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Cancelled Loans? Careful, IRS May Say Its Taxable

Amidst the praise and criticism of student loan forgiveness, are there any tax issues? The tax rules have traditionally been confusing, but President Biden's \$1.9 trillion relief package makes it pretty simple. If student loan is forgiven between Dec. 31, 2020, to Jan. 1, 2026, it won't count as taxable income. That's a relief to many, since in the past, these rules were very tricky and contained tax traps. That's why the five year tax moratorium is such a big deal. For helpful summaries of some of the past complexity, check out [IRS issues tax guidance on discharged student loans](#) or [is student loan forgiveness taxable? it depends](#). But what about loan forgiveness in general? There are volumes of confusing tax law about when and how loan forgiveness is taxed. It is hardly a new topic, as the tax law on this point goes all the way back to 1931, when the U.S. Supreme Court said a discharge of debt was taxable as income in *U.S. v. Kirby Lumber*, 284 U.S. 1 (1931). Commonly known as cancellation of debt, or "COD," income, the idea is that a discharge of debt frees up money which the tax code says is taxable. The IRS doesn't just rely on self-reporting. A creditor who cancels debt of \$600 or more is generally required to issue a Form 1099-C, Cancellation of Debt.



IRS Forms 1099 come in many varieties, but among the most dreaded Form 1099 is [Form 1099-C, Cancellation of Debt \(PDF\)](#) showing cancellation of debt. 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. It is worth reviewing the basic rules and why the IRS usually taxes loan forgiveness in the first place. 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.

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](#).

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. 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.

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.

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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