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# IRS Says Loans Aren't Taxed, But Audits When Loans Are Income

Can the IRS tax a loan? Say your uncle loans you \$10,000 to tide you over, is it taxable income? No, it shouldn't be. What about when the bank loans you \$100,000? No again. You have to pay it back, so it does not count as income, provided it's a real loan. That's a key distinction that lands lots of taxpayers in trouble. But even if it's a real loan and is later forgiven, it is income *then*. That tax on forgiveness is called [cancellation of debt income](#), often shortened to COD income. You got cash when you borrowed the money. When you don't have to repay it, that cash is no longer loan proceeds and becomes income.

The tax code generally taxes you when you are relieved of paying back a debt, treating it like cash paid to you. See [10 Things About COD Income](#). This unpleasant rule might seem easy to ignore, except that when a loan is forgiven, you'll generally receive a [Form 1099-C](#) reporting income to you—and telling the IRS. If you receive one and disagree with the amount shown, write the lender requesting a corrected [Form 1099-C](#) showing the proper amount of cancelled debt. Don't ignore [Forms 1099](#). In some cases COD income isn't taxed. If you believe the cancelled debt isn't income because you're insolvent or for any other reason, you'll need to address this on your return.

If you receive a loan, can the IRS claim the “loan” you received—that is still outstanding and hasn't been forgiven—isn't a loan and was *actually a sale*? In other words, can the IRS claim that “loan” proceeds are really sales proceeds and therefore taxable? Sometimes, yes. That's exactly what happened to [Jonathan Landow](#). Landow took out a 90% loan against securities he put up

as collateral. The loan was non-recourse—meaning that Landow could not be sued personally if he defaulted. Yet the securities were pledged as collateral.

In fact, the lender had the ability to sell the securities in ways that were unusual for garden-variety loans. And that's just what the lender did, even though Landow later claimed he had no idea his securities would be sold. Landow didn't pay off *any* of the \$13.5 million principal amount of the loan.

He also didn't report the "loan proceeds" as income. The IRS claimed the loan transaction wasn't a loan at all and instead was a sale. The Tax Court agreed with the IRS, treating the putative loan as a highly orchestrated transaction. The court thought everyone *knew* the transaction would be documented as a loan but *really* amounted to a sale. How real is the danger that the IRS will treat loans as sales? In transactions like Landow's, very. Landow's deal was part of a litigated and controversial tax shelter that produced a series of cases. See [\*Shao v. Commissioner\*](#) and [\*Kurata v. Commissioner\*](#). In that sense, the result in Landow's case was no surprise.

How you structure a transaction is important, as is how the transaction actually plays out. In general, courts look to indicators such as whether legal title passes, how the parties treat the transaction, and the parties' intent. There can also be danger in simple family transactions. But there, the question is often whether something is a loan or a gift. Gifts may not trigger income tax, but they can trigger gift tax. Loan vs. income vs. gift? Think about taxes up front, and document what you intend. Everyone will be better off.

*This is not legal advice. For tax alerts or tax advice, email me at [Wood@WoodLLP.com](mailto:Wood@WoodLLP.com).*