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Doron F. Eghbali Taxation Law

Debt Forgiveness May Increase Your Tax Bill

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Everybody with forgiven debt should feel exhilarated. Nonetheless, such exhilaration might be premature as the individual might have to pay taxes on the forgiven debt, unless an exemption applies. Let us review some of these exemptions and further analyze this rather unfortunate topic.

DEFINITION OF CANCELLATION OF DEBT INCOME

Cancellation of debt income occurs when a lender forgives some or all of our debt, we would have otherwise had to pay. Generally, cancellation of debt income is taxable and the lender is required to report the amount to you and the IRS in the year the cancellation of debt income occurs.

Nonetheless, there are some favorable exceptions we could use to avoid cancellation of debt income. Here are *some* of these exceptions, hopefully, most helpful to us.

1. BANKRUPTCY EXCEPTION

If the cancellation of debt income occurs while the borrower IS involved in Title 11 bankruptcy proceedings, then the cancellation of debt income is COMPLETELY exempt from FEDERAL taxes. Title 11 bankruptcy proceedings include:

- Chapter 7 (Liquidations)
- Chapter 11 (Reorganizations)
- Chapter 13 (Wage-Earner Filings)

CAVEAT

Since 2005, it is more difficult to file for chapter 7 bankruptcy. Therefore, it is much harder to be exempted totally from unsecured debts such as credit card debt.

2. INSOLVENCY EXCEPTION

Let us first define insolvency for the purposes of cancellation of debt income exception. Insolvency is when debts exceed assets. In this situation, if borrower is insolvent BUT NOT IN BANKRUPTCY before the cancellation of debt income occurs, then the cancellation of debt income is COMPLETELY exempted from FEDERAL taxes, TO THE EXTENT of the insolvency.

3. HOME MORTGAGE EXCEPTION

Through 2012, this exception provides some solace for sold undervalued properties. Undervalued properties are those whose mortgage is more than their fair market value.

To qualify for this exception, taxpayers need not be bankrupt or insolvent and such exception affords qualified principal residence owners of up to $2 million dollars in federal tax exemptions.

CAVEAT

This is very important to note the home mortgage exception ONLY applies to the money used to purchase, improve or build that residence. In addition, such money MUST be secured by such residence. Refinanced debt is applicable to the extent it replaces the money used to build, improve or purchase the residence.

In addition, you MUST reduce your tax basis in the residence, but NOT below zero, to the extent of the cancellation of debt income.

4. DEDUCTIBLE INTEREST EXCEPTION

If the cancellation of debt income includes unpaid interest on a loan's principal, the unpaid interest would be exempted from federal taxes. In fact, any unpaid interest that COULD HAVE BEEN DEDUCTED if you had paid it, is free from federal income taxation. This situation happens in forgiven principal residence mortgage interest, vacation home mortgage interest and rental property mortgage interest.

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