

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

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Cancellation of Debt Income

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

- Internal Revenue Code Section 61:
 - Gross Income includes “income from discharge of indebtedness.”



Cancellation of Debt Income

- Most creditors and debt collectors are required to report the cancelled debt to both the debtor and the IRS on a Form 1099-C.
 - These include:
 - Financial Institutions.
 - Any of the following, its successor, or sub-unit:
 - The Federal Deposit Insurance Corporation (FDIC);
 - The Resolution Trust Corporation (RTC);
 - The National Credit Union Administration (NCUA); or
 - Any other federal executive agency, including government corporations, any military department, the U.S. Postal Service, or the Postal Rate Commission.



Cancellation of Debt Income

- A corporate subsidiary of a financial institution or credit union (if the affiliation subjects the subsidiary to federal or state regulation).
- A federal government agency, including a department, an agency, a court or court administrative office, or a judicial or legislative instrumentality.
- Any organization a significant trade or business of which is lending money.

Cancellation of Debt Income

- Exceptions to Cancellation of Debt Income:
 - Amounts cancelled as gifts, bequests, devises, or inheritances.
 - Certain qualified student loans cancelled under provisions that the loans would be cancelled if the taxpayer works for a certain period of time in certain professions.
 - Certain other education loan repayment or loan forgiveness programs to provide health services in certain areas.
 - Amounts of cancelled debt that would be deductible if the taxpayer, as a cash basis taxpayer, paid it.

Cancellation of Debt Income

- Exceptions to Cancellation of Debt Income (Cont'd):
 - A qualified purchase price reduction given by the seller of property to the buyer.
 - Any Pay-for-Performance Success Payments that reduce the principal balance of a home mortgage under the Home Affordable Modification Program.
 - Amounts from student loans discharged on the account of death or total and permanent disability of the student.



Cancellation of Debt Income

- Exclusions from Gross Income:
 - Debt cancelled in a Title 11 bankruptcy case.
 - Debt cancelled during insolvency.
 - Cancellation of qualified farm indebtedness.
 - Cancellation of qualified real property business indebtedness.
 - 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.

Cancellation of Debt Income

- Debt Secured by Property:
 - 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.
 - 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.
 - If not personally liable for the debt, then there won't be any cancellation of debt income.

Cancellation of Debt Income

- Debt Cancelled During Insolvency:
 - The insolvency exclusion from Cancellation of Debt Income only applies up to the amount by which a debtor is insolvent immediately before the cancellation of debt.



Cancellation of Debt Income

- Examples:
 - 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.

Cancellation of Debt Income

- Examples (Cont'd):
 - 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.

Income Tax Treatment in Individual Bankruptcy Proceedings

- Discharge of unpaid income taxes in personal bankruptcy cases: Most are not dischargeable in individual bankruptcy proceedings.



Income Tax Treatment in Individual Bankruptcy Proceedings

- Primarily two types of individual bankruptcy proceedings:
 - 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.
 - 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.



Income Tax Treatment in Individual Bankruptcy Proceedings

- Whether or not income tax debts can be discharged depends in large part, on whether they are considered “priority” debts.
 - 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.



Income Tax Treatment in Individual Bankruptcy Proceedings

- The Requirements to Discharge Income Tax Debt:
 1. The due date for filing the tax return in question was at least three years ago. The due date includes any extensions.
 2. The tax return was filed at least two years ago.
 - Measured from the date the return was actually filed.
 - Tax debts that arise from unfiled tax returns are not dischargeable.

Income Tax Treatment in Individual Bankruptcy Proceedings

- The Requirements to Discharge Income Tax Debt (Cont'd):
 3. The tax assessment is at least 240 days old.
 - The operative date is often the same as with the first two rules (when the tax return is filed).
 - Assessment can arise from a self-reported balance due on a filed tax return, but also 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.

Income Tax Treatment in Individual Bankruptcy Proceedings

- Other Considerations:
 - The taxpayer must prove that the previous four years' tax returns have been filed with the IRS in order to receive a discharge in a Chapter 13 Plan.
 - In both Chapter 7 and Chapter 13, the debtor must also provide a copy of their most recent tax return to the bankruptcy court.
 - 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.

Income Tax Treatment in Individual Bankruptcy Proceedings

- Determining Potentially Dischargeable Income Taxes:
 - Order a transcript of record.
 - Review for 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)).
 - When a bankruptcy filing date is computed, the transcript should be rechecked immediately prior to the filing date.

Income Tax Treatment in Individual Bankruptcy Proceedings

- Planning:
 - Consideration should also be given to those tax debts that may soon meet the discharge requirements when picking a bankruptcy filing date.
 - Certain tax resolution methods do extend the time allowed for IRS collection and the mechanical time frames that must be met for discharge of taxes.



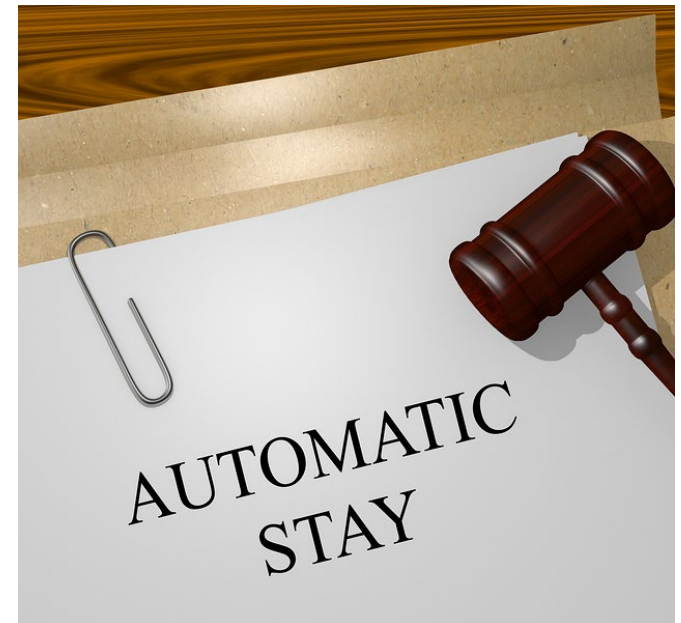
Income Tax Treatment in Individual Bankruptcy Proceedings

- Tax Liens: to the extent that a tax lien was recorded on the debtor's property, it will remain.
 - Federal Tax Liens
 - State Tax Liens



Income Tax Treatment in Individual Bankruptcy Proceedings

- The bankruptcy automatic stay is applicable to the filing of tax liens.
 - A notice of tax lien that was filed prior to the bankruptcy filing will remain in place through the bankruptcy proceeding and after discharge.



Income Tax Treatment in Individual Bankruptcy Proceedings

- Tax liens are secured claims in a bankruptcy proceeding
 - Chapter 7: 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.
 - Prior mortgages or security interests in the subject property will be paid first, and the tax lien will be paid if there is any remaining equity.
 - 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.
 - Selling assets may not be worthwhile for in a Chapter 7 bankruptcy proceeding.

Income Tax Treatment in Individual Bankruptcy Proceedings

- Chapter 13: 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.



Income Tax Treatment in Individual Bankruptcy Proceedings

- If the tax liens are not discharged through the bankruptcy process through payment, they survive, and a debtor's options of dealing with them remain the same as before bankruptcy.

