

## Chapter 2: Financial Distress

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**Please note.** Corrections were made to this workbook through January of 2022. No subsequent modifications were made.

For your convenience, in-text website links are also provided as short URLs. Anywhere you see **uofi.tax/xxx**, the link points to the address immediately following in brackets.

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# 2021 Workbook

The COVID-19 pandemic created not just a health emergency but also a financial emergency as businesses were forced to quarantine or shut down during much of 2020–21. This action caused unprecedented increases in unemployment, lost wages, and lost income. As a result, indebted persons or businesses may have settled debts for less than they owed or they were forced to default on borrowing.

Many of the relief programs created by the federal government in response to the pandemic are not part of this chapter. The Coronavirus Aid, Relief, and Economic Security<sup>1</sup> (CARES) Act provides guidance that Paycheck Protection Program (PPP) loans<sup>2</sup> and economic injury disaster (EIDL) grants<sup>3</sup> are not required to be included in the borrower's taxable income when forgiven.

As a result of natural disasters, the COVID-19 pandemic, and other struggles, many taxpayers are experiencing various degrees of financial distress. To combat the economic hardships, the IRS instituted several programs to assist taxpayers struggling to pay their taxes. Preparers may want to be alert for potential warning signs of financial distress and be aware of available remedies for paying taxes, advising taxpayers on the ability to avoid losing their homes, or how their clients might receive relief from student loan debt. Additionally, preparers need to know which types of cancelled debt, foreclosures and repossessions, and abandonments are potentially includable in taxable income.

## POTENTIAL WARNING SIGNS OF FINANCIAL DISTRESS

Recognizing early warning signs that a client is in financial distress may potentially prevent the client from having to pay additional interest and penalties beyond the debt they already have difficulty managing. This recognition may help the client avoid declaring bankruptcy (or direct the client to discuss bankruptcy options with an attorney) and assist them with a decision to continue or close their business. There is no concrete list of warning signs but there are some common indications that a business or individual is in distress and may need some assistance.

Some indications that a business is in financial distress may be more evident to a practitioner than other warning signs that may only be identified during an audit or review of the business financials. A few potential indicators that a business may be facing financial issues include the following.<sup>4</sup>

- The business is slow in paying its bills.
- The business owner or principals of the company do not know how much money the company is bringing in or the profit (or loss) the company has each month.
- The employer's share of payroll taxes is not being remitted to governmental agencies on a timely basis.
- The principals or owners of the business do not have any money left over to pay themselves or take paychecks that cannot be cashed currently.
- Creditors of the business are pursuing the owners or principals of the business personally for payment of business obligations.

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<sup>1</sup> CARES Act, PL 116-136.

<sup>2</sup> CARES Act, PL 116-136, §1106(i).

<sup>3</sup> CARES Act, PL 116-136, §1110(e)(5).

<sup>4</sup> *Small Businesses: Top 5 Warning Signs of Financial Problems*. Winter, Daniel J. BankruptcyLawChicago.com. [bankruptcylawchicago.com/small-businesses-top-5-warning-signs-of-financial-problems/] Accessed on Apr. 23, 2021.

Other indicators that a business may be facing financial hardship include the following.

- Owners having a lackadaisical attitude toward their business
- Personal or family issues such as substance abuse, divorce, disability, issues with children, etc.
- Selling business assets necessary for conducting business to raise cash which causes the business to be unable to perform (e.g., a farmer sells a tractor and then expects to raise a crop without one.)
- Increase in interest payments
- Weakened financial ratios (cash flow, debt-to-equity ratio, etc.)

## Practitioner Planning Tip

Tax professionals, whether intentional or not, are often placed in the role of counselor and personal advisor to their clients. While attempting to stay focused on advising clients on the financial aspects of their life, it can be difficult to separate the business from the person. Recognizing early signs of potential financial issues may help ward off longer term, more serious financial issues.

**Example 1.** Mary Sellzalot, a local real estate agent, operates her business as an S corporation. Mary engages Cynthia Gleem, an enrolled agent, to prepare her 2021 tax returns. In her first meeting with Mary, Cynthia discovers that Mary reports \$175,000 of payroll expense on the S corporation return. However, Mary tells Cynthia she is holding over \$100,000 in payroll checks from the last year that she has not cashed because she does not have adequate cash flow. Mary admits that she does not have the money to pay both the payroll taxes and cash the checks. Cynthia advises Mary to reduce her payroll, amend previously filed payroll tax returns, and reduce her payroll going forward.

## Practitioner Planning Tip

Many of the warning signs for financial distress an individual experiences are the same as mentioned previously for a business. However, a practitioner who prepares an individual's tax return may want to watch for any new lines of credit, unpaid taxes, or a client who declares bankruptcy because these may indicate financial trouble.

**Example 2.** Use the same facts as **Example 1**. After completing Mary's S corporation return, Cynthia begins working on Mary's personal tax return. Mary mentions that she did not make the last quarter estimated tax payment and is hoping for a big refund because she cannot afford another large payment like last year. She took out a second mortgage during the year to help cover her credit card payments and the first three quarters of estimated payments.



## Practitioner Planning Tip

If caught early, practitioners can advise taxpayers in financial distress to mitigate some of their struggles. For example, a taxpayer could talk with their creditors to renegotiate terms, liquidate underperforming assets, or make a payment plan with the IRS for any unpaid taxes.

## CANCELLED DEBT

Borrowing money from a lender does not result in taxable income at the time of the loan because there is an offsetting obligation to repay the debt. However, if a lender cancels or forgives all or part of a loan, then the taxpayer **may need** to include the amount of cancelled debt in taxable income. Including cancelled debt in taxable income can be a difficult concept (and reality) for a taxpayer to grasp given they are already struggling financially. This section highlights some of the exceptions to including cancelled debt in ordinary income.

### SBA LOAN FORGIVENESS

The Small Business Administration (SBA) offers several loan programs to assist small businesses facing financial distress. In addition to PPP loans and EIDL grants, the SBA provides the following loan programs.

**Note.** For information on the tax implications of COVID-19 relief programs such as PPP loans, EIDL grants, etc., see the 2021 *University of Illinois Federal Tax Workbook*, Volume A, Chapter 1: New Developments.

- 7(a) loans (provide financial assistance to small businesses with special requirements, usually when real estate is involved)<sup>5</sup>
- 504 loans (provide up to \$5 million of long-term, fixed-rate financing to purchase, construct, or improve/modernize major fixed assets)<sup>6</sup>
- Microloans (provide small loans up to \$50,000 to help small businesses start up and expand)<sup>7</sup>

The CARES Act authorized the SBA to pay interest, principal, and any related fees for six months for borrowers who took out a 7(a) loan, 504 loan, or microloan. Originally, debt relief was dependent on the loan being fully disbursed before September 27, 2020. On December 27, 2020, the Consolidated Appropriations Act (CAA)<sup>8</sup> expanded the assistance to include all loans approved by September 27, 2020, even if not fully disbursed.<sup>9</sup> Additional relief may be available. The borrower should contact their lender for more information.

<sup>5</sup> *7(a) Loans*. SBA. [[www.sba.gov/funding-programs/loans/7a-loans](http://www.sba.gov/funding-programs/loans/7a-loans)] Accessed on Apr. 29, 2021.

<sup>6</sup> *504 Loans*. SBA. [[www.sba.gov/funding-programs/loans/504-loans](http://www.sba.gov/funding-programs/loans/504-loans)] Accessed on Apr. 29, 2021.

<sup>7</sup> *Microloans*. SBA. [[www.sba.gov/funding-programs/loans/microloans](http://www.sba.gov/funding-programs/loans/microloans)] Accessed on Apr. 29, 2021.

<sup>8</sup> *Consolidated Appropriations Act of 2021*, PL 116-260, §278(c)(1); SBA Information Notice 5000-20087. Jan. 28, 2021. SBA. [[www.sba.gov/sites/default/files/2021-01/Information%20Notice%205000-20087%20Updated%20Section%201112%20Tax%20Implication%20Reporting%20Requirements-508.pdf](http://www.sba.gov/sites/default/files/2021-01/Information%20Notice%205000-20087%20Updated%20Section%201112%20Tax%20Implication%20Reporting%20Requirements-508.pdf)] Accessed on Apr. 23, 2021.

<sup>9</sup> *SBA Debt Relief*. SBA. [[www.sba.gov/funding-programs/loans/covid-19-relief-options/sba-debt-relief](http://www.sba.gov/funding-programs/loans/covid-19-relief-options/sba-debt-relief)] Accessed on Apr. 23, 2021.

Even though the SBA makes the loan program payments on behalf of the borrower, the SBA payments are not taxable income to the borrower and interest expense paid for the borrower with the SBA subsidized loan proceeds are fully deductible.<sup>10</sup> The IRS supports this position as stated in Notice 2021-06.<sup>11</sup>

*Section 278(c)(1) of the COVID Relief Act provides that such a payment is not included in the gross income of the person on whose behalf the payment is being made. Section 278(c)(2) provides that no deduction shall be denied by reason of the exclusion of the loan payments from gross income.*

In conclusion, SBA assistance with these loan programs does not constitute cancellation of debt income.

**Note.** The guidance on repaying SBA loans is constantly evolving and beyond the scope of this chapter.

## RECOURSE VERSUS NONRECOURSE DEBT<sup>12</sup>

Debt for which a taxpayer is personally liable is referred to as **recourse debt**. All other debt is **nonrecourse debt**.

If recourse debt is cancelled, the amount of cancelled debt is generally ordinary income to the taxpayer. In contrast, if nonrecourse debt is cancelled, the cancelled debt is generally not ordinary income unless the collateral is retained and the lender provides a discount for early payment or modifies the loan, reducing the principal owed.

Cancelled debts that meet the requirements for any of the following exceptions or exclusions are **not** taxable.

Cancelled debt that qualifies for an **exception** from gross income includes the following.<sup>13</sup>

1. Amounts specifically excluded from income by law such as gifts, bequests, devises, or inheritances
2. Cancellation of certain qualified student loans
3. Cancelled debt, that if paid by a cash basis taxpayer, would be deductible
4. A qualified purchase price reduction given by a seller

Cancelled debt that qualifies for an **exclusion** from gross income includes the following.<sup>14</sup>

- Debts discharged in a Title 11 bankruptcy proceeding
- Debts discharged while the taxpayer is insolvent
- Qualified farm indebtedness
- Qualified real property business indebtedness (QRPBI) of a taxpayer other than a C corporation
- \$750,000 of qualified principal residence indebtedness (QPRI) discharged after December 31, 2020 and prior to January 1, 2026, for all taxpayers other than married filing separately (MFS)<sup>15</sup>
- \$375,000 of QPRI discharged after December 31, 2020 and prior to January 1, 2026 for MFS taxpayers

<sup>10</sup> *Consolidated Appropriations Act of 2021*, PL 116-260, §278(c); and SBA Information Notice 5000-20087. Jan. 28, 2021. SBA. [www.sba.gov/sites/default/files/2021-01/Information%20Notice%205000-20087%20Updated%20Section%201112%20Tax%20Implication%20Reporting%20Requirements-508.pdf] Accessed on Apr. 23, 2021.

<sup>11</sup> IRS Notice 2021-06, 2021-6 IRB 822.

<sup>12</sup> *Tax Topic 431 — Canceled Debt — Is It Taxable or Not?* Mar. 12, 2021. IRS. [www.irs.gov/taxtopics/tc431.html] Accessed on Mar. 18, 2021.

<sup>13</sup> IRS Pub. 4681, *Canceled Debts, Foreclosures, Repossessions, and Abandonments (for Individuals)*.

<sup>14</sup> IRC §108(a)(1).

<sup>15</sup> *Consolidated Appropriations Act of 2021*, PL 116-260, §§114(a) and (b).

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## Summary of Cancelled Debt Exclusions

Exclusion	Requirements	Election	Limit	Reporting	Reduction of Tax Attributes
Bankruptcy	Varies depending on which chapter is filed		Total amount cancelled	Form 982, line 1a	Reduce basis of personal-use property
Insolvency	Immediately before cancellation to the extent total of all liabilities was more than FMV of all assets		Extent of insolvency	Form 982, line 1b	
Qualified farm indebtedness	Debt incurred directly in connection with operation of trade or business of farming; 50% or more of total gross receipts for 3 preceding years were from trade or business of farming; cancellation made by a qualified person not related to the taxpayer, from whom the taxpayer acquired the property, or a person who receives a fee from taxpayer's investment in property		Sum of adjusted tax attributes and total adjusted basis of qualified property held at beginning of tax year	Form 982, line 1c	Reduce basis of qualified property in the following order: depreciable qualified property, land that is qualified property and used in farming business, and other qualified property
QRPBI	Incurred in connection with real property used in trade or business; secured by real property; incurred before 1993	Required	Outstanding principal amount of qualified real property business debt over FMV of business real property securing debt	Form 982, line 1d	Reduce basis of depreciable real property by amount cancelled (not below \$0)
QPRI	Mortgage to buy, build, or substantially improve main home or refinance up to the amount of the old mortgage principal		\$750,000 for all taxpayers, except \$375,000 for MFS	Form 982, line 1e	Reduce basis by amount of cancelled QPRI excluded (but not below \$0)

## Practitioner Planning Tip

The Further Consolidated Appropriations Act, 2020<sup>16</sup> (FCAA), was enacted on December 20, 2019. The FCAA extended the \$1 million dollar exclusion of QPRI (\$2 million for couples married filing jointly (MFJ)) for agreements entered into by December 31, 2020, even if the actual debt discharge happened later.<sup>17</sup> The exclusion had previously expired on December 31, 2017 (if an agreement was entered into by December 31, 2017 but not finalized until sometime in 2018, the exclusion rules which expired on December 31, 2017 still applied).

FCAA also made the QPRI discharge exclusion provisions retroactive for QPRI discharged for tax years 2018 and 2019. Taxpayers with QPRI discharge in 2018 or 2019 should consider amending their returns for 2018 or 2019. If taxpayers did not use another rule to exclude the debt forgiveness from taxable income, such as the insolvency exception, and therefore realized taxable income from QPRI in 2018 or 2019, they may be eligible to exclude QPRI debt discharge under the QPRI provisions extended by the FCAA for those tax years.

## Practitioner Planning Tip

Tax professionals might assume when a client receives a Form 1099-C, *Cancellation of Debt*, that the taxpayer immediately has debt forgiveness income to report. Practitioners are advised to carefully consider the exceptions described previously. These exceptions provide opportunities to avoid including debt forgiveness in current income. However, exclusion of debt forgiveness income now may create future tax implications. The implications are discussed later in this chapter.

### Issuance of Form 1099-C<sup>18</sup>

Generally, if a recourse debt owed by the taxpayer is forgiven or satisfied for less than the full amount owed, the debt is considered cancelled to the extent of the indebtedness forgiven or unpaid. The lender must issue a Form 1099-C upon the cancellation of debt of \$600 or more. This is taxable income for the taxpayer unless an exception applies that allows the taxpayer to exclude the cancelled debt from income. If the taxpayer's forgiveness relates to business, it is potentially reported as income on the taxpayer's business return. Otherwise, the forgiveness is generally reported as **other income** on Form 1040, Schedule 1, line 8.

<sup>16</sup> *Further Consolidated Appropriations Act of 2020*, PL 116-94, §101.

<sup>17</sup> IRC §108(a)(1)(E), as amended by the *Further Consolidated Appropriations Act of 2020*, PL 116-94, §101.

<sup>18</sup> IRS Pub. 4681, *Canceled Debts, Foreclosures, Repossessions, and Abandonments (for Individuals)*.

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**Example 3.** Jack owed \$10,000 to Jill, who is a lender by trade. Jack paid \$8,000 in satisfaction of the entire debt, which Jill agreed to accept. Jack has \$2,000 of cancelled debt and, because this amount is greater than \$600, Jill must send Jack a Form 1099-C reflecting the \$2,000 in cancelled debt. If determined to be includable in Jack's income, this personal debt forgiveness is reported on Jack's Form 1040, Schedule 1, line 8.

**Example 4.** Jack owed \$10,000 to Jill. Jack and Jill agreed that Jack would provide Jill with hill-climbing services (instead of money) in full satisfaction of the debt. Jack does not have cancellation of indebtedness income. Instead, he has income from services.

Entities required to submit a Form 1099-C include the following.

- Federal government agencies
- Financial institutions
- Credit unions
- Any organization whose significant trade or business is the lending of money

**Even if the taxpayer does not receive a Form 1099-C, the cancelled debt must be reported as gross income on the tax return unless an exception applies.** For debts of \$10,000 or more that involve debtors who are jointly and severally liable for the debt, the lender must report the entire amount of the cancelled debt on each debtor's Form 1099-C.<sup>19</sup>



## Practitioner Planning Tip

Practitioners should ask probing questions to determine if the taxpayer had debt forgiveness even in the absence of the taxpayer receiving Form 1099-C.

CORRECTED (if checked)

CREDITOR'S name, street address, city or town, state or province, country, ZIP or foreign postal code, and telephone no.		1 Date of identifiable event	OMB No. 1545-1424  <span style="font-size: 2em; font-weight: bold;">2021</span>  Form <b>1099-C</b>	<b>Cancellation of Debt</b>
		2 Amount of debt discharged \$		
		3 Interest, if included in box 2 \$		
CREDITOR'S TIN	DEBTOR'S TIN	4 Debt description		<b>Copy B For Debtor</b>  This is important tax information and is being furnished to the IRS. If you are required to file a return, a negligence penalty or other sanction may be imposed on you if taxable income results from this transaction and the IRS determines that it has not been reported.
DEBTOR'S name  Street address (including apt. no.)  City or town, state or province, country, and ZIP or foreign postal code		5 If checked, the debtor was personally liable for repayment of the debt . . . . . <input type="checkbox"/>		
Account number (see instructions)		6 Identifiable event code	7 Fair market value of property \$	
Form <b>1099-C</b>		(keep for your records)		

www.irs.gov/Form1099C      Department of the Treasury - Internal Revenue Service

<sup>19</sup> See instructions to Form 1099-C.

Box 2 of Form 1099-C shows the amount of debt cancelled and must be reported as ordinary income by the taxpayer. This amount can also include interest, fees, and penalties. If interest is forgiven and included as cancelled debt, the interest portion should be listed in box 3. If the interest would normally be deductible by the taxpayer, it does not have to be included in gross income. If the interest would not be deductible, the entire amount reported in box 2 should be included in the taxpayer's gross income.

Codes for identifying the type of event that led to the issuance of Form 1099-C are required. The following codes are used to report the identifiable event in box 6.

- A. Bankruptcy
- B. Other judicial debt relief, used to identify cancellation of debt as a result of receivership, foreclosure, or similar federal or state court proceedings other than bankruptcy
- C. Statute of limitations or expiration of deficiency period (In the case of the expiration of a statute of limitations, an identifiable event occurs only when the affirmative defense of the statute of limitations is upheld in a final judgment or decision in a judicial proceeding, and the period for appealing the judgment or decision has expired.)
- D. Foreclosure
- E. Debt relief from probate or similar proceeding
- F. Cancellation of debt as a result of an agreement between the creditor and the debtor to cancel the debt at less than full consideration
- G. A discharge of debt because of a decision or a defined policy to discontinue collection activity and cancel the debt
- H. Other actual discharge before identifiable event; used to identify an actual cancellation of debt that occurs before any of the identifiable events described previously

## BANKRUPTCY

In 2005, Congress passed the Bankruptcy Abuse Prevention and Consumer Protection Act (BAPCPA).<sup>20</sup> This legislation made numerous changes to bankruptcy laws and tightened restrictions on debtors seeking bankruptcy protection.

A bankruptcy estate is created at the beginning of a bankruptcy case. Generally, the estate includes all the legal and equitable interests in property owned by the debtor, but bankruptcy and state law can determine which assets become part of the estate and which are excluded or exempted. Exempted and abandoned property is initially included in the bankruptcy estate but is later removed from the estate.<sup>21</sup>

The transfer of assets from the debtor to the bankruptcy estate is not a taxable event. The estate assumes the same basis and character of the transferred assets and generally accounts for the property in the same manner as the debtor. Likewise, when the bankruptcy estate is terminated or dissolved, the transfer of the remaining assets back to the debtor is not treated as a disposition of property and does not result in any gain or loss, recapture, or acceleration of income or deductions.<sup>22</sup>

The individual taxpayer should not include any cancelled debt as income on their tax return if the debt was cancelled because of a bankruptcy discharge. If debt was cancelled outside the bankruptcy proceeding, it is reported as income to the individual taxpayer unless the debt is otherwise eligible for exclusion.<sup>23</sup>

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<sup>20</sup> *Bankruptcy Abuse Prevention and Consumer Protection Act*, PL 109-8.

<sup>21</sup> 11 USC §541.

<sup>22</sup> IRS Pub. 908, *Bankruptcy Tax Guide*.

<sup>23</sup> *Ibid*.

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There are multiple types of cases under the Bankruptcy Code, which fall under different chapters. Following is a synopsis of each.

## Chapter 7<sup>24</sup>

**Chapter 7** is a voluntary liquidation process for individuals, partnerships, corporations, and other business entities.<sup>25</sup> The debtor must meet a means test,<sup>26</sup> but the test does not require the debtor to be insolvent. The debtor must also have attended credit counseling, not had a previous case dismissed for improper conduct, and not filed a previous case within the past eight years.<sup>27</sup>

The result at the end of a successful Chapter 7 proceeding is the liquidation of assets and the discharge of debt. The debtor turns over all their assets to the bankruptcy court and a trustee is appointed to handle the estate. The court returns assets to the debtor that are exempt from creditors and the debtor's dischargeable debts are discharged.

Under Chapter 7, a separate bankruptcy estate is created and treated as a separate taxable entity. An employer identification number (EIN) must be obtained for the estate. The trustee (or debtor-in-possession) is responsible for filing bankruptcy estate tax returns, including Form 1041, *U.S. Income Tax Return for Estates and Trusts*. The trustee must use the EIN on all tax returns filed with the IRS.<sup>28</sup>

The debtor remains liable for filing their own income tax returns and paying taxes on any income not belonging to the estate. Debtors cannot claim deductions related to the bankruptcy.<sup>29</sup>

**Note.** An EIN for a bankruptcy estate can be obtained in the following ways.<sup>30</sup>

- Apply online at [www.irs.gov/ein](http://www.irs.gov/ein)
- Call (800) 829-4933 from 7 a.m. to 7 p.m. in the trustee's or debtor-in-possession's local time zone
- Mail or fax a Form SS-4, *Application for Employer Identification Number*

## Chapter 11<sup>31</sup>

**Chapter 11** bankruptcy is a reorganization plan for corporations, sole proprietorships, and partnerships to keep the business operating and to pay creditors over time. Typically, personal assets are not at risk; however, a Chapter 11 case for a sole proprietorship may involve the debtor's personal assets as well as the business assets. For a partnership debtor, the partners' personal assets may be used to repay creditors, which could force the partners to file for bankruptcy protection as well.

<sup>24</sup> See *Chapter 7 — Bankruptcy Basics*. United States Courts. [[www.uscourts.gov/services-forms/bankruptcy/bankruptcy-basics/chapter-7-bankruptcy-basics](http://www.uscourts.gov/services-forms/bankruptcy/bankruptcy-basics/chapter-7-bankruptcy-basics)] Accessed on Apr. 1, 2021.

<sup>25</sup> 11 USC §§101(41) and 109(b).

<sup>26</sup> BAPCPA put in place a means test to determine whether abuse will be presumed. This test projects the debtor's monthly income minus expenses for a 5-year period. If the debtor's current net monthly income exceeds the median income for the debtor's state, the debtor is subject to the means test. The means test is used to determine whether the debtor's Chapter 7 case should be dismissed or converted to a Chapter 13 proceeding based on the finding of abuse by the bankruptcy court. The median income chart can be found at [[www.justice.gov/ust/eo/bapcpa/20201101/bci\\_data/median\\_income\\_table.htm](http://www.justice.gov/ust/eo/bapcpa/20201101/bci_data/median_income_table.htm)].

<sup>27</sup> 11 USC §727(a)(8-9).

<sup>28</sup> IRS Pub. 908, *Bankruptcy Tax Guide*.

<sup>29</sup> *Ibid.*

<sup>30</sup> *Ibid.*

<sup>31</sup> See *Chapter 11 — Bankruptcy Basics*. United States Courts. [[www.uscourts.gov/services-forms/bankruptcy/bankruptcy-basics/chapter-11-bankruptcy-basics](http://www.uscourts.gov/services-forms/bankruptcy/bankruptcy-basics/chapter-11-bankruptcy-basics)] Accessed on Apr. 1, 2021.

In Chapter 11 bankruptcy, the debtor-in-possession performs the trustee's duties, such as filing tax returns. A creditors' committee is established to consult with the debtor to administer the case, operate the business, and assist in formulating a reorganization plan. The debtor files a reorganization plan, which must be approved by the court. After a waiting period, a creditor can also file a competing plan. Confirmation of the reorganization plan discharges debtors from most types of prepetition debts. At the end of the bankruptcy case, some or all the debts are repaid.

Under Chapter 11, a separate bankruptcy estate is created and treated as a separate taxable entity. An EIN must be obtained. The bankruptcy trustee files the estate tax returns and pays taxes owed by the estate.

**Note.** A debtor-in-possession may be compensated by the estate for managing a trade or business that the debtor conducted before the bankruptcy filing.<sup>32</sup> The payments received by the debtor for this service should be reported as miscellaneous income. The estate is entitled to deduct the payments as administrative expenses.

## Chapter 12<sup>33</sup>

**Chapter 12** bankruptcy protection is only for family farmers and fishermen with regular annual income from the business activity and who meet other specific criteria. The debtor must file a schedule of assets and liabilities, schedule of current income and expenditures, schedule of executor contracts and unexpired leases, and a statement of financial affairs.

A meeting of creditors is held between 21 and 35 days after filing. The debtor must attend this meeting and answer questions regarding their finances and proposed repayment plan. Unsecured creditors must file claims within 90 days after the scheduled creditors' meeting.

Within 45 days after the reorganization plan is filed, the court determines whether the plan is feasible and whether it can be confirmed. If the court confirms the plan, the Chapter 12 trustee distributes funds received in accordance with the terms of the plan. If it is not approved, the debtor may file a modified plan or the debtor may convert the case to a Chapter 7 liquidation. The reorganization lasts between three and five years (but no longer than five years).<sup>34</sup> At the conclusion, the debts will have been adjusted to reflect cash flow, while protecting the family's needs. However, all unsecured creditors must receive at least as much as they would have received under a Chapter 7 liquidation. Secured creditors must be paid at least as much as the value of the collateral pledged for the debt.

## Chapter 13<sup>35</sup>

**Chapter 13** bankruptcy is a reorganization plan for individuals and sole proprietorships that allows for repayment of all or part of the debts through regular installment payments over three to five years. If the debtor's monthly income is less than the applicable state median, the repayment period generally lasts only three years. If the debtor's monthly income is higher than the applicable state median, the plan generally must be for five years.

To be eligible for Chapter 13, the debtor must participate in credit counseling. In addition, the individual's unsecured debts cannot exceed certain limits, which in 2020 and 2021 are \$1,257,850 for secured debt and \$419,275 for unsecured debt.<sup>36</sup>

<sup>32</sup> IRS Notice 2006-83, 2006-40 IRB 596.

<sup>33</sup> See *Chapter 12 — Bankruptcy Basics*. United States Courts. [[www.uscourts.gov/services-forms/bankruptcy/bankruptcy-basics/chapter-12-bankruptcy-basics](http://www.uscourts.gov/services-forms/bankruptcy/bankruptcy-basics/chapter-12-bankruptcy-basics)] Accessed on Apr. 8, 2021.

<sup>34</sup> Secured creditors can sometimes be paid over more than five years. For instance, if an equipment loan had an original repayment schedule that was longer than five years, that repayment schedule continues. It is only the portion of the payment in arrears that must be corrected during the reorganization plan period.

<sup>35</sup> See *Chapter 13 — Bankruptcy Basics*. United States Courts. [[www.uscourts.gov/services-forms/bankruptcy/bankruptcy-basics/chapter-13-bankruptcy-basics](http://www.uscourts.gov/services-forms/bankruptcy/bankruptcy-basics/chapter-13-bankruptcy-basics)] Accessed on Apr. 9, 2021.

<sup>36</sup> IRM 5.9.10.2; 11 USC §109(e).

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Approximately 21 to 50 days after the Chapter 13 bankruptcy petition is filed, the trustee holds a creditors' meeting in which the debtor must answer creditors' questions regarding the reorganization plan. At the meeting, issues regarding the plan can be reviewed and the parties can decide whether there should be a court hearing on the reorganization plan. If the plan is approved, the debtor must make regular payments in accordance with the plan. The trustee then distributes the funds to the creditors according to the terms of the plan.

At the conclusion of the bankruptcy case, some or all the debts will be repaid. The debtor is eligible for discharge of the remaining debts if the debtor:

- Certifies all domestic support obligations have been paid,
- Has not received a discharge in a prior case within a certain time period, and
- Has completed an approved course in financial management.

Under Chapter 13 cases, the bankruptcy estate is not a separate taxable entity.<sup>37</sup>

**Note.** For a more thorough description of each bankruptcy chapter and the requirements for debtors, see the 2008 *University of Illinois Federal Tax Workbook*, Chapter 13: Financial Distress. This can be found at [uofi.tax/arc](http://uofi.tax/arc) [[taxschool.illinois.edu/taxbookarchive](http://taxschool.illinois.edu/taxbookarchive)].

## Tax Returns<sup>38</sup>

Corporate, partnership, and individual Chapter 12 and Chapter 13 bankruptcy proceedings require the debtor to continue to file all income tax returns. Under Chapter 7 and Chapter 11 bankruptcies, a separate bankruptcy estate is created.

The bankruptcy estate is entitled to deduct expenses incurred in a trade, business, or other activity and to use credits in the same way that the debtor would have used them. The estate may also deduct administrative expenses. These expenses include accounting fees, attorney fees, and court costs, which are deducted on Form 1040, Schedule 1, *Additional Income and Adjustments to Income*. These expenses are deductible as allowable in arriving at adjusted gross income (AGI) because they would not have been incurred if property had not been held by the bankruptcy estate. Prior to 2018, these expenses were reported on Form 1040, Schedule A, *Itemized Deductions*, as miscellaneous itemized deductions, not subject to the 2% floor. If some of the expenses incurred by the bankruptcy estate are attributable to conducting a trade or business for the production of estate rents or royalties, these are deductible in determining AGI on Form 1040, Schedule C, *Profit or Loss from Business (Sole Proprietorship)*; Schedule E, *Supplemental Income and Loss*; or Schedule F, *Profit or Loss From Farming*.

The bankruptcy estate uses Form 1041 as a **transmittal** for the return prepared on Form 1040.

**Note.** If the administrative expenses of the estate are more than the estate's AGI, the excess amount can be carried back three years and forward for seven years. This amount is treated like a net operating loss (NOL) and must first be carried back to the earliest year possible before it can be carried forward. However, this amount can only be carried to a bankruptcy estate's tax year. The individual debtor is not allowed to deduct the bankruptcy estate's administrative expenses.

<sup>37</sup> IRS Pub. 908, *Bankruptcy Tax Guide*.

<sup>38</sup> *Ibid.*

**Statutory Filing Requirements for Prebankruptcy Periods, Specifically in Chapter 13.**<sup>39</sup> The bankruptcy code specifically requires Chapter 13 debtors to timely file all tax returns for tax years ending within four years of the filing of the bankruptcy petition. All federal returns must be filed before the date set for the first meeting of creditors. The debtor can request the trustee hold the meeting open for an additional 120 days to allow the debtor time to file the returns, or if later, until the date the returns are due under an IRS extension. The debtor can also request an additional 30-day extension from the bankruptcy court after notice and hearing. If the debtor fails to timely file the tax returns, the debtor's case can be dismissed or converted to a Chapter 7 bankruptcy.<sup>40</sup> This conversion or dismissal has been deemed mandatory if requested by a party in interest.<sup>41</sup>

**Note.** In general, taxpayers are required to file tax returns. There may be reasons for not filing a return, such as a situation in which the person did not make enough money to require filing a return. In other instances, individuals may have simply not filed. Bankruptcy trustees may require a tax return from the debtor. In the case of an individual who had only nontaxable income or did not make enough to require filing a return, an affidavit stating the facts may be sufficient. In other instances, the debtor should be aware that there may be implications in the bankruptcy for failing to timely file a return. For instance, for past tax obligations to be dischargeable, tax returns due at least three years before the Chapter 7 bankruptcy case is initiated must have been filed at least two years before the petition is filed and the taxes have been assessed at least 240 days prior to the filing of the bankruptcy case.<sup>42</sup>

**Tax Returns Due After Bankruptcy Filing.**<sup>43</sup> Under all chapters of the Bankruptcy Code, debtors must file all applicable federal, state, and local tax returns that become due after a case commences. Failure to file returns (or obtain timely extensions) can result in conversion of the taxpayer's bankruptcy case from one chapter to another or dismissal of the entire case. If the debtor fails to timely file any returns, the applicable taxing authority can request the bankruptcy court to convert the case or dismiss it. If the debtor fails to file the return within 90 days of the taxing authority's request, the bankruptcy court must convert the case or dismiss it. The court's actions are required by statute and are not discretionary.

**Chapter 11 Tax Reporting.**<sup>44</sup> If a Chapter 11 debtor receives W-2 wages and a portion of the wages are post-petition services includible in the bankruptcy estate, the W-2 amounts are allocated between the debtor and the estate. This includes allocation of both the wages that are reported in box 1 of the W-2 and the income tax withheld that is reported in box 2. The trustee and the debtor can agree to use a simple percentage method to allocate the amounts but must use the same method to allocate both the income and the tax paid. The allocation must also reflect the debtor's post-petition gross earnings. All post-petition gross earnings are included in the estate and not in the debtor's gross income.

The debtor attaches a statement to their tax return stating that the return is filed subject to a Chapter 11 bankruptcy.<sup>45</sup> The statement must include all the following.

- Show allocations of income and income tax withheld.
- Describe the method used to allocate these amounts.
- List the filing date of the bankruptcy case, the court in which the case is pending, the bankruptcy court case number, and the bankruptcy estate's EIN number.

<sup>39</sup> 11 USC §1308.

<sup>40</sup> 11 USC §1307(e).

<sup>41</sup> See e.g. *In re Cushing*, 401 B.R. 528 (1st Cir. BAP 2009); *In re Kuhar*, 391 B.R. 733 (Bankr. E.D. Pa. 2008).

<sup>42</sup> *Using Bankruptcy to Provide Relief From Tax Debt*. 2013. IRS. [www.irs.gov/pub/irs-utl/2013\_NTF\_Bankruptcy\_Relief.pdf] Accessed on Apr. 13, 2021.

<sup>43</sup> IRS Pub. 908, *Bankruptcy Tax Guide*.

<sup>44</sup> *Ibid*.

<sup>45</sup> IRS Notice 2006-83, 2006-2 CB 596.

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The Bankruptcy Code does not affect the determination of what earnings are deemed wages for FICA and FUTA tax purposes.<sup>46</sup> The debtor's employer should continue to report all wages and withholding on Form W-2, *Wage and Tax Statement*, under the debtor's name and social security number. The debtor is not required to file a new Form W-4, *Employee's Withholding Allowance Certificate*, simply because of the bankruptcy filing. However, the debtor may need to file a new Form W-4 if they are no longer entitled to claim the same number of allowances because certain deductions or credits belong to the estate.<sup>47</sup> The debtor may also want to increase income tax withholding to avoid having to make estimated tax payments for the estate.<sup>48</sup>

With the exception of persons or entities filing Forms W-2, the trustee should provide the bankruptcy estate's EIN to all persons and entities required to file information returns pertaining to the estate's gross income, gross proceeds, or other reportable payments.<sup>49</sup> Because the income is the property of the estate, these individuals and entities should file all information returns using the estate's name and EIN.<sup>50</sup> When the bankruptcy case is closed, dismissed, or converted, the estate is no longer a separate taxable entity. The debtor should provide notice to all individuals and entities previously notified of the case to ensure that gross income, proceeds, and other reportable payments are thereafter reported to the debtor rather than the bankruptcy estate.

If a Chapter 11 bankruptcy is converted to Chapter 7, the bankruptcy estate continues to exist. Gross income, profits, and other events are reported to the estate if they relate to property of the estate. Services performed by the debtor in Chapter 7 bankruptcy, however, are not considered property of the estate.

**Note.** The trustee must withhold income and social security taxes and file applicable employment returns for any wages paid.

If the debtor has self-employment (SE) income, the debtor should continue to report this income on Schedule SE, *Self-Employment Tax*. This includes the SE income earned post-petition. The debtor, of course, must pay any SE tax due.

**Note.** Neither the Bankruptcy Code nor IRC §1398 address the application of SE tax to post-petition earnings.

If the bankruptcy estate has gross income exceeding the threshold filing amount, then a tax return must be filed on Form 1041. The threshold amount in 2021 is \$12,550.<sup>51</sup>

**Special Election in Year of Bankruptcy: IRC §1398.**<sup>52</sup> Individual debtors in Chapter 7 or Chapter 11 bankruptcies can make an election under IRC §1398 to close the tax year as of the day before the bankruptcy petition is filed. If the election is made, the debtor has two separate tax years of less than 12 months. This election cannot be made, however, if there are **only exempt assets** in the bankruptcy estate. For example, this election cannot be made if an individual debtor only has assets that constitute the necessities of life, such as a modest home with little equity, a modest automobile, and without significant funds in a bank account.

The debtor elects to end their tax year by filing a return on Form 1040 on or before the 15th day of the fourth full month after the end of the first tax year (i.e., the day before the filing of the bankruptcy petition). To avoid delays in processing, the tax preparer should write "Section 1398 Election" at the top of the return.

<sup>46</sup> 11 USC §1115; IRS Notice 2006-83, 2006-2 CB 596.

<sup>47</sup> See Treas. Reg. §31.3402(f)(2)-1.

<sup>48</sup> See IRC §6654(a).

<sup>49</sup> See IRC §6109(a)(2).

<sup>50</sup> See IRC §§6041 through 6049.

<sup>51</sup> IRS News. Rel. 2020-245 (Oct. 26, 2020).

<sup>52</sup> IRS Pub. 908, *Bankruptcy Tax Guide*.

## Practitioner Planning Tip

Making a §1398 election may allow the bankrupt taxpayer to utilize tax attributes during the first short year (prior to the effective date of the bankruptcy). If the election is not made, the taxpayer loses tax attributes that transfer to the bankruptcy estate as of the beginning of the year in which the bankruptcy is filed. Tax attributes are discussed later in this section.

**Example 5.** Riley files her tax returns on a calendar-year basis. She filed a Chapter 11 bankruptcy petition on June 5, 2021. Riley makes an §1398 election to close her tax year at the commencement of her bankruptcy case. Her first tax year for 2021 runs from January 1 through June 4 (the day before the filing of the bankruptcy petition). Her second tax year for 2021 runs from June 5 through December 31. Riley is required to file her tax return for the first short tax year by October 15, 2021 (the 15th day of the fourth month after the end of the first short tax year).

An election can also be made by attaching a statement to Form 4868, *Application for Automatic Extension of Time To File U.S. Individual Income Tax Return*. The statement must specify that the debtor elects under §1398(d)(2) to close their tax year on the day before filing the bankruptcy case.

**After the election is made, the debtor must file a second return on Form 1040 by the regular due date for an income tax return.** To avoid delays, the phrase “Second Short Year Return After Section 1398 Election” should be written at the top of the return.

The spouse of a debtor may join in the election to end the tax year. If the spouse joins the election, a joint return must be filed for the short year. Once the election is made, it cannot be revoked for the first short tax year. The debtor and spouse, however, can file separate returns for the second short year.

If a debtor’s spouse also files for bankruptcy later in the same year, the spouse can also make a separate §1398 election. Thus, if the spouse chose to end the tax year with the original debtor, then each spouse could have up to three short tax years. If the spouse joined the debtor in the debtor’s election, the debtor could join the spouse in the spouse’s election. This would result in three short tax years for both the spouse and the debtor. If the spouse did not join the debtor’s short-year election, then the debtor cannot join the spouse’s election because their tax years do not coincide.

**Example 6.** Marshall and Kate Connors are married calendar-year taxpayers. Marshall’s Chapter 7 bankruptcy case begins on May 6, 2021, and Kate’s bankruptcy case begins on October 1, 2021.

Kate can elect to end her tax year on September 30, 2021 (the day before her bankruptcy case begins). If Marshall did not elect to end his tax year on May 5, 2021, or if he elected to do so but Kate did not join in his election, Kate would have two tax years in the same calendar year. Her first 2021 tax year is January 1 through September 30, and her second tax year is October 1 through December 31.

If Marshall did not end his tax year as of May 5, 2021, he can join Kate’s election to close her tax year on September 30, 2021, but only if they file a joint return for the January 1 through September 30 tax year.

If Marshall elected to end his tax year on May 5 but Kate did not join in his election, Marshall cannot join in Kate’s election to end her tax year on September 30. Marshall and Kate cannot file a joint return for that short tax year because their tax years preceding September 30 are not the same.

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**Example 7.** Jane and Brian Daily are married calendar-year taxpayers. Jane’s Chapter 7 bankruptcy case began on April 10, 2021, and Brian’s Chapter 7 bankruptcy case began on October 3, 2021. Jane elected to close her tax year on April 9, 2021, and Brian joins in Jane’s election.

If Brian also makes the election relating to his own bankruptcy case, he has three tax years for the 2021 calendar year. The first tax year is January 1 through April 9; the second is April 10 through October 2; and the third is October 3 through December 31.

Jane may join in Brian’s election if they file a joint return for the second short tax year (April 10 through October 2). If she does so, she would have the same three short tax years as Brian. In addition, Jane and Brian may file a joint return for the third short tax year, but they are not required to do so.

**Note.** If the debtor elects to close the tax year, the debtor must annualize taxable income for each short year in the same manner that a change in annual accounting period is calculated. For more information on how to annualize the debtor’s income and how to calculate the tax for the short tax year, see IRS Pub. 538, *Accounting Periods and Methods*.

If a Chapter 7 or Chapter 11 individual bankruptcy case is dismissed for any reason after the election was made, the bankruptcy estate is no longer a separate taxable entity and the debtor must file amended tax returns to replace all full- or short-year returns. The amended returns are filed on Form 1040X, *Amended U.S. Individual Income Tax Return*, along with a short statement explaining why the amended returns are being filed. The debtor must report all income, deductions, and credits taken by the bankruptcy estate on the amended returns.

## Discharge of Tax Debts<sup>53</sup>

**Note.** Alternatives to filing bankruptcy to settle tax debts are discussed later in this chapter.

The bankruptcy court may discharge the debtor from personal liability for certain tax debt. The scope of the discharge depends on the chapter under which the case was filed and the nature of the debt.

**Chapter 7.** For individuals in Chapter 7 bankruptcy cases the following tax debts are **not** subject to discharge under 11 USC §523.

- Taxes entitled to eighth priority (explained later in this chapter)
- Taxes for which no return was filed
- Taxes for which a late return was filed within two years of the bankruptcy filing
- Taxes for which the debtor filed a fraudulent return or willfully attempted to evade or defeat the tax

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<sup>53</sup> Ibid.



## Practitioner Planning Tip

For the reasons described, tax professional should advise taxpayers contemplating bankruptcy to file all outstanding returns prior to the bankruptcy filing. Not filing outstanding returns risks the IRS assessing taxes which may not be dischargeable because the returns were not filed. It is also worth noting that the statute of limitations for a return not filed is unlimited.<sup>54</sup> One goal of a debtor filing bankruptcy is to have a financial fresh start. Unfiled returns could result in new tax debts emerging post-bankruptcy.

Penalties in a Chapter 7 bankruptcy are dischargeable unless the event that gave rise to the penalty occurred within three years of the bankruptcy and the penalty relates to a tax that is not discharged.

**Chapter 11.** The exceptions to discharge that apply to individuals in Chapter 7 cases also apply to individuals in Chapter 11 cases. However, different rules apply to corporations. A corporation in a Chapter 11 case may receive a broad discharge at the time the reorganization plan is confirmed. However, secured and priority claims must be satisfied under the plan. There is an exception to discharge for taxes for which the debtor filed a fraudulent return or willfully attempted to evade or defeat the tax.

**Chapter 12.** Once the debtor has completed payments under a Chapter 12 plan, the court issues a discharge of all debts provided for in the plan, except for those listed in 11 USC §523.<sup>55</sup> In certain circumstances, a judge can issue a hardship discharge before the plan is completed.<sup>56</sup>

**Chapter 13.** A debtor who completes all payments under a Chapter 13 plan receives a broad discharge of all debts provided for by the plan. However, priority tax claims must be paid in full under the Chapter 13 plan. The following taxes are excepted from the broad Chapter 13 discharge.

- Withholding taxes for which the debtor is liable in any capacity
- Taxes for which no return was filed
- Taxes for which a return was filed late within two years before the bankruptcy petition was filed
- Taxes for which a fraudulent return was filed
- Taxes that the debtor willfully attempted to evade or defeat
- Taxes for which creditors, including the IRS, did not receive notice of the bankruptcy case in time to file a claim

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<sup>54</sup> IRC §6501(c)(3).

<sup>55</sup> 11 USC §1228(a).

<sup>56</sup> 11 USC §1228(b).

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## Eighth Priority Taxes<sup>57</sup>

Generally, certain unsecured debts are given priority in bankruptcy cases. Certain tax debts that existed before the bankruptcy case was filed are classified as eighth priority claims. The following federal taxes, if unsecured, are eighth priority taxes.

- Income taxes for tax years ending on or before the date the bankruptcy petition was filed, for which a return is due (including extensions) within three years before the date of the filing of the bankruptcy petition
- Income taxes assessed within 240 days before the date of filing the bankruptcy petition
- Income taxes that were not assessed before the petition date but were assessable as of the petition date, unless these taxes were still assessable solely because no return was filed, a late return was filed within two years of the filing of the bankruptcy petition, a fraudulent return was filed, or because the debtor willfully attempted to evade or defeat the tax
- Withholding taxes for which the taxpayer is liable in any capacity
- Employer's share of employment taxes on wages, salaries, or commissions (including vacation, severance, and sick leave pay) paid as priority claims under 11 USC §507(a)(4) or for which a return is due within three years of the filing of the bankruptcy petition, including a return for which an extension of the filing date was obtained
- Excise taxes on transactions occurring before the date of filing the bankruptcy petition, for which a return, if required, is due (including extensions) within three years of the filing of the bankruptcy petition (If a return is not required, these excise taxes include only those on transactions occurring during the three years immediately before the date of filing the petition.)

**Payment of Eighth Priority Taxes.** The method for payment of eighth priority taxes depends on the type of bankruptcy case involved.

**Chapter 7.** In a Chapter 7 case, eighth priority taxes may be paid out of assets of the bankruptcy estate to the extent that assets remain after paying the claims of secured creditors and other higher priority claims of creditors.

**Chapter 11.** A Chapter 11 plan can provide for the payment of the taxes, with interest from the date of the plan confirmation, over a period of five years from the date of the order for bankruptcy relief. The manner of payment must not be less favorable than the most favored nonpriority claims (except for convenience claims under §1122(b) of the Bankruptcy Code).

**Chapter 12.** In a Chapter 12 case, the debtor can pay tax claims in deferred cash payments over time.

**Note.** Under Chapter 12 rules, tax liability from the sale of certain assets is treated as a nonpriority claim.

**Chapter 13.** In a Chapter 13 case, the debtor can pay the taxes over three years (or over five years if the court approves).

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<sup>57</sup> IRS Pub. 908, *Bankruptcy Tax Guide*.

## Tax Debt versus Tax Liens<sup>58</sup>

A federal tax lien is a legal claim against the taxpayer's property for unpaid tax debt. The lien protects the government's interest in all property. A federal tax lien exists after **all** the following occur.

- The IRS assesses the taxpayer's liability.
- The IRS sends a notice and demand for payment.
- The taxpayer fails to fully pay the debt in time.

A notice of federal tax lien is filed to alert creditors that the government has a lien on the taxpayer's property.

A bankruptcy discharge of income taxes eliminates the personal obligation to pay the tax. A tax lien recorded before filing for bankruptcy remains to the extent of the value of the taxpayer's equity in the property.<sup>59</sup>

## Tax Attributes<sup>60</sup>

If a debtor excludes cancelled debt from income because it is cancelled in a bankruptcy case or during insolvency, the debtor must use the excluded amount to reduce certain tax attributes. Tax attributes include losses and credits and the basis of certain assets. The effect of reducing tax attributes is that the tax on the cancelled debt is partially postponed instead of being entirely forgiven. This prevents any tax benefit to the taxpayer from the debt cancellation. These reductions are reported on Form 982, *Reduction of Tax Attributes Due to Discharge of Indebtedness (and Section 1082 Basis Adjustment)*.

If the debt was forgiven under an individual Chapter 7 or Chapter 11 bankruptcy, then the trustee reduces the estate's attributes by the cancelled debt (but not below zero). The bankruptcy estate may use tax attributes in the same way the debtor would have.

**Order of Reduction.** Generally, the amount of cancelled debt reduces the tax attributes in the following order.

1. **NOL** — Reduce any NOL for the tax year in which the debt cancellation takes place and any NOL carryover to that tax year.
2. **General business credit carryovers** — Reduce any carryovers, to or from the tax year of the debt cancellation, of amounts used to determine the general business credit.
3. **Minimum tax credit** — Reduce any minimum tax credit available as of the beginning of the tax year following the tax year of the debt cancellation.
4. **Capital losses** — Reduce any net capital loss for the tax year of the debt cancellation and any capital loss carryover to that year.
5. **Basis** — Reduce basis in depreciable and nondepreciable property.

**Note.** The bankruptcy estate, in the case of an individual bankruptcy under Chapter 7 or 11, may choose to reduce the basis of depreciable property **before** reducing any other tax attributes.

6. **Passive activity loss and credit carryovers** — Reduce any passive activity loss or credit carryover from the tax year of the debt cancellation.
7. **Foreign tax credit** — Reduce any carryover, to or from the tax year of the debt cancellation, of an amount used to determine the foreign tax credit.

<sup>58</sup> *Understanding a Federal Tax Lien*. Apr. 14, 2021. IRS. [www.irs.gov/businesses/small-businesses-self-employed/understanding-a-federal-tax-lien#:~:text=A%20federal%20tax%20lien%20is,personal%20property%20and%20financial%20assets] Accessed on Apr. 14, 2021.

<sup>59</sup> IRS Pub. 908, *Bankruptcy Tax Guide*.

<sup>60</sup> *Ibid.*

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**Note.** Because the attributed carryovers are determined on the first day of the bankruptcy filing, the debtor should consider making an election (§1398 election discussed previously) to have two short tax years in the year of filing if the debtor has significant carryovers. The first short tax year would end the day before the bankruptcy petition was filed. This election prevents the debtor's personal loss of all the carryovers. These carryovers transfer to the bankruptcy estate on the date the bankruptcy petition is filed and are no longer available to the individual.

Upon termination of the bankruptcy case or when the estate is terminated, the debtor assumes any remaining tax attributes taken by the bankruptcy estate. The debtor also assumes any attributes that arose during the estate's administration. The debtor does not, however, assume any of the estate's administrative expense losses because the debtor cannot deduct administrative expenses.

The debtor cannot carry back any NOL or credit from a tax year ending after the bankruptcy case began to any tax year ending before the case began. If the estate has an NOL or excess credit that does not transfer to the debtor, the bankruptcy estate can carry back the NOL or credit to the bankruptcy estate's previous tax years as well as to prebankruptcy tax years.

## Practitioner Planning Tip

When a taxpayer emerges from bankruptcy, they should request a copy of the returns filed by the bankruptcy estate to determine what amount of tax attributes remain to be reassumed by the taxpayer. Copies of forms the bankruptcy estate filed and the amount of tax attributes used by the bankruptcy estate are seldom provided to the bankrupt taxpayer without being requested.

**Amount of Reduction.** Except for credit carryovers, tax attributes should be reduced in the same amount as the cancelled debt that is excluded from income. Credit carryovers should be reduced by 33⅓ cents for each dollar of cancelled debt excluded from income.

**Making the Reduction.** The required reductions in tax attributes are made after calculating the tax for the year of the debt cancellation. NOLs and capital losses are reduced first in the year of the debt cancellation; any carryovers are reduced in order of the tax years from which the carryovers arose, starting with the earliest year. Reductions of credit carryovers are made in the order in which the carryovers are considered for the tax year of the debt cancellation.

Tax attributes in individual Chapter 7 or Chapter 11 bankruptcies are reduced in the bankruptcy estate by the trustee. The trustee can decide whether to reduce the basis of depreciable property first before reducing other tax attributes.



## Practitioner Planning Tip

The decision to reduce current income tax attributes (NOL carryovers, capital loss carryovers, etc.) versus reducing basis in depreciable and nondepreciable assets (discussed next), provides significant planning opportunities. For example, if a taxpayer anticipates increased income in a future year, then reducing current tax attributes might be a mistake. Conversely, if a low-income taxpayer decides to reduce basis in depreciable assets and they are contemplating selling the depreciable property in question, that decision may not be the most practical.

**Basis Reduction.** If any amount of debt cancellation reduces the basis of an asset, the following rules apply.

- The reduction in basis should be made at the beginning of the tax year following the year of debt cancellation and should be applied to all property held at the time of the reduction.<sup>61</sup>
- The reduction in basis cannot be more than the total basis of the property held immediately after the cancellation, minus total liabilities immediately after the debt cancellation. This limit does not apply if an election is made to reduce basis before reducing other attributes.
- No reduction in basis should be made on property that the debtor treats as exempt property under 11 USC §522.
- An election can be made to reduce the basis of depreciable property before reducing other tax attributes. This reduction cannot be more than the total basis of depreciable property held at the beginning of the tax year after the debt cancellation. The election is made on Form 982 for the tax year of the debt cancellation. However, if the debtor establishes reasonable cause, the election can be made on an amended return or a claim for refund or credit. Once the election is made, it cannot be revoked without IRS approval.
- If any basis in property is reduced and is later sold for a gain, the portion of the gain corresponding to the basis reduction is taxable as ordinary income. The ordinary income can be computed by treating the amount of the basis reduction as a depreciation deduction and by treating the basis-reduced property as IRC §1245 property (if it is not already §1245 or §1250 property). If the property is §1250 property, the determination of what the straight-line depreciation would have been is made as though there had been no basis reduction associated with the debt cancellation.<sup>62</sup>

**Note.** IRS Form 982, part I, is used to select the reason why debt forgiveness is not included in current income and report the amount not included. IRS Form 982, part II, is used to make the election to reduce tax attributes or reduce basis in depreciable and nondepreciable assets.

<sup>61</sup> See Treas. Reg. §1.1017-1.

<sup>62</sup> For information on IRC §§1245 and 1250, see IRS Pub. 544, *Sales and Other Dispositions of Assets*.

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## INSOLVENCY<sup>63</sup>

A taxpayer is insolvent when their total debts exceed the total fair market value (FMV) of all their assets immediately before the debt cancellation, meaning the taxpayer has a negative net worth. Assets include everything owned, including property that could be excluded in bankruptcy. This includes assets that are collateral for the debt and assets that are exempt under state law and are beyond the reach of creditors.

### Practitioner Planning Tip

IRS Pub. 4681, *Canceled Debts, Foreclosures, Repossessions, and Abandonments (for Individuals)*, provides an insolvency worksheet. Practitioners should recommend the **debtor** complete this worksheet to determine assets and liabilities **immediately prior to** the debt forgiveness. The IRS will likely request a copy of this worksheet when the insolvency exclusion is selected.

Liabilities used to determine insolvency include the following.

- The entire amount of recourse debts
- The amount of nonrecourse debt that is not in excess of the FMV of the collateral used to secure the debt
- The amount of **forgiven** nonrecourse debt in excess of the FMV of the secured property

If the taxpayer is insolvent immediately before the debt is cancelled, the taxpayer can exclude from income the amount of debt cancelled **to the extent they are insolvent**. The taxpayer checks box 1b of Form 982 to exclude cancelled debt from income. On line 2, the taxpayer includes the lesser of either the amount of debt cancelled or the amount by which the taxpayer was insolvent immediately before the cancellation. Form 982 must be attached to the taxpayer's income tax return.

### Practitioner Planning Tip

The taxpayer can elect to apply the insolvency exclusion instead of the QPRI exclusion. This might be more advantageous to taxpayers who are insolvent and who refinance their mortgage to pay debts unrelated to the principal residence.

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<sup>63</sup> IRS Pub. 4681, *Canceled Debts, Foreclosures, Repossessions, and Abandonments (for Individuals)*.

**Example 8.** Barry Bondsman had \$15,000 in credit card debt cancelled. San Francisco Giant Bank sent him a Form 1099-C to report the \$15,000 of cancelled debt income. Barry’s total liabilities before the cancellation were \$100,000. The FMV of his assets is only \$45,000. Barry’s assets are \$55,000 (\$100,000 - \$45,000) less than his liabilities. Therefore, he is insolvent in the amount of \$55,000.

Barry’s insolvency is greater than the amount of the credit card debt cancelled, so he can exclude the entire \$15,000. Barry checks the box on line 1b of Form 982. On line 2, he includes the \$15,000 cancelled debt because it is less than the amount by which he is insolvent. **Barry does not include the \$15,000 as income on his Form 1040.**

Form <b>982</b> (Rev. March 2018) Department of the Treasury Internal Revenue Service	<b>Reduction of Tax Attributes Due to Discharge of                  Indebtedness (and Section 1082 Basis Adjustment)</b> ▶ Attach this form to your income tax return. ▶ Go to <a href="http://www.irs.gov/Form982">www.irs.gov/Form982</a> for instructions and the latest information.	OMB No. 1545-0046  Attachment Sequence No. <b>94</b>
Name shown on return <b>Barry Bondsman</b>		Identifying number <b>777-66-6677</b>

**Part I** General Information (see instructions)

<b>1</b>	Amount excluded is due to (check applicable box(es)):		
<b>a</b>	Discharge of indebtedness in a title 11 case . . . . .	<input type="checkbox"/>	
<b>b</b>	Discharge of indebtedness to the extent insolvent (not in a title 11 case) . . . . .	<input checked="" type="checkbox"/>	
<b>c</b>	Discharge of qualified farm indebtedness . . . . .	<input type="checkbox"/>	
<b>d</b>	Discharge of qualified real property business indebtedness . . . . .	<input type="checkbox"/>	
<b>e</b>	Discharge of qualified principal residence indebtedness ( <b>Caution:</b> See instructions before checking this box if debt was discharged after 2017.) . . . . .	<input type="checkbox"/>	
<b>2</b>	Total amount of discharged indebtedness excluded from gross income . . . . .	<b>2</b>	<b>15,000</b>
<b>3</b>	Do you elect to treat all real property described in section 1221(a)(1), relating to property held for sale to customers in the ordinary course of a trade or business, as if it were depreciable property? . . . . . <input type="checkbox"/> Yes <input type="checkbox"/> No		

**Part II** Reduction of Tax Attributes. You must attach a description of any transactions resulting in the reduction in

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**Example 9.** Evan Rodriguez had personal credit card debt that was cancelled. Evan received a Form 1099-C from Ranger Card Company, showing that \$20,000 of debt was cancelled. Evan's total liabilities before the cancellation were \$62,500. The FMV of his assets was only \$50,000. Evan's assets were \$12,500 (\$62,500 – \$50,000) less than his liabilities. Therefore, he is insolvent in the amount of \$12,500. The amount of his cancelled debt from Ranger Card Company is more than the amount by which he is insolvent; therefore, he can only exclude \$12,500 of the \$20,000 cancelled debt from income.

Evan checks the box on line 1b of Form 982. On line 2, he enters \$12,500 because his insolvency is less than the amount of debt cancelled. He includes the remaining \$7,500 (\$20,000 cancelled debt – \$12,500 amount insolvent) as income on his Form 1040, Schedule 1, line 8.

<b>Form 982</b> (Rev. March 2018) Department of the Treasury Internal Revenue Service	<b>Reduction of Tax Attributes Due to Discharge of Indebtedness (and Section 1082 Basis Adjustment)</b> ▶ Attach this form to your income tax return. ▶ Go to <a href="http://www.irs.gov/Form982">www.irs.gov/Form982</a> for instructions and the latest information.	OMB No. 1545-0046  Attachment Sequence No. <b>94</b>
Name shown on return <b>Evan Rodriguez</b>		Identifying number <b>333-33-1234</b>

**Part I General Information** (see instructions)

<b>1</b>	Amount excluded is due to (check applicable box(es)):		
<b>a</b>	Discharge of indebtedness in a title 11 case . . . . .	<input type="checkbox"/>	
<b>b</b>	Discharge of indebtedness to the extent insolvent (not in a title 11 case) . . . . .	<input checked="" type="checkbox"/>	
<b>c</b>	Discharge of qualified farm indebtedness . . . . .	<input type="checkbox"/>	
<b>d</b>	Discharge of qualified real property business indebtedness . . . . .	<input type="checkbox"/>	
<b>e</b>	Discharge of qualified principal residence indebtedness ( <b>Caution:</b> See instructions before checking this box if debt was discharged after 2017.) . . . . .	<input type="checkbox"/>	
<b>2</b>	Total amount of discharged indebtedness excluded from gross income . . . . .	<b>2</b>	<b>12,500</b>
<b>3</b>	Do you elect to treat all real property described in section 1221(a)(1), relating to property held for sale to customers in the ordinary course of a trade or business, as if it were depreciable property? . . . . . <input type="checkbox"/> Yes <input type="checkbox"/> No		

**Part II Reduction of Tax Attributes.** You must attach a description of any transactions resulting in the reduction in . . . . . See Regulations . . . . . for . . . . .

<b>SCHEDULE 1</b> (Form 1040)  Department of the Treasury Internal Revenue Service	<b>Additional Income and Adjustments to Income</b> ▶ Attach to Form 1040, 1040-SR, or 1040-NR. ▶ Go to <a href="http://www.irs.gov/Form1040">www.irs.gov/Form1040</a> for instructions and the latest information.	OMB No. 1545-0074  <b>2020</b> Attachment Sequence No. <b>01</b>
Name(s) shown on Form 1040, 1040-SR, or 1040-NR <b>Evan Rodriguez</b>		Your social security number <b>333-33-1234</b>

**Part I Additional Income**

<b>1</b>	Taxable refunds, credits, or offsets of state and local income taxes . . . . .		
<b>2a</b>	Alimony received . . . . .	<b>2a</b>	
<b>b</b>	Date of original divorce or separation agreement (see instructions) ▶		
<b>3</b>	Business income or (loss). Attach Schedule C . . . . .	<b>3</b>	
<b>4</b>	Other gains or (losses). Attach Form 4797 . . . . .	<b>4</b>	
<b>5</b>	Rental real estate, royalties, partnerships, S corporations, trusts, etc. Attach Schedule E	<b>5</b>	
<b>6</b>	Farm income or (loss). Attach Schedule F . . . . .	<b>6</b>	
<b>7</b>	Unemployment compensation . . . . .	<b>7</b>	
<b>8</b>	Other income. List type and amount ▶ <u>Cancellation of Indebtedness</u>	<b>8</b>	<b>7,500</b>
<b>9</b>	Combine lines 1 through 8. Enter here and on Form 1040, 1040-SR, or 1040-NR, line 8 . . . . .	<b>9</b>	<b>7,500</b>

**Part II Adjustments to Income**

## QUALIFIED FARM INDEBTEDNESS<sup>64</sup>

**Note.** The American Rescue Plan Act of 2021<sup>65</sup> (ARPA) enacted on March 11, 2021, includes a provision for the U.S. Department of Agriculture (USDA) to **pay up to 120% of loan balances** in existence as of January 1, 2021, for agricultural loans obtained through the Farm Service Agency (FSA) Direct and Guaranteed Farm Loans and Farm Storage Facility Loans. An eligible borrower is a **socially disadvantaged producer** who has a qualifying loan with the FSA.<sup>66</sup> For more information regarding the qualifications, potential tax consequences, and current legislative status of this provision, see the 2021 *University of Illinois Federal Tax Workbook*, Volume A, Chapter 5: Agricultural Issues and Rural Investments.

Cancelled debt is not included in the income of the taxpayer to the extent that it is qualified farm indebtedness (QFI). To qualify for the QFI exclusion, **three requirements must be met.**<sup>67</sup>

1. The discharged debt must have been incurred directly in connection with the operation of the taxpayer's trade or business of farming.
2. At least 50% of the aggregate gross receipts of the taxpayer for the three tax years preceding the tax year in which the discharge of indebtedness occurs must be attributable to the trade or business of farming.
3. The debt must be discharged either by a federal, state, or local government or agency, or by a person who is actively and regularly engaged in the business of lending money and who is independent of the taxpayer.

To qualify as independent under the third requirement, the lender cannot be a member of the taxpayer's family, the seller of the property financed by the loan (or a relative of such a person), or a person who receives a commission from the taxpayer's investment in the property (or a relative of such person).

The amount the taxpayer can exclude from income as a result of discharge of QFI cannot exceed the sum of the following.<sup>68</sup>

- The adjusted tax attributes of the taxpayer
- The aggregate adjusted bases of qualified property held by the taxpayer at the beginning of the tax year following the tax year in which the discharge occurs

QFI may not be used before other exclusions. If the cancelled debt qualifies for the bankruptcy exclusion, that exclusion must be applied first. If the debt qualifies for the insolvency exclusion, that exclusion must be applied before the QFI exclusion. The tax attributes are the same under QFI but only the basis of farm property is adjusted.

<sup>64</sup> Ibid.

<sup>65</sup> *The American Rescue Plan Act of 2021*, PL 117-2.

<sup>66</sup> *The American Rescue Plan Act of 2021*, PL 117-2, §1005.

<sup>67</sup> IRC §108(g).

<sup>68</sup> IRC §108(g)(3).

# 2021 Workbook

## QUALIFIED REAL PROPERTY BUSINESS INDEBTEDNESS<sup>69</sup>

Taxpayers can elect to exclude cancelled QRPBI from income. This is debt that meets the following requirements.<sup>70</sup>

- It was incurred in connection with real property used in a trade or business.
- It is secured by real property.
- It was either:
  - ♦ Incurred or assumed before 1993;
  - ♦ Qualified acquisition indebtedness, which is debt incurred or assumed to acquire, construct, reconstruct, or substantially improve real property that is used in a trade or business and secures the debt; or
  - ♦ Debt incurred to refinance QRPBI (but only to the extent that original debt is refinanced).
- An election to treat the debt as QRPBI is made.

The amount of cancelled QRPBI is limited to:<sup>71</sup>

- The excess (if any) of the outstanding principal amount of the QRPBI immediately before the cancellation, less
- The FMV of the property securing the debt immediately before the cancellation, reduced by the outstanding principal amount of any other QRPBI secured by that property.

In addition, the amount of QRPBI that can be excluded from income cannot exceed the aggregate adjusted basis of depreciable real property held immediately before the cancellation. When figuring this overall limit, the adjusted basis of the depreciable real property is determined after any reductions in basis required because of the exclusion of debt cancelled under the bankruptcy, insolvency, or farm debt exclusions.

The election to treat the debt as QRPBI is made on a timely filed (including extensions) federal income tax return for the tax year in which the discharge occurs. It is revoked only with IRS consent. The taxpayer makes the election by filing Form 982 and checking the box on line 1d.

Form <b>982</b> (Rev. March 2018) Department of the Treasury Internal Revenue Service	<b>Reduction of Tax Attributes Due to Discharge of Indebtedness (and Section 1082 Basis Adjustment)</b> ▶ Attach this form to your income tax return. ▶ Go to <a href="http://www.irs.gov/Form982">www.irs.gov/Form982</a> for instructions and the latest information.	OMB No. 1545-0046
		Attachment Sequence No. <b>94</b>
Name shown on return	Identifying number	

### Part I General Information (see instructions)

- 1 Amount excluded is due to (check applicable box(es)):
  - a Discharge of indebtedness in a title 11 case
  - b Discharge of indebtedness to the extent insolvent (not in a title 11 case)
  - c Discharge of qualified farm indebtedness
  - d Discharge of qualified real property business indebtedness
  - e Discharge of qualified principal residence indebtedness (**Caution:** See instructions before checking this box if debt was discharged after 2017.)
- 2 Total amount of discharged indebtedness excluded from gross income 2
- 3 Do you elect to treat all real property described in section 1221(a)(1), relating to property held for sale to customers in the ordinary course of a trade or business, as if it were depreciable property?  Yes  No

### Part II Reduction of Tax Attributes. You must attach a description of any transactions resulting in the reduction in

**Note.** If QRPBI is cancelled in a Chapter 11 bankruptcy, the bankruptcy exclusion must be used first. If the QRPBI income could be excluded under the insolvency exclusion, then the insolvency exclusion must be used before the QRPBI election.

<sup>69</sup> IRS Pub. 4681, *Canceled Debts, Foreclosures, Repossessions, and Abandonments (for Individuals)*.

<sup>70</sup> IRC §108(c)(3).

<sup>71</sup> IRC §108(c)(2).

## STUDENT LOAN DEBT CANCELLATION<sup>72</sup>

**Note.** There is growing national interest to provide multiple ways to reduce or eliminate student loan debt. Practitioners are encouraged to become informed about programs sponsored at the state or local level that might impact planning and preparation of tax returns.<sup>73</sup>

Borrowers are generally responsible for making loan payments and if a loan is cancelled or repaid by someone else, the borrower must include the amount cancelled or paid on their behalf in their gross income for tax purposes. However, student loan borrowers may be able to exclude amounts from gross income as a result of one of the following.

- Student loan cancellation due to specific employment
- Student loans cancelled because of death or permanent disability
- Student loan repayment assistance

**Note.** Several actions by Congress during 2020 and 2021 contained taxpayer friendly provisions regarding student loan indebtedness.

- On March 27, 2020, CARES Act §§4513 and 4513(d) provided federal student loan relief through September 30, 2020, under COVID-19 emergency relief measures for suspension of payments and interest accrual on student loan debt.
- On August 8, 2020, the COVID-19 emergency relief measures were extended by executive order on federal student loans through December 31, 2020.
- On December 4, 2020, the COVID-19 emergency relief measures were extended by executive order on federal student loan debt through January 31, 2021.
- On January 20, 2021, the suspension on federal student loans was extended through September 30, 2021.
- On March 11, 2021, the ARPA excludes from income student loan debt forgiven in 2021 through 2025 under the rules specified in the ARPA provision.<sup>74</sup>
- On March 30, 2021, the federal student loan relief programs were extended to loans in default obtained through the Federal Family Education Loan (FFEL) Program (no new loans have been made under this program since July 1, 2010).<sup>75</sup>
- On August 6, 2021, the U.S. Department of Education announced an extension to delay the repayment, interest accrual, and collection of student loans until January 31, 2022. Without this extension, measures which were previously enacted to delay student loan repayments would have expired on September 30, 2021.<sup>76</sup>

As of the date of publication, additional legislation was introduced to forgive student loan debt. The amounts and circumstances of such debt forgiveness and the impact on taxpayers for potential debt forgiveness to be included as taxable income were neither finalized nor enacted as of the date this publication went to press.

<sup>72</sup> IRS Pub. 4681, *Canceled Debts, Foreclosures, Repossessions, and Abandonments (for Individuals)*.

<sup>73</sup> *Welcome to SmartBuy*. IDHA Mortgage. [www.ihdamortgage.org/smartbuy]. Accessed on Apr. 28, 2021.

<sup>74</sup> IRC §108(f) as amended by *The American Rescue Plan Act of 2021*, PL117-2, §9675(a)(5) for tax years beginning after Dec. 31, 2020 and ending before Jan. 1, 2026.

<sup>75</sup> *The Standard Repayment Plan is the basic repayment plan for loans from the William D. Ford Federal Direct Loan (Direct Loan) Program and Federal Family Education Loan (FFEL) Program*. U.S. Department of Education. [studentaid.gov/manage-loans/repayment/plans/standard?studentloanplannernew=]. Accessed on Apr. 26, 2021.

<sup>76</sup> *Biden Administration Extends Student Loan Pause Until January 31, 2022*. Aug. 6, 2021. U.S. Department of Education. [www.ed.gov/news/press-releases/biden-administration-extends-student-loan-pause-until-january-31-2022] Accessed on Aug. 11, 2021.

# 2021 Workbook

## Cancellation

If a student loan was cancelled in part or in whole in 2020, the borrower might not have to include the cancelled debt in their income. For cancelled student loan debt to be excluded from income, the loan must have been made through a **qualified lender** to help the student attend an **eligible educational institution**. Additionally, the cancellation must be due to death or permanent and total disability or for students who work off their debt if the work meets the following criteria.

- The student works for a certain period of time.
- The student works in an eligible profession.
- The class of employers can be broad.

An eligible educational institution is an educational establishment with a regular faculty and **actual classrooms** for the students to attend.

**Note.** This provision appears to specifically target 100% online colleges and universities. This does not appear to be aimed toward colleges and universities that offer online classes in addition to actual classroom settings.

Qualified lenders include the following.

1. The United States, or U.S. government agencies
2. A U.S. state, territory, or possession, the District of Columbia, or any political subdivision thereof
3. A public benefit corporation tax-exempt under IRC §501(c)(3) and that assumed control of a state, county, or municipal hospital, and the employees are treated as public employees under state law
4. An eligible educational institution if the loan is made:
  - a. As part of an agreement with an entity described in (1), (2), or (3) under which the funds to make the loan were provided directly to the educational institution; or
  - b. Under a program of the educational institution designed to encourage serving in occupations with unmet needs (such as trade schools) or in areas with unmet needs. In areas with unmet needs, the work the students (or former students) perform is for or supervised by a government unit or a tax-exempt §501(c)(3) organization.
5. The provider of a private education loan (as defined in the Consumer Credit Protection Act, §1407) if loans are cancelled because of death or disability of the student

## Exception

The cancellation of a student loan does not qualify for tax-free treatment if it is cancelled because the student performed services for the educational institution that made the loan or other organization that provided the funds. When student debt is forgiven because of services provided by the student for the institution, the value of the services performed is includable in gross income.

## Refinanced Loan

If a student loan is refinanced with another loan from an eligible educational institution or a tax-exempt organization, the loan may be considered as being issued by a qualified lender. The refinanced loan is considered issued by a qualified lender if it is made under a program developed to encourage students to serve in occupations with unmet needs or underserved areas if the students are employed by or supervised by a governmental unit or a tax-exempt §501(c)(3) organization.

## Student Loan Repayment Assistance

Student loan repayments by third parties **are tax free** if they are received under the following circumstances.

- Received under the National Health Service Corps Loan repayment program
- A state education loan repayment program eligible for funds under the Public Health Service Act
- Any other state repayment or loan forgiveness program designed to provide for the increased availability of health services in underserved or health professional shortage areas

Beginning in 2020, employer-provided student loan repayments are a tax-free benefit to employees. The CARES Act made this assistance available for payments made from March 27 through December 31, 2020.<sup>77</sup> The CAA extends the provision five additional years until December 31, 2025.<sup>78</sup> Employers can provide tax-free annual payments of up to \$5,250<sup>79</sup> per employee toward eligible education debt. The funds used for student loan payments are not includable in the employee's gross taxable income nor are the payments considered debt forgiveness income.<sup>80</sup>

Interest paid on a student loan cannot be deducted to the extent payments were made through participation in any of the above programs.<sup>81</sup>

### Practitioner Planning Tip

Tax professionals should ask clients with student loan debt (the first indicator would be the taxpayer's receipt of a Form 1098-E, *Student Loan Interest Statement*) if their employer made any payments on the client's behalf because the interest on the student loan debt paid by the employer is not deductible by the client.<sup>82</sup>

<sup>77</sup>. CARES Act, PL 116-136, §2206.

<sup>78</sup>. Consolidated Appropriations Act of 2021, PL 116-260, §120(a).

<sup>79</sup>. Tax-free amount of educational assistance provided in IRC §127(a).

<sup>80</sup>. IRC §108(f)(5), as amended by *The American Rescue Plan Act of 2021*.

<sup>81</sup>. IRC §127(c)(7).

<sup>82</sup>. IRC §221(e)(1).

# 2021 Workbook

**Income-Based Student Loan Repayment Programs.**<sup>83</sup> An income-based repayment plan sets monthly student loan payments at an amount intended to be affordable based on income and family size. The U.S. Department of Education offers the following four income-based repayment plans.

**Note.** The U.S. Department of Education encourages borrowers who may seek loan forgiveness through Public Service Loan Forgiveness programs to use one of the income-based repayment plans to repay student debt.

- 1. Revised Pay as You Earn Repayment Plan (REPAYE Plan)** — Generally 10% of discretionary income (the difference between the borrower's annual income and percentage of the poverty guidelines given the borrower's family size and state of residence);<sup>84</sup> 20-year repayment for undergraduate debt; 25-year repayment for post undergraduate debt.
- 2. Pay as You Earn Repayment Plan (PAYE Plan)** — Generally 10% of discretionary income, but not more than the 10-year standard repayment plan amount (the basic repayment plan amount for federal direct loans and FFEL);<sup>85</sup> 20-year repayment
- 3. Income-Based Repayment Plan (IBR Plan)** — Generally 10% of discretionary income for new borrowers on or after July 1, 2014, but not greater than the 10-year standard repayment plan amount; 15% of discretionary income if borrowing is not new on or after July 1, 2014, but not greater than the 10-year standard repayment plan amount; 20-year repayment for new borrowers after July 1, 2014; 25 years for existing borrowers as of July 1, 2014.
- 4. Income-Contingent Repayment Plan (ICR Plan)** — Lesser of 20% of discretionary income or the amount repayments would be with a fixed-payment over 12 years, adjusted according to income; 25-year repayment.

**Caution.** At the end of the repayment term, any remaining student loan debt is automatically forgiven. Under current law, debt forgiveness represents potentially taxable income unless one of the other exceptions discussed previously can be utilized at the time of debt forgiveness.<sup>86</sup>

Income-based repayment plans may result in larger interest payments in comparison to a standard repayment plan and substantial remaining balances at the end of the payment term.

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<sup>83</sup> *If your federal student loan payments are high compared to your income, you may want to repay your loans under an income-driven repayment plan.* U.S. Department of Education. [studentaid.gov/manage-loans/repayment/plans/income-driven]. Accessed on Apr. 26, 2021.

<sup>84</sup> *Glossary.* U.S. Department of Education. [studentaid.gov/help-center/answers/topic/glossary/articles] Accessed on May 4, 2021.

<sup>85</sup> *Ibid.*

<sup>86</sup> *If your federal student loan payments are high compared to your income, you may want to repay your loans under an income-driven repayment plan.* U.S. Department of Education. [studentaid.gov/manage-loans/repayment/plans/income-driven]. Accessed on May 4, 2021.

## Practitioner Planning Tip

Taxpayers with student loan debt are sometimes advised to choose MFS rather than MFJ when pursuing income-based student loan repayment programs. When using the filing status of MFS, only the income of the debtor is included when calculating the yearly loan payment. When using the filing status of MFJ, the income from both spouses is included to determine the yearly loan payment. For example, Bill and Nancy Williams have an AGI of \$275,000. Bill earns \$75,000 and Nancy earns \$200,000. Bill has the student loan debt. If the couple files separately, Bill's student loan repayment under several of the programs listed previously will be based solely on his income. If they file a joint return, the combined \$275,000 must be considered in the loan repayment calculation. Tax professionals are encouraged to illustrate the annual tax results for MFS vs. MFJ and to remind their clients regarding the potential inclusion in income of remaining student loan debt which will be forgiven at the end of the repayment program period.

Although the complexities of filing status extend beyond the scope of this section, tax practitioners may consider offering assistance to their clients in resolving issues arising from student loan repayment alternatives. Choosing the proper alternative can make a significant difference in clients' finances, but this assistance should consider the following issues, in addition to many others.

- MFJ vs. MFS issues
- Taxpayer AGI
- Repayment plans that may have already been chosen
- Whether the client resides or owns property in a community property state

Practitioners may find that advising clients in student loan repayment matters presents a worthwhile off-season opportunity.

## QPRI<sup>87</sup>

The QPRI exclusion, enacted by the Mortgage Forgiveness Debt Relief Act, applies to cancellation of debt **used to buy, build, or substantially improve the taxpayer's principal residence, or to refinance debt incurred for those purposes**. To be eligible for the exclusion, the debt must be secured by the residence.<sup>88</sup> This exclusion was revised and renewed several times; most recently by the CAA and extended for the period before January 1, 2026.<sup>89</sup>

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<sup>87</sup> IRS Pub. 4681, *Canceled Debts, Foreclosures, Repossessions, and Abandonments (for Individuals)*.

<sup>88</sup> IRC §163(h)(3)(B)(i).

<sup>89</sup> *Consolidated Appropriations Act of 2021*, PL 116-260, §114(a).



## Practitioner Planning Tip

It is important for tax professionals to ask their clients with mortgage indebtedness what the borrowing was used for. QPRI provides potential interest deductions as mortgage interest and debt relief options. Home loan borrowing not used to buy, build, or substantially improve the taxpayer's primary residence are not deductible as QPRI but may be deductible elsewhere on a taxpayer's return, such as primary residence borrowing used to purchase a rental property. The interest associated with this debt could be deductible against the rental income received. Furthermore, for a borrower in financial distress, this portion of the debt may be eligible for exclusion under other provisions such as bankruptcy, insolvency, or qualified real property indebtedness.

Cancelled debt for a taxpayer's principal residence can be excluded from income if it is QPRI. All taxpayers, except MFS, may exclude a maximum of \$750,000 as QPRI. If the taxpayer files MFS, the maximum amount is \$375,000.<sup>90</sup> The exclusion only applies to cancellations of debt related to a decline in the value of the home or to the taxpayer's financial condition.

If the mortgage was refinanced, only the amount of the mortgage immediately before the refinancing qualifies as QPRI. If a loan was taken out for a home mortgage and to finance additional purchases or payments, such as paying down credit card debt, then the exclusion only applies to the portion of the loan that qualifies as QPRI.

The taxpayer must complete Form 982 to report the forgiveness of QPRI. If there is a foreclosure or other loss of the home, only lines 1e and 2 of Form 982 are completed.

If the taxpayer retained ownership in the home and modified the mortgage terms, which resulted in the forgiveness of QPRI, then the taxpayer completes lines 1e, 2, and 10b of Form 982. In this situation, the taxpayer reduces the basis in the home by the amount of the QPRI excluded from income. This is documented on line 10b of Form 982. The basis cannot be reduced below zero.

**Note.** If the taxpayer filed Chapter 11 bankruptcy and the debt was cancelled as part of the bankruptcy, then the taxpayer must apply the bankruptcy exclusion rather than the QPRI exclusion. If the taxpayer was insolvent immediately before the debt cancellation, then the taxpayer may elect to take the insolvency exclusion instead. In this situation, the taxpayer should check the box on line 1b of Form 982 rather than the box on line 1e.

<sup>90</sup> *Consolidated Appropriations Act of 2021*, PL 116-260, §114(b).

**Example 10.** Shelleen Flanagan purchased a home in Boston in 2017 for \$200,000. She made a 5% down payment and financed the remaining \$190,000 through Running Bear Bank with a loan secured by her home. She is personally liable for the debt.

In 2019, she lost her job at the beer factory. At that time, her home was only worth \$150,000. Unfortunately, she still owed \$185,000 on the loan and had no prospects for income from a new job. In 2021, Shelleen convinced the bank to modify her loan and allow her to remain in the home. The bank reduced the principal owed to reflect the current value of the home (\$150,000) and forgave the remaining \$35,000 (\$185,000 mortgage balance – \$150,000 FMV).

Because all the borrowing was QPRI, on her 2021 tax return Shelleen checks the box on line 1e of Form 982.

- On line 2, she reports the \$35,000 of cancelled debt.
- She also enters this amount on line 10b of Form 982 and reduces the basis in her home accordingly.
- She does not include the \$35,000 as income on her Form 1040.

# 2021 Workbook

## For Example 10

Form **982**  
(Rev. March 2018)  
Department of the Treasury  
Internal Revenue Service

### Reduction of Tax Attributes Due to Discharge of Indebtedness (and Section 1082 Basis Adjustment)

OMB No. 1545-0046

▶ Attach this form to your income tax return.

Attachment  
Sequence No. **94**

▶ Go to [www.irs.gov/Form982](http://www.irs.gov/Form982) for instructions and the latest information.

Name shown on return

Identifying number

**Shelleen Flanagan**

**111-11-1111**

#### **Part I** General Information (see instructions)

- 1** Amount excluded is due to (check applicable box(es)):
- a** Discharge of indebtedness in a title 11 case
  - b** Discharge of indebtedness to the extent insolvent (not in a title 11 case)
  - c** Discharge of qualified farm indebtedness
  - d** Discharge of qualified real property business indebtedness
  - e** Discharge of qualified principal residence indebtedness (**Caution:** See instructions before checking this box if debt was discharged after 2017.)
- 2** Total amount of discharged indebtedness excluded from gross income **2** **35,000**
- 3** Do you elect to treat all real property described in section 1221(a)(1), relating to property held for sale to customers in the ordinary course of a trade or business, as if it were depreciable property?  Yes  No

#### **Part II** Reduction of Tax Attributes. You must attach a description of any transactions resulting in the reduction in basis under section 1017. See Regulations section 1.1017-1 for basis reduction ordering rules, and, if applicable, required partnership consent statements. (For additional information, see the instructions for Part II.)

##### Enter amount excluded from gross income:

- |   |            |               |
|---|------------|---------------|
| <b>4</b> For a discharge of qualified real property business indebtedness applied to reduce the basis of depreciable real property  | <b>4</b>   |               |
| <b>5</b> That you elect under section 108(b)(5) to apply first to reduce the basis (under section 1017) of depreciable property   | <b>5</b>   |               |
| <b>6</b> Applied to reduce any net operating loss that occurred in the tax year of the discharge or carried over to the tax year of the discharge                                     | <b>6</b>   |               |
| <b>7</b> Applied to reduce any general business credit carryover to or from the tax year of the discharge   | <b>7</b>   |               |
| <b>8</b> Applied to reduce any minimum tax credit as of the beginning of the tax year immediately after the tax year of the discharge   | <b>8</b>   |               |
| <b>9</b> Applied to reduce any net capital loss for the tax year of the discharge, including any capital loss carryovers to the tax year of the discharge                             | <b>9</b>   |               |
| <b>10a</b> Applied to reduce the basis of nondepreciable and depreciable property if not reduced on line 5. <i>DO NOT use in the case of discharge of qualified farm indebtedness</i> | <b>10a</b> |               |
| <b>b</b> Applied to reduce the basis of your principal residence. <i>Enter amount here ONLY if line 1e is checked</i>   | <b>10b</b> | <b>35,000</b> |
| <b>11</b> For a discharge of qualified farm indebtedness applied to reduce the basis of:  |            |               |
| <b>a</b> Depreciable property used or held for use in a trade or business or for the production of income if not reduced on line 5  | <b>11a</b> |               |
| <b>b</b> Land used or held for use in a trade or business of farming  | <b>11b</b> |               |
| <b>c</b> Other property used or held for use in a trade or business or for the production of income   | <b>11c</b> |               |
| <b>12</b> Applied to reduce any passive activity loss and credit carryovers from the tax year of the discharge  | <b>12</b>  |               |
| <b>13</b> Applied to reduce any foreign tax credit carryover to or from the tax year of the discharge   | <b>13</b>  |               |

#### **Part III** Consent of Corporation to Adjustment of Basis of Its Property Under Section 1082(a)(2)

Under section 1081(b), the corporation named above has excluded \$ \_\_\_\_\_ from its gross income for the tax year beginning \_\_\_\_\_ and ending \_\_\_\_\_.

Under that section, the corporation consents to have the basis of its property adjusted in accordance with the regulations prescribed under section 1082(a)(2) in effect at the time of filing its income tax return for that year. The corporation is organized under the laws of \_\_\_\_\_.

(State of incorporation)

**Note:** You must attach a description of the transactions resulting in the nonrecognition of gain under section 1081.

For Paperwork Reduction Act Notice, see separate instructions.

Cat. No. 17066E

Form **982** (Rev. 3-2018)

**Example 11.** Rian Halle purchased a house in 2017 for \$150,000. He made a 20% down payment and financed the remaining \$120,000 with Fast Feet Bank. In 2019, Rian fell behind on his mortgage payments. In 2021, the bank foreclosed on the property. At that time, the value of Rian’s house was only \$90,000 because he spent all his time running marathons rather than maintaining the house. Rian still owed Fast Feet Bank \$100,000 on the mortgage.

In 2021, the house sold for its full \$90,000 FMV. Rian was still personally liable for \$10,000 on the loan. However, the bank forgave the debt in excess of the FMV of the house (\$10,000).

**Note.** The circumstances illustrated describe a “short sale” which is discussed later.

On Rian’s tax return he checks the box on line 1e of Form 982 and reports the following.

- On line 2, he enters the \$10,000 of cancelled debt.
- He does not include the \$10,000 as income on his Form 1040.

Rian also has a \$60,000 loss on the sale of the home (\$150,000 basis (assuming he had made no improvements to the property) – \$90,000 sale proceeds). **This was his personal residence, so the loss is not deductible.**

**Example 12.** Michael Weston wanted to marry his long-time girlfriend, Fiona. He purchased a home in Miami for \$400,000. He made an \$80,000 down payment and took out a mortgage for \$320,000. The home secured the **recourse** mortgage.

When Fiona moved in, she insisted on new shelving for the home to showcase her snow globes. Michael took out a second **recourse** mortgage for \$20,000 to finance the improvement to the home.

Michael decided to refinance the two mortgages, which at that time had a combined balance of \$330,000. The value of the home had increased to \$450,000 so he was able to replace the two mortgages with a new recourse loan in the amount of \$400,000. He used the additional \$70,000 (\$400,000 new recourse loan – \$330,000 combined balances) to pay for a vacation to Ireland. Unfortunately, while he was away, Michael lost his job and was left with no steady income. Shortly thereafter, the housing market collapsed and the lender foreclosed the home. The home sold at auction for \$325,000. The bank agreed to cancel the remaining debt for which Michael was personally liable, which was \$75,000 (\$400,000 loan amount – \$325,000 sale proceeds).

Of the \$75,000 of cancelled debt income, only \$5,000 qualifies as QPRI. The remainder is includable as income unless another exclusion applies.

Mortgage balance at time of refinancing	\$400,000
FMV of home at time of foreclosure	<u>325,000</u>
Total cancelled debt	\$ 75,000
Nonqualified debt (amount used for vacation)	<u>(70,000)</u>
Debt excludable as QPRI	\$ 5,000

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## For Example 12

CORRECTED (if checked)

CREDITOR'S name, street address, city or town, state or province, country, ZIP or foreign postal code, and telephone no.  <b>Miami General Bank</b> <b>1212 Florida Road</b> <b>Miami, FL 12345</b>		1 Date of identifiable event <b>01/01/2020</b>	OMB No. 1545-1424  <b>2020</b>  Form <b>1099-C</b>	<b>Cancellation of Debt</b>
		2 Amount of debt discharged \$ <b>75000</b>		
		3 Interest, if included in box 2 \$		
CREDITOR'S TIN <b>12-3456789</b>	DEBTOR'S TIN <b>123-45-6789</b>	4 Debt description <b>Home mortgage loan</b>		<b>Copy B For Debtor</b>  This is important tax information and is being furnished to the IRS. If you are required to file a return, a negligence penalty or other sanction may be imposed on you if taxable income results from this transaction and the IRS determines that it has not been reported.
DEBTOR'S name <b>Michael Weston</b>		5 If checked, the debtor was personally liable for repayment of the debt . . . . . <input checked="" type="checkbox"/>		
Street address (including apt. no.) <b>123 Warehouse Rd., No. 123</b> City or town, state or province, country, and ZIP or foreign postal code <b>Miami, FL 12345</b>		6 Identifiable event code <b>D</b>		
Account number (see instructions) <b>99999999999999-0</b>		7 Fair market value of property \$		

Form **1099-C** (keep for your records) [www.irs.gov/Form1099C](http://www.irs.gov/Form1099C) Department of the Treasury - Internal Revenue Service

Michael reports the \$70,000 of nonexcludable cancellation of debt income on his 2020 Form 1040, Schedule 1, line 8.

<b>SCHEDULE 1</b> <b>(Form 1040)</b>  Department of the Treasury Internal Revenue Service	<b>Additional Income and Adjustments to Income</b>  ▶ Attach to Form 1040, 1040-SR, or 1040-NR. ▶ Go to <a href="http://www.irs.gov/Form1040">www.irs.gov/Form1040</a> for instructions and the latest information.	OMB No. 1545-0074  <b>2020</b> Attachment Sequence No. <b>01</b>
Name(s) shown on Form 1040, 1040-SR, or 1040-NR <b>Michael Weston</b>		Your social security number <b>123-45-6789</b>
<b>Part I Additional Income</b>		
1 Taxable refunds, credits, or offsets of state and local income taxes . . . . .	<b>1</b>	
2a Alimony received . . . . .	<b>2a</b>	
b Date of original divorce or separation agreement (see instructions) ▶		
3 Business income or (loss). Attach Schedule C . . . . .	<b>3</b>	
4 Other gains or (losses). Attach Form 4797 . . . . .	<b>4</b>	
5 Rental real estate, royalties, partnerships, S corporations, trusts, etc. Attach Schedule E	<b>5</b>	
6 Farm income or (loss). Attach Schedule F . . . . .	<b>6</b>	
7 Unemployment compensation . . . . .	<b>7</b>	
8 Other income. List type and amount ▶ <u>Cancellation of Indebtedness</u>	<b>8</b>	<b>70,000</b>
9 Combine lines 1 through 8. Enter here and on Form 1040, 1040-SR, or 1040-NR, line 8 . . . . .	<b>9</b>	<b>70,000</b>
<b>Adjustments to Income</b>		

Michael's Form 982 reflects the \$5,000 QPRI exclusion.

## For Example 12

Form <b>982</b> (Rev. March 2018) Department of the Treasury Internal Revenue Service	<b>Reduction of Tax Attributes Due to Discharge of                  Indebtedness (and Section 1082 Basis Adjustment)</b> ▶ Attach this form to your income tax return. ▶ Go to <a href="http://www.irs.gov/Form982">www.irs.gov/Form982</a> for instructions and the latest information.	OMB No. 1545-0046  Attachment Sequence No. <b>94</b>
Name shown on return <b>Michael Weston</b>		Identifying number <b>123-45-6789</b>

### Part I General Information (see instructions)

1 Amount excluded is due to (check applicable box(es)):	
a Discharge of indebtedness in a title 11 case . . . . .	<input type="checkbox"/>
b Discharge of indebtedness to the extent insolvent (not in a title 11 case) . . . . .	<input type="checkbox"/>
c Discharge of qualified farm indebtedness . . . . .	<input type="checkbox"/>
d Discharge of qualified real property business indebtedness . . . . .	<input type="checkbox"/>
e Discharge of qualified principal residence indebtedness ( <b>Caution:</b> See instructions before checking this box if debt was discharged after 2017.) . . . . .	<input checked="" type="checkbox"/>
2 Total amount of discharged indebtedness excluded from gross income . . . . .	2   5,000
3 Do you elect to treat all real property described in section 1221(a)(1), relating to property held for sale to customers in the ordinary course of a trade or business, as if it were depreciable property? . . . . .	
	<input type="checkbox"/> Yes <input type="checkbox"/> No

### Part II Reduction of Tax Attributes. You must attach a description of any transactions resulting in the reduction in

## MORTGAGE RELIEF PROGRAMS AVAILABLE IN 2021

### FORECLOSURE MORATORIUM AND RIGHT TO REQUEST FORBEARANCE<sup>91</sup>

CARES Act §4022 provides for a moratorium on foreclosures (except for vacant or abandoned property) for federally backed mortgages. A servicer of the mortgage cannot commence any of the following foreclosure activities.

- Initiate any judicial or nonjudicial foreclosure process
- Move for a foreclosure judgement or order of sale
- Execute a foreclosure-related eviction or foreclosure sale for not less than the 60-day period beginning on March 18, 2020

The foreclosure moratorium applies even if the borrower did not experience a hardship related to COVID-19.

A borrower with a federally backed mortgage that is experiencing financial hardship due, directly or indirectly, to COVID-19 can request **forbearance** on the mortgage. Forbearance is the **pause** or reduction of mortgage payments to allow the borrower an opportunity to regroup their financial stability.<sup>92</sup> **It does not alter the amount owed.** The borrower must submit a request to the servicers and affirm that the borrower experienced a financial hardship during the COVID-19 pandemic. During the period of forbearance, no fees, penalties, or interest may accrue beyond the amounts scheduled or calculated as if the borrower made all contractual payments on time and in full under the terms of the mortgage contract. The forbearance is granted for up to 180 days and can be extended for an additional period of up to 180 days at the request of the borrower.

<sup>91</sup> CARES Act, PL 116-136, §4022.

<sup>92</sup> Mortgage relief deadlines extended. Dec. 23, 2020. Consumer Finance. [www.consumerfinance.gov/about-us/blog/mortgage-relief-deadlines-extended/] Accessed on May 4, 2021.

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The deadline to apply for forbearance depends on the backer of the loan. Currently, there is no deadline for loans that are backed by Fannie Mae or Freddie Mac.<sup>93</sup>

**Note.** There may be local or state ordinances or moratoriums to protect homeowners against foreclosures and evictions. To search by state, see [uofi.tax/21a2x1](https://www.justia.com/covid-19/50-state-covid-19-resources/eviction-mortgage-foreclosure-relief-during-covid-19-50-state-resource) [www.justia.com/covid-19/50-state-covid-19-resources/eviction-mortgage-foreclosure-relief-during-covid-19-50-state-resource].

## REFINANCING RELIEF OPTIONS

There are options available for homeowners needing more permanent relief, like lower payments, such as the High Loan to Value Refinance Option (HIRO) program through the Federal National Mortgage Association (FNMA). The Federal Home Loan Mortgage Corporation (Freddie Mac) has the Enhanced Relief Refinance program (FMERR). These programs are designed to assist homeowners with little or no equity to refinance their debt and hopefully reduce their monthly loan payment obligation and avoid foreclosure.

### HIRO<sup>94</sup>

The HIRO program allows homeowners with existing Fannie Mae mortgages to refinance if they have been making timely mortgage payments but they have little or no equity or have negative equity. The borrower must demonstrate a clear benefit to them for refinancing, such as a lower payment, lower interest rate, shorter mortgage term, or moving from an adjustable-rate loan to a fixed-rate loan. Eligibility for the program include the following requirements.

- The current loan-to-value ratio is at or above 97.01% for a single-family home. Different rates apply to multi-unit single-family homes, second homes, and investment properties.
- The loan originated on or after October 1, 2017.
- The original mortgage date was more than 15 months prior to the date of refinancing.
- The borrower has consistently made their payments on time.
- The borrower is current on their mortgage payments.
- The borrower has not had a 30-day delinquency in the previous 6-month period, has not had more than one 30-day delinquency in the last 12 months, and no delinquency longer than 30 days.

### FMERR<sup>95</sup>

FMERR is similar to the HIRO program from Fannie Mae but is for mortgages underwritten through Freddie Mac. The relief helps borrowers who make their mortgage payments on time but could not refinance because their property value has declined. Currently, there is no expiration date for the FMERR program. Eligible mortgage requirements include the following.

- The current loan-to-value ratio is at 97.01% or higher for a single-family, primary residence. Different percentages apply for multi-unit primary residents, second homes, and investment properties.
- The loan application originated on or after November 1, 2018.
- The loan has been in existence for at least 15 months.
- The borrower has not been 30-days delinquent in the last six months and has not been more than 30 days delinquent more than one time in the past 12 months.

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<sup>93</sup> Ibid.

<sup>94</sup> *High Loan-to-Value Refinance Option*. Sep. 2019. Fannie Mae. [singlefamily.fanniemae.com/media/8711/display] Accessed on May 6, 2021.

<sup>95</sup> *Enhanced Relief Refinance Mortgage*. Freddie Mac. [sf.freddiemac.com/working-with-us/origination-underwriting/mortgage-products/enhanced-relief-refinance-mortgage] Accessed on May 6, 2021.

## Streamline Refinance Program

**Federal Housing Administration (FHA).**<sup>96</sup> Homeowners with a government-backed FHA mortgage have access to a streamline refinance program (SRP). **Streamline** refers to the reduced amount of paperwork required to refinance the mortgage. For example, an SRP does not require an appraisal. There are four basic requirements of an SRP.

1. The mortgage is insured by the FHA.
2. The mortgage must be current (i.e., not delinquent).
3. SRP must result in a net tangible benefit (depends on the type of refinanced loan, interest rate, term, etc.).
4. The refinancer cannot take out more than \$500 of cash using an SRP.

**United States Department of Agriculture (USDA).**<sup>97</sup> Homeowners with little to no equity and their mortgage is through the USDA are eligible to refinance their loan for more advantageous terms using an SRP. The rural borrower must be current on the mortgage for at least the last 12 months and there are AGI limits based on the geographical area of the residence. Benefits of the USDA SRP include the following.

- Generally, no additional appraisal or credit review required.
- No home inspection or calculation of debt ratios are required.
- Net principal, interest, real estate taxes, and homeowner's insurance payments must be reduced by at least \$50.

**Interest Rate Reduction Refinance Loan (IRRRL) for Veterans.**<sup>98</sup> Borrowers with a mortgage backed by the Veterans Administration (VA) may take advantage of streamlined refinancing through an IRRRL. An IRRRL may lower monthly mortgage payments or stabilize the monthly mortgage payments by changing from a variable or adjustable rate to a fixed interest rate. Eligible borrowers must meet all the following requirements.

- Have an existing VA-backed mortgage
- Use the IRRRL to refinance the VA-backed mortgage
- Certify that they live or previously lived in the residence covered by the VA-backed mortgage

**Note.** There are additional mortgage relief options for veterans beyond the IRRRL and COVID-19 specific forbearance.<sup>99</sup> A **special forbearance** provides mortgage relief for veterans suffering temporary financial distress unrelated to COVID-19. **Repayment plans** are available for veterans to pay a specified amount above their regular mortgage payments each month to bring their loan current. Mortgage companies may offer veterans an opportunity for **loan modification** to extend the term of the loan and amortize any missed payments into the loan amount.

**Note.** Private lenders also provide options to help homeowners make their mortgage payments. To search by lender, see **uofi.tax/21a2x2** [[www.aba.com/about-us/press-room/industry-response-coronavirus](http://www.aba.com/about-us/press-room/industry-response-coronavirus)]. Homeowners who do not see their lender on the list should contact their bank and ask if there is any relief available.

<sup>96</sup> *Streamline Your FHA Mortgage*. HUD. [[www.hud.gov/program\\_offices/housing/sfh/ins/streamline](http://www.hud.gov/program_offices/housing/sfh/ins/streamline)] Accessed May 6, 2021; *Handbook 4000.1*. Apr. 19, 2021. HUD. [[www.hud.gov/sites/dfiles/OCHCO/documents/4000.1hshg\\_Update8.pdf](http://www.hud.gov/sites/dfiles/OCHCO/documents/4000.1hshg_Update8.pdf)] Accessed on May 6, 2021.

<sup>97</sup> *Streamlined Assist Refinance Loans*. May 2016. USDA. [[www.rd.usda.gov/files/RD-RHS-SFHStreamlinedAssistRefinanceLoans.pdf](http://www.rd.usda.gov/files/RD-RHS-SFHStreamlinedAssistRefinanceLoans.pdf)] Accessed on May 7, 2021.

<sup>98</sup> *Interest Rate Reduction Refinance Loan*. U.S. Department of Veterans Affairs. [[www.va.gov/housing-assistance/home-loans/loan-types/interest-rate-reduction-loan/](http://www.va.gov/housing-assistance/home-loans/loan-types/interest-rate-reduction-loan/)] Accessed on May 7, 2021.

<sup>99</sup> *Information for VA home loan borrowers during COVID-19*. Feb. 23, 2021. U.S. Department of Veterans Affairs. [[benefits.va.gov/homeloans/cares-act-frequently-asked-questions.asp](http://benefits.va.gov/homeloans/cares-act-frequently-asked-questions.asp)]. Accessed on Apr. 26, 2021.

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## TAX IMPLICATIONS

### Early Payment of Mortgage Loan

If a taxpayer pays off a home mortgage loan early, **there may be a prepayment penalty assessed.** The taxpayer can deduct that penalty as home mortgage interest on their tax return provided the penalty is not for a specific service performed or cost incurred in connection with their mortgage loan.<sup>100</sup>

If a lender offers a discount to the principal balance of a loan for early repayment or agrees to a loan modification that reduces the principal balance, the discount or reduction is cancelled debt. The cancelled debt is taxable as ordinary income unless an exception applies. If this reduction or modification is for the mortgage of the taxpayer's principal residence, for instance, the QPRI exclusion may apply. If the debt is nonrecourse, however, and the taxpayer does not retain the collateral, then there is no cancellation of debt.<sup>101</sup>

### Short Sales<sup>102</sup>

A "short sale" is a common term referring to a situation in which a homeowner sells a house for less than the existing mortgage balance. The seller then requests that the lender forgive the remaining, unpaid mortgage balance. If the lender agrees, the lender receives the entire sale price for the home in return for forgiving the outstanding difference between the mortgage and the sale price.

A short sale is taxed in the same manner as a foreclosure. If the debt is recourse debt, the cancelled debt is not satisfied with the surrender of the property. Therefore, any debt not satisfied with the sales proceeds is taxable cancellation of debt income. The amount **realized** from the sale of the property that secures a recourse liability does not include amounts that are income from the discharge of indebtedness. The transaction is bifurcated into a taxable sale of property and a taxable discharge of indebtedness. The lender sends the seller a Form 1099-C, which reports the amount of the mortgage debt that was cancelled.

**Note.** A short sale may be preferable to a lender because it is often cheaper than a foreclosure. In a short sale, the debtor sells the property and the lender receives a certain amount. In a foreclosure, the lender must sell the property, which could cost more to the lender in time and effort and could result in a lower sales price.

If a short sale involves nonrecourse debt and the seller and buyer require cancellation of the remaining debt as a condition of the sale, the amount of the debt cancelled is included in the sale proceeds. If the sale involves a principal residence, the taxpayer may qualify for the exclusion from income of the gain from the sale. This makes a short sale on a nonrecourse debt a viable alternative to foreclosure.

**Example 13.** Lily Muenster purchased her primary residence in 2007 for \$500,000 subject to an interest-only recourse mortgage of \$480,000. Her economic situation declined dramatically in 2019 when her husband began working the graveyard shift and she was left with primary responsibility to care for her grandfather and to keep him out of trouble.

Lily arranged with the lender for a short sale. By that time, the value of homes in her neighborhood had declined and hers was no exception. It was now worth only \$350,000 and the home sold for this amount. The lender received the sale proceeds net of the cost of the sale, which was \$325,500 (\$350,000 selling price – \$24,500 cost of sale). As part of the agreement, the lender forgave the remaining debt owed by Lily, which was \$154,500 (\$480,000 – \$325,500).

Lily had a loss of \$174,500 (\$500,000 basis – \$325,500 net sales price). This loss is not deductible for Lily because it arises from the sale of her personal residence. Lily has income in the amount of the cancelled debt but she uses the QPRI exception to exclude this amount.

<sup>100</sup>. IRS Pub. 530, *Tax Information for Homeowners*.

<sup>101</sup>. IRS Pub. 4681, *Canceled Debts, Foreclosures, Repossessions, and Abandonments (for Individuals)*.

<sup>102</sup>. *Real Estate Property Foreclosure and Cancellation of Debt Audit Technique Guide*. Feb. 22, 2019. IRS. [www.irs.gov/pub/irs-utl/real\_estate\_foreclosure\_atg.pdf]. Accessed on Apr. 26, 2021.

**Example 14.** Lily Muenster's niece, Marilyn, purchased her primary residence in 2005 for \$300,000, subject to a nonrecourse mortgage of \$250,000. Marilyn's economic situation declined dramatically in 2019 when she was unable to win a single beauty pageant.

Marilyn arranged with the lender for a short sale. By that time, \$225,000 remained on the mortgage, but her home was only worth \$190,000 and it sold for that amount. The lender received the sale proceeds net of the cost of sale, which was \$178,600 (\$190,000 proceeds – \$11,400 cost of sale). The lender forgave the remaining debt owed by Marilyn, which was \$46,400 (\$225,000 – \$178,600). Marilyn's debt was nonrecourse, so the amount Marilyn realized is the net sale proceeds plus the amount of forgiven debt, which is \$225,000 (\$178,600 + \$46,400). Therefore, Marilyn has a nondeductible loss of \$75,000 (\$300,000 basis – \$225,000) but she has no income from the cancelled nonrecourse debt because it is QPRI.

## FORECLOSURES AND REPOSSESSIONS<sup>103</sup>

When a taxpayer fails to make payments on a loan that is secured by property, the lender may foreclose the loan or repossess the property. For tax purposes, this is treated as a sale or exchange, which may give rise to a gain or a loss.

If the loan balance was more than the FMV of the property and the remaining balance of the loan is cancelled, there may be ordinary income from the cancellation of the remaining debt. **This amount may be excluded from income if the taxpayer qualifies for one of the exceptions discussed earlier in this chapter, such as insolvency.**

### CALCULATING GAIN OR LOSS

Gain or loss from a foreclosure or repossession is calculated in the same way as gain or loss from a sale and should be reported similarly. The gain is calculated as the excess of the amount realized over the adjusted basis in the property. The loss is the excess of the adjusted basis in the transferred property over the amount realized. Losses from the sale or foreclosure of personal property are not deductible.

For recourse debt, the **amount realized** on the foreclosure or repossession is the smaller of the following.

- The outstanding debt immediately before the transfer, reduced by any amount for which the taxpayer remains personally liable immediately after the transfer
- The FMV of the transferred property

**Note.** For more information, see IRS Pub. 544, *Sales and Other Dispositions of Assets*.

In addition, if there is a recourse loan on the repossessed property and more is owed than the FMV of the property, ordinary income may be realized if the lender cancels the remaining loan.

For nonrecourse debts, the taxpayer realizes an amount that includes the full outstanding debt immediately before the transfer. Even if the FMV of the property is less than the outstanding debt, the full outstanding debt is still realized.

<sup>103</sup>. IRS Pub. 544, *Sales and Other Dispositions of Assets*.

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**Example 15.** Geoff Jordan is a novice race car enthusiast. Even though he does not believe he might ever compete in competitive racing, he bought a new race car for \$30,000. He paid \$10,000 down and borrowed the remaining \$20,000 through dealer financing. Geoff is personally liable for the loan and pledged the car as security for the loan. The lender ultimately repossessed the car because Geoff stopped making loan payments after a couple of failed attempts at racing. The balance due on the loan at the time of repossession was \$10,000. The FMV of the car when it was repossessed was \$3,000 because of the sustained high-speed use of the car. The lender forgave the remaining \$10,000 balance on the loan.

Because Geoff's debt is recourse, the amount realized on the repossession is calculated as the smaller of the following amounts.

- The \$10,000 outstanding debt immediately before the repossession reduced by the \$7,000 for which he remains personally liable immediately after the repossession ( $\$10,000 - \$7,000 = \$3,000$ ), or
- The \$3,000 FMV of the car.

Geoff calculates his gain or loss on the repossession by comparing the amount realized of \$3,000 with his \$20,000 adjusted basis. He has a \$17,000 nondeductible loss because the car was not used in a trade or business. After the cancellation of the remaining balance on the loan, Geoff also has ordinary income from cancellation of debt in the amount of \$7,000 ( $\$10,000$  balance due at time of repossession – \$3,000 FMV of car). Geoff must report this \$7,000 on his tax return as income on Form 1040, Schedule 1, line 8, unless he qualifies for another exclusion such as insolvency.

**Note.** In the previous example, the facts and circumstances indicated the activity was engaged in for personal pleasure as a hobby.

## INSTALLMENT SALES<sup>104</sup>

An installment sale is a sale of property in which at least one payment is received after the tax year in which the sale occurs. The seller is required to report a gain on an installment sale under the installment method unless they make an election to not use the installment method on or before the due date (including extensions) for filing their tax return for the year of the sale. The election can be made by reporting all the gain as income in the year of the sale on Form 4797, *Sales of Business Property*, Form 8949, *Sales and Other Dispositions of Capital Assets*, or both.

**Note.** Installment method rules do not apply to sales that result in a loss.

Form 6252, *Installment Sale Income*, is used to report a sale of property on the installment method. Form 6252 is used both to report the sale in the year it takes place and to report payments received in later years.

If property is **repossessed** after an installment sale is initiated, then the taxpayer repossessing the property must determine the gain or loss on the repossession and the adjusted basis of the repossessed property. The rules for calculating these amounts depend on the kind of property repossessed. The rules that apply to personal property are different than those that apply to real property.

**Note.** Title does not have to transfer for the repossession rules to apply. The taxpayer must either foreclose on the property or have the buyer voluntarily relinquish the property to the taxpayer for the repossession rules to apply. In addition, the property must secure the installment obligation and repossession of the property must at least partially satisfy the buyer's obligation.

<sup>104</sup>. IRS Pub. 537, *Installment Sales*.

## Personal Property

If the original sale was reported using the installment method, the basis in personal property is calculated by multiplying the unpaid balance of the installment obligation by the gross profit percentage. This amount is subtracted from the unpaid balance. The result is the basis in the installment obligation.

**Note.** For information on how to calculate the gross profit percentage, see IRS Pub. 537, *Installment Sales*.

If the FMV of the repossessed property is more than the total of the taxpayer's basis in the obligation plus any repossession costs, the taxpayer has a gain. If the FMV is less, the taxpayer has a loss. This gain or loss on the repossession has the same character (capital or ordinary) as the original sale.

**Example 16.** Use the same facts as **Example 15**. The dealer's gross profit percentage is 30% and it cost \$1,000 to repossess the car. The dealer reported the original sale on its tax return using the installment method.

The dealer's loss is calculated using the following worksheet from IRS Pub. 537.

Worksheet C. **Figuring Gain or Loss on Repossession of Personal Property**

**Note.** Use this worksheet only if you used the installment method to report the gain on the original sale.

Keep for Your Records 

1. Enter the FMV of the repossessed property .....	<b>3,000</b>
2. Enter the unpaid balance of the installment obligation .....	<b>10,000</b>
3. Enter your gross profit percentage for the installment sale .....	<b>30%</b>
4. Multiply line 2 by line 3. This is your unrealized profit .....	<b>3,000</b>
5. Subtract line 4 from line 2. This is the basis of the obligation .....	<b>7,000</b>
6. Enter your costs of repossessing the property .....	<b>1,000</b>
7. Add lines 5 and 6 .....	<b>8,000</b>
8. Subtract line 7 from line 1. This is your gain or loss on the repossession .....	<b>(5,000)</b>

# 2021 Workbook

## Real Property

The rules for the repossession of real property allow a taxpayer to keep essentially the same adjusted basis in the repossessed property that they had before the original installment sale. The taxpayer can recover the entire basis when the property is resold. This effectively cancels out the tax treatment that applied to the taxpayer on the original installment sale and puts the taxpayer in the same tax position as before that sale.

Rules concerning basis and gain on repossessed real property are **mandatory**. The taxpayer must use these rules to calculate the basis in the repossessed real property and gain on the repossession. The rules apply regardless of whether the taxpayer reported the sale on the installment method. However, the rules apply **only** if all the following conditions are met.

1. The repossession was to protect the taxpayer's security rights in the property.
2. The installment obligation satisfied by the repossession must have been received in the original sale.
3. The taxpayer did not pay any additional consideration to the buyer to get the property back unless either of the following situations applies.
  - a. The requisition and payment of the additional consideration were provided for in the original contract of sale.
  - b. The buyer has defaulted or default is imminent.

If any one of the preceding three conditions is not met, the rules for repossessed personal property should be used, as if the property repossessed were personal rather than real property.

**Calculating Gain on Repossession.** The gain on the repossession of real property is either ordinary income or capital gain, the same as the gain on the original sale. However, if the taxpayer did not report the sale on the installment method, the gain on repossession is ordinary income.

The taxpayer's gain on repossession is the difference between the following amounts.

- The total payments received, or considered received, on the sale.
- The total gain already reported as income.

However, taxable gain is **limited** to the taxpayer's gross profit on the original sale minus the sum of the following amounts.

- The gain on the sale the taxpayer reported as income before the repossession
- Repossession costs (includes money or property paid to reacquire the property, such as court costs and legal fees, publishing costs, recording fees, and lien clearance.)

This method of calculating taxable gain essentially treats all payments received as income but limits the taxable gain to the gross profit the taxpayer originally expected on the sale. The limit on taxable income does not apply if the selling price is indefinite and cannot be determined at the time of the repossession. An example of an indefinite selling price is when the selling price is stated as a percentage of profits from the development of the real property.

**Example 17.** Beni Cartwright sold a tract of land in January 2019 for \$25,000 to Matt Dyllon. He accepted a \$5,000 down payment, plus a \$20,000 mortgage secured by the property and payable at the rate of \$4,000 annually plus interest (9.5%). The payments began on January 1, 2020. The adjusted basis in the property was \$19,000 and Beni reported the transaction as an installment sale. His selling expenses were \$1,000. Beni calculated his gross profit as follows.<sup>105</sup>

Selling price		\$25,000	
Adjusted basis	\$19,000		
Selling expenses	<u>1,000</u>		
	\$20,000	<u>(20,000)</u>	
Gross profit		\$ 5,000	

For this sale, the contract price equals the selling price. The gross profit percentage is 20% (\$5,000 gross profit ÷ \$25,000 contract price).

In 2019, Beni included \$1,000 in income (20% × \$5,000 down payment) on Form 6252. In 2020, he reported a profit of \$800 (20% × \$4,000 annual installment). In 2021, Matt defaulted and Beni repossessed the property. Beni paid \$500 in legal fees to get the property back. The taxable gain on the repossession is calculated as follows, using a worksheet from IRS Pub. 537.

Worksheet D. **Taxable Gain on  
Repossession of Real  
Property**

**Note.** Use this worksheet to determine taxable gain on the repossession of real property if you used the installment method to report the gain on the original sale.

*Keep for Your Records*

1. Enter the total of all payments received or treated as received before repossession .....	9,000
2. Enter the total gain already reported as income .....	1,800
3. Subtract line 2 from line 1. This is your gain on the repossession .....	7,200
4. Enter your gross profit on the original sale .....	5,000
5. Enter your costs of repossessing the property .....	500
6. Add line 2 and line 5 .....	2,300
7. Subtract line 6 from line 4 .....	2,700
8. Enter the lesser of line 3 or line 7. This is your taxable gain on the repossession .....	2,700

<sup>105</sup>. This example is adapted from IRS Pub. 537, *Installment Sales*.

# 2021 Workbook

**Basis.** The basis in the repossessed real property is determined as of the date of repossession. It is the sum of the following amounts.

- Adjusted basis in the installment obligation
- Repossession costs
- Taxable gain on the repossession

To calculate the adjusted basis in the installment obligation at the time of repossession, the unpaid balance is multiplied by the gross profit percentage. This amount is subtracted from the unpaid balance.

**Example 18.** Use the same facts as **Example 17**. The unpaid balance of the installment obligation is \$16,000 at the time of repossession (\$20,000 note – \$4,000 payment). Beni’s basis in the repossessed property is calculated as follows, using a worksheet from IRS Pub. 537.

## Worksheet E. **Basis of Repossessed Real Property**

Keep for Your Records



**Note.** Use this worksheet to determine your basis in the repossessed real property.

1. Enter the unpaid balance on the installment obligation .....	<u>16,000</u>
2. Enter your gross profit percentage for the installment sale .....	<u>20%</u>
3. Multiply line 1 by line 2. This is your unrealized profit .....	<u>3,200</u>
4. Subtract line 3 from line 1. This is your adjusted basis in the installment obligation on the date of the repossession .....	<u>12,800</u>
5. Enter your taxable gain on the repossession .....	<u>2,700</u>
6. Enter your costs of repossessing the property .....	<u>500</u>
7. Add lines 4, 5, and 6. This is your basis in the repossessed real property .....	<u>16,000</u>

## ABANDONMENT<sup>106</sup>

An abandonment occurs when possession and use of the property is given up voluntarily and permanently, with no intention to recover the property or transfer ownership to another person. There must be an intention to abandon the property and affirmative steps must be taken toward abandonment. The determination of whether abandonment occurred is based on the facts and circumstances of the situation.

Because abandonment requires an intention to permanently give up possession without any intention to transfer ownership of the property to another person, a voluntary conveyance of the property in lieu of foreclosure is not abandonment. Instead, it is treated as the exchange of property to satisfy a debt.

In most cases, if the taxpayer abandons property that secures recourse debt, there is no recognition of gain or loss until a foreclosure is completed later. If the taxpayer abandons property that secures nonrecourse debt, the abandonment is treated as a sale or exchange. The amount realized is the amount of the nonrecourse debt. If the amount realized is more than the adjusted basis in the property, then the taxpayer has a gain. If the adjusted basis is more than the amount realized, the taxpayer has a loss.

<sup>106</sup> IRS Pub. 4681, *Canceled Debts, Foreclosures, Repossessions, and Abandonments (for Individuals)*.

# 2021 Workbook

## FORM 1099-A

**Note.** When a taxpayer receives a Form 1099-A *Acquisition or Abandonment of Secured Property*, they have a “sale” to report. Whether the property was abandoned, foreclosed, or repossessed, the taxpayer has a transaction to report which may result in gain or loss. When a lender acquires an interest in the taxpayer’s property either through a foreclosure, repossession, or abandonment, the lender generally sends a Form 1099-A to the taxpayer. This form provides the necessary information for the taxpayer to calculate the gain or loss.

The lender completes the Form 1099-A in the following manner.<sup>107</sup>

- Box 1 states the date the lender acquired the property, which is either the date that the title is transferred to the lender or the date of possession by the lender. If the property is purchased at a sale, the date of sale is used unless the borrower has a right of redemption. If the borrower has a right of redemption, then the date the redemption period expires is used. For an abandonment, the date shown is the date on which the lender first knew that the property was abandoned.
- Box 2 lists the balance of the debt outstanding as of the date listed in box 1.
- Box 4 shows the FMV of the property.
- Box 5 indicates whether the debt was recourse or nonrecourse.
- Box 6 should include a general description of the property.

**Example 19.** After the tragic death of his wife, Pat Jane got a position with the police force solving crimes. The value of Pat’s home diminished after his wife’s death. It was worth only \$60,000 but had a recourse mortgage loan with a balance of \$100,000.

Pat packed up his collection of suits and drove away, vowing to never step foot in the home again. The bank became aware that Pat had abandoned the property on January 3, 2020, and sent him a Form 1099-A.

CORRECTED (if checked)

LENDER'S name, street address, city or town, state or province, country, ZIP or foreign postal code, and telephone no.  <b>Sacramento General Bank 1212 Florida Road Sacramento, CA 98765</b>			OMB No. 1545-0877  <b>2020</b> Form 1099-A	<b>Acquisition or Abandonment of Secured Property</b>
LENDER'S TIN <b>98-7654321</b>	BORROWER'S TIN <b>987-65-4321</b>	<b>1</b> Date of lender's acquisition or knowledge of abandonment <b>01/03/2020</b>	<b>2</b> Balance of principal outstanding \$ <b>100000.00</b>	<b>Copy B For Borrower</b>  This is important tax information and is being furnished to the IRS. If you are required to file a return, a negligence penalty or other sanction may be imposed on you if taxable income results from this transaction and the IRS determines that it has not been reported.
BORROWER'S name  <b>Patrick Jane</b>  Street address (including apt. no.) <b>987 Red John Lane</b>  City or town, state or province, country, and ZIP or foreign postal code <b>Sacramento, CA 98765</b>		<b>3</b>	<b>4</b> Fair market value of property \$ <b>60000.00</b>	
Account number (see instructions) <b>11111111111111-0</b>		<b>5</b> If checked, the borrower was personally liable for repayment of the debt . . . . . <input checked="" type="checkbox"/>		
Description of property <b>987 Red John Lane Sacramento, CA 98765</b>				
Form <b>1099-A</b> (keep for your records)		www.irs.gov/Form1099A		Department of the Treasury - Internal Revenue Service

<sup>107</sup>. Instructions for Form 1099-A.

# 2021 Workbook

## ORDINARY INCOME FROM CANCELLED DEBT

If the abandoned property secures recourse debt and the debt is cancelled, the taxpayer may realize ordinary income equal to the cancelled debt. This income is separate from any loss realized from the abandonment of the property.

The lender generally sends a Form 1099-A showing the information needed to calculate the loss from the abandonment of the property. If the taxpayer's debt is cancelled and the lender must file Form 1099-C, the lender may include the information about the abandonment on that form rather than on Form 1099-A. In this situation, Form 1099-A is not required.

## ABANDONED BUSINESS PROPERTY<sup>108</sup>

Generally, a taxpayer is entitled to a deduction for losses sustained from the abandonment of business property. The taxpayer's loss is equal to the adjusted basis of the property if incurred in a trade or business. Loss from abandonment of business or investment property is deductible as an ordinary loss if it is not treated as a sale or exchange. This applies to leasehold improvements the lessor made that were abandoned. The abandonment loss is deducted in the tax year in which the loss is sustained.

**Example 20.** In 2017, Jason purchased business property for \$100,000. He borrowed the entire purchase price with nonrecourse debt but secured the loan with the property. In 2020, Jason was unable to continue making his loan payments, so he decided to abandon the property on September 1, 2021. Because Jason was not personally liable for the debt, the abandonment is treated as a sale or exchange of the property in the 2021 tax year. At the time of the abandonment, Jason owed \$90,000 on the loan but the FMV of the property was only \$75,000. The amount Jason realized is \$90,000 (the amount owed on the loan) and his basis in the property is \$100,000; therefore, he has a \$10,000 deductible loss in 2021.

The lender sells the property at a foreclosure sale in 2021 but Jason does not realize gain or loss from the foreclosure sale. He also has no cancellation of debt income because it was a nonrecourse debt.

## ALTERNATIVES TO BANKRUPTCY FILING FOR TAX DEBTS

The IRS provides a variety of payments plans as alternatives to bankruptcy filing for taxpayers experiencing financial distress. A payment plan is an agreement between the taxpayer and the IRS to extend the payment date for taxes owed. Payment plans are beneficial if the taxpayer believes they can pay the taxes owed within the extended timeframe. Taxpayers who cannot pay within the extended timeframe are subject to IRS levies and/or tax liens.<sup>109</sup>

## INSTALLMENT AGREEMENT

Taxpayers who are unable to pay their tax liability on their tax return or IRS notice can request an installment agreement (IA) by filing Form 9465, *Installment Agreement Request*. The IA is guaranteed to be accepted if the tax owed is not more than \$10,000 and **all** the following apply.<sup>110</sup>

- During the past five years, the taxpayer (and their spouse, if MFJ) have timely filed all income tax returns and paid any income tax due and have not entered into an IA for the payment of income tax.
- The taxpayer agrees to pay the full amount owed within three years and to comply with the tax laws while the agreement is in effect.
- The taxpayer is financially unable to pay the liability in full when due.

<sup>108</sup>. IRS Pub. 544, *Sales and Other Dispositions of Assets*.

<sup>109</sup>. *Additional Information on Payment Plans*. Mar. 16, 2021. IRS. [[www.irs.gov/payments/payment-plans-installment-agreements](http://www.irs.gov/payments/payment-plans-installment-agreements)] Accessed on Apr. 23, 2021.

<sup>110</sup>. Instructions for Form 9465.

**Note.** The preceding discussion does not intend to suggest taxpayers with larger amounts owed are precluded from entering an installment plan. For those taxpayer/debtors, the IRS will likely require more information on Form 433-A, *Collection Information Statement for Wage Earners and Self-Employed Individuals*, or Form 433-B, *Collection Information Statement for Businesses*. Depending on the size of the debt and the taxpayer's history of payment, the IRS may also file liens against property owned by the taxpayer/debtor.

## Online Payment Plan<sup>111</sup>

Qualified taxpayers and authorized representatives with a power of attorney can apply online for a payment plan, including an IA, to pay off tax balances over time. Applicants receive immediate notification of whether the payment plan is approved.

**Individual Payment Plan.** Payment options for individuals include full payment, a short-term payment plan (paid in 120 days or less) and a long-term payment plan like an IA (paid in more than 120 days). Individuals qualify to apply online for a long-term payment plan if they owe \$50,000 or less in combined tax, penalties, and interest, and have filed all required returns. Individuals qualify for a short-term payment plan if they owe less than \$100,000 in combined tax, penalties, and interest.

To apply for a payment plan, the following information must be provided.

- Taxpayer name exactly as it appears on the most recently filed tax return
- Valid email address
- Address from most recently filed tax return
- Date of birth
- Filing status
- Social security number (SSN) for taxpayer and MFJ spouse, or individual taxpayer identification number (ITIN)

Taxpayers may also need to provide the amount of the balance due. Additionally, the taxpayer must provide a financial account number, mobile phone registered in their name, or an activation code received by postal mail to confirm their identity.

**Note.** Sole proprietors and independent contractors apply for a payment plan as individuals.

**Note.** Requests to pay taxes owed on an installment method can be filed with the return electronically. The IRS takes several months to respond to the installment request and it may be necessary to respond to IRS requests for payment while it processes both the return and the installment payment request.

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<sup>111</sup> *Apply Online for a Payment Plan*. Apr. 14, 2021. IRS. [[www.irs.gov/payments/online-payment-agreement-application](http://www.irs.gov/payments/online-payment-agreement-application)] Accessed on May 7, 2021.

# 2021 Workbook

**Business Payment Plan.** There are two payment plan options available for a business. They are full payment and an IA paid in more than 120 days. A business qualifies to apply online for an IA if it has filed all required returns and owes less than \$25,000 in combined tax, penalties, and interest. To apply, a business must provide the following information.

- Information to prove the taxpayer's identity as an individual (see the list under Individual Payment Plan)
- EIN
- Date the business was established (month and year)
- Address from the most recently filed tax return
- Caller ID from notice

Taxpayers may also need to provide the amount of the balance due, tax form filed or examined, and the tax period filed or examined.

**Note.** For more information on how to pay installment agreements for individuals or businesses, see the 2021 *University of Illinois Federal Tax Workbook*, Volume A, Chapter 3: Representation Before the IRS.

## Streamlined IA<sup>112</sup>

On September 26, 2018, the IRS finalized its criteria for processing streamlined IA. The enhanced criteria for streamlined IAs improves customer service, reduces taxpayer burden, and increases agency efficiency.

Most taxpayers with a balance due of up to \$25,000 meet the criteria for streamlined processing of their IA request. To qualify, all taxpayers must be current with all required return filings. Generally, IRS assistors can set up an IA without the completion of a collection information statement or a determination to file a notice of federal tax lien.

The new streamlined processing criteria apply to the following types of taxpayers.

- Individuals and out-of-business sole proprietors with an assessed balance of tax, penalties, and interest up to \$50,000
- Out-of-business taxpayers with assessed balances up to \$25,000
- In-business taxpayers with income tax only assessed balances up to \$25,000

**Processing Criteria.** Taxpayers have the lesser of up to 72 months or the number of months necessary to satisfy their liability in full by the expiration date of the statute of limitations. A collection information statement is not required. The IRS prefers taxpayers pay by direct debit or payroll deduction but it is not a requirement.

A notice of federal tax lien is not required for assessed balances up to \$25,000 or for assessed balances of \$25,000–\$50,000 with the use of a direct debit or payroll deduction agreement. Streamlined IAs over \$25,000 for which there is no direct debit or payroll deduction agreement required a notice of federal tax lien.

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<sup>112</sup>. *Streamlined Installment Agreements*. Jun. 9, 2020. IRS. [[www.irs.gov/businesses/small-businesses-self-employed/streamlined-processing-of-installment-agreements](http://www.irs.gov/businesses/small-businesses-self-employed/streamlined-processing-of-installment-agreements)] Accessed on May 7, 2021.

## OFFER IN COMPROMISE<sup>113</sup>

Taxpayers who cannot pay the amount due in full or through installments may be eligible for an offer in compromise (OIC) to settle for an amount less than what is owed. Reasons the IRS may accept an OIC include the following.

1. The IRS agrees that the taxpayer's tax debt may not be accurate.
2. The taxpayer has insufficient assets and income to pay the amount due.
3. Due to the taxpayer's exceptional circumstances, payment of the full amount due causes the taxpayer economic hardship or is unjust.

**Note.** For more information on OICs such as who qualifies and the process to apply, see the 2021 *University of Illinois Federal Tax Workbook*, Volume A, Chapter 3: Representation Before the IRS.



### Practitioner Planning Tip

As a practical matter, the IRS only allows federal standard expenses based on household size rather than the actual cost of operating the household to determine the amount of monthly net income a taxpayer may have to direct toward an OIC. See the following table for the national standards for food, clothing and other items. Additional IRS collection financial standards can be found at **uofi.tax/21a2x3** [[www.irs.gov/businesses/small-businesses-self-employed/collection-financial-standards](http://www.irs.gov/businesses/small-businesses-self-employed/collection-financial-standards)].

In addition, any equity in assets must be included as part of an offer. Seldom is a taxpayer permitted to borrow 100% of the value of assets and “fire sale” liquidation of assets may create much less cash than the stated value. With these factors in mind, an “ideal” OIC candidate is one for whom income (or potential income prospects) is limited and equity in assets is negligible. Taxpayers with sizeable disposable net income and equity in assets are seldom approved for an OIC.

### 2021 Allowable Living Expenses National Standards<sup>114</sup>

Expense	One Person	Two Persons	Three Persons	Four Persons	For Each Person Above Four Persons
Food	\$400	\$ 724	\$ 838	\$ 955	
Housekeeping supplies	41	76	69	79	
Apparel and services	92	150	191	259	
Personal care products and services	42	76	72	89	
Miscellaneous	148	266	303	358	
<b>Total</b>	<b>\$723</b>	<b>\$1,292</b>	<b>\$1,473</b>	<b>\$1,740</b>	<b>\$341</b>

<sup>113</sup> See Form 656 Booklet, *Offer in Compromise* and Form 656, *Offer in Compromise*. Nov. 23, 2021. IRS. [[www.irs.gov/Individuals/Offer-in-Compromise-1](http://www.irs.gov/Individuals/Offer-in-Compromise-1)] for more information. Accessed on Apr. 23, 2021.

<sup>114</sup> *National Standards: Food, Clothing and Other Items*. Apr. 29, 2021. IRS. [[www.irs.gov/businesses/small-businesses-self-employed/national-standards-food-clothing-and-other-items](http://www.irs.gov/businesses/small-businesses-self-employed/national-standards-food-clothing-and-other-items)] Accessed on Jun. 3, 2021.

# 2021 Workbook

## IRS Prequalifier Tool<sup>115</sup>

The IRS offers an OIC prequalifier tool for taxpayers to determine if they are eligible for an OIC before completing the paperwork. The taxpayer enters their financial information and tax filing status to calculate a preliminary offer amount. The IRS makes its determination based on the completed OIC application and its investigation. **The tool is only a guide; it is not a guarantee of offer acceptance.** The prequalifier tool is not available for partnerships, corporations, or for taxpayers who reside in a U.S. territory, foreign country, or are military personnel using an APO or FPO address. The tool can be accessed at [uofi.tax/21a2x4](https://uofi.tax/21a2x4) [irs.treasury.gov/oic\_pre\_qualifier/faces/OIC\_Screen1.jsp].

**Example 21.** Joe the Plumber runs a solely owned service business. In 2020, he experienced great success and as a result he owes the IRS \$30,000. Even though his business was profitable, Joe has no cash available to pay the taxes. Although Joe is quite successful at being a plumber, he is quite active and unsuccessful at sports betting. Joe is a single taxpayer who rents a small house for \$1,000 per month. He has \$100 in his business account and owns a 1979 Ford Ranger pickup truck worth \$250. This is the extent of his assets. He prepared his 2020 return through free online software, but he now requests the assistance of Prudence Filer, a local CPA. At their first meeting, Prudence walks Joe through the IRS OIC qualifier.

### Offer In Compromise Pre-Qualifier



Use this tool to see if you may be eligible for an offer in compromise (OIC). Enter your financial information and tax filing status to calculate a preliminary offer amount. We make our final decision based on your completed OIC application and our associated investigation. This tool should only be used as a guide. Although it may show you can full pay your liability, you may still file an offer in compromise and discuss your individual financial situation with the IRS.

If you are a partnership, corporation, or reside in a U.S. Territory, foreign country, or are military personnel using an APO or FPO address the OIC Pre-Qualifier is not applicable for your situation. Please proceed to the application in the [Offer in Compromise Booklet](#).

**Are you in an open bankruptcy proceeding?**

- Yes  
 No

**Have you filed all required federal tax returns?**

- Yes  
 No

**Have you made all required estimated tax payments?**

- Yes  
 No  
 N/A

**If you are self-employed and have employees, have you submitted all required federal tax deposits?**

- Yes  
 No  
 N/A

**NEXT** >

<sup>115</sup> See Form 656 Booklet, *Offer in Compromise*.

# 2021 Workbook

## For Example 21

### Offer In Compromise Pre-Qualifier



Enter information about your location, household and tax debt.

ZIP or postal code

State

County

Total members of household

Total members of household 65 years or older

Total IRS tax debt including penalties & interest (whole dollars)

What is the most recent tax year you are requesting to compromise?

(For example, if you owe 1040 taxes for 2015, 2016 and 2018, enter 2018. If the most recent tax year is more than ten years old, please enter the year the tax return was filed. This assists us in the future income calculation of your offer.)

# 2021 Workbook

## For Example 21

### Offer In Compromise Pre-Qualifier



Enter information about your **assets** (in whole dollars). Your equity is the value of your asset minus what you still owe on the asset.

Total bank balances

Home market value

Home loan balance

Vehicle 1 equity

Vehicle 2 equity

Retirement account equity (401k, IRA, etc.)

Other real property equity

Other asset equity (airplane, motorcycle, recreational vehicles, etc.)

Stocks, bonds and other investments, etc.

Miscellaneous

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## For Example 21

### Offer In Compromise Pre-Qualifier



Enter information about your household monthly income (in whole dollars). The entire household includes all those in addition to yourself who contribute money to pay expenses relating to the household such as rent, utilities, insurance, groceries, etc.

Gross wages including Social Security, pensions, unemployment, etc

Interest and dividends

Distributions from partnerships, sub-S corporations, etc.

Net rental income

Net business income

Child support received

Alimony received

Additional Income

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**Note.** The \$2,083 illustrated as Joe's monthly gross wages is calculated using his 2020 business net profit. It is entirely possible that his current net profit could be more or less than this result.

# 2021 Workbook

## For Example 21

### Offer In Compromise Pre-Qualifier



Status Basic Info Assets Income Expenses Proposal

Enter information about your **typical month's household expenses** (in whole dollars). Maximum allowances for expenses are determined based on your location and number of members of your household. We estimate and include expenses for your food, clothing, miscellaneous items and out of pocket medical expenses.

Rent or mortgage and utilities

\$1000

Total vehicles owned

Vehicle 1 loan or lease payment

\$

Vehicle operating costs

\$

Public transportation costs

\$

Health insurance premiums

\$

Life insurance premiums

\$

Federal, state and local taxes

\$399

Court-ordered payments

\$

Child dependent care costs

\$

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**Note.** The monthly illustration of \$399 for federal, state, and local taxes consists of Joe's SE tax plus projected income tax divided by 12 months.

## For Example 21

### Offer In Compromise Pre-Qualifier



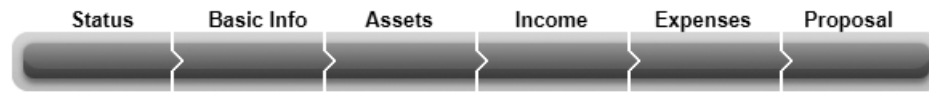
The following proposal is based on the information you entered for tax debt, equity and monthly income. Allowable monthly expenses are based on the information you entered, as well as any adjustments to those expenses in accordance with the IRS [collection financial standards](#).

<b>Tax debt:</b>		<b>\$30,000</b>
<b>Total available equity:</b>		<b>\$0</b>
Equity Type	Your Entry	IRS Calculated Equity
Total Bank Balance	\$100	\$0
Home equity (Home Market value minus home loan balance)	\$0	\$0
Vehicle 1 equity	\$250	\$0
Vehicle 2 equity	\$0	\$0
Retirement account equity	\$0	\$0
Other real property equity (rental, business, land, timeshare, etc.)	\$0	\$0
Other assets equity (air plane, motorcycle, recreational vehicle etc.)	\$0	\$0
Stocks, Bonds, Money Market, CDs, other investments, etc.	\$0	\$0
Miscellaneous equity (art, coins, gun collection etc.)	\$0	\$0
<b>Total Equity</b>	<b>\$350</b>	<b>\$0</b>
<b>Monthly income:</b>		<b>\$2,083</b>

# 2021 Workbook

## For Example 21

### Offer In Compromise Pre-Qualifier



The following proposal is based on the information you entered for tax debt, equity and monthly income. Allowable monthly expenses are based on the information you entered, as well as any adjustments to those expenses in accordance with the IRS [collection financial standards](#).

<b>Tax debt:</b>	<b>\$30,000</b>
<b>Total available equity:</b>	<b>\$0</b>
<b>Monthly income:</b>	<b>\$2,083</b>
<b>Allowable monthly expenses:</b>	<b>\$2,407</b>

Expense Type	Your Entry	What We Allow
Food, clothing and miscellaneous	---	\$723
Rent or mortgage and utilities	\$1,000	\$1,000
Vehicle 1 loan or lease payment	\$0	\$0
Vehicle operating costs (gas, repairs, etc.)	\$0	\$0
Public transportation costs	\$0	\$217
Out-of-pocket medical expenses	---	\$68
Health Insurance Premiums	\$0	\$0
Life insurance premiums	\$0	\$0
Federal, state and local taxes	\$399	\$399
Court-ordered payments (child support, alimony)	\$0	\$0
Child/dependent care costs	\$0	\$0
<b>Total remaining income:</b>		<b>\$0</b>

Joe is advised by the IRS to file the paperwork for an OIC or to request his account to be placed in uncollectible status. Prudence suggests Joe make an offer to the IRS and he agrees to a \$1,000 offer. Prudence then prepares the offer packet for submission to the IRS.

### Practitioner Planning Tip

Indebted taxpayers may be enticed by late night television or social media advertisements promoting services to settle tax debts for pennies on the dollar. Tax professionals may wish to advise their clients who feel these advertised services may be a better alternative than meeting with a tax professional to first ask the advertiser what constitutes a “settlement” per their ads, how much will they charge, and whether a fee must be paid up front regardless of the “settlement” outcome.

## COLLECTION DELAY REQUEST<sup>116</sup>

Taxpayers who cannot pay the amount due because payment prevents them from meeting basic living expenses, can request a delay in collection until they are able to pay. The IRS may require completion of a collection information statement and proof of the taxpayer's financial status before approving the request. Penalties and interest nevertheless continue to accrue until the debt is fully paid. The IRS may still file a notice of federal tax lien at their discretion.

**Note.** IRS Pub. 594, *The IRS Collection Process*, provides details of IRS publications and online resources dealing with federal tax liens including information concerning withdrawal, discharge, and subordination of these liens to other taxpayer creditors.

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<sup>116</sup> *Temporarily Delay the Collections Process*. Oct. 25, 2020. IRS. [[www.irs.gov/businesses/small-businesses-self-employed/temporarily-delay-the-collection-process](http://www.irs.gov/businesses/small-businesses-self-employed/temporarily-delay-the-collection-process)] Accessed on May 7, 2021.

# 2021 Workbook