

What Are the Tax Consequences of Debt Discharge Income?

In these troubled economic times, many financially distressed borrowers may have had some or all of their debt cancelled or forgiven by their lender last year. While such relief was no doubt welcome to people who received it, what they may not have realized is that debt forgiveness may have tax consequences. Specifically, debt forgiven in 2011 may have to be included as income on your 2011 return. However, not all canceled debts trigger taxable income. And, even if there is no exception or exclusion in a particular case, that may not be the last word. The tax bite may be reduced or eliminated if you can show that the amount reported by the lender is incorrect.

General rule. The tax laws specifically include income from the discharge of indebtedness in gross income. However, there are several exceptions to this rule. In addition, there are numerous exclusions from gross income for certain types of forgiven debts.

Exceptions. If the cancellation of debt by a private lender, such as a relative or friend, is intended as a gift, there is no income. Likewise, a debt cancelled by a private lender's Last Will and Testament triggers no income to the borrower.

There is also an exception for certain student loans. For example, doctors, nurses, and teachers agreeing to serve in rural or low income areas in exchange for cancellation of their student loans won't have income from the cancellation if they meet certain conditions.

Also keep in mind that there is no income from cancellation of deductible debt. For example, if a lender cancels home mortgage interest that could have been claimed as an itemized deduction on Schedule A of Form 1040, there is no tax problem to contend with.

Price adjustment. There is no income if an individual purchases property and the seller later reduces the price. The purchaser's basis (yardstick for measuring gain or loss on a later sale) in the property, however, is reduced by the amount of the purchase price adjustment.

Exclusions. In addition to the above exceptions, there are exclusions from the general rule for reporting canceled debt as income for:

- discharge of debt through bankruptcy,
- discharge of debt of an insolvent taxpayer,
- discharge of qualified farm debt,
- discharge of qualified real property business debt, and
- discharge of qualified principal residence debt.

These exclusions are quite complicated. However, it is worth pointing out that the qualified principal residence debt exclusion applies where individuals restructure their acquisition debt on a principal residence, lose their principal residence in a foreclosure, or sell a principal residence in a short sale (where the sales proceeds are insufficient to pay off the mortgage and the lender cancels the balance). Also, the exclusions require certain tax attributes to be reduced and must be reported to the IRS on its Form 982.

Repurchased business debt. Income from certain repurchased business debt can be stretched out over several years. Although all of the deferred debt discharge income will eventually be recognized, you benefit from the deferral of tax to later years.

Form 1099-C, Cancellation of Debt. A taxpayer should receive a Form 1099-C from a federal government agency, financial institution, or credit union that forgives a debt of \$600 or more. The amount of the canceled debt is shown in box 2. Any forgiven interest included in the amount of canceled debt in box 2 will also be shown in box 3. As noted above, if the interest would otherwise be deductible, it does not have to be included in income.

An individual who doesn't agree with the amount shown on Form 1099-C should contact the lender in writing and request it to issue a corrected Form 1099-C showing the proper amount of canceled debt. Even if the lender refuses to issue a corrected report, there still may be recourse if you have adequate documentation to show that the lender incorrectly reported the amount canceled.

If you had a debt forgiven last year, we can determine how it may affect your 2011 taxes, make sure you gain maximum advantage from any exception or exclusion that may apply, and guide you through various choices that may be available to you, depending on the specific circumstances of your situation. We also may be able to help you to resolve any discrepancy concerning the amount reported by the lender.

Very truly yours,

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