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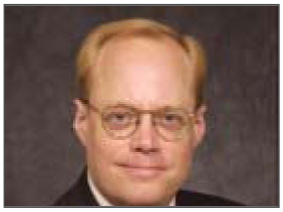

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When "Loans" Are Taxed As Income

Image via epersonalloan.org

When your uncle loans you $5,000 to tide you over, is it taxable income? Of course not. What about when the bank loans you $100,000? Again no. Yet if a loan is ***forgiven***, it suddenly is income ***then***.

That's cancellation of debt income, often shortened to ***COD income***. You got cash when you borrowed the money, and when you don't have to repay it, that cash is no longer loan proceeds. 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 canceled debt. Don't ignore Forms 1099.

In some cases discussed here, COD income isn't taxed. See also Short Sale Tax Problems. If you believe the canceled debt isn't income to you because you're insolvent or for any other reason, you'll need to address this on your return. See Beware Each Form 1099! and The Truth About IRS Forms 1099.

As if all this isn't frightening enough, can the IRS come along and claim that a "loan" you received—that is still outstanding and hasn't been forgiven—isn't a loan at all and was ***actually a sale***? In other words, can the IRS assert that some "loan" proceeds are really sales proceeds and therefore taxable? Yes, and that's exactly what happened to [Jonathan Landow] in Tax Court.

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 off the securities in ways that were unusual for garden-variety loans. And that's just what the lender did, despite the fact that 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 and didn't report the "loan proceeds" as income. The IRS claimed the loan transaction really wasn't a loan at all and instead was a sale. The Tax Court agreed with the IRS, treating this putative loan deal as a highly orchestrated transaction in which everyone ***knew*** the transaction would be documented as a loan but ***really*** amounted to a sale.

How real is the danger that will IRS will treat loans as sales? In transactions like Landow's, very real. Landow's deal was part of a litigated and controversial tax shelter that has produced a series of cases. See also *Shao v. Commissioner* and *Kurata v. Commissioner*. In that sense, the result in Landow's case was no surprise.

How you structure the 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.

For more, see:

Short Sale Tax Problems

Home Foreclosures And Tax Returns

10 Things About COD Income

[When You've Got Taxable Income But No Cash]

[IRS Tax Topic Topic 431 – Canceled Debt – Is it Taxable or Not?]

[IRS Publication 4681 Canceled Debts, Foreclosures, Repossessions, and Abandonments]

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