

## CLIENT LETTER

### What Does and Does Not Constitute Cancellation of Debt Income

Dear Client:

This letter is intended to provide you with some information related to cancellation of debt (COD) income. If you have had a lender discharge part or all of a debt that you were liable for, you may owe income tax on the amount that was discharged. This is because certain debts that are cancelled or forgiven by a lender result in taxable income to you, even though you have not technically received any money in hand from the debt forgiveness.

Generally, debt that is discharged or canceled by a lender must be included in your taxable income. Debt forgiveness income, or COD income, is the product of the amount of debt that a lender discharges or cancels. Unless a specific exception applies, a lender's cancellation of debt will generally result in income to the borrower. If you have had a lender discharge all or part of a debt that you owe, and you would like to know what your tax obligations are regarding the cancelled amount, please contact our office.

In general, if the amount forgiven or canceled is \$600 or more, the lender must issue to you and to the IRS a Form 1099-C, Cancellation of Debt, showing the amount of debt canceled. Even though the creditor has issued Form 1099-C, you may be able to claim an exclusion from income for the canceled debt.

Exclusions from income. COD income is not always taxable. The most common situations in which cancelled debt does not result in taxable income include the following:

1. The debt has been discharged through a bankruptcy proceeding under Title 11;
  2. Insolvency (your total debts exceed your total assets);
  3. The debt is due to a qualified farm expense or farm property ("qualified farm indebtedness");
- and
4. The debt is due to certain real property used in a trade or business ("qualified real property business indebtedness").

Other exclusions may apply to student loans, disaster victims, gifts, general welfare payments, and deductible payments.

Reduction of attributes. When canceled debt is excluded from income, the debtor may be required to reduce tax attributes, such as the basis of property. The reduction of attributes must be reported on Form 982, Reduction of Tax Attributes Due to Discharge of Indebtedness, and included with your federal income tax return. If you do not reduce attributes, the IRS may take the position that you are taxable on the COD income.

A note on non-recourse loans. A non-recourse loan is a loan in which your lender's only remedy in case of default is to repossess the property subject to the loan. That is, property that is

either being financed or used as collateral for the loan. In these cases, your lender cannot pursue you personally in case of default. Although forgiveness of a non-recourse loan resulting from a foreclosure does not result in COD income, it may result in other tax ramifications. Please contact our office if this applies to your situation, or if you don't know whether your loan is non-recourse.

Mortgage debt forgiveness. For a limited period of time, certain mortgage debt that is discharged by the lender is excludable from COD income and therefore does not result in taxable income to homeowners. This is generally referred to as "qualified principal residence indebtedness." The cancellation of qualifying mortgage debt is excludable from income if it is incurred with respect to the taxpayer's principal residence for "acquisition" debt forgiven on or after January 1, 2007 and before January 1, 2013. Acquisition debt is indebtedness secured by the residence and incurred in the acquisition, construction or substantial improvement of the residence.

Certain debt used to refinance the debt is also eligible. Debt forgiven on a second home or rental property does not qualify.

Credit card and car loan debt. Noticeably absent from the specific exceptions to COD 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 includable in gross income, unless the debtor is bankrupt or insolvent. The lender will report the amount of forgiven debt on Form 1099-C.

If you had debt discharged from income in 2009 that does, or does not, qualify for an exception, you must include the amount of cancelled debt in your gross income on your tax return. If you have questions about COD income, the exclusions from income, or your reporting responsibilities, please contact our office.

Sincerely yours,