It’s Great When Debt Is Forgiven, But Don’t Forget About Taxes

By Robert W. Wood

What about non-recourse loans such as home mortgages? This too can be confusing. Many home loans are non-recourse. That means that the lender’s only remedy on default is to repossess the property being financed or used as collateral. Forgiveness of a non-recourse loan resulting from a foreclosure does not result in cancellation of debt income.

However, don’t assume you are home free. A foreclosure is still treated as a sale, and you are treated as getting the money even though it goes to pay your lender. These situations can be much more complex than you might think. But if you qualify, you might be able to shield some or all of the gain. So, get some help on your facts and numbers.

There is also an exception from COD income for tax deductible interest. That is, there is no income from cancellation of deductible debt. That means if a lender cancels home mortgage interest (interest only, not the principal of the debt), and that interest could have been claimed as an itemized deduction on Schedule A to your Form 1040, there is no income.

Disputed debts and price adjustments can also save the day in some cases. Regarding price adjustments, say you purchase property and the seller later reduces the price of the property. The purchaser's basis in the property, has to be reduced by the amount of the adjustment. However, it should not be considered COD income.

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 is COD income. But if it is written as an adjustment to the purchase price, it should not be.

This kind of drafting can come in handy with disputed debts too. Say you are litigating whether the $1M debt the lender says you owe was valid in the first place. You reach a settlement and the lender agrees you only owe $100K. You might be able to characterize this as a write down of the debt that does not trigger COD income.

There are many other exceptions to COD income. For example, there are rules for certain farm and real business property debt. Basis reductions are usually required, so the amount of money you have in the property goes down. That means you could owe more taxes later on sale. But a delay in the tax hit is almost always a good thing. When it comes to taxes, stretching your payment or discharge, it is COD income. But if it is written as an adjustment to the purchase price, it should not be.

Finally, don’t forget about tax reporting forms. If you strike a deal and assume that there will be no tax problem, you might be surprised next year. In most cases, you will end up with an IRS Form 1099-C. As with most Forms 1099, they report income to the IRS (and FTB), with a copy to you.

And as with most other types of Forms 1099, these generally arrive in January for the prior year. Most discharged debts are reported, and you can’t just ignore them. You can try to get the lender to correct it, but most such attempts after the fact fail. That means you’ll need to address it on your tax return.