MONEY MATTERS — Tax and financial planning strategies

Cancellation of debt: Are you liable for taxes?

By Benjamin Aspir

THANKS TO THE STATE OF THE ECO-nomy many borrowers are restructuring and/or defaulting on their debt. Whether a borrower is in the process or has completed the process of canceling a debt they may be liable for taxes.

What constitutes cancellation of debt?
When a creditor forgives a debt without receiving consideration in return, it's commonly referred to as cancellation of debt (COD). In most instances a canceled debt is considered to be a taxable event. An example of COD is if a debtor has a $20,000 loan but can only pay back $5,000, the lender agrees to forgive the rest of loan and the remaining $15,000 is considered to be COD. At year's end, the debtor should receive IRS form 1099-C from the creditor reporting the amount that's been forgiven.

Business COD
The borrower can elect to exclude (up to certain limits) the cancellation of qualified real property business debt. If the election is made, the basis of the depreciable real property must be reduced by the amount excluded. This reduction should be done at the beginning of the tax year following the tax year in which the cancellation occurs. However, if the borrower disposes of the property before that time, the basis must be reduced immediately before the disposition.

Recourse and nonrecourse debt
The first step in determining the proper tax treatment of COD is for the borrower to find out whether the debt is recourse or nonrecourse debt. Recourse debt is where the borrower is personally liable in the event of default, in addition to, or irrespective of, any secured property or collateral. Nonrecourse debt is where the lender's only remedy if there is a default is to repossess the property being financed or used as collateral. The lender cannot pursue the borrower's personal assets. If the COD is recourse, sale of the property will result in a gain equal to the difference between the value of the property and its basis. If the COD is nonrecourse, it doesn't result in COD income; however, it can result in other tax consequences.

There may be tax consequences when debt is canceled, known as COD (cancellation of debt) Income. A careful examination of one's COD income is important to determine any potential tax liability.

Cancellation of debt exclusions
There are several situations which occur that may exclude COD from being a taxable event: a Title 11 bankruptcy case; when the taxpayer is insolvent immediately before cancellation; discharge of qualified farm indebtedness; a discharged loan secured by a qualified principal residence under the Mortgage Forgiveness Debt Relief Act (detailed below); discharge of qualified real property business indebtedness; debt by a private lender, such as a relative or friend that is intended as a gift; debt canceled by a private lender's Last Will and Testament; certain forgiveness of student loans.

Forgiven credit card debt is usually taxable. In some instances, certain credit card companies do not fully discharge the debt; they agree to stop collections. If the borrower was to apply for another credit card at the same company in the future, the borrower would be required to repay the debt. In this instance the debt is therefore not fully discharged and doesn't result in COD income.

The Mortgage Forgiveness Debt Relief Act
The Mortgage Forgiveness Debt Relief Act enacted in the midst of the subprime mortgage crisis allows debtors to exclude COD income of up to $2 million (married filing jointly) or $1 million (single or married filing separately) for a loan secured by a qualified principal residence. The exclusion applies whether the homeowner restructures their debt or loses their principal residence to foreclosure. The discharge doesn't apply to second mortgages or home equity loans. The Act expires after 2012.

The last thing a borrower may want to hear after the stressful process of cancelling a debt is that it may be a taxable event. In light of this, it's imperative that the borrower be aware and understands the tax rules regarding cancellation of debt in order to avoid any surprise tax liabilities that may arise. One should contact a qualified tax professional when needed. ❑

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