



---

## Is Cancellation of Debt Income Taxable?

One question that I am asked often these days is whether cancellation of debt (COD) income is taxable or not?

For tax purposes, the general rule is that all debt that is forgiven, canceled or discharged by a lender is considered income to you. Just like everything else in our tax code, everything is income!

Furthermore, real estate that is foreclosed upon, taken back by the lender in a deed-in-lieu of a foreclosure or sold through a short sale can potentially generate two taxable events:

1. Cancellation of debt income, and/or
2. Gain or loss on the sale.

However, the cancellation of debt income could be taxable or not, depending on whether the debt is non-recourse or recourse.

Now let's get familiar with the terms that will be used throughout this article:

**Non-Recourse Debt** - A debt is considered non-recourse under California law when a loan is made under either one of the following two circumstances:

1. When the loan is made to purchase a one-to-four unit property and the borrower intends to occupy at least one of the units, or
2. When the seller carries back financing for all or a portion of the purchase price of any real property.

Furthermore, non-recourse loans can apply to commercial properties as well. Besides state law, a loan could also be non-recourse as a result of provisions in the loan documents.

Therefore, in the event of default by the borrower, the lender, or financing seller, is restricted to recovering the property with no right to proceed against the borrower for any deficiency, should the property be worth less than the loan amount.

Thus, there is never cancellation of debt income to the borrower in a non-recourse debt regardless if the debt was for a personal or investment property whether foreclosed upon, taken back through a deed-in-lieu of foreclosure or sold through a short sale.

**Recourse Debt** - A debt is considered recourse when the borrower is personally liable for repayment. The lender can repossess the property but the borrower remains personally liable for any deficiency if the property does not fully repay the loan. However, the cancellation of debt income may not be taxable!

**Foreclosure** - Foreclosure is a process that allows a lender to recover the amount owed on a defaulted loan by taking ownership (repossession) of the property securing the loan.

**Deed-In-Lieu of Foreclosure** - A deed in lieu of foreclosure is a deed given by the borrower (trustor) to the lender (beneficiary) to stop the foreclosure process or as a way to completely avoid the start of the foreclosure process. By accepting a deed in lieu of foreclosure, the lender avoids the costs and delays of foreclosing. However, (1) junior liens are not extinguished (a foreclosure wipes out junior liens), (2) the borrower may later try to set the conveyance (transfer) aside, and/or (3) the borrower's other creditors may argue that the conveyance was a "fraudulent



---

conveyance", which jeopardizes their ability to satisfy their claims against the borrower. Lenders can protect themselves against hidden junior liens by obtaining an endorsement to the beneficiary's title insurance policy that places title in the beneficiary free and clear of any junior liens.

**Short Sale** - In essence, a short sale is a sale transaction subject to a lender's approval in which the lender consents to a sale of the security interest, the property, for less than what is owed on the note and accepts the proceeds in full satisfaction of the loan amount. The property owner still owns the property through the short sale process, not the bank.

**Cancellation of Debt Income** – Cancellation of debt income is usually the amount of debt forgiven, cancelled or discharged. It is considered ordinary income subject to your marginal federal and state income tax rates. Your personal marginal federal tax rate can be as high as 35% for 2010 and possibly 39.6% for 2011. Currently, California's highest personal marginal rate is 10.55%.

**Gain or Loss** – For tax purposes, when a property is foreclosed upon, taken back through a deed-in-lieu of a foreclosure or sold through a short sale, a sale has occurred. Therefore, the taxpayer must calculate the gain or loss on the sale and pay the appropriate federal and state taxes. The gain or loss is the difference between your adjusted tax basis and the amount you sell the property for. Adjusted tax basis is usually your purchase price plus improvements less accumulated depreciation. This is a very basic definition of the adjusted tax basis and it is beyond the scope of this article.

The sale is usually considered a sale of a capital asset, real estate. Therefore, the gain or loss is referred to as a capital gain or loss. Furthermore, capital gain or loss is taxed differently than ordinary income or loss. Capital assets that are held for more than one year and sold at a gain are currently taxed at a maximum federal rate of 15%. Capital assets that are held for less than one year and sold for a profit are taxed at your marginal federal and state tax rates. Capital assets that are sold at a loss, short or long term, can only be offset against other capital gain incomes and the remaining balance, up to \$3,000, can be offset against your ordinary income per year. The balance is carried over to future years and you do not lose it. In addition, there is no lower capital gains rate for state of California.

However, if the real estate is held for investment or for use in a trade or business, it is referred to as a Section 1231 asset. Thus when investment property is sold at a loss, the loss is treated as an ordinary loss and can be used to offset against other ordinary income such as W-2 income, business income or interest and dividends income. If the investment property is sold at a gain, the gain is considered a long-term capital gain and taxed at the lower capital gains tax rate of currently 15%. Basically, the IRS gives you the best of both worlds on investment properties. There are a couple of other issues with Section 1231 assets, such as depreciation recapture, that are beyond the scope of this article.

Finally, if a principal residence is sold at a loss, the loss is personal and nondeductible.

However, just like all other tax laws, there are exceptions to the general rule that all cancellation of debt income is taxable. Thus, some debts that are forgiven, cancelled or discharged may not be taxable if one of the allowable exclusions applies. Note, that more than one of the exclusions can apply to your transaction. Below is a list of the allowable exclusions and in the order that they must be followed. For example, if exclusion number 1 does not apply to you, you go to exclusion number 2. If that one does not apply then you go to exclusion number 3 and so on. However, the description for each item below is very brief and general in nature. Each exclusion has its own set of requirements and is beyond the scope of this article.



---

**1. Debt Discharge Through Bankruptcy Exclusion** - Debtors may get a “fresh start” in business by having some or all of their debts forgiven, cancelled, reduced or discharged. A solvent debtor outside bankruptcy must report the debt discharge amount as taxable income in the year the debt is discharged (unless one of the other exclusions listed below apply). A bankrupt or insolvent debtor does not have to report the debt discharge amount as income. But, the amount of debt that is cancelled must reduce your tax attributes.

**What are Tax Attributes?** – You can think of tax attributes as tax items that reduce your federal tax liability. These are the good guys. Therefore, since the government is giving you a break and not currently taxing you on the cancellation of debt income, it makes you reduce the items that help you so it can recoup its lost tax dollars in future years. The following is a list of tax attributes that must be reduced and in the following order:

1. Net Operating Loss - Any net operating loss realized in the tax year of the discharge plus any net operating loss carryover to that year must be reduced dollar-for-dollar.
2. General Business Credit - Any amount of general business credit that was carried over to or from the tax year of the discharge must be reduced by 33 1/3-cent per dollar of discharged debt.
3. Minimum Tax Credit - The amount of minimum tax credit available at the beginning of the taxable year immediately following the tax year of the discharge must be reduced by 33 1/3-cent per dollar of discharged debt.
4. Capital Loss Carryovers - Any net capital loss that was either generated for the tax year of the discharge or carried over to that year must be reduced dollar-for-dollar.
5. Basis Reduction - The basis of the property associated with the discharge reduced dollar-for-dollar.
6. Passive Activity Loss and Credit Carryovers - Any passive activity loss or credit carryover from the tax year of discharge must be reduced dollar-for-dollar for losses and reduced by 33 1/3-cent per dollar for credits of discharged debt.
7. Foreign Tax Credit Carryovers - Any carryover of foreign tax credit to or from the tax year of discharge must be reduced by 33 1/3-cent per dollar of discharged debt.

However, you can elect to forego the above ordering rule of the tax attributes and apply any portion of the cancellation of debt first to the basis of certain depreciable property (this too has its own ordering rule and is beyond the scope of this article). For example, this may be advantageous over reducing your net operating losses, which can be deducted against your ordinary income that is taxed at a higher rate, versus reducing your tax basis in your capital asset that is possibly taxed at a lower capital gains rate.

This election is designed to aid those taxpayers holding real estate that has substantially declined in value and is secured by significant debt that exceeds the property's market value. Eligible taxpayers may dispose of this property without currently recognizing income, but, in turn, they will be faced with a basis reduction. The income exclusion is available only to the extent that the taxpayer has basis in depreciable real estate before the debt discharge occurs.

**2. Debt of an Insolvent Taxpayer Exclusion** - A very basic definition of an insolvent taxpayer is when the taxpayer's liabilities exceed their assets. The determination of insolvency is based on the amount of liabilities and the value of



the assets immediately before the discharge of debt. But, the amount of debt that is cancelled must reduce your tax attributes as explained in exclusion number 1 above.

3. Qualified Farm Debt Exclusion - An exclusion is available for a discharge of qualified farm indebtedness by a qualified person. The exclusion for qualified farm indebtedness is not available if the taxpayer is in Chapter 11 bankruptcy or to the extent that the taxpayer is insolvent, in which case the insolvency exclusion would apply. However, taxpayers who have used the insolvency provision to the extent of their insolvency may use the qualified farm indebtedness exception for additional discharged amounts. But, the amount of debt that is cancelled must reduce your tax attributes as explained in exclusion number 1 above.

4. Qualified Real Property Business Debt Exclusion - Taxpayers other than C corporations may elect to exclude from gross income the discharge of qualified real property business indebtedness limited to the lesser of:

1. Excess of debt securing the property over FMV of property, or
2. Aggregate adjust basis of all depreciable property held by the taxpayer, either personally or through a partnership.

Amounts excluded from gross income will instead be used to reduce the taxpayer's tax attributes stated in exclusion number 1 above, or the taxpayer can elect to decrease the basis of the taxpayer's depreciable real property. Qualified real property business indebtedness is indebtedness which:

1. Was incurred or assumed before January 1, 1993 in connection with real property used in a trade or business and is secured by that real property, or
2. After January 1, 1993, is debt incurred or assumed to acquire, construct, reconstruct or substantially improve real property used in a trade or business.

The qualified real property business indebtedness exception can apply even if you are solvent. However, the bankruptcy exclusion and the insolvency exclusion both take precedence over this exclusion.

5. Qualified Principal Residence Debt Exclusion – For federal tax purposes, qualified principal residence debt means acquisition indebtedness on the taxpayer's principal residence, up to a \$2 million limit (\$1 million for married individuals filing separately). Acquisition indebtedness is debt that was borrowed to acquire, construct, or substantially improve the taxpayer's principal residence and must have been secured by that residence. A principal residence is the property that the taxpayer uses a majority of the time during the year. A taxpayer can have only one principal residence at a time. This exception is good through the end of 2012 and it is applicable to foreclosures, deed-in-lieu of foreclosures, short sales, debt modification and debt reductions. Therefore, cancellation of debt income on your principal residence up to the limits stated above is not taxable.

California conforms to the federal law, but with the following changes:

- (1) The maximum amount of qualified principal residence indebtedness is \$800,000 for married couples filing jointly, registered domestic partners filing jointly, single persons, head of household, widow/widower; and \$400,000 for married couples or registered domestic partners filing separately, and
- (2) The maximum amount of cancellation debt income that can be excluded is \$500,000 for married couples filing jointly, registered domestic partners filing jointly, single persons, head of household, widow/widower; and \$250,000 for married couples or registered domestic partners filing separately, and



(3) California's debt relief statute applies to property sold on or after January 1, 2009 and before Jan. 1, 2013.

Qualifying taxpayers who have already filed their 2009 California tax returns should file Form 540X, Amended Individual Income Tax Return, to subtract the amount of debt relief from income if it was originally included.

Finally, taxpayers who qualify under this exclusion may elect to use the insolvency exclusion if they are insolvent. This may be advantageous for those who have qualified principal residence debt of more than \$2 million, have recourse or nonqualified debt or will have gain in excess of their allowable Section 121 exclusion.

6. Discharge of Certain Indebtedness of a Qualified Individual Because of Midwestern Disasters – This exclusion allows affected individuals to exclude non-business debt that was forgiven by a governmental agency or certain financial institutions if the discharge occurred between the date of the disaster and January 1, 2010.

Other exceptions are:

1. The Payment of the Liability Would Have Given Rise to a Tax Deduction - The cancellation of debt income is not taxable if the debt was deductible to begin with. For example, if a lender cancels home-mortgage interest that could have been claimed as an itemized deduction on Schedule A of Form 1040, then there is no tax problem to contend with.

2. Debt Reduced After Purchase - There is no income if an individual purchases a property and the seller later reduces the loan amount. Instead, the purchaser's basis—the yardstick for measuring gain or loss when the property is sold—is reduced by the amount of the loan reduction. Additional conditions must be met and there is an ordering rule that needs to be followed.

3. Other Certain Student Loans, Disaster Victims, Gifts and General Welfare Payments – Please see below for examples of each type.

To make this stuff easier to understand, below are various examples and scenarios that apply to different types of debts and assets.

### **Principal Residence Debt**

The taxation of cancellation of debt on your principal residence depends on whether the debt is non-recourse or recourse.

Moreover, while purchase money loans in certain states such as California, Arizona and Texas are non-recourse, refinancing the loan typically converts the debt to recourse. Also, home equity line of credit is usually a recourse loan unless otherwise agreed to.

Principal Residence Debt – Non-Recourse – Foreclosure, Deed-in-Lieu of Foreclosure or Short Sale - If your principal residence debt is non-recourse and the property is foreclosed on, given back to the lender through a deed-in-lieu of a foreclosure or sold through a short sale, then you do not have cancellation of debt income. Furthermore, if you do not have cancellation of debt income, then you do not need to reduce your tax attributes. You only reduce your tax attributes when you have cancellation of debt income that is not being taxed due to one of the exclusions above.

However, you may have a gain or loss on the deemed sale and it is calculated in the following manner:

Outstanding Debt (which includes the amount of cash and FMV of any property paid to the debtor)

- Adjusted Tax Basis  
= Gain or Loss

Example: The fair market value of the taxpayer's personal residence is \$300,000, the outstanding balance of the debt is \$450,000 and the taxpayer's adjusted tax basis is \$250,000.

Outstanding Debt	\$450,000
Less Adjusted Tax Basis	<u>\$250,000</u>
Equals to Gain	<u>\$200,000</u>

The taxpayer's gain of \$200,000 may be taxable unless the taxpayer qualifies for a Code Sec. 121 gain exclusion on the sale of principal residence. In general, under Code. Sec. 121, if you live in your principal residence for at least two years out of the last five years from the date of sale, the first \$250,000, if single, or the first \$500,000, if married, of the gain is tax free. There is more involved with Code Sec. 121 and it is beyond the scope of this article. There is no cancellation of debt income because it is a non-recourse loan.

Note that if you have a loss on the sale of your principal residence, the loss is not deductible.

One way to remember that in a non-recourse loan you have to use the amount of outstanding debt as your sales price is by keeping in mind since there is no cancellation of debt income in a non-recourse loan, the government is losing tax dollars on the cancellation of debt income that is not taxable. Therefore, in order for the government to recoup their lost tax dollars, they make you calculate the gain or loss based on the outstanding debt amount, which is usually higher than the fair market value of the property. If the fair market value was higher, then the property owner would have sold the property and satisfied the debt.

Principal Residence Debt – Recourse Debt – Foreclosure, Deed-in-Lieu of Foreclosure or Short Sale - If your principal residence debt is recourse and it is foreclosed on, given back to the lender through a deed-in-lieu of a foreclosure or sold through a short sale, then you do have cancellation of debt income.

The cancellation of debt income is calculated in the following manner:

$$\begin{array}{l} \text{Outstanding Debt} \\ - \text{Fair Market Value} \\ \hline = \text{Cancellation of Debt Income} \end{array}$$

Furthermore, you may have a gain or loss on the sell and it is calculated in the following manner:

$$\begin{array}{l} \text{Fair Market Value} \\ - \text{Adjusted Tax Basis} \\ \hline = \text{Gain or Loss} \end{array}$$

Example: As a result of nonpayment of a recourse mortgage, creditors foreclosed on taxpayer's home. At the time of the foreclosure, taxpayer's adjusted tax basis in the home was \$170,000, the home's fair market value was \$200,000, and the outstanding amount of mortgage debt on the home was \$220,000.

The cancellation of debt income is calculated in the following manner:

Outstanding Debt	\$220,000
------------------	-----------



---

Less Fair Market Value	<u>\$200,000</u>
Equals to Cancellation of Debt Income	<u>\$ 20,000</u>

The gain or loss is calculated in the following manner:

Fair Market Value	\$200,000
Less Adjusted Tax Basis	<u>\$170,000</u>
Equals to Gain on Sale	<u>\$ 30,000</u>

Note that the cancellation of debt income may not be taxable because of one or more of the exclusions stated above. Also, the gain of \$30,000 may not be taxable because of Code Sec. 121 exclusion.

One way to remember that you only have to use the fair market value as the sales price, is that when the loan is recourse, there is cancellation of debt income so the government is not losing tax dollars like on a non-recourse loan. Thus, they allow you to use the fair market value as the sales price, which is usually less than the outstanding debt.

Principal Residence Debt – Non-Recourse and Recourse Debts – Either a Foreclosure, Deed-in-Lieu of Foreclosure or Short Sale (Catch All) - As we all know, nothing in the real world is clear cut. There is always a “what if.” Therefore, the following examples below will address some possible scenarios of having both a non-recourse and recourse debt on a property that is either foreclosed on, taken back through a deed-in-lieu of a foreclosure or sold through a short sale. The combinations are endless so the examples below are from real cases that I had to deal with.

Example: In 2002, taxpayer bought a main home for \$315,000 using a \$300,000 loan that was secured by the home. In 2003, taxpayer took out a \$50,000 second mortgage that was used to add a garage. Both the first and second mortgages qualify for the qualified principal residence debt exclusion because both debts were borrowed to acquire, construct, or substantially improve the taxpayer's principal residence and were secured by that residence.

Example: In 2005, the taxpayer had an original first mortgage for the amount of \$325,000 and the taxpayer decided to refinance to get a better rate and take some money out since the taxpayer's property was doubling every year. The taxpayer refinanced the first mortgage and received a new loan for \$400,000. Taxpayer used \$75,000 of the loan proceeds to pay credit card bills and buy a new car. Only \$325,000 of the \$400,000 refinanced debt qualifies under the qualified principal residence debt exclusion. The remaining balance of \$75,000 is taxable as cancellation of debt income unless one of the other exclusions apply.

Example: The taxpayer purchased a condo in 2005 and lived in it as her principal residence until 2008. In 2008, the taxpayer moved to a new city and started to rent the condo through present. In 2010, the taxpayer is trying to sell the condo through a short sale. Assuming it is a non-recourse loan, the taxpayer will not have cancellation of debt income because the qualified principal residence debt exclusion would apply since the taxpayer lived in it for at least two years and it was her principal residence.

### **Investment Property Debt**

Same rules as principal residence debt apply to investment properties, except for an investment property you cannot use the qualified principal residence debt exclusion.



If the investment property debt is non-recourse, then there is no cancellation of debt income if foreclosed on, taken back through a deed-in-lieu of foreclosure or sold through a short sale. If the investment property is recourse debt, then there is cancellation of debt income. Also, there is a deemed sale and either a gain or loss must be calculated on the transaction.

Example: Taxpayer purchased a multi-unit apartment building for \$700,000. Over the years, the taxpayer took depreciation deductions for a total of \$300,000. Therefore, the taxpayer's adjusted tax basis is \$400,000 (\$700,000 - \$300,000). The taxpayer owes \$680,000 on the property and it is a recourse debt. The taxpayer sells the property for \$660,000 through a short sale.

The taxpayer's cancellation of debt income is calculated in the following manner:

Outstanding Debt	\$680,000
Less Fair Market Value	<u>\$660,000</u>
Equals to Cancellation of Debt Income	<u>\$ 20,000</u>

The gain or loss is calculated in the following manner:

Fair Market Value	\$660,000
Less Adjusted Tax Basis	<u>\$400,000</u>
Equals to Gain on Sale	<u>\$260,000</u>

Furthermore, the taxpayer elects not to reduce his or her tax attributes but to reduce the tax basis in the property by the amount of cancellation of debt income, \$20,000. Therefore, the taxpayer's adjusted tax basis is now \$380,000 (\$700,000 - \$300,000 - \$20,000). Thus, the taxpayer's gain is now \$280,000 (\$660,000 - \$380,000). Note if the election was not made and other tax attributes were reduced, the taxpayer's capital gain would have been \$260,000 as calculated above.

**The Payment of the Liability Would Have Given Rise to a Deduction**

There is no income from cancellation of a debt that was deductible to begin with.

Example: If a lender cancels home mortgage interest that could have been claimed as an itemized deduction on Schedule A of Form 1040 by the taxpayer, then there is no tax problem to contend with, since the mortgage interest was deductible to begin with, unless the taxpayer deducted the interest for some reason.

**Debt Reduced After Purchase**

There is no cancellation of debt income if an individual purchases property from the seller and the seller later reduces the loan amount. Instead, the purchaser's basis—the yardstick for measuring gain or loss when the property is sold—is reduced by the amount of the loan reduction. This exclusion applies to seller-financed properties. While banks were at one time foolish enough to lend in excess of 100% of the property value on an initial purchase, I find it hard to believe a non-bank seller would!

Example: Taxpayer purchases his or her residence for \$400,000 and gets a loan for \$430,000. Only makes monthly interest payments, no principal payments. Later, he or she does a loan modification and the lender agrees to reduce the principal balance to \$390,000. The \$40,000 (\$430,000 - \$390,000) reduction in the loan amount is cancellation of debt income to the taxpayer but it is not taxable. The taxpayer must reduce his or basis in the property by \$40,000. Thus, the taxpayer's new basis in the property would be \$360,000 (\$400,000 - \$40,000).



---

### **Other Certain Student Loans, Disaster Victims, Gifts and General Welfare Payments**

**Student Loans** – There is an exception for certain student loans. For example, doctors, nurses and teachers who agree to serve in rural or low-income areas in exchange for cancellation of their student loans will not have cancellation of debt income if they meet certain conditions. However, if the student just for the fun of it decides not to pay their student loan because they are going to file for bankruptcy and thinks the debt will be discharged, they are in for a surprise. Student loans are not discharged through bankruptcy unless the student can prove undue hardship.

**Gifts** - If the mortgage debt is cancelled by way of a gift, the cancellation would not result in the creation of taxable income. In order for the cancellation to qualify as gratuitous, the creditor must receive no consideration for it and there must be donative intent. The burden of showing donative intent is, of course, upon the debtor-taxpayer. But for there to be a gift cancellation of a debt, it is normally essential that the parties prove some personal relationship to each other besides debtor-creditor. While showing that the cancellation is a gift solves the debtor's income tax problem, the creditor must now try to avoid paying a gift tax.

**Credit Card and Car Loan Debt** - Noticeably absent from the specific exclusions to cancellation of debt income are two of the biggest consumer debt items: credit cards and car loans. Credit card debt or an unpaid debt on a car loan that is forgiven by the lender is cancellation of debt income and includable in gross income unless one of the exclusions stated above apply.

**Form 1099-C** - A taxpayer will receive a Form 1099-C, Cancellation of Debt, from a financial institution, credit union, or federal government agency 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. If you disagree with the amount shown on Form 1099-C, you should contact the lender in writing and ask for a corrected Form 1099-C (good luck with that!). Even if the lender refuses, you may still have recourse if you can document the correct amount of canceled debt. Do not take the lender's figures as final. There are many ways to calculate the figures yourself accurately.

**Form 982** – When you have cancellation of debt income – whether taxable or not, it must be reported on Form 982. Also, the reduction of your tax attributes are reported on this form as well. However, note that this form is not used to actually calculate your cancellation of debt income or the gain or loss. These two calculations are reported elsewhere on your returns and are beyond the scope of this article.

Finally, there are many different variables at play when real estate is foreclosed on, taken back through a deed-in-lieu of a foreclosure or sold through a short sale. However, with proper planning, you can perhaps avoid paying taxes on the cancellation of debt income, saving your valuable tax attributes and even reducing the gain on the transaction.

The above technical reference is provided as a courtesy to the reader by David Silkman, CPA, Silkman & Associates Accountancy Corporation and SilkRoad Realty, Inc. The information is technical in nature, may not include all the details on a particular subject and may require review of the reader's circumstances by a professional. You should consult with your tax advisor.

David S. Silkman is a CPA, has a Masters in Taxation (MST) and is a licensed real estate broker. He specializes in real estate tax laws and accounting. If you have any questions, please do not hesitate to call him at 310.479.7020 x301, email him at [david@saacpa.com](mailto:david@saacpa.com) or visit his websites at [www.saacpa.com](http://www.saacpa.com) or [www.SilkRoadRealtyInc.com](http://www.SilkRoadRealtyInc.com). Thank you.