

Sy Accountancy Corporation

Member, American Institute of CPAs

704 Mira Monte Place, Pasadena, California 91101

Tel (626) 744-0200 • Fax (626) 744-0300 • vsy@victorsycpa.com • www.victorsycpa.com

TAX CONSEQUENCES OF DEBT DISCHARGE

By Victor Sy, CPA

As the recession lingers, many financially distressed borrowers may have had their loans cancelled last year. It was a relief to have their debts reduced or forgiven, but the same debt relief also triggers **tax consequences** that you have to be aware of.

General Rule:

- Tax laws specifically include income from the discharge of indebtedness in gross income.
- However, there are several exceptions and exclusions to this rule, as discussed below.

Exceptions: There is no income from the following circumstances.

- Cancellation of debt by a private lender such as a relative or friend, if intended as a gift.
- Cancellation of debt by a private lender's Last Will and Testament.
- Student loans for doctors, nurses, and teachers who agree to serve in rural or low income areas in exchange for cancellation of their student loans.
- Price adjustment if an individual purchases property and the seller later reduces the price.

Exclusions: There is no income from discharge of debt in the following situations:

- Bankruptcy,
- Insolvent taxpayer,
- Qualified farm debt,
- Qualified real property business debt, and
- Qualified principal residence debt (discussed below).

Qualified Principal Residence Debt Exclusion: This 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).

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 should be shown in box 2.
- Any forgiven interest included in the amount of canceled debt in box 2 should also be shown in box 3.
- If you don't agree with the amount shown on Form 1099-C, request your lender in writing to issue a corrected Form 1099-C showing the proper amount of canceled debt.
- If the lender refuses to issue a corrected report, attach to your tax return adequate documentation to show that the lender incorrectly reported the amount canceled.