



# Cancellation of Debt

*“What You Should Know”*

IRS Nationwide

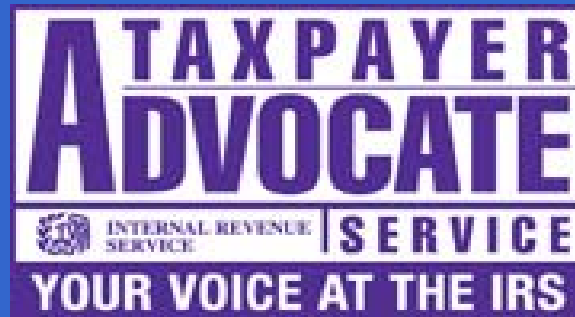
2008

**Tax  
FORUM**

Partners in Tax  
Administration

# National Taxpayer Advocate

## *Podcast*







# Current Law

*IRS Office of Chief Counsel*

# Cancellation of Debt

**Section 61(a)(12) of the Internal Revenue Code provides that gross income includes “income from discharge of indebtedness.”**

## **Example:**

**Taxpayer A borrows \$10,000 from Bank X in 2006. When the loan comes due in 2007, Taxpayer A is able to repay only \$8,000. Bank X discharges the remaining \$2,000. Taxpayer A has \$2,000 of cancellation of debt (COD) income.**

# Issuance of Form 1099-C

Section 6050P of the Internal Revenue Code requires certain financial institutions and federal agencies that cancel a debt of \$600 or more during any calendar year to file an information return (Form 1099-C) with the IRS and provide a copy to the taxpayer whose debt was canceled.

# **COD income can arise in various contexts, including:**

- **Cancellation of credit card debt**
- **Cancellation of automobile debt**
- **Cancellation of student loan debt**
- **Cancellation of home mortgage debt**



# Nonrecourse Debt

- When nonrecourse debt is canceled:
  - By reason of the disposition of property, no COD income is realized; instead, the full amount of the debt is included in the amount realized on the disposition. See Treas. Reg. section 1.1001-2(c), Ex. 7.
  - In a workout (i.e., without transfer of underlying property), COD income can arise. See Rev. Rul. 91-31; Rev. Rul. 92-99.



# Gain or Loss on Disposition

If a debt for which the taxpayer is personally liable is discharged as a result of a foreclosure, sale, or other disposition of property that secures the debt, the taxpayer may realize gain or loss on the disposition as well as COD income.

In the case of personal use property, such as a principal residence, any loss would be nondeductible.

# Deductible Debt

**Section 108(e)(2) provides that no COD income is realized to the extent that payment of the debt would have given rise to a deduction.**

- Mortgage interest is generally deductible under section 163(h)(3).**
- Interest on other types of consumer debt (e.g., credit card debt, automobile financing) generally is nondeductible personal interest under section 163(h)(2).**

# Workouts



**COD income can arise in a debt “workout” as well as in a foreclosure.**

**Whether this COD income is taxable depends on whether an exception in section 108 applies.**

## **Section 108 excludes discharges of indebtedness from gross income if:**

- The discharge occurs in bankruptcy**
- The discharge occurs when the taxpayer is insolvent**
- The debt is “qualified farm indebtedness”**
- The debt is a student loan for which the exclusion provided by section 108(f) applies**
- The debt is “qualified principal residence indebtedness”**

# The Mortgage Forgiveness Debt Relief Act of 2007 (Pub. Law 110-142)



- Created a new exclusion under sections 108(a)(1)(E) and 108(h) for discharged qualified principal residence indebtedness.
- Applies to qualified principal residence indebtedness that is discharged on or after Jan. 1, 2007 and before Jan. 1, 2010.

# Qualified Principal Residence Indebtedness



- Acquisition indebtedness (within the meaning of section 163(h)(3)(B)) for a principal residence.
  - “Acquisition indebtedness” = Debt incurred in acquiring, constructing or substantially improving the home and secured by the home. May include refinanced debt and the proceeds of a “home equity” loan used to substantially improve the home.
  - “Principal residence” as defined in section 121 (note: the 5-year lookback test in section 121 is NOT part of the definition of “principal residence”).
- \$2 million limitation



# Application of the Law

*Taxpayer Advocate Service*

# Form 1099-A versus Form 1099-C



- Differences in reporting requirements
- Interaction of reporting requirements
- Differences in tax consequences for recipient



# General Rule: COD income is taxable as ordinary income

| <b>IF THE DEBT IS RELATED TO...</b>                                                                                                          | <b>REPORT NET TAXABLE AMOUNT ON...</b>               |
|----------------------------------------------------------------------------------------------------------------------------------------------|------------------------------------------------------|
| <b>Nonbusiness debt</b>                                                                                                                      | <b>Form 1040, line 21 (or Form 1040NR, line 21)</b>  |
| <b>Nonfarm sole proprietorship</b>                                                                                                           | <b>Schedule C, line 6 (or Schedule C-EZ, line 1)</b> |
| <b>Nonfarm rental activity</b>                                                                                                               | <b>Schedule E, line 3</b>                            |
| <b>Farm debt (taxpayer is a farmer)</b>                                                                                                      | <b>Schedule F, line 10</b>                           |
| <b>Farm rental activity for which the taxpayer uses Form 4835 to report rental income based on crops or livestock produced by the tenant</b> | <b>Form 4835, line 6</b>                             |

# Exceptions and Exclusions

## Exceptions

- Amounts otherwise excluded from income
- Certain student loans
- Deductible debt (for taxpayers using the cash method of accounting)
- Price reduced after purchase

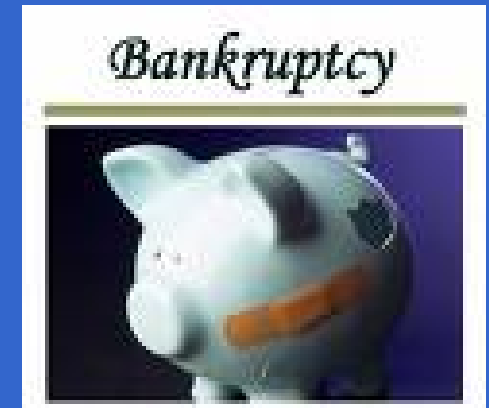
## Exclusions

- Bankruptcy
- Insolvency
- Qualified farm indebtedness
- Qualified real property business indebtedness
- Qualified principal residence indebtedness

# Bankruptcy and Insolvency

## Bankruptcy

- Line 1a of Form 982.
- No other exclusion applies if the debt was canceled in a title 11 bankruptcy case.

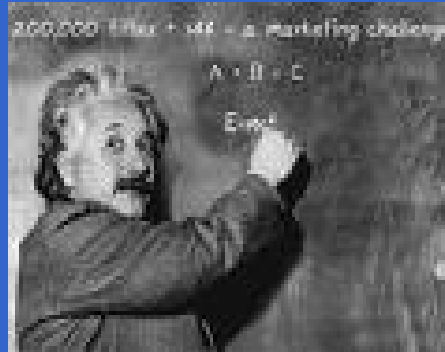


## Insolvency

- Line 1b of Form 982.
- Exclusion is limited to the extent of insolvency.



# Calculating Insolvency



- Total liabilities immediately before the discharge
- FMV of total assets immediately before the discharge
- = Extent to which the taxpayer is insolvent

# Qualified Principal Residence Indebtedness



- The maximum amount you can treat as qualified principal residence indebtedness is \$2 million (\$1 million if MFS).
- Must be qualified acquisition indebtedness.
- Ordering rule – if only a part of the loan is qualified principal residence indebtedness, the exclusion for discharged qualified principal residence indebtedness applies only to the extent the amount discharged exceeds the amount of the loan (immediately before the discharge) that was not qualified principal residence indebtedness.

# Example – Ordering Rule



**Outstanding mortgage balance = \$750,000**

- **Refinanced for \$850,000**
- **Additional \$100,000 used to buy car & pay credit card debt**
- **Lender forecloses, sells the house for \$735,000, and cancels the remaining \$115,000 of debt**

**Ordering rule:**

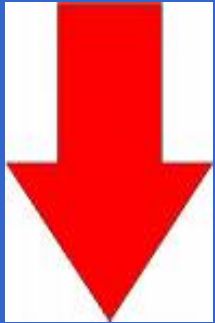
**\$115,000 canceled debt**

- **\$100,000 of nonqualified debt**

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**\$ 15,000 amount eligible for exclusion as QPRI**

**The remaining \$100,000 must be included in income unless another exception or exclusion applies (e.g., insolvency).**

# Reduction of Tax Attributes



- Net operating loss (NOL) and NOL carryover
- General business credit carryover
- Minimum tax credit
- Capital loss and capital loss carryover
- Basis
- Passive activity loss and credit carryover
- Foreign tax credit

## Example (Pub. 4681 - Page 15)

- In 2003, Kathy and Frank Willow entered into a contract to build their principal residence for \$3 million – using a \$2.6 million mortgage and \$400,000 down.
- Recourse loan which is secured by the principal residence.
- In 2007, when the outstanding balance on the mortgage loan was \$2.5 million, the FMV of the property fell and Kathy and Frank abandoned the property.
- The lender foreclosed and sold the property that year for \$1,750,000.
- Later that year (after the foreclosure sale), the lender canceled the remaining debt.



# Low Income Taxpayer Clinic



# Examination (AUR)



# TAS Focus Groups

## Tuesday

**11:30 am** – IRS Stuffers in Notices

## Wednesday

**9:00 am** – ACS: How Can We Improve It

**11:00 am** – Feedback on TAS Podcast

***THANK YOU!***

**For Helping Us  
Help Taxpayers**