Tax Implications of Cancelled Debt

So you are considering contacting a creditor to obtain a reduction in the outstanding balance of a loan. You may be seeking an agreement to allow you to sell you home for less than the outstanding balance due on your mortgage. This is referred to as a short sale. Or you may be asking a credit card company to reduce the amount due on a credit card. Before you talk to a creditor about reducing your debt, it is important to understand the tax implication involved when a creditor eliminates, or “forgives” any or all of your outstanding debt.

Reductions in debt are called cancelled debt, and cancelled debt is considered income for federal and state income tax purposes. At the end of the year in which the debt was forgiven, the entity that reduced your debt will report the cancelled debt amount to both you and the IRS on a Form 1099-C. In general, you must report this income on your federal and state tax returns and pay taxes on that amount. Failure to report and pay taxes on cancelled debt can result in scrutiny of your tax return by the IRS of Pennsylvania Department of Revenue, as well as additional tax amounts due, plus penalties and interest.

There are some exceptions to the general rules that cancelled debt is taxable. For example, a debt that it discharged through a bankruptcy is not taxable income. Also, some cancelled mortgage debt is excluded from taxable income, provided it meets certain IRS requirements.

Paying the taxes due on a cancelled debt will typically cost you less than paying the cancelled debt directly to a creditor; however it is important to understand how cancelling any type of debt will affect you come tax time.

If you have any questions regarding cancelled debt and how it will affect your taxes, please call my office at 717-657-7770 to schedule an appointment.

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