

# Your Debt Was Canceled, But Now You Have Taxable Income

By Robert W. Wood

Most people know that if they receive cash, it is probably taxable unless it is an honest to goodness gift. Most people know that if they receive property, that the property is probably also taxed, again, unless it is a true gift. (More about gifts below.) But how about what happens if it doesn't really seem that you got anything? Say your uncle loaned you money, and then says don't worry about paying me back? Can that somehow be taxed?

In the tax world, COD is short for "cancellation of debt." If that phrase doesn't sound familiar, you may want to read on. 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 that you must report. If you owe \$500,000 to the bank, but the bank forgives it, it's as if the bank just handed you \$500,000 so the IRS and the state want a cut.

There are other types of phantom income that can incur a tax despite the fact that you've gotten no cash. However, COD income ranks near the top of my list of little understood tax traps. The good news is that there are exceptions and exclusions from tax that may keep you from having to write a check to the IRS. So you are not caught off guard, here are some useful rules about COD income.

**Loans that are forgiven as gifts aren't taxable.** 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 \$17,000 in a year (the gift tax annual exclusion), it may count against his or her own lifetime exemption from the gift tax. That can make it best for these loans to be forgiven a little at a time. A debt canceled by a private lender's will, upon his death, isn't income to you either.

**There's an exception for the mortgage on your home.** During the 2007 financial crisis, Congress cut back on the IRS's ability to tax debt relief. Applying only to your principal residence, the Mortgage Debt Relief Act excluded as income any debt discharge up to \$2 million (an amount that was cut back to \$750,000 for 2021 to 2025). This applied to most homeowners, and it included partial debt relief gained through mortgage restructuring as well as full foreclosure. Refinancing was also allowed, but only up to the amount of principal balance of the original mortgage.

The Mortgage Debt Relief Act also covered loans and subsequent debt forgiveness for amounts borrowed to substantially improve a principal residence. The Act initially covered 2007 through 2010 and was eventually extended to 2020. Then, the Consolidated Appropriations Act extended the exclusion to cover 2021 through 2025. However, the maximum amount of excluded forgiven debt is now limited to \$750,000.

Not surprisingly, 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 that does not count 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, with the intimidating title, "Reduction of Tax Attributes Due to Discharge of Indebtedness (and Section 1082 Basis Adjustment)."

**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 taxed as income to you. However, the amount of the discharged debt goes to reduce certain tax attributes, such as net operating losses or the basis of property. Once again, the rules are complicated and filing an IRS 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 that 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 is not income because the amount forgiven is less than the amount of your insolvency.

**Disputed debts are different.** Some taxpayers argue that the debt was invalid in the first place so there is really no discharge of debt income. It can be a slick position where it works, either to claim that the entire debt was bad, or that part of it was. The IRS tends to read this exception narrowly, but there are some decided court cases that can help if you are in a pinch.

The argument is based on the notion that a discharged debt is not income if the taxpayer contests the original amount of the alleged debt in good faith. In *Preslar v. Commissioner*, 216 F.3d 1323 (10th Cir. 1999), the court stated that a subsequent settlement of a disputed debt is treated as the amount of debt for tax purposes. In other words, the excess of the original debt over the amount determined to have been due can be disregarded in calculating gross income.

Thus, a write down of a \$1M debt to \$400,000 usually causes \$600,000 of COD income. But if the debt was disputed, and borrower and lender agree that only \$400,000 is due, it might be different. Be careful, though. The IRS is alert to arguments that a debt was disputed when it looks like there really was no dispute that only time the taxpayer mentioned a dispute is when it came tax time.

**Price adjustments are also not 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 forgiven student loans aren't income.** Another exception protects forgiveness of certain student

loans. In the past, the IRS rules about taxing student debt relief hinged on the nature of the relief and who was getting it. Thus, traditionally, students who had their debts forgiven because they worked a certain term for public agencies were generally home free. In more recent times, the federal tax rules have gotten more liberal.

Before 2021, student debt cancellation was generally considered a form of income, and therefore taxable both at the federal and usually state level. But in March of 2021, the American Rescue Plan changed that. Until the end of 2025, the U.S. government will *not* consider canceled student loan debts to be taxable income. Thus, President Biden's sweeping student debt relief is not subject to federal income tax.

Last month, Gov. Newsom also signed into law legislation that exempts Californians from paying income taxes on forgiven federal student loans and some pandemic-era emergency grants.

**There's an exception for deductible interest.** 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 a deduction on your tax return, there is no taxable income to the borrower.

**Be Alert for IRS Form 1099-C.** No one likes IRS Forms 1099. In general, businesses must issue the forms to any payee (other than a corporation) who receives \$600 or more during the year. That's just the basic threshold, but there are many exceptions. That's why you probably get a Form 1099 for every bank account you have, even if you earned only \$10 of interest income. The key is IRS's matching.

Every Form 1099 includes the payer's employer identification number and the payee's Social Security number. The IRS matches Forms 1099 with the payee's tax return. There are lots of kinds of them, and there is one for COD income too. The IRS provides a list of lenders that must report using a Form 1099-C. It includes lenders who are regularly engaged in the business of lending money like banks, credit unions, credit card companies and any entity whose significant trade or business is the lending of money.

If you receive a Form 1099-C and disagree with the amount shown, write the lender requesting that it issue a corrected Form 1099-C showing the proper amount of canceled debt. 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, you will need to address it on your tax return, explaining why it isn't taxable. And you may need a tax opinion and/or disclosure as well.

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