Cancelled Debt is Considered Taxable Income

For anyone who's ever been in a serious debt, getting the credit card company or any other creditors to reduce or even cancel your debt seems like the best thing that could ever happen to you and your family. Ideally, you will have a clean record and you'll no longer suffer the burden of having to pay a substantial debt. Often, people don't realize that if they are not careful, and do not prepare properly, then they're actually setting themselves up for a potential IRS problem. The fact is, the IRS treats the reduced or cancelled debt as taxable income, hence, you will be required to pay taxes on this. So the next time that you get your credit card or other creditors to reduce or cancel your debt, know that you will automatically be in debt to the IRS. This is among the basic guidelines concerning cancelled or reduced debt.

Until recently, it was rather easy to accumulate credit. For the earlier part of the decade, many could get loans and be approved for credit cards with relatively little difficulty. Many people spent uncontrollably and accumulate substantial sums of debt. Too much have they spent that they lose track of their financial capability to realistically pay off their debts.

Banks understand that they cannot send people to jail just for being in massive debt. In most cases, banks and other creditors hire a specialized collections firm so the latter will be the ones to collect from delinquent payers. Payment to these firms is dependent on how successful they are at collecting money. Now, back on the effect of a reduced or cancelled debt on your taxes. For instance, if you've successfully convinced your creditor to reduce your $20,000 debt to only $10,000, that $10,000 will be considered by the IRS as income. This will fall under income from another source and with that, the reduced debt will be considered taxable.

The IRS will definitely know of a reduced tax because your creditors will forward to them a copy of your Form 1099-C. This will be considered as part of your other income, which is written on line 21 of Form 1040. In the above example, instead of paying to your creditors, you will now be paying a certain percentage of $10,000 to the IRS. Thus, tax reduction will lead to more taxes as this will be added on top of your regular and state taxes. This is why before requesting your creditors to have your debts reduced, you have to understand first what the consequences of that move are.

Unlike regular creditors, the government can send you to jail if you consistently don't settle your taxes. It is a good thing, however, that certain measures are available to assist those who are in need. For example, if your home loan is reduced from $200,000 to $100,000, the other $100,000 should be reported to the IRS and shall be counted as part of your other income. With such an amount of money to pay taxes on, it is rather likely that you'll be bumping into an IRS trouble. Fortunately in 2007, Congress has passed a policy specifying that tax reductions amounting up to $2 million and attached to your primary residence are to be excluded from your 2007, 2008 and 2009 tax returns. In our example above, you'll be exempted from paying taxes on the tax reduction because of this new law. On another light, the government also provides a number of remedies for tax payments on reduced debt. It is best that you refer to a tax professional first before availing any of these procedures.