Cancellation Of Debt Income

Presented by Bobby L Burns

Training Outline

- Lesson 1: What is COD Income?
  - Forclosure, repossession or default.
- Lesson 2: IRC 108 provisions
  - Exceptions and exclusions.
- Lesson 3: Defenses
  - Court cases and other COD news

Lesson 1: Objectives

- Understanding of Cancellation of Debt Income.
- Reporting COD Income.

Lesson 1: COD Income

- US v Kirby Lumber Co., 284 US 1931
  - When a company settles its debt for less than the face amount a taxable gain has occurred
- Commissioner v Glenshaw Glass Company 384 US 426 (1955)
  - Any undeniable accession to wealth
  - Which is clearly realized
  - Over which the taxpayer has Dominion.

Lesson 1: COD Income

- General Rule
- COD income taxable as ordinary income
- IRC 61 Gross Income
- All income from whatever source
- IRC 61(a)(12)
- Specifically includes COD as an item of Gross income

Lesson 1: COD Income

- COD income can arise in various contexts, including:
  - Cancellation of Nonbusiness credit card debt
  - Cancellation of automobile debt
  - Cancellation of student loan debt
  - Cancellation of home mortgage debt
    - Foreclosure or Abandonment

Lesson 1: COD Income

- Recourse – Personally Liable
  - COD income may be realized
- Non-Recourse
  - No COD income
  - Debt included in disposition of property

Non-Recourse states

The following states are non-recourse states for most residential mortgages:

- Alaska
- Arizona
- California
- Hawaii
- Minnesota
- Montana
- Nevada (for most residential mortgages initiated from October 2009 onward)
- North Carolina
- North Dakota
- Oklahoma
- Oregon
- Washington

Lesson 1: COD Income

- Gain or Loss on Disposition
  - If a debt for which the taxpayer is personally liable is discharged as a result of a foreclosure, sale, or other disposition of property that secures the debt, the taxpayer may realize gain or loss on the disposition as well as COD income.
  - In the case of personal use property, such as a principal residence, any loss would be nondeductible.

Lesson 1: Reporting COD Income

- 1099A

- Cancelled Debts
- Foreclosures
- Repossessions and
- Abandoments

- Lenders with interest in property that is security for a loan

- The Greater off
  - Adjusted basis – Amount of debt cancelled or
  - Adjusted basis – Sales proceeds

Lesson 1: Reporting COD Income

- 1099C

- Cancelled Debts, Abandonments
- Joint Debts
- Greater than $600

- A financial Institution
  - Bank, Credit Union
- An Organization whose trade or business is lending money
  - Finance Company
  - Credit card Company

Identifiable Event Codes

- A - Bankruptcy
- B – Other Judicial Debt Relief
- C – Statute of limitations
- D – Foreclosure Election
- E – Debt Relief From Probate
- F – By Agreement
- G – Decision or Policy

Lesson 1: Reporting COD Income

Nonbusiness debt	1040 or 1040NR, Line 21
Non farm sole propreitor	Sch C line 6, Sch C EZ, Line 1
Non Farm rental activities	Sch E, Line 3
Farm debt (farmer)	Sch F, Line 10
Farm rental activity tax payer uses form 4835	Form 4835, Line 6

Lesson 1: Wrap-up

- Canceled Debt is income
- May have tax consequences to borrower
- Reported by Lender on 1099 C.
- COD income can arise in a debt "workout" as well as in a foreclosure.
- Whether this COD income is taxable depends on whether an exception in section 108 applies.

Lesson 2: Objectives

- Understand the Exceptions of Section 108
- Understand the Exclusions of Section 108
- Understand the Reduction requirements

Lesson 2: Exceptions

Section 108(e)(2) provides that no COD income is realized to the extent that payment of the debt would have given rise to a deduction.

- Amounts otherwise excluded from income
- Gifts, Bequests, Devises and Inheritances
- Certain student loans
- Deductible debt (for taxpayers using the cash method of accounting)
- Price reduced after purchase
- Home Affordability Modification Program(HAMP)

Lesson 2: Sec. 108. Income from discharge of indebtedness.

- (a) Exclusion from gross income.
  - (1) In general. Gross income does not include any amount which (but for this subsection) would be includible in gross income by reason of the discharge (in whole or in part) of indebtedness of the taxpayer if—

Lesson 2: Sec. 108. Income from discharge of indebtedness.

- Exclusion from gross income.
  - (A) the discharge occurs in a title 11 case,
  - (B) the discharge occurs when the taxpayer is insolvent,
  - (C) the indebtedness discharged is qualified farm indebtedness, or
  - (D) in the case of a taxpayer other than a C corporation, the indebtedness discharged is qualified real property business indebtedness.

Lesson 2: Sec. 108. Income from discharge of indebtedness.

- (e) the indebtedness discharged is qualified principal residence indebtedness which is discharged—
  - (i) before January 1, 2017, or
  - (ii) subject to an arrangement that is entered into and evidenced in writing before January 1, 2017.

Lesson 2: Qualified Principal Residence Indebtedness

- Acquisition indebtedness (within the meaning of section 163(h)(3)(B)) for a principal residence.
  - "Acquisition indebtedness" = Debt incurred in acquiring, constructing or substantially improving the home and secured by the home. May include refinanced debt and the proceeds of a "home equity" loan used to substantially improve the home.
  - "Principal residence" as defined in section 121 (note: the 5-year lookback test in section 121 is NOT part of the definition of "principal residence").
- •$2 million limitation

Lesson 2: Application of the Law

- Bankruptcy - No other exclusion applies if the debt was canceled in a title 11 bankruptcy case.

  - Check Line 1a of Form 982.
  - Enter Amount of discharged debt on Line 2

Lesson 2: Application of the Law

- Insolvency - Exclusion is limited to the extent of insolvency.
  - Calculate Extent of Insolvency
    - Total liabilities immediately before the discharge - FMV of total assets immediately before the discharge = Extent to which the taxpayer is insolvent
  - Check Line 1b of Form 982.
  - Enter amount of discharged debt on Line 2

Lesson 2: Application of the Law

- Qualified Farm Indebtedness
  - Debt was directly incurred in connection with the operation of a Farm
  - 50% or more of gross receipts over 3 year period before discharge from Farming
  - Check Line 1c of Form 982.
  - Enter amount of discharged debt on Line 2

Lesson 2: Application of the Law

- Qualified Principal Residence Indebtedness
  - $2 million maximum ($1 million if MFS).
  - Must be qualified acquisition indebtedness.
  - Ordering rule – if only a part of the loan is qualified principal residence indebtedness, the exclusion for discharged qualified principal residence indebtedness applies only to the extent the amount discharged exceeds the amount of the loan (immediately before the discharge) that was not qualified principal residence indebtedness.

Lesson 2: Ordering Rule

- Outstanding mortgage balance = $750,000
  - Refinanced for $850,000
  - Additional $100,000 used to buy car & pay credit card debt
  - Lender forecloses, sells the house for $735,000, and cancels the remaining $115,000 of debt

Lesson 2: Ordering Rule

- Ordering rule:
  - $115,000 canceled debt
  - - $100,000 of nonqualified debt
  - --
  - $ 15,000 amount eligible for exclusion as QPRI
- The remaining $100,000 must be included in income unless another exception or exclusion applies (e.g., insolvency)..

Lesson 2: Reduction of Tax Attributes

- 108 (b) (1) In General.
  - The amount excluded from gross income under subparagraph (A) , (B) , or (C) of subsection (a)(1) shall be applied to reduce the tax attributes of the taxpayer as provided in paragraph (2) .

Lesson 2: Reduction of Tax Attributes

- Net operating loss (NOL) and NOL carryover
- General business credit carryover
- Minimum tax credit
- Capital loss and capital loss carryover
- Basis
- Passive activity loss and credit carryover
- Foreign tax credit

Lesson 2: Reduction of Tax Attributes

- Taxpayer buys car for $12,000
- Defaults and Owes $8,500
- Car has FMV of $7,000
- Lender forgive $1,500

Lesson 2: Reduction of Tax Attributes

- Taxpayer Assets
  - Furniture cost $5,000 FMV 3,000
  - Jewelry cost $500 FMV 1,000
  - Checking Account Bal 600
  - FMV of Car 7,000
- --
- Total FMV of Assets = 11,600

Lesson 2: Reduction of Tax Attributes

- Taxpayer Liabilities
  - Car 8,500
  - Student Loan 6,000
- ---
- Total FMV of Liabilities = 14,500
- Extent of Taxpayer insolvency = 2,900

Lesson 2: Reduction of Tax Attributes

- Taxpayer excludes 1,500
- Reduces tax attribute of property
  - Basis of property 5,500
  - Cash in Checking 600
  - --
  - Total assets 6,100
  - Liabilities - 6,000
  - Excess of basis 100

Lesson 2: Reduction of Tax Attributes

- Net operating loss (NOL) and NOL carryover
- General business credit carryover
- Minimum tax credit
- Capital loss and capital loss carryover
- Basis
- Passive activity loss and credit carryover
- Foreign tax credit

Lesson 1: Reduction of Tax Attributes

- Basis Reduction
  - Real Property (except inventory used in trade or business)
  - Personal Property (except inventory and accounts and notes receivable used in trade or business)
  - Other property (except inventory and accounts and notes receivable used in trade or business)
  - Inventory, accounts and notes receivable, real property held for sale
  - Personal use property (not used in trade or business

Lesson 1: Reduction of Tax Attributes

- Basis Reduction
  - Reduce Furniture by $91
    - 100 x (5000 / 5500) = 90.90 or $91
  - Reduce Jewelry by 9

Lesson 2: Reduction of Tax Attributes

Part II **Reduction of Tax Attributes.** You must attach a description of any transactions resulting in the reduction i basis under section 1017. See Regulations section 1.1017-1 for basis reduction ordering rules, and, if applicabl required partnership consent statements. (For additional information, see the instructions for Part II.)

Enter amount excluded from gross income:

4	For a discharge of qualified real property business indebtedness, applied to reduce the basis of depreciable real property	4	
5	That you elect under section 108(b)(5) to apply first to reduce the basis (under section 1017) of depreciable property	5	
6	Applied to reduce any net operating loss that occurred in the tax year of the discharge or carried over to the tax year of the discharge	6	
7	Applied to reduce any general business credit carryover to or from the tax year of the discharge	7	
8	Applied to reduce any minimum tax credit as of the beginning of the tax year immediately after the tax year of the discharge	8	
9	Applied to reduce any net capital loss for the tax year of the discharge including any capital loss carryovers to the tax year of the discharge	9	

Lesson 2: Wrap-up

- IRC Sec 108 provides Exceptions and Exclusions to COD income.
- Tax attributes must be reduced
  - Bankruptcy, Insolvency and Farm
- Qualified Principle Residence Max $2 mil.

Lesson 3: Objectives

- Introduce Possible Defenses

Lesson 3: Defenses

- Commissioner v Glenshaw Glass Company 384 US 426 (1955)
  - Any undeniable accession to wealth
  - Which is clearly realized
  - Over which the taxpayer has Dominion.

Lesson 3: Defenses

- Zarin v Commissioner
  - Debt has to be Legal in the State
  - Dispute as to amount

- Deductible debt is not COD income

Summary of Training

- Discharge of debt may give rise to income and thus a tax liability
- COD Income must be reported on tax return
- Exclusions reported on form 982
- At least 4 court determined defenses

Assessment and Evaluation

- Prepare a quiz or challenge to assess how much information participants learned.
- Survey participants to see if they found the training beneficial.