

GAO

Report to the Chairman, Subcommittee  
on Private Retirement Plans and  
Oversight of the Internal Revenue  
Service, Committee on Finance, U.S.  
Senate

February 1993

TAX  
ADMINISTRATION

Information Returns  
Can Improve Reporting  
of Forgiven Debts



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**General Government Division**

B-249599.2

February 17, 1993

The Honorable David Pryor  
Chairman, Subcommittee on Private  
Retirement Plans and Oversight of  
the Internal Revenue Service  
Committee on Finance  
United States Senate

Dear Mr. Chairman:

You requested that we study whether lenders should be required to report taxpayers' forgiven debts to the Internal Revenue Service (IRS). Under federal law, taxpayers do not have to consider borrowed funds as income because they are expected to pay back the lender. However, if the lender forgives the debt and the funds are not paid back, the law says taxpayers must include the borrowed funds as income except when the forgiveness occurs in bankruptcy or insolvency or for certain farm debts.

Generally, private sector lenders are not required to submit information returns to IRS and taxpayers when forgiving debts. However, the Office of Management and Budget (OMB) requires most federal agencies to report forgiven debts in this manner. These annual returns are to include the taxpayer's name, tax identification number, and amount of forgiven debt that exceeds \$600. The two agency exceptions are the Federal Deposit Insurance Corporation (FDIC) and Resolution Trust Corporation (RTC).

IRS has found that information returns increase voluntary tax compliance. When taxpayers know that IRS has been notified, more will report the income on their tax returns. The IRS computer then matches information returns against taxpayers' tax returns to identify potential noncompliance. IRS then may pursue the potential noncompliance to see whether the taxpayers owe additional taxes. The purpose of this report is to measure the potential effects on voluntary compliance if information reporting on forgiven debts were to be extended to FDIC and RTC.

When federally insured banks fail, FDIC may assume their loans and choose to forgive some or all of the debt. For 1986, FDIC issued information returns on its forgiven debts. But it then stopped because FDIC and RTC officials interpreted the Right to Financial Privacy Act (RFPA) as prohibiting such reporting. This decision to stop issuing information returns after 1986 enabled us to collect data to compare taxpayers' voluntary compliance with and without information returns.

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To determine the effect of information returns on taxpayers' reporting of forgiven debts, we compared the compliance of two random samples of taxpayers whose bank loans were forgiven by FDIC in either 1986 or 1989.<sup>1</sup> For each year, we randomly selected taxpayers from the population of FDIC-forgiven debts, which allowed us to estimate the compliance of each population.<sup>2</sup>

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## Results in Brief

We found that 1 percent of taxpayers voluntarily reported FDIC-forgiven debts when they had no information returns compared to 48 percent when they had information returns. Moreover, by computer matching the information returns and pursuing potential noncompliance, IRS determined that another 20 percent failed to report their forgiven debt income and owed taxes for 1986. Thus, a total of 68 percent (48 plus 20) of the taxpayers eventually complied in reporting the forgiven debt income when they had information returns compared to 1 percent without information returns.

The match found another 32 percent who may have underreported forgiven debt income. After further work, IRS found that 12 percent did not owe additional taxes. IRS did not pursue the other 20 percent of these potential underreporters largely due to limited resources. Had IRS pursued them, the compliance level of 68 percent for taxpayers who received information returns might have been higher.

For those 1986 cases that were pursued, IRS generated an estimated \$37 in recommended taxes for every \$1 that IRS spent. For those cases where IRS had complete records, 83 percent of the taxpayers subsequently paid the recommended taxes while the remaining 17 percent had not yet fully paid as of the time of our study.

When information returns were not filed for 1989, an estimated \$78 million in federal income taxes were lost (see app. II). For 1989, only 1 percent of the 40,050 taxpayers in our population correctly reported FDIC's forgiven debts. FDIC's forgiven debts totalled \$2.2 billion in 1989 and increased to over \$8.4 billion by 1991. This total rises to \$10.9 billion if RTC's 1991 forgiven debts of \$2.5 billion are included. To help taxpayers to report

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<sup>1</sup>We chose 1989 because when we selected our sample, it was the most recent year for which both FDIC and IRS had complete taxpayer data. Also, due to its relatively recent creation, RTC did not have records to allow us to do such a comparison. However, we assume that our FDIC results also would apply at RTC because of the similarity of their forgiven loan activities.

<sup>2</sup>Appendix II shows the sampling errors and confidence intervals for the statistical estimates included in the report.

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these debts, we recommend that Congress extend information reporting to cover debts forgiven by FDIC and RTC.

However, if such legislation is enacted, taxpayers with debts forgiven by FDIC or RTC will be subject to more IRS scrutiny than those, for example, whose debts are forgiven by private lending institutions (e.g., banks and savings and loans). The amount of debt forgiven by these institutions has doubled to \$40 billion from 1985 to 1990. Because loans in our FDIC samples came from banks and were selected randomly, taxpayers' compliance in reporting this \$40 billion would likely be similar to the 1-percent compliance we found for FDIC's debts that were forgiven but not covered by information returns. Accordingly, after obtaining results from extending information reporting to FDIC and RTC, it may be worthwhile for Congress to explore the appropriateness of extending the reporting requirements to other institutions that forgive debt.

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## Background

To ensure compliance with the tax laws, the Internal Revenue Code requires various types of information returns. These returns cover income such as salaries, interest, dividends, and real estate proceeds. Having the information returns helps taxpayers to voluntarily report the income.

IRS matches information returns against tax returns to identify taxpayers who underreport income or who do not file required tax returns. If the match shows a discrepancy, IRS contacts the taxpayer if resources allow, to try to resolve the discrepancy. This matching program has proven to be a relatively cost-effective way to foster voluntary compliance and increase IRS' ability to identify those who do not comply.

Section 61 of the Internal Revenue Code requires taxpayers to report forgiven debts as income on tax returns. The debts are not considered income if the forgiveness occurs due to bankruptcy or insolvency or is related to certain farm debts. In these cases, taxpayers are required to reduce tax benefits, such as a deduction for operating losses, generally by the excluded amount.

To increase the likelihood of taxpayers reporting income from forgiven debts, a 1984 OMB memorandum to all federal agencies conveyed a request from IRS to report forgiven debt income on an information return (Form 1099-G, "Certain Government Payments"). Department of the Treasury guidelines required federal agencies to report forgiven debt amounts exceeding \$600 to IRS on a Form 1099-G, except where prohibited by law.

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In response to OMB and Treasury, FDIC only issued information returns on their forgiven debts for 1986. FDIC stopped after it requested a legal opinion from a private firm, which advised that information reporting may violate the RFFPA of 1978. This act prohibits access to financial records in response to congressional concerns over disclosing financial information, such as loan balances, security for loans, and payment schedules.

According to its legislative history, RFFPA sought to protect customers of financial institutions from unwarranted government intrusion into their records and to balance privacy rights with the need of law enforcement agencies to obtain financial records for legitimate investigations. Congress intended RFFPA to prevent "fishing expeditions" into an individual's financial history and the "wholesale transfers" between government agencies of such financial information without a specific investigative purpose. Congress wanted to close off routine inquiries into an individual's financial records without informing that individual of the inquiry or getting that individual's consent.

Even with these concerns, Congress has created exceptions to allow disclosure of financial information to other government agencies. One exception involves tax considerations. Information reporting on forgiven debts is allowed under RFFPA if the Internal Revenue Code requires it. The private legal opinion that FDIC received also pointed to this exception.

Because the Code does not require it, neither FDIC nor private lending institutions generally report forgiven debts to taxpayers or IRS. The only exception is when a lender acquires an interest in property guaranteeing a debt from a foreclosure or if property guaranteeing a debt is abandoned.

Preliminary IRS data for 1990 indicate that the private sector claimed bad debt deductions (i.e., forgiven debts) of \$86.6 billion. This consists of \$39.7 billion forgiven by corporate financial lending institutions, \$42.4 billion by nonfinancial corporations (e.g., a department store with its own credit card), \$3.5 billion by partnerships, and \$1 billion by sole proprietors.

Further, debt restructures have become a potentially large source of forgiven debt income. Unlike debt compromises or charge-offs that eliminate specific debt amounts, restructured debt requires complex calculations to determine the amount of any forgiven debt income. Many debt restructures did not create any forgiven debt income until Congress and IRS recently clarified various legal ambiguities. Appendix IV contains

details on these changes and their potential effects, as well as other information on debt restructures.

## Objectives, Scope, and Methodology

Our primary objective was to assess whether taxpayer compliance in reporting forgiven debts would increase significantly if information reporting were extended to FDIC and RTC. To meet this objective, we first selected random samples of taxpayers with debts that FDIC forgave in (1) 1986 when information returns were filed and (2) 1989 when such returns were not filed.

Our 1989 random sample included 188 of the 40,050 FDIC-forgiven debts, which were not reported on information returns. For 1986, our random sample included 105 of the 1,084 FDIC-forgiven debts, which were reported on information returns. For both years, we matched these debt amounts to the taxpayers' tax returns to determine whether they reported the forgiven debt income. We then compared differences in taxpayer compliance for 1986 and 1989. Appendix I contains detailed information on our scope and methodology.

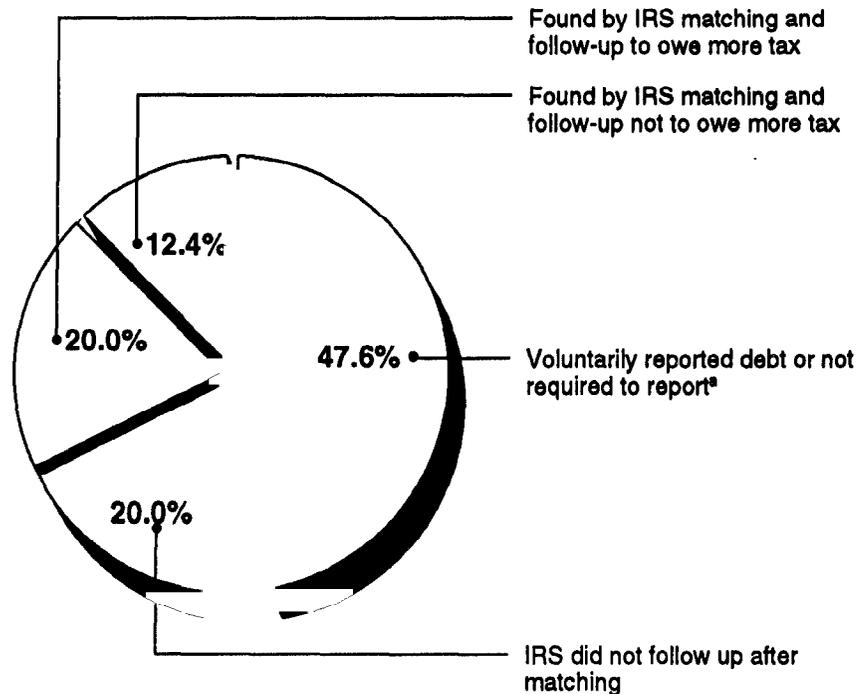
Because of data availability, we focused on FDIC's forgiven debts from loan compromises and charge-offs. Compromises occur when FDIC agrees to settle the debt for an amount less than owed and releases the debtor from the remaining amount. The amount released becomes forgiven debt income to the debtor. Charge-offs occur when FDIC determines that a loan is not collectible and forgives the entire debt.

We did our work between July 1991 and July 1992 in accordance with generally accepted government auditing standards.

## Taxpayer Compliance Significantly Higher When FDIC Reported Forgiven Debts

We found that taxpayers' voluntary compliance was much higher when FDIC filed information returns on 1986 forgiven debts compared to the 1989 forgiven debts on which no information reporting occurred. Further, the taxpayers appeared to have the ability to pay additional taxes owed on the forgiven debt income. Figures 1 and 2 illustrate the dramatic difference in taxpayer's voluntary compliance between the 2 years.

**Figure 1: 1986 Taxpayer Reporting of Forgiven Debt Income From FDIC With Receipt of an Information Return**



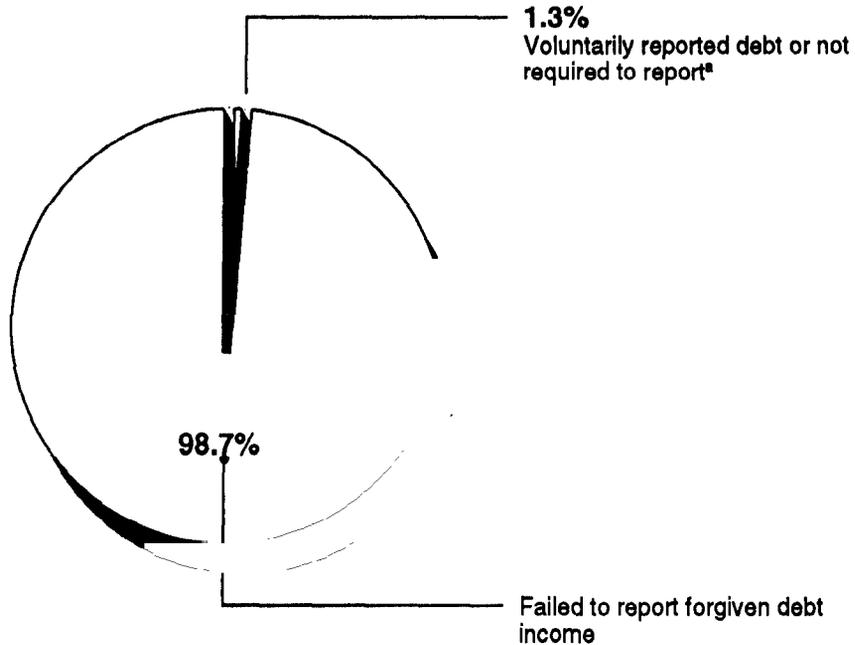
\*Taxpayers are not required to report debt forgiven due to bankruptcy or insolvency or certain forgiven farm debts.

Source: GAO analysis of FDIC and IRS data.

As shown in figure 1, we estimate that 516 (47.6 percent) of the 1,084 taxpayers in our 1986 population voluntarily reported the income they received from the forgiven debts. For the remaining taxpayers, we estimate that

- 217 (20 percent) underreported the forgiven debt income and owed additional taxes,
- 134 (12 percent) did not underreport this income and did not owe additional tax, and
- 217 (20 percent) may have underreported this income but were not pursued after the computer match primarily because of limited IRS resources.

**Figure 2: 1989 Taxpayer Reporting of Forgiven Debt Income From FDIC Without Receipt of an Information Return**



Note: IRS matching was not possible for 1989 because FDIC did not file information returns.

\*Taxpayers are not required to report debt forgiven due to bankruptcy or insolvency or certain forgiven farm debts.

Source: GAO analysis of FDIC and IRS data.

In contrast, as shown in figure 2, our 1989 sample results showed an estimated 1.3 percent (524) of the 40,050 taxpayers voluntarily reported income from FDIC-forgiven debts. Because FDIC did not issue information returns for 1989, IRS could not use its matching program to identify whether the remaining 98.7 percent (39,526) of these taxpayers reported this income.

## Projection of Lost Tax Revenues in 1989 From FDIC's Forgiven Debts

On the basis of our 1989 sample results, we estimate that \$78 million in tax revenues were lost. Without information returns, only an estimated 1.3 percent of the 40,050 taxpayers in our 1989 population correctly reported FDIC's forgiven debts. Appendix II provides details on the confidence intervals for this estimate.

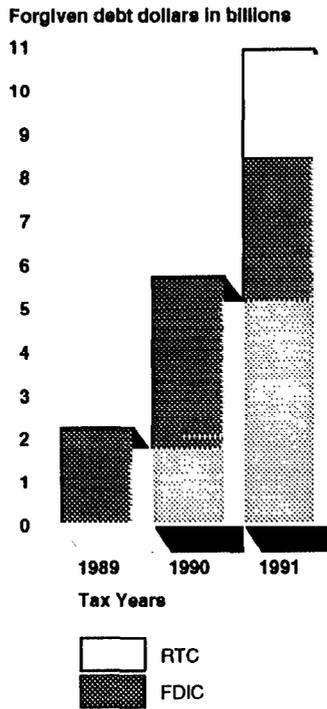
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We believe that our tax loss estimate is conservative because it does not include taxes lost (1) on unreported forgiven debt income that fell below the \$600 annual reporting threshold for information reporting and (2) from taxpayers with farm income whose forgiven debt may not have actually qualified for the farm income exemption (see app. III).

Consequently, some taxpayers in these two groups probably owed additional taxes that were not included in our estimate. For example, in our 1986 sample, 14 of 36 taxpayers had farm income but still reported income from and paid taxes on their forgiven debts. Because our review did not focus on how taxpayers used the borrowed funds that FDIC forgave, we chose to be conservative by assuming that all farmers' 1989 forgiven debts were farm-related.

The tax revenue losses from FDIC not reporting forgiven debts have probably grown since 1989. In 1989, FDIC compromised or wrote off \$2.2 billion in loans. This amount increased to \$8.4 billion in 1991. By including RTC, the amount of forgiven debts for 1991 increases to \$10.9 billion. Figure 3 illustrates the recent growth of FDIC's forgiven debts and includes forgiven debt amounts from RTC for 1991, the only year data were available.

**Figure 3: Extent of FDIC- and RTC-  
Forgiven Debt Activities**



Note: The 1989-90 RTC-forgiven debt information was unavailable.

Source: GAO analysis of FDIC and RTC data.

This high level of debt forgiveness by FDIC and RTC may not continue once the national economy improves and fewer financial institutions fail. Nevertheless, significant tax losses will continue—even at lower levels of debt forgiveness—if nothing is done to increase the 1 percent voluntary compliance level.

## IRS' Use of Forgiven Debt Information Returns Proven Cost-Effective

IRS did not have aggregate results available from its computer matching of 1986 information returns from FDIC. However, using IRS' methodology and data obtained on the taxpayers in our 1986 sample, we calculated a cost-benefit ratio from doing this match.

From its match, IRS identified and worked (i.e., staff follow-up on the match) 53 cases where taxpayers potentially did not report their 1986 debt forgiveness income. In 32 cases, the taxpayer either had reported this income or had an exception for not reporting it. In the other 21 cases, the taxpayers had not reported the forgiven debts and owed \$17,086 in additional recommended taxes. IRS officials told us that its average cost to work a 1986 underreporter case was \$8.73. Therefore, we estimated that each \$1 in costs to match and work the 53 cases yielded over \$37 in recommended tax assessments. This estimate does not include any penalties or interest.

In addition, IRS' computer match of other federal agencies' 1988 information returns on forgiven debts generated a similarly high cost-benefit ratio. Tax year 1988 was the first year IRS had a separate category for underreported income from forgiven federal debts. IRS worked 1,227 cases and found 756 cases of unreported forgiven debt income. IRS recommended tax assessments, interest, and penalties of \$471,178 and spent \$16,181. This is a cost-benefit ratio of over 29 to 1. As a result, the forgiven federal debt category for 1988 had the 21st highest ratio out of 225 underreporting categories.<sup>3</sup> IRS will not have final results of 1989 underreporter cases until 1993.

## Noncompliant Taxpayers Appeared Able to Pay Additional Taxes

For the 21 computer match cases in our sample where the taxpayer did not report the 1986 forgiven debt and owed additional taxes, IRS could not provide complete payment data for 3 cases. For the remaining 18 cases, we found that 15 (83 percent) paid the additional taxes. For the other three, one taxpayer had made a partial payment while two had not made any payments.

Similarly, taxpayers who did not voluntarily report 1989 forgiven debts generally (1) had median incomes that were above average and (2) had sufficient funds to pay the taxes on their other income without having to sign installment agreements with IRS. Moreover, we believe that taxpayers would be more willing to pay the taxes owed on a forgiven debt rather than repay the entire debt because (1) they wish to avoid further disputes with IRS and (2) the amount of taxes owed will be much lower than that debt.

<sup>3</sup>These 225 categories represented 51 combinations of unreported income by their various change in potential tax revenue.

In our 1989 sample, the median adjusted gross income of taxpayers who owed taxes on unreported forgiven debt income was \$29,268 (excluding this forgiven debt income). This exceeded the \$24,339 median income for full-time workers in 1989, as reported by the Bureau of the Census. The median additional tax owed on the unreported forgiven debt income was \$1,008. Appendix III provides our results on these taxpayers' apparent ability to pay.

## FDIC and RTC Costs of Issuing Information Returns

In discussing the costs and benefits of filing information returns on their forgiven debts, FDIC and RTC officials were generally supportive of information reporting. While FDIC officials had some concern over initial start-up costs, they generally agreed that subsequent processing costs would not be particularly onerous.

If FDIC and RTC were to begin issuing information returns, some corporations may be among the taxpayers who should report the forgiven debt as income. Unproductive mismatches could arise because information returns are reported on a calendar year basis while about 60 percent of corporations file tax returns by fiscal year. Thus, to make IRS' computer match more productive, the information returns should include the date of the forgiveness. For example, a corporation's tax return may cover the period from June 1, 1992, to May 31, 1993. If the information return included the date of the forgiven loan (e.g., May 1993), IRS' computer could be programmed to match the forgiven debt with the correct corporate tax return.

## Additional Benefits From Information Reporting

FDIC's reporting of forgiven debts could generate benefits beyond helping to ensure that taxpayers properly report the forgiven debt income. For example, unreported forgiven debts can result in unpaid Social Security tax. A 1989 tax return we reviewed showed a taxpayer who reported adjusted gross income of \$50,892 and paid \$7,086 in income tax after accounting for various tax deductions. However, this person failed to report an FDIC-forgiven debt of \$27,710, avoiding an additional \$7,763 in income tax, as well as additional Social Security tax on the income.

Information reporting by FDIC could also help IRS to locate taxpayers who may have not filed required tax returns. In deciding whether to forgive debts, FDIC attempts to obtain information on the debtors, including their current address. When reporting forgiven debts, FDIC could provide this information to IRS for use in its enforcement programs.

Information returns from FDIC would be beneficial even when the taxpayers meet an exception for not reporting forgiven debts as income. If taxpayers meet an exception, they must reduce certain tax benefits by the forgiven debt amount. For example, if an insolvent taxpayer has a \$25,000 net operating loss and a \$20,000 debt forgiven, the taxpayer should not report the forgiven debt as income. Rather, the net operating loss should be reduced by \$20,000. In such cases, information reporting by FDIC would allow taxpayers to reduce their tax benefits correctly and IRS to identify those that do not.

## Information Reporting by Private Lending Institutions May Also Improve Compliance

During our review, we found that private lending institutions forgive large amounts of debt and deduct these amounts from their taxable income. IRS data showed that bad debt deductions by private lending institutions totalled nearly \$19 billion in 1985 and increased to \$40 billion in 1990. However, unlike most federal agencies, private lending institutions are not required to file information returns on forgiven debts.

Our work at FDIC indicated that debts forgiven by private lending institutions would not materially differ from those forgiven by FDIC. FDIC's loans originated in private banks that failed and came under FDIC control. Because FDIC's forgiven debts came from the same source, a similar increase in taxpayers' compliance may occur if information reporting were extended to private lending institutions.<sup>4</sup>

## Views of Private Lending Institutions

We discussed extending forgiven debt information reporting to private lending institutions with banking and savings and loan representatives. They represented the American Bankers Association (ABA) and Savings and Community Bankers of America, which represents savings and loans institutions.

ABA officials strongly objected to any requirement to issue information returns on forgiven debts. They said banks already incur significant expenses to issue other types of information returns and the costs to begin reporting forgiven debts would be prohibitive. However, they did not provide us with the cost estimates we requested.

Without cost estimates, it is difficult to assess the merits of ABA's concerns. However, we know that banks would not have to pay for new systems to

<sup>4</sup>An estimate of the increase in tax revenue from private lending institutions reporting forgiven debts cannot be statistically made from our sample results.

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begin tracking forgiven debts. They currently track bad debt expenses in their financial records in order to deduct them from taxable income. Further, we know that they would probably do their information reporting to IRS on computer tape, which would reduce paperwork burden and costs.

Savings and loan association representatives said their costs to report forgiven debts would be minimal because they already compile much of the necessary information. Both bank and savings and loan association representatives said it would be inequitable to extend information reporting to their member institutions and not other businesses that forgive debts (e.g., a department store with its own credit card). They said these other businesses could avoid the costs to issue information returns that their members would incur.

Although we appreciate these concerns, the dramatic difference in taxpayers' compliance (from 1 percent to 68 percent) in our FDIC samples suggests that Congress may wish to consider information reporting by private lending institutions. After all, loans in our FDIC samples originated in such institutions. Because the loans come from the same universe, taxpayers' compliance in reporting debts forgiven by these institutions is likely to be as low as for debts forgiven by FDIC without any information reporting. Even so, our review did not include the institutions' forgiven debts. As a result, any consideration of information reporting by the institutions should include the costs to the IRS and institutions.

Another reason for considering this extension to private lending institutions involves equitable treatment of taxpayers. Compared to those whose debts are forgiven by a federal agency, taxpayers whose debts are forgiven by these institutions would receive less IRS scrutiny without this extension. They also would have more opportunity to underreport forgiven debt income and not pay all of the taxes they owed.

Examples from our FDIC work illustrate the potential inequity to taxpayers. A taxpayer in our 1986 FDIC sample received an information return and reported \$11,494 in forgiven debt income, paying an additional \$464 tax. However, a taxpayer in our 1989 sample neither received an information return nor reported \$13,613 in forgiven debt income. Because IRS did not catch this underreporting, the taxpayer avoided an additional \$4,493 tax liability. Such inequities could result if information reporting excludes debts forgiven by private lending institutions.

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## Conclusions

Our results show clearly that taxpayers had a significantly higher level of voluntary compliance in reporting forgiven debt income when information returns were issued as well as an apparent ability to pay taxes owed on that income. Furthermore, both we and IRS found that IRS could cost-effectively use the information returns to identify taxpayers who did not comply.

We believe these results justify Congress's amending the Internal Revenue Code to extend federal information reporting to FDIC and RTC. Adding such a provision to the Code should generate significant tax revenues regardless of whether future levels of forgiven debt approach the 1990 level—over \$10 billion. Also, this statutory authority would ensure that such reporting conforms to the Right to Financial Privacy Act, which Congress enacted to protect taxpayers from privacy invasion and unwarranted government intrusion. This act specifically authorizes disclosure of financial information, such as forgiven debts, if required by the Internal Revenue Code.

If FDIC and RTC information reporting proves to be cost-effective, Congress could consider the appropriateness of extending to other institutions information reporting on forgiven debts. Otherwise, taxpayers with debts forgiven by FDIC or RTC will be subject to more IRS scrutiny than those with debts forgiven by other institutions. We found, for example, that private lending institutions forgive much higher amounts of debt than FDIC. If Congress considers such information reporting, IRS' and these institutions' costs should be among the factors included in the deliberations.

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## Recommendation to Congress

To improve taxpayer compliance in reporting forgiven debt, we recommend that Congress require FDIC and RTC to issue information returns on forgiven debts that exceed \$600 and to include the date of the compromised or charged-off debt on the return.

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## Matter for Congressional Consideration

If FDIC and RTC information reporting on forgiven debts proves to be cost-effective, Congress also may wish to explore whether extending similar information reporting to other institutions is warranted.

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## Recommendation to the Commissioner of Internal Revenue

If Congress enacts related legislation, we recommend that the Commissioner of Internal Revenue require IRS to use the information returns on forgiven debts in its enforcement programs.

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## Agency Comments and Our Evaluation

IRS officials provided oral comments on a draft of this report. They agreed with our recommendations to Congress and to IRS.

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As agreed with the Subcommittee, we plan no further distribution of this report until 30 days after the date of issuance, unless you publicly announce its contents earlier. At that time, we will send copies to the Secretary of the Treasury, the Commissioner of Internal Revenue, the Chairman of FDIC, the Executive Director of RTC, and other interested parties. We will also make copies available to others upon request.

The major contributors to this report are listed in appendix IV. If you have any questions, please contact me at (202) 275-6407.

Sincerely yours,



Jennie S. Stathis  
Director, Tax Policy and  
Administration Issues

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**Abbreviations**

ABA	American Bankers Association
FDIC	Federal Deposit Insurance Corporation
IRS	Internal Revenue Service
OMB	Office of Management and Budget
RFPA	Right to Financial Privacy Act
RTC	Resolution Trust Corporation

# Objectives, Scope, and Methodology

On January 15, 1991, the Chairman, Subcommittee on Private Retirement Plans and Oversight of the Internal Revenue Service, Senate Committee on Finance, requested that we study the impact of information returns on compliance in reporting forgiven debt income. Specifically, we examined the following:

- How well did taxpayers comply in reporting debts forgiven by FDIC?
- Are any changes, such as information returns, needed to improve compliance in reporting FDIC's forgiven debts?
- Could these changes be expected to improve compliance in reporting forgiven debts by private lending institutions?

To determine how well taxpayers complied with reporting forgiven debt income, we obtained a random sample of FDIC-forgiven debts in 1989 that were not reported on information returns. We compared the forgiven amounts to taxpayers' 1989 tax returns to determine how well they reported forgiven debt income. We obtained a random sample of FDIC-forgiven loans in 1986 that were reported to IRS and taxpayers on information returns. For this 1986 sample, we also matched the forgiven FDIC loan amounts to corresponding tax returns. Then, we compared the differences in taxpayer reporting compliance between the 1989 and 1986 samples. Appendix II discusses our sampling methodology.

We reviewed forgiven debt reporting guidance in the Internal Revenue Code, IRS rulings, Treasury directives, OMB directives, and OMB Circular A-129. We examined the 1978 RFPA and the legal opinions FDIC and RTC obtained on the act's restrictions. We did not evaluate the rationale used by FDIC in forgiving debt.

We discussed information reporting with officials in IRS' National Office; the Southwest Regional Office, Dallas, TX; and the Dallas and Austin, TX, district offices. We interviewed pertinent officials in FDIC's National Office on information reporting. We also contacted RTC officials in Arlington, VA, responsible for information reporting.

We obtained an industry view of the potential costs and benefits of information reporting on forgiven debts from ABA, the national association for commercial banks whose member assets account for about 90 percent of the industry total. We also contacted the Savings and Community Bankers of America, the national thrift association whose 2,000 members have assets of \$800 billion.

# GAO Sampling and Data Analysis Methodology

This appendix describes our sampling approach for selecting taxpayers who had debts forgiven by FDIC to achieve a 95-percent confidence level for our estimates. Statistical sampling enables us to make estimates and draw conclusions about the universe on the basis of information in a sample of that universe. Our particular samples cover taxpayers who had loans compromised or charged off by FDIC in 1986 or 1989.

## Sample Selection and Scope

We requested IRS Form 1099-G information returns from 1986 that had a value in Block 5—Discharge of Indebtedness. This was the only year FDIC reported forgiven debt information to IRS through information returns. We identified a population of 1,084 information returns that IRS received from FDIC reporting forgiven debts in 1986. FDIC records were not available to determine whether the forgiven debts were for loan compromises or loan charge-offs. From this population, we reviewed a random sample of 105 corresponding tax returns obtained from IRS to determine whether taxpayers reported the forgiven debt amounts reported on the information returns as forgiven debt income, and if not, why.

We also requested a listing from FDIC of the population of forgiven debts in 1989 resulting from loan compromises and charge-offs. This was the first year FDIC's computer information system could generate a complete listing of these forgiven debts. Using these data, we identified 40,050 taxpayers who had debts forgiven by FDIC in 1989. From this population, we reviewed a random sample of 188 tax returns to determine if taxpayers reported the FDIC-forgiven debt amounts as forgiven debt income, and if not, why. Table II.1 provides additional information regarding our 1986 and 1989 samples.

**Table II.1: 1986 and 1989  
FDIC-Forgiven Debt Universe and  
Sample Information**

Dollars in millions

Calendar year	Number of forgiven debts	Amount of forgiven debt	Number of forgiven debts in sample	Amount of forgiven debt in sample
1986	1,084	\$ 34.6	105	\$1.9
1989 <sup>a</sup>	40,050	2,239.0	188	3.9
Compromises	6,494	239.0	104	1.8
Charge-offs	33,556	2,000.0	84	2.1

<sup>a</sup>1989 was the first year complete compromise and charge-off information was available.

Table II.2 shows point estimates and ranges we developed from our samples. We computed the intervals using a 95 percent confidence level. This means that 19 out of 20 of all possible samples would yield intervals that contain the true population value.

**Table II.2: Point Estimates and Data Ranges Used in the Report**

<b>Description of universe estimates</b>	<b>Point estimate</b>	<b>Interval range estimate (95% confidence level)</b>	
		<b>Lower limit</b>	<b>Upper limit</b>
Percentage of taxpayers who reported FDIC-forgiven debt income in 1986	47.6%	37.9%	57.3%
Percentage of taxpayers IRS identified in 1986 through matching who did not report FDIC-forgiven debt income	32.4%	23.3%	41.5%
Percentage of taxpayers IRS matching did not identify as failing to report FDIC-forgiven debt income for 1986	20.0%	12.1%	27.9%
Percentage of taxpayers who reported FDIC-forgiven debt income in 1989	1.3%	.07%	6.42%
Tax revenue lost in 1989 from unreported FDIC-forgiven debt income (in millions)	\$78	\$23	\$154

# 1989 Sampling Results on Estimated Tax Losses and the Ability to Pay Taxes

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## 1989 Sample Results on Potential Tax Revenue Losses From Unreported Forgiven Debt Income

Of the 188 taxpayers in our sample, 71 had forgiven debt income that should have been reported and formed the basis for our estimated \$78 million tax revenue loss. However, only 1 of the 71 taxpayers reported any forgiven debt income. This taxpayer reported an adjusted gross income of \$322,036 and \$4,888 of forgiven debt income.

The remaining 117 taxpayers were not included in our tax loss estimate for various reasons. For example, the reporting of forgiven debt income by two taxpayers may not have generated any additional tax. One of these taxpayers reported a negative adjusted gross income but properly recognized \$2,866,277 in forgiven debt by reducing a net operating loss deduction.

The other 115 taxpayers excluded from our tax revenue loss estimate for 1989 include

- 34 whose forgiven debts fell below the annual \$600 threshold for reporting forgiven debts;
- 44 whose debts were exempt from reporting because they were bankrupt or insolvent, or for other reasons; and
- 37 whose forgiven debt may have been farm related, which is exempt from reporting.

To be conservative, we excluded the 37 taxpayers from our 1989 sample who reported any farm income because their forgiven debt might have been farm related. However, additional tax revenues could be obtained from these taxpayers. For example, our 1986 sample results identified 36 taxpayers who had farm income. Although they had farm income, 14 of these taxpayers still voluntarily reported the income from their forgiven debts and paid additional taxes. For our 1989 sample, it was beyond the scope of our work to determine whether taxpayers with farm income should have reported their forgiven debts as income.

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## Ability of Taxpayers in 1989 Sample to Pay Taxes

Generally, the 71 taxpayers in our 1989 sample who owed taxes on unreported forgiven debt income appeared to have the ability to pay. As table III.1 shows, 47 of the 71 taxpayers had an adjusted gross income exceeding \$20,000. Of the other 24 taxpayers, 17 had adjusted gross income between \$10,000 and \$20,000 but only owed on average, additional tax of \$450.

**Appendix III**  
**1989 Sampling Results on Estimated Tax**  
**Losses and the Ability to Pay Taxes**

**Table III.1: Income Levels and Median Taxes Owed for the 71 Taxpayers in Our 1989 Sample Who Did Not Report Forgiven Debt Income**

<b>Adjusted gross income levels</b>	<b>Number of taxpayers</b>	<b>Median tax owed on unreported income</b>
\$80,001 and above	6	\$7,162
\$40,001 to \$80,000	14	1,325
\$20,001 to \$40,000	24	837
\$10,001 to \$20,000	17	450
\$10,000 and below	7	1,134

Our work also showed that only 1 of the 71 taxpayers entered into an installment agreement with IRS to pay the taxes on their other income over a period of time. This suggests to us that they probably had the ability to pay the additional tax on their unreported forgiven debt.

# Recent Developments on Debt Restructures

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Until recently, many debt restructures did not create forgiven debt income. However, Congress and IRS recently clarified various legal ambiguities. Under the Revenue Reconciliation Act of 1990 and an IRS Revenue Ruling in May 1991, taxpayers involved with debt restructures are much more likely to receive forgiven debt income in the year of the restructure, as discussed below.

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## Amendments to Internal Revenue Code Section 108

The Revenue Reconciliation Act of 1990 amended Internal Revenue Code Section 108(e)(11) to treat the issuance of new debt in satisfaction of an old debt as a transaction that results in forgiven debt income for solvent taxpayers. Ambiguities in interpreting prior tax law allowed tax postponement for certain debt restructures. With the clarifications in the act, forgiven debt income now is created if a restructure materially modifies the debt. Generally, a debt is materially modified if the terms of the new debt instrument differ materially in kind or extent from the old debt. For example, IRS has generally held that lowering interest rates by 1/8 of a percentage point can trigger forgiven debt income.

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## IRS Revenue Ruling 91-31

Holders of nonrecourse debt have no "recourse" (i.e., choice) but to accept the loan collateral pledged by a borrower in case of default. Prior to May 1991, nonrecourse debtors avoided recognizing forgiven debt income in a debt restructure by reducing the basis of the property (generally the acquisition cost) securing their debt. In doing so, debtors would not realize taxable income until the property was sold and could then apply more favorable capital gain or loss tax rates.

IRS Revenue Ruling 91-31 changed this procedure and stated that nonrecourse debt restructures can now produce taxable income. Beginning in May 1991, the revenue ruling began requiring that nonrecourse debt be treated the same as recourse debt, with forgiven debt income being recognized in the year that the debt restructure takes place.

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## Potential Effects of the Legal Clarifications

Adverse conditions in the real estate market and the downturn in the national economy have led private lending institutions as well as FDIC and RTC to use debt restructures. Unlike debt compromises or charge-offs that eliminate a specific amount of debt, restructuring debt requires complex financial calculations to determine the amount of any forgiven debt income.

The amount of dollars involved in debt restructures is large. According to an estimate prepared by a private investment firm, debt restructures in 1990 alone affected \$57 billion in bank loans.

Because of the related complexities and recency of the changes, taxpayers' compliance in reporting income from the debt restructures could be quite low. Data did not yet exist to show the level of compliance. Noncompliance also could arise because neither financial institutions nor FDIC are required to issue information returns on restructures. IRS studies have shown that information reporting helps taxpayers to voluntarily comply and IRS to identify any noncompliance.

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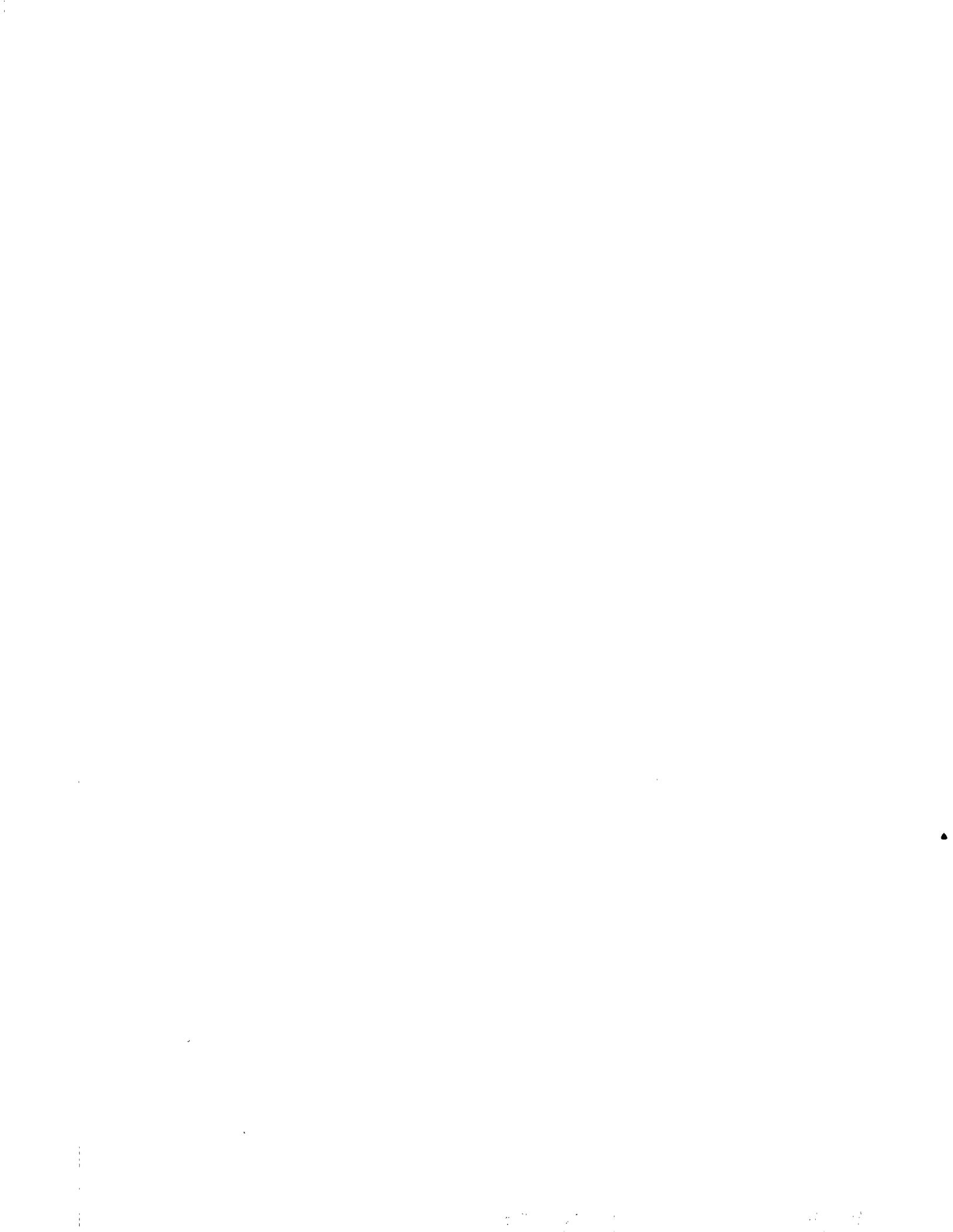
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