PUBLICATION

Cancellation of Indebtedness Income

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As a general rule, when a debt is cancelled or becomes unenforceable, the debtor recognizes cancellation of debt income (COD).

The principal exceptions are the following:

a) The discharge occurs in a Title 11 (bankruptcy) case. The taxpayer must be under the jurisdiction of the bankruptcy court and the discharge must be granted by the court or must be under a plan approved by the court.

b) The discharge occurs when the taxpayer is insolvent. The determination is based on the amount of liabilities and the value of the assets immediately before the discharge.

c) The debt discharged is "qualified farm indebtedness." Qualified farm indebtedness is debt incurred directly in the operation of a farm.

d) In the case of a taxpayer other than a C corporation, the indebtedness discharged is "qualified real property indebtedness." Unlike the other exceptions, this one is elective as there are side effects from non-recognition of COD income. Qualified real property indebtedness is debt incurred or assumed after 1992 to acquire, construct, or substantially improve real property used in a trade or business.

e) The indebtedness is "qualified principal residence indebtedness" which is discharged after 2006 and before 2013. The exclusion is available for debt secured by a principal residence and only if the discharge is related to a decline in the value of the residence or to the financial condition of the taxpayer.

Forgiveness of COD income requires reduction of various tax attributes. The attributes required to be reduced are as follows, in the indicated order:

1. Net operating loss carryovers;
2. General business credits;
3. Minimum tax credits;
4. Capital loss carryovers;
5. Basis of depreciable property;
6. Passive activity loss and credit carryovers; and
7. Foreign tax credit carryovers.

In practical terms, whenever debt is cancelled, the practitioner should ascertain whether there is a loss deduction to use to offset it, without having to rely on the exceptions.