

Cancellation of Debt – Insolvency



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If some or all of your debt is cancelled, the amount of cancelled debt is generally taxable and must be reported on your return. However, you may be able to exclude the cancellation of debt income to the extent you were insolvent immediately before the cancellation. If cancelled debt is excluded from income, it is nontaxable.

Cancellation of Debt

Cancellation of debt (COD) is settlement of a debt for less than the amount owed. A debt may be cancelled by a lender voluntarily or through bankruptcy or other legal proceedings and may result in ordinary income, income from the sale of assets, or both.

Cancelled Debt Situation	Tax Treatment
Debt owed is cancelled or forgiven. <i>Example:</i> Credit card debt.	Amount cancelled or forgiven is generally taxable as ordinary income from cancellation of debt.
Property that is security for a debt is taken by the lender in full or partial satisfaction of that debt. <i>Example:</i> Vehicle repossessed.	The transaction is treated as a sale of the property, which may result in a gain or loss.
Property that is security for a debt is taken by the lender, and lender cancels recourse debt in excess of FMV of property taken. <i>Example:</i> Main home foreclosure.	Excess of cancelled debt over FMV is ordinary income from cancellation of debt, in addition to any gain or loss from the sale.
Cancelled debt is intended as gift.	Amount cancelled is not income.*

* Gift tax may apply.

Form 1099-C, Cancellation of Debt

If a lender cancels or forgives a debt of \$600 or more, it must provide the borrower with Form 1099-C, showing the amount of cancelled debt to be reported as income.

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Generally, you must include all cancelled amounts, even if less than \$600, as Other Income on Form 1040.

Examples of COD Income

Nonbusiness credit card debt cancellation. If nonbusiness credit card debt is cancelled, you may be able to exclude the cancelled debt from income up to the extent you are insolvent.

Personal vehicle repossession. If you had a personal vehicle repossessed during the year, the transaction is treated as a sale, and gain or loss on the repossession must be computed. If the lender also cancels all or part of the remaining debt, you may be able to exclude the cancelled debt from income to the extent you are insolvent.

Insolvency

You are insolvent to the extent that the total of all your liabilities exceeds the fair market value (FMV) of all your assets immediately before the cancellation of debt.

For purposes of determining insolvency, assets include the value of everything you own, including assets that serve as collateral for debt and exempt assets which are beyond the reach of creditors, such as the value of a retirement account. A recourse debt holds the borrower personally liable. A nonrecourse debt does not allow the lender to pursue anything other than the collateral. Liabilities include:

- The entire amount of recourse debts,
- The amount of nonrecourse debt that is not in excess of the FMV of the property that is security for the debt, and
- The amount of nonrecourse debt in excess of the FMV of the property subject to the nonrecourse debt to the extent nonrecourse debt in excess of the FMV of the property subject to the debt is forgiven.

Do not forget to include the amount of debt that was cancelled as part of your liabilities.