

Cancellation of Debt – Insolvency



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Cancellation of Debt – Insolvency

Taxpayers with cancelled debt can often exclude the cancellation of debt income to the extent they were insolvent immediately before the cancellation. If a cancelled debt is excluded from income, it is nontaxable.

Cancellation of Debt

Cancellation of debt (COD) is settlement of a debt for less than the amount owed. A debt may be cancelled by a lender voluntarily or through bankruptcy or other legal proceedings and may result in ordinary income, income from the sale of assets, or both.

| Cancelled Debt Situation | Tax Treatment |
|---|--|
| Debt owed by a taxpayer is cancelled or forgiven. | Amount cancelled or forgiven is generally taxable as ordinary income from cancellation of debt. |
| Property that is security for a debt is taken by the lender in full or partial satisfaction of that debt. | The transaction is treated as a sale of the property, which may result in a gain or loss. |
| Property that is security for a debt is taken by the lender, and lender cancels recourse debt in excess of FMV of property taken. | Excess of cancelled debt over FMV is ordinary income from cancellation of debt, in addition to any gain or loss from the sale. |
| Cancelled debt is intended as gift. | Amount cancelled is not income.* |

* Gift tax may apply.

Form 1099-C, Cancellation of Debt

If a lender cancels or forgives a debt of \$600 or more, it must provide the borrower with Form 1099-C, showing the amount of cancelled debt to be reported as income. Generally, individual taxpayers must include all cancelled amounts, even if less than \$600, as Other Income on line 21, Form 1040.

Examples of COD Income

Nonbusiness credit card debt cancellation. If non-business credit card debt is cancelled, the taxpayer may be able to exclude the cancelled debt from income up to the extent he or she is insolvent.

Personal vehicle repossession. If the taxpayer had a personal vehicle repossessed during the year, the transaction is treated as a sale, and gain or loss on the repossession must be computed. If the lender also cancels all or part of the remaining debt, the taxpayer may be able to exclude the cancelled debt from income to the extent he or she is insolvent.

Taxpayer Insolvency

A taxpayer is insolvent to the extent that the total of all their liabilities exceeds the fair market value (FMV) of all their assets immediately before the cancellation of debt.

For purposes of determining insolvency, assets include the value of everything the taxpayer owns (including assets that serve as collateral for debt and exempt assets which are beyond the reach of creditors, such as the value of a retirement account). Liabilities include the following items.

- The entire amount of recourse debts,
- The amount of nonrecourse debt that is not in excess of the FMV of the property that is security for the debt, and
- The amount of nonrecourse debt in excess of the FMV of the property subject to the nonrecourse debt to the extent nonrecourse debt in excess of the FMV of the property subject to the debt is forgiven.



Cancellation of Debt – Insolvency

Insolvency Worksheet

All amounts listed should be immediately before the debt cancellation.

Liabilities

| | |
|--|-----------|
| 1) Credit card debt..... | 1) _____ |
| 2) Mortgages (and home equity loans)..... | 2) _____ |
| 3) Car and other vehicle loans..... | 3) _____ |
| 4) Medical bills owed..... | 4) _____ |
| 5) Student loans..... | 5) _____ |
| 6) Accrued or past-due bills owed..... | 6) _____ |
| 7) Federal or state income taxes due..... | 7) _____ |
| 8) Judgments..... | 8) _____ |
| 9) Business debts..... | 9) _____ |
| 10) Other loans and past-due bills..... | 10) _____ |
| 11) Total liabilities. Add lines 1 through 10..... | 11) _____ |

Assets

| | |
|---|-----------|
| 12) Cash and bank account balances..... | 12) _____ |
| 13) FMV real estate..... | 13) _____ |
| 14) FMV vehicles..... | 14) _____ |
| 15) FMV household items (computers, tools, jewelry, clothing, appliances, furniture, etc.)..... | 15) _____ |
| 16) Retirement accounts, IRAs, etc..... | 16) _____ |
| 17) Cash value of life insurance..... | 17) _____ |
| 18) Stocks and bonds..... | 18) _____ |
| 19) Interest in education account..... | 19) _____ |
| 20) Investments in collectibles..... | 20) _____ |
| 21) Security deposits..... | 21) _____ |
| 22) Interests in partnerships..... | 22) _____ |
| 23) Value of investment in business..... | 23) _____ |
| 24) Other assets..... | 24) _____ |
| 25) Total assets. Add lines 12 through 24..... | 25) _____ |
| 26) Amount of insolvency. Subtract line 25 from 11..... | 26) _____ |

If zero or less, taxpayer is not insolvent. If over zero, the amount is the extent to which the taxpayer is insolvent.

Example #1 – Amount of Insolvency More Than Cancelled Debt

Jill was released from her obligation to pay her personal credit card debt in the amount of \$5,000. Jill received a Form 1099-C from her credit card lender showing cancelled debt of \$5,000. Jill uses the insolvency worksheet to determine that her total liabilities immediately before the cancellation were \$15,000 and the FMV of her total assets immediately before the cancellation were \$7,000, which

means that immediately before the cancellation, Jill was insolvent to the extent of \$8,000 (\$15,000 total liabilities minus \$7,000 FMV of her total assets). Because the amount by which Jill was insolvent immediately before the cancellation was more than the amount of her debt cancelled, Jill can exclude the entire \$5,000 cancelled debt from income.

Example #2 – Amount of Insolvency Less Than Cancelled Debt

Assume the same facts as Example #1, except that Jill's total liabilities immediately before the cancellation were \$10,000 and the FMV of her total assets immediately before cancellation were \$7,000. In this case, Jill is insolvent to the extent of \$3,000 (\$10,000 total liabilities minus \$7,000 FMV of her total assets) immediately before the cancellation. Because the amount of the cancelled debt was more than the amount by which Jill was insolvent immediately before the cancellation, Jill can exclude only \$3,000 of the \$5,000 cancelled debt from income under the insolvency exception. Jill must include \$2,000 of cancelled debt as an addition to her income, unless another exclusion applies.

Form 982

Form 982, *Reduction of Tax Attributes Due to Discharge of Indebtedness*, is used to exclude cancelled debt from income due to insolvency and also to indicate a reduction in tax attributes for certain assets, if required.

Reduction of Tax Attributes

If cancelled debt is excluded from income, the taxpayer must reduce certain tax attributes by the amount excluded. Tax attributes include the basis of certain assets, losses, and credits. By reducing the tax attributes, the tax on the cancelled debt is partially postponed instead of being entirely forgiven. This prevents an excessive tax benefit from the debt cancellation.

Contact Us

There are many events that occur during the year that can affect your tax situation. Preparation of your tax return involves summarizing transactions and events that occurred during the prior year. In most situations, treatment is firmly established at the time the transaction occurs. However, negative tax effects can be avoided by proper planning. Please contact us in advance if you have questions about the tax effects of a transaction or event, including the following:

- Pension or IRA distributions.
- Significant change in income or deductions.
- Job change.
- Marriage.
- Attainment of age 59½ or 70½.
- Sale or purchase of a business.
- Sale or purchase of a residence or other real estate.
- Retirement.
- Notice from IRS or other revenue department.
- Divorce or separation.
- Self-employment.
- Charitable contributions of property in excess of \$5,000.

This brochure contains general information for taxpayers and should not be relied upon as the only source of authority. Taxpayers should seek professional tax advice for more information.

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