data, albeit at some cost, IRS would be better positioned to determine whether additional resources are needed to monitor compliance with forgiven mortgage debt rules.

IRS also provided technical changes to the report, which we incorporated where appropriate.

As agreed with your offices, unless you publicly announce the contents of this report earlier, we plan no further distribution until 30 days from the report date. At that time, we will send copies to the Chairmen and Ranking Members of other Senate and House committees and subcommittees that have appropriation, authorization, and oversight responsibilities for IRS. We will also send copies to the Commissioner of Internal Revenue, the Secretary of the Treasury, the Chairman of the IRS Oversight Board, and the Director of the Office of Management and Budget. The report also will be available at no charge on the GAO Web site at http://www.gao.gov.

If you or your staff have any questions or wish to discuss the material in this report further, please contact me at (202) 512-9110 or at whitej@gao.gov. Contact points for our Offices of Congressional Relations and Public Affairs may be found on the last page of this report. Major contributors to this report were Joanna Stamatiades, Assistant Director; Amy Bowser; James Cook; John Dell'Osso; Tom Gilbert; Mark Kehoe; Kirsten Lauber; Patricia MacWilliams; Jessica Thomsen; Benjamin Wories; and Jeff Wojcik.

James R. White

James R. White
Director, Tax Issues
Strategic Issues

Appendix I: Updated Slides from the July 28, 2010 Congressional Briefing

Tax Administration: Expanded Information Reporting Could Help IRS Address Compliance Challenges with Forgiven Mortgage Debt

Senate Committee on Finance

House Committee on Ways and Means, Subcommittee on Oversight

1

Mortgage Debt Forgiveness Objectives

1. How many taxpayers have reported the exclusion of forgiven mortgage debt from taxable income since the program's inception and what is the total dollar amount excluded?

2. What challenges, if any, does IRS face in administering the exclusion of forgiven mortgage debt from taxable income and how effectively is IRS addressing the challenges?

3. What challenges, if any, could taxpayers face in understanding whether forgiven mortgage debt can be excluded from taxable income and what steps can be taken to address these challenges?

2

Results

- IRS estimates suggest the dollar amount of forgiven mortgage debt excluded from income could be significant.

- Although conditions in the current housing market suggest that the potential for significant noncompliance exists, IRS is unable to measure the extent to which taxpayers are compliant with the mortgage debt forgiveness exclusion. Information provided on IRS Forms 982 and 1099-C does not allow IRS to systematically check for noncompliance, nor does IRS require lenders or taxpayers to report the address of the property secured by the mortgage debt being forgiven. Without such information, IRS is unable to determine what additional resources, if any, are needed to ensure compliance.

- The complexity of tax provisions regarding forgiven mortgage debt, as well as IRS forms and instructions, makes it difficult for taxpayers to determine whether and what portion of forgiven mortgage debt can be excluded from income. However, IRS has not explored several low-cost options that would be relatively easy to implement and would help clarify the tax treatment of forgiven debt for tax purposes including making existing interactive tools available, using existing telephone software, and conducting further outreach to external stakeholders.

3

Scope and Methodology

- To accomplish our objectives, we
  - worked with IRS officials to determine the availability of information related to the tax treatment of forgiven mortgage debt;
  - analyzed IRS data concerning the number and dollar amount of cancelled debts from 2007 through June 2010;
  - analyzed related forms and publications, education and outreach materials, and actions taken by IRS to inform taxpayers, tax software companies, and paid preparers about the tax treatment of cancelled mortgage debt;
  - reviewed how tax software packages from companies that cover 90 percent of the market treat forgiven mortgage debt; and
  - interviewed IRS officials about a variety of issues, and housing market experts from an industry association and a private research company familiar with the current condition of the housing market, including trends in foreclosure and debt cancellation.
- We conducted this performance audit from July 2010 through August 2010 in accordance with generally accepted government auditing standards. We interviewed IRS officials and housing market experts about available data and determined that the data included in this briefing were sufficiently reliable our purposes.

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Background

- The Mortgage Forgiveness Debt Relief Act of 2007 (P.L. 110-142) generally allows homeowners to exclude forgiven mortgage debt from taxable income for a principal residence (subject to a variety of restrictions that introduce varying degrees of complexity) from 2007 to 2009. The Emergency Economic Stabilization Act of 2008 (P.L. 110-343) extended this through 2012.
  - Includes both debt forgiven through foreclosure and loan modification as long as discharge of debt was due to a decline in the value of the residence or the financial condition of the taxpayer.
  - The mortgage debt must have been used to buy, build, or substantially improve a principal residence and must be secured by the property.
- Historically, if a lender cancelled a debt, it has been subject to taxes, with exceptions made for taxpayers who are insolvent or in bankruptcy.

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Background (cont.)

- Taxpayers report mortgage debt excluded from taxable income by completing Form 982, “Reduction of Tax Attributes Due to Discharge of Indebtedness (and Section 1082 Basis Adjustment).” Part 1 of this form is used to report reasons why cancelled debt can be excluded from taxable income, including
  - bankruptcy,
  - insolvency,
  - qualified farm indebtedness,
  - qualified real property business indebtedness,
  - qualified Midwestern disaster area indebtedness, or
  - qualified principal residence indebtedness.
- Lenders report all types of cancelled debts to IRS on Form 1099-C, “Cancellation of Debt.”

6

Background (cont.)

- Joint Committee on Taxation (JCT) estimates originally suggested that the exclusion of forgiven mortgage debt from taxable income may result in about $968 million in federal revenue losses from fiscal year (FY) 2008 through FY 2013 and more recent estimates suggest that the revenue losses could be closer to $1.9 billion.[1] The Department of Treasury estimates suggest that the exclusion may result in federal revenue losses of about $1.4 billion from FY 2008 through FY 2013.[2]
    - This suggests that not all taxpayers with forgiven mortgage debt are bankrupt or insolvent and may have the ability to pay taxes on forgiven debts.
        - Taxpayers who are in bankruptcy or insolvent are to exclude forgiven mortgage debt under the bankruptcy or insolvency category on Form 982.
        - Taxpayers with forgiven mortgage debt who are not bankrupt or insolvent are to exclude forgiven mortgage debt under the qualified principal residence category on Form 982.

[1] We added JCT estimated revenue effects from JCX-118-07, Dec. 18, 2007, and JCX-78-08, Oct. 1, 2008, and from JCS-2-08, Oct. 31, 2008, and JCS-1-10, Jan. 11, 2010.

[2] We added revenue loss estimates from the President's fiscal years 2010 and 2011 budget requests, Feb. 26, 2009, and Feb. 1, 2010, respectively.

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Objective 1: IRS Estimates Suggest the Dollar Amount of Forgiven Mortgage Debt Excluded from Income Could be Significant

- Based on a sample of 2008 tax returns, IRS Statistics of Income (SOI) officials estimate that for tax year (TY) 2008, about 126,000 to 169,000 returns included a Form 982, excluding a total of about $15.2 billion to $24.6 billion of forgiven debt from taxable income.
  - IRS estimates also suggest that for about 61,000 to 93,000 of the returns with a Form 982, debt for qualified principal residence was the only type of forgiven debt, and taxpayers excluded about $6.4 billion to $11.8 billion from taxable income.
- Because taxpayers excluding multiple types of debt only report the total amount being excluded, and not individual debt amounts, IRS lacks the data to determine the dollar amount of forgiven mortgage debt excluded for these taxpayers.

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Objective 2: IRS Challenges – Potential for Significant Noncompliance Exists

- In the absence of detailed audits, IRS does not know the extent of noncompliance for forgiven mortgage debt. However, we identified several conditions suggesting the potential for significant noncompliance exists.

    1. Housing market data show significant amounts of forgiven mortgage debt could be taxable income.

        - Real estate market experts estimate that, in 2010, over 3 million foreclosure filings will take place, while about 1 million homes will be repossessed by lenders.[3] Housing market experts who publish regular foreclosure and delinquency surveys confirmed to us that mortgages on vacation and investment homes may account for a substantial portion of current delinquencies and foreclosures. Over the last 5 years, vacation home and investment property purchases are estimated to have ranged from 40 percent (2005) to 27 percent (2009) of home sales.[4]

            - Taxpayers who own second homes or investment properties may differ in their ability to pay taxes than taxpayers with a single residence.

        - During the height of the housing market, homeowners withdrew increasing amounts of housing-secured equity through refinancing, second mortgages, and lines of credit. Estimates of the amount withdrawn in 2005 range from $301 billion to 515 billion.[5] However, IRS is unable to determine whether the proceeds from these loans were used to buy, build, or substantially improve a principal residence.

[3] Realty Trac, *Midyear 2010 U.S. Foreclosure Market Report,* July 15, 2010.
[4] National Association of Realtors, *Investment and Vacation Home Buyers Survey, 2010.*
[5] Freddie Mac, *Refinance Report,* 1st Quarter 2010, April 28, 2010, and Alan Greenspan and James Kennedy, *Sources and Uses of Equity Extracted from Homes*, Federal Reserve Board 2007-20 (Washington, D.C.: March 2007).

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IRS Challenges – Potential for Significant Noncompliance Exists (cont.)

2. IRS data show a significant increase in the amount and number of cancelled debts since TY 2007.

   - IRS estimates the amount of cancelled debt reported on Form 1099-C has increased over 10 times—from about $19 billion worth of debt in TY 2007 to about $216 billion worth of debt for TY 2009 (as reported to IRS through June 2010).

   - The number of Form 1099-Cs has increased about 80 percent from about 2 million debts to about 3.6 million debts.

   - However, IRS is unable to identify the extent to which this increase is attributable to foreclosures and mortgage modifications, and particularly to debt attributable to a principal residence.

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IRS Challenges – Potential for Significant Noncompliance Exists (cont.)

3. IRS dedicates minimal resources in this area and is unable to report how many returns have been subject to further examination due to cancellation of debt issues, including forgiven mortgage debt.

   - The Automated Underreporter (AUR) program does not pursue underreported income from cancelled debts over certain thresholds based on the assumption that such cancelled debts would be for mortgages and yield little change in the amount of tax owed.
   - Using a rationale similar to AUR, the Wage and Investment examination division does not include cancelled debts or mortgage debt forgiveness as part of the examination process.
   - The Small Business/Self-Employed division may include mortgage cancellations as part of broader audits of taxpayers, including requiring taxpayers to supply supporting documentation related to debt cancellation.

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IRS Challenges – Potential for Significant Noncompliance Exists (cont.)

- According to IRS officials, it may be difficult to collect additional taxes on forgiven debts, particularly when taxpayers are already insolvent and defaulting on debts, and that this and other considerations, such as return on investment, would affect IRS's decisions about allocating resources for enforcing this provision.
- There is evidence that some taxpayers have the ability to pay additional tax, if owed.
    - JCT and Treasury revenue loss estimates suggest that without the exclusion, forgiven mortgage debts would generate federal revenue.
    - Taxpayers selecting the qualified principal residence category on the Form 982 are indicating that they are not in bankruptcy or insolvent because if they were, they would be claiming the exclusion under the "bankruptcy" or "insolvency" category on the Form 982 (as we noted earlier).

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IRS Challenges – Current IRS Forms Provide Limited Information on Mortgage Debt Forgiveness

- Several limitations with Form 982 and Form 1099-C make it difficult for IRS to measure noncompliance.
  - Form 982 does not contain enough information to allow IRS to check for compliance because the form cannot be matched against information received from lenders on Form 1099-C.
    - Form 982, Part 1 uses check boxes instead of dollars to report the amount of forgiven debt being excluded. As a result, IRS cannot determine what dollar amounts are being excluded for each type of qualified cancelled debts.

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IRS Challenges – Current IRS Forms Provide Limited Information on Mortgage Debt Forgiveness (cont.)

- Possible changes to Form 982 to enhance compliance

Form **982** (Rev. March 2009)
Department of the Treasury Internal Revenue Service

Reduction of Tax Attributes Due to Discharge of Indebtedness (and Section 1082 Basis Adjustment)

▶ Attach this form to your income tax return.

OMB No. 1545-0046
Attachment Sequence No. **94**

Name shown on return | **Identifying number**

Part I **General Information** (see instructions)

1 Amount excluded is due to (check applicable box(es)):
a Discharge of indebtedness in a title 11 case . . . . ☐
b Discharge of indebtedness to the extent insolvent (not in a title 11 case) . . . . ☐
c Discharge of qualified farm indebtedness . . . . ☐
d Discharge of qualified real property business indebtedness . . . . ☐
e Discharge of qualified principal residence indebtedness . . . . ☐
f Discharge of certain indebtedness of a qualified individual because of Midwestern disasters . . . . ☐
2 Total amount of discharged indebtedness excluded from gross income. 2
3 Do you elect to treat all real property described in section 1221(a)(1), relating to property held for sale to customers in the ordinary course of a trade or business, as if it were depreciable property?. . . . . . . ☐ Yes ☐ No

Check boxes could be replaced with actual dollar amount of the cancelled debt that the taxpayer is excluding from income.

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IRS Challenges – Current IRS Forms Provide Limited Information on Mortgage Debt Forgiveness (cont.)

- Form 1099-C does not provide information in a format that could help determine eligibility, including what type of debt (mortgage, credit card, car loan, etc.) is being forgiven.
    - Although IRS receives nearly all 1099-C information returns electronically, the information cannot be used by itself to determine whether the cancelled debt is for a mortgage. IRS instructions ask lenders to be as specific as possible when describing the type of debt being forgiven, but do not require lenders to uniformly identify the specific type of cancelled debt. For example, lenders filing 1099-Cs do not select from a list of types of forgiven debt when completing box 4, which describes the type of debt being forgiven. Because box 4 is an open-ended description, IRS is unable to code or quantify cancelled debts by type.
    - Without being able to systematically identify whether the forgiven debt is for a mortgage, IRS also cannot identify taxpayers who may be eligible for the provision, but are not taking advantage of it.

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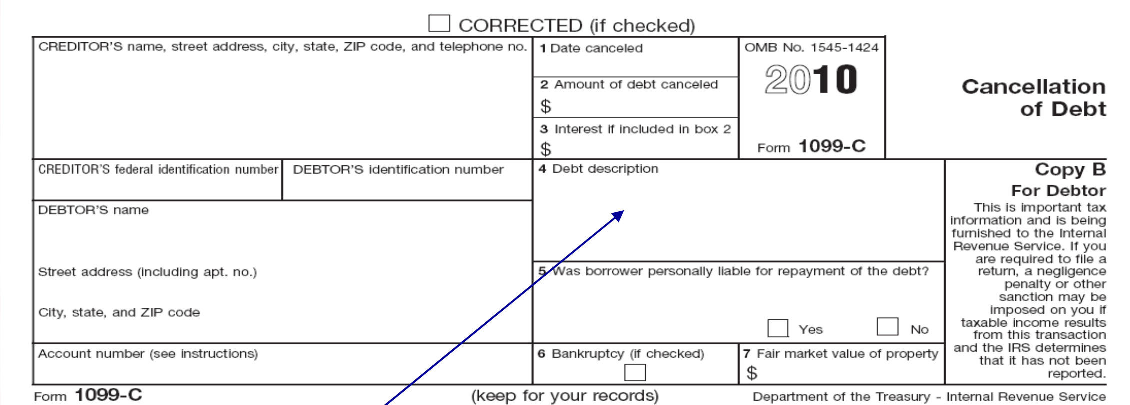
IRS Challenges – Current IRS Forms Provide Limited Information on Mortgage Debt Forgiveness (cont.)

- Possible changes to Form 1099-C to enhance information reporting.



☐ CORRECTED (if checked)

CREDITOR'S name, street address, city, state, ZIP code, and telephone no.		1 Date canceled 2 Amount of debt canceled $ 3 Interest if included in box 2 $	OMB No. 1545-1424 2010 Form 1099-C	Cancellation of Debt
CREDITOR'S federal identification number	DEBTOR'S identification number	4 Debt description		Copy B For Debtor This is important tax information and is being furnished to the Internal Revenue Service. If you are required to file a return, a negligence penalty or other sanction may be imposed on you if taxable income results from this transaction and the IRS determines that it has not been reported.
DEBTOR'S name Street address (including apt. no.) City, state, and ZIP code		5 Was borrower personally liable for repayment of the debt? ☐ Yes ☐ No		
Account number (see instructions)		6 Bankruptcy (if checked) ☐	7 Fair market value of property $	

Form 1099-C (keep for your records) Department of the Treasury - Internal Revenue Service

Possible modifications

- Box 4 could include a type of debt indicator (e.g., check boxes or codes that would disclose the type of debt).
- If the debt is a mortgage, lenders could report which type (e.g., acquisition, refinance, home equity, etc.).

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IRS Challenges – Current IRS Forms Provide Limited Information on Mortgage Debt Forgiveness (cont.)

- Neither Form 982 nor Form 1099-C requires the taxpayer or lender to disclose the address of the property secured by the forgiven debt. According to IRS officials, collecting such information might not result in a perfect match across the two forms in all cases. However, it would allow IRS to better determine whether the forgiven debt is for a principal residence.
    - For example, IRS would be able to check whether the forgiven mortgage debt is for the same address reported on current and prior year Form 1040s, "U.S. Individual Tax Return" (which is likely to be the taxpayer's principal residence).
    - We previously recommended that IRS collect the address of the secured property for taxpayers deducting mortgage interest, which could help determine the home's use and eligibility for the deduction, and could improve compliance for taxpayers reporting rental real estate activity.[6]
- IRS is not using available data (internal or third party) to determine whether taxpayers with forgiven mortgage debt own multiple homes—also a potential indicator that the forgiven debt is not on a principal residence.

[6] GAO, *Home Mortgage Interest Deduction: Despite Challenges Presented by Complex Tax Rules, IRS Could Enhance Enforcement and Guidance*, GAO-09-769 (Washington, D.C.: July 29, 2009) and *Tax Gap: Actions that Could Improve Rental Real Estate Reporting Compliance*, GAO-08-956 (Washington, D.C.: Aug. 28, 2008).

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IRS Challenges – Current IRS Forms Provide Limited Information on Mortgage Debt Forgiveness (cont.)

- These limitations prevent IRS from determining whether the forgiven debt can be excluded from taxable income.
- However, if IRS were to modify and capture information from Form 982 and Form 1099-C, it could better measure noncompliance.
  - Without having an estimate of the extent of noncompliance, IRS is unable to determine whether additional resources should be dedicated to compliance monitoring for mortgage debt forgiveness or if automated compliance checks are needed.
- AUR officials generally agreed that modifications to Form 982 and Form 1099-C would place little burden on IRS and taxpayers and allow IRS to better verify the type of debt and amount that can be excluded.

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Objective 3: Taxpayer Challenges - Complexities Exist in Reporting Forgiven Mortgage Debt

- Little concrete information exists to measure the extent to which paid preparers and taxpayers experience difficulty adhering to mortgage debt forgiveness provisions due to the complexity of the law, IRS forms, and instructions.
  - However, anecdotal evidence suggests IRS's forms and instructions and the related tax laws are difficult to understand. For example:
    - IRS officials acknowledged that the mortgage debt forgiveness law is complex.
    - The National Taxpayer Advocate described Form 982 as "technically challenging."
    - The Center for Responsible Lending (a nonprofit organization that seeks to eliminate abusive financial practices) characterized Form 982 as "a very complicated and difficult form."

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Taxpayer Challenges - Complexities Exist in Reporting Forgiven Mortgage Debt (cont.)

- Examples illustrating the complexity of Form 982 and its instructions include:
  - multiple types of cancelled debts are reported on Form 982 by both individuals and businesses;
  - title of Form 982 is difficult to understand – "Reduction of Tax Attributes Due to Discharge of Indebtedness (and Section 1082 Basis Adjustment)";
  - Form 982 consists of 23 lines with four pages of instructions and includes technical terms such as "basis reduction" and "debt discharged"; and
  - Form 982 instructions attempt to explain a difficult-to-understand "ordering rule" that requires taxpayers to distinguish between qualified and nonqualified debt.

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Taxpayer Challenges - Complexities Exist in Reporting Forgiven Mortgage Debt (cont.)

- IRS has taken actions to reduce the complexity associated with filing Form 982, including:
  - Revising Form 982 instructions and Publication 4681, *Cancelled Debts, Foreclosures, Repossessions, and Abandonments*, to explain the requirements for excluding forgiven mortgage debt.
  - Engaging in outreach to paid preparers and software providers on cancelled debt, including providing presentations and conducting focus groups at tax forums, and issuing press releases and other publications to clarify the tax treatment of forgiven mortgage debt.
    - ✓ IRS officials said that paid preparers and software providers have asked few questions about how forgiven mortgage debt should be treated for tax purposes.

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Taxpayer Challenges - Complexities Exist in Reporting Forgiven Mortgage Debt (cont.)

- IRS has not explored several options that would be relatively easy to implement and with some additional cost could help clarify how to treat forgiven mortgage debt for tax purposes. For example,
    - Beginning in March 2010, IRS pilot-tested several interactive tax assistant tools on its Web site (e.g., Child Tax Credit, and Making Work Pay Tax Credit). These tools are similar to commercial tax preparation products. IRS officials reported that the test was successful with a high completion rate for available issues. Further, they expect to expand the number of interactive tools on IRS's Web site for more complex tax law issues in the 2011 filing season and beyond.
    - Although IRS developed an interactive tool for cancelled debt that is used by IRS telephone and walk-in employees, IRS did not make the tool publicly available in 2010 because it was not part of the pilot test.
    - IRS officials reported that making this tool publicly available would introduce some additional costs. However, based on our observation of the tool, it may clarify the tax treatment of forgiven debt, including mortgage debt, for tax purposes. Further, because the tool provides information on all types of forgiven debts excluded from income, it would be of value beyond 2012, when the exclusion for mortgage debt expires.

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Taxpayer Challenges - Complexities Exist in Reporting Forgiven Mortgage Debt (cont.)

- Another low-cost option that IRS has yet to explore would involve
  - using contact analytics software (which allows IRS to analyze recorded phone calls) to examine the reasons taxpayers call IRS with questions about forgiven mortgage debt. IRS is in the initial stages of using contact analytics for other purposes, and could leverage contact analytics to help understand why taxpayers are calling about mortgage or cancelled debt.

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Taxpayer Challenges - Complexities Exist in Reporting Forgiven Mortgage Debt (cont.)

- About 90 percent of returns are prepared by individual taxpayers or paid preparers using professional or commercial software.
    - IRS National Account Managers, through regularly scheduled conference calls, discuss issues of mutual interest with tax software companies, including tax law changes, updates to IRS forms and publications, and the upcoming tax filing season.
    - IRS also works with software companies on an ad hoc basis to influence and improve specific guidance provided by tax software regarding complicated tax provisions (e.g., Earned Income Tax Credit eligibility).

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Taxpayer Challenges - Complexities Exist in Reporting Forgiven Mortgage Debt (cont.)

- Currently, the most frequently used commercial software packages provide varying degrees of support for Form 982; although the major software packages generally support taxpayers with relatively simple forgiven mortgage debt situations, they provide more limited support for more complex situations, including instances where taxpayers have multiple forgiven debts.
  - Generally, these commercial software packages provide detailed interactive questionnaires or worksheets to calculate other complicated deductions (e.g., what portion of a homeowner’s expenses can be deducted for using a home office).

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Conclusions

- IRS is responsible for enforcing complex tax laws and must consider trade-offs when allocating its enforcement resources, such as the ability to collect assessed taxes and return on investment. Deteriorating trends in the housing market have led to an increase in the number and amount of forgiven mortgage debts, which have complex tax consequences. However, IRS is missing opportunities to both identify noncompliance and assist eligible taxpayers in excluding forgiven mortgage debt before the provision expires in 2012.
  - Revising the forms and using third-party information could provide IRS with more information to determine whether taxpayers are correctly excluding forgiven mortgage debt from income and whether IRS needs to dedicate additional resources to this issue.
  - Providing greater assistance to eligible taxpayers could help ensure that homeowners understand the potential tax consequences of cancelled debts, in particular foreclosures or mortgage modifications.
  - Expanding outreach efforts to external stakeholders, including software providers, could be part of an effort to reduce common types of misreporting related to cancellation of debt (including forgiven mortgages).

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Recommendations for Executive Action

- We recommend that the Commissioner of Internal Revenue take the following nine actions.
  - To enhance IRS's ability to detect noncompliance with mortgage debt forgiveness provisions,

1. modify Form 982, Part 1 to segregate the total dollar amount of forgiven debt by exclusion type and capture the information in IRS's databases;
2. modify Form 1099-C to require lenders to identify in a more useable format (check boxes or coding, for example) the specific type of cancelled debt and capture the information in IRS's databases;
3. modify the Form 982 and Form 1099-C so that filers disclose the address of the secured property for which the debt is being forgiven and capture the information in IRS's databases;
4. determine if available data (including IRS and third-party data) would allow IRS to better identify whether the forgiven debt is for a principal residence; and
5. use the additional data reported on the revised Form 982 and Form 1099-C to assess the extent to which taxpayers are compliant.

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Recommendations for Executive Action

- To provide better information for paid preparers and taxpayers to determine eligibility for excluding forgiven mortgage debt from taxable income, explore and implement readily available options that would not add significant additional costs, including options such as

6. make IRS's interactive tool for cancelled debt publicly available for the 2011 filing season;
7. use IRS's telephone software to obtain better information about why, if at all, taxpayers call IRS with questions about forgiven mortgage debt;
8. work with tax return preparation software companies to more fully support complex debt cancellation issues, particularly those related to forgiven mortgage debts; and
9. either send notices to taxpayers when a lender files a 1099-C indicating a forgiven mortgage and the taxpayer does not file a Form 982 or document that the costs of doing so would exceed the benefits.

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Appendix II: Comments from the Department of the Treasury

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

DEPUTY COMMISSIONER

August 27 2010

Mr. James R. White
Director, Tax Issues
U.S. Government Accountability Office
441 G Street, N.W.
Washington, DC 20548

Dear Mr. White:

We have reviewed your draft report entitled *Tax Administration: Expanded Information Reporting Could Help IRS Address Compliance Challenges with Forgiven Mortgage Debt*. We appreciate your recognition of the challenges the IRS faces in administering this complicated tax provision.

We appreciate your suggestions and comments on the possible improvements the IRS could make in administering the mortgage debt forgiveness issue through enhanced reporting and compliance measures. We also appreciate your recognition that there is currently little data available upon which IRS can measure the extent to which taxpayers and paid return preparers experience difficulty in complying with debt forgiveness provisions of the tax Code. The lack of detailed data also presents challenges in estimating the extent of non-compliance, and also in determining whether additional resources should be dedicated to compliance monitoring and/or automated compliance checks.

While we see significant value in your recommendations, we must first address the task of acquiring an accurate understanding of the costs of non-compliance in terms of lost revenue to the Treasury, additional administrative activities, and burden to the taxpayer and business communities. After ascertaining the costs and benefits, we will make a determination on whether or not the analysis supports the recommended changes to Form 982, *Reduction of Tax Attributes Due to Discharge of Indebtedness (and Section 1082 Basis Adjustment)* and Form 1099-C, *Cancellation of Debt*; additional compliance processing; and the provision of supplemental services and education through soft notices.

To determine the extent to which forgiven debts are not being correctly reported, we will conduct a sample review of Tax Year (TY) 2009 Forms 1040, *U.S. Individual Income Tax Return,* that were filed with Form 982. Our review will include a comprehensive analysis of tax return data and available third-party data necessary to determine the character of cancelled debt reported on the corresponding Forms 1099-C.

In addition to the need to perform a cost benefit analysis, any programming changes to our automated processing systems and requisite form layout changes cannot be fully implemented prior to the 2013 filing season (TY 2012 returns). We anticipate our review and analysis being completed in time to meet this same time frame should the results support adoption of the recommendations.

Responses to your specific recommendations are enclosed. If you have any questions, please contact Robin Canady, Director, Strategy and Finance, Wage and Investment Division, at (404) 338-8801.

Sincerely,

Steven T. Miller

Enclosure

Enclosure

To enhance IRS's ability to detect noncompliance with mortgage debt forgiveness provisions,

RECOMMENDATION 1
Modify Form 982, Part 1 to segregate the total dollar amount of forgiven debt by exclusion type and capture the information in IRS's databases;

COMMENT
We agree with this recommendation, however, implementation will be dependent on the change being supported by our cost benefit analysis. If the form is changed, we will also capture the dollar amount entries for further data analysis.

RECOMMENDATION 2
Modify Form 1099-C to require lenders to identify in a more useable format (check boxes or coding, for example) the specific type of cancelled debt and capture the information in IRS's databases;

COMMENT
We agree with this recommendation, however, implementation will be dependent on the change being supported by our cost benefit analysis. If the form is changed, we will also capture the identified debt type for further data analysis.

RECOMMENDATION 3
Modify the Form 982 and Form 1099-C so that filers disclose the address of the secured property for which the debt is being forgiven and capture the information in IRS's databases;

COMMENT
We agree with this recommendation, however, implementation will be dependent on the change being supported by our cost benefit analysis. If the forms are changed, we will also capture the addresses of the secured property for further data analysis.

RECOMMENDATION 4
Determine if available data (including IRS and third-party data) would allow IRS to better identify whether the debt being excluded is for a principal residence;

COMMENT
We agree with this recommendation. We will review a statistical sample of TY 2009 income tax returns filed with Form 982, *Reduction of Tax Attributes Due to Discharge of Indebtedness (and Section 1082 Basis Adjustment),* and compare to available third-party data to ascertain if forgiven debt is taxable or qualifies as an exclusion item. The intent of this review will be to determine the revenue loss to the Treasury from incorrect

taxpayer treatment of cancelled debt, and to compare that information to the additional administrative cost and taxpayer burden associated with the recommended form and administrative changes. Commensurate with the review, we will evaluate the benefits to be derived from recommended form changes and the additional resulting data that would become available.

RECOMMENDATION 5
Use the additional data reported on the revised Form 982 and Form 1099-C to assess the extent to which taxpayers are compliant.

COMMENT
We agree with this recommendation to use the additional data reported on the revised Form 982 and Form 1099-C, Cancellation of Debt, to assess the extent to which taxpayers are compliant. However, implementation of this recommendation is dependent on the outcome of our decision on whether or not to make the recommended changes. That decision, in turn, is dependent on the outcome of the cost benefit analysis we will perform to assess the extent of lost revenue, administrative costs, and taxpayer burden associated with the changes.

To provide better information for paid preparers and taxpayers to determine eligibility for excluding forgiven mortgage debt from taxable income, explore and implement readily available, low-cost options to help clarify the tax treatment of forgiven debt, including options such as

RECOMMENDATION 6
Make IRS's interactive tool for cancelled debt publicly available for the 2011 filing season;

COMMENT
We agree with this recommendation and will deploy the Cancellation of Debt tax law topic on IRS.gov for the Fiscal Year 2011 filing season.

RECOMMENDATION 7
Use IRS's telephone software to obtain better information about why, if at all, taxpayers call IRS with questions about forgiven mortgage debt;

COMMENT
We agree with this recommendation. The Information gathered from Contact Analytics (CA) will be used to ensure Customer Service Representatives (CSRs) have the information needed to answer questions on Mortgage Debt Forgiveness successfully. If deficiencies are identified, clarifications in the form of Internal Revenue Manual (IRM) procedural updates and Servicewide Electronic Research Program Alerts will be used to disseminate information to CSRs. The CA will also be utilized to target specific issues

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within the Mortgage Debt Forgiveness program to ensure that the full scope of the program is covered in the IRM. Success will be measured utilizing targeted reviews via the Centralized Quality Review System.

RECOMMENDATION 8
Work with software companies to more fully support complex debt cancellation issues, particularly those related to forgiven mortgage debts;

COMMENT
We agree with this recommendation. The IRS has robust partnerships with the tax return preparation software industry and uses diverse and multiple channels to engage them on matters of mutual interest and importance. The Electronic Tax Administration and Refundable Credits (ETARC) organization collaborates directly with industry to ensure they have first hand access to real time information and direct engagement with subject matter experts. Our most recent monthly industry call, held in August 2010, addressed mortgage debt forgiveness. Through this collaboration, IRS engaged industry to assist us in raising taxpayer awareness among the population that will most likely be affected by the mortgage debt forgiveness policy, and who will need to file a Form 982. As a result of this collaboration, industry agreed to include wherever feasible; interactive worksheets and other intelligent software features specifically for Form 982 filers to help them calculate what portion of a forgiven mortgage debt can be excluded from income. The ETARC organization will continue to provide this vigorous level of direct communications to the tax return preparation software industry.

RECOMMENDATION 9
Either send notices to taxpayers when a lender files a Form 1099-C indicating a forgiven mortgage and the taxpayer does not file a Form 982 or document that the costs of doing so would exceed the benefits.

COMMENT
We agree with this recommendation. We will either send notices to taxpayers or document that the costs of doing so exceed the benefit. Implementation of this recommendation will be dependent on the outcome of our decision on whether or not to make the recommended changes to Form 982 and Form 1099-C, which would provide the additional data needed to initiate a soft notice process for this issue. The decision to change Form 982 and Form 1099-C is, in turn, dependent on the outcome of the cost benefit analysis we will perform to assess the extent of lost revenue, administrative costs, and taxpayer burden associated with the changes.

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