EVERYTHING YOU NEVER WANTED TO KNOW ABOUT FORM 1099-C but we'll tell you anyway . . . .

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Course Objectives. Upon completion of this course, the practitioner should be able to:

- Recognize IRS Form 1099-C, and utilize the information shown thereon;
- Understand the effect of Cancellation of Indebtedness, as shown by Form 1099-C, upon taxable income;
- Apply the *exceptions* and *exclusions* from gross income, where allowable;
- Recognize when the client may, or may not, benefit from allowable exclusion;
- Advise clients on when, from a tax standpoint, bankruptcy may be preferable to insolvency exclusion of cancelled debt; and
- Be aware that there may be incidents of a cancelled debt transaction that give rise to a deduction.

Complexity. This course is basic level and suitable for all C.P.A.s, EAs, and other tax practitioners. It is particularly relevant for practitioners who prepare a number of individual tax returns (Forms 1040).

Scope of material. Cancellation of indebtedness affects both individual and business (e.g. 1040 with Sch. C, 1065, 1120) returns. This course material is primarily directed at properly accounting for it on non-business individual returns, where the debt cancelled is personal (consumer) debt. This course is intended to address a variety of commonly-occurring tax situations, and does not purport to be an exhaustive read on all exigencies of treatment of discharged debt. To be aware of such exigencies and their proper treatment, the practitioner is encouraged to also review 26 USC §108, and §1017, and the sections referenced therein, and IRS Pub. 4681, *Canceled Debts, Foreclosures, Repossessions, and Abandonments.*

A. WHAT IS FORM 1099-C?

IRS Form 1099-C is issued when a debt, or part of a debt, is cancelled. This may commonly occur by a creditor's settlement for a lesser sum than the total owed, or by discharge of a mortgage debt by foreclosure.

> **Example 1.** John bought a refrigerator for $1,600. He paid for it with a major credit card. Through monthly payments, he paid the credit card company (the *creditor*) $600 on it, then lost his job. The debt goes into default for several months, and, after many collection calls, the creditor realizes that there's little point in suing John for the $1,000; as John doesn't have executable assets. *(For now, for simplicity, we will disregard interest, late fees, etc. The effect of these will be discussed later.)*
>
> Rather than just writing the entire debt off as a bad debt, the creditor tries offering John a *settlement in full* if he can pay $300, in cash, now. John accepts the settlement offer and pays the $300, and the rest of the debt ($700) is discharged (by the creditor's cancelling of it).

By this settlement agreement, the creditor is precluded from taking further legal or collection action as regards this debt, and John is no longer legally liable for the $700 that he didn't have to pay.

Note that, in fact, John is enriched by this. He still has the $1,600 refrigerator, but he only had to pay $900 for it. IRS treats this as if he had paid $1,600 -- the fair market value -- for the refrigerator; the credit card company (the *creditor*) made a $1,600 loan to John (that he used to pay for the refrigerator) and then the creditor gave John $700; but because the transaction arises in the course of business, rather than simple benevolence, it does not qualify as an actual gift (which would not be taxable to the donee); it is considered income to John. This gives rise to *income from the cancellation of indebtedness*.

> **Practitioner's note:** Had John owed the debt directly *to the seller* of the refrigerator, and not to a third party (such as the credit card company), and if at the time of discharge, John was not in bankruptcy, and was not insolvent, then an after-purchase agreement to reduce that debt is treated as an adjustment of the purchase price, and does ***not*** result in income to John.[1] In this case, instead, John's tax *basis* of the refrigerator would take the $700 hit. His basis would be $900, rather than $1,600. Assuming, however, that it was a personal-use refrigerator, this difference in basis would not *usually* have tax consequences for John.
>
> Similarly, if John had Lutheraned[2] the price down to $900 at the time of the original purchase, that would not have given rise to income for John.

Getting back to our example, put differently, in a balance sheet scenario, John has income from this sequence of events because, upon the cancellation of debt, his assets didn't change, but his liabilities were reduced by $700, increasing his net worth by that amount.

Accordingly, by January 31st of the year following the cancellation of debt, the creditor must send John a Form 1099-C showing the amount of debt cancelled ($700).[3]

> **Note:** If the amount of the cancellation had been less than $600, the creditor would not have to provide Form 1099-C, *but John would still be required to include the cancelled debt in income unless an exception or exclusion (detailed, post) applied*.
>
> **Practitioner's note:** In practice, forms 1099-C are often in error as to the amount of the cancelled debt, and should generally be scrutinized for the correct amount.

If the debt was ***not*** cancelled in the course of bankruptcy, then, unless an exception or exclusion applies, John must include that $700 in his gross income for the year of the cancellation.[4] It is normally shown on the *other income* line of Form 1040, and identified as *income from the cancellation of indebtedness*.

> **Note.** If the debt **was** cancelled by bankruptcy, John may generally exclude it from income, but must still file Form 982 (discussed, post) with his return.

Acquisition of a debt by a person related to the debtor may also give rise to *income from discharge of indebtedness*. This is so even though a 1099-C may not have been issued.[5]

Interest and late fees may be included in the *amount of debt discharged* in box 2 of 1099-C, and, if so,

1 26 USC §108(e)(5); IRS Pub. 4681, *Canceled Debts, Foreclosures, Repossessions, and Abandonments* (2014), p. 5
2 This would normally be stated as *Jewed*, but we try, here, to give other religions fair and equal recognition.
3 26 CFR §1.6050P-1
4 26 USC §61(a)(12), §108
5 26 CFR §1.108-2

should also be separately stated in box 3. This amount, however, is prone to error because should a mere account balance have been transferred by a predecessor owner of the debt (as might occur in sale or merger of the financial institution, or sale of the loan to another institution or collection agency); the present owner of the obligation, who cancelled the debt and issued 1099-C, would not necessarily have any way of knowing how much accrued interest/late fees was contained in the transferred balance. The practitioner, therefore, may have to determine how much of the cancelled debt was actually principal, interest, and late, or other miscellaneous, fees.

Some, or all, of the discharged **interest, if it would have been deductible if paid, is excepted from inclusion** in income (please see sec. B(7), post). For other discharged interest and late fees, the IRS position,[6] as ratified by the Tax Court,[7] is that, unless an exception or exclusion (sec. B, post) applies, said **discharged interest and late fees are taxable.** This is so, notwithstanding that, unlike the discharged principal amount, from a balance sheet perspective, the taxpayer received no economic benefit by these items.

> **Practitioner's note:** The legal illogic of this is well-discussed in the New York Law School Law Review article, *The Tax Treatment of Cancelled Interest and Penalties on Consumer Debt*,[8] which states a strong argument for exception, and suggests that the results in *Hahn* and *Payne* might have been different if the cases had been appealed to the USCA. Given the known Tax Court position, a practitioner taking (per his client's wishes) an aggressive position on this issue would want to carefully choose his forum; the U.S. District Courts (USDC), or the U.S. Court of Claims, might well find differently from the Tax Court. Of course, as a practical matter, and explaining the sparse precedent, taxpayers having cancelled debt cannot usually afford the undertaking that such a legal challenge would require.

Figure 1 -- Form 1099-C -- Source: Internal Revenue Service

☐ CORRECTED (if checked)

CREDITOR'S name, street address, city or town, state or province, country, ZIP or foreign postal code, and telephone no.	1 Date of identifiable event	OMB No. 1545-1424	Cancellation of Debt
	2 Amount of debt discharged $	2015	
	3 Interest if included in box 2 $	Form 1099-C	
CREDITOR'S federal identification number / DEBTOR'S identification number	4 Debt description		Copy B For Debtor
DEBTOR'S name			This is important tax information and is being furnished to the Internal Revenue Service. If you are required to file a return, a negligence penalty or other sanction may be imposed on you if taxable income results from this transaction and the IRS determines that it has not been reported.
Street address (including apt. no.)	5 If checked, the debtor was personally liable for repayment of the debt . . . . . ► ☐		
City or town, state or province, country, and ZIP or foreign postal code			
Account number (see instructions)	6 Identifiable event code	7 Fair market value of property $	

Form **1099-C** (keep for your records) www.irs.gov/form1099c Department of the Treasury - Internal Revenue Service

B. When discharge is *not* includible in gross income. Whether or not Form 1099-C has been issued, the following discharges are not includible. As debt settlements often occur because the debtor is

6 IRS Pub. 4681 (2014), p. 4

7 *Payne v. Commissioner* (2008), 95 T.C.M. (CCH) 1253; *Hahn v. Commissioner* (2007), 93 T.C.M. (CCH) 1055

8 New York Law School Law Review, Vol. 53 (2008-09), p. 1025, et seq. Author: Richard C.E. Beck. Accessible at http://www.nylslawreview.com/wp-content/uploads/sites/16/2013/11/53-4.Beck_.pdf (last accessed 05/26/15).

insolvent, and hence unexecutionable, the insolvency exclusion, discussed in detail, post, is of particular note, and is often applicable to exclude cancelled consumer debt.

Practitioners Note. If the taxpayer is claiming any of the ***exclusions*** listed in Sec. 9, below, he does so by filing Form 982 (discussed, post) with his return. If he has received a 1099-C, and is excepted from including the amount, or a portion thereof, in income by way of the ***exceptions*** of Sections 1 through 8, below; then Form 982 is not required nor appropriate, but, to avoid IRS inquiry, a statement should be filed with the return detailing which exception is met, and the amount excepted from inclusion in income thereby.

1. **A discharge where the taxpayer was not personally liable** for the debt is not *generally* includible in gross income.[9] This may occur, for instance, in the case of foreclosure of a nonrecourse mortgage, where the lender's (*mortgagee's*) sole remedy for default lies in repossession and sale of the property, and the lender cannot pursue legal action against the debtor (*mortgagor*) for any balance not paid by the foreclosure sale. Normally, if the taxpayer is not personally liable for the debt, Box 5 of Form 1099-C will not be checked.

Practitioner's note: While a nonrecourse foreclosure does not usually produce *income from the discharge of indebtedness*, it may, like any other transfer of property, produce *capital or ordinary gain or loss.* Gain might result if the property had increased in value while held by the debtor, or if depreciation of it had been deducted or was allowable. Gain will generally be present if the total amount realized (the entire amount of the debt, plus any foreclosure sale proceeds[10] that the debtor receives) exceeds the debtor's *adjusted basis*[11] (for nonbusiness property, this is usually the original cost, including the amount mortgaged) of the property. If the gain is from foreclosure of the taxpayer's residence, however, it is subject to the same exclusion rules as other sales of a residence.[12]

Tax planning note: Foreclosure of a recourse mortgage may, at the same time, result in both reportable *income from discharge of indebtedness*, and also reportable (ordinary or capital) *gain or loss* from the disposition of property. **If a loss is capital in nature, it will not necessarily fully offset the income from discharge of indebtedness**, as that is fully (subject to these exceptions and exclusions) includible as ordinary income; whereas the capital loss can only be deducted against ordinary income up to a maximum of $3,000 per year.

2. A discharge, **where the taxpayer is only the co-signer** or guarantor for the debt, and did not receive any economic benefit of the proceeds.[13]

3. Reduction of the debt **by the seller of the property** that the debt financed (discussed, p. 2, ante).

4. A discharge that occurs by way of a settlement of an, in good faith, **disputed debt** or **contested liability**.[14]

Practitioner's note: Even where the principal amount of the debt is not disputed, a bona-fide dispute may exist as to validity of interest, late fees, etc. In a settlement

9 For exceptions to this general rule, please see IRS Pub. 4681 (2014), p. 4
10 Including the Fair Market Value (FMV) of any property received by the debtor
11 IRS Pub. 4681 (2014), p. 4
12 For rules of residence sale gain exclusion, please See IRS Pub. 523, *Selling Your Home.*
13 *Landreth v. Commissioner*, 50 T.C. 803 (1968)
14 *Zarin v. Commissioner*, USCA 3rd Cir. (1990), 916 F2d 110

resolving those issues in compromise, the portion of the discharge which was a cancellation of the disputed amount, or a part thereof, is not included in income.

5. If the debt is cancelled as a **gift, bequest, devise, or inheritance.**[15]

6. **Certain student loans** that are cancelled because

a. the person who received the loan works for a certain period of time in certain professions for any of a broad class of employers;[16] or

b. on account of death or disability.[17]

7. Amounts of debt discharged, which, had it been paid, would be **deductible** (such as qualified home mortgage interest).[18]

8. Certain ***Home Affordable Modification Program*** payments.[19]

9. The following items specifically excluded by 26 USC §108:[20]

a. Discharge in Title 11 **bankruptcy;**

b. Discharge when the debtor is **insolvent**. This is one of the most utilized exceptions. Details of using this exception are discussed, post;

c. The indebtedness discharged is **qualified farm indebtedness**;[21]

d. In the case of a taxpayer other than a C corporation, the indebtedness discharged is **qualified real property business indebtedness;**[20] or

e. The indebtedness discharged is **qualified principal residence indebtedness** which is discharged before January 1, 2015.[20, 22]

Precedence. These §108 exclusions take precedence as follows.

i. If the **bankruptcy** exclusion applies, it must be used instead of the other §108 exclusions.
ii. If the **qualified principal residence indebtedness (QPRI)** exclusion applies, the **insolvency** exclusion may not be used for the same debt, unless the taxpayer elects to apply the insolvency exclusion in lieu of the QPRI exclusion.
iii. The **insolvency exclusion** takes precedence over the **qualified farm indebtedness** exclusion (QFI) and **qualified real property business**

15 IRS Pub. 4681 (2014), p. 4
16 Ibid.
17 26 USC §108 (f)(5) -- (added by the Tax Cuts And Jobs Act of 2017)
18 IRS Pub. 4681 (2014), p. 5
19 However, certain principal reductions may be taxable. Please see IRS Pub. 4681 (2014), p. 5.
20 26 USC §108
21 Defined, Appendix C
22 The ending date of this exception has been updated, by Congress, from year to year. Code updates should be consulted.

indebtedness (QRPBI) exclusion; and a taxpayer may not claim the QFI or QRPBI exclusions to the extent that he is insolvent.

This means that in cases where the taxpayer is insolvent, and the QFI or QRPBI exclusions may also apply, the insolvency exclusion must first be used, and then any remaining amount of discharge may be subject to the QFI and QRPBI exclusions.

Tax effect: This precedence -- which exclusion may be used, and in what order -- affects the ordering of the reduction of tax attributes, discussed at Sec. C(4), post.

Reduction of tax attributes may affect the net tax benefit that the taxpayer achieves from exclusion of the discharge from income; and is particularly likely to reduce benefit for i) business taxpayers, and ii) taxpayers who have deduction(s) for capital loss, net operating loss (NOL), and/or carryovers of same.

C. APPLYING THE INSOLVENCY EXCLUSION FOR TAXPAYERS FILING FORM 1040. Nonbusiness taxpayers filing form 1040, if insolvent, can often benefit by excluding part, or all, of the income from cancellation of debt without offsetting or adverse future tax consequences.

1. Whose debt is it? Liability is an individual attribute -- so is insolvency.

Caution. The following discussion is written as it applies to taxpayers in non-community property states. In **community property states**, a more detailed analysis, in keeping with state law, of asset ownership, and personal liability for the specific debt discharged, as well as for other separate, and joint, liabilities, would be required to properly apply the insolvency exclusion.

As defined by 26 USC 108(d)(1), for purposes of determining income from discharge of same, "indebtedness of the taxpayer" means any indebtedness (a) for which the taxpayer is liable, or (b) subject to which the taxpayer holds property.

As regards married taxpayers, whether filing jointly or separately, before applying the insolvency exclusion, it is necessary to determine which spouse, or both, was legally liable for the debt; and if both are liable, then what portion of the discharge is allocable to each spouse. Although liability attaches to a particular *individual*, in some cases, both spouses may each be individually liable for the debt, such as where they both signed the credit agreement, and agreed to be jointly and severally liable for the debt.

If only one spouse signed the credit or loan agreement giving rise to the debt, then the entire liability may attach to that spouse, solely. Legal liability for certain types of debts, however, may be mitigated by state law. Some non-community-property states, for example, hold that a spouse may be personally liable for the other spouse's medical expenses.

Where only one spouse is liable for the cancelled debt, to exclude income therefrom, the IRS position has been that **only that spouse must meet insolvency criteria.** This is not changed by the filing of a joint return.[23]

23 IRS Private Letter Ruling 8920019 (02/14/89) holds, in part, that, "While section 6013 requires the aggregation of income and deductions, the determination of a taxpayer's entitlement to the insolvency exclusion under section 108(a)(1)(B) is based on all the assets reachable ***by the individual taxpayer's*** creditors [emphasis added]. The filing of a joint return, pursuant to section 6013(b) of the Code, does not affect whether a spouse's separate assets will be used to determine the insolvency of the taxpayer." -- Ltr. Rul. 8920019 (02/14/89), as reported by *Legal bitstream*,

Example 2. Abraham and Sarah are married taxpayers, filing jointly. They live in a non-community property state. Sarah, alone, applies for and obtains a credit card which she uses solely for purchases for her benefit and there are no state law provisions that would render Abraham liable for any part of the resultant debt. Subsequently, payments on the card became delinquent, and after many collection contacts, the credit card company agrees on a *settlement in full* for less than the total debt. Sarah receives a 1099-C for the cancelled amount.

This is wholly Sarah's debt, and any income from discharge accrues only to Sarah. In attempting to exclude the discharge due to insolvency, only Sarah's personal insolvency is at issue. In completing the *Insolvency Worksheet*, post, only her assets and liabilities (including her share of jointly-owned assets and jointly-owed liabilities) are considered. If she, personally, is insolvent, the discharge may be excluded; notwithstanding that Abraham may not be insolvent; and that taken as a whole, the couple's assets may exceed their liabilities.

Practitioner's note: Where two or more persons were jointly and severally liable for a discharged debt, the creditor may issue a 1099-C, showing the *entire* discharged amount, *to each of them*. In this case, an allocation of the discharged amount must be made, and the total discharge allocated to all parties to the debt should not exceed the total amount of debt cancelled.

Example 3. Bill and Bob take out a $10,000 unsecured personal loan from a bank. They use the proceeds to buy a boat, of which each is a half-owner. They both signed the note, the terms of which specify joint and several liability for the amount due. After $4,000 has been paid on the note, it becomes delinquent, with $6,000 still due (again, for clear illustration, we are disregarding interest accrued). In time, the bank agrees to settle for $4,000 cash. Said settlement discharges the other $2,000 of debt. The bank sends a 1099-C to Bill showing $2,000 in Box 2. They also send one to Bob, with $2,000 in Box 2. But the total debt discharged, here, is not $4000; it is only $2,000. If no exception or exclusion applied, Bill and Bob would each report, on their tax returns, *income from cancellation of indebtedness* in the amount of $1,000.

Where both spouses are liable for the discharged debt, they may, or may not, accrue the income from the discharge in equal shares. In allocating the debt between spouses (or any two or more persons who were jointly and severally liable) the practitioner should take into consideration facts and circumstances including:

- State law;
- The amount of debt proceeds, or other benefit of the debt, each person received;
- How much of any interest deduction from the debt was claimed by each person; and
- How much of the basis of any co-owned property bought with the debt proceeds was allocated to each co-owner.[24]

Example 4.[25] In 2014, James and his wife Robin were released from their obligation to pay a debt of $10,000 for which they were jointly and severally liable. None of the exceptions to the general rule that cancelled debt is included in income apply, except that they might qualify for

http://www.legalbitstream.com/scripts/ isyswebext.dll?op=get&uri=/isysquery/irlebd/2/doc last accessed 05/12/15

24 IRS Pub. 4681 (2014), p. 4, as adapted

25 This example is adapted from *Example 3* of IRS Pub. 4681 (2014), p. 6.

the insolvency exclusion. They incurred the debt (originally $12,000) to finance James's purchase of a $9,000 motorcycle and Robin's purchase of a laptop computer and software for personal use for $3,000. They ***each*** received a 2014 Form 1099-C from the bank showing the entire cancelled debt of $10,000 in box 2. Based on the use of the loan proceeds, they agreed that James was responsible for 75% of the debt and Robin was responsible for the remaining 25%. Therefore, James's share of the debt is $7,500 (75% of $10,000), and Robin's share is $2,500 (25% of $10,000). By completing the *Insolvency Worksheet* (discussed post), James determines that, immediately before the cancellation of the debt, he was insolvent to the extent of $5,000 ($15,000 total liabilities minus $10,000 FMV of his total assets). He can exclude $5,000 of his $7,500 cancelled debt. Robin completes a separate insolvency worksheet and determines she was insolvent to the extent of $4,000 ($9,000 total liabilities minus $5,000 FMV of her total assets). She can exclude her entire cancelled debt of $2,500.

Practitioner's note. The full context of the IRS example just presented, perhaps for clarity, uses separate returns to illustrate the point. Although IRS does not offer guidance on this computation in the environment of a joint return, your author opines that, as insolvency is a personal attribute, the same result would be had if James and Robin were filing a joint return. They would still have to allocate the debt, and complete separate *insolvency worksheets*, to see if the insolvency exclusion applied to either, or both; and if so, the extent to which it applied. Ltr. Rul. 8920019 (ante) clearly holds that whether or not the taxpayer files a joint return, does not affect the computation of a taxpayer's insolvency, and entitlement to the insolvency exclusion.

However, in the case of joint and several liability, hypothetically, a case could be also made for non-allocation of the debt. This is because Ltr. Rul. 8920019 bases its reasoning upon assets reachable by the taxpayer's creditors. In the instance of joint and several liability, if one taxpayer's assets weren't reachable by the creditors, they could execute ***the entire debt*** against the other's assets, so any part of the debt cancelled would constitute income to the non-insolvent spouse.

This might have created a quandary for the practitioner. It is clear, however, from the above IRS-provided Example 4, that the present IRS position is to allow allocation of a debt for which the spouses are jointly and severally liable, without reassignment of an insolvent spouse's portion to the non-insolvent spouse; and if that is permissible on separate returns, then, under the reasoning of Ltr. Rul. 8920019, and absent IRS guidance otherwise, that permissibility should not be affected by the taxpayers' filing of a joint return to optimize their rates of tax, unrelated deductions and credits, etc. In deciding whether to take a conservative, or more aggressive position, the practitioner should remember that IRS private letter rulings are only binding upon the IRS in the case to which they relate; they do not constitute "substantial authority" (for relief from taxpayer and preparer penalties) and do not constitute precedent in the Tax Court or any other court.

2. Computation of insolvency.

Insolvency of the taxpayer, or of each taxpayer liable for the debt or a part thereof, is calculated on the IRS *Insolvency Worksheet* found in IRS Pub. 4681, and annexed hereto as Appendix A. The *worksheet* states at the top, "Keep for Your Records," and so the completed form is not filed with the return; but should be retained in the practitioner's file, with a "client's copy" retained in the client's records. In practice, upon filing a return claiming the insolvency exclusion, IRS will likely subsequently request a copy of the *insolvency worksheet*.

In the case of married taxpayers who are jointly liable, or other taxpayers who are jointly liable, each

taxpayer claiming the insolvency exclusion must complete their own, individual, insolvency worksheet. If married, but only one spouse is liable, only that spouse must complete their individual insolvency worksheet. Each individual taxpayer's insolvency worksheet should include that taxpayer's separate assets and liabilities, and that taxpayer's share of joint assets and liabilities.[26]

The insolvency worksheet is to reflect the taxpayer's financial position immediately before cancellation of the subject debt (the date of cancellation should be shown in Box 1 of 1099-C), and so should include that liability, or the taxpayer's share of same. In completing the insolvency worksheet, per the IRS instructions,[27] **the taxpayer must include all assets, including those subject to exemption from execution by state law (such as the homestead exemption), or federal bankruptcy exemption (such as retirement plans)**.

Liabilities, for the insolvency worksheet, include:

- The entire amount of recourse debts;
- The amount of nonrecourse debt that is not in excess of the Fair Market Value (FMV) of the property that is security for the debt (this may be shown in box 7 of 1099-C); 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.

> **Practitioner's note.** The requirement to list all assets, including those beyond the reach of creditors, flies in the face of the stated reasoning of IRS Ltr. Rul. 8920019 (02/14/89) that "the determination of a taxpayer's entitlement to the insolvency exclusion under section 108(a)(1)(B) is based on all the assets reachable by the individual taxpayer's creditors." Said requirement, however, apparently reflects the present position of the IRS. In a contested case, a tax court might be persuaded to apply the same legal reasoning as in said letter ruling. Again, in deciding whether to take a conservative, or more aggressive position, the practitioner should remember that IRS private letter rulings are only binding upon the IRS in the case to which they relate; they do not constitute "substantial authority" (for relief from taxpayer and preparer penalties) and do not constitute precedent in the Tax Court or any other court.

Upon completion of the insolvency worksheet, the practitioner will arrive, on line 38 thereof, at the *amount of insolvency* immediately before the cancellation.

- If that amount is zero or less than zero, the taxpayer is not insolvent and is not entitled to any insolvency exclusion.
- If that amount exceeds the amount of debt cancelled, the taxpayer may exclude the entire cancelled debt.
- If the said *amount of insolvency*, immediately before the cancellation, is positive, but less than the taxpayer's share of cancelled debt, then that taxpayer's insolvency exclusion is limited to the amount of insolvency. The practitioner would exclude only the amount of insolvency, and the remainder of the taxpayer's share of the cancelled debt would be shown as income on the return.

On a joint return, the non-excluded income of the two spouses (figured separately) would be aggregated (combined) and reported.

3. Effect on basis. Any exclusion of cancelled debt under 26 USC §108 (i.e. insolvency, or the other

26 IRS Ltr. Rul. 8920019 (02/14/89)
27 IRS Pub. 4681 (2014), p. 5

§108 exclusions listed in sec. B(9)(a-e), ante) may be claimed only where the taxpayer agrees to reduce his tax attributes (but not below zero). For consumer debt, this often takes the form of a basis adjustment of personal-use property, because the taxpayer does not have superior tax attributes to reduce. For nonbusiness taxpayers, this will *usually* not have further tax consequences. But basis of personal-use property may affect future tax computation in certain circumstances, such as if the property affected is subsequently contributed to charity, is sold at a gain (considering the reduced basis), is subject to a deduction (or gain) due to casualty or theft, or in other issues where basis is a factor.

> **Practitioners note:** A table of tax attributes, and order of their reduction, is shown in subsection 4, below. Because NOL and net capital loss deductions and carryovers must be reduced by the amount of excluded debt, before bases can be reduced; taxpayers, even nonbusiness taxpayers, who have these tax attributes, may not actually achieve a net tax benefit by said exclusion.

4. Claiming the insolvency exclusion on the tax return. The insolvency exclusion is claimed by filing Form 982, *Reduction of Tax Attributes Due to Discharge of Indebtedness* . . ., (illustrated at Appendix B, hereof) with the taxpayer's Form 1040. Line 1b of 982 would be checked, and the portion of the discharge excluded (which may be all of it) would be shown on line 2. Most of the lines on Form 982 are not generally used; and the lines that need to be completed, depending on the type of debt, and nature of the exclusion, are shown in a table in the IRS instructions for Form 982.

Then the taxpayer must reduce, on the 982, his tax attributes in order which follows.[28] Taxpayers will generally not have all of the attributes which may be reduced; and many nonbusiness individuals with discharged consumer debt will only have the tax attribute of *basis* to reduce (item (g)(ii)(3) in the following Table 1; and line 10a of Form 982). Attribute reductions are dollar for dollar, unless otherwise noted. As some tax attribute reductions are not dollar-for-dollar, and also as the basis reductions as limited by Table 1, para. (g) may be less than the excluded debt discharge, the sum of the amounts shown on Form 982 lines 4 through 13 may, correctly, be less than the amount shown on Line 2.

> **Note.** All line number references to Form 982 correspond to the July, 2013 revision, shown herein at Appendix B.

The following ordering table applies to exclusions due to *insolvency*. It also applies to exclusion for *bankruptcy*, or exclusion of *qualified principal residence indebtedness*. (For exclusions due to *qualified farm indebtedness* or *qualified real property business indebtedness*, please see IRS Pub. 4681 for ordering of reduction of tax attributes.) *Tax attributes*, if present, are reduced (but not below zero) in the order as shown in Table 1.

> **Important Note re Basis Adjustments.** If bases are reduced under either para. (b) or (g) of Table 1, the following rules apply: The basis adjustment i) reduces allowable depreciation in future years; and ii) is treated, in a future sale or exchange of the property, as *depreciation allowed*. For purposes of computing ordinary income from a future Sec. 1250 exchange, it is considered to be accelerated depreciation; in the event of subsequent sale of the property, any gain due to these basis reductions is treated as ordinary income, and not capital gain. If the subject property, the bases of which are reduced, is neither Sec. 1245, nor Sec. 1250 property; then it will, for future transactions, be treated as Sec. 1245 property.[29] In exclusions due to bankruptcy, bases of federally exempt property are not reduced.[30]

28 IRS Pub. 4681 (2014), p. 10; 26 USC §108(b); 26 CFR §1.108-7
29 26 USC §1017(d)
30 26 USC §1017(c)(1); 11 USC §522

Table 1. Order of reduction of tax attributes.[31]

For exclusions due to insolvency, bankruptcy, and exclusion of qualified principal residence indebtedness.

a) **If the debt is excluded as qualified principal residence indebtedness,** and the taxpayer continues to own the home after the cancellation, then the basis of the residence is reduced (but not below zero) by the amount of the cancelled debt which was excluded from income.[32] The reduction is entered on Form 982, line 10b.

> **Practitioner's note:** The code and regs are silent as to whether, if the amount excluded exceeded said basis, the taxpayer would be required to reduce other tax attributes. Per the IRS instructions for Form 982, however, it does not appear that other tax attributes would be reduced; further, should the taxpayer not continue to own the residence after the discharge, it does not appear that his other tax attributes would have to be reduced. In other words, in cases of exclusion for qualified principal residence indebtedness, the only tax attribute reduction that is made is to the basis of the residence. The other lines of Form 982 would be left blank. If, however, the home was disposed of incidental to the discharge, your author opines that any gain or loss on said disposition would have to be figured using the basis, as reduced for the excluded discharge.

b) In exclusions for insolvency or bankruptcy, the **taxpayer <u>may elect</u> to first reduce the bases of depreciable property** held after the close of the year when the discharge occurred.[33] The election is made by entering the appropriate information on Form 982, including line 5 thereof, and attaching the form to the timely filed (including extensions) return, or an amended return filed within 6 months of a timely filed return. Once made, the election may be revoked only with the consent of the Commissioner.[34] Please see ***Important Note re Basis Adjustments***, immediately preceding this table. If this election is made, bases must be reduced in the special order shown in IRS Pub. 4681 (2014), p.10. ***Limitation:*** This reduction is limited to the total adjusted bases of all of the taxpayer's depreciable property,[35] and **not** by the limitation of subsection (g), below.

> **Real property accounted for as inventory.** A taxpayer holding real property as inventory may elect, for purposes of this subsection, to treat the same as depreciable property.[36] The election is made by checking the box on line 3 of Form 982.

c) **Net operating loss** -- firstly current year NOL, then any NOL carryover to the current year.

d) **General Business Credit carryover**. Reduce by 33 1/3 cents on the dollar of excluded debt.

e) **Minimum Tax Credit**. Reduce by 33 1/3 cents on the dollar.

f) **Net capital loss** -- firstly current year loss, then any carryover to the current year.

g) **Bases of property** held after the end of the taxable year of the discharge. ***Limitation:*** *The total of these basis reductions cannot be more than the excess of the total bases of the property and the amount of money that the taxpayer held immediately after the debt cancellation, over his total liabilities immediately after the cancellation.*[34] Please see ***Important Note re Basis Adjustments***, immediately preceding this table. Bases should be reduced (but not below zero) in the following order:

i. **Property which secured the cancelled debt, and which is <u>not</u> A) real property held for sale to customers in the ordinary course of business, B) inventory, or C) accounts or notes receivable:**
   1) The basis of real property held for investment or used in the taxpayer's trade or business ;
   2) The basis of personal property held for investment or used in the taxpayer's trade or business ;

ii. **Other property:**
   1) The basis of property held for investment or used in the taxpayer's trade or business (other than inventory, accounts receivable, notes receivable, and real property held for sale to customers in the ordinary course of business);
   2) The basis of inventory, accounts receivable, notes receivable, and real property held primarily for sale to customers in the ordinary course of business; and
   3) The basis of personal-use property (property not used in the taxpayer's trade or business nor held for investment).

h) **Passive activity loss and credit carryovers.** Loss carryovers are reduced dollar-for-dollar. Credit carryovers are reduced by 33 1/3 cents on the dollar.

i) **Foreign Tax Credit** is reduced by 33 1/3 cents on the dollar.

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31 26 USC §108; IRS Pub. 4681 (2014), p. 10
32 26 USC §108(h)(1); IRS Pub. 4681 (2014), p. 8
33 26 USC §108(b)(5)

D. TAX PLANNING -- WHEN BANKRUPTCY MAY BE PREFERABLE TO THE INSOLVENCY EXCLUSION.

In determining insolvency, a conflict exists between the reasoning of IRS Ltr. Rul. 8920019 (02/14/89) that,

- "the determination of a taxpayer's entitlement to the insolvency exclusion under section 108(a)(1)(B) is based on all the assets reachable by the individual taxpayer's creditors";

and the position adopted by IRS, and published in Pub. 4681, that,

- "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 your creditors under the law . . .)."

The following discussion presumes that the practitioner has adopted the more conservative IRS position.

When a taxpayer is considering the tax implications of bankruptcy, vs. settlement of debt outside of bankruptcy; he may be disadvantaged by an outside settlement if he,

- has a retirement plan; and/or
- has other property which would be exempted, in bankruptcy, by applicable state or federal exemptions (such as the various states' homestead exemptions).

> **Example 5.** Issac and Rebecca reside in Minnesota, a non-community property state. They have $10,000 joint debt from a credit card on which both are signers. The credit card company offers to settle in full for $4,000. Assuming equal liability, this would result in each realizing $3,000 income from discharge of indebtedness. They would be insolvent, except that Issac has $100,000 in his 401(k) plan, and they have, jointly, $50,000 equity in their house. If not bankrupt, they would both fail the insolvency test, and would have to include the $6,000 in income. If they declared bankruptcy, however, they could elect state exemptions, making their homestead exempt, and still exempt their retirement fund under a special federal provision that applies even where state exemptions are claimed.[37] And if they declared bankruptcy, they would not realize income from discharge of indebtedness, although they would still be required to reduce their tax attributes. On their Forms 982, they would check box 1a, rather than 1b.

E. FORECLOSURE SALE MAY RESULT IN INTEREST DEDUCTION.

In instances where a discharge of indebtedness occurs as incidental to a mortgage foreclosure and sale, it is important to determine whether any of the sales proceeds (paid to the creditor) included an element of deductible interest.[38] This element may be present in both recourse, and nonrecourse, mortgages; and if so, may result in an interest deduction for the taxpayer. Interest, paid to the creditor, from the foreclosure sale proceeds; is treated as if it was paid by the taxpayer. This applies, however, only to interest *actually paid* from the proceeds, and *not interest forgiven* as part of the discharge of

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34 26 CFR §1.108-4

35 26 USC §1017(b)(2), (b)(3); 26 USC §108(b)(5); IRS Pub. 4681 (2014), pp. 10, 11

36 26 USC §1017(b)(3)(E)

37 26 USC §522(b)(3)(C)

38 *Catalano v. Commissioner*, USTC T.C. Memo. 2000-82, citing Harris v. Commissioner, T.C. Memo. 1975-125, affd. without published opinion 554 F.2d 1068 (9th Cir. 1977).

indebtedness. The latter would not be deducted, but that part of the discharge may, instead, be excepted from inclusion in income (please see Sec. B(7), ante).

G. PRACTITIONER'S CHECKLIST.

Where a client 1099-C is present, to determine optimal tax treatment, the practitioner should check for the following.

1) Was the discharge in **bankruptcy**?
2) Was the debt **reduced by the <u>seller</u>** of the property that the debt was used to finance?
3) Is it a **recourse debt** for which the taxpayer is personally liable (is box 5 of 1099-C checked)?
4) Was the taxpayer merely the **cosigner or guarantor** and received no economic benefit from the debt proceeds?
5) Was the debt **disputed**?
6) Was the discharge a bona fide **gift, bequest, devise, or inheritance**?
7) Does the discharged debt constitute **qualified principal residence indebtedness**?
8) Does the discharged debt constitute **qualified real property business indebtedness**?
9) Was the obligation a **student loan** discharged for certain work, or death or disability?
10) Does the discharge meet the exception for certain **Home Affordable Modification Program** payments?
11) Does the discharged debt constitute **qualified farm indebtedness**?
12) **Does the discharged amount include interest** that would have been deductible had the taxpayer paid it?
13) Does the discharge transaction have a **capital or ordinary gain/loss** component?
14) If there was a mortgage foreclosure incident to the discharge, **did the foreclosure sale result in a deductible interest component**?
15) If taxpayers are married, **is only one spouse liable**?
16) Was the debtor-taxpayer **insolvent** at the time of the discharge?
17) Given the **adjustment of tax attributes, will the taxpayer benefit** by excluding the discharge?

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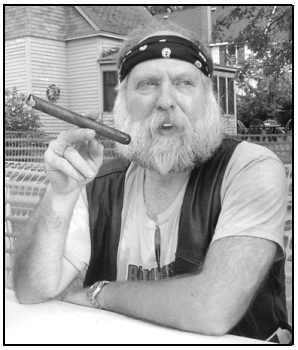

ABOUT THE AUTHOR: Adam Steele is a C.P.A. and former Enrolled Agent practicing at Bemidji, Minnesota. Since first establishing his accountancy practice, at Minneapolis, in 1981, it has been limited, almost exclusively, to the field of taxation. Before becoming certified, he supervised the tax department for a major West Coast C.P.A. firm. His past tax workbook articles, written for a well-known university's tax school CPE program, include *Accrual of Income*, and *Expense the Repair or Capitalize It? - The New Regs Clarify. (Everything you always wanted to know about T.D. 9636, but were afraid to ask).* Steele has also written many published newspaper columns on tax, for general public consumption.

Steele is a lead Plaintiff in the lawsuit, *Steele, Montrois, et al. v. U.S.*, a class-action suit brought in the USDC at Washington, D.C. (case no. 1-14-cv-01523-TSC). The suit sought, and won, injunction of the IRS's charging of annual PTIN fees, and refund of same for the practitioners who paid them. At the time of this writing (May, 2018), the U.S. (i.e. IRS) is appealing the decision. Refunds are yet to be made, pending the appeal opinion, but IRS has discontinued charging the fees.

APPENDIX A

INSOLVENCY WORKSHEET

Source: IRS Pub. 4681 (2014)

Insolvency Worksheet

Keep for Your Records

Date debt was canceled (mm/dd/yy)		
Part I. Total liabilities immediately before the cancellation (do not include the same liability in more than one category)		
	Liabilities (debts)	**Amount Owed Immediately Before the Cancellation**
1.	Credit card debt	$
2.	Mortgage(s) on real property (including first and second mortgages and home equity loans) (mortgage(s) can be on personal residence, any additional residence, or property held for investment or used in a trade or business)	$
3.	Car and other vehicle loans	$
4.	Medical bills owed	$
5.	Student loans	$
6.	Accrued or past-due mortgage interest	$
7.	Accrued or past-due real estate taxes	$
8.	Accrued or past-due utilities (water, gas, electric)	$
9.	Accrued or past-due child care costs	$
10.	Federal or state income taxes remaining due (for prior tax years)	$
11.	Judgments	$
12.	Business debts (including those owed as a sole proprietor or partner)	$
13.	Margin debt on stocks and other debt to purchase or secured by investment assets other than real property	$
14.	Other liabilities (debts) not included above	$
15.	**Total liabilities immediately before the cancellation. Add lines 1 through 14.**	$
Part II. Fair market value (FMV) of assets owned immediately before the cancellation (do not include the FMV of the same asset in more than one category)		
	Assets	**FMV Immediately Before the Cancellation**
16.	Cash and bank account balances	$
17.	Real property, including the value of land (can be main home, any additional home, or property held for investment or used in a trade or business)	$
18.	Cars and other vehicles	$
19.	Computers	$
20.	Household goods and furnishings (for example, appliances, electronics, furniture, etc.)	$
21.	Tools	$
22.	Jewelry	$
23.	Clothing	$
24.	Books	$
25.	Stocks and bonds	$
26.	Investments in coins, stamps, paintings, or other collectibles	$
27.	Firearms, sports, photographic, and other hobby equipment	$
28.	Interest in retirement accounts (IRA accounts, 401(k) accounts, and other retirement accounts)	$
29.	Interest in a pension plan	$
30.	Interest in education accounts	$
31.	Cash value of life insurance	$
32.	Security deposits with landlords, utilities, and others	$
33.	Interests in partnerships	$
34.	Value of investment in a business	$
35.	Other investments (for example, annuity contracts, guaranteed investment contracts, mutual funds, commodity accounts, interests in hedge funds, and options)	$
36.	Other assets not included above	$
37.	**FMV of total assets immediately before the cancellation. Add lines 16 through 36.**	$
Part III. Insolvency		
38.	**Amount of Insolvency.** Subtract line 37 from line 15. If zero or less, you are not insolvent.	**$**

APPENDIX B

IRS Form 982 (Rev. 7-2013) (size reduced)

Source: Internal Revenue Service

Form **982** (Rev. July 2013) Department of the Treasury Internal Revenue Service

Reduction of Tax Attributes Due to Discharge of Indebtedness (and Section 1082 Basis Adjustment)

▶ Attach this form to your income tax return.
▶ Information about Form 982 and its instructions is at *www.irs.gov/form982*.

OMB No. 1545-0046

Attachment Sequence No. **94**

Name shown on return | Identifying number

Part I **General Information** (see instructions)

1 Amount excluded is due to (check applicable box(es)):
- a Discharge of indebtedness in a title 11 case ☐
- b Discharge of indebtedness to the extent insolvent (not in a title 11 case) ☐
- c Discharge of qualified farm indebtedness ☐
- d Discharge of qualified real property business indebtedness ☐
- e Discharge of qualified principal residence indebtedness ☐

2 Total amount of discharged indebtedness excluded from gross income 2

3 Do you elect to treat all real property described in section 1221(a)(1), relating to property held for sale to customers in the ordinary course of a trade or business, as if it were depreciable property? . . . . . ☐ Yes ☐ No

Part II **Reduction of Tax Attributes.** You must attach a description of any transactions resulting in the reduction in basis under section 1017. See Regulations section 1.1017-1 for basis reduction ordering rules, and, if applicable, 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	
10a	Applied to reduce the basis of nondepreciable and depreciable property if not reduced on line 5. *DO NOT use in the case of discharge of qualified farm indebtedness*	10a	
b	Applied to reduce the basis of your principal residence. *Enter amount here ONLY if line 1e is checked*	10b	
11	For a discharge of qualified farm indebtedness applied to reduce the basis of:		
a	Depreciable property used or held for use in a trade or business or for the production of income if not reduced on line 5	11a	
b	Land used or held for use in a trade or business of farming	11b	
c	Other property used or held for use in a trade or business or for the production of income	11c	
12	Applied to reduce any passive activity loss and credit carryovers from the tax year of the discharge	12	
13	Applied to reduce any foreign tax credit carryover to or from the tax year of the discharge	13	

Part III **Consent of Corporation to Adjustment of Basis of Its Property Under Section 1082(a)(2)**

Under section 1081(b), the corporation named above has excluded $ _____ from its gross income for the tax year beginning _____ and ending _____.
Under that section, the corporation consents to have the basis of its property adjusted in accordance with the regulations prescribed under section 1082(a)(2) in effect at the time of filing its income tax return for that year. The corporation is organized under the laws of _____.
(State of incorporation)

Note. *You must attach a description of the transactions resulting in the nonrecognition of gain under section 1081.*

For Paperwork Reduction Act Notice, see page 5 of this form. Cat. No. 17066E Form **982** (Rev. 7-2013)

APPENDIX C

DEFINITIONS[39]

***Qualified Farm Indebtedness* (QFI)** is debt that was incurred directly in connection with the taxpayer's operation of the trade or business of farming, and meets the following qualifications:

1) Fifty percent or more of the taxpayer's total gross receipts for each of the three taxable years, prior to the year of the debt discharge, were from the trade or business of farming; and
2) The cancellation was made by an unrelated individual, organization, partnership, association, corporation, or other person, who is actively and regularly engaged in the business of lending money. This includes any federal, state, or local government or agency or instrumentality of one of those governments; such as the USDA. However, the cancellation cannot have been made by:
    a) the person from whom the taxpayer acquired the property, or a person related to said person (but the exception for seller's reduction of seller-financed debt, discussed ante, may apply; please see Sec. B(3), hereof); or
    b) a person who receives a fee due to the taxpayer's investment in the property, or a person related to said person.

The exclusion for QFI is limited to the sum of 1) the taxpayer's total tax attributes[40] other than basis items (for this purpose, credits and credit carryovers are figured at three times their actual amount), and 2) the total adjusted bases of all property used or held for use in the taxpayer's trade or business or for the production of income.

***Qualified Principal Residence Indebtedness* (QPRI)** is any mortgage that the taxpayer obtained to buy, build, or substantially improve his main home, and which is secured by said home. It also includes a loan, secured by said home, which is used to refinance a loan which was qualified principal residence indebtedness, but only to the extent of the old mortgage principal immediately before the refinancing. Exclusion of discharged QPRI is **limited to $2,000,000** (or $1,000,000 if married filing separately). **The criteria for exclusion of discharge of QPRI are not met** if the discharge occurred on account of any other factor not directly related to 1) a decline in the value of the home, or 2) the taxpayer's financial condition.

> **Practitioner's note:** If the taxpayer cannot exclude discharged debt under the QPRI exclusion, **other exclusions, such as insolvency, may still apply**. The QPRI exclusion does not apply if the debt was discharged due to bankruptcy; in that case, the bankruptcy exclusion should be used. If the taxpayer was insolvent, but not bankrupt, at the time of the cancellation, he has a choice as to which exclusion to use, but may not use both for the same debt. The difference is that the **bankruptcy and insolvency exclusions reduce all tax attributes; whereas the QPRI exclusion reduces only the basis of the home**, which, for most individuals, will not have later adverse tax consequences.

39 IRS Pub. 4681 (2014); 26 USC §108

40 These tax attributes are listed in Table 1, items (c-f), (h), and (i), ante. For further detail, please see IRS Pub. 4681.

Qualified Real Property Business Indebtedness **(QRPBI)** is debt (other than qualified farm indebtedness) that meets **all** of the following conditions.

1) It was incurred or assumed in connection with real property used in a trade or business.

   Note. Residential rental property generally qualifies as trade or business property, unless the taxpayer also uses the dwelling as a home.[41]

2) It is secured by that real property.

   Note. As long as certain other requirements are met, indebtedness that is secured by 100% of the ownership interest in a disregarded entity (e.g., an LLC) holding real property will be treated as indebtedness that is secured by real property.[42]

3) It was incurred or assumed:

   a) Before 1993; or

   b) After 1992, if the debt is either,

      (i) qualified acquisition indebtedness (defined next), or

      (ii) debt incurred to refinance qualified real property business debt incurred or assumed before 1993 (but only to the extent the amount of such debt does not exceed the amount of debt being refinanced).

      Qualified acquisition indebtedness is debt incurred or assumed to acquire, construct, reconstruct, or substantially improve real property that is used in a trade or business and secures the debt, or debt resulting from the refinancing of qualified acquisition indebtedness, to the extent the amount of the debt does not exceed the amount of debt being refinanced.

4) It is debt to which the taxpayer elects to apply the rules for exclusion of QRPBI, including its limitations, and it's requirement to reduce the bases of depreciable real property (but not below zero) by the amount of the discharged debt which is excluded from income.[43]

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41 IRS Pub. 4681(2014), p. 7

42 For more information, and for the requirements that must be met, see Rev. Proc. 2014–20, available at www.irs.gov/irb/2014-9_IRB/ar09.html

43 For limitations, and details of election and application of this exclusion, please see IRS Pub. 4681.