



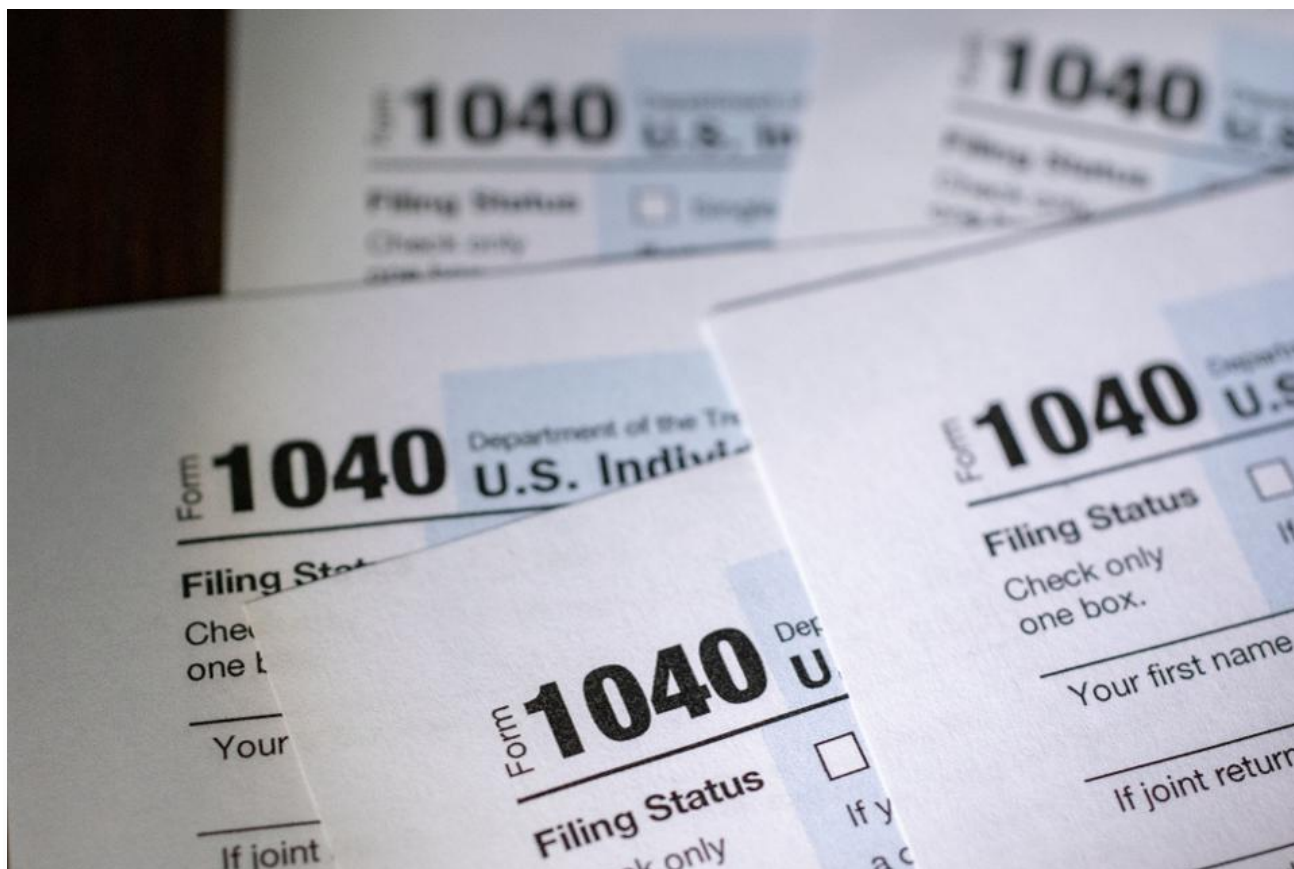
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TAXES 05/27/20

IRS Taxes Most Loan Forgiveness, Be Careful With Exceptions

The Payroll Protection Program or PPP has been one of the things holding many small businesses together. Now that loan forgiveness applications are available, there are many businesses struggling with whether they will qualify and how to make sure of that. For an excellent summary of the lay of the PPP land, see [May 22 PPP final interim rules provide further guidance](#). More generally, it is worth reviewing the basic rules and why the IRS usually taxes loan forgiveness in the first place, since the IRS *usually* looks to tax loan forgiveness. Like it or not, when a debt you owe is canceled or discharged, in many cases the tax code treats the wiped out debt as cash income to you. In most cases, if you owe \$500,000 to the bank, but the bank forgives it, it's as if the bank just handed you \$500,000 and Uncle Sam wants his cut. In the tax world, COD is short for cancellation of debt. There are other types of [taxable income that occur even without cash](#), but COD income ranks as one of the most widely misunderstood tax traps. The good news is that there are exceptions and exclusions that may keep you from having to write a check to the IRS.



Loans forgiven as gifts aren't taxed. If your debt is canceled by a private lender—say a relative or friend—and the cancellation is intended as a gift, there is no income to you. While it's not income to you, if the lender forgives more than \$15,000 in a year (the gift tax annual exclusion), it may count against his or her own lifetime exemption from the gift and estate tax. Thus, these loans are often forgiven a little at a time. A debt canceled by a private lender's will, upon his death, isn't income to you either.

If your lender writes off some of your mortgage, you will have to reduce your basis in the residence by the amount of discharged debt not counted as income to you. Note that this special relief for forgiven mortgages isn't automatic; to take advantage of it you must file IRS [Form 982, Reduction of Tax Attributes Due to Discharge](#).

Bankruptcy discharges aren't taxable. If your debt is discharged when you're in bankruptcy as part of a court-approved bankruptcy plan, it isn't

income to you. The amount of the discharged debt goes to reduce certain tax attributes, such as net operating losses or the basis of property. The rules are complicated and Form 982 is required.

If you're insolvent, you get a pass. Even if you are not in bankruptcy, if you are insolvent when your debt is discharged, there is no tax. Insolvency is a simple test meaning your liabilities exceed your assets. To escape tax, your liabilities must exceed your assets by *more* than the amount of the debt discharged. Say you have \$1,000 in assets and \$2,000 in liabilities, so you're underwater to the tune of \$1,000. If your bank forgives a \$500 debt, it's not income because the amount forgiven is less than the amount of your insolvency.

Certain forgiven student loans aren't income. Another exception protects forgiveness of certain student loans, but the rules are complex and keep changing, so be careful. The student or former student escapes the tax hit if the loan is forgiven under certain conditions. For helpful summaries, check out [IRS issues tax guidance on discharged student loans](#) or [is student loan forgiveness taxable? it depends](#).

You must account for Form 1099-Cs. No one likes IRS Forms 1099, which comes in many varieties. But among the most dreaded Form 1099 is [Form 1099-C, Cancellation of Debt \(PDF\)](#) showing the amount of cancellation of debt and the date of cancellation. If you receive a Form 1099-C, you generally have to pay tax. If you believe the canceled debt isn't income to you because you're insolvent or for any other reason, don't ignore the 1099-C. Instead, fill out Form 982 explaining why it isn't taxable.

A price adjustment isn't income. There is no income if an individual purchases property and the seller later reduces the price of the property. The

purchaser's basis in the property, however, is reduced by the amount of the adjustment. These days this exception can be particularly important. Say you bought a rental unit five years ago for \$500,000 from the bank, and still owe the bank \$400,000. The unit is now worth only \$350,000. The bank agrees to reduce the debt by \$50,000. If this is just debt discharge, it's COD income. But if it is written as an adjustment to the purchase price, it's not.

Certain farm and real business property debt gets special

treatment. Even if you are solvent, there are special rules for certain qualified farm debt. These rules apply only after you already apply the insolvency and bankruptcy rules. Similarly, a discharge of debt incurred to acquire or construct certain property used in a trade or business (qualified real property business debt) won't trigger income (subject to limits). In both cases, the amount of forgiven debt excluded from gross income reduces your basis in property. See [Publication 4681, Canceled Debts, Foreclosures, Repossessions, and Abandonments \(for Individuals\) \(PDF\)](#) for detailed information on canceled debt and on reporting gain or loss from repossession, foreclosure, or abandonment of property. The bottom line is that COD income has always been a confusing and complicated issue. But with the special exceptions Congress has made, it's even more so.

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