Cancellation of Debt

Background

A taxpayer who receives funds through a loan or buys products or services on credit does not report those transactions as income. Since the taxpayer is obligated to repay the funds to the lender/pay for products and services purchased, she is only making temporary use of the money. However, if the lender or other creditor releases the taxpayer from her payment obligation, she has received a benefit for which she has not paid and may be required to report it as income in the year the debt is cancelled.

Taxpayers who are beneficiaries of debt cancellation may receive a Form 1099-C from the creditor. Receiving a 1099-C does not necessarily mean that the income is taxable. **Taxpayers wanting to dispute a 1099-C entry can be referred to Texas RioGrande Legal Aid (http://www.trla.org/office/austin or 1-888-988-9996).** This referral is preferably done before the return is filed but can also be done after.

Foundation Communities Policy

All VITA volunteers who assist clients with cancellation of debt must complete certification in Advanced tax preparation. If no such certified preparer is available when a client requires assistance, see your site manager for available options.

How To Assist Tax Clients

Only two categories of cancelled debt are in scope for VITA tax preparation:

1. Consumer Credit Card Debt
Cancellation of non-business credit card debt may be non-taxable if at the time of the cancellation the taxpayer was insolvent or had filed bankruptcy. The screening sheet for cancellation of credit card debt is found of page D-58 of Publication 4012. To determine insolvency, use the worksheet on page D-59 of Publication 4012. If the taxpayer was insolvent, then preparation of her return is considered out-of-scope. Refer such clients to the CTC out-of-scope project; see your site manager for details.

Taxpayers must report taxable cancellation of non-business credit card debt as ordinary income on Form 1040, line 21. In TaxSlayer, on the *Less Common Income* page, click Begin on the *Cancellation of Debt* line. Enter the information from the client's Form 1099-C. A screen shot of these steps is shown on page D-60 of Publication 4012.

2. Qualified Principal Residence Debt
Cancellation of mortgage debt is often associated with an exchange of the related mortgaged real property, which may need to be reported on Form 8949. Properly reporting such a transaction may require a calculation of any gain or loss from the exchange. Use the attached Table 1-1 *Worksheet for Foreclosures and Repossessions*, excerpted from IRS Publication 4681.

The qualifications for cancellation of mortgage debt are found on pages Ext-1, Ext-2, and Ext-3 of Publication 4012. The process for entering this cancellation of mortgage debt is found on page Ext-4 and Ext-5 of Publication 4012.

Under the Mortgage Forgiveness Debt Relief Act, taxpayers may exclude from income up to $2 million in cancelled debt on their principal residence. The provisions of this Act were extended by the Protecting Americans from Tax Hikes Act of 2015 to apply to foreclosures on principal residences that occur through 2016. For taxpayers who receive Form 1099-C as a result of foreclosure on their home during this period and are eligible to exclude the cancelled mortgage debt from taxable income, click on *Exclusions* (Form 982) on the *Cancellation of Debt* page. Enter the amount to be excluded. Click the box for “Discharge of qualified principal residence indebtedness”. Also enter the excluded amount under the second line titled “Basis of nondepreciable and depreciable property”. (Caution: This procedure may change in the final released version of TaxSlayer.)

Table 1-1. **Worksheet for Foreclosures and Repossessions** *Keep for Your Records*

Part 1. Complete Part 1 only if you were personally liable for the debt (even if none of the debt was canceled). Otherwise, go to Part 2.	
1. Enter the amount of outstanding debt immediately before the transfer of property reduced by any amount for which you remain personally liable immediately after the transfer of property	
2. Enter the fair market value of the transferred property	
3. Ordinary income from the cancellation of debt upon foreclosure or repossession.* Subtract line 2 from line 1. If less than zero, enter zero. Next, go to Part 2	
Part 2. Gain or loss from foreclosure or repossession.	
4. Enter the **smaller** of line 1 or line 2. If you did not complete Part 1 (because you were not personally liable for the debt), enter the amount of outstanding debt immediately before the transfer of property	
5. Enter any proceeds you received from the foreclosure sale	
6. Add line 4 and line 5	
7. Enter the adjusted basis of the transferred property	
8. Gain or loss from foreclosure or repossession. Subtract line 7 from line 6	
* The income may not be taxable. See chapter 1 for more details.	

2.

Foreclosures and

Amount realized and ordinary income on a recourse debt. If you are personally liable for the debt, the amount realized on the foreclosure or repossession includes the smaller of:

- The outstanding debt immediately before the transfer reduced by any amount for which you remain personally liable immediately after the transfer, or
- The FMV of the transferred property.

$1,000 for which she remains personally liable immediately after the repossession ($10,000 – $1,000 = $9,000), or
- The $9,000 FMV of the car.

Tara figures her gain or loss on the repossession by comparing the $9,000 amount realized with her $15,000 adjusted basis. She has a $6,000 nondeductible loss. After the cancellation of the remaining balance on the loan in November, Tara also has ordinary income from cancellation of debt in the amount of $1,000 (the remaining balance on the $10,000 loan after the $9,000 amount satisfied by the FMV of the repossessed car). Tara must report this $1,000 on her return unless one of the exceptions or exclusions described in chapter 1 applies.

Example 2. Lili paid $200,000 for her home. She made a $15,000 downpayment and borrowed the remaining $185,000 from a bank. Lili is personally liable for the mortgage loan and the house secures the loan. In 2014, the bank foreclosed on the mortgage because Lili stopped making payments. When the bank foreclosed the mortgage, the balance due was $180,000, the FMV of the house was $170,000, and Lili's adjusted basis was $175,000 due to a casualty loss she had deducted. At the time of the foreclosure, the bank forgave $2,000 of the $10,000 debt in excess of the FMV ($180,000 minus $170,000). She remained personally liable for the $8,000 balance.

In this case, Lili has ordinary income from the cancellation of debt in the amount of $2,000. The $2,000 income from the cancellation of debt is figured by subtracting the