



United States
General Accounting Office
Washington, D.C. 20548

General Government Division

B-255468

November 10, 1993

The Honorable Robert L. Livingston
House of Representatives

Dear Mr. Livingston:

In an August 5, 1993 letter, you asked us to provide information on five issues related to farm loan programs. Other GAO groups are responding to the first four issues. We are responding to the fifth, which deals with our work on loans that have been forgiven by the Farmers Home Administration (FmHA) and other government agencies. You asked us to determine (1) the tax implications of debt forgiveness; (2) whether forgiven debts are taxable; and (3) if such debts are not taxable, what the implications of taxing them would be.

In February 1993, we issued a report on debts forgiven by the Federal Deposit Insurance Corporation (FDIC) and Resolution Trust Corporation (RTC).¹ A copy is attached for your information. We believe it answers your questions to a large extent, if not completely.

Section 61 of the Internal Revenue Code (IRC) requires taxpayers to report their forgiven debts as income. Certain exceptions exist under IRC Section 108 and are described in detail for farmers in IRS Publication 225, "Farmer's Tax Guide." Taxpayers who take advantage of the exceptions to declaring forgiven debts as income are required to reduce tax benefits, such as a deduction for net operating losses or the cost basis for a property, generally by the excluded amount.

Under these exceptions, forgiven debts are not considered taxable income if (1) the debt is forgiven in a case under federal bankruptcy proceedings, (2) the debtor is insolvent and the amount of debt forgiven does

¹Tax Administration: Information Returns Can Improve Reporting of Forgiven Debts (GAO/GGD-93-42, Feb. 17, 1993).

not exceed the amount by which he or she is insolvent, (3) the forgiven debt is a qualified farm debt held by an unrelated lender,² or (4) the forgiven debt is qualified real property business indebtedness.³

Our report did not focus on taxpayer compliance in reporting debts forgiven by FmHA, but rather on debts forgiven by FDIC and RTC. However, a GAO High-Risk Series report found that as of June 30, 1992, FmHA's farm loan portfolio totaled \$20.5 billion in direct and guaranteed loans.⁴ From fiscal year 1989 through the first three quarters of 1992, FmHA forgave about \$3.1 billion in direct loan obligations. FmHA wrote off another \$4.5 billion in the course of settling direct loan obligations with borrowers who had generally ceased to farm. We were unable to determine the portion of the forgiven debt that would be excluded from taxable income due to the bankruptcy, insolvency, or qualified debt exclusions described above.

Although forgiven debts are generally considered taxable income, we found in our February 1993, report that compliance with the requirement to report the income varied greatly depending on whether IRS and the debtor received an information return on the amount of the forgiven debt. In 1986, FDIC sent information returns on forgiven debts to IRS; in 1989, it did not.⁵ We found that 48 percent of taxpayers voluntarily reported FDIC-forgiven debt in 1986, while only 1 percent did so in 1989. We estimated that the government did not receive \$78 million in

²A debt is a qualified farm debt if (1) it was incurred directly in operating a farming business and (2) at least 50 percent of the total gross receipts for the 3 tax years preceding the year the debt was forgiven were from the farming business. Also, the person who forgives a qualified farm debt must be in the business of lending money and not related to the debtor. Neither should they have sold the property to the debtor nor received a fee from the debtor's investment in the property. The U.S. Department of Agriculture is considered a qualified lender.

³A debt is a qualified real property debt if it was incurred or assumed in connection with real property used in a business and secured by the property and if an election is made under IRC Section 108 in connection with the debt. Only taxpayers that are not C corporations are eligible for this exception.

⁴Farmers Home Administration's Farm Loan Programs (GAO/HR-93-1, Dec. 1992).

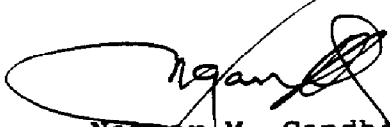
⁵Congress has acted on this issue since our report was published. The Revenue Reconciliation Act of 1993 requires FDIC, RTC, and certain other federal agencies and financial institutions to file information returns with IRS on forgiven debts of \$600 or more.

federal income taxes in 1989 due to this noncompliance. FDIC's forgiven debts totaled \$2.2 billion in 1989 and increased to over \$8.4 billion in 1991.

We also found that taxpayers who did not report forgiven debts as taxable income appeared able to pay additional taxes. 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. The median additional tax owed on the unreported forgiven debts in our 1989 sample was \$1,008.

We hope this information and our February 1993 report meet your needs. If you have any questions, please feel free to call me on (202) 272-7904.

Sincerely yours,



Natwar M. Gandhi
Associate Director, Tax
Policy and Administration Issues

Enclosure

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