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Cancellation of Indebtedness: A Good Thing?

By: Ezra Dyckman and Charles S. Nelson

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When an unpaid debt is cancelled or extinguished, the borrower generally recognizes taxable income in the amount of the cancelled debt. However, the character of the income depends on the situation and whether the debt is recourse (that is, the borrower is personally liable for repayment of the debt) or nonrecourse (that is, the lender can only look to the value of the collateral for repayment of the debt).

If property that is subject to nonrecourse debt is transferred to a lender in a foreclosure or similar transaction, the taxpayer is treated as selling the property for a price equal to the balance of the debt. This is the case even if the balance of the debt is higher than the property's fair market value. Thus, the taxable gain or loss that the taxpayer recognizes from the deemed sale includes the portion of the nonrecourse debt that is effectively forgiven. In many cases, any such gain will be taxed as capital gain.

In contrast, if property that is subject to recourse debt is foreclosed on, the borrower typically remains liable for the unpaid balance of the loan. If the lender agrees to waive this unpaid balance, the taxpayer recognizes cancellation-of-indebtedness ("COD") income, which is taxed as ordinary income. COD income can also result from situations where debt (whether recourse or nonrecourse) is cancelled by the lender other than in connection with a transfer of the collateral.

COD income can also be recognized in certain debt workouts. For example, if the debtor (or a person related to the debtor) purchases its own debt at a discount, the debtor typically recognizes COD income in an amount equal to the discount. COD income can also sometimes arise when debt is converted into equity of the borrower.

There are several exceptions to the recognition of COD income. For example, if debt secured by real property was originally incurred to acquire the property or to make substantial improvements to the property, the taxpayer can often elect to exclude the COD income and instead reduce his tax basis in the property by the amount of the forgiven debt. In addition, it is sometimes possible to structure debt workouts to avoid the recognition of COD income in the first place.

When a lender is a government agency or financial institution or is otherwise engaged in the business of lending money, the lender is required to report the amount of any discharged debt to the IRS on Form 1099-C. This obligation to file a Form 1099-C exists if one or more "identifiable events" described in regulations has occurred during the taxable year, regardless of whether the taxpayer actually recognizes COD income. Among the listed identifiable events are a cancellation of indebtedness resulting from a foreclosure, bankruptcy, agreement with the borrower, or the expiration of the applicable statute of limitations for collection of the debt. A unilateral decision by the creditor to discharge the debt is also considered an identifiable event.

A lender who fails to issue a Form 1099-C when required faces monetary penalties; therefore, some lenders may issue Form 1099-C as a precautionary matter in situations where it is arguably not required or where the taxpayer does not actually recognize COD income. In such situations, the borrower would face an elevated risk of an IRS audit if the COD income is not reported on his tax return.

A recent case illustrates some of the potential issues that can arise with Form 1099-C reporting. In *Sinclair v. Bank of America*, No. 23-CV-00295 (E.D.N.Y. Feb. 21, 2025), the pro se plaintiff received two Forms 1099 that he alleged related to "bogus" loans. While the complaint and the underlying facts were unclear, the plaintiff apparently disagreed that the debt at issue had existed or had been cancelled, and sued the lenders for fraud and under a provision of the Internal Revenue Code that grants a private right of action for certain willful filings of fraudulent information returns. However, this statute only applies to a list of specified information returns, and Form 1099-C is not on this list. The court dismissed the plaintiff's claims for this reason and because the plaintiff failed to allege that any information return filed was fraudulent or that the defendants acted willfully with respect to the filing.

While the result of this case may be obvious and colored by the fact that the plaintiff represented himself, it illustrates a recurring problem with debt workouts. If a lender decides to issue Form 1099-C, the borrower will be faced with increased IRS scrutiny and often has no effective remedies against the lender, even if the Form 1099-C was incorrectly issued. To avoid this result, if a borrower engages in a workout with a lender and believes that no debt was discharged, the borrower should negotiate contractual protections to ensure that the lender does not issue an improper Form 1099-C. However, this is just one of many issues raised by debt workouts, and great care should be taken to ensure that such restructurings achieve the intended tax result.

Ezra Dyckman and Charles S. Nelson are partners of Roberts & Holland LLP.