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HOW INSOLVENT TAXPAYERS CAN EXCLUDE DEBT FORGIVENESS INCOME

By Victor Sy, CPA, MBA

I once received a call from a lawyer who was preparing an offer in compromise for a taxpayer's prior years' tax liabilities with the Internal Revenue Service (IRS). The taxpayer had more than \$300,000 of unpaid prior tax liabilities. He had just been handed the taxpayer's current individual income tax return that showed an additional \$54,000 taxes due to cancellation of debt. He asked me to check it out before having the taxpayer file the tax return.

As you know, cancellation of debt income can surface from the foreclosure of your residence or any other real property. Like adding salt to an open wound, you are then faced with debt forgiveness income from the cancellation of debt on the mortgage of your property that has just been foreclosed. The bank issues a 1099C for the cancellation of debt income that typically is the difference between the fair market value and loan balance. For example, you purchased a house for \$300,000, placed a downpayment of \$30,000, leaving a mortgage balance of \$270,000, and saw the value plummet to about \$200,000. By the time of the foreclosure, you could end up with a cancellation of debt (COD) income of \$70,000. Not only have you just lost your house to foreclosure, you now have to pay tax on the debt forgiven of \$70,000!

As for the taxpayer who was referred to me by the lawyer, we reviewed the return and found an **exception that zeroed out his COD income!** Let's discuss exceptions that we analyzed for that client.

You do not have to pay taxes on such COD income if:

1. The discharge occurs in bankruptcy,
2. The discharge occurs when you are insolvent,
3. The discharged debt is qualified real property business indebtedness or qualified farm indebtedness,
4. The discharged debt arises from the purchase of the property where the seller carried the note and is now writing it down,
5. The canceled debt would have been deductible if paid.
6. The discharged debt is a student loan and certain conditions apply.

If one of the first three exceptions applies, your tax attributes (net operating loss, capital loss, tax credit carryovers, and tax basis in depreciable assets) must be reduced by the amount of the canceled debt. If the COD income exceeds the amount of the tax attributes, the excess simply vanishes. When excluding income under the fourth or fifth exceptions, tax attributes must also be reduced but only with respect to your real property or with respect to a specific property acquired with the debt. The last two exceptions do not require any reductions of attributes. In other words, the government allows you to get away from COD income but requires you to reduce the attributes enumerated above.

Now, let's talk about insolvency and how it can get you out of paying taxes on forgiven debt. Neither the Internal Revenue Code nor the applicable committee reports define when a taxpayer is insolvent. There is no statutory or even regulatory guidance to help determine which assets and liabilities are included in a solvency test. You are insolvent when your liability exceeds the fair market value of your assets.

In conclusion, an analysis of your situation before foreclosure could save you from having to pay large amounts of taxes through planning and strategy with respect to insolvency and the timing of multiple foreclosures. Consult your own Enrolled Agent, CPA, or Tax Lawyer. Good luck.

Income Exclusion for Home Mortgage Debt Discharges: As you know, Debt Discharge Income (DDI) is taxable unless an exception applies. The Mortgage Relief Act creates an exception for certain discharges of home mortgage debts that occur from January 2007 through December 31, 2009 (extended through 2012). The new exception generally allows a homeowner to exclude up to \$2 million of “qualified principal residence indebtedness” DDI from gross income.

The exception only applies to a debt that’s used to acquire, construct, or improve a principal residence. It applies to acquisition debt only. If refinanced, exclusion applies up to the amount of the old mortgage principal balance. It only helps if you borrowed too much to acquire, build, or improve a principal residence.

The exclusion applies to:

- Foreclosures
- Short sales
- Restructuring (loan modifications):

The particular exclusion does not apply to:

- Vacation home mortgages.
- A taxpayer in bankruptcy.
- Any factor not directly related to a decline in the value of a residence or taxpayer’s financial condition.