TAX YEAR 2021

Cancellation of Debt — Insolvency

ACCUSURE TAX

HELPING SMALL BUSINESS AND FAMILIES MANAGE THEIR FINANCIAL AND INSURANCE AFFAIRS

Cancellation of Debt — Insolvency

If some or all of your debt is cancelled, the amount of cancelled debt is generally taxable and must be reported on your return. However, you may be able to exclude the cancellation of debt income to the extent you were insolvent immediately before the cancellation. If cancelled debt is excluded from income, it is nontaxable.

Cancellation of Debt

Cancellation of debt (COD) is settlement of a debt for less than the amount owed. A debt may be cancelled by a lender voluntarily or through bankruptcy or other legal proceedings and may result in ordinary income, income from the sale of assets, or both.

Cancelled Debt Situation	Tax Treatment
Debt owed is cancelled or forgiven.	Amount cancelled or forgiven is generally taxable as ordinary income from cancellation of debt.
Property that is security for a debt is taken by the lender in full or partial satisfaction of that debt.	The transaction is treated as a sale of the property, which may result in a gain or loss.
Property that is security for a debt is taken by the lender, and lender cancels recourse debt in excess of FMV of property taken.	Excess of cancelled debt over FMV is ordinary income from cancellation of debt, in addition to any gain or loss from the sale.
Cancelled debt is intended as gift.	Amount cancelled is not income.*
* Gift tax may apply.	

Form 1099-C, *Cancellation of Debt*

If a lender cancels or forgives a debt of $600 or more, it must provide the borrower with Form 1099-C, showing the amount of cancelled debt to be reported as income. Generally, you must include all cancelled amounts, even if less than $600, as Other Income on Form 1040.

Examples of COD Income

Nonbusiness credit card debt cancellation. If nonbusiness credit card debt is cancelled, you may be able to exclude the cancelled debt from income up to the extent you are insolvent.

Personal vehicle repossession. If you had a personal vehicle repossessed during the year, the transaction is treated as a sale, and gain or loss on the repossession must be computed. If the lender also cancels all or part of the remaining debt, you may be able to exclude the cancelled debt from income to the extent you are insolvent.

Insolvency

You are insolvent to the extent that the total of all your liabilities exceeds the fair market value (FMV) of all your assets immediately before the cancellation of debt.

For purposes of determining insolvency, assets include the value of everything you own, including assets that serve as collateral for debt and exempt assets which are beyond the reach of creditors, such as the value of a retirement account. A recourse debt holds the borrower personally liable. A nonrecourse debt does not allow the lender to pursue anything other than the collateral. Liabilities include:

- The entire amount of recourse debts,
- The amount of nonrecourse debt that is not in excess of the FMV of the property that is security for the debt, and
- The amount of nonrecourse debt in excess of the FMV of the property subject to the nonrecourse debt to the extent nonrecourse debt in excess of the FMV of the property subject to the debt is forgiven.

Do not forget to include the amount of debt that was cancelled as part of your liabilities.

Cancellation of Debt — Insolvency

Insolvency Worksheet

All amounts listed should be immediately before the debt cancellation.

Liabilities

1) Credit card debt .... 1) ______
2) Mortgages (and home equity loans) .... 2) ______
3) Car and other vehicle loans .... 3) ______
4) Medical bills owed .... 4) ______
5) Student loans .... 5) ______
6) Accrued or past-due bills owed .... 6) ______
7) Federal or state income taxes remaining due for prior tax years .... 7) ______
8) Judgments .... 8) ______
9) Business debts .... 9) ______
10) Other loans and past-due bills .... 10) ______
11) Total liabilities. Add lines 1 through 10 .... 11) ______

Assets

12) Cash and bank account balances .... 12) ______
13) FMV real estate .... 13) ______
14) FMV vehicles .... 14) ______
15) FMV household items (computers, tools, jewelry, clothing, appliances, furniture, etc.) .... 15) ______
16) Retirement accounts, IRAs, etc. .... 16) ______
17) Cash value of life insurance .... 17) ______
18) Stocks and bonds .... 18) ______
19) Interest in education account .... 19) ______
20) Investments in collectibles .... 20) ______
21) Security deposits .... 21) ______
22) Interests in partnerships .... 22) ______
23) Value of investment in business .... 23) ______
24) Other assets .... 24) ______
25) Total assets. Add lines 12 through 24 .... 25) ______
26) Amount of insolvency. Subtract line 25 from 11 .... 26) ______

If zero or less, you are not insolvent. If over zero, the amount is the extent to which you are insolvent.

Example #1 – Amount of Insolvency More Than Cancelled Debt

Jill was released from her obligation to pay her personal credit card debt in the amount of $5,000. Jill received a Form 1099-C from her credit card lender showing cancelled debt of $5,000. Jill uses the insolvency worksheet to determine that her total liabilities immediately before the cancellation were $15,000 and the FMV of her total assets immediately before the cancellation was $7,000, which means that immediately before the cancellation, Jill was insolvent to the extent of $8,000 ($15,000 total liabilities minus $7,000 FMV of her total assets). Because the amount by which Jill was insolvent immediately before the cancellation was more than the amount of her debt cancelled, Jill can exclude the entire $5,000 cancelled debt from income.

Example #2 – Amount of Insolvency Less Than Cancelled Debt

Assume the same facts as Example #1, except that Jill's total liabilities immediately before the cancellation were $10,000 and the FMV of her total assets immediately before cancellation were $7,000. In this case, Jill is insolvent to the extent of $3,000 ($10,000 total liabilities minus $7,000 FMV of her total assets) immediately before the cancellation. Because the amount of the cancelled debt was more than the amount by which Jill was insolvent immediately before the cancellation, Jill can exclude only $3,000 of the $5,000 cancelled debt from income under the insolvency exception. Jill must include $2,000 of cancelled debt as an addition to her income, unless another exclusion applies.

Form 982

Form 982, *Reduction of Tax Attributes Due to Discharge of Indebtedness,* is used to exclude cancelled debt from income due to insolvency and also to indicate a reduction in tax attributes for certain assets, if required.

Reduction of Tax Attributes

If cancelled debt is excluded from income, you must reduce certain tax attributes by the amount excluded. Tax attributes include the basis of certain assets, losses, and credits. By reducing the tax attributes, the tax on the cancelled debt is partially postponed instead of being entirely forgiven. This prevents an excessive tax benefit from the debt cancellation.

Contact Us

There are many events that occur during the year that can affect your tax situation. Preparation of your tax return involves summarizing transactions and events that occurred during the prior year. In most situations, treatment is firmly established at the time the transaction occurs. However, negative tax effects can be avoided by proper planning. Please contact us in advance if you have questions about the tax effects of a transaction or event, including the following:

- Pension or IRA distributions.
- Significant change in income or deductions.
- Job change.
- Marriage.
- Attainment of age 59½ or 72.
- Sale or purchase of a business.
- Sale or purchase of a residence or other real estate.
- Retirement.
- Notice from IRS or other revenue department.
- Divorce or separation.
- Self-employment.
- Charitable contributions of property in excess of $5,000.