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 a friend is viewed as a gift and not taxable.
- Cancellation of student loan debt is not federally taxable (this provision is set to expire after 2025)
- 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 circumstances.

- Debt discharged in a 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 resident debt (up to $750,000 or $375,000 if married filing separately) discharged between 1/1/21 and 12/31/25 will not be taxed. Personal residence debt is a mortgage that a taxpayer obtains to buy, build, or to improve their principal resident. 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.

- Forgiven Paycheck Protection Program (PPP) debt can be excluded from income. Furthermore, Congress acted to allow business owners to deduct expenses purchased with forgiven PPP loan proceeds (new law clarifying this was passed 12/27/20).

- Qualified real property business debt and farm debt *can be* excluded, but not always. Please consult your tax preparer for more details.

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 to the extent of insolvency.

- **A foreclosure or short sale of the taxpayers principle home** is taxable unless it qualifies as personal residence debt (see above for details), 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 a personal resident debt (see above for details).