

Forgiven Debt Taxable to the Borrower?

9 Feb 2017

[Roy L. Kaufmann](#)

Generally, if a borrower is required to pay a sum certain at a specific time, the obligation is considered debt under the Internal Revenue Code. If the lender forgives a portion, it has cancelled the debt and the borrower must declare and take into income the dollar amount cancelled. A lender may unilaterally decide that a debt is not collectable and declare the debt cancelled.

A lender may file with the IRS and send to the borrower a [1099-C](#). If a person receives a 1099-C that contains an error, the lender should be contacted quickly to resolve the issue. For example, the debt is probably not cancelled if the lender has persisted in collections efforts after the cancellation date on the 1099-C. Even if the borrower does not receive a 1099c, there is an obligation to include the amount of the cancelled debt on the borrower's tax return.

If the debt is secured by real estate, and the borrower signs a deed in lieu of foreclosure to transfer the property back to the lender, the amount of the outstanding debt must be taken as income by the borrower. Details about this scenario can be found in IRS Publications [544](#) and [523](#).

In some states, when a lender forecloses, the underlying debt cannot be collected and is, thus cancelled debt.

There are two carve-outs from the foregoing:

A. Exceptions to Cancellation of Debt Income.

- 1 Gifts (such as the \$14,000 per person annual exclusion) which should be documented in the form of a letter and delivered to the borrower.
- 2 Forgiveness or Cancellations pursuant to a Will.
- 3 A qualified price reduction offered by a seller of property to the buyer. [See IRS Publication 4681](#)
- 4 Cash basis borrower: amount of debt that would be deductible [Buy-For-Performance Success Payments](#) that reduce a mortgage balance under the [Home Affordable Modification](#)
- 5 Some student debt if the student works in certain professions. [See IRS Publication 4681](#)

B. Cancellations that are, nevertheless EXCLUDED from Gross Income:

[Title 11 Bankruptcy debt cancellations](#)

- 1 Debt cancelled during insolvency



Worthwhile Legal News and Commentary

(CONTINUED)

FORGIVEN DEBT TAXABLE TO THE BORROWER?

Qualified farm debt

[Qualified real property business debt](#)

[Qualified Principal Residence indebtedness](#) which, at the moment, only applies to transactions evidenced in writing before January 1, 2017 (Laws may change to extend that date).

Notes:

In order to exclude these items, an [IRS Form 982](#) will need to be filed with the IRS Form 1040 or applicable return.

In order for income to be excludable from State taxation, the State's laws must conform to the federal laws. For example, in Hawaii, there was a delay in conforming the laws, so a borrower was counseled to file an extension of the tax return until the laws were conformed.

The rules, as set forth above, can become more difficult to navigate in complex matters or when there is nonrecourse debt. Jackson & Campbell, P.C. stands by to assist lenders and borrowers confronted with these scenarios.

TAGGED: [bankruptcy](#), [irs](#), [taxes](#), [2016 taxes](#), [2017 taxes](#), [chapter 11](#), [chapter 7](#), [debt](#), [Federal taxes](#), [tax](#)