Internal Revenue Service

United States Department of the Treasury

Topic 431 - Canceled Debt -Is it Taxable or Not?

In general, if a debt for which you *w*ere personally liable is canceled or forgiven, other than as a gift or bequest, you may have to include the canceled amount in gross income. Depending on the circumstances by which your debt was canceled and the nature of any property associated with the debt, the canceled debt *may* qualify for an exception to resulting in gross income, or the canceled debt may result in gross income but the income may be excluded.

A debt includes any indebtedness for which you are liable or which attaches to property you hold. If property is associated with a debt, a cancellation of all or part of the debt may occur as a result of foreclosure proceedings on the property, repossession of the property, your return of the property to the lender or your abandonment of the property. Regardless of the factors relating to the cancellation, you must report any taxable amount as ordinary income from the cancellation of debt on Form 1040 or Form 1040NR and associated sub-schedules as advised in IRS Publication 4681, *Canceled Debts, Foreclosures, Repossessions, and Abandonments*

If a federal government agency or an applicable financial entity cancels or forgives a debt you owe of $600 or more, you should receive a Form 1099-C, *Cancellation of Debt,* showing amounts and other information relating to the cancellation. The amount of canceled debt is shown in Box 2 of the form.

Canceled Debts that meet the requirements for any of the following exceptions or exclusions will not be taxable.

Canceled Debt that Qualifies for Exception to Resulting In Gross Income:

1. Amounts specifically excluded from income by law such as gifts or bequests
2. Cancellation of certain qualified student loans
3. Canceled debt that, if paid by a cash basis taxpayer, is otherwise deductible
4. A qualified purchase price reduction given by a seller

Canceled Debt that Qualifies for Exclusion from Gross Income:

1. Cancellation of qualified principal residence indebtedness
2. Debt canceled in a Title 11 bankruptcy case
3. Debt canceled due to insolvency
4. Cancellation of qualified farm indebtedness
5. Cancellation of qualified real property business indebtedness

The exclusion for "qualified principal residence indebtedness", enacted by the 2007 Mortgage Relief Act, now provides additional canceled debt tax relief for many American home owners involved in the mortgage foreclosure crisis currently affecting much of the country. The Act allows taxpayers to exclude up to $2,000,000 of "qualified principal residence indebtedness".

Generally, if you exclude canceled debt from income under one of the exclusions listed above, you must also reduce your tax attributes (certain credits, losses, and basis of assets) by the amount excluded. You must file Form 982, *Reduction of* Tax *Attributes Due to Discharge of Indebtedness (and* Section *1082 Basis Adjustment ,* to report the exclusion and the corresponding reduction of certain tax attributes.

Refer to Publication 4681, *Canceled Debts, Foreclosures, Repossessions, and Abandonments,* for more detailed information regarding: taxability of canceled debt, how to report it, and related exceptions and exclusions. Additional information can also be found in Publication 525, *Taxable and Nontaxable Income.*

Caution: If you have property that is security for a debt and that property is taken by the lender in full or partial satisfaction of your debt, you will be treated as having sold that property and may have gain or loss as a result. The gain or loss on such a deemed sale of your property is a separate issue from whether any canceled debt also associated with that same property is includable in gross income. See IRS Publication 544, *Sales and other Dispositions* of *Assets,* for detailed information on reporting gain or loss from repossession, foreclosure or abandonment of property.

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