

CANCELLATION OF DEBT INCOME AND INCOME TAX TREATMENT IN INDIVIDUAL BANKRUPTCY PROCEEDINGS

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I. CANCELLATION OF DEBT INCOME

A. Introduction: The forgiveness of debt by a creditor may not provide complete relief.

B. Internal Revenue Code Section 61:

1. Gross Income includes “income from discharge of indebtedness.”

2. Cancellation of Debt Income:

a. Example: Suppose you have a client with a \$20,000.00 credit card balance that she is unable to pay. A settlement is reached with the credit card company in which it agrees to a one-time, lump-sum payment of \$10,000.00 in full satisfaction of the \$20,000.00 debt. That is \$10,000.00 less than your client is obligated to pay and according to the IRS, that \$10,000.00 is reportable as “other income” on your client’s tax forms.

b. Most creditors and debt collectors are required to report the cancelled debt to both the debtor and the IRS on a Form 1099-C.

c. These include:

i. Financial Institutions.

ii. Any of the following, its successor, or sub-unit:

- aa. The Federal Deposit Insurance Corporation (FDIC);
 - bb. The Resolution Trust Corporation (RTC);
 - cc. The National Credit Union Administration (NCUA); or
 - dd. Any other federal executive agency, including government corporations, any military department, the U.S. Postal Service, or the Postal Rate Commission.
- iii. A corporate subsidiary of a financial institution or credit union (if the affiliation subjects the subsidiary to federal or state regulation).
 - iv. A federal government agency, including a department, an agency, a court or court administrative office, or a judicial or legislative instrumentality.
 - v. Any organization a significant trade or business of which is lending money.

C. Exceptions to Cancellation of Debtor Income:

- 1. Amounts cancelled as gifts, bequests, devises, or inheritances.
- 2. Certain qualified student loans cancelled under provisions that the loans would be cancelled if you work for a certain period of time in certain professions for a broad class of employers.
- 3. Certain other education loan repayment or loan forgiveness programs to help provide health services in certain areas.

4. Amounts of cancelled debt that would be deductible if you, as a cash basis taxpayer, paid it.
5. A qualified purchase price reduction given by the seller of property to the buyer.
6. Any Pay-for-Performance Success Payments that reduce the principal balance of your home mortgage under the Home Affordable Modification Program.
7. Amounts from student loans discharged on the account of death or total and permanent disability of the student.

D. Exclusion from Gross Income:

1. Debt cancelled in a Title 11 bankruptcy case.
2. Debt cancelled during insolvency.
3. Cancellation of qualified farm indebtedness.
4. Cancellation of qualified real property business indebtedness.
5. Cancellation of qualified principal residence indebtedness that is discharged subject to an arrangement that is entered into and evidenced in writing before January 1, 2018.

E. Debt Secured by Property:

1. If property secures the debt and the creditor takes that property in full or partial satisfaction of the debt, it is treated as a sale of that property to the creditor. The tax treatment depends on whether the debtor was personally liable for the debt or not.
 - a. If personally liable, the amount realized is the fair market value of the property. The cancellation of debt income is

the amount of the debt in excess of the fair market value of the property that the lender forgives. It must be included as income unless an exception or exclusion applies. The difference between the fair market value and the adjusted basis (usually the cost) will be a gain or loss on the disposition of the property. The character of the gain or loss depends on the character of the property.

- b. If not personally liable for the debt, the amount realized is the entire amount of the debt plus the amount of cash and the fair market value of any property you received. There will be no cancellation of debt income.

2. Examples:

- a. Rob buys a ski boat for \$40,000. Rob pays \$10,000 down and signs a personally guaranteed note for \$30,000. The boat dealer takes a security interest in the boat. After paying down \$5,000 on the note, Rob defaults on the loan. The boat is repossessed, which is now worth \$21,000. Rob will have cancellation of debt income of \$4,000 (\$25,000 remaining debt owed minus \$21,000 FMV of boat). Rob has a \$19,000 loss on the disposition of the boat, which is the difference between the boat's fair market value of \$21,000 (the amount realized on repossession) minus \$40,000 (the adjusted basis in the boat).
- b. The facts are the same except that Rob signed a note that does not give the boat dealer any recourse against him personally. When the dealer repossesses the boat, Rob has a loss of \$15,000, the difference between the

\$25,000 amount realized (the face amount of the remaining debt) and \$40,000 (the adjusted basis in the boat). Rob will have no cancellation of debt income.

F. Debt Cancelled During Insolvency:

The insolvency exclusion from Cancellation of Debt Income exception only applies up to the amount by which a debtor is insolvent immediately before the cancellation of debt. Consider the following examples:

1. As of June 24, 2019, Frank had assets with an aggregate value of \$40,000 and had liabilities totaling \$70,000, making him insolvent in the amount of \$30,000. On that date, a creditor offered to accept a payment of \$5,000 in cancellation of a \$20,000.00 debt. Frank accepted and made the payment, which resulted in \$15,000.00 of C.O.D. Income. Because immediately before the cancellation of debt occurred, Frank was insolvent by (\$30,000.00) more than the amount of debt that was forgiven (\$15,000.00), Frank does not recognize any income from the cancellation of debt.
2. As of June 24, 2019, Sue had assets with an aggregate value of \$115,000 and liabilities totaling \$135,000, making her insolvent in the amount of \$20,000. On that date, a creditor offered to accept a payment of \$25,000 in cancellation of a \$60,000.00 debt. Sue accepted and made the payment, which resulted in C.O.D. Income of \$35,000. Sue's insolvency immediately before the transaction was only \$20,000.00. Therefore, she does not recognize income for \$20,000 of the cancelled debt, but Sue does recognize income for \$15,000 of the cancelled debt.

- G. While clients should always be counseled that the cancellation of debt may result in taxable income, the extent of that taxable income may vary, or even be nonexistent. A close examination of the client's financial circumstances, as well as the type of debt and manner in which it is forgiven, is necessary to determine whether the relief provided by the debt cancellation is complete.

II. INCOME TAX TREATMENT IN INDIVIDUAL BANKRUPTCY PROCEEDINGS

- A. Discharge of unpaid income taxes in personal bankruptcy cases: Most are not dischargeable in individual bankruptcy proceedings.
- B. Primarily two types of individual bankruptcy proceedings:
 - 1. Chapter 7 bankruptcy proceeding: Chapter 7 Trustee is appointed to collect and liquidate the debtor's assets and distribute the proceeds to the debtor's creditors.
 - 2. Chapter 13 bankruptcy proceeding: Sometimes called a wage earner's bankruptcy. The debtor proposes a repayment plan to make installment payments to creditors over three to five years.
- C. Whether or not income tax debts can be discharged depends in large part, on whether they are considered "priority" debts. If the income tax debt qualifies as a priority debt, it must be paid in full during the bankruptcy or it will not be discharged.
- D. Under Section 507(a)(8) of the Bankruptcy Code, income tax debt is considered a priority debt, which means they are paid first when assets are liquidated in a Chapter 7 bankruptcy proceeding and it means they must be paid in full through a Chapter 13 plan.
 - 1. Depending on the value of the assets available to liquidate in a Chapter 7 bankruptcy proceeding, these priority tax debts may not be paid in full. If they are not paid in full, Section 523(a)(1)

of the Bankruptcy Code provides that such taxes are not discharged by the Chapter 7 bankruptcy proceeding.

2. In a Chapter 13 bankruptcy proceeding, priority tax debts must be paid in full over the life of the Chapter 13 Plan. If they are not so provided for in the Plan, the Plan cannot be confirmed by the bankruptcy court, which may result in dismissal of the bankruptcy proceeding without the debtor having received a bankruptcy discharge for any of his or her debts.

E. The Requirements.

1. The due date for filing the tax return in question was at least three years ago. The due date includes any extensions. Therefore, if an extension is received for a 2017 return, making it due in October 2018, the debtor would not be able to discharge it in bankruptcy until at least October of 2021.
2. The tax return was filed at least two years ago.
 - a. The tax debt must be related to a tax return that was filed at least two years before the debtor files for bankruptcy.
 - b. Measured from the date the return was actually filed. In most cases, this should be the same as the due date, unless a due date is missed and the return is filed late.
 - c. Tax debts that arise from unfiled tax returns are not dischargeable. The IRS routinely assesses tax on unfiled returns, and these liabilities cannot be discharged unless and until the debtor files a tax return for the year in question.

3. The tax assessment is at least 240 days old.
 - a. Often covers the same ground as the first two rules.
 - b. The IRS must assess the tax at least 240 days before the bankruptcy petition is filed.
 - c. Assessment can arise from a self-reported balance due on a filed tax return, from an IRS final determination in an audit, or an IRS proposed assessment that becomes final.
 4. The tax return was not fraudulent.
 5. The taxpayer is not guilty of tax evasion.
 6. Other considerations:
 - a. In addition, the taxpayer must prove that the previous four years' tax returns have been filed with the IRS in order to receive a discharge.
 - b. The debtor must also provide a copy of their most recent tax return to the bankruptcy court.
- F. Keep in mind that certain other types of taxes, including withheld payroll taxes, the trust fund penalty under IRC § 6672, most state sales taxes and certain excise taxes, are never dischargeable.
- G. Determining Potentially Dischargeable Taxes:
1. Order a transcript of record.
 2. Should advise the client of the possibility of an audit adjustment that creates a post-bankruptcy tax, the existence of assessed fraud penalties, or other activities that might constitute an

attempt “to evade or defeat ... [a] tax,” which may provide an argument that the tax should not be discharged (11 USC § 523(a)(1)(C)).

3. In addition, once a future bankruptcy date (the date on which the tax liability meets all the mechanical tests for discharge) is computed, the transcript should be rechecked immediately prior to the filing date, to verify that there are no intervening events have occurred that might extend the above time frames.

H. Planning:

1. When picking the bankruptcy filing date, consideration should also be given to those tax debts that may soon meet the discharge requirements as well as those that currently meet the requirements.
2. While an installment agreement does not toll the above timeframes, other tax resolution methods do extend the time allowed for IRS collection and the mechanical time frames that must be met for discharge of taxes. For example, a collection due process hearing request will extend the three-year and 240-day periods, while an offer in compromise filing will extend only the 240-day period.

I. Tax Liens:

1. Even though income tax debt may be discharged through bankruptcy, to the extent that a tax lien was recorded on the debtor’s property, it will remain.
 - a. Federal Tax Liens
 - b. State Tax Liens

2. The bankruptcy automatic stay is applicable to the filing of tax liens.
 - a. If the relevant taxing authority has not filed a notice of tax lien prior to the date the bankruptcy is filed, it cannot do so after the case has been filed with respect to unpaid taxes that accrued prior to the bankruptcy proceeding.
 - b. A notice of tax lien that was filed prior to the bankruptcy filing will remain in place through the bankruptcy proceeding and after discharge.
3. Tax liens are secured claims in a bankruptcy proceeding, and may be paid through the sale of assets.
 - a. In a Chapter 7 proceeding, the Trustee may sell some of the debtor's assets to make distributions to creditors. Creditors who have valid and perfected security interests, such as a tax lien, are paid in full from the proceeds of the secured asset to the extent of the value of the asset.

Example: If a secured creditor has a claim of \$100.00 and the asset is worth \$500.00, the creditor is paid the full \$100.00. The remaining value of the asset is property of the Estate and can be used to satisfy the claims of other creditors. On the other hand, if the asset is worth only \$50.00, the creditor gets paid the full \$50.00, and will have an unsecured claim for the remaining \$50.00.

- b. If there are prior mortgages or security interests in the subject property, those creditors will be paid first, and the tax lien will be paid if there is any remaining equity.
 - c. If the sale of the subject asset does not result in payment in full of the tax lien, the tax lien will remain attached to other of the debtor's assets, but the amount will be reduced by the amount received by virtue of the asset sale.
 - d. **However, it is often the case that a Chapter 7 Trustee will only sell assets if there is sufficient equity in that asset, after satisfaction of all secured debts. But often, selling the asset isn't worthwhile. In that case, the tax lien would remain in place after the bankruptcy is concluded, in the original amount in which it was filed.**
- 4. In a Chapter 13 proceeding, the same rules apply. If the debtor does not pay off the entire amount of the tax lien through the Chapter 13 Plan, whether through Plan payments or a sale of the asset, the lien will remain in place after the bankruptcy case has concluded.
- 5. As stated above, tax liens also attach to personal property, such as cars and household furniture. These assets are not usually sold in bankruptcy because they are worth little or subject to exemptions.
- 6. If the tax liens are discharged through the bankruptcy process through payment, then again, they survive, and a debtor's options of dealing with them remain the same as before bankruptcy.

- a. The amount of the lien can be paid.
- b. A payment plan or compromise can be negotiated.
- c. It might be possible to redeem a specific item by paying its value.
- d. Do nothing and gamble that the IRS won't take any action to foreclose on its lien. This makes more sense when the value of the property subject to the lien is relatively low, and personal liability for the debt has already been discharged.