Transcript for Canceled Debt (Tax Consequences)

Hello. I'm Jean Wetzler, with a reenactment of a March 2009 IRS National Phone Forum on the "Tax Consequences of Canceled Debt". The presenter for the phone forum was Anne Freeman, chief of the Individual Review section of the IRS Tax Forms and Publications Division.

In this presentation, we'll cover four areas of interest relating to the tax consequences of canceled debt:

- One: the general rule for including canceled debt in gross income, the information returns that will clue you in to the fact that you are dealing with a canceled debt situation, and how to report income from the cancellation of debt on your tax return;
- Two: the exceptions and exclusions – with a focus on the bankruptcy, insolvency, and qualified principal residence indebtedness exclusions, and how to report those exclusions on your tax return;
- Three: reduction of tax attributes-- certain credits, losses and deductions -- and how to report them, and
- Four: new cancellation of debt provisions in the American Recovery and Reinvestment Act and other recent COD news.

Throughout the presentation, I will frequently use the acronym C-O-D to refer to cancellation of debt.

First, I'll cover the general rule, which is:

Cancellation of debt income is taxable as ordinary income. Internal Revenue Code section 61 provides that gross income means all income from whatever source derived.

Section 61(a)(12) specifically includes "income from discharge of indebtedness" as an item of gross income.

COD income can arise in a number of areas, such as:

- Cancellation of credit card debt
- Foreclosure of personal residence, or
- Cancellation of an automobile loan

So, which information returns would indicate that you are facing a COD situation? There are two 1099 forms which can arise in a COD / foreclosure situation. Form 1099-A, Acquisition or Abandonment of Secured Property, and Form 1099-C, Cancellation of Debt.

Form 1099-A is used when the lender acquires an interest in property that is security for the debt, or the lender knows or has reason to know that the property has been abandoned.

Form 1099-C is used when the lender cancels debt of $600 or more without receiving anything of value in exchange for the cancellation.

You should be aware of the interaction between these two forms. If, in the same calendar year a lender cancels a debt in connection with a foreclosure or abandonment of property with respect to the same debtor, the lender can file only Form 1099-C and still satisfy the Form 1099-A reporting requirements. If the lender files a consolidated Form 1099-C, that lender must complete box 5 (description of property) and box 7 (Fair Market Value, or FMV).

These two forms, however, have much different tax consequences for the debtor.
Form 1099-A results in a deemed disposition by the debtor. Thus, the debtor must calculate the gain or loss on the disposition as well as the character, excludability, and deductibility of any gain or loss.

Form 1099-C results in ordinary income from the cancellation of indebtedness and generally must be included in income unless certain exceptions or exclusions under IRC section 108 are met.

A consolidated 1099-A/1099-C results in **both** a deemed disposition and ordinary income from the cancellation of debt (unless any exceptions or exclusions apply).

One area that gets a lot of attention and warnings about is the fair market value amount shown on the Form 1099. If you disagree with the amount shown, the first thing that you should do is contact the lender. Also, while the IRS presumes the FMV amount to be correct as shown on the 1099, you can dispute the amount if you provide information from reliable sources that support the amount you assert as the true value.

So, if you are in a COD situation, how do you report it on the tax return? Where the COD income gets reported on the individual tax return depends on the type of debt that is canceled.

- Report the taxable COD amount of any **nonbusiness** debt on Form 1040 or Form 1040NR, line 21.
- If the debt is related to a **nonfarm sole proprietorship**, report the taxable CODamount on Schedule C, line 6, or on Schedule C-EZ, line 1.
- If the debt is related to **nonfarm rental activity**, report the taxable COD amount on Schedule E, line 3.
- If the debt is related to farm debt (and taxpayer is a **farmer**), the taxable COD amount goes on Schedule F, line 10.
- If the taxpayer **uses Form 4835, Farm Rental and Expenses**, to report rental income based on crops or livestock produced by the tenant, report the taxable COD amount on line 6 of Form 4835.

In all of these situations, it’s important to note that **only taxable** COD income is what gets reported. For example, if you have $5,000 of COD income and can exclude $1,000 of this income under a section 108 exclusion, you would report the $4,000 net taxable amount on the appropriate line of the applicable form or schedule.

So what **is** the difference between total COD and taxable COD? Here are the exceptions and exclusions that can account for the difference.
Exceptions are:

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

Exclusions are:

- Bankruptcy
- Insolvency
- Qualified farm indebtedness
- Qualified real property business indebtedness
- Qualified principal residence indebtedness, and
- Certain non-business debt of a qualified individual because of the Midwestern disasters

This presentation will cover the most relevant of the exclusions – bankruptcy, insolvency, and qualified principal residence indebtedness – and how to report these exclusions on the tax return.

But first, you should know that there is a special rule dealing with nonrecourse debt. Nonrecourse debt is debt for which the taxpayer is not personally liable. COD rules differ based on whether or not there has been a disposition of the property. If there has been a disposition (for example, through a foreclosure, repossession or abandonment), no COD income is realized. Instead, the full amount of debt is included in the amount realized on the disposition. If there is no disposition – perhaps there was a workout situation – COD income can arise on forgiveness of nonrecourse debt.

Now, back to the exclusions, starting with **bankruptcy.** If you are under the jurisdiction of the court in a title 11 bankruptcy case, and the discharge is granted by the court, or is under a plan approved by the court, this exclusion applies. And, it takes precedence over the other exclusions. There are no dollar limitations on the amount you can exclude under section 108 in a title 11 bankruptcy case.

The next exclusion is **insolvency**. Here, there is a dollar limit because the exclusion is limited to the extent of insolvency measured immediately before the discharge. The calculation is easy in theory – total liabilities immediately before the discharge minus the FMV of total assets at that time – but the calculation is more difficult in application because taxpayers generally do not have such a listing of assets and liabilities readily available.

The final exclusion covered in the presentation is the one for **qualified principal residence indebtedness.** This exclusion applies to debt discharged on or **after** Jan. 1, 2007 and **before** Jan. 1, 2013. The maximum amount you can treat as qualified principal residence indebtedness is $2 million – or if married filing separately, $1 million.

This must be qualified acquisition indebtedness, or debt incurred in acquiring, constructing or substantially improving the home, and secured by the home. It can also include refinanced debt with certain limitations having to do with the amount of qualified indebtedness on the original loan. Qualified acquisition indebtedness can also include the proceeds of a "home equity" loan used to substantially improve the home.

If the mortgage debt is used for nonqualified purposes – such as to pay off credit card debts or student loans - it is not qualified acquisition indebtedness and cannot be excluded under this provision. However, such debt may qualify for exclusion under another provision, such as insolvency.

However, it is important to note that once you have a situation in which there is nonqualified debt, the ordering rule comes into play. The ordering rule says that 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 that the amount discharged exceeds the amount of the loan, immediately before the discharge, that was **not** qualified principal residence indebtedness.

Here is an example:

- Let's say we have an outstanding mortgage balance of $750,000
- We've refinanced the mortgage for $850,000 – so we've acquired an additional $100,000.
- We used that $100,000 to buy a car and pay off credit card debt -- that makes it nonqualified debt because it was used for nonqualified purposes. Assume also that the lender forecloses, and sells the house for $735,000. The lender also cancels the remaining $115,000 of debt.

The ordering rule says we must first subtract the $100,000 of nonqualified debt – the amount we used to buy a car and pay off credit cards – from the $115,000 the lender canceled at foreclosure. This leaves us with only $15,000 eligible for exclusion as qualified principal residence indebtedness. The remaining $100,000 must be included in income unless another exception or exclusion applies – for instance, insolvency.

Because this example involves a foreclosure, keep in mind that the taxpayer in this situation would also need to calculate the gain or loss on the disposition of the home. Since we are dealing with a personal residence, any gain would potentially be eligible for exclusion under section 121 – any loss would be a nondeductible loss.

How To Claim Exclusions. You would use Form 982, Reduction of Tax Attributes Due to Discharge of Indebtedness (and Section 1082 Basis Adjustment), to let the IRS know that you are claiming such an exclusion, and to reduce tax attributes due to the discharge of indebtedness. You can find Form 982 and other tax forms on the IRS website, IRS.gov.

To show the IRS that you are claiming an exclusion, you must complete and attach Form 982 to the tax return. The IRS will look for Form 982 as part of the document matching program. Use Part I of Form 982 to show the reason, or reasons, for the exclusion and the total amount excluded. Essentially, you check the box or boxes relating to the exclusion you are entitled to on line 1, and enter the total amount of the exclusion on line 2.

It's important to note that if the exclusion is not the **full** amount of the debt **discharged**, the **taxable** amount gets reported on the tax return, as discussed earlier.

Now, let's get into the rules for **reduction of tax attributes**. Essentially, the rules say that if you exclude income from the discharge of indebtedness, you must also reduce tax attributes. Tax attributes are certain credits, losses, and deductions that you may have that would give you a tax benefit some time in the future. The reduction of tax attributes is made after determination of your tax liability for the year of the discharge.

Internal Revenue Code section 108(b)(2) lists the general order in which tax attributes must be reduced:

- One: net operating loss and NOL carryover
- Two: general business credit carryover
- Three: minimum tax credit
- Four: capital loss and capital loss carryover
- Five: basis
- Six: passive activity loss and credit carryover
- Seven: foreign tax credit

However, there is an election which can be made under section 108(b)(5) to first reduce the basis of depreciable property, and there is also a special rule for qualified principal residence indebtedness. This rule essentially says that if you are excluding income based only on the qualified principal residence indebtedness exclusion, you only need to reduce the basis of the residence – and **only** if you retain ownership.

The basis reduction rules are generally one of the most relevant to nonbusiness taxpayers. Basis includes the basis of property held at the beginning of the tax year **following** the year of the discharge. And the basis reduction rules must also be made in a specific order – and you must allocate the reduction within each category in proportion to the adjusted basis. To help figure this out and do the calculations properly, I encourage you to refer to Publication 4681 for individuals. It's titled Canceled Debts, Foreclosures, Repossessions, and Abandonments, and it's available on IRS.gov.

You will use part two of Form 982 to show the reduction of tax attributes. Form 982 is also available on IRS.gov. Be aware that the amount in part two will not necessarily equal the part 1 exclusion.

Now, let's turn to some recent developments in the COD arena. On February 17, 2009, the American Recovery and Reinvestment Act of 2009 – ARRA -- was enacted. This law contains a provision that allows certain businesses to elect to defer, and include ratably over five tax years, any income from the discharge of business debt arising from the reacquisition of certain specified types of business debt repurchased in 2009 and 2010.

Let's say, for example, that a company buys back debt for 30 cents on the dollar – generally this would result in COD income. Under the ARRA provision, certain businesses will be allowed to recognize qualified cancellation of debt income over 10 years by deferring the tax on the income for the first four or five years, and recognizing this income ratably over the following five taxable years.

For details, including how to make the election, see newly enacted section 108(i).

There are also a couple other recent developments you may be interested in:

- First, a proposed regulation has been released describing how an S corporation should reduce its tax attributes. For your reference, the number for that proposed regulation is REG-102822-08.
- And second, the National Taxpayer Advocate's 2008 Annual Report to Congress contained some recommendations relating to cancellation of debt. This is the second year in a row that COD is covered in this report. In the 2008 report, the National Taxpayer Advocate recommends: removing taxpayers with modest amounts of debt cancellation from the COD regime; providing an insolvency worksheet for taxpayers; and creating a centralized unit in the IRS dedicated to handling COD issues.

Please note that this information was accurate at the time this program was recorded, and is subject to change.

That concludes the presentation on "Tax Consequences of Canceled Debt." For more information, visit our Web site, IRS.gov.

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