

# Your Debt is Forgiven — But is it Still Taxable?



AMIT PATEL

Over the past few years, our community has been hit with an unprecedented wave of foreclosures, short sales and bankruptcies.

Many people facing financial hardship often ask about the tax consequences associated with debt forgiveness. Generally, if you have borrowed money from a lender and that debt is forgiven, you must report the cancellation-of-debt as income for federal tax purposes. For example, if you borrow \$10,000 from your bank and your bank eventually forgives the entire amount of the debt, you will have to report \$10,000 as ordinary income on your tax return.

There is good news for those who are concerned about large tax obligations resulting from debt forgiveness. The IRS has promulgated some key exceptions to the cancellation-of-debt rules that allow certain taxpayers facing financial distress to avoid taxation on debt forgiveness. The following are common situations where cancellation-of-debt income is not taxable:

- Homeowners who have had their debt discharged on their principal residence. The Mortgage Forgiveness Debt Relief Act of 2007, which has been extended to Dec. 31, 2012, provides tax relief for those facing foreclosure or modification on their principal residence. Only the first \$2 million of forgiven debt (for married couples) is eligible for the

exclusion and the debt must be secured by the principal residence.

- Debts discharged through Chapter 7 or 13 bankruptcy.

- Legal insolvency when the debt is canceled. The insolvency exclusion can only be used if the taxpayer can prove to the IRS that his/her total debts exceeded the total fair market value of the assets.

- Certain student loans that are canceled if the taxpayer fulfills a loan provision requirement to work in a certain profession for a specified period of time.

It is important to note that the taxpayer's situation will often dictate whether cancellation-of-debt is considered taxable or not. For instance, under the Mortgage Forgiveness Debt Relief Act of 2007, loans secured by vacation homes would not be exempt from taxation because the debt is not secured by the taxpayer's principal residence. Also, loans or lines of credit used for personal expenses that are secured by the taxpayer's principal residence will not be exempt and could create taxable income. A homeowner may not be eligible for exclusion under the act, but that does not necessarily mean that he/she is automatically subject to cancellation-of-debt taxation. The homeowner may find amnesty under another exemption, such as the insolvency exemption, if certain requirements are met.

There are many other exemptions to the cancellation-of-debt income rules



and there are just as many limitations on what income is allowed to be excluded from taxation under current law. Those seeking amnesty from taxation on debt forgiveness should consult their tax adviser and appropriate legal counsel to fully understand their debt forgiveness tax obligations.

*Amit Patel is a licensed Certified Public Accountant and CERTIFIED FINANCIAL PLANNER™ practitioner with A.P. Accounting & Tax Services in Sanford. His practice areas include tax planning, financial planning and business consulting. To learn more about A.P. Accounting & Tax Services, visit [www.apfcpa.com](http://www.apfcpa.com).*