PERSPECTIVE

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

By Robert W. Wood

If someone forgives your debt so you do not have to pay back the lender, isn't that *always* a good thing? Yes, but generally not when it comes to taxes. The issue can arise in your personal life, or in your business or professional life. The unhappy tax result is generally the same.

When a debt is forgiven or cancelled, the IRS and the California Franchise Tax Board generally view the loan money as income at that point. Although you won't have to pay back the debt itself, you may have to pay taxes on the entire principle and interest being forgiven. COD is shorthand for cancellation of debt.

In most cases, the tax code treats the wiped-out debt as cash income to you. 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 like most other money, that's taxable. In fact, COD income is near the top of my list of little understood tax traps.

There are a few exceptions and exclusions that may keep you from having to write a check for the taxes. First, let's talk about gifts. 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. Even here there's a trap.

Although it is not income to you, if the lender forgives more than $14,000 in a year (the gift tax annual exclusion), it may count against his or her lifetime exemption from the gift tax. In some families, loans are cancelled in installments, or on death. A debt canceled by a private lender's will, upon his death, isn't income to you either.

A bigger exception occurs in bankruptcy. Debts discharged in bankruptcy are not taxable either. If your debt is discharged 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 if you have them.

Examples are net operating losses and the basis of property. The rules are complicated and special tax forms may be required to be filed. If you are insolvent (even though you don't file for bankruptcy), you may also sidestep the COD income. 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. For example, suppose that you have $1,000 in assets and $2,000 in liabilities. You are underwater to the tune of $1,000.

If your bank forgives a $500 debt, it is not income because the amount forgiven is less than the amount of your insolvency. But keep good records of all your assets at the time. It can be tough to provide this later. If the stakes are big, getting assets appraised can be a good idea.

Certain forgiven student loans also are not income, but this is a surprisingly complex topic. Some students or former students can escape the tax hit if the loan is forgiven under a provision specifying that all or part of the debt is discharged if the individual works for a certain period of time in certain fields for a class of employers. For example, doctors, nurses and teachers agreeing to serve in rural or low-income areas in exchange for cancellation of their student loans should not have income from the cancellation. Watch out for special programs and limitations, including dates to make sure you qualify, because untangling it later can be tough.

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 obligations into the future is much better than paying now.

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.

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