

The Tax Consequences of Debt Relief: What You Should Know before Settling, Modifying, Defaulting, or Declaring Bankruptcy

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Millions of American consumers have been enticed into following the siren song of Wall Street's marketing mavens into burdensome credit card debt, seductive home equity loans and unaffordable exotic mortgages. As with the sirens of folklore, easily accessed and overly-abused credit has lead many into financial intensive care. Now media outlets are saturated with ads for companies promoting "pennies on the dollar" debt settlement programs, home saving mortgage loan modifications, and bankruptcy cure-alls for our financial woes. While some of these options may provide some legitimate debt relief, they may also produce adverse tax consequences which could make the "cure" worse than the problem. This article examines the potential adverse tax consequences for some of the most used debt reduction strategies.

General Rule

The default rule, Internal Revenue Code § 61(a) (12), states that any reduction or cancellation of debt is considered taxable income. Most recipients of debt reduction or cancellation will receive a Form 1099-A or 1099-C, stating the amount of income received, in time for tax preparation. Luckily, for many consumers plagued by debt, exemptions to including the income will most likely apply. The most useful exemptions are listed in Internal Revenue Code § 108 and include debt reductions in bankruptcy, when the debtor is insolvent, and recently added provisions focused on mortgages on primary residences.

An important note: Debt relief, cancellation or forgiveness only applies when there is a reduction in the principal amount owed. Lowered interest rates, payment forbearance programs, and extensions of time to pay may have other consequences but not the ones discussed below.

Bankruptcy

When considering bankruptcy, the average consumer usually has two choices: a chapter 7, in which the debtor does not have to repay any of the debt or a chapter 13 which requires a period of repayment before the debt is discharged. In both cases, any debt eliminated through a bankruptcy is not taxable. It is important to keep in mind that filing bankruptcy can adversely affect many other parts of your life and should not be entered into lightly. If you are considering bankruptcy, it is highly recommended that you speak with an attorney to evaluate your options and the consequences.

Insolvency

Many times excess debt can be eliminated without resorting to bankruptcy, often through "debt settlements" with various creditors or collection agencies. While some consumers enter into settlements to get out of paying all that they owe, most consumers do it because they owe far more than they can ever reasonably pay off. Usually owing more than you can ever repay is a hallmark of insolvency, which has a technical definition of having more liabilities (debt) than assets (things worth something). Internal Revenue Code §108 allows a taxpayer to exempt debt cancellation income to the extent the taxpayer is insolvent

immediately before the cancellation. While this may seem as clear as mud, the following examples should provide some clarity:

Ex. 1: Joe is sinking in debt and dodging calls from collection agencies every day. One day, his father gives him some money and he uses it to settle with his various creditors. On the morning of the settlement he has the following:

Assets: \$7,000 Liabilities: \$20,000

As we can see, Joe owes \$13,000 more than he has, so he is insolvent to the extent of \$13,000. Using the money his father gave him, he paid off all of his debts for \$15,000. He received debt cancellation income in the amount of \$5,000 as his creditors accepted his settlement as payment in full. To determine how much is taxable, we compare Joe's \$13,000 insolvency and \$5,000 in debt cancellation income. Since he was more insolvent than the amount of his debt cancellation income, all of the \$5,000 is considered non-taxable.

Ex. 2: Amy, tired of making endless payments on her credit cards, looks to settle with her creditors. They agree to accept a settlement payment which leaves Amy with \$7,500 in cancelled debt. However, she wants to know how much she has to include as income.

We begin as we did in example 1, calculating how insolvent Amy is on the day of cancellation. That day, Amy had assets of \$15,000 and liabilities of \$20,000, making her insolvent to the extent of \$5,000. However, she received \$7,500 in debt cancellation, more than her insolvency. Therefore Amy can exclude \$5,000 of the debt cancellation income but must include the remaining \$2,500 as taxable income.

Mortgage Debt Cancelled

In response to the on-going mortgage crisis, the government enacted the Mortgage Forgiveness Debt Relief Act of 2007, which applied to debt forgiven through 2009. Later legislation extended the debt forgiveness period to December 31, 2012. The Act allows that debt secured by a taxpayer's primary residence, up to \$2,000,000 in loan value, may be excluded from taxable income.

However, not all debt secured by a home automatically qualifies for exclusion. The Act only applies to debt that was incurred to buy, build, renovate, or refinance debt for those reasons. This legislation holds great relief for many troubled homeowners seeking loan modifications or those who have succumbed to foreclosure. Since the Act is written in typical tax jargon, I'm going to provide a couple of examples.

Ex. 3: Sam purchased a \$475,000 house in 2006, using a down payment of \$50,000 and financing the rest through a mortgage. In early 2008, Sam lost his job and quickly lost any hope of making his mortgage payments. Early in December 2008, the bank finally foreclosed on the property. On the day of the foreclosure Sam owed \$405,000 on his mortgage but the house was worth only \$355,000. A few days after the foreclosure, the bank cancelled the remainder of the mortgage due. Even though Sam received a 1099-C reflecting \$50,000 in debt cancellation (\$405,000 owed - \$355,000 value of the house), he can exclude the entire amount under the Mortgage Debt Relief Act of 2007.

Ex. 4: John and Mary Smith purchased a \$300,000 home in 2000 and were never late with their mortgage payments. In late 2005, they decided to refinance their home to pay off some credit cards, John's remaining student loans, and buy a car. At the time of the refinancing, the mortgage had \$252,000 remaining and the house was appraised at \$575,000. The Smiths decided to refinance for \$500,000. In early 2008, the Smiths were unable to continue making their mortgage payments and the mortgage fell into default. At the time of the default, the home was worth \$380,000, even though the Smiths owed \$434,000 on the mortgage. Fortunately, the bank agreed to a short sale for \$380,000, with \$368,000 going toward the mortgage and the remainder for transactional fees. The bank also cancelled the rest of the mortgage.

Early the next year, the Smiths received a 1099-C indicating \$54,000 in debt cancellation income. Even though it appears as though the Smiths do not have recognizable income since the debt relief came from their mortgage, initial appearances can be deceiving. When the Smiths refinanced the home, they only owed \$252,000 on their mortgage and used the rest of the refinanced mortgage for cars and other debt. Since the amount spent on debt not incurred to buy, build, or renovate a home exceeds the amount of the cancelled debt, none of the cancelled loan amount is excludible. This means that the Smiths must pay income taxes on the entire \$54,000 amount.

It is important to note that the exclusions discussed above do not work in isolation and a taxpayer can use combinations of the three exemptions discussed above, as well as others available, to exclude as much debt cancellation income as possible. Since debt cancellation can have significant tax consequences, not to mention other financial ramifications, it is important to discuss the effects of any debt cancellation plans with a qualified attorney or tax professional.

The above article is general and educational in nature. For specific questions regarding bankruptcy, loan modification, or tax issues, please contact the attorneys of Green & Campbell, LLP at 805-306-1100, via e-mail to Audrey@gdclawyers.com, or visit our website at www.gdclawyers.com.