

## TAX ON CANCELLED DEBT

By

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In today's real estate market, unaffordable loans coupled with declining market values mean many homeowners face short sales or foreclosure, and a possible tax bill treating the difference between sale price and amount owed as income. The Mortgage Forgiveness Debt Relief Act of 2007, though granting needed relief to some, still leaves many borrowers exposed to tax liability resulting from foreclosure. Because bankruptcy eliminates cancellation of debt income, it deserves serious consideration even when a workout agreement with the lender is possible, particularly if a residence has been refinanced to pay off other consumer debt, or the property is not the debtor's primary residence.

When a borrower is relieved of debt, the economic value conveyed by the transaction is considered taxable income. The Supreme Court clearly stated this principal in the often cited case of *United States v. Kirby Lumber Co.*, 284 U.S. 1, 76 L. Ed. 131, 52 S. Ct. 4 (1931). It is possible to realize income from the discharge of a debt even when there was no cash or other property received<sup>1</sup>. Over the years the courts have carved out various exceptions to this rule. Perhaps the most obvious early exception is granted when the debtor is already insolvent<sup>2</sup>. Even if the debtor is not insolvent when debt is cancelled, to the extent assets of the debtor less the debtor's liabilities results in an amount that is less than the amount of debt cancelled, the taxable income is limited to the amount by which assets exceed liabilities<sup>3</sup>.

The idea that being relieved of a debt improves a debtor's financial position is not particularly novel. For a bankruptcy lawyer and the lawyer's clients, it generally forms the very basis of the relationship. However, BAPCPA changes to the law made bankruptcy a less satisfactory alternative to many consumers burdened with debt.

Credit card banks, credit unions and other consumer lenders aggressively attacked consumer debtors when they lobbied successfully for significant, consumer unfriendly changes to the bankruptcy law. Individual

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<sup>1</sup> In *Old Colony Trust Co. v. Commissioner*, 279 U.S. 716 (1929) the court found that payment, by an employer, of an employee's State and Federal income tax liabilities resulted in income to the employee.

<sup>2</sup> *Dallas Transfer & Terminal Warehouse Co. v. Comm'r*, 70 F.2d 95 (5th Cir. 1934).

<sup>3</sup> *Lakeland Grocery Co.*, 36 B.T.A. 289 (1937).

debtors are now required to consider (or at least receive a briefing on) credit counseling as an option before a bankruptcy filing is permissible. Congress even created an incentive for creditors to be reasonable in dealing with credit counseling agencies that negotiate repayment plans for consumers<sup>4</sup>. Despite this push to keep consumers out of bankruptcy and encourage them to work out their debts without resorting to a bankruptcy proceeding, tax laws continue to penalize those who attempt to adjust their debts.

The advent of computer matching programs has allowed the Internal Revenue Service to track many types of transactions impacting the consumer. Now that banks, home lenders, and many other consumer creditors are required to send notification when debts are cancelled, consumer taxpayers are being faced with a phenomenon that seems to make little sense in view of the obvious legislative bias against consumer bankruptcy. In its most dramatic form, a tax deficiency notice arrives in the mailbox a year or two after the tragic loss of a family home to foreclosure. A consumer, after struggling to settle and pay credit card debts by negotiation through a credit counseling service, receives a similar notice that tax is due. The computer age and burgeoning debt problems mean that more consumers are being ever more frequently faced with cancellation of debt taxation.

The Internal Revenue Code defines gross income as “all income from whatever source derived”. Discharge of indebtedness is expressly included as part of the taxpayer’s income in 26 USC § 61(a)(12). Or, as stated by Justice Thomas in *Gitlitz v. Commissioner*, “Section 61(a)(12) states that discharge of indebtedness generally is included in gross income.” 531 U.S. 206, 213 (2001). Exceptions to the rule that discharge of indebtedness is includible income, many of which were crafted by the courts, are now listed in the tax code at 26 USC §108(a)(1)<sup>5</sup>. With the enactment of this statute, Congress specifically prohibited the courts from creation of new judicial exceptions.

When Congress enacted the insolvency exception into the Code as *section 108(a)(1)(B)*, one of the related provisions it also enacted is *section 108(e)(1)*. *Section 108(e)(1)* provides that, for purposes of title 26 of the United States Code

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<sup>4</sup> 11 USC §502(k) allows the court, on motion of the debtor, to reduce the claim of consumer creditor by up to 20% if the creditor was unreasonable in negotiating a repayment schedule proposed by an approved budgeting and credit counseling agency.

<sup>5</sup> § 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--

(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,

(D) in the case of a taxpayer other than a C corporation, the indebtedness discharged is qualified real property business indebtedness, or

(E) the indebtedness discharged is qualified principal residence indebtedness which is discharged before January 1, 2010.

(i.e., the Internal Revenue Code, including *section 61(a)(12)*), "there shall be no insolvency exception from the general rule that gross income includes income from the discharge of indebtedness" except as provided in *section 108(a)(1)(B)*. As the Supreme Court very recently stated, "*Section 108(e)(1)*" precludes us from relying on any understanding of the judicial insolvency exception that was not codified in '108." *Gitlitz v. Commissioner*, 531 U.S. at \_\_\_, 69 *U.S.L.W.* at 4063. Even before *Gitlitz* was decided, we reached a similar conclusion in *Merkel v. Commissioner*, 109 T.C. 463 (1997). *Carlson v. Commissioner* 116 T.C. 87 at 100.

With the increasing media attention and public pressure brought on by the excessively exuberant, profit driven home loan practices of subprime lenders, and often referred to as the subprime loan crisis, Congress quickly enacted the Mortgage Forgiveness Debt Relief Act of 2007. This much needed but inadequate legislation allows for cancellation of debt in amounts up to \$2,000,000 on a qualified personal residence. Under the ideal fact pattern (if the loss of a personal residence to foreclosure can ever be referred to in such terms) a foreclosure sale will result in no added tax to the homeowner. However, as with most legislation impacting the tax code, the devil is in the details.

The Mortgage Forgiveness Debt Relief Act of 2007<sup>6</sup> is time limited. It only covers cancellation of debt

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<sup>6</sup>The relevant portion of the act states as follows:

(a) In General- Paragraph (1) of section 108(a) of the Internal Revenue Code of 1986 is amended by striking `or' at the end of subparagraph (C), by striking the period at the end of subparagraph (D) and inserting `, or', and by inserting after subparagraph (D) the following new subparagraph:

`(E) the indebtedness discharged is qualified principal residence indebtedness which is discharged before January 1, 2010.'

(b) Special Rules Relating to Qualified Principal Residence Indebtedness- Section 108 of such Code is amended by adding at the end the following new subsection:

`(h) Special Rules Relating to Qualified Principal Residence Indebtedness-

`(1) BASIS REDUCTION- The amount excluded from gross income by reason of subsection (a)(1)(E) shall be applied to reduce (but not below zero) the basis of the principal residence of the taxpayer.

`(2) QUALIFIED PRINCIPAL RESIDENCE INDEBTEDNESS- For purposes of this section, the term `qualified principal residence indebtedness' means acquisition indebtedness (within the meaning of section 163(h)(3)(B), applied by substituting `\$2,000,000 (\$1,000,000' for `\$1,000,000 (\$500,000' in clause (ii) thereof) with respect to the principal residence of the taxpayer.

`(3) EXCEPTION FOR CERTAIN DISCHARGES NOT RELATED TO TAXPAYER'S FINANCIAL CONDITION- Subsection (a)(1)(E) shall not apply to the discharge of a loan if the discharge is on account of services performed for the lender or any other factor not directly related to a decline in the value of the residence or to the financial condition of the taxpayer.

after December 31, 2006, and before January 1, 2010. Unfortunately, this relief is also limited to acquisition indebtedness as defined by 26 USC 163(h)(3)(B)<sup>7</sup>. This means that refinance debt used for a purpose other than substantially improving the house or paying off a loan used to build, buy or substantially improve the house is not covered by this exemption. Consequently, the portion of a discharged home loan that was used to pay off non-qualified debt will not be excluded from income and can result in tax liability for the debtor.

With the growth in home equity that was common in recent years, many debt pressured homeowners turned to a refinance of the existing loan on their personal residence in order to pay down credit card debt, fund dramatically increased higher education expenses for their children, cover uninsured medical expenses, or simply supplement personal income. Lenders frequently required these borrowers to pay off outstanding consumer debt in order to qualify for the loan. If a refinanced home loan used for these purposes were to be discharged with less

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'(4) ORDERING RULE- If any loan is discharged, in whole or in part, and only a portion of such loan is qualified principal residence indebtedness, subsection (a)(1)(E) shall apply only to so much of the amount discharged as exceeds the amount of the loan (as determined immediately before such discharge) which is not qualified principal residence indebtedness.

'(5) PRINCIPAL RESIDENCE- For purposes of this subsection, the term 'principal residence' has the same meaning as when used in section 121.'

(c) Coordination-

(1) Subparagraph (A) of section 108(a)(2) of such Code is amended by striking 'and (D)' and inserting '(D), and (E)'

(2) Paragraph (2) of section 108(a) of such Code is amended by adding at the end the following new subparagraph:

'(C) PRINCIPAL RESIDENCE EXCLUSION TAKES PRECEDENCE OVER INSOLVENCY EXCLUSION UNLESS ELECTED OTHERWISE- Paragraph (1)(B) shall not apply to a discharge to which paragraph (1)(E) applies unless the taxpayer elects to apply paragraph (1)(B) in lieu of paragraph (1)(E).'

(d) Effective Date- The amendments made by this section shall apply to discharges of indebtedness on or after January 1, 2007.

<sup>7</sup> Acquisition indebtedness.

(i) In general. The term "acquisition indebtedness" means any indebtedness which--

(I) is incurred in acquiring, constructing, or substantially improving any qualified residence of the taxpayer, and  
(II) is secured by such residence.

Such term also includes any indebtedness secured by such residence resulting from the refinancing of indebtedness meeting the requirements of the preceding sentence (or this sentence); but only to the extent the amount of the indebtedness resulting from such refinancing does not exceed the amount of the refinanced indebtedness.

(ii) \$ 1,000,000 Limitation. The aggregate amount treated as acquisition indebtedness for any period shall not exceed \$ 1,000,000 (\$ 500,000 in the case of a married individual filing a separate return).

than full payment due to foreclosure or short sale there would be additional income that must be recognized by the borrower when the tax return is prepared for the year in which the discharge occurred.

It may seem unfair to tax an unfortunate former homeowner after loss of the family home. However, cancelled debt that would ordinarily be treated as income is excluded from income for tax purposes under 26 USC §108(a)(1)(A) if it was cancelled as a result of a bankruptcy discharge. There are no limitations in dollar amount and no restrictions on the type of debt that is cancelled in a bankruptcy proceeding. In the event bankruptcy discharge is the reason for cancellation of a debt, it is excluded from income.

For many consumers, particularly those who have refinanced their personal residence acquisition loan and utilized some of their home equity for purposes other than a major home remodeling project, bankruptcy may offer significant advantages from the perspective of their potential future tax liability. This is an even more important consideration when a property threatened with foreclosure is not the personal residence of the borrower. Vacation homes, rentals and real property investments that no longer have positive equity all carry potential tax consequences for the owner in the event of foreclosure.

The way in which the statutory exclusions from income for cancelled debt can be used is set forth in 26 USC §108(a)(2). While several different exclusions may apply to a specific debtor or transaction, exclusions are only available for use in a specific order set forth in the statutory scheme. The title 11 (bankruptcy) exclusion from income for cancelled debt takes precedence, and no other exclusion is available, to a debt discharged in bankruptcy. The newly available exclusion for cancelled debt under the Mortgage Forgiveness Debt Relief Act of 2007, added to the statute as 26 USC §108(a)(1)(E), may be used if there is no bankruptcy discharge when a personal residence is involved. An election must be made if the borrower is insolvent and wishes to use that exception; otherwise the Mortgage Forgiveness Act applies. If there is non-qualifying debt on the personal residence, there may be exposure to cancellation of indebtedness income if a foreclosure is permitted and the borrower relies on the Mortgage Forgiveness Act. This can be avoided if a bankruptcy is filed to discharge the debt before the foreclosure proceeding is concluded.

There is a price to be paid for the exclusion of discharge of indebtedness from the income of the borrower. The same statute that provides for relief from tax on this income also demands a price from the taxpayer seeking its benefit. To the extent that cancelled debt is excluded from income for tax purposes due to

bankruptcy, insolvency or if it is qualified farm indebtedness, 26 USC §108(b) requires a corresponding reduction in tax attributes such as net operating losses from a business, minimum tax credit (used for calculation of alternative minimum tax) or capital loss carryover. These tax attribute reductions are not of particular consequence to most individual consumers without substantial business or investment income but should be considered when alternative minimum tax is possible. The rules for applying a reduction of tax attributes are set forth in the statute and have their own order of precedence.

When investment properties and business entities are added to the mix, the issue can become complex. Timing can be critical in avoiding unnecessary capital gains. The attached article, titled *Income Tax Liability With No Money*<sup>8</sup>, describes some of the ugly problems that can occur with cancellation of debt, capital gains and a bankruptcy proceeding. The authors of this article label these unanticipated tax problems as “Tax Bombs”.

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<sup>8</sup> *Income Tax Liability with No Money* is an article written by Jeffrey Wong and Heather Harriman Vogle that was presented by Mr. Wong to the Northwest Bankruptcy Institute at its 2007 annual meeting in Vancouver, BC. It is included in these materials with the express permission of its authors.