Cancellation of Debt

General rule:

Cancellation of debt is a taxable event, however there are exceptions and exclusions. A taxpayer should get a Form 1099-C from a financial institution or a government agency on debt forgiveness of $600 or more.

Exceptions:

- Cancellation of debt from a private lender such as a relative or friend is viewed as a gift.
- Cancellation of student loan debt by professionals agreeing to serve in rural or low income areas is generally excepted from federal taxation.
- Cancellation of debt that would yield a deduction is not taxable.

Exclusions:

Cancellation of debt can be excluded, all or in part, in the following cases:

- Debt discharged in bankruptcy does not create taxable income.
- Cancellation of debt is not taxable to the extent the taxpayer is insolvent. A taxpayer is insolvent to the extent that what he/she owes (debts) exceeds what he/she has (assets). Insolvency can be easily calculated by making a list of assets and debts and comparing the totals.
- Qualified personal residence debt discharged through 12/31/16 of up to $2 million will not be taxed. Personal residence debt is a mortgage a taxpayer obtains to buy, build, or improve his/her principal residence. This is also called acquisition debt. Home equity or refinance debt not used for the above purpose can not be relieved from tax with this exception. ***Important note: Congress has not extended this provision beyond tax year 2016. However, personal residence debt discharged in 2017 may still be excluded in some situations where there is a binding written agreement entered into during 2016.***
- Qualified real property business debt can be excluded. (This is beyond the scope of this fact sheet.)
- Qualified farm debt (also beyond the scope of this fact sheet) can be excluded.

Common examples:

- **Cancellation of credit card debt is taxable** unless it is discharged in bankruptcy or the taxpayer is insolvent. If the taxpayer is insolvent, the debt cancellation is excludable only to the extent of insolvency.
- **A foreclosure or short sale of the taxpayers principal home** is taxable unless it qualifies as personal residence debt and it happens before 2014, the debt is discharged in bankruptcy, or the taxpayer is insolvent.
- **Cancellation of debt due to a loan restructured by the lender** can be excluded if the taxpayer is insolvent or it qualifies as personal residence debt and occurs before 2014.