United States Senate
WASHINGTON, DC 20510

August 11, 2015

The Honorable Jack Lew
Secretary
U.S. Department of the Treasury

The Honorable John Koskinen
Commissioner
Internal Revenue Service

Dear Secretary Lew and IRS Commissioner Koskinen:

As you are aware, on June 8, 2015, the Department of Education (ED) announced a streamlined process for settling and discharging the student loans of approximately 40,000 Corinthian students. The announced settlement and discharge process includes discharges for those who were induced into student loans through fraud and misrepresentation and those whose schools have closed down. On June 25, a Special Master was appointed to oversee this settlement process and make recommendations on loan discharges by August of this year. Should these discharges be considered taxable events, borrowers would be liable to remit payments to the U.S. Treasury by April 15, 2016.

Despite the Administration's ongoing commitment to provide discharges to Corinthian students, borrowers remain in the dark about the tax consequences of the Administration's actions. Neither students nor Congress have received clarity regarding the tax liability created by the Administration's proposed student loan discharge process. Furthermore, past guidance submitted to Congress by the Treasury Department has been inconsistent with the Higher Education Act's statutory requirements. Treasury has also insisted that the Department has given no timeline as to when they will issue guidance on these discharges. Furthermore, Treasury has indicated that, based on their preliminary analysis, they lack the authority to do so. We disagree.

We believe that existing statutory authority, administrative authority and case law affirm that defense to repayment discharges and closed school discharges are non-taxable events and as such are excluded from gross income and do not require the issuance of 1099-Cs. We ask that you issue public guidance accordingly.

I. Guidance on Tax Treatment of Closed School Discharges

In 1993, Congress inserted the following provision to the Higher Education Act's closed school discharge authority: "The amount discharged under this subsection shall be treated the same as loans under section 1087ee(a)(5) of this title."[1] Section 1087ee(a)(5) provides that "[t]he amount of a loan, and interest on a loan, which is canceled under this section shall not be

[1] Higher Education Act of 1965, Pub. L. 103–208, §2(c)(65), 107 Stat. 2469 (1993) (current version at 20 U.S.C. § 1087(a)(c)(4) (2012)).

considered income for purposes of Title 26."[2] The statutory language is unambiguous about closed school discharges being exempt from gross income.

Yet on September 18, 2008, the Department of the Treasury's Assistant Secretary for Tax Policy wrote to Congressman Sander Levin suggesting that student loan discharges were a taxable event. This letter analyzed multiple federal student loan discharges exclusively under I.R.C. section 108(f) and came to the conclusion that closed school discharges "do not satisfy the requirements for income exclusion under Code section 108(f)(1)." The letter did not consider the Higher Education Act provision excluding such discharges from income.

As a direct result of Treasury's letter, many students remain confused about the tax treatment of their student loans under closed school discharges. For example, Intuit's TurboTax question and answer page directly links to the Treasury Department's 2008 letter on multiple pages.[3] The National Consumer Law Center has received numerous questions from borrowers who located this Treasury Department letter online and were confused about their discharges.

Given the ongoing confusion created by the Treasury Department's letter and the unambiguous tax implications of 20 U.S.C.A. § 1087ee (a)(5), public guidance from Treasury or IRS is urgently needed to clarify that closed school discharges are not taxable.

II. Guidance on Tax Treatment of Defense to Repayment Discharges

The Education Department has also announced plans to cancel Corinthian borrowers' Federal Family Education Loans (FFEL) and Direct Loans based on its defense to repayment authority.[4] The following sections provide analysis of the statutory authority, administrative authority and case law that demonstrate that defense to repayment discharges should not be taxable as income.

A. General Welfare Exception

Since 1957, the Internal Revenue Service has consistently held that certain payments made under legislatively provided social benefit programs for promotion of the general welfare are not includible in a recipient's gross income.[5]

To qualify under the general welfare exception, payments must: (1) be made pursuant to a governmental program, (2) be for the promotion of the general welfare (that is, based on need), and (3) not represent compensation for services.[6] Although there are additional statutory

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[2] 20 U.S.C. § 1087ee(a)(5) (2012) .

[3] *See, e.g.*, Question Forum, Do I Have to Pay Taxes on Forgiven Student Loan Debts, https://ttlc.intuit.com/questions/2555252; Is My Son s Who Died on 6/7/14 Forgiven Student Loans Reported on 1099c Tax-table, https://ttlc.intuit.com/questions/2772631 (last visited on July 31, 2015).

[4] Press Release, Dep't of Educ., Fact Sheet: Protecting Students from Abusive Career Colleges (June 8th, 2015), http://www.ed.gov/news/press-releases/fact-sheet-protecting-students-abusive-career-colleges.

[5] *See e.g.*, Rev. Rul. 57-102, 1957-1 C.B. 26 (excluding payments to the blind from inclusion in income determinations); Rev. Rul. 75-271, 1975-2 C.B. 23 (excluding mortgage assistance payments from inclusion in income determinations); Rev. Rul. 74-205, 1974-1 C.B. 20 (excluding replacement housing payments from inclusion in income determinations).

[6] Rev. Proc. 2014-35, 2014-26 I.R.B. 1110.

requirements for Indian general welfare benefits, Section 139E was intended to coexist with the prior general welfare exception determinations and does not replace them.[7]

To satisfy the requirement that payments are for the promotion of the general welfare and are based on need, the Service has looked to many different forms of need rather than financial need exclusively. In Rev. Rul. 57-102, assistance based on blindness and age, rather than financial need, was sufficient to satisfy the general welfare requirement.[8] In Rev. Rul. 68-38, employment status, and a lack of education in construction, was a criterion for participation in a program that qualified for the social welfare exclusion.[9] This satisfied the requirements of the general welfare exception.

In 2002, the IRS explicitly referred to educational background as a valid criterion for determining whether government payments promoted the general welfare. IRS Notice 2002-76, which excluded residential grants made by the Lower Manhattan Development Corporation to individuals affected by 9/11 under the general welfare exception, states that "in the absence of a disaster, however, governmental payments made without regard to financial status, health, *educational background*, or employment status are not based on need and, thus, do not qualify under the general welfare exclusion."[10] The implication of this statement is that government payments contingent on educational background may satisfy the public need requirement of the general welfare exception to gross income.

Federal student loans are a social benefit program created by statute.[11] The forgiveness of these loans under defense to repayment authority is also provided by statute.[12] Individuals qualify for defense to repayment based, in part, on their educational background.[13] Relief is provided by a governmental unit and does not represent compensation for services. Under the General Welfare Exception, payments to individuals by governmental units, under legislatively provided social benefit programs, for the promotion of the general welfare, are not includible in a recipient's gross income. Therefore, defense to repayment discharges should be excluded from gross income and 1099-C's should not be issued.

B. Contingent Liabilities

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[7] Technical Explanation of the "Victims of Terrorism Tax Relief Act of 2001," Joint Committee on Taxation; JCX-93-01, pp 15-16.

[8] Rev. Rul. 57-102, 1957-1 C.B. 26. *See generally* 42 U.S.C. § 1381 (2012) (appropriating funding for the general welfare of persons over the age of 65, the blind, and the disabled).

[9] Rev. Rul. 68-38, 1968-1 C.B. 446. (noting that payments received in conjunction with participation in a federal vocational training program were not to be included in income determinations).

[10] I.R.S Notice 2002-76, Tax Treatment of Residential Grants Made by the Lower Manhattan Development Corp. to Individuals and Families Affected by the September 11th, 2001, Disaster, http://www.irs.gov/pub/irs-drop/n-02-76.pdf (last visited on Aug. 6, 2015).

[11] 20 U.S.C. § 1070(a) (noting that the purpose of the statute is to provide eligible borrowers with the benefit of a post-secondary education).

[12] 20 U.S.C. § 1087e(h) (2012) (establishing the authority of the secretary of education to establish the criteria for a defense of repayment claim).

[13] Dep't of Educ., Fact Sheet: Information about Debt Relief for Corinthian Colleges Students (noting that defense of repayment eligibility is dependent upon the fraudulent action being related to the educational services sought by the borrower), https://studentaid.ed.gov/sa/about/announcements/corinthian (last visited on Aug. 6, 2015).

Alternatively, Treasury should treat defense to repayment discharges as the removal of a contingent liability that did not give rise to true indebtedness at the time of issuance and that had no fair certainty of repayment.

A taxpayer does not have cancellation of indebtedness income if the discharged liability is contingent or indefinite to such a degree that it does not constitute a debt of the taxpayer.[14] If the debt is too contingent to be included in basis for federal income tax purposes at the time of the creation of the debt, then the taxpayer-debtor cannot realize income upon the release of the obligation because the debt never represented, in the first instance, an unconditional obligation to repay.[15] In a similar context, the Tax Court has held that a debt void under state usury laws is not a debt for purposes of the bad debt deduction under section I.R.C. § 166.[16] Under the freeing of assets theory of income, the discharge of contingent obligations also may not result in income since the assets were not encumbered.[17]

The relief offered to Corinthian students is not a loan forgiven *ex post*. The underlying obligation was contingent on the college not triggering any repayment defenses. Both Direct Loans and FEEL loans included terms at their origination, in the promissory note, in statute, and in regulation, providing borrowers with a defense to repayment and extinguishment of repayment obligations.[18] Student loans entered into by Corinthian students with the Department of

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[14] *See* Central Paper Co. v. Commissioner, 158 F.2d 131, 133 (6th Cir. 1946); Terminal Inv. Co. v. Commissioner, 2 T.C. 1004, 1015 (1943), *acq.*, 1944 C.B. 27 (Judge, Arnold) ("because of their contingent nature, certificates did not constitute an indebtedness and were without value, and the petitioner did not realize taxable income upon their surrender").

[15] *See* Treas. Reg. § 1.1001-2(a)(3); CRC Corp. v. Commissioner, 693 F.2d 281, 283 (3d Cir. 1982); Hotel Astoria, Inc. v. Commissioner, 42 B.T.A. 759 (1940), *acq. in result*, 1940-2 C.B. 4; N. Sobel, Inc. v. Commissioner, 40 B.T.A. 1263, 1265 (1939), *nonacq.*, 1940-1 C.B. 8; *see also* Bailey v. Commissioner, 90 T.C. 558, 615-19 (1988) (partnership's nonrecourse purchase money notes must be disregarded because the debts had no substance and thus are not includable in depreciation bases); La Rue v. Commissioner, 90 T.C. 465, 477-79 (1988) (reserves for potential liabilities to customers that were not fixed were not treated as "liabilities" which could increase bases of partners' interests in partnership); Estate of Baron v. Commissioner, 83 T.C. 542, 548-550 (1984) (debt too contingent to be included in basis), *aff'd*, 798 F.2d 65 (2d Cir. 1986); Long v. Commissioner, 71 T.C. 1, 7-8 (1978) (contingent liabilities not includable in basis until year of settlement), aff'd in part and rev'd in part on other grounds, 660 F.2d 416 (10th Cir. 1981); Yoc Heating Corp. v. Commissioner, 61 T.C. 168, 179 (1973) (contingent liabilities not includable in basis of assets); Albany Car Wheel Co. v. Commissioner, 40 T.C. 831, 841 (1963) (taxpayer may not increase cost basis of assets purchased by contingent liability), *aff'd in part*, 333 F.2d 653 (2d Cir. 1964) (per curiam); Redford v. Commissioner, 28 T.C. 773, 777-78 (1957) (contingent liabilities not includable in basis of assets); Rev. Rul. 88-77, 1988-2 C.B. 128 (accrued interest and accounts payable of cash basis partnership were not "liabilities" under § 752 which could increase bases of partners' interest in partnership, revoking Rev. Rul. 60-345, 1960-2 C.B. 211).

[16] *See* Tharp v. Commissioner, 31 T.C.M. (CCH) 22, 25 (1972) (noting that a contract is rendered void from its inception when one party is acting in direct violation of a regulatory provision made pursuant to a state's police powers).

[17] *See* Corporacion de Ventas de Salitre y Yoda de Chile v. Commissioner, 130 F.2d 141, 143 (2d Cir. 1942); Main Properties, Inc. v. Commissioner, 4 T.C. 364, 379 (1944), *acq.* 1945-1 C.B. 5; Terminal Inv. Co. v. Commissioner, 2 T.C. 1004. 1013-15 (1943), *acq.* 1944-1 C.B. 27.

[18] *See* Direct Loan Master Promissory Note (MPN), Important Notice, 22 (informing borrowers that they have a right "to assert a defense against repayment . . . if the school's act or omission directly relates to [his or her] loan or to the educational service that the loan was intended to pay for . . . ."), http://www.direct.ed.gov/pubs/plusmpn.pdf (last accessed on Aug. 6, 2014); *see also* 34 C.F.R. § 685.206(c) (regulations providing for borrower defense to

Education were contingent from their inception and the claim of borrower defense should be viewed as the nontaxable removal of a contingent liability rather than a discharge of indebtedness. Such analysis also supports the conclusion that a 1099-C need not be issued for defense to repayment settlements. This reasoning is also consistent with the contested liability doctrine discussed below.

C. Contested Liability Doctrine and the Infirmity Exception

Alternatively, Treasury should offer public guidance on defense to repayment discharges using the contested liability doctrine (also referred to as the "disputed liability doctrine").

Under this doctrine, if the cancellation of all or part of a debt is made to settle a dispute concerning the debt, no income from cancellation of indebtedness arises.[19] The logic here is that disputed indebtedness does not encumber assets and, therefore, settlement of the disputed indebtedness does not occasion a freeing of assets and accession to income.[20]

Bittker and McMahon's Federal Income Taxation of Individuals, provides the following hypothetical of a contested liability fact pattern in their treatise.[21] In their example, an individual buys business equipment for $1,000 on credit but then refuses to pay because of an alleged misrepresentation or breach of warranty. The parties settle for $750. Bittker and McMahon explain that the $250 debt reduction is not taxable under the contested liability doctrine. The Service is to look to the value as determined at the time of settlement, rather than perform additional valuation of the original amount borrowed. The fact that the $1,000 is a liquidated debt does not enter into the analysis.

Even under Preslar v. C.I.R., an opinion which applies a narrower reading of the disputed liability doctrine from Zarin, the Court clearly distinguishes between purchase price reductions and the "infirmity exception." "Of course, if the debt is unenforceable as a result of an infirmity at the time of its creation (e.g., fraud or misrepresentation), tax liability may be avoided through a purchase price reduction under 26 U.S.C. § 108(e)(5) or an 'infirmity exception.'" [22] This infirmity exception applies when the underlying instrument did not give rise to true indebtedness under general contract principles and prevents the Service from recognizing income on transactions that would not be recognized under state law.

Corinthian students who submit a claim of borrower defense to repayment must contest the amount due under their promissory notes as the result of a violation of applicable state law.

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repayment). *See* 20 U.S.C. § 1087e(h) (2012) (mandating that the secretary of education establish guidelines providing for the defense of repayment claim); *see also* 34 C.F.R. § 682.209(g) (stating that lenders are subject to a borrowers claim of defense of repayment when they agree to participate in the federal student loan program).

[19] *See* Zarin v. Commissioner, 916 F.2d 110, 115 (3d Cir.1990), *revg.* 92 T.C. 1084 (1989); N. Sobel, Inc. v. Commissioner, 40 B.T.A. 1263, 1265 (1939); *see also* Colonial Sav. Association v. Commissioner, 85 T.C. 855, 862–863 (1985), *aff'd.* 854 F.2d 1001 (7th Cir.1988).

[20] N. Sobel, Inc., at 1265. *See, e.g.*, United States v. Hall, 307 F.2d 238, 240-41 (10th Cir. 1962); Fidelity & Columbia Trust Co. v. Lucas, 11 F. Supp. 537, 539 (W.D. Ky. 1935), *aff'd on other grounds,* 89 F.2d 945 (6th Cir. 1937).

[21] Boris I. Bittker and Martin J. McMahon, Jr., Federal Income Taxation of Individuals ¶ 4.5[3][c] (2d ed.1995).

[22] Preslar v. C.I.R., 167 F.3d 1323, 1329 (10th Cir. 1999).

They must attest to this violation in a declaration submitted to the Department of Education. The disputed loan is then reviewed by an appointed Special Master who evaluates the attestation. The Special Agent then makes a recommendation to the Department on the attestation and the defense to repayment settlement.

Given that Corinthian students, in good faith, have disputed the full amount of the debt incurred, the dollar value of the subsequent settlement of the dispute should be treated as the amount of debt recognized for tax purposes and not the original amount borrowed. No additional valuation is required.

D. Purchase Price Adjustment and Nontaxable Recovery of a Previously Paid Expense

Finally, Treasury has the authority to analyze defense to repayment discharges as a purchase price adjustment.

In a purchase price adjustment, the full or partial forgiveness of a debt incurred for the purchase of property is treated as a readjustment of the contract rather than a gain.[23] The fact patterns of this judicially developed doctrine closely follow the price adjustments of Corinthian borrowers. And while I.R.C. § 108(e)(5) includes a limitation to purchases of real property, the doctrine of a purchase price adjustment was not extinguished by § 108(e)(5) and the holding in Sherman has not been overturned.

In Commissioner v. Estate of Sherman, the taxpayer actively contested the lawful right of the mortgagee to demand full payment of the face amount of the mortgage, by reason of misrepresentations made in connection with the purchase of the property. The Court then held that the offer of settlement disclosed an intent to regard the adjustment as a reduction in the selling price of the property. According to the Court:

> The final payment of cash and certificates of claim completed the transaction and, viewing it as a whole, there was no gain, since the property at that time was worth less than the unpaid amount of the mortgage. The effect of the whole transaction was a reduction in the purchase price of the property.[24]

In Pinkney Packing Co. v. Commissioner, the seller promised that if the buyer prepaid its purchase money note, he would give the buyer a discount of between $ 25,000 and $ 50,000 off the nominal contract price.[25] The purchase money note then was assigned to third parties. The buyer later met with both the seller and the then-current noteholders, recalled the seller's promise, and offered to pay the lower discounted price in cash. The noteholders accepted. The Board held the discharge represented a revision of the original purchase price.

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[23] *See, e.g.*, Commissioner v. Estate of Sherman, 135 F.2d 68 (6th Cir. 1943); Helvering v. A.L. Killian Co., 128 F.2d 433 (8th Cir. 1942); Allen v. Courts, 127 F.2d 127 (5th Cir. 1942); Hirsch v. Commissioner, 115 F.2d 656 (7th Cir. 1940); *see also* Helvering v. American Dental Co., 318 U.S. 322, 327-28 (1943) (Reed, J.) ("Where the indebtedness has represented the purchase price of property, a partial forgiveness has been treated as a readjustment of the contract rather than a gain.").

[24] Sherman, at 70.

[25] 42 B.T.A. 823 (1940).

Third party lender transactions have also received purchase price adjustment treatment. "The Service will, however, treat a debt reduction in third-party lender cases as a purchase price adjustment to the extent that the debt reduction by the third-party lender is based on an infirmity that clearly relates back to the original sale *(e.g.*, the seller's inducement of a higher purchase price by misrepresentation of a material fact or by fraud)."[26] Rev.Rul. 92-99 treats the underlying misrepresentation at the origination of the contract as the material fact for determining whether purchase price adjustment shall apply, not the issue of a third party. "The reduction in the note by the third-party lender (C) in this case was not based on an infirmity that clearly relates back to the original sale, so *A* cannot treat *C*'s debt reduction as a purchase price adjustment."

On May 13, 2010, the IRS Office of Chief Counsel submitted a letter to Senator Nelson applying the reasoning of Rev. Rul. 92-99 to students who attended a vocational school in Florida.[27] A third-party loan servicer discharged the loans of these borrowers after they alleged fraud, aiding and abetting fraud, negligent misrepresentation, and violations of state and federal consumer protection acts by the vocational school. The letter from the Chief Counsel's office to Senator Nelson argued, among other possible theories, that "the loan restructurings and debt forgiveness could be viewed as… a medium of payment for a nontaxable recovery of a previously paid expense (assuming the class member did not previously deduct the tuition paid or receive an education tax credit for the tuition previously paid)."

Corinthian students received student loans calculated as the cost of attendance. The contractual terms of the master promissory note signed by the borrower limited all loan proceeds to the cost of attendance.[28] The terms of the promissory note also include an acceleration clause that required immediate repayment of the entire unpaid amount if any funds were spent on a non-educational expense.[29] Loan payments were made directly to Corinthian and not to students.

Upon a borrower's attestation to the Department of Education of a violation of state law eligible for defense to repayment, the Special Master may recommend that the value of the education was $0 and settle any outstanding debts as a purchase price adjustment. Such adjustments should be non-taxable as a recovery of a previously paid expense.

III. Questions

In light of the analysis provided above, we request that you issue public guidance stating that defense to repayment discharges and closed school discharges are non-taxable events that are excluded from gross income and do not require the issuance of 1099-Cs.

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[26] Rev.Rul. 92-99, 1992-2 C.B. 35 (citing Sherman).

[27] Letter From, Michael Montenurro, Chief Counsel, I.R.S., to, Senator Bill Nelson, US Senate (May 13, 2010), http://www.irs.gov/pub/irs-wd/10-0141.pdf (redactions inserted by I.R.S.).

[28] *See* Direct Loan Master Promissory Note (MPN), Important Notice, 6 ("You may use the loan money you receive only to pay for your authorized educational expenses for attendance at the school that determined you were eligible to receive the loan."), http://www.direct.ed.gov/pubs/dlmpn.pdf (last visited on Aug. 6, 2015).

[29] *See* Direct Loan Master Promissory Note (MPN), Important Notice, 19 ("The entire unpaid amount of your loan becomes due and payable (this is called "acceleration") if you: Use your loan money to pay for anything other than expenses related to your education at the school that determined you were eligible to receive the loan."), http://www.direct.ed.gov/pubs/dlmpn.pdf (last visited on Aug. 6 2015).

If you decline to issue such guidance, we ask that you respond to the following within 30 days:

1. What are the laws, regulations, authorities or other precedent that prevent Treasury or IRS from offering new public guidance on the tax treatment of closed school discharges and clarifying past guidance, including guidance submitted to Congress?

2. What are the laws, regulations, authorities or other precedent that prevent Treasury or IRS from issuing guidance consistent with past revenue rulings, revenue procedures, and IRS notices, stating that defense to repayment discharges made by the Department of Education satisfy the requirements of the general welfare exception?

3. What are the laws, regulations, authorities or other precedent that prevent Treasury or IRS from issuing guidance stating that the disputed liability doctrine applied to defense to repayment discharges and the income derived should be valued as the agreed settlement price?

4. What are the laws, regulations, authorities or other precedent that prevent Treasury from applying and administering the Code consistent with the theory of contingent liability to provide public guidance that states that defense to repayment discharges should be regarded as the discharge of an unenforceable debt?

5. What are the laws, regulations, authorities or other precedent that prevent Treasury from applying and administering the Code consistent with Rev. Rul. 92-99 to provide public guidance that states that defense to repayment discharges should be regarded as a purchase price adjustment?

6. What are the laws, regulations, authorities or other precedent that prevent Treasury from applying the whole transaction analysis of *Sherman* to provide public guidance that income derived from defense to repayment discharges should be a nontaxable recovery of a previously paid expense?

We look forward to your response.

Elizabeth Warren

United States Senator

Sherrod Brown

United States Senator

Richard J. Durbin

United States Senator

Maxine Waters

Member of Congress