

## Debt cancellation income rules take on increased importance this filing season

### Practice Alert

As tax season heats up, practitioners may discover that more clients have debt cancellation income than in past filing seasons. That is understandable. When the recession got into high gear in early 2009, many credit card lenders realized that some consumers were so overextended that they would never be able to pay the full amount of their debts. As a result, some lenders decided to take whatever they could get from these distressed borrowers and forgive the rest. In addition, as real estate prices soured, more and more lenders foreclosed on home loans or allowed borrowers to engage in short sales. All this has translated to more clients with debt cancellation income, which is taxable unless an exception or exclusion applies. To help practitioners deal with this important development, this **Practice Alert** reviews the essential rules governing debt cancellation income and provides references to more detailed discussions of them. It is accompanied by a separate Client Letter (see below) on the subject.

**General rule.** Gross income includes income from the discharge of indebtedness. This applies equally to debts discharged by commercial lenders and those canceled by private lenders. (Code Sec. 61(a)(12)) However, there are several exceptions to the general rule that treats a debt forgiveness as taxable. In addition, there are numerous exclusions from gross income for certain types of forgiven debts. Exceptions and exclusions are separately covered below.

**Gift exception.** If a debt cancelled by a private lender, such as a relative or friend, is intended as a gift, there is no income. Likewise, a debt cancelled by a private lender's Last Will and Testament triggers no income to the borrower. (Code Sec. 102)

**Student loan exception.** There is an exception for certain student loans. In the case of an individual, gross income doesn't include any amount which (but for this rule) would be includible in gross income by reason of the discharge of all or part of any student loan if the discharge was made under a provision of the loan that all or part of the indebtedness would be discharged if the individual worked for a certain period of time in certain professions for any of a broad class of employers. (Code Sec. 108(f)) For example, doctors, nurses, and teachers agreeing to serve in rural or low income areas in exchange for cancellation of their student loans won't have income from the cancellation if they meet certain conditions.

**Exception for deductible debt.** There is no income from cancellation of deductible debt. For example, if a lender cancels home mortgage interest that could have been claimed as an itemized deduction on Schedule A of Form 1040, there is no income. (Code Sec. 108(e)(2))

**Price adjustment.** There is no income if an individual purchases property and the seller later reduces the price. (Code Sec. 108(e)(5)) The purchaser's basis in the property, however, is reduced by the amount of the purchase price adjustment. (Code Sec. 1012)

**Discharge of debt through bankruptcy.** No amount is included in a debtor's gross income by reason of a discharge of indebtedness in a Title 11 (bankruptcy) case, but only if the taxpayer is under the jurisdiction of the court in such a case and the discharge is granted by the court or in a court-approved plan. (Code Sec. 108(a)(1)(A), Code Sec. 108(d)(2)) The amount of discharged debt which thus is excluded from the debtor's gross

income must be applied to reduce certain of his tax attributes unless he elects to reduce his basis in depreciable assets or in real property held as inventory. (Code Sec. 108(b)(1), Code Sec. 108(b)(5)(A))

**Discharge of debt of an insolvent taxpayer.** A debtor may be insolvent (although not in bankruptcy) when his indebtedness is discharged. In this case, the amount of debt discharge is excluded from the debtor's gross income, up to the amount of his insolvency. (Code Sec. 108(a)(1)(B), Code Sec. 108(a)(3)) The amount excluded under this insolvency exception is applied to reduce the debtor's tax attributes in a specified manner. (Code Sec. 108(b)) Or the insolvent debtor may elect to reduce his basis in depreciable assets or in real property held as inventory. (Code Sec. 108(b)(5)(A))

**Discharge of qualified farm debt.** The discharge of qualified farm indebtedness by a qualified person outside of bankruptcy doesn't generate cancellation of debt income to a solvent taxpayer. (Code Sec. 108(a)(1)(C)) This qualified farm indebtedness exclusion is applied after the insolvency and Title 11 (bankruptcy) exclusions. Thus, it doesn't apply to the extent the debtor is insolvent or to a debtor in Chapter 11 bankruptcy. (Code Sec. 108(a)(2)) The excluded amount of discharged qualified farm indebtedness can't exceed the sum of the taxpayer's adjusted tax attributes plus the aggregate adjusted bases of qualified property he holds at the beginning of the tax year following the tax year in which the discharge occurs. (Code Sec. 108(g)(3)(A))

**Discharge of qualified real property business debt.** A discharge of qualified real property business indebtedness of a solvent taxpayer other than a C corporation outside of bankruptcy doesn't result in cancellation of debt income (subject to a limit). (Code Sec. 108(a)(1)(D)) The amount excluded from gross income is applied to reduce the basis of the taxpayer's depreciable real property. (Code Sec. 108(c)(1)(A))

**Discharge of qualified principal residence debt.** Any discharge of indebtedness income by reason of a discharge (in whole or in part) of qualified principal residence indebtedness (below) is excluded from the taxpayer's gross income. (Code Sec. 108(a)(1)(D)) This exclusion applies where a taxpayer restructures his acquisition debt on a principal residence, loses his principal residence in a foreclosure, or sells a principal residence in a short sale (where the sales proceeds are insufficient to pay off the mortgage and the lender cancels the balance). The taxpayer's basis in the residence must be reduced. "Qualified principal residence indebtedness" is acquisition indebtedness on the taxpayer's principal residence, up to a \$2 million limit (\$1 million for married individuals filing separately). (Code Sec. 108(h))

**Deferral of cancellation of debt income on the repurchase of debt at a discount.** For debt discharges in tax years ending after Dec. 31, 2008, a taxpayer can elect to have debt discharge income from the reacquisition of an applicable debt instrument after Dec. 31, 2008, and before Jan. 1, 2011, included in gross income ratably over five tax years beginning with:

(1) for repurchases occurring in 2009, the fifth tax year following the tax year in which the repurchase occurs, and

(2) for repurchases occurring in 2010, the fourth tax year following the tax year in which the repurchase occurs. (Code Sec. 108(i))

**RIA observation:** Although all of the deferred debt discharge income will eventually be recognized, the taxpayer benefits from the deferral of tax to later years. And, none of the taxpayer's tax attributes have to be reduced.

An applicable debt instrument means any debt instrument that was issued by a C corporation, or any other person in connection with the conduct of a trade or business by such person. (Code Sec. 108(i)(3)(A)) Debt instrument is broadly defined to include a bond, debenture, note, certificate, or any other instrument or contractual arrangement constituting indebtedness under Code Sec. 1275(a). (Code Sec. 108(i)(3)(B))

**Form 1099-C, Cancellation of Debt.** A taxpayer should receive a Form 1099-C from a federal government agency, financial institution, or credit union that forgives a debt of \$600 or more. The amount of the canceled debt is shown in box 2. Any forgiven interest included in the amount of canceled debt in box 2 will also be shown in box 3. As noted above, if the interest would otherwise be deductible, it does not have to be included in income.

An individual who doesn't agree with the amount shown on Form 1099-C should contact the lender in writing and request it to issue a corrected Form 1099-C showing the proper amount of canceled debt. Even if the lender refuses to issue a corrected report, there still may be recourse if the taxpayer has adequate documentation to show that the lender incorrectly reported the amount canceled. For example, in McCormick, TC Memo 2009-239 (see Federal Taxes Weekly Alert 10/29/2009), a \$2,875 debt was no longer collectible because the period of limitations on a suit to collect had expired. Even so, the borrower offered to pay \$1,000 as the amount "actually owed." The lender accepted and sent a 1099-C showing debt cancellation income of \$1,875. The Tax Court found that the borrower had an uncontested and liquidated outstanding balance of \$1,000. Because he paid \$1,000 to settle the account, he had no debt cancellation income. The borrower in that case also showed that a second lender failed to properly credit an insurance refund. The Tax Court agreed and reduced the amount that had to be reported as debt cancellation income by the amount of the insurance refund.

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