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# The Case against the Debt Tax

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# THE CASE AGAINST THE DEBT TAX

*Vijay Raghavan**

*Americans are increasingly agitating for debt relief. In the last decade, there have been national campaigns to cancel student debt, credit card debt, and mortgage debt. These national campaigns have paralleled local efforts to cancel taxi medallion debt, carceral debt, and lunch debt. But as the public increasingly pursues broad-scale debt relief outside bankruptcy, they face an important institutional obstacle: canceled debt is generally taxable.*

*The taxability of canceled debt is often raised by opponents as an objection to broad debt cancellation and potentially discounts the value of any debt relief. The conventional account for why we tax canceled debt is that debt incurred in one year and canceled in a later year reflects an accession to wealth that ought to be taxable. The conventional account naturalizes the tax in a way that obscures its present function and history. This Article seeks to clarify its present function and recover its history.*

*Modern credit markets grew, in part, because of policy decisions in the 1970s and 1980s to manage distributional conflict with credit. As Professor Abbye Atkinson has argued, easy access to credit and a shrinking welfare state meant that credit replaced direct transfers of cash as our primary form of social provision. One consequence of these decisions is that the modern tax on canceled debt functions less as a measure of wealth and more as a punitive tax on excessive debt. This Article situates this shift within the context of larger political changes. In the 1980s and 1990s, Congress made changes to tax administration that operationalized the tax in a way that would primarily affect individual debtors. These changes corresponded to a broader shift in the policymaking landscape toward the redistribution of burdens and risk in society.*

*This Article suggests that the tax on canceled debt is the product of these broader political forces and not just the internal logic of tax. This reorientation enriches and deepens existing critiques of our tax and financial systems by revealing how the tax on canceled debt contributes to the*

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*regressivity and racial inequity of our federal income tax and contributes to what some scholars term the acoustic separation of credit and debt in federal policy. It also suggests that it is time to reconsider the wisdom of taxing canceled debt. And this Article concludes by proposing changes to tax administration and the tax code that would circumscribe the scope of the tax.*

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## INTRODUCTION

On October 20, 2021, New York City taxi drivers began a hunger strike for debt relief.[1] From 2002 to 2014, taxi drivers took on substantial debt to purchase taxi medallions[2] at inflated prices.[3] Lenders looking to prop up and profit from a bubble in medallion prices steered drivers into taking these

1. Brian M. Rosenthal, *N.Y. Cabbies Stage Hunger Strike for More Aid: 'We're Not Backing Down,'* N.Y. TIMES, https://www.nytimes.com/2021/11/01/nyregion/ny-taxi-drivers-hunger-strike.html [https://perma.cc/6HF5-48LF] (Nov. 3, 2021).

2. New York City taxi medallions are transferrable licenses affixed to cars authorizing drivers to use the cars as a taxi in New York City. *See Taxicab Medallion*, N.Y.C. TAXI & LIMOUSINE COMM'N, https://www1.nyc.gov/site/tlc/businesses/medallion-owners-and-agents.page [https://perma.cc/3W9G-4YEP] (last visited Mar. 6, 2023).

3. Brian M. Rosenthal, *'They Were Conned': How Reckless Loans Devastated a Generation of Taxi Drivers*, N.Y. TIMES (May 19, 2019), https://www.nytimes.com/2019/05/19/nyregion/nyc-taxis-medallions-suicides.html [https://perma.cc/L2KP-RM68] (noting that "[b]etween 2002 and 2014, the price of a medallion rose to more than $1 million from $200,000, even though city records showed that driver incomes barely changed").

loans.[4] And investigative reports suggest that New York City officials were often complicit in these schemes.[5]

When the medallion bubble finally burst in 2014, taxi drivers were saddled with debt that they could not repay.[6] Lenders used aggressive tactics to pursue this debt,[7] and some drivers died by suicide out of despair.[8] In recent years, taxi drivers have turned to organizing and direct action.[9] These efforts culminated in a fifteen-day hunger strike that prompted reluctant city officials to grant the drivers extensive debt relief.[10] Under the terms of the deal that the city announced on November 3, 2021, as much as $500 million of medallion debt may be forgiven.[11]

But this victory against unjust debt came with one important caveat: any medallion debt forgiven might be taxable.[12] Under federal tax law, canceled

4. *See id.*

5. Brian M. Rosenthal, *As Thousands of Taxi Drivers Were Trapped in Loans, Top Officials Counted the Money*, N.Y. TIMES (May 19, 2019), https://www.nytimes.com/2019/05/19/nyregion/taxi-medallions.html [https://perma.cc/HE8R-BCBU].

6. Rosenthal, *supra* note 3.

7. Brian M. Rosenthal, *Notorious Debt Collector in Taxi Industry Is Arrested*, N.Y. TIMES (July 2, 2019), https://www.nytimes.com/2019/07/02/nyregion/nyc-taxis-arrest.html [https://perma.cc/Z6L7-GGZF].

8. Brian M. Rosenthal, *A $750,000 Taxi Medallion, a Driver's Suicide and a Brother's Guilt*, N.Y. TIMES (Dec. 23, 2019), https://www.nytimes.com/2019/12/23/nyregion/nyc-taxi-suicides.html [https://perma.cc/UJ8L-J4BY].

9. *See Medallion Debt Forgiveness Campaign Victory*, N.Y. TAXI WORKERS ALL., https://www.nytwa.org/debt-forgiveness [https://perma.cc/6FU5-WYMP] (last visited Mar. 6, 2023) (detailing direct action efforts by taxi workers over the past three years). As detailed on the New York Taxi Workers Alliance website, the drivers' efforts were supported by elected officials and scholars, including the New York attorney general. *See* Press Release, N.Y. Att'y Gen., Attorney General James to Sue New York City Government for Fraudulent Practices by Taxi and Limousine Commission (Feb. 20, 2020), https://ag.ny.gov/press-release/2020/attorney-general-james-sue-new-york-city-government-fraudulent-practices-taxi-and [https://perma.cc/N6LV-KAYQ].

10. Rosenthal, *supra* note 1. After dragging their feet for several years, city officials offered a modest plan in March 2021 that many viewed as profoundly inadequate. Brian M. Rosenthal, *New York to Spend $65 Million to Rescue Cab Drivers. Is It Enough?*, N.Y. TIMES (Mar. 10, 2021), https://www.nytimes.com/2021/03/09/nyregion/nyc-taxi-drivers-bailout.html [https://perma.cc/KBA4-JB3W].

11. For details on the program, see *Taxi Medallion Owner Relief Program*, N.Y.C. TAXI & LIMOUSINE COMM'N, https://www1.nyc.gov/site/tlc/about/taxi-medallion-owner-relief-program.page [https://perma.cc/277D-VPVH] (last visited Mar. 6, 2023).

12. To illustrate the potential tax consequences of cancellation, consider the following example. Assume that a New York City taxi driver was the sole earner of a four-person household and had an adjusted gross income of $35,000 in 2021. Under these facts, the driver's taxable income would have been approximately $2,100 (deducting $25,900 as the standard deduction for joint filers and $7,000 as a qualified business income deduction) and federal income tax would have been $211. The driver would have been entitled to an earned income tax credit of $3,968 and a refundable child tax credit of approximately $4,000 (more if the driver's children were younger than six). If the driver had $600,000 of outstanding medallion debt that was restructured to $200,000 in 2021, the driver would presumptively have had $400,000 in cancellation of indebtedness income. This would push the driver's adjusted gross income up to $435,000, taxable income to $402,100, and tax to $90,326 (ignoring the alternative minimum tax to simplify the calculation). The driver would also no longer be eligible for the earned income tax credit or the child tax credit. This hypothetical may seem stark, but even if the driver's outstanding debt was $300,000, the driver's tax would

debt is generally treated as taxable income.[13] The theory is that if I have a debt, and that debt is canceled, I have become wealthier by the amount of debt that was forgiven.[14] And that accession to wealth ought to be taxable because it is functionally equivalent to receiving additional income.[15]

The tax on canceled debt[16] has existed in some form since as early as 1918.[17] Long provided for by an obscure provision of the tax code that mainly concerned tax scholars, the tax has become increasingly relevant as Americans attempt to deal with growing and unmanageable debt. The tax emerged as an issue during the 2008 financial crisis, when Americans who lost their homes to foreclosure received large bills in back taxes from the Internal Revenue Service (IRS).[18] Since then, the tax has served as an initial

be $24,169, and the driver would lose out on the earned income tax credit. This is, of course, a stylized and somewhat reductive example. It assumes the taxpayer is subject to taxation on the cancellation of debt. There may be valid reasons for which canceled medallion debt is not taxable, including, for example, that the canceled debt is disputed or that the taxpayer is insolvent. I discuss these exceptions in more detail in Part II. However, I think that these figures do capture something real because of the way the tax is operationalized. If the driver fails to include the canceled debt in his income (highly likely), the driver may receive an automated letter from the Internal Revenue Service showing a large deficiency (again, highly likely), as was true in the case of the Stouts discussed in Part II. Thus, the example gives a general sense of the potential harm cancellation may visit on drivers attempting to restructure inflated medallion debt.

13. To be precise, canceled debt is included in the calculation of the taxpayer's gross income that is subject to tax. 26 U.S.C. § 61(a)(11).

14. This account, known as the freeing-of-assets or net worth theory, is one of two competing rationales for taxing canceled debt. The other account, known as the loan proceeds or mistake correction theory, justifies taxing canceled debt because the whole transaction reflects a net gain. For a discussion of the difference between these two competing rationales, see Lawrence Zelenak, *Cancellation-of-Indebtedness Income and Transactional Accounting*, 29 VA. TAX REV. 277, 280–81 (2009).

15. As an example, assume I borrow $100 from a bank in year 1 and make no payments on my debt. In year 2, the bank cancels my obligation to repay the $100. My liabilities have gone down by $100, and my net worth has correspondingly increased by $100. The same would be true if the bank did not cancel my debt, and I received an additional $100 from my employer as a bonus in year 2.

16. As a technical matter, canceled debt generates cancellation of indebtedness income, or COD income, which can increase a taxpayer's federal income tax liability (as well as state and municipal income tax liability in certain jurisdictions). As such, it is somewhat imprecise within the conventions of tax law and tax scholarship to refer to the potential tax liability generated by cancellation of indebtedness income as a separately imposed tax. Although I understand this concern, I choose this convention for two reasons. The first is simplicity. It is simply much easier to describe the phenomena I am interested in as a tax as opposed to tax liability generated by cancellation of indebtedness income. And the second reason is that the linguistic conventions in tax tend to mute the salience and costs of choices in tax law. Though the tax on canceled debt is not a separately imposed tax within the conventions of tax law, it is a fair characterization if we take a broader view. For purposes of this Article, describing the tax consequences of canceled debt as a tax on canceled debt captures the way that tax law operates as a constraint on policymaking and imposes costs on debtors who obtain debt relief. As an example of another article that flouts these conventions, see Nyamagaga Gondwe, *The Black Tax: How the Charitable Contribution Subsidy Reinforces Black Poverty*, 76 TAX. L. REV. (forthcoming 2023) (on file with author).

17. United States v. Kirby Lumber Co., 284 U.S. 1, 3 (1931).

18. Geraldine Fabrikant, *After Foreclosure, a Big Tax Bill from the I.R.S.*, N.Y. TIMES (Aug. 20, 2007), https://www.nytimes.com/2007/08/20/business/20taxes.html [https://perma.cc/Y77J-59R6].

barrier to public and private efforts to cancel or modify credit card debt,[19] medical debt,[20] student debt,[21] and even fraudulent debt.[22] The practical effect is that the tax often sets a ceiling on the amount of debt relief an individual can receive.

Based on the potential tax issues associated with debt relief, some scholars and policy makers have pushed for legislative exemptions for particular kinds of debt.[23] And the new relevance of the tax has resurrected a long-standing

19. *See* Zelenak, *supra* note 14, at 279 (noting relevance of the appropriate theoretical basis for taxing canceled debt in light of "prospect that hundreds of thousands, or even millions, of taxpayers may soon be relieved of obligations to pay accrued credit card interest"); Richard C.E. Beck, *The Tax Treatment of Cancelled Interest and Penalties on Consumer Debt*, 53 N.Y.L. SCH. L. REV. 1025, 1026–27 (2009) (noting that punitive credit card interest and penalties may lead to a wave of defaults and taxable cancellation of debt).

20. Two somewhat recent examples of efforts to cancel medical debt are those undertaken by Rolling Jubilee and John Oliver. In 2012, the Rolling Jubilee fund, an offshoot of Occupy Wall Street and Strike Debt, raised funds to purchase delinquent medical debt on the secondary market and cancel it. *See* Ariel Kaminer, *Occupy Wall St. Offshoot Aims to Erase People's Debts*, N.Y. TIMES (Nov. 13, 2012), https://www.nytimes.com/2012/11/14/nyregion/occupy-offshoot-aims-to-erase-peoples-debts.html [https://perma.cc/Y9VJ-84Y7]. Their actions immediately set off a debate about the taxability of the canceled medical debt. *See* Meghan McArdle, *Debt and Taxes*, DAILY BEAST (Nov. 14, 2012, 2:47 PM), https://www.thedailybeast.com/debt-and-taxes [https://perma.cc/9UK5-WH5J] (summarizing the contours of the debate but siding with the critics). Four years later, John Oliver pursued a similar project and structured the transaction to avoid any potential tax consequences. *See* David S. Miller, *The Tax Consequences of John Oliver's $15 Million Medical Debt Forgiveness*, PROSKAUER (June 15, 2016), https://www.proskauertaxtalks.com/2016/06/last-week-tonight-debt-forgiveness/ [https://perma.cc/4XSA-4YFK].

21. For example, President Joe Biden's early proposals to cancel student loans by executive order were met with immediate skepticism from some economists based in part on the tax consequences. *See* Jason Furman (@JasonFurman), TWITTER (Nov. 15, 2020, 11:31 PM), https://twitter.com/jasonfurman/status/1328193936364539909 [https://perma.cc/RY4G-K7Y7] (arguing that student loan debt "[f]orgiveness is taxable"). But whether student loan debt forgiveness is actually taxable is the subject of debate. *See* Luke Herrine, *The Law and Political Economy of a Student Debt Jubilee*, 68 BUFF. L. REV. 281, 402–10 (2020) (summarizing the legal arguments against treating canceled student debt as taxable income); John R. Brooks, *The Tax Treatment of Student Loan Discharge and Cancellation*, *in* DELIVERING ON DEBT RELIEF: PROPOSALS, IDEAS, AND ACTIONS TO CANCEL STUDENT DEBT ON DAY ONE AND BEYOND 166 (Student Borrower Prot. Ctr., Demos & Student Loan L. Initiative ed., 2020), https://protectborrowers.org/wp-content/uploads/2021/02/Delivering-on-Debt-Relief-Final.pdf [https://perma.cc/3XEN-V2YR].

22. This observation comes from personal experience negotiating restitution claims for consumers defrauded by financial institutions. The tax on canceled debt discounts the value of consumer restitution, and much work is devoted to securing language that either defeats the tax or assures the regulator that any canceled debt will not be reported to the IRS. Financial institutions are, unsurprisingly, a bit squeamish about making any firm representations about their obligations under federal law without a promise from the IRS that they will face no penalties for failure to report canceled debt. When these negotiations fail, you end up with somewhat ominous language that advises consumers to contact the IRS for assistance if they receive a Form 1099 reporting the canceled debt. As an example, see the language used by the settlement administrator for the multistate settlement with Santander Consumer USA. WELCOME TO THE SANTANDER MULTI-STATE SUB PRIME AUTO LENDING INFORMATIONAL WEBSITE, https://santandermultistateagsettlement.com/ [https://perma.cc/M38B-7XJ8] (last visited Mar. 6, 2023).

23. *See, e.g.*, Gregory Crespi, *Should We Defuse the Tax Bomb Facing Lawyers Who Are Enrolled in Income-Based Student Loan Repayment Plans?*, 68 S.C. L. REV. 117 (2016); John R. Brooks, *Treasury Should Exclude Income from Discharge of Student Loans*, 152 TAX

academic debate about the theoretical underpinnings of the tax.[24] But across the various efforts to deal with the tax on canceled debt and to think about its theoretical underpinnings, few have asked a more foundational question: should we tax canceled debt in the first place? This Article takes up that question.

Our federal income tax is, in principle, progressive. It attempts to impose a higher tax burden on those with a greater ability to pay, using income as a proxy for ability to pay. But what is income? Surely, income includes labor income, but what about capital income or imputed income?[25] And what about the costs of earning income? Which costs should we deduct from an individual's taxable income to account for their "real" ability to pay?

For over a century, scholars have debated different theoretical approaches to a "pure" or "ideal" definition of income.[26] But as Professor John Brooks argues, "a truly complete and rigorous definition of income is impossible or unworkable."[27] Instead, income is a "constructed idea" that "incorporates normative views about . . . justice, social policy, and economics."[28] The question of whether we should treat something as taxable income is often a political question that reflects policy priorities.[29]

In this Article, I build on the critical insights of Brooks and other tax scholars and consider what the current landscape of individual debt suggests about the nature of the tax on canceled debt. As I argue below, we can divide

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NOTES 751 (2016). These efforts occasionally bear fruit. The American Rescue Plan Act of 2021 modified the tax code to include an exemption for student loan debt canceled between 2021 and 2026. *See* Pub. L. No. 117-2, § 9675, 135 Stat. 4, 185 (codified at 26 U.S.C. § 108(f)(5)). This provision tracks a similar provision for canceled mortgage debt, which was first introduced in 2007 for debt canceled before January 1, 2010, but has been repeatedly renewed. *See* Mortgage Forgiveness Debt Relief Act of 2007, Pub. L. No. 110-142, § 2(b), 121 Stat. 1803, 1803–04 (codified at 26 U.S.C. § 108(h)). More recently, Congressman Gregory Meeks has pushed for an exemption for what he terms "qualified taxi medallion indebtedness." Press Release, Gregory Meeks, Rep., U.S. House of Reps., Meeks and New York City Delegation Reintroduce Bill for Taxi Medallion Loan Forgiveness (Mar. 19, 2021), https://meeks.house.gov/media/press-releases/meeks-and-new-york-city-delegation-reintroduce-bill-taxi-medallion-loan [https://perma.cc/2XC3-HUDW].

24. *See, e.g.*, Zelenak, *supra* note 14; Jeffrey H. Kahn & Douglas A. Kahn, *Cancellation of Debt and Related Transactions*, 69 TAX LAW. 161 (2015); Boris I. Bittker & Barton H. Thompson, Jr., *Income from the Discharge of Indebtedness: The Progeny of* United States v. Kirby Lumber Co., 66 CALIF. L. REV. 1159 (1978); Beck, *supra* note 19.

25. Imputed income refers to wealth generated from not paying for services or expenses. Common examples include imputed income that homeowners have by avoiding rent and imputed income that parents who provide their own childcare have by avoiding third-party expenses for childcare. *See* John R. Brooks, *The Definitions of Income*, 71 TAX L. REV. 253, 254 (2018).

26. *See, e.g.*, HENRY C. SIMONS, PERSONAL INCOME TAXATION: THE DEFINITION OF INCOME AS A PROBLEM OF FISCAL POLICY (1938); Boris I. Bittker, *A "Comprehensive Tax Base" as a Goal of Income Tax Reform*, 80 HARV. L. REV. 925, 985 (1967); James A. Mirrlees, *An Exploration in the Theory of Optimum Income Taxation*, 38 REV. ECON. STUD. 175 (1971).

27. Brooks, *supra* note 25, at 253.

28. *Id.* at 254.

29. This is a point that Professor Dorothy Brown makes sharply in *The Whiteness of Wealth*, which examines the relationship between tax policy and the racial wealth gap as discussed in Part III. *See generally* DOROTHY BROWN, THE WHITENESS OF WEALTH: HOW THE TAX SYSTEM IMPOVERISHES BLACK AMERICANS—AND HOW WE CAN FIX IT (2021).

up the universe of individual debt into one of three categories, which I term "policy debt," "consumption debt," and "acquisition debt." By policy debt, I refer to debt incurred to obtain credit that is directly provided or subsidized by the federal government to achieve certain policy ends (such as expanding homeownership or increasing access to higher education). Policy debt includes the two largest categories of consumer debt: mortgages and student loans. By consumption debt, I refer to debt incurred to finance present consumption for emergency and nonemergency reasons.[30] Examples of consumption debt include credit cards and payday loans. Finally, by acquisition debt, I refer to debt incurred to finance the acquisition of goods that are not exclusively for present consumption, examples of which include auto loans and retail installment credit. These categories are not airtight but are a useful way to organize the world of modern individual debt.[31] And this categorization reveals a few important things about the function of the tax on canceled debt.

The first is that the tax penalizes individuals who cannot take full advantage of the federal policy promoting homeownership and higher education. Individuals who lose their homes to foreclosure or are underemployed with significant student debt would benefit from debt forgiveness but face a penalty in the form of a tax on canceled debt. There are good reasons why we should reconsider subsidizing homeownership and higher education with credit.[32] But it seems strange that the costs of imperfect federal policy should be borne by those who can least afford it.[33]

The second is that the tax penalizes low-income consumers who rely on high-cost credit to finance basic needs. We have a two-tiered financial

30. The definition of present consumption here tracks Professor Jonathan Macey's definition of the term. Jonathan Macey, *Fair Credit Markets: Using Household Balance Sheets to Promote Consumer Welfare*, 100 TEX. L. REV. 683, 687 (2022).

31. Some consumption debt is used to finance the acquisition of goods for future consumption, and some acquisition debt is arguably used for present consumption. Moreover, housing debt includes debt that is incurred to acquire an asset (a home) and debt that is incurred for present consumption. There are certainly other ways to organize the world of consumer debt, but I use this taxonomy to illustrate the way in which the tax on canceled debt tends to function as a punitive tax as opposed to a tax on wealth. *Cf. id.* (categorizing loans as "(a) to fund an investment by the borrower; (b) to acquire a long-term capital asset; or (c) to fund current consumption" to "put into sharp focus the fact that the third category of borrowing is highly problematic because, unlike the other two categories of borrowing, . . . it adds an ongoing liability to the borrower's balance sheet without adding anything whatsoever to the asset side of the borrower's balance sheet").

32. *See, e.g.*, Abbye Atkinson, *Rethinking Credit as Social Provision*, 71 STAN. L. REV. 1093 (2019) (on the limits of credit as a tool to improve general welfare); KEEANGA-YAMAHTTA TAYLOR, RACE FOR PROFIT: HOW BANKS AND THE REAL ESTATE INDUSTRY UNDERMINED BLACK HOMEOWNERSHIP (2019) (on abandoning interventions in the housing market to expand access to homeownership for Black Americans); ADAM J. LEVITIN & SUSAN M. WACHTER, THE GREAT AMERICAN HOUSING BUBBLE: WHAT WENT WRONG AND HOW WE CAN PROTECT OURSELVES IN THE FUTURE (2020) (on redesigning the structure of housing finance); John R. Brooks & Adam J. Levitin, *Redesigning Education Finance: How Student Loans Outgrew the "Debt" Paradigm*, 109 GEO. L.J. 5 (2020).

33. And the recent "temporary" exemptions in the tax code for mortgage debt and student loans suggest that there is some consensus that we should not tax canceled subsidized debt. *See* 26 U.S.C. § 108(f)(2), (h).

marketplace.[34] Wealthier consumers have broad access to various credit products and can generally obtain credit at low rates. Lower-income consumers have constrained choices and can generally only obtain credit at exorbitant rates. Declining wages, a threadbare safety net, and a largely privatized financial system mean that lower-income consumers must turn to high-cost credit to pay for basic living expenses, emergencies, and, increasingly, to participate in the American economy.[35] For these consumers, the tax operates to accentuate the regressivity of the financial marketplace.[36]

And the third is that the tax penalizes individuals who are saddled with excessive debt to finance the acquisition of goods. The forces that underwrote the growth of policy debt and consumption debt in the last half century are equally relevant for understanding the growth of acquisition debt during this same time period. These forces both increased the profitability of and demand for acquisition credit and made particularly extractive models of lending more widespread. Assuming a borrower's outstanding acquisition debt reflects "real" value that the borrower received ignores the way in which legal, political, and social forces construct value in consumer debt markets. And this is a point that is not limited to consumer debt but extends to certain commercial debt, such as the medallion debt that this Article began with.

Examining the underlying dynamics of consumer debt markets reveals that the modern tax on canceled debt tends to function less as a measure of wealth and more as a punitive tax on excessive debt. This Article situates this shift within the context of larger political changes. In the 1980s and 1990s, Congress dramatically expanded the number of third-party information reports that entities were required to annually file with the IRS. As part of this expansion, Congress required that lenders report any canceled debt to the IRS. These changes to tax administration operationalized the tax on canceled debt in a way that would primarily affect individual debtors and corresponded to a broader shift in federal policy toward the redistribution of burdens and risk in society.

There is also an important racial dimension to this story. In the late 1960s and 1970s, the federal government faced not only competing claims for federal support, but also deteriorating economic conditions. The competing

34. *See, e.g.*, Lynn Drysdale & Kathleen E. Keest, *The Two-Tiered Consumer Financial Services Marketplace: The Fringe Banking System and Its Challenge to Current Thinking About the Role of Usury Laws in Today's Society*, 51 S.C. L. REV. 589 (2000). *But see* Prasad Krishnamurthy & Tucker Cochenour, An Economic Case Against and for Public Banking (June 8, 2022) (unpublished manuscript), https://papers.ssrn.com/sol3/papers.cfm?abstract_id=4029311 [https://perma.cc/WA85-6EXG] (critiquing the two-tiered view of consumer banking on welfarist grounds).

35. *See* Atkinson, *supra* note 32, at 1101–02 ("[P]olicymakers have left low-income Americans in a terrible position by decimating public-assistance forms of social provision . . . yet failing to solve the threshold problems of persistent wage stagnation and other entrenched social pathologies. Thus, high-risk, low-income borrowers must provide for their own welfare in the credit marketplace, where lenders build their business models on the expected transfer of wealth out of economically vulnerable communities." (footnote omitted)).

36. *See id.* at 1154 (on the regressivity of consumer credit markets).

claims included claims by Black borrowers who had been shut out of conventional credit markets by federal policy. The federal government responded to this distributional conflict by deregulating credit markets and expanding access to credit. One consequence of deregulating credit markets and shrinking the social safety net after the redlining era is that the modern burdens of debt are disproportionately borne by Black borrowers and other borrowers from socioeconomically marginalized groups.[37] Thus, canceling debt is in many ways a racial justice issue.[38] Yet the tax on canceled debt places a ceiling on how much justice we can achieve.

This Article suggests that the tax on canceled debt is the product of these broader forces and not just the internal logic of tax. This reorientation enriches and deepens existing scholarly critiques of our tax and financial systems. Within tax, scholars such as Professors Dorothy A. Brown and Nyamagaga Gondwe have shown that tax expenditures can exacerbate the racial wealth gap,[39] and scholars such as Professor Ariel Jurow Kleiman have highlighted regressive aspects of our tax laws.[40] Outside tax, scholars such as Professor Abbye Atkinson and Abigail Faust have highlighted the acoustic separation of credit and debt in federal policy.[41] This Article expands on this scholarship by showing not only how tax administration and the definitions of taxable income can exacerbate racial inequity and the regressivity of the tax code, but also how the acoustic separation of credit and debt in federal policy can be understood as a way to regressively reallocate the costs of the federal shift from public to private social provision.

This Article proceeds in four parts. In Part I, I describe the landscape of modern consumer debt. A central argument in Part I is that current outstanding debt reflects past political decisions to use credit to solve various

37. *See, e.g.*, TAYLOR, *supra* note 32; Louise Seamster, *Black Debt, White Debt*, CONTEXTS, Winter 2019, at 30; Paul Kiel & Annie Waldmen, *The Color of Debt: How Collection Suits Squeeze Black Neighborhoods*, PROPUBLICA (Oct. 8, 2015), https://www.propublica.org/article/debt-collection-lawsuits-squeeze-black-neighborhoods [https://perma.cc/5684-JXPE]; Mehrsa Baradaran, *Jim Crow Credit*, 9 U.C. IRVINE L. REV. 887 (2019).

38. *See* Abbye Atkinson, *Borrowing Equality*, 120 COLUM. L. REV. 1403 (2020).

39. *See* BROWN, *supra* note 29; Gondwe, *supra* note 16. For other accounts that focus on racial discrimination in tax administration, see Steven Dean, *Filing While Black: The Casual Racism of the Tax Law*, 2022 UTAH L. REV. 801; Jeremy Bearer-Friend, *Colorblind Tax Enforcement*, 92 N.Y.U L. REV. 1 (2022); Goldburn P. Maynard Jr. & David Gamage, *Wage Enslavement: How the Tax System Holds Back Historically Disadvantaged Groups of Americans*, 110 KY. L.J. 665 (2021).

40. *See* Ariel Jurow Kleiman, *Impoverishment by Taxation*, 170 U. PA. L. REV. 1451 (2022) [hereinafter Kleiman, *Impoverishment*]; Ariel Jurow Kleiman, *Low-End Regressivity*, 72 TAX L. REV. 101 (2019) [hereinafter Kleiman, *Regressivity*]. Kleiman's work focuses on regressivity in positive law, whereas this Article looks to regressivity in tax administration. Professor Leslie Book has long written about regressive tax administration. *See, e.g.*, Leslie Book, T. Keith Fogg & Nina E. Olson, *Reducing Administrative Burdens to Protect Taxpayer Rights*, 74 OKLA. L. REV. 527, 548–71 (2022); Leslie Book, *The Poor and Tax Compliance: One Size Does Not Fit All*, 51 KAN. L. REV. 1145 (2003). This Article builds on and extends Book's work by showing how information reporting (a topic that is generally understudied in the tax literature) can both enable and sharpen the effects of regressive tax enforcement.

41. *See generally* Atkinson, *supra* note 38; Abigail Faust, *The Acoustic Separation of Consumer Bankruptcy and Consumer Credit Laws*, 95 AM. BANKR. L.J. 671 (2021).

political, social, and economic problems. Understood this way, the tax on canceled debt functions less as a means of taxing wealth accession and more as a means of allocating the costs of these political decisions to the people who benefited the least from them.

In Part II, I explain how we got here. For most of the twentieth century, the tax on canceled debt was a judicial doctrine. Throughout this period, the theoretical justification for the tax and its various exceptions were the subject of extensive academic debate. Although scholars disagreed about the justifications for the tax, most agreed that the tax did not exist to punish individual debtors who fell on hard times. In the 1980s and 1990s, Congress quietly created a procedural framework for the tax that would eventually ensnare the kinds of individual debtors long thought to be outside the scope of the tax. These changes would fundamentally alter the way that the tax functioned and, as noted above, corresponded to broader policy shifts outside tax.

In Part III, I make the normative case against the tax by showing how my reframing fits with and extends existing scholarly critiques of tax and credit policy.

Finally, in Part IV, I offer thoughts on reform. I propose two kinds of reform: changes to tax administration and substantive changes to federal tax law. Both reforms raise potential problems, including problems of horizontal equity and tax abuse. I consider these objections but ultimately conclude that the case against the tax outweighs potential costs.

## I. THE DEBT LANDSCAPE

There is presently approximately $17 trillion of outstanding consumer debt.[42] This consists of approximately $12.26 trillion in housing debt, $1.6 trillion in student debt, $1.25 trillion in consumption debt, and $1.8 trillion in acquisition debt.[43] These numbers reflect significant growth in both real and nominal terms over the last fifty years.[44] To illustrate this point,

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42. *Household Debt and Credit Report*, FED. RSRV. BANK OF N.Y., https://www.newyorkfed.org/microeconomics/hhdc [https://perma.cc/X3K2-6K3W] (last visited Mar. 6, 2023).

43. These figures are pulled from the Federal Reserve Bank of New York's report on household debt and credit. *Id.* The report defines housing debt as including first mortgages and home-equity lines of credit, and student debt as including public and private loans. *See* FED. RSRV. BANK OF NEW YORK, DATA DICTIONARY 28 (2013), https://www.newyorkfed.org/medialibrary/interactives/householdcredit/data/pdf/data_dictionary_HHDC.pdf [https://perma.cc/998W-VDYZ]. The figures for both consumption debt and survival debt are very rough approximations that are likely conservative estimates. The $1.8 trillion figure for acquisition debt includes $1.55 trillion in auto debt plus half of the $0.51 trillion in other debt. The consumption debt figure is $0.99 trillion in credit card debt plus half of the $0.51 trillion in other debt, which the report defines as "Consumer Finance (sales financing, personal loans) and Retail (clothing, grocery, department stores, home furnishings, gas etc) loans." *Id.*

44. *See* ANDREW HAUGHWOUT, DONGHOON LEE, JOELLE SCALLY, LAUREN THOMAS & WILBERT VAN DER KLAAUW, FED. RSRV. BANK OF N.Y., TRENDS IN HOUSEHOLD DEBT AND CREDIT (2019), https://www.newyorkfed.org/medialibrary/media/research/staff_reports/sr882.pdf [https://perma.cc/Z7BU-S34H]; *see also* ATIF MIAN & AMIR SUFI, HOUSE OF DEBT 3–6 (2014) (on the dramatic growth in household debt from 2000 to 2007).

below are two graphs charting growth in the primary categories of consumer debt since 1945. Figure 1 charts the growth of household debt[45]:

*Figure 1*

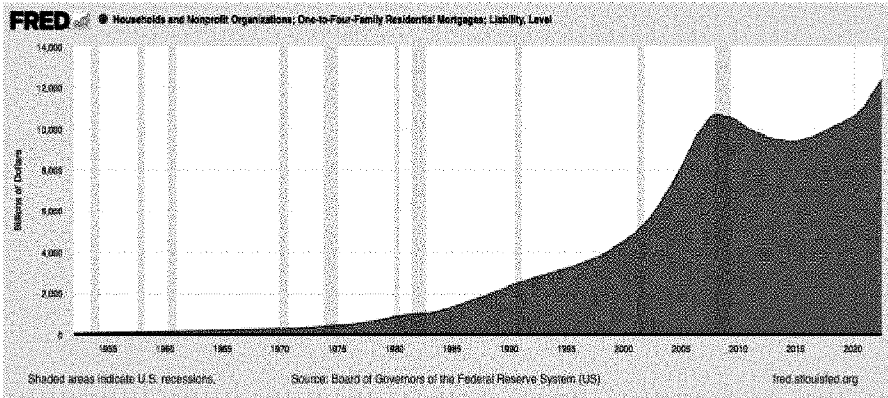
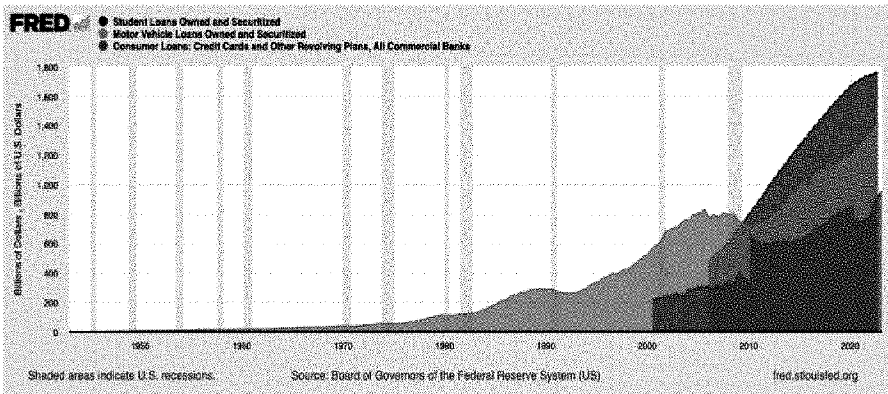



Figure 2 charts the growth of student debt, auto debt, and revolving debt based on when origination data was available[46]:

*Figure 2*




45. *Households and Nonprofit Organizations; One-to-Four-Family Residential Mortgages; Liability, Level*, FED. RSRV. BANK OF ST. LOUIS, https://fred.stlouisfed.org/series/HHMSDODNS [https://perma.cc/BYC7-GLA2] (last visited Mar. 6, 2022).

46. This chart is compiled from three different data sets. *See Student Loans Owned and Securitized*, FED. RSRV. BANK OF ST. LOUIS, https://fred.stlouisfed.org/series/SLOAS [https://perma.cc/W4PB-PQXG] (last visited Mar. 6, 2023); *Motor Vehicle Loans Owned and Securitized*, FED. RSRV. BANK OF ST. LOUIS, https://fred.stlouisfed.org/series/MVLOAS [https://perma.cc/TJT3-HKBL] (last visited Mar. 6, 2023); *Consumer Loans: Credit Cards and Other Revolving Plans, All Commercial Banks*, FED. RSRV. BANK OF ST. LOUIS, https://fred.stlouisfed.org/series/CCLACBW027SBOG [https://perma.cc/J9AQ-F9UT] (last visited Mar. 6, 2023).

As these graphs illustrate, consumer debt grew significantly during this time period, with inflection points around 1980 and 2000. In this part, I explain that growth. A central theme of this part is that this growth was not merely the product of market forces but also of federal policy. In telling that story, I do not mean to present a monocausal explanation of this growth. Instead, by foregrounding the state's role in shaping consumer debt markets, I hope to complicate the way we understand the purpose of consumer debt and the function of the tax on canceled debt.

I start by discussing places where the story of the federal government's role in shaping consumer debt markets is perhaps least complicated and most familiar: policy debt, that is, housing debt and student debt. I first chronicle how the federal government created the mortgage market and how the present size and shape of this market follow from deregulatory moves in the 1970s and 1980s. I then explain how the student debt market emerged from changes to higher education policy in the 1970s. A key theme of these sections is how the federal government turned to debt markets to solve thorny distributional questions in housing policy and higher education policy.

From there, I shift to consumption debt. As I explain here, one way to understand the growth of consumption debt is as the product of financial deregulation, declining wage security, and welfare reform. Financial deregulation created competitive pressures on institutions that had historically served low-income consumers. In the 1990s, declining wages, growing wealth inequality, and the effective elimination of the social safety net for the poorest Americans dramatically increased demand for credit among low-income consumers. These forces underwrote the emergence and expansion of extractive lending models built to prey on the financial distress of low-income Americans.

I conclude by discussing acquisition debt. As I argue below, the forces that underwrote the growth of policy debt and consumption debt in the last half century are relevant for understanding the growth of acquisition debt during this same time period. Financial deregulation, securitization, and the evolution of credit risk models increased the profitability of consumer lending. These developments occurred in conjunction with other legal, political, and social changes that encouraged and supported consumer indebtedness. The increased profitability of consumer lending and the increased demand for consumer credit contributed to the growth of acquisition debt over the last half century and price increases in certain markets that rely on debt-financed purchases.

### *A. Housing Debt*

The modern mortgage market is the product of two distinct periods of policy innovation: (1) New Deal interventions in the 1930s designed to stabilize the then collapsing American mortgage market and (2) financial deregulation and the development of securitization in the 1970s and 1980s designed to repair the decaying New Deal infrastructure. Policies pursued

during both periods would dramatically expand the size of the housing market but with vastly different distributional consequences.[47]

Prior to the Great Depression, the mortgage market was much smaller than it is today.[48] Homeownership rates were low, housing finance was scarce and locally provided, and there was no national secondary market.[49] The federal government had little to no involvement in the daily functioning of these markets.[50] The primary form of pre-Depression financing was a short-term, nonamortizing loan known as a bullet loan.[51] Bullet loans were often seller-financed, required large down payments, and were routinely rolled over.[52] Because loan performance was typically tied to seasonal income, the pre-Depression housing market was vulnerable to outside shocks[53] and regularly cycled between periods of boom and bust—i.e., a rise in prices would be followed by a steep decline and a wave of defaults and foreclosures.[54] These downturns could ripple out and affect the broader American economy even though the housing market itself was relatively small.[55]

During the Great Depression, housing prices collapsed, which caused credit markets to seize up and led to a wave of defaults and foreclosures.[56] Through a series of dramatic interventions in the 1930s, the federal government fundamentally transformed the size and shape of housing

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47. Much of the history in this section comes from LEVITIN & WACHTER, *supra* note 32, and GRETA R. KRIPPNER, CAPITALIZING ON CRISIS (2011). But parts of this history are retold by many other sources. *See, e.g.*, TAYLOR, *supra* note 32, at 29–37; SARAH L. QUINN, AMERICAN BONDS: HOW CREDIT MARKETS SHAPED A NATION 139–49 (2019); MEHRSA BARADARAN, THE COLOR OF MONEY: BLACK BANKS AND THE RACIAL WEALTH GAP 101–34 (2017); MONICA PRASAD, THE LAND OF TOO MUCH: AMERICAN ABUNDANCE AND THE PARADOX OF POVERTY 196–227 (2012); LOUIS HYMAN, DEBTOR NATION: THE HISTORY OF AMERICA IN RED INK 73–98 (2011).

48. *See* LEVITIN & WACHTER, *supra* note 32, at 16.

49. *See id.* at 17–32.

50. To be sure, although the federal government had little involvement in the residential mortgage market prior to the New Deal, it was involved in housing in other ways. Two that Levitin and Wachter note are its involvement in the farm finance system and extensive housing development during World War I. *Id.* at 32–37. In addition, Professor Sarah Quinn notes that the federal government had extensive involvement in direct lending during the early years of the American Republic and after the Civil War to encourage land development along the frontier. QUINN, *supra* note 47, at 22–48.

51. *See* LEVITIN & WACHTER, *supra* note 32, at 19.

52. *See id.* at 19–22.

53. *Id.* at 23 (explaining that "[t]he pre-New Deal housing market was vulnerable to national economic conditions, such as the seasonal flows of capital from money centers to the interior in conjunction with the harvest").

54. *See id.* at 22 (explaining that because of a lack of equity and a "volatile monetary environment," borrowers in the pre–New Deal housing market would likely default during a severe market downturn). Examples of boom-and-bust cycles include the panics of 1819, 1873, and 1893, as well as the Great Depression. *See* QUINN, *supra* note 47, at 27–37 (on the panics of 1819 and 1873 as examples of Kindlebergian booms and busts); LEVITIN & WACHTER, *supra* note 32, at 28, 41 (on the panic of 1893 and the Great Depression).

55. *See* QUINN, *supra* note 47, at 29 (on defaults triggering a broader collapse in land prices during the panic of 1819); LEVITIN & WACHTER, *supra* note 32, at 41 (on the broader collapse in housing prices triggered by the defaults during the Great Depression).

56. *See supra* note 55.

finance in America. The government initially intervened only to stabilize housing markets but later intervened to revive and rebuild the American economy.[57] The core of these interventions was the creation of new federal agencies that would prop up and expand the housing market. As Professors Adam J. Levitin and Susan M. Wachter explain, these reforms led to the development of a new mortgage product that would come to dominate mortgage finance after the Great Depression: the thirty-year, fixed-rate, amortizing mortgage, or, as Levitin and Wachter call it, the "American Mortgage."[58] The federal government fabricated the American Mortgage, and its wide availability during the twentieth century would underwrite the dramatic growth of the American middle class.[59]

Yet there were two fault lines embedded in the New Deal framework. The first related to race. New Deal policy virtually excluded aspiring Black homeowners from the mainstream mortgage market, which pushed these homeowners to the predatory margins of the housing market.[60] In the late 1960s and 1970s, Congress formally eliminated race-based discrimination in mortgage lending. And Black homeowners who had been previously shut out of the conventional mortgage market began demanding access to safe and conventional mortgages.

The second fault line was macroeconomic. The New Deal framework was designed not only to support and stabilize the housing market, but also to decrease volatility in the economy.[61] It achieved stability in a rather complicated way. New Deal–era legislation broke up the financial system into a number of discrete components with very specific functions.[62] When times were good, credit would flow through these narrow and tightly regulated channels to businesses and consumers.[63] When the economy overheated, credit markets would contract in order to allow the economy to cool down.[64] The goal was to have small and regular periods of growth and contraction rather than large and dramatic swings.[65]

Housing sat in the center of this complex hydraulic system. During good times, loose mortgage credit encouraged and supported economic growth.[66] But aspiring homeowners were the first to feel the pinch when the economy overheated and credit markets contracted.[67] Thus, the system only worked if

57. *See supra* note 55; PRASAD, *supra* note 47, at 202 (explaining that "Roosevelt and many other observers . . . saw reviving homeownership as a key lever with which to get the economy moving").

58. LEVITIN & WACHTER, *supra* note 32, at 38.

59. *See id.* at 60–61.

60. *See* LEVITIN & WACHTER, *supra* note 32, at 61–64 (on redlining by the Federal Housing Administration). For a rich history of the predation that redlining engendered, see BERYL SATTER, FAMILY PROPERTIES: RACE, REAL ESTATE, AND THE EXPLOITATION OF BLACK URBAN AMERICA (2009).

61. *See* KRIPPNER, *supra* note 47, at 61–63.

62. *See id.*

63. *See id.*

64. *See id.*

65. *See id.*

66. *See id.* at 62–63.

67. *See id.*

periods of contraction were brief and small in scale. In the 1960s and 1970s, this system began to unravel under the forces of disintermediation and inflationary pressure.[68] A number of new entities emerged to compete with banks and thrifts for capital.[69] At the same time, the economy began to experience price increases across a number of sectors.[70] These disintermediating and inflationary forces made long-term lending less profitable, and financial institutions scaled back housing finance.[71]

The federal government responded to these trends and competing claims by turning to markets as opposed to repairing "New Deal–era institutions."[72] First, the government pioneered a new technique to increase the amount of capital available to finance new mortgages—securitization. The government created new entities that would purchase, bundle, and sell mortgages that met specific criteria to investors. Securitization allowed regulated entities to offload risk to government sponsored entities.[73] Second, the government pursued broad-scale financial deregulation, a key element of which was the deregulation of interest rates. The government deregulated both the interest that financial institutions had to pay depositors and deregulated the kind and amount of interest that financial institutions could charge borrowers.[74]

Deregulation and securitization made mortgage credit more profitable by allowing financial institutions to offload risk onto investors and borrowers. These moves were not just about thawing credit markets, but also about addressing the claims of borrowers who were shut out of credit markets. As Professor Louis Hyman explains, for policy makers of the era, "the problems of inequality were framed as a problem of credit access rather than job access."[75] Thus, "[m]ore credit, and not higher wages, would be enough to solve" urban unrest that stemmed, in part, from decades of racist federal housing policy.[76] And deregulation and securitization were part of a broader policy program to expand credit access to communities previously shut out of conventional housing markets.[77]

The market-oriented turn in housing policy in the 1970s and 1980s paved the way for the eventual emergence of "a completely private, largely unregulated secondary mortgage market."[78] Private-label securitizations (PLS) first emerged in the late 1970s and would grow to eventually account for 56 percent of the securitization market in 2006.[79] The dominance of PLS and PLS products in the early aughts did not necessarily change the public nature of housing finance. PLS issuers benefitted from the state-supported

68. *See id.* at 63–73.
69. *See id.*
70. *See id.*
71. *See id.*
72. *See* HYMAN, *supra* note 47, at 224.
73. *See id.* at 223–34.
74. *See id.* at 234–47.
75. *Id.* at 224.
76. *See id.*
77. *See generally id.* at 220–81.
78. LEVITIN & WACHTER, *supra* note 32, at 95.
79. *See id.* at 98–100.

architecture and implicit state guarantees that provided market liquidity and market stability.[80]

But deregulation and securitization changed the character of the kinds of mortgages that were available to aspiring homeowners (including many aspiring Black homeowners previously shut out of conventional mortgage markets). Variable-rate and second-lien mortgages with complex and opaque payment structures became increasingly common.[81] Indeed, by 2006, loans that were functionally equivalent to pre-Depression-era bullet loans were widespread.[82] And the conditions in the housing market resembled the conditions that existed prior to the Great Depression, only on a much larger scale.[83]

The deregulatory moves of the 1970s and 1980s fundamentally reallocated the benefits and burdens of housing finance. Under the New Deal framework, the benefits and burdens of housing finance were widespread among those eligible to participate. Following deregulation, mortgage credit was broadly available, yet the benefits were concentrated among those with the greatest capacity to pay, and the burdens were concentrated among those with the least capacity to pay. In many ways, deregulation accentuated the inequities of the New Deal framework by saddling borrowers previously shut out of mortgage markets with excessive and unaffordable debt. Moreover, this reallocation of benefits and burdens was somewhat opaque, and the costs of this reallocation would not become apparent until homeowners began defaulting in large numbers in 2007.

### *B. Student Debt*

For most of the twentieth century, higher education was characterized by low tuition and direct subsidies to institutions and students.[84] In the late-nineteenth century, the federal government granted federal land to state governments to facilitate the creation and expansion of public universities.[85] These early efforts were followed by a period of progressive policymaking, which dramatically expanded the educational franchise.[86] In the 1970s, the

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80. Professor Greta R. Krippner's financialization framework provides another way to understand the public nature of the emergence of PLS. For Krippner, policy makers sought to financialize the economy to solve "a series of economic, social, and political dilemmas . . . in the late 1960s and 1970s." KRIPPNER, *supra* note 47, at 2–3. Thus, the emergence and dominance of PLS in the early aughts was, in many ways, a state project and not an organic and endogenous market development.

81. *See* LEVITIN & WACHTER, *supra* note 32, at 104–09.

82. *See id.*

83. *See id.*

84. *See* SUZANNE METTLER, DEGREES OF INEQUALITY: HOW THE POLITICS OF HIGHER EDUCATION SABOTAGED THE AMERICAN DREAM 51–64 (2014); John R. Brooks, *Income-Driven Repayment and the Public Financing of Higher Education*, 104 GEO. L.J. 229, 245 (2016); Herrine, *supra* note 21, at 288–94 (on education policy before the Higher Education Act of 1965).

85. *See* METTLER, *supra* note 84, at 5–6.

86. Two key policies were the Servicemen's Readjustment Act of 1944 (the "GI Bill"), *see* ch. 268, 58 Stat. 284 (codified in scattered sections of 38 U.S.C.), which provided tuition coverage for World War II veterans, and the National Defense Education Act of 1958

structure of higher education financing began to shift from direct subsidies, low tuition, and limited student borrowing to indirect subsidies, higher tuition, and significant student borrowing.[87] Although the reasons for this shift are multifaceted, a common explanation is that it provided an easy solution to competing social, economic, and political pressures.[88]

In the 1970s, the federal government was facing rapidly rising tuition costs and declining state budgets, which put significant strain on the then existing regulatory framework in higher education.[89] At the same time, the federal government was under pressure to continue and expand its postwar commitments to broad social provision.[90] This included expanding educational opportunities for socioeconomically marginalized groups.[91] Expanding access to credit provided a simple solution to these problems. In higher education, that tended to mean scaling back direct support for tuition and expanding subsidies for student loans.[92]

The federal government accomplished this in several ways: First, it expanded existing subsidies and guarantees for private student loans.[93] Second, it created a new government-sponsored entity, the Student Loan Marketing Association, or "Sallie Mae," to provide secondary market liquidity for student loans.[94] Third, it scaled back support for direct aid such as tuition assistance and need-based grants.[95] And fourth, it began to allow students to seek financial aid to attend for-profit colleges, which offered

(NDEA), *see* Pub. L. No. 85-864, 72 Stat. 1580 (no longer in force), which provided low-interest, need-based federal loans and merit-based fellowships for certain kinds of study.

87. *See* METTLER, *supra* note 84, at 64–66; Brooks, *supra* note 84, at 247–51; Jonathan D. Glater, *Student Debt and Higher Education Risk*, 103 CALIF. L. REV. 1561, 1577–79 (2015).

88. *See* METTLER, *supra* note 84, at 64–68.

89. *See* Brooks, *supra* note 84, at 246.

90. *See* KRIPPNER, *supra* note 47, at 16–23.

91. There were two important gaps in postwar higher education policy. First, the GI Bill was limited to men. *See* METTLER, *supra* note 84, at 57–58. Second, Black veterans struggled to take advantage of the GI Bill because of discrimination and limited education opportunities in the segregated South. *See* Erin Blakemore, *How the GI Bill's Promise Was Denied to a Million Black WWII Veterans*, HISTORY, https://www.history.com/news/gi-bill-black-wwii-veterans-benefits [https://perma.cc/2KNC-PGC6] (Apr. 20, 2021).

92. *See* Brooks, *supra* note 84, at 246. Brooks suggests that the shift from public to private spending was the product of declining state support, rising tuition, and "an explicit policy push for students and families to share more of the overall cost" of higher education. *Id.* Professor Suzanne Mettler, on the other hand, suggests that this legislative response was a product of both policy "drift" and the innate characteristics of higher education law. METTLER, *supra* note 84, at 67 (quoting Jacob S. Hacker, *Privatizing Risk Without Privatizing the Welfare State: The Hidden Politics of Social Policy Retrenchment in the United States*, 98 AM. POL. SCI. REV. 243, 246 (2004)). Per Mettler, the politics of fiscal conservatism led lawmakers to respond to rising tuition and declining state budgets by scaling back Pell grant spending and expanding student loans. *Id.* at 76.

93. *See* METTLER, *supra* note 84, at 64–66; Brooks, *supra* note 84, at 247–51; Glater, *supra* note 87, at 1577–79.

94. *See* Herrine, *supra* note 21, at 298; METTLER, *supra* note 84, at 63.

95. *See* Brooks, *supra* note 84, at 249.

expensive certificates of dubious merit to students on the margins of the educational system.[96]

Thus, the broad character of higher education policy from the 1970s until 2010 was to shrink the public option in education and expand the publicly subsidized, private student-lending market.[97] During this period, tuition for higher education rose dramatically.[98] The costs of this rise, however, were not distributed evenly, with students from socioeconomically marginalized groups bearing a disproportionate burden relative to other students.[99] As with housing debt, this era of policymaking reflected an opaque reallocation of the costs and risks associated with higher education from the broader public to individual students and their families.

In the past decade, policy makers have begun to push back against this policy shift in higher education. In 2010, the federal government eliminated indirect subsidies for private student loans and began providing loans directly.[100] Moreover, Congress introduced a number of income-driven repayment programs that decreased monthly payments on qualifying student loans and, in some cases, offered debt forgiveness.[101] This shift has led scholars such as Brooks and Levitin to argue that "[t]he current economic structure of federal student loans does not resemble a true credit product, but a government grant program coupled with a progressive, income-based tax on recipients."[102] One implication of this shift for Brooks and Levitin is that we ought to eliminate aspects of the "legal, financial, and institutional apparatus" that reflect the pre-2010 status quo of a publicly subsidized, private student-lending market, including the taxability of canceled student loan debt.[103]

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96. *See id.*; Herrine, *supra* note 21, at 299–300 (arguing that "the inclusion of for-profits and the more general move from 'higher education' to 'postsecondary' education was part of the emerging understanding of the higher education field as a market"). For a rich account on the growth of for-profit colleges, see TRESSIE MCMILLAN COTTOM, LOWER ED: THE TROUBLING RISE OF FOR-PROFIT COLLEGES IN THE NEW ECONOMY (2017).

97. To be sure, there were some legislative departures from this general mode of policymaking. In the early 1990s, the federal government began directly offering loans through the Federal Direct Student Loan Program. Omnibus Budget Reconciliation Act of 1993, Pub. L. No. 103-66, sec. 4021, § 455(d)(1)(D), 107 Stat. 312, 348 (codified at 20 U.S.C. § 1087e(d)(1)(D)). Congress also introduced the Income-Contingent Repayment (ICR) plan, which allowed certain borrowers to make payments based on 20 percent of their discretionary income, with the remaining balance of the loan forgiven after twenty-five years. *Id.*

98. For example, Mettler notes that tuition at four-year public institutions grew from an inflation-adjusted amount of approximately $7,000 in 1973 to approximately $22,000 in 2010. METTLER, *supra* note 84, at 53. The cause of rising tuition is multifaceted, but a common explanation for the rise is Professor William J. Baumol's "cost disease," under which decreasing costs in sectors with high labor productivity (e.g., manufacturing, retail) are offset by increasing costs in sectors with low labor productivity (e.g., health care, higher education). *See* Brooks, *supra* note 84, at 240 (on Baumol's cost disease and other explanations for tuition increases).

99. *See* Glater, *supra* note 87, at 1563–64; Brooks, *supra* note 84, at 258.

100. *See* Health Care and Education Reconciliation Act of 2010, Pub. L. No. 111-152, § 2201, 124 Stat. 1029, 1074 (codified as amended at 20 U.S.C. § 1071).

101. *Id.*

102. Brooks & Levitin, *supra* note 32, at 5.

103. *Id.*

### *C. Consumption Debt*

By consumption debt, I generally refer to debt that consumers incur to purchase basic and necessary living expenses or manage unexpected economic shocks. In other words, debt that consumers use to smooth out consumption across periods of income volatility. Since the 1980s, outstanding consumption debt of this variety has steadily grown.[104] This part summarizes recent scholarly explanations of that growth.

One way to understand the growth of consumption debt is as the product of financial deregulation, declining wage security, and welfare reform. For most of the twentieth century, the financial needs of low-income consumers were served by a diverse array of financial institutions.[105] These institutions[106] abandoned low-income communities because of competitive pressures and financial deregulation as described in Part I.A.[107] Both forces precipitated the unraveling of traditional financial services for low-income consumers.[108]

Financial deregulation of the 1970s and 1980s was followed by legal and economic shifts in the 1990s that increased the demand for credit among low-income consumers. Declining wages and growing wealth inequality meant that more middle- and low-income consumers were turning to credit markets to finance basic needs.[109] And welfare reform of the 1990s

104. *See* Neil Bhutta, Paige Marta Skiba & Jeremy Tobacman, *Payday Loan Choices and Consequences*, 47 J. MONEY CREDIT & BANKING 223, 227 (2015) (on the growth of payday loans). *See generally* HYMAN, *supra* note 47, at 220–81 (on credit card growth since the 1980s).

105. *See, e.g.*, Michael S. Barr, *Banking the Poor*, 21 YALE J. REGUL. 121, 152 (2004); Mehrsa Baradaran, *How the Poor Got Cut Out of Banking*, 62 EMORY L.J. 483, 487 (2013); ANNE FLEMING, CITY OF DEBTORS: A CENTURY OF FRINGE FINANCE 235–40 (2018). I describe this account in more detail in another work. *See* Vijay Raghavan, *Consumer Law's Equity Gap*, 2022 UTAH L. REV. 511.

106. These included credit unions, savings and loans, industrial loan companies, personal finance companies, and traditional banks. *See* Baradaran, *supra* note 105, at 486–87; FLEMING, *supra* note 105, at 231–35.

107. Specifically, banks, facing competition from new entrants in the late 1960s, put pressure on Congress to eliminate restrictions on deposits and lending. *See* FLEMING, *supra* note 105, at 228–31. Congress, aided by the Supreme Court, responded to this pressure with the deregulatory moves in the 1970s and early 1980s described in Part I.A, which fundamentally reshaped the consumer financial landscape. *See id.* (describing the Supreme Court's interpretation of the preemptive scope of the National Bank Act in *Marquette National Bank of Minneapolis v. First of Omaha Service Corp.*, 439 U.S. 299 (1978), and deregulatory efforts that followed to level the playing field between federal- and state-chartered banks); *see also* Baradaran, *supra* note 105, at 515 (describing efforts to repeal Regulation Q, which restricts the payment of interest on checking accounts). The deregulation of consumer financial markets caused conventional financial institutions (such as credit unions) to drop services for low-income consumers—in response to competitive pressure from newly deregulated banks—and to push federal and state governments for further deregulation. In addition, less conventional financial institutions (such as personal finance companies) abandoned low-income communities for newer and more profitable opportunities created by deregulation. *Id.* at 505–09, 514–19, 523–26.

108. *See supra* note 107.

109. *See* HYMAN, *supra* note 47, at 221–23.

effectively ended the social safety net and pushed a new class of poor borrowers into credit markets.[110]

These developments occurred in conjunction with other legal, political, and social changes that encouraged and supported consumer indebtedness. Perhaps the most important of these was the legitimization of indebtedness "by an evolving coalition between progressive activists and consumer lenders."[111] Professor Gunnar Trumbull explains:

> [B]y the 1990s, household credit was viewed on both the left and right of the political spectrum as an effective tool for improving poor households' access to economic prosperity. The idea that free access to financial markets could play a role in generating social equality dominated the third-way politics of the Bill Clinton presidency, and carried through seamlessly to the George Bush presidency under the new label of the ownership society.[112]

This gave credit a political lightness that manifested in a hands-off approach to the regulation of consumer credit markets and an increasing dependence on consumer credit for not just housing, education, and present consumption, but most other matters.[113]

A number of new financial institutions and business models emerged to meet the growing demand spurred by these shifts. One example is fringe financial institutions, which emerged in the late 1980s and began offering credit products targeting low-income consumers with immediate cash needs.[114] These products were typically short-term, thinly underwritten, high-interest loans.[115] Most borrowers who received a short-term, high-interest loan were expected to default.[116] And lenders made money through interest, fees, and the ability to garnish the borrower's wages or seize their assets.[117]

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110. The centerpiece of welfare reform in the 1990s was the Personal Responsibility and Work Opportunity Reconciliation Act of 1996 (PRWORA), which replaced broad-based state support with narrow, incentive-based state support. Pub. L. No. 104-193, 110 Stat. 2105 (codified as amended in scattered sections of the U.S.C.). These changes dramatically reduced enrollment in direct state support, and today, most agree that the public safety net is effectively dead. *See* Sara Sternberg Greene, *The Bootstrap Trap*, 67 DUKE L.J. 233, 244 (2017).

111. GUNNAR TRUMBULL, CONSUMER LENDING IN FRANCE AND AMERICA: CREDIT AND WELFARE 13 (2014).

112. *Id.* at 209.

113. HYMAN, *supra* note 47, at 281. On the political lightness of credit, see QUINN, *supra* note 47; KRIPPNER, *supra* note 47.

114. *See* FLEMING, *supra* note 105, at 237–38.

115. Examples include payday loans, title loans, and installment loans. The costs on the loans could be quite high. For example, the annualized cost of a payday loan can range from 391 percent to well over 1,000 percent. *See* Payday, Vehicle Title, and Certain High-Cost Installment Loans, 82 Fed. Reg. 54472, 54477 (Nov. 17, 2017) (noting that the median storefront payday loan fee is $15 per $100 borrowed, which results in an annualized cost of credit of 391 percent for a fourteen-day loan); King v. B&B Inv. Grp., Inc., 2014-NMSC-024, 329 P.3d 658, 662 (N.M. 2014) (noting that defendant's loan products carried APRs between 1,147.14 and 1,500 percent).

116. *See* Payday, Vehicle Title, and Certain High-Cost Installment Loans, 81 Fed. Reg. at 47864, 47874, 47883.

117. *See id.*

A second example is the credit card industry, which began to increasingly rely on revenue from low-income and minority borrowers. Securitization and developments in credit-risk modeling decreased the costs of credit card lending, but credit card demand among prime borrowers declined in the early 1990s.[118] As a result, credit card companies began targeting borrowers with riskier credit profiles and credit needs.[119] As the credit card industry shifted its focus from prime to subprime borrowers in the late 1990s, its profitability model shifted as well to what Professor Ronald J. Mann described as the "sweat box" model of lending.[120] For credit card companies, profits no longer turned on the repayment of loans and instead depended on delinquency and the ability to extract fees and interest from "borrowers who become financially distressed."[121]

A third example is overdraft. An overdraft occurs when a consumer withdraws an amount that exceeds the funds available in a deposit account.[122] As Professor Natasha Sarin explains, "[o]verdraft is essentially a very high-interest loan: If paid within two weeks, a $27 overdraft fee for a $20 overdraft incident is equivalent to a bank loan with an APR of 3,520 percent."[123] Overdraft has become a critical source of revenue for banks,[124] and deposit accounts are often structured in ways to steer borrowers into overdraft, conceal costs, and maximize the fees generated from an overdraft transaction.[125] Moreover, banks use fees from overdraft to cross-subsidize cheaper services for affluent customers.[126]

The financial products that emerged in the last half century to meet the credit demands of low-income consumers were not designed to be welfare enhancing.[127] To the contrary, the profitability of these loans was often

118. *See* HYMAN, *supra* note 47, at 264.

119. *See id.* at 268–75.

120. Ronald J. Mann, *Bankruptcy Reform and the "Sweat Box" of Credit Card Debt*, 2007 U. ILL. L. REV. 375, 384.

121. *Id.* at 384–85.

122. *See* Natasha Sarin, *Making Consumer Finance Work*, 119 COLUM. L. REV. 1519, 1552 (2019).

123. *Id.* at 1553. Indeed, overdraft fees are the primary substitutes for payday loans. *See* Robert DeYoung & Ronnie J. Phillips, *Payday Loan Pricing* 6 (Fed. Rsrv. Bank Kan. City Econ. Rsch. Dep't, Working Paper RWP 09-07, 2009) ("The centrality of the bank account in the payday loan production function suggests that the closest competitive substitutes for payday loans are not the products offered by fringe financiers, but the overdraft protection offered by mainstream banks, thrifts, and credit unions.").

124. *See* CFPB, CFPB STUDY OF OVERDRAFT PROGRAMS 13 (2013), https://files.consumerfinance.gov/f/201306_cfpb_whitepaper_overdraft-practices.pdf [https://perma.cc/95UZ-6DLR]; Sarin, *supra* note 122, at 1552–53; *CFPB Research Shows Banks' Deep Dependence on Overdraft Fees*, CFPB (Dec. 1, 2021), https://www.consumerfinance.gov/about-us/newsroom/cfpb-research-shows-banks-deep-dependence-on-overdraft-fees/ [https://perma.cc/YF4L-MKAZ].

125. *See* Sarin, *supra* note 122, at 1554 ("The lack of salience of these fees to the consumers who bear them enables banks to generate large overdraft profits."); Gutierrez v. Wells Fargo Bank, 704 F.3d. 712, 716–17 (9th Cir. 2012) (on the sequencing of charges to maximize overdraft fees).

126. *See* Sarin, *supra* note 122, at 1569.

127. Part of the promise of fintech products is their ability to leverage technology to meet the demands on low-income consumers in a nonpredatory fashion. But there is good reason

explicitly tied to a borrower's financial distress. As Atkinson and Professor Jonathan R. Macey have recently argued, the notion that consumption credit constitutes an accession to wealth is highly problematic. Per Macey, "borrowing for current consumption makes the borrower immediately poorer for the simple reason that it adds an ongoing liability to the borrower's balance sheet without adding anything whatsoever to the asset side of the borrower's balance sheet."[128] Atkinson advances this point more sharply by arguing that credit is, at best, "a mechanism of intertemporal and intrapersonal redistribution."[129] But due to the "persistent financial instability" of low-income Americans, credit often functions as a form of regressive redistribution that moves "wealth out of distressed communities and into more affluent ones."[130] In this context, the tax on canceled debt accentuates the regressivity built into modern consumer credit markets.

### *D. Acquisition Debt*

Finally, there is acquisition debt. By acquisition debt, I generally refer to debt that is incurred to finance the purchase of an asset that is not an investment or a home. On some level, the case for taxing the cancellation of acquisition debt may seem more sensible than taxing the cancellation of policy debt or consumption debt. First, there is no long-standing public infrastructure supporting acquisition credit. And second, borrowing to fund the acquisition of an asset like a car is arguably welfare enhancing. Indeed, Macey, who is quite critical of the view that consumption credit is welfare enhancing, argues that the acquisition of capital assets like cars has "real value for the consumer who uses borrowed funds to acquire these assets" and ought to be regulated lightly.[131]

A corollary of Macey's argument is that the cost of a good (or the amount of debt used to finance the acquisition of a good) reflects the value that a consumer receives. In this section, I seek to question the presumptions that borrowing to acquire a good is a welfare-enhancing transaction that transfers "real" value and that the cost of a good reflects value received. One argument against both presumptions is that each ignores the way in which the sociolegal forces described in Part I.C above shape demand in consumer markets that rely on debt financing.

A second argument is that each ignores the way in which legal changes shape the supply of credit in certain markets. The supply-side argument I advance here builds on the postcrisis financialization thesis advanced by scholars such as Professor Greta R. Krippner. A central claim of that literature is that the moves to deregulate credit markets in the 1970s and

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to think that these products replicate many of problems with long-standing fringe financial products. *See* Christopher K. Odinet, *Predatory Fintech and the Politics of Banking*, 106 IOWA L. REV. 1739 (2021); Nakita Q. Cuttino, *The Rise of "Fringetech": Regulatory Risks in Earned-Wage Access*, 115 NW. L. REV. 1505 (2021).

128. Macey, *supra* note 30, at 687.

129. Atkinson, *supra* note 32, at 1093.

130. *Id.* at 1093, 1154.

131. Macey, *supra* note 30, at 693.

1980s merely shifted the locus of inflation rather than eliminating it.[132] In particular, deregulation and easy access to credit created the conditions for financialization of the economy such that capital was redirected from nonfinancial activities to financial activities.[133] This resulted in asset inflation in goods that were primarily purchased with debt.[134]

The theoretical case for this kind of inflation is famously associated with economists Hyman Minsky and Charles P. Kindleberger.[135] Although the mechanics of the Minsky-Kindleberger thesis are complicated, the basic insight is that excess credit during periods of stability leads to overinvestment in unproductive assets.[136] This overinvestment triggers a speculative bubble—in which the asset price becomes untethered from the asset's underlying value—followed by a collapse in asset prices with effects that can ripple throughout the economy.[137]

For Minsky and Kindleberger, these speculative bubbles are endogenous features of capital markets.[138] Yet as Krippner argues, a Minsky-Kindleberger bubble can be triggered by outside forces such as federal policy that channels capital to financial assets.[139] Proponents of the financialization thesis generally advance it to explain the growth in consumer debt markets over the last half century.[140] In recent years, there has been increasing skepticism of that claim.[141] However, even if one rejects the broader causal claims of the financialization thesis, it is hard not to see how demand-side encouragement of credit consumption and supply-side liberalization can converge to create asset bubbles in markets that rely on debt-financed consumption by marginalized consumers.

In such markets, consumers might be price insensitive because the purchase is debt-financed. Structural features of the market and price insensitivity might lead to some general price inflation even in the absence

132. *See* KRIPPNER, *supra* note 47, at 14–16.

133. *See id.*

134. *See id.*

135. *See id.* at 4–7; QUINN, *supra* note 47, at 27–29. *But see* Carolyn Sissoko, *Growth and Financial Instability: Schumpeter's Hypothesis*, SYNTHETIC ASSETS (July 16, 2015), https://syntheticassets.wordpress.com/2015/07/16/growth-and-financial-instability-schumpeters-hypothesis/ [https://perma.cc/9VRZ-T5VX] (crediting Joseph Schumpeter as the initial source for ideas commonly associated with Minsky and Kindleberger).

136. *See* KRIPPNER, *supra* note 47, at 4–7; QUINN, *supra* note 47, at 27–29.

137. *See* KRIPPNER, *supra* note 47, at 4–7; QUINN, *supra* note 47, at 27–29.

138. *See* KRIPPNER, *supra* note 47, at 4–7. Krippner's view on the endogeneity of Minsky's thesis is not necessarily a universal one. For a contrary take that examines the relationship between Minsky's thesis and the social embeddedness of credit markets, see Luke Herrine & Raúl Carillo, The Law & Political Economy of Consumer Finance (July 14, 2022) (unpublished manuscript) (on file with author).

139. *See* KRIPPNER, *supra* note 47, at 16.

140. *See id.*

141. *See, e.g.*, Samuel Knafo & Sahil Jai Dutta, *The Myth of the Shareholder Revolution and the Financialization of the Firm*, 27 REV. INT'L POL. ECON. 476 (2020); Joel Rabinovich, *The Financialization of the Nonfinancial Corporation: A Critique to the Financial Turn of Accumulation Hypothesis*, 70 METROECONOMICA 738 (2019); J.W. Mason & Arjun Jayadev, *The Post-1980 Debt Disinflation: An Exercise in Historical Accounting*, 3 REV. KEYNESIAN ECON. 314 (2015).

of federal policy. When these conditions hold, credit dependence and financialization could create supply-side competition that dramatically bids up the price of the asset in a way that is not necessarily transparent. Because the market primarily serves low-income consumers, risk of the asset bubble bursting might not have any macroeconomic consequences but would cause significant and regressive dislocation.

As an example, consider the growth of the subprime auto lending market in the 2010s.[142] Consumers interested in purchasing a car rarely come to a dealer with independent financing.[143] In most cases, the dealer arranges financing for the consumer with a third party.[144] These loans, known as indirect auto loans, make up the bulk of outstanding auto debt.[145] The subprime auto lending market is the part of the auto lending market that focuses on borrowers who need cars and have riskier credit profiles. Unlike with conventional auto loans, subprime auto lender profits are typically tied to the repossession value of a vehicle and a sweat box model of lending.[146]

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142. Although I focus on the growth of subprime auto lending during the 2010s, there is good reason to think that these trends are relevant today. *See* Amanda Harris, *Subprime Auto ABS Delinquencies Reach Pre-Covid Levels*, AUTO FIN. NEWS (Sep. 6, 2022), https://www.autofinancenews.net/allposts/risk-management/subprime-auto-abs-delinquencies-reach-pre-covid-levels/ [https://perma.cc/5KUB-35CP].

143. *See* Adam J. Levitin, *The Fast and the Usurious: Putting the Brakes on Auto Lending Abuses*, 108 GEO. L.J. 1257, 1261 (2020).

144. *See id.*

145. *See id.* The distinction between indirect and direct auto loans refers to the way in which they are financed. With an indirect loan, the loan is "indirectly" financed by the dealer through a third-party finance company. *See id.* at 1276. With a direct auto loan, by contrast, the loan is financed directly by the dealer. *See id.* at 1275. In practice, this distinction is not particularly meaningful, as many direct auto loans are securitized and sold on secondary markets. *See DriveTime Preps $300M Subprime Auto Securitization*, AM. BANKER (Apr. 1, 2016, 1:12 PM), https://asreport.americanbanker.com/news/drivetime-preps-300m-subprime-auto-securitization [https://perma.cc/BPB8-UM9H] (on securitization by the nation's largest direct auto lender).

146. *See generally* Levitin, *supra* note 143, at 1289–306 (on consumer abuses in the auto lending market, which often increase the risk of repossession). The sweat box model follows from the interest accrual method that most auto loans use: daily simple interest. In a daily simple-interest loan, interest accrues daily and is calculated by multiplying the outstanding principal balance by the interest rate and the period between the current payment and the last payment of accrued interest (measured by days). *See* Mark Macesich, *What Is a Simple Interest Contract in Auto Financing?*, SANTANDER CONSUMER USA (Mar. 25, 2021), https://santanderconsumerusa.com/blog/putting-the-simple-back-into-simple-interest-vehicle-financing [https://perma.cc/A4QP-4PKE]. The amount of a consumer's payment that is allocated to interest depends on how many days have lapsed between payments. Daily simple-interest loans are fully amortizing at the time the loan is originated but cease being fully amortizing if the borrower is late. For a chronically late consumer (even one who is only late by a few days), most of the borrower's payments may go to interest, leaving a large balloon payment at the end of the loan. Borrowers who are in financial distress will almost certainly default because of the compounding effect of being late under a simple interest loan. Consumers are often confused about the mechanics of simple interest and being late, which lenders can exploit. *See* Santander Consumer USA Inc., CFPB No. 2018-BCFP-0008 (Nov. 20, 2018) (alleging subprime auto lender "misrepresented to consumers the impact of receiving a loan extension, including by obscuring that the additional interest accrued during the extension period would be paid before any payments to principal when the consumer resumed making payments").

And the indirect auto lenders who provide this financing compete aggressively for a dealer's business by offering the dealer flexibility on front- and back-end pricing.[147] In addition, because most vehicle purchases are debt-financed, consumers tend to be price insensitive, and there is little downward pressure from consumers on price.[148] This is particularly true of consumers who purchase cars at dealers that target those with poor or no credit.

Auto lenders also have a number of relatively cheap remedies they can pursue to collect amounts from delinquent debtors and seize collateral, including starter-interrupter devices and repossession.[149] Together, indirect financing, price insensitivity, and robust remedies mean that dealers can generally charge supracompetitive prices for cars, and auto lenders can charge supracompetitve rates for auto loans.[150]

In the 2010s, several additional factors added to the inflationary pressures built into the subprime auto lending market, the most important of which was a very liquid secondary market.[151] Following the financial crisis, interest rates were at historically low levels, which lowered the costs of auto lending.[152] In particular, because overall yields were low after the financial crisis, investors were hungry for high-yield, low-risk investments.[153] Subprime auto loans were an ideal target because they provided relatively high yields for relatively little risk.[154] This meant that subprime auto lenders could borrow cheaply from capital markets to finance their operations. This led to a substantial growth of outstanding auto debt, which, from the first quarter of 2010 to the first quarter of 2020, grew approximately 93 percent,

147. *See* Levitin, *supra* note 143, at 1264.

148. *See id.*

149. *See* Pamela Foohey, *Consumers' Declining Power in the Fintech Auto Loan Market*, 15 BROOK. J. CORP. FIN. & COM. L. 1, 4, 25 (2020).

150. *See* Levitin, *supra* note 143, at 1265. Fear that the structural features of the auto lending market might be driving price inflation is a core concern in the Federal Trade Commission's proposed rule regulating fees in vehicle transactions. *See* Motor Vehicle Dealers Trade Regulation Rule, 87 Fed. Reg. 42012 (proposed July 13, 2022) (to be codified at 16 C.F.R. pt. 463).

151. Other factors include the fact that car dealers were exempt from the Dodd-Frank Wall Street Reform and Consumer Protection Act, *see* Pub. L. No. 111-203, 124 Stat. 1376 (2010) (codified as amended in scattered sections of the U.S.C.), that technological advances allowed lenders to forecast credit risk with greater accuracy, and that a very robust auction market for repossessed vehicles limited lenders' risk if a borrower defaulted. *See* Arthur Delaney & Ryan Grim, *How Congress Gave Auto Dealers a Pass*, HUFFPOST, https://www.huffpost.com/entry/car-sales-subprime_n_5614047 [https://perma.cc/E2VS-LFCZ] (July 25, 2014).

152. For example, yields on three-month treasury bills were less than 0.5 percent from November 2008 until December 2016 (and less than 0.1 percent for long stretches during that interval), which had not been seen since 1941. *See 3-Month Treasury Bill Secondary Market Rate*, FED. RSRV. BANK OF ST. LOUIS, https://fred.stlouisfed.org/series/TB3MS [https://perma.cc/KAJ6-4VC8] (last visited Mar. 6, 2023).

153. *See* Robert Armstrong, *Yield-Crazed Investors Pile into US Subprime Car Loans*, FIN. TIMES (Nov. 25, 2019, 5:05 PM), https://www.ft.com/content/59f3a084-0d80-11ea-bb52-34c8d9dc6d84 [https://perma.cc/9BYD-KV8K].

154. *See id.*

from $700 billion to $1.35 trillion.[155] And part of this growth was attributable to growth in the subprime sector.[156]

One consequence of this trend is that subprime auto lenders were able to originate large loans with a very high risk of default while still maintaining a profit. In fact, it was not uncommon during the 2010s to see subprime auto loan securitizations with projected defaults as high as 37 percent of the underlying pool.[157] The growth in subprime auto lending brought with it regulatory concerns that subprime auto lenders were extending credit without regard to the borrower's ability to repay the loan. In some cases, this scrutiny led to enforcement actions and settlements to forgive auto debt.[158] Any amounts that are canceled under such settlements are presumptively taxable. But it is hard to see how that is sensible. The debt that is canceled does not reflect value that these consumers received but the amount that lenders were able to profitably extract from these credit-dependent consumers.

And this point is not limited to subprime auto debt. As a recent example, consider the recent emergence of "Buy Now, Pay Later" (BNPL) credit. BNPL allows consumers to make purchases of consumer goods and services online and pay the purchase price in monthly installments.[159] BNPL borrowers typically have lower incomes and are from socioeconomically marginalized groups.[160] BNPL lenders are generally able to escape regulatory scrutiny because the loans are structured as interest-free installments.[161] With the phenomenon of general price inflation, it is not implausible that retailers using BNPL financing might attempt to pass on costs in the form of price increases. These increases might be hard to disaggregate from general price inflation but might saddle consumers with excessive debt. As BNPL delinquencies rise, and the issue of debt

155. *See Household Debt and Credit Report*, *supra* note 42.

156. *See* Pamela Foohey, *Bursting the Auto Loan Bubble in the Wake of COVID-19*, 106 IOWA L. REV. 2215, 2217 (2021).

157. *See* Larissa Padden, *GO Financial Preps 2nd ABS Offering with Lower Losses*, AUTO FIN. NEWS (Nov. 17, 2015), https://www.autofinancenews.net/allposts/capital-funding/go-financial-ups-credit-enhancements-in-latest-abs-offering/ [https://perma.cc/8FCL-JYAX].

158. Press Release, Ill. Att'y Gen., Attorney General Raoul Announces $550 Million Settlement with Nation's Largest Subprime Auto Financing Company (May 19, 2020), https://illinoisattorneygeneral.gov/pressroom/2020_05/20200519.html [https://perma.cc/7Z2U-3Z52]. In the interest of full disclosure, I was the principal attorney on this multistate investigation, but I was not involved with its final settlement, and this Article does not disclose any confidential or nonpublic information about the investigation.

159. *See* Julian Alcazar & Terri Bradford, *The Appeal and Proliferation of Buy Now, Pay Later: Consumer and Merchant Perspectives*, FED. RSRV. BANK OF KAN. CITY (Nov. 10, 2021), https://www.kansascityfed.org/research/payments-system-research-briefings/the-appeal-and-proliferation-of-buy-now-pay-later-consumer-and-merchant-perspectives/ [https://perma.cc/APD5-YM6F].

160. *See* TOM AKANA, BUY NOW, PAY LATER: SURVEY EVIDENCE OF CONSUMER ADOPTION AND ATTITUDES 6 (2022), https://www.philadelphiafed.org/consumer-finance/consumer-credit/buy-now-pay-later-survey-evidence-of-consumer-adoption-and-attitudes [https://perma.cc/W388-V4HM].

161. *See* CONSUMER FIN. PROT. BUREAU, BUY NOW, PAY LATER: MARKET TRENDS AND CONSUMER IMPACTS (2022), https://files.consumerfinance.gov/f/documents/cfpb_buy-now-pay-later-market-trends-consumer-impacts_report_2022-09.pdf [https://perma.cc/45U3-JXYD].

forgiveness and its tax consequences may become more salient, the question of whether outstanding BNPL debt reflects "real" value becomes relevant.[162]

The broader point of these examples is that value in these cases is legally contingent on and constructed by the forces that underwrite both credit dependence and easy access to credit. And this point applies to the cancellation of some nonconsumer acquisition debt. For example, the story of the taxi medallion bubble that this Article began with is fundamentally a story of how an asset bubble was built by local policy and punctured by federal and state policy. It seems perverse to characterize the cancellation of such debt as an accession to wealth. That does not mean that the cancellation of acquisition debt never reflects an accession to wealth but that we ought to be somewhat circumspect about presuming that a transaction involving acquisition debt is a welfare-enhancing transaction that transfers real value.

Cross-cutting themes in this part suggest that debt is often a destabilizing force and that policy can either sharpen or soften debt's destabilizing nature. Postcrisis legal and sociological scholarship has emphasized the ways in which the market-oriented turn in the last half century sharpened debt's destabilizing effects. A key question, then, is: who ought to bear the costs of this shift? In this context, the tax on canceled debt appears to be one of a number of federal policies[163] that suggests that borrowers ought to be the ones to bear the costs of debt's destabilizing effects. In the next part, I set out to explain how we got here.

## II. A COMPACT HISTORY OF THE DEBT TAX

The story of Part I shows how the federal government turned to credit markets in the late twentieth century to manage competing claims on its resources in the face of perceived constraints. Yet the turn to credit markets failed to resolve distributional conflict. Instead, it shifted the core of this conflict from being about access to being about costs. Easy access to credit created excessive debt, which burdened those who lacked the capacity to repay their debt. The question was no longer who gets access but whether the costs of the government's market-oriented turn should be borne by those who benefitted the least and were burdened the most by this arrangement.

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162. *See, e.g.*, AnnaMaria Andriotis & John Stensholt, *Missed Payments, Rising Interest Rates Put 'Buy Now, Pay Later' to the Test*, WALL ST. J. (June 1, 2022, 5:30 AM), https://www.wsj.com/articles/missed-payments-rising-interest-rates-put-buy-now-pay-later-to-the-test-11654033930 [https://perma.cc/XR3N-GNVY]; Gabriel Cortés, *Over 40% of Shoppers Have Made a Late Payment Using Buy Now, Pay Later: That's 'An Awful Lot of People,'* GROW (May 17, 2022), https://grow.acorns.com/how-many-shoppers-make-late-payments-using-buy-now-pay-later/ [https://perma.cc/B65K-JMJ6]; Anna Irrera, *As 'Buy Now, Pay Later' Surges, a Third of U.S. Users Fall Behind on Payments*, REUTERS (Sept. 9, 2021, 10:52 AM), https://www.reuters.com/technology/buy-now-pay-later-surges-third-us-users-fall-behind-payments-2021-09-09/ [https://perma.cc/FA3P-4F74].

163. For accounts of how other federal policies shift costs onto borrowers, see discussion *infra* Part III.C.

The tax aspects of this question became particularly salient in 2007.[164] The collapse of the housing market precipitated a wave of defaults and foreclosures that created tax liability for many American families. *The New York Times* detailed the story of one of these families.[165] In 2005, William Stout and his wife lost their home in Allentown, Pennsylvania, because they could not keep up with payments on their $106,000 mortgage.[166] Their lender, Wells Fargo, purchased the property at auction for $1 and then reported that the Stouts had a significant amount of canceled debt to the IRS.[167] The Stouts subsequently received a tax bill of $34,603 from the IRS.[168] At the time, Mr. Stout was only making $25,000 a year.[169]

In the Stouts' case, the matter was eventually resolved, but their situation highlighted problems with how the tax on canceled debt functioned. The federal government created the housing finance market to expand homeownership. For families like the Stouts, federal support for housing finance not only failed to materially improve their lives but left them worse off. The tax on canceled debt seemed to penalize families like the Stouts for foolishly pursuing the American dream.

But the function of the tax in 2007 was far more insidious than serving as a mere penalty. At a time when the federal government was bailing out financial institutions that engaged in reckless lending, it offered virtually no relief to Americans who lost their homes to foreclosure.[170] In this context, the tax functioned less like a deterrent penalty and more like a way to allocate the burdens of stabilizing the financial sector after the crisis. Put differently, the tax arguably redistributed income from Americans who lost their homes to the institutions that made predatory loans to these Americans in the first place.

In the last decade, the cancellation of credit card debt, education debt, and medical debt raised similar questions about the purpose and function of the tax on canceled debt.[171] This part sets out to explain how we got here. One

164. A natural question is why the tax consequences of canceling individual debt only became broadly salient in 2007. The country was beset by smaller consumer debt crises in the 1970s and 1990s. *See* HYMAN, *supra* note 47, at 263, 282. Yet neither seemed to trigger concerns about the tax consequences of canceling debt. Part of the answer could be that neither of those crises was accompanied by any broad-scale movement to cancel debt. But as I argue in this part, the better answer is that the procedural provisions that operationalized the tax against individual debtors had not been fully in place during these prior crises.

165. Geraldine Fabrikant, *Former Home Owners Find Foreclosure Can Have Unintended Tax Consequences*, N.Y. TIMES (Aug. 20, 2007), https://www.nytimes.com/2007/08/20/business/worldbusiness/20iht-tax.1.7180085.html [https://perma.cc/C8M2-X5YP].

166. *Id.*

167. *Id.*

168. *Id.*

169. *Id.* (his salary had decreased 62 percent because of the housing downturn).

170. There are countless postcrisis accounts detailing both the generous support for financial institutions and the weak support for homeowners. For representative and exemplary accounts, see ADAM TOOZE, CRASHED (2010) (on the generous support for financial institutions); DAVID DAYEN, CHAIN OF TITLE (2016) (on the punitive nature of postcrisis homeowner relief even in the face of extensive evidence of fraud by financial institutions).

171. *See supra* notes 19–21 and accompanying text.

simple explanation is that it was an accident. The tax on canceled debt was initially imposed on an economy in which debt played a much smaller role in the lives of average Americans.[172] As the economy developed and the size of debt markets grew, the tax on canceled debt failed to keep pace with these changes. Though there is some truth to this story, this part builds the case for an alternative account.

This part starts by presenting the conventional account of how the tax on canceled debt evolved. From there, it shifts to situating the tax within broader political changes in the twentieth century. Although early versions of the tax are best understood as part of the early income tax's progressive architecture, the tax's function shifted after changes to tax administration in the 1980s and 1990s. In particular, Congress dramatically expanded the number of third-party information reports that entities were required to file annually with the IRS.

As part of this expansion, Congress required that lenders report any canceled debt to the IRS. These changes to tax administration operationalized the tax on canceled debt in a way that would primarily affect individual debtors. As I argue below, these changes accompanied dramatic reductions to our social safety net and can be understood as a component of the late-twentieth century shift from public to private welfare.[173]

### *A. The* Kirby Lumber *Rule and Its Exceptions*

The origins of the tax on canceled debt can be traced to administrative and judicial decisions in the first half of the twentieth century. Following the ratification of the Sixteenth Amendment, Congress passed a series of acts that imposed a national income tax on corporations and individuals. In these early versions of the Internal Revenue Code, Congress defined taxable income with vague and open-textured language.[174] And the task of making sense of this language fell to the IRS and courts.

In 1921, the IRS published treasury regulations that suggested that canceled debt might be taxable.[175] However, those regulations were limited in scope because of U.S. Supreme Court decisions that defined taxable income narrowly.[176] This changed with the Supreme Court's landmark decision in *United States v. Kirby Lumber Co*.[177] *Kirby Lumber* is famously

172. *See* HYMAN, *supra* note 47.

173. *See generally* JACOB HACKER, THE GREAT RISK SHIFT (2006).

174. Examples include the Tariff of 1913 and the Revenue Acts of 1916 and 1921, which all defined taxable income to include gains, profits, and income derived from any source. Tariff of 1913, ch. 16, § 2(B), 38 Stat. 114, 166 (no longer in force); Revenue Act of 1916, ch. 463, § 2(a), 39 Stat. 756, 757 (no longer in force); Revenue Act of 1921, ch. 136, § 213(a), 42 Stat. 227, 238 (no longer in force).

175. Treas. Reg. § 62, art. 545(1)(c) (1921).

176. For example, in *Eisner v. Macomber*, the Supreme Court limited the definition of income to "the gain derived from capital, from labor, or from both combined." 252 U.S. 189, 207 (1920). And in *Bowers v. Kerbaugh-Empire Co.*, the Court refused to recognize income derived from transactions that reflected an economic loss as taxable income. 271 U.S. 170, 175 (1926).

177. 284 U.S. 1 (1931).

recognized as the case that established the taxability of canceled debt, but the case itself did not concern the cancellation of individual debt.[178] Instead, the case concerned the validity of treasury regulations that addressed the taxability of corporate bond repurchases.

In *Kirby Lumber*, the Kirby Lumber Company issued bonds and repurchased them later in the same year at $137,521.30 less than face value.[179] Treasury regulations in operation at the time provided that the difference between the issuance and repurchase prices would be taxable income to Kirby Lumber.[180] The issue in the case was whether the treasury regulations were valid under Court precedent.[181] The Court held that the treasury regulations were valid and offered two reasons why the difference between the issuance and repurchase prices ought to be taxable.[182]

The first is that the transaction as a whole reflected "a clear gain" to the Kirby Lumber Company.[183] The second is that the Kirby Lumber Company realized an accession to wealth by purchasing the corporate bonds for less than their face value.[184] The distinction between the two justifications is subtle but important. The accession to wealth rationale looks at a taxpayer's balance sheet in the year that the debt is forgiven.[185] Because debt forgiveness decreases a taxpayer's liabilities in a particular year, it increases the taxpayer's net worth in that year.

As a simple example, assume a consumer borrowed $100 from a bank in year 1 and that this $100 loan represented the full extent of the consumer's balance sheet. Thus, the consumer's balance sheet in year 1 would reflect $100 of cash as an asset (the loan proceeds) and an offsetting liability of $100:

Starting Balance

| Assets | Liabilities |
|---|---|
| $100 | $100 |

Assume that, in year 2, the bank decides to forgive $50 of its $100 loan. At the time of forgiveness, the consumer's asset picture remains the same (i.e., the consumer had not spent the $100 or purchased goods valued at

178. Professor Richard C.E. Beck makes a similar point, noting that "*Kirby Lumber* said not a single word about cancellation of debts, and imposed tax only because the taxpayer had realized a 'clear gain.'" Richard C.E. Beck, *Cancellation of Debt and Other Incidental Items of Income: Puritan Tax Rules in the U.S.*, 49 N.Y.L. SCH. L. REV. 695, 705 (2004).

179. *Kirby Lumber*, 284 U.S. at 2.

180. *Id.*

181. *Id.* at 3.

182. *Id.*; *see also* Bittker & Thompson, *supra* note 24, at 1162–66 (discussing the two rationales of *Kirby Lumber*).

183. *Kirby Lumber*, 284 U.S. at 3.

184. *Id.*

185. The accession to wealth theory is commonly known today as the freeing-of-assets or net worth theory. *See* Zelenak, *supra* note 14, at 280–81.

$100), and the consumer had not repaid the loan. The consumer's post-cancellation balance sheet would now reflect $50 of equity (as the consumer has $100 of assets) and only $50 of post-cancellation liabilities:

Post-Cancellation

| Assets | Liabilities |
|---|---|
| $100 | $50 |
| | Equity $50 |

Under the accession to wealth rationale, the consumer ought to be taxed on the $50 of equity that the consumer realized as a result of debt cancellation in year 2.

The whole transaction rationale, on the other hand, takes a more expansive approach.[186] Rather than evaluating the taxpayer's balance sheet in a particular year, it looks at the overall transaction to determine whether the taxpayer realized an economic gain or loss. Thus, in the example above, we would attempt to determine whether the consumer really derived $100 of benefit from the loan it received in year 1 and only tax the consumer to the extent that the canceled debt diminished the consumer's liability on benefits they actually received.

Though the two rationales largely overlap, adoption of one over the other matters in certain cases.[187] And in the wake of *Kirby Lumber*, courts struggled to apply its messy logic in a principled manner. Courts instead developed exceptions to the general rule in *Kirby Lumber* to cabin the scope of the decision. Some courts refused to treat canceled debt as taxable income if the debtor was insolvent at the time of cancellation.[188] Other courts refused

186. *See* Bittker & Thompson, *supra* note 24, at 1162–64.

187. For example, assume a consumer purchased a car on credit in year 1 for $20,000. In year 4, after paying $12,000, the dealer forgives the remaining balance because the car's price was inflated by $10,000 in year 1. Under a transactional approach, the consumer likely has no tax liability because the transaction as whole a reflects a loss. Under a net worth approach, the consumer likely has tax liability to the extent of the forgiven debt. *See* Beck, *supra* note 178, at 706–07 (on the taxability of reductions in purchase price). As another example, consider what Professor Lawrence A. Zelenak terms "no-benefit" debts, which arise when "the taxpayer received nothing of value when the debt was created." Zelenak, *supra* note 14, at 279. Per Zelenak, such forgiveness would be taxable under the net worth theory but not taxable under the loan proceeds theory (a narrower version of the whole transaction approach). *Id.*

188. The insolvency exception post–*Kirby Lumber* is typically traced to *Dallas Transfer & Terminal Warehouse Co. v. Commissioner*, 70 F.2d 95 (5th Cir. 1934). *See* Bittker & Thompson, *supra* note 24, at 1183 n.89. For a richer discussion of the evolution of the insolvency exception both before and after *Kirby Lumber*, see James E. Eustice, *Cancellation of Indebtedness and the Federal Income Tax: A Problem of Creeping Confusion*, 14 TAX L. REV. 225, 247–48 (1959).

to treat canceled debt as taxable income if the debt was reduced because the fair market value of property securing the debt had declined.[189]

Scholars and judges criticized these exceptions and the development of the doctrine after *Kirby Lumber*, calling them confusing, chaotic, and even "irrational."[190] Judges criticized exceptions to the *Kirby Lumber* rule as unsound and attempted to rein in some of those judge-made exceptions.[191] Scholars similarly complained that the judicial exceptions to the *Kirby Lumber* rule reflected conceptual confusion and implored Congress to step in and fix the problem.[192] However, conceptual confusion also plagued congressional attempts to fix the matter. When Congress finally codified the *Kirby Lumber* rule in 1954, it largely left courts to determine the contours of the tax on canceled debt.[193]

In 1978, Professors Boris I. Bittker and Barton H. Thompson surveyed the post–*Kirby Lumber* landscape and concluded that "many of the judicial exceptions to the *Kirby Lumber* rule [were] based on erroneous interpretations of that case."[194] For Bittker and Thompson, the only reason that borrowed funds are not taxed is because the taxpayer must repay the funds.[195] When this proves false, a tax should be imposed.[196] Bittker and Thompson's simple rationale for the tax on canceled debt, known today as

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189. *Helvering v. A.L. Killian Co.*, 128 F.2d 433 (8th Cir. 1942), is a representative example. In *Killian*, the creditor agreed to effectively reduce the principal of the taxpayer's purchase-money mortgage because the fair market value of the property had declined. *Id.* The issue in the case was whether the reduction constituted canceled debt income. *Id.* at 433–34. The U.S. Court of Appeals for the Eighth Circuit concluded it did not: "The transaction in question here was not a mere cancellation of indebtedness, but was a reduction in the purchase price of property brought about by shrinkage in the value of the property and the consequent decrease in the assets of the taxpayer." *Id.* at 434. For more on the purchase-price adjustment exception to the *Kirby Lumber* rule, see Eustice, *supra* note 188, at 244–46. There are several other judicial exceptions to the *Kirby Lumber* rule that are broadly similar, including gift cancellations, spurious cancellations, and settlements. These and other early judicial exceptions to *Kirby Lumber* are discussed in Eustice, *supra* note 188, at 226–50.

190. *See* William C. Warren & Norman A. Sugarman, *Cancellation of Indebtedness and Its Tax Consequences: I*, 40 COLUM. L. REV. 1326, 1326 (1940) (describing doctrinal "developments in the courts and the legislature" as "add[ing] confusion and chaos in a field of law which for many years has been in need of clarification"); Bittker & Thompson, *supra* note 24, at 1169–70 n.34 (noting that Judge Jerome N. Frank of the U.S. Court of Appeals for the Second Circuit had described the development of the purchase money obligation exception to the taxation of canceled debt as "irrational").

191. *See generally* Bittker & Thompson, *supra* note 24, at 1169–70 (on conflict among courts applying the various early exceptions to the taxation of canceled debt).

192. *See, e.g.*, Eustice, *supra* note 188; Warren & Sugarman, *supra* note 190, at 1356; Norris Darrell, *Discharge of Indebtedness and the Federal Income Tax*, 53 HARV. L. REV. 977 (1940); Stanley S. Surrey, *The Revenue Act of 1939 and the Income Tax Treatment of Cancellation of Indebtedness*, 49 YALE L.J. 1153 (1939).

193. *See* Bittker & Thompson, *supra* note 24, at 1180–81 n.79 (explaining that when Congress finally codified the tax on canceled debt in 1954, "[t]he Senate Finance Committee rejected the House proposal [to codify the judicial exceptions to the tax] because 'of considerable doubt as to its meaning and effects,' preferring to leave the situation 'to be settled according to rules developed by the courts.'" (quoting S. REP. NO. 83-1622 (1954))).

194. *Id.* at 1159.

195. *Id.*

196. *Id.* at 1159–60.

the loan proceeds theory, is a narrower version of the whole transaction theory.[197] And many of the judicial exceptions to the tax on canceled debt would no longer apply under their theory.[198]

Scholars writing after Bittker and Thompson have generally rejected Bittker and Thompson's specific theory but agree with their broader argument that the theoretical underpinnings of the tax and its exceptions are shaky.[199] These scholars conceptualize the problems with the tax and its exceptions differently, but each attempts to make sense of existing doctrine within the internal logic of tax. However, many of these scholars fail to recognize that one way to understand the development of the tax is as the product of broader political forces outside tax.[200]

### *B. A Progressive Intervention and Its Unraveling*

Recent historical scholarship has emphasized the populist roots of the income tax.[201] The progressivism of the income tax was not merely a way to raise revenue and spread the burden based on ability to pay, but a way to constrain wealth and concentrated power. For these historians, there is a through line between anti-monopoly and public utility legislation of the late-nineteenth century and the move for a broad-based tax in the early-twentieth century.[202] And one way to make sense of both the tax on canceled debt as initially articulated by the U.S. Department of the Treasury and certain judicial exceptions is by looking at this broader narrative.[203]

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197. *See* Zelenak, *supra* note 14, at 282–83 n.13 (distinguishing the loan proceeds theory from the whole transaction approach under *Kirby Lumber*).

198. *See generally* Bittker & Thompson, *supra* note 24.

199. *See, e.g.*, Zelenak, *supra* note 14, at 278–79 (examining the theoretical underpinnings of the tax and concluding that "the whole-transaction [approach] should be recognized as the only rationale" for the tax because it is consistent with the overall structure of the income tax); Theodore P. Seto, *The Function of the Discharge of Indebtedness Doctrine: Complete Accounting in the Federal Income Tax System*, 51 TAX L. REV. 199 (1995) (proposing an interpretive theory to harmonize the tax and its various exceptions); Deborah A. Geier, *Tufts and the Evolution of Debt-Discharge Theory*, 1 FLA. TAX REV. 115 (1992) (challenging the coherence of the differing tax treatment between recourse and nonrecourse debt).

200. The way politics shaped the development of particular exceptions to the tax was not necessarily lost on scholars of an earlier generation. *See* Eustice, *supra* note 188, at 246 (arguing that the development of the insolvency exception "stems largely from an emotional response by the courts to the plight of financially embarrassed debtors rather than from any strict application of judicial logic").

201. *See* PRASAD, *supra* note 47, at 148–75; AJAY MEHROTRA, MAKING THE MODERN AMERICAN FISCAL STATE: LAW, POLITICS, AND THE RISE OF PROGRESSIVE TAXATION, 1877–1929, at 143–85 (2013); ELIZABETH SANDERS, ROOTS OF REFORM: FARMERS, WORKERS, AND THE AMERICAN STATE, 1877–1917, at 217–67 (1999).

202. As discussed in Part III.A, for scholars like Professors Monica Prasad and Ajay K. Mehrotra, the implications of recovering this history are complicated. For both Prasad and Mehrotra, the development of progressive income tax undermined the development of a European-style welfare state, with general public social provisions being funded by broad-based, regressive taxes. *See* PRASAD, *supra* note 47, at 99–125; MEHROTRA, *supra* note 201, at 17–18.

203. For a similar argument with respect to the early evolution of the merger rules under the tax code, see Ajay K. Mehrotra, *Mergers, Taxes, and Historical Materialism*, 83 IND. L.J. 881 (2008).

The treasury regulations at issue in *Kirby Lumber* were about corporations recharacterizing their income to avoid the then new tax laws. The regulations were not directed at individual debt. As such, the exceptions that developed in the wake of *Kirby Lumber* (such as the insolvency exception and the purchase price exception) can be understood as attempts to limit its scope to abusive income recharacterization rather than to transactions that reflected true economic loss. Thus, though the decisions may not have made sense within the internal logic of tax, they arguably made sense within the broader external debates about wealth and corporate power.

Through a series of acts passed in the 1980s and 1990s, Congress largely unsettled this understanding of the tax on canceled debt and its exceptions as ways to maintain the progressivity of the tax code and constrain concentrated wealth. These acts would operationalize the tax in ways that fundamentally changed its character. The changes to the tax code in this period involved a dramatic expansion of information reporting. Before diving into the specifics, it is helpful to have some understanding of what information reporting is and why it is important.

As a general matter, information reporting refers to reports that certain third parties are required to make to the IRS about individual taxpayers.[204] Common examples of information reports include Form W-2 for wages earned, Schedule K-1 for partnership income, and Form 1099-DIV for dividend income. Information reporting is a critical element of modern tax administration.[205] Professor Leandra Lederman explains: "A core problem for enforcement of tax laws is asymmetric information. One aspect of the problem is that the taxpayer knows the facts regarding the relevant transactions he or she engaged in during the tax year—or at least has ready access to that information."[206]

Information reporting addresses this information gap by requiring that third parties report information they possess about the income a taxpayer earned in a particular tax year.[207] This third-party information helps the IRS enforce federal tax laws and close the tax gap—"the gap each year between taxes due and taxes paid."[208] However, as some scholars are increasingly recognizing, information reporting is not a neutral legal technology and can have distributional effects depending on which items are prioritized and which items are ignored.[209]

204. Information reporting rules also extend to first-party information reports. *See* Joshua D. Blank & Ari Glogower, *The Tax Information Gap at the Top*, 108 IOWA L. REV. (forthcoming 2023) (manuscript at 12–14), https://papers.ssrn.com/sol3/papers.cfm?abstract_id=4092160 [https://perma.cc/FR5X-GHCC].

205. Leandra Lederman, *Reducing Information Gaps to Reduce the Tax Gap: When Is Information Reporting Warranted?*, 78 FORDHAM L. REV. 1733 (2010).

206. *Id.* at 1735.

207. *Id.*

208. *Id.* at 1734.

209. Blank & Glogower, *supra* note 204 (manuscript at 5) (arguing that the government's present approach to information reporting reflects an "activity-based approach to information reporting often allows high-end taxpayers to engage in tax noncompliance while other taxpayers face significant automatic IRS scrutiny").

In the 1980s and the 1990s, Congress amended the tax code to impose reporting requirements on creditors who canceled debt. The scope of these requirements would start small but eventually expand to encompass a very broad set of public and private creditors. The first act in this series was the Tax Reform Act of 1984,[210] which added section 6050J to the tax code.[211] Section 6050J provided that mortgage lenders must report cancellation of mortgage debt due to foreclosure or abandonment to the IRS.[212] The second in this series came with the Omnibus Budget Reconciliation Act of 1993,[213] also known as the Deficit Reduction Act of 1993, which added section 6050P to the tax code.[214] Section 6050P expanded section 6050J by requiring all financial institutions and federal executive agencies to report any canceled debt to the IRS. The legislative history of the act provides virtually no justification for adding section 6050P other than to harmonize the treatment of nonmortgage debt with mortgage debt and other debt subject to a reporting requirement.[215]

The third in this series of changes came with the Debt Collection Improvement Act of 1996,[216] which Congress designed to raise revenue from delinquent federal debtors by privatizing and improving the federal government's debt collection architecture.[217] In a section of the act titled "Barring delinquent Federal debtors from obtaining Federal loans or loan insurance guarantees," Congress amended section 6050P to require that all government agencies report canceled debt.[218] The final change came when Congress passed the Ticket to Work and Work Incentives Improvement Act of 1999,[219] which was designed to address purported "work disincentives" for individuals receiving social security disability insurance of supplemental security income.[220] As part of that act, Congress amended section 6050P to require that any organization with "a significant trade or business [in] the lending of money" report canceled debt to the IRS.[221]

The expansion of information reporting in the 1980s and 1990s seemed to precipitate a shift in the way that the tax on canceled debt functioned. We

210. Pub. L. No. 98-369, 98 Stat. 494 (codified as amended in scattered sections of the U.S.C.).

211. *Id.* § 148(a), 98 Stat. at 689 (codified as amended at 26 U.S.C. § 6050J).

212. 26 U.S.C. § 6050J.

213. Pub. L. No. 103-66, 107 Stat. 312 (codified as amended in scattered sections of the U.S.C.).

214. *Id.* § 13252(a), 107 Stat. at 531 (codified as amended at 26 U.S.C. § 6050P).

215. *See* H.R. REP. NO. 103-213 (1993) (Conf. Rep.).

216. Pub. L. No. 104-134, tit. III, ch. 10, 110 Stat. 1321-358 (codified as amended in scattered sections of the U.S.C.).

217. *Id.* § 31001(j)(1), 110 Stat. at 1321-368 to 1321-369 (codified as amended at 26 U.S.C. § 6050P).

218. *Id.* § 31001(j)(1), 110 Stat. at 1321-365 (codified as amended at 31 U.S.C. § 3720B).

219. Pub. L. No. 106-170, 113 Stat. 1860 (codified as amended in scattered sections of the U.S.C.).

220. WILLIAM R. MORTON, CONG. RSCH. SERV., R41934, TICKET TO WORK AND SELF-SUFFICIENCY PROGRAM: OVERVIEW AND CURRENT ISSUES 1 (2013).

221. Ticket to Work and Work Incentives Improvement Act of 1999 § 533, 113 Stat. at 1931.

can find some evidence of this shift in the kinds of cases brought before the tax court after the 1990s. Whereas, for most of the twentieth century, the tax on canceled debt was primarily an issue for corporations or wealthy individuals, the modern tax on canceled debt ensnared ordinary Americans. As an example, consider the case of Ancil Payne:

> At the end of 1992 . . . Ancil N. Payne, Jr. . . . opened a credit card account with MBNA America Bank. Mr. Payne used the credit card to pay hospital bills and receive cash advances during periods of unemployment. By April 26, 2004, Mr. Payne had accumulated $21,407 of credit card debt . . . .
>
> By October 19, 2004, Mr. Payne and MBNA entered into an agreement whereby MBNA agreed to accept $4,592 as a full settlement of the account balance of $21,270, payable in installments over 4 months. Mr. Payne made the necessary payments, and MBNA issued him a Form 1099-C, Cancellation of Debt, reporting $16,678 of discharge of indebtedness income.[222]

Or consider the case of Patricia Clark:

> On December 22, 1999, [Ms. Clark] entered into a retail installment contract with an automobile dealership to purchase a used 1996 vehicle for $13,547. [She] made a downpayment of $1,000 and financed the remaining $12,547 at an annual rate of 21.5 percent, which resulted in a projected total sale price of $21,578.20. . . .
>
> . . . .
>
> By 2005 [she] had defaulted under the terms of the contract. The vehicle was repossessed on March 21, 2005, and sold for $1,300 at an auction on June 16, 2005. The proceeds from the auction were applied to [her] account on June 20, 2005. However, [she] still owed $4,768.79 on the contract and $743.50 for collection expenses and late fees. . . .
>
> AmeriCredit attempted to collect [her] debt and, over time, assigned it to five separate third-party debt collectors. The first debt collection agency was assigned [Ms. Clark's] debt on May 18, 2006, and returned the assignment uncollected on September 22, 2006. The other four collection agencies experienced the same lack of success over the next four-plus years, with the last debt collection agency returning the assignment as uncollectible on June 29, 2011.
>
> AmeriCredit determined petitioner's chargeoff balance to be $4,602.46. It reported on Form 1099-C, Cancellation of Debt, that petitioner's debt of $4,496.71 (the outstanding principal balance) was discharged on August

222. Payne v. Comm'r, 95 T.C.M. (CCH) 1253, 1253–54 (2008) (footnote omitted). Mr. Payne argued that the adjusted debt reflected a change in interest as opposed to a change in principal and thus the reduction should not be taxable. *Id.* The court disagreed. *Id.* at 1254; *see also* Beck, *supra* note 19, at 1035–37 (discussing *Payne*).

> 25, 2011. The Form 1099-C indicated that petitioner was personally liable for the repayment of the debt. . . .[223]

Or, as a final example, consider the case of David Scott Stewart:

> On October 22, 1994, David Scott Stewart . . . incurred a credit card obligation to Maryland Bank National Association (MBNA). [He] defaulted on his obligation to MBNA at some time between October 22, 1994, and September 6, 1996. [He] made no payments on the debt after the default. MBNA charged off the debt on September 12, 1996. At some point between September 12, 1996, and December 28, 2007, NCO Portfolio Management, Inc. (NCO), acquired [Mr. Stewart's] defaulted account from MBNA.
>
> On December 28, 2007, Portfolio Recovery Associates, LLC (PRA), acquired [Mr. Stewart's] defaulted account from NCO. Although aware that a State statute of limitations period for commencing collection activity in regard to the debt had expired on February 15, 2001, PRA began making automated attempts to collect payments from petitioner.
>
> On April 14, 2008, PRA received a letter from [Mr. Stewart] (2008 letter) that demanded PRA cease its automated collection activities. Once PRA received the 2008 letter, the company stopped its automated attempts at collection and took no other collection-related action. PRA subsequently issued to petitioner a Form 1099-C, Cancellation of Debt, which reported $8,570.71 in COI income for the taxable year 2008.[224]

These are three of many examples that illustrate that we have come a long way from the bond repurchases at issue in *Kirby Lumber*. Beyond case law, there is also evidence of a shift in scholarship. Whereas scholarship of a prior generation wrestled with the way that the tax on canceled debt interacted with corporate debt,[225] modern scholars who write about the tax tend to focus on the costs to average borrowers.[226] And finally, there is the growing public

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223. Clark v. Comm'r, No. 27786-13, 2015 WL 5243760, at *1–2 (T.C. Sept. 9, 2015). Ms. Clark ultimately prevailed on the grounds that the debt was discharged in 2008 and not 2011. *Id.* at *4.

224. Stewart v. Comm'r, No. 10374-11S, 2012 BL 404637, at *1 (T.C. May 21, 2012). In Mr. Stewart's case, he prevailed on the grounds that it was not clear that collection activity had ceased. *Id.* at *4.

225. *See* Warren & Sugarman, *supra* note 190, at 1326 (arguing that doctrinal "confusion and chaos" is particularly bad for corporations who must understand "the taxable effect of present, past and future cancellations of indebtedness" in order to adequately plan); Surrey, *supra* note 192, at 1153 (arguing that "the *Kirby* decision has resulted in considerable confusion as to the income tax consequences of a cancellation of indebtedness, and placed a heavy burden upon corporations seeking to adjust their capital structures").

226. An early example of scholars exhibiting this kind of concern is Deborah Geier's 1992 article Tufts *and the Evolution of Debt-Discharge Theory*, which was written in the aftermath of the savings and loan crisis and begins with the following anecdote:

> Consider poor Debtor, who purchased a personal residence for $130,000 several years ago with a hefty mortgage and today, like many others caught between the Scylla of the economic recession and the Charybdis of collapsing real estate values, finds himself losing his home. Perhaps he loses his home because he can no longer continue to meet the mortgage payments. Perhaps he simply stops making mortgage payments because he appreciates the economic reality that it would not be wise to continue to make payments on the $122,000 remaining mortgage when the fair

awareness of the tax as a legal impediment to broad-scale debt cancellation. Taken together, this evidence suggests that something has changed in the way that the tax on canceled debt operates. Why?

### *C. Shifting Logics*

The federal government initially imposed the tax on canceled debt to curb income recharacterization by wealthy individuals and corporations. Yet over the course of the twentieth century, the rationale for the tax seemed to shift from a concern about income recharacterization to a concern about debtors who were trying to shirk their obligations. How did we get here? One simple answer is the shift was the inadvertent consequence of the pursuit of other policy aims. The government faced growing deficits in the early 1980s, which were compounded by President Ronald Reagan's 1981 tax cuts.[227] This created a perceived fiscal crisis, and the Reagan administration sought to manage this crisis by raising revenue without reversing the 1981 tax cuts.[228] Expanding information reporting requirements provided one easy solution to this problem—the government could raise revenue through politically cheap improvements to tax administration as opposed to politically costly rate hikes.[229]

The incidence of this shift, including the potential regressivity of expanding efforts to identify and collect certain forms of taxable income (such as canceled debt income), might not have been apparent to the budget-obsessed policy makers of the 1980s and 1990s. And in this sense, the shifting function of the tax on canceled debt may have merely been an inadvertent product of the government's attempt to manage budget deficits

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> market value of the home has plunged to $100,000. This approach would be particularly appealing if Debtor knew that the creditor would not, or could not, enforce any deficiency against Debtor's other assets.
>
> What are the tax consequences upon transfer of the home to the mortgagee in *full* satisfaction of the debt? Upon researching the law, Debtor's tax advisor learns that, because the debt discharged ($122,000) exceeds the fair market value of the property transferred in satisfaction of the debt ($100,000), the tax consequences will vary dramatically depending on whether the debt is styled "recourse" or "nonrecourse."

Geier, *supra* note 199, at 116 (footnote omitted). For more recent examples, see Zelenak, *supra* note 14, at 278 (arguing that resolving confusion over cancellation of debt income is "particularly timely because of the prospect that hundreds of thousands, or even millions, of taxpayers may soon be relieved of obligations to pay accrued credit card interest"); Beck, *supra* note 19, at 1026 ("As of this writing, foreclosure threatens millions of American homeowners in the biggest housing crisis since the Great Depression of the 1930s. In addition, a second financial bubble of defaulting credit card debt appears about to burst. Both are likely to result in the renegotiation and discharge of large amounts of nonbusiness debt."); Crespi, *supra* note 23 (on the tax consequences for lawyers enrolled in income-based student loan repayment plans); Brooks, *supra* note 23 (arguing that the Treasury Department should exclude discharge of student loans from income).

227. *See* KRIPPNER, *supra* note 47, at 92–94.

228. *See id.*

229. These changes were coupled with other changes that explicitly raised the borrower costs of taxing on consumer debt. *See* HYMAN, *supra* note 47, at 252 (on the phasing out of interest deductions for nonmortgage interest).

in a politically expedient way. Yet there is a way to understand the shifting function of the tax as a reflection of the underlying political logic of this era.

The legislative changes to the information reporting rules for canceled debt correlated with a larger policy shift that redistributed risk and burdens in society.[230] As Professor Jacob Hacker has famously argued, the policy changes of the late twentieth century "shift[ed] the responsibility for managing economic risk from government and employers onto individuals and their families."[231] This shift extended beyond tax and included changes to education policy (discussed above), health policy,[232] poverty law,[233] and creditor-debtor law.[234] The effect of early efforts in this turn were arguably inadvertent and unanticipated.[235] But by the 1990s and early 2000s, these policy changes had a clearer political valence.

Legislation such as the Personal Responsibility and Work Opportunity Act of 1996[236] (PRWORA) and the Bankruptcy Abuse Prevention and Consumer Protection Act of 2005[237] (BAPCPA) reflected moral concerns about dependency and abuse by the poor and the indebted.[238] As Professor Sara Sternberg Greene explains, when PRWORA was passed, "there was widespread, bipartisan agreement that change was needed because the existing welfare program's structure unintentionally disincentivized work and promoted dependency."[239] Similarly, as Professors Pamela Foohey, Robert M. Lawless, Deborah Thorne and then Professor Katie Porter explain, BAPCPA was "designed to decrease consumer bankruptcy filings by making filing more difficult, expensive, and time-consuming."[240] Notably, BAPCPA capitulated to the concerns of the credit card industry, which felt that reform was needed "because bankruptcy courts were full of deadbeat, 'can-pay' debtors who filed 'bankruptcies of convenience' to try to escape their rightful obligations and who felt no shame in 'abusing' the system."[241] The changes that Congress made to tax administration, outlined above, were embedded in legislation that reflected a similar moral logic. For example,

230. *See generally* HACKER, *supra* note 173.

231. Jacob Hacker, *The Privatization of Risk and the Growing Economic Insecurity of Americans*, ITEMS (June 7, 2006), https://items.ssrc.org/privatization-of-risk/the-privatization-of-risk-and-the-growing-economic-insecurity-of-americans/ [https://perma.cc/7MN2-9MN3].

232. *See id.*

233. *See* Greene, *supra* note 110.

234. *See* Atkinson, *supra* note 38; Faust, *supra* note 41.

235. *See* METTLER, *supra* note 84.

236. Pub. L. No. 104-193, 110 Stat. 2105 (codified as amended in scattered sections of the U.S.C.).

237. Pub. L. No. 109-8, 119 Stat. 23 (codified as amended in scattered sections of the U.S.C.).

238. On welfare reform, see David A. Super, *Offering an Invisible Hand: The Rise of the Personal Choice Model for Rationing Public Benefits*, 113 YALE L.J. 815 (2004); Greene, *supra* note 110. On bankruptcy reform, see Pamela Foohey, Robert M. Lawless, Katherine Porter & Deborah Thorne, *Life in the Sweatbox*, 94 NOTRE DAME L. REV. 219 (2018); Mann, *supra* note 120.

239. Greene, *supra* note 110, at 236; *see also* Super, *supra* note 238.

240. Foohey et al., *supra* note 238, at 221; *see* Mann, *supra* note 120.

241. Foohey et al., *supra* note 238, at 221.

the Debt Collection Improvement Act of 1996 was designed to improve procedures for collecting federal debt from individuals who were delinquent on their obligations.[242] And the Ticket to Work and Work Incentives Improvement Act of 1999 sought to create work incentives for recipients of social security disability insurance and supplemental security income, both to decrease dependence on what was left of the social safety net after PRWORA and to increase federal savings in the operation of each program.[243]

The changes to tax administration described above can thus be understood as reflecting the punitive and regressive logic of late-twentieth century policymaking. To be sure, one can accept this account and still see the changes to tax administration in the 1980s and 1990s as inadvertent. The information reporting rules for canceled debt were not self-executing—the IRS had to affirmatively decide to rely on information returns as an enforcement tool and may have been driven to this decision because of budget cuts that sharply circumscribed its enforcement capacity.[244]

On some level, the question of whether changes to the tax on canceled debt were consistent with the logic of late-twentieth century policymaking may seem like a distraction. In either case, the functional point—that the tax operates less as a measure of wealth and more as a tax on excessive debt—remains the same. Yet I press this point to underscore that shifts in the way a tax functions often cannot be rationalized by looking to the internal logic of tax but by appealing to the external logic of broader political shifts. As I argue in Part IV, recognizing this point is important both for understanding the rationale for past changes and for justifying future reforms.

## III. THE CASE AGAINST THE DEBT TAX

Taxing canceled debt is a political choice that tends to allocate the costs of managing distributional conflict with credit onto those who benefit the least from this arrangement. We are not bound by this choice. In this part, I make the case against the tax by situating this Article's arguments within existing critiques of our tax and financial systems. First, I show how this Article's critique builds on recent critiques about the regressivity of the tax code by highlighting how information reporting (an area most tax scholars ignore) affects distribution. Second, I show how it fits into the story that scholars

242. *See* H.R. REP. NO. 104-537, at 565 (1996) (Conf. Rep.).

243. *See* H.R. REP. NO. 106-220, pt. 1, at 2–3 (1999).

244. Paul Kiel has done incredible journalistic work in the past few years documenting the way in which budget cuts constrain the IRS's ability to audit the rich and push the IRS to rely on regressive audit mechanisms with embedded racial disparities. *See* Paul Kiel, *It's Getting Worse: The IRS Now Audits Poor Americans at About the Same Rate as the Top 1%*, PROPUBLICA (May 30, 2019), https://www.propublica.org/article/irs-now-audits-poor-americans-at-about-the-same-rate-as-the-top-1-percent [https://perma.cc/YN3V-CYCG]; Paul Kiel, *IRS: Sorry, but It's Just Easier and Cheaper to Audit the Poor*, PROPUBLICA (Oct. 2, 2019), https://www.propublica.org/article/irs-sorry-but-its-just-easier-and-cheaper-to-audit-the-poor [https://perma.cc/RJ8Y-AJCJ]; Paul Kiel & Hannah Fresques, *Where in the U.S. Are You Most Likely to Be Audited by the IRS?*, PROPUBLICA (Apr. 1, 2019), https://projects.propublica.org/graphics/eitc-audit [https://perma.cc/TVC3-5WNR].

such as Professor Dorothy A. Brown are telling about how the tax code privileges the accumulation of white wealth. And third, I show how it fits into the larger story scholars are telling about our distinct legal regimes for credit and debt.

### *A. Regressivity*

Recent tax scholarship has emphasized that although progressivity is a primary goal of our tax system, the tax system is regressive in certain important ways. For example, Kleiman has argued that the structure of certain anti-poverty tax credits, such as the earned income tax credit, exhibit what Kleiman terms as low-end regressivity: "Certain poorer households face higher average federal tax rates compared to better-off households."[245] Kleiman also argues in a forthcoming work that although our tax system is broadly progressive, it can result in fiscal impoverishment in individual cases, such as when an individual's net tax liability pushes them into poverty.[246] And Professor Leslie Book's scholarship has long demonstrated how modern tax administration disproportionately burdens low-income taxpayers.[247]

The Article's critique fits into this conversation in important ways. First, as a matter of substance, it shows how the definitions of taxable income can violate the general maxim of progressivity. Kleiman's scholarship focuses primarily on the regressive structure of refundable credits or how the tax liability an individual faces outside the federal income tax (e.g., payroll tax and state and local tax) may result in fiscal impoverishment.[248] This Article suggests that the choices we make about what to consider as income can introduce regressivity into an otherwise progressive structure. For example, a taxpayer who lacks the capacity to pay (as Mr. Stout, Mr. Payne, Ms. Clark, or Mr. Stewart did) may have a positive and significant tax liability as a result of having their debt forgiven *because* they lack the capacity to pay.[249]

Second, as a matter of procedure, it shows how inequity in tax administration is not just a function of the IRS's enforcement priorities, but also of how those enforcement priorities intersect with legal mandates. Information reporting is an essential component of tax administration but tends to receive very little scholarly attention. This has begun to change. In forthcoming work, Professors Joshua D. Blank and Ari Glogower highlight the ways in which the current tax information reporting rules can contribute to the inequity of the tax system.[250] For Blank and Glogower, the inequity of the information reporting rules results from the way that the IRS targets activities (e.g., wages, financial transactions) for reporting as opposed to taxpayers. This Article, however, suggests that, in some cases, this inequity

245. Kleiman, *Regressivity*, *supra* note 40, at 103.
246. Kleiman, *Impoverishment*, *supra* note 40.
247. Book et al., *supra* note 40; Book, *supra* note 40.
248. Kleiman, *Regressivity*, *supra* note 40; Kleiman, *Impoverishment*, *supra* note 40.
249. This thereby inverts the general progressive structure of the federal income tax.
250. Blank & Glogower, *supra* note 204 (manuscript at 33).

may not be inadvertent and may reflect a specific political logic. Moreover, whereas Blank and Glogower suggest that greater reporting compliance can close the tax gap, this Article suggests that information reporting can invert positive tax law by creating an operational presumption of tax liability when no liability ought to attach.[251]

There are at least two objections one might raise to the general argument that the tax on canceled debt is regressive. First, is regressivity really that bad? Scholars such as Professors Monica Prasad and Ajay K. Mehrotra have argued that the progressive structure of our income tax may have undermined the development of a generous welfare state funded with broad-based and regressive consumption taxes.[252] As such, we might conclude that potential regressivity of the tax on canceled debt is desirable. Yet the regressivity of our present system (including the regressive effects of the tax on canceled debt) is closer to the haphazard regressivity of the late-nineteenth century's tax system than the broad-based consumption taxes of European welfare states.[253] For this reason, Kleiman cautions against doubling down on the regressivity of the tax system because it may sharpen some of the present system's burdens rather than alleviate them.[254]

Second, is it clear that the tax on canceled debt is actually regressive? The examples in Part II above suggest that, in individual cases, the tax may be regressive, but it is not clear what the overall incidence of the tax is. Moreover, obtaining the relevant information to measure the incidence of the tax is likely unlawful under existing tax law.[255] And even if we were to obtain these measures, as Professor Manoj Viswanathan argues, there is no commonly accepted and easy way to use these figures to determine the distributional effects of the change.[256] These are important objections, and for those who find them compelling, I offer two other reasons why we ought to revisit the tax on canceled debt anyway.

### *B. Racial Inequity*

Tax scholars are increasingly recognizing that our tax system contributes to the racial wealth gap. Much of this recent work builds on Brown's pioneering scholarship demonstrating that the tax code is embedded with racial preferences.[257] As Brown explains, "our tax laws were designed with

251. *See* discussion *infra* Part IV.A; Bryan Camp, *Proceduralist Reflections on Home Mortgage Foreclosures*, 117 TAX NOTES 483 (2007).

252. *See* PRASAD, *supra* note 47, at 99–125; MEHROTRA, *supra* note 201, at 17–18.

253. Indeed, Mehrotra refers to the tax system of this period as a system of partisan taxation. MEHROTRA, *supra* note 201, at 37–85.

254. Kleiman, *Regressivity*, *supra* note 40, at 9.

255. *See* 26 U.S.C. § 6103.

256. Manoj Viswanathan, *Retheorizing Progressive Taxation*, 75 TAX L. REV. 91 (2021) (arguing that accurate assessments of progressivity must consider nontax burdens such as incidence, inefficiency, and expenditures).

257. *See, e.g.*, Dorothy A. Brown, *Race and Class Matters in Tax Policy*, 107 COLUM. L. REV. 790 (2007); Dorothy A. Brown, *The Tax Treatment of Children: Separate but Unequal*, 54 EMORY L.J. 755 (2005); Dorothy A. Brown, *Shades of the American Dream*, 87 WASH. U. L. REV. 329 (2009); Dorothy A. Brown, *The Marriage Bonus/Penalty in Black and White*,

white Americans in mind," and taxable income is often defined in a manner that facilitates the accumulation of white wealth and penalizes the accumulation of Black wealth.[258] In practice, this means that "black Americans of all income levels . . . are paying more in taxes than their white peers."[259]

Brown's scholarship highlights the many ways in which racial preferences are embedded in the tax code. For example, tax preferences for marriage has long rewarded single-earner households and penalized dual-earner households, which disproportionately benefitted white households.[260] As dual-earner households became more common in the late-twentieth century, Congress attempted to remedy this disparity.[261] But Brown argues that the remedy made this bias sharper by increasing the marriage bonus for high earners and adding a marriage penalty for low-income households.[262]

Other examples that Brown points to are the tax code's long-standing preferences for homeownership[263] and subsidies for retirement savings[264] and wealth transfers.[265] In each case, Brown argues that these preferences reinforce racial disparities in the existing distribution of wealth. In recent years, a number of scholars have built on Brown's work to show the different ways that the tax code perpetuates racial inequality in its charitable expenditure provisions,[266] in the way that it relies on wage and salary income as a proxy for wealth,[267] and in tax administration.[268]

This tax scholarship parallels recent sociological and legal scholarship on the ways that debt contributes to the racial wealth gap. As Professor Louise Seamster explains, "in an economy increasingly reliant on debt, studying debt is essential to understand the rapid widening of the racial wealth gap."[269] And studying debt reveals that debt operates very differently for white and Black borrowers. For white borrowers, "debt promotes agency and grants opportunities as an investment in an imagined better future," and it "can serve as an advantage for tax purposes or showing credit 'worthiness.'"[270] For Black borrowers, by contrast, debt "represents the negative balance sheet that must be worked through just to get to the starting line."[271] This distinction

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65 U. CIN. L. REV. 787 (1997). Brown has also long written about the lukewarm and at times hostile reception she has received from her colleagues for raising these issues. *See, e.g.*, Dorothy A. Brown, *Tales from a Tax Crit*, 10 PITT. TAX REV. 47 (2012); Dorothy A. Brown, *Split Personalities: Tax Law and Critical Race Theory*, 19 W. NEW ENG. L. REV. 89 (1997).

258. BROWN, *supra* note 29, at 21.
259. *Id.*
260. *Id.* at 29–64.
261. *Id.*
262. *Id.*
263. *Id.* at 64–96.
264. *Id.* at 132–66.
265. *Id.* at 166–200.
266. *See* Gondwe, *supra* note 16.
267. *See* Maynard & Gamage, *supra* note 39.
268. *See* Dean, *supra* note 39; Bearer-Friend, *supra* note 39.
269. Seamster, *supra* note 37, at 31.
270. *Id.*
271. *Id.* at 32.

manifests in the size of debt,[272] the costs of credit,[273] the kinds of products that target white and Black borrowers,[274] and the effects of debt.[275] Moreover, as Atkinson argues, debt's role in exacerbating the racial wealth gap was supported by congressional policy, which viewed "the ability to borrow money as an unqualified public good, duly capable of and appropriate for mitigating socioeconomic inequality for marginalized groups."[276]

This Article contributes to these conversations in several ways. First, it shows that what is considered as income beyond wage and salary can perpetuate racial inequality. Second, it highlights that information reporting can sharpen some of the biases that exist in tax administration.[277] And third, it connects conversations about racial inequity throughout tax and consumer finance by showing how the tax code reenforces the racial costs of debt. Debt disproportionately burdens Black borrowers and other borrowers of socioeconomically marginalized groups. Canceling debt is thus a racial justice issue.[278] But the tax on canceled debt places a ceiling on how much justice we can achieve by discounting the value of any debt cancellation outside of bankruptcy.[279]

### *C. Decoupling Debt from Credit*

Finally, this Article contributes to recent scholarship on the distinct ways in which we regulate credit and debt in federal policy. Atkinson and Faust have separately written about what each calls the "acoustic separation" of credit and debt in federal policy. Atkinson explains:

272. *See* Andre M. Perry, Marshall Steinbaum & Carl Romer, *Student Loans, the Racial Wealth Divide, and Why We Need Full Student Debt Cancellation*, BROOKINGS (June 23, 2021), https://www.brookings.edu/research/student-loans-the-racial-wealth-divide-and-why-we-need-full-student-debt-cancellation/ [https://perma.cc/Z4AF-LF4P] (highlighting racial disparities in outstanding student debt across a variety of dimensions).

273. *See* ALEXANDER W. BUTLER, ERIK J. MAYER & JAMES P. WESTON, RACIAL DISCRIMINATION IN THE AUTO LOAN MARKET (2021), https://files.consumerfinance.gov/f/documents/cfpb_mayer_racial-discrimination-in-the-auto-loan-market.pdf [https://perma.cc/YYZ3-672W].

274. *See* Seamster, *supra* note 37, at 31.

275. *See* Kiel & Waldman, *supra* note 37 (on racial disparities in debt collection).

276. Atkinson, *supra* note 38, at 1405.

277. This is a point that Blank and Glogower also note in their forthcoming work on information reporting. *See* Blank & Glogower, *supra* note 204 (manuscript at 34–35).

278. *See generally* Atkinson, *supra* note 38.

279. And there are good reasons to worry that individual bankruptcy replicates the racial inequity of credit markets and is not a replacement for broad-scale debt cancellation. *See, e.g.*, Nicole Langston, *Discharge Discrimination*, 111 CALIF. L. REV. (forthcoming 2023) (on file with author); Edward R. Morrison, Belisa Pang & Antoine Uettwiller, *Race and Bankruptcy: Explaining Racial Disparities in Consumer Bankruptcy*, 63 J.L. & ECON. 269 (2020); Sara S. Greene, Parina Patel & Katherine Porter, *Cracking the Code: An Empirical Analysis of Consumer Bankruptcy Outcomes*, 101 MINN. L. REV. 1031 (2017); Abbye Atkinson, *Consumer Bankruptcy, Nondischargeability, and Penal Debt*, 70 VAND. L. REV. 917 (2017); Jean Braucher, Dov Cohen & Robert M. Lawless, *Race, Attorney Influence, and Bankruptcy Chapter Choice*, 9 J. EMPIRICAL LEGAL STUD. 393 (2012); Robert M. Lawless, *Race Disparity in Bankruptcy Chapter Choice and the Role of Debtor's Attorneys*, 20 AM. BANKR. INST. L. REV. 611 (2012); Rory Van Loo, *A Tale of Two Debtors: Bankruptcy Disparities by Race*, 72 ALB. L. REV. 231 (2009).

> [C]redit and debt are quantumly entangled, given that a loan is comprised of both credit and debt. Nevertheless, Congress has curiously disconnected its regulation of credit and debt, acoustically separating them . . . in ways that assume credit can meaningfully function as a mechanism of enhanced socioeconomic capacity separately from its complement, debt. Moreover, this bifurcated approach exhibits tension in its relatively optimistic and expansive posture in the treatment of credit as compared to its relatively negative and restrictive treatment of debt.[280]

As examples of this acoustic separation, Atkinson points to the distinct ways in which federal law encourages credit-based consumption in federal consumer credit and banking law[281] but seemingly penalizes the accumulation of debt in federal debt collection and bankruptcy law.[282] While Atkinson does not specifically theorize about the reasons for the acoustic separation of credit and debt in federal policy, Faust suggests that this acoustic separation is a function of parliamentary procedure.[283] Faust specifically contends that congressional rules, which assign bankruptcy and consumer credit legislation to different congressional subcommittees, allows "creditors to lobby for restrictions on bankruptcy access without concurrently having to concede to substantive regulation of their consumer lending practices."[284]

Though the mechanics of Atkinson and Faust's accounts of separation differ slightly, both agree that the acoustic separation of credit and debt in federal policy has damaging consequences. For Faust, acoustic separation insulates consumer creditors from substantive consumer credit regulation. For Atkinson, in separating credit and debt, Congress ignores the social embeddedness of credit and debt in a society "plagued by discrimination, raced and gendered hierarchy, and other socioeconomic pathologies."[285] This means that debt often functions as "a force of subordination" as opposed to a "catalyst of mobility and equality."[286]

The tax on canceled debt is another way in which our policies treat credit and debt distinctly. And in some ways, it is a sharper example of the phenomena that Atkinson and Faust identify. The tax on canceled debt imposes direct costs on borrowers who are saddled with excessive debt,

280. Atkinson, *supra* note 38, at 1406–07 (footnote omitted).

281. These include the Higher Education Act of 1965, *see* Pub. L. No. 89-329, 79 Stat. 1219 (codified as amended in scattered sections of 20 U.S.C.), the Consumer Credit Protection Act, *see* Pub. L. No. 90-321, 82 Stat. 146 (1968) (codified as amended in scattered sections of 15 and 18 U.S.C.), the Equal Credit Opportunity Act, *see* Pub. L. No. 93-495, tit. V, 88 Stat. 1521 (1974) (codified as amended in scattered sections of 15 U.S.C.), and the Community Reinvestment Act of 1977, *see* Pub. L. No. 95-128, tit. VIII, 91 Stat. 1147 (codified as amended in scattered sections of 12 and 42 U.S.C.). *See* Atkinson, *supra* note 38, at 1407.

282. These include the Bankruptcy Reform Act of 1978, *see* Pub. L. No. 95-598, 92 Stat. 2549 (codified as amended in scattered sections of the U.S.C.), and the Fair Debt Collection Practices Act, *see* Pub. L. No. 90-321, tit. VIII, 91 Stat. 874 (1977) (codified as amended in scattered sections of 15 and 18 U.S.C.). *See* Atkinson, *supra* note 38, at 1408.

283. Faust, *supra* note 41.

284. *Id.* at 674.

285. Atkinson, *supra* note 38, at 1413.

286. *Id.* at 1410.

whereas federal bankruptcy law and debt collection law impose costs on those borrowers indirectly. Taken together, the ways in which the tax on canceled debt reenforces the regressivity and racial inequity of tax and credit policy and sharpens the asymmetric treatment of credit and debt in federal policy suggest that we ought to modify the scope of the tax on canceled debt. In the next part, I offer some thoughts on reform.

## IV. LESS TAX, LESS DEBT

In this last part, I offer some thoughts on how we might reform the tax on canceled debt to soften its effects. I propose two kinds of reforms: procedural and substantive. The procedural reform involves reversing the operational presumption that canceled debt is generally taxable. And the substantive reform is to consider excluding broad classes of both consumer and small-business debt from the scope of the tax.

### *A. Reversing the Operational Presumption*

In Part II above, I argue that the introduction of information reporting rules for canceled debt seemed to change the nature of the tax on canceled debt.[287] A first reform would thus reverse this change and eliminate the information reporting rules for canceled debt. In more direct terms, we ought to consider striking sections 6050J and 6050P from the tax code. The most obvious objection to this reform is the effect that it would have on the tax gap—"the gap each year between taxes due and taxes paid."[288]

As noted above, information reporting plays an important role in modern tax enforcement. Thus, it stands to reason that eliminating the information reporting rules for canceled debt would result in underreported income, which would expand the tax gap. There are at least two reasons why this might not be true. First, as Professor Richard C.E. Beck has argued, it is difficult to comply with the information reporting rules, and some third parties may overstate the amount of canceled debt because it is simply easier to do so.[289]

Second, and more importantly, information reporting rules create an operational presumption of tax liability when there may be no liability. This observation was first made by Professor Bryan Camp fifteen years ago.[290] Camp, commenting on the case of the Stouts, argued that the Stouts should

287. Although I am the first, to my knowledge, to suggest that the information reporting rules reflect the political logic of the eras of their enactment, I am not the first to argue that the information reporting rules changed the nature of the tax on canceled debt. *See* Beck, *supra* note 19, at 1037–38 (arguing that "[i]t appears that the only reason taxing canceled consumer interest has become an issue is the government's ill-advised decision to force lenders to report canceled consumer debt on Form 1099-C").

288. Lederman, *supra* note 205, at 1734.

289. Beck, *supra* note 19, at 1037–38. Beck specifically suggests that third-party debt collectors find it easier to combine all charges when canceling debt as opposed to determining the amount of canceled principal, which is often an impossible exercise for third-party debt collectors. *Id.*

290. Camp, *supra* note 251.

not have had any tax liability because their situation was covered by one of the existing exceptions to the tax on canceled debt.[291] For Camp, the problem was procedural and not substantive:

> Foreclosed taxpayers face tax troubles even if, like Stout, they do not have any [cancellation of debt] or, more commonly, they qualify for the section 108(a) insolvency exception. Their pain is procedural because the statutory system—written by Congress and obeyed by the IRS—creates an operational presumption of income to match the substantive presumption of inclusion.[292]

In other words, the information reporting rules create a presumption of tax liability and a burden that the taxpayer must overcome. Overcoming the presumption of tax liability is complicated because taxpayers may not know about the tax (as appeared to be the case with the taxpayers discussed in Part II.B) and, even if taxpayers know about the tax, it is not easy for a taxpayer to prove that they are not liable. For example, § 108 of the tax code provides that canceled debt is not included in income if the debt is canceled "when the taxpayer is insolvent."[293] Section 108 codifies the judicial insolvency exception discussed in Part II.A above and defines insolvency:

> [T]he excess of liabilities over the fair market value of assets. With respect to any discharge, whether or not the taxpayer is insolvent, and the amount by which the taxpayer is insolvent, shall be determined on the basis of the taxpayer's assets and liabilities immediately before the discharge.[294]

Because it may be unclear as to how a taxpayer should apply this definition to determine whether they qualify for the insolvency exception, the IRS provides taxpayers with a worksheet to help them determine if they are insolvent. But to fill it out, a taxpayer needs to know the amount owed on all their debts and the fair market value of their assets as of the date of cancellation.[295] In other words, individuals who are insolvent (which likely describes many overindebted taxpayers) may find that they lack the capacity to establish their insolvency. These individuals may face tax liability even though they owe no tax.

Repealing the information reporting rules for canceled debt will provide relief to taxpayers who have difficulty demonstrating that they should not have any tax liability. On the other hand, reversing the operational presumption of tax liability almost certainly means that some taxpayers will underreport and underpay. This is a real cost. But it is not obvious that the cost to the fisc outweighs the costs that our current procedural rules impose on the overindebted.

291. Camp suggests that the Stouts are most likely eligible for the insolvency exception, but their debt may have also been excluded under the purchase-price adjustment exception or as contested liability. *Id.* at 486.

292. *Id.*

293. 26 U.S.C. § 108(a)(1)(B).

294. *Id.* § 108(d)(3).

295. INTERNAL REVENUE SERV., CANCELED DEBTS, FORECLOSURES, REPOSSESSIONS, AND ABANDONMENTS (FOR INDIVIDUALS) (2022), https://www.irs.gov/pub/irs-pdf/p4681.pdf [https://perma.cc/RA8E-89R9].

### *B. Beyond Kludgy Patches*

Our current approach to managing the costs of the tax on canceled debt is to occasionally amend the tax code with narrow, time-limited exemptions. For example, in 2007, Congress passed the Mortgage Forgiveness Debt Relief Act of 2007,[296] which excluded canceled "qualified principal residence indebtedness" (QPRI) from the tax if the debt was canceled between January 1, 2007, and January 1, 2010.[297] QPRI initially only included debt incurred to purchase a principal residence that was less than two million dollars and that was canceled because of a decline in the home's value or the taxpayer's financial condition.[298] This provision has been repeatedly renewed and extended by Congress, with its scope changing over time. The current exception is limited to mortgages less than $750,000 and expires on January 1, 2026.[299]

More recently, Congress passed the American Rescue Plan Act of 2021,[300] which modified the tax code to include an exemption for student loan debt canceled between 2021 and 2026.[301] Seizing on the prior examples, Congressman Gregory Meeks pushed for an exemption for what he terms "qualified taxi medallion indebtedness" to exempt canceled taxi medallion debt.[302] Meeks's bill would apply to debt secured by a taxi medallion that is under two million dollars and discharged by January 1, 2023.[303]

Rather than working with kludgy patches to exempt specific debt as problems arise, I propose that we broadly exclude the discharge of:

- (1) consumer credit, defined as credit (within the meaning of 15 U.S.C. § 1691a(d)) incurred for personal, family, or household purposes, provided that such credit does not exceed two million dollars; and
- (2) commercial credit, defined as a loan of a principal amount of $5,000 or more, or any loan under an open-end credit plan, the proceeds of which are intended by the recipient for use primarily for other than personal, family, or household purposes, provided that any such loan does not exceed $500,000.

The first provision broadly excludes consumer credit under two million dollars using the capacious definition of credit in the Equal Credit Opportunity Act.[304] The second provision exempts commercial credit that is less than $500,000 and borrows its definition of credit from California's recently enacted Commercial Financial Disclosure Law.[305]

296. Pub. L. No. 110-142, 121 Stat. 1803 (codified as amended in scattered sections of 26 U.S.C.).

297. *Id.* § 2(b), 121 Stat. at 1803–04 (codified at 26 U.S.C. § 108(h)).

298. *Id.*

299. 26 U.S.C § 108(a)(1)(E), (h).

300. Pub. L. No. 117-2, 135 Stat. 4 (codified in scattered sections of the U.S.C.).

301. *Id.* § 9675(a), 135 Stat. at 185 (codified at 26 U.S.C. § 108(f)(5)).

302. Press Release, Gregory Meeks, *supra* note 23.

303. H.R. 2077, 117th Cong. (2021).

304. Pub. L. No. 93-495, tit. V, 88 Stat. 1521 (1974) (codified as amended in scattered sections of 15 U.S.C.).

305. 2018 Cal. Stat. 6661.

The commercial credit provision is designed to encompass debt like the taxi medallion debt described in the introduction to this Article. Although the story I tell throughout this Article is a story of consumer debt, given the fissuring of the workplace,[306] there is increasing recognition that commercial debt may have the same dislocating effects for sole proprietors and small businesses as it has had for consumers. In recent years, several states have passed commercial financing disclosure laws that mirror federal and state consumer credit disclosure laws,[307] and federal regulators have begun to scrutinize small-business lending.[308]

These exceptions may seem radical, but they are generally consistent with the nature of recent amendments to § 108. Since its inception, the debt tax has embodied two conflicting rationales: the simple but inequitable net worth theory and the complex but equitable whole transaction theory. One way to understand the early history of the debt tax, then, is as a compromise between these two rationales. Courts, and later, Congress, exempted transactions when cancellation likely reflected a loss and only applied the tax when cancellation most likely reflected a gain.

The procedural changes in the 1980s and 1990s unsettled this balance by creating an operational presumption of taxability for otherwise exempt transactions. The recent amendments to the tax code for canceled mortgage debt and student debt are best understood as attempts to revert back to the 1970s status quo with one key difference: the new exemptions for mortgage debt and student debt are sensitive to the way that these markets are shaped by federal policy.[309] Unwinding the information reporting rules and expanding the category of exempt transactions as specified above is a way to fulfill the aims of these initial efforts in a manner that is consistent with a more complete understanding of the way that law shapes the size and distribution of debt.

However, even taking all of this to be true, there are still some objections one might raise to categorically exempting certain consumer debt and small-business debt. An initial objection might be that these exceptions create moral hazard risk. By decreasing the costs of being overleveraged, consumers and small businesses may be encouraged to take out too much debt. It is probably unsurprising that I get off the train of this argument pretty early on. The story I tell here is mostly a supply-side story of credit creation, and I do not believe moral hazard risk is a compelling objection.

306. *See* DAVID WEIL, THE FISSURED WORKPLACE: WHY WORK BECAME SO BAD FOR SO MANY AND WHAT CAN BE DONE TO IMPROVE IT (2017).

307. Following California's lead, New York recently enacted the Commercial Finance Disclosure Law. *See* Keith Salmeri, *New York Commercial Finance Disclosure Law*, NAT'L L. REV. (Mar. 2, 2022), https://www.natlawreview.com/article/new-york-commercial-finance-disclosure-law [https://perma.cc/2AYG-923X].

308. *CFPB Proposes Rule to Shine New Light on Small Businesses' Access to Credit*, CFPB (Sept. 1, 2021), https://www.consumerfinance.gov/about-us/newsroom/cfpb-proposes-rule-to-shine-new-light-on-small-businesses-access-to-credit/ [https://perma.cc/4YU3-SUJN].

309. *See* John R. Brooks, *The Big Student Loan Lie*, AM. PROSPECT (Jan. 5, 2022), https://prospect.org/education/big-student-loan-lie/ [https://perma.cc/4MTW-FDNB].

There are two objections that I take more seriously: horizontal equity and abuse. Horizontal equity requires that those similarly situated be treated equally and is a general principle of tax design.[310] As a matter of horizontal equity, we may worry that a broad exception is unfair to individuals whose debt was discharged and had a positive tax liability or who paid their debt to avoid the tax on canceled debt. Determining whether a broad exception actually creates horizontal equity concerns is a complicated exercise. As with evaluating whether a tax is regressive or progressive, we would need to know all offsetting transfers to measure the total cost of this change to similarly situated taxpayers.[311] And it is possible that our current regime creates more horizontal equity concerns than reform would. Moreover, there is something perverse about the logic of preserving a punitive tax so that its costs can be evenly distributed across time.

Abuse is a trickier problem. Broad exceptions for consumer credit and commercial credit may invite individuals or entities to restructure their affairs to avoid tax.[312] For example, an employer could characterize income as a discharged loan to avoid tax. We can manage some of this abuse with language that targets specific schemes. Indeed, many of the existing exceptions in § 108 specifically limit the exception to the extent that debt was incurred for services provided to the lender.[313] And consistent with those provisions, it seems sensible to add the following qualification to the language above:

- This exclusion shall not apply to the discharge of a loan if the discharge is on account of services performed by the borrower.

In addition, we could cap the amount of canceled debt that is exempt and rely on ex post enforcement of statutory and judicial anti-abuse doctrines.[314] But adopting these broad exceptions will likely mean more abuse at the margins.

Reversing the operational presumption of tax liability for canceled debt and adopting broad exceptions for consumer credit and commercial credit will likely put some pressure on the tax gap. Determining whether we ought to tolerate these costs is fundamentally a political question. It cannot be resolved by solely appealing to principles of sound tax design and administration. Choosing to prioritize certain kinds of noncompliance has

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310. *See* Louis Kaplow, *Horizontal Equity: Measures in Search of a Principle*, 42 NAT'L TAX J. 139 (1989). For particularly sharp critiques of horizontal equity, see *id.* at 140–41, 148–50. *See also* David A. Weisbach, *The Taxation of Carried Interests in Private Equity*, 94 VA. L. REV. 715, 718 (2008) (describing horizontal equity as "Sesame Street reasoning—which one of these things is more like the other").

311. *See* Viswanathan, *supra* note 256.

312. As an example of the kind of noxious abuse that already takes place, see David Enrich, Russ Buettner, Mike McIntire & Susanne Craig, *How Trump Maneuvered His Way out of Trouble in Chicago*, N.Y. TIMES (Oct. 27, 2020), https://www.nytimes.com/2020/10/27/business/trump-chicago-taxes.html [https://perma.cc/5VT4-HVL8].

313. *See* 26 U.S.C. § 108(f)(3), (f)(5)(D), (h).

314. Jonathan H. Choi, *The Substantive Canons of Tax Law*, 72 STAN. L. REV. 195, 197 (2020) (defining judicial and statutory anti-abuse doctrines).

distributional consequences.[315] And this Article suggests that those costs are too great to justify our current regime.

## CONCLUSION

Thirty years ago, Professor Deborah A. Geier posed the following questions about the different tax treatment for the cancellation of recourse and nonrecourse debt: "Does the dichotomy in treatment of recourse and nonrecourse debt make conceptual sense? If not, how did it come about and why does it remain? What are the practical consequences of the dichotomy?"[316]

Geier noted that, although "the questions seem to be fairly narrow in scope, their resolutions require a broad consideration of fundamental principles of income taxation."[317] Much the same can be said of the questions that this Article poses. Although examining the development of the tax on canceled debt is a narrow inquiry, resolving this question can help us understand how our tax laws often cannot be rationalized within the internal logic of tax, and how broader political forces can shape the development of our tax laws.

Moreover, although the reforms that this Article proposes seem small, they have potentially large implications. For much of the twentieth century, consumer advocacy sounded in "the register of access to credit as a social good."[318] Modern consumer advocacy, however, sounds in a very different register. It is one that views credit as a fundamentally destabilizing force, which is embedded in a social context plagued with subordinating pathologies.[319]

For scholars and activists, any solution to the problems that plague credit markets must start with broad-scale debt cancellation or "debt jubilees."[320] Astra Taylor argued earlier this year:

> Hundreds of millions of people are in debt not because they are immoral and live beyond their means but because they are denied the means to live. Debt jubilees are part of righting this wrong . . . they won't happen unless debtors rise up and demand them. The first step is abolishing the shame that makes us reluctant to fight for what we deserve.[321]

The tax on canceled debt operates as one obstacle to these claims. Thus, unwinding the regressive parts of the tax will not only provide some relief to overindebted individuals like taxi drivers, but it may help clear the path for the debt jubilees that many are agitating for.

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315. This is a central point made in Blank & Glogower, *supra* note 204.

316. Geier, *supra* note 199, at 120.

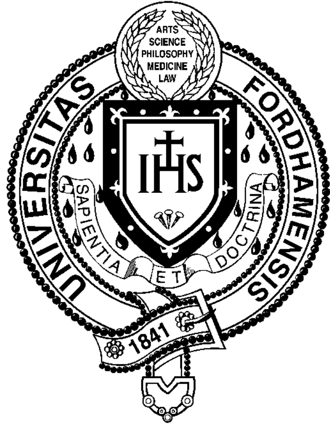
317. *Id.*

318. Atkinson, *supra* note 38, at 1428.

319. These are views that are encapsulated in forthcoming theoretical work by Luke Herrine and Raúl Carrillo. *See* Herrine & Carrillo, *supra* note 138.

320. DEBT COLLECTIVE, CAN'T PAY, WON'T PAY: THE CASE FOR ECONOMIC DISOBEDIENCE AND DEBT ABOLITION (2020).

321. Astra Taylor, *Debtors, Unite! You Have Nothing to Lose but Your Shame*, N.Y. TIMES (Sept. 6, 2022), https://www.nytimes.com/2022/09/06/opinion/biden-student-loan-debt-relief.html [https://perma.cc/9DCH-Y33B].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