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Phantom Income: The 1099-C and How You Can Protect Yourself

Robert D. Forster, II

Author Contact Information:

Robert D. Forster, II
Barrett Daffin Frappier
Turner & Engel, LLP
Addison, Texas

robertfo@bdfgroup.com

(972) 340-7948

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By: Robert D. Forster, II

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I. Introduction

This paper provides a general overview of the federal income tax consequences to a taxpayer who receives an IRS Form 1099-C from a creditor as the result of some type of canceled debt, whether it result from foreclosure, short sale, negotiated settlement or a debt that has been dormant for at least three years with no collection activities in the last twelve months. In general, if you have cancellation of debt income because your debt is canceled, forgiven, or discharged for less than the amount you must pay, the amount of the canceled debt is taxable and you must report the canceled debt on your tax return for the year the cancellation occurs. The canceled debt is not taxable, however, if the law specifically allows you to exclude it from gross income. Not only will the events that result in issuance of an IRS Form 1099-C be addressed, but also the tax consequences, along with exclusions, exceptions and ways to combat this tax liability. Lastly, key IRS forms are attached for your reference.

II. What is a 1099-C?

a. Defined

Any financial institution, credit union, federal government agency, or entity that is in the business of lending money that cancels or forgives more than \$ 600.00 of a taxpayer's debt, must provide IRS Form 1099-C to the taxpayer upon the event that creates cancellation of debt

income. *See Form 1.* Form 1099-C is used only for cancellation of a debt the taxpayer actually incurred and not if the debt was canceled due to identity theft. Form 1099-C must be provided to the taxpayer even if the taxpayer will not be required to report any income for tax purposes.

The lender reports the cancelled debt to both the debtor and the IRS on Form 1099-C. The Form 1099-C lists the following: debtors name; social security number; date of cancellation; amount of discharged debt; whether the debtor was personally liable for the debt; lenders information; and for secured property, like a rental property or an automobile, the fair market value. As common sense would dictate, the fair market value of the secured property is hands-down the most contested issue between the debtor and the IRS.

b. What is considered canceled debt?

If you borrow money and are legally obligated to repay a fixed or determinable amount at a future date, you have a debt. When a debtor borrows money, they are not required to include the loan proceeds as debt on their tax return because of their obligation to repay the lender. However, if that obligation to repay is subsequently forgiven, the amount of loan proceeds received is then reportable as income because the obligation to repay the lender no longer exists. The debtor may be personally liable for a debt or may own a property that is subject to a debt. If the debt is forgiven or discharged for less than the full amount you owe, the debt is considered canceled in the amount that you do not have to pay. The law provides several exceptions, however, in which the amount you do not have to pay is not considered canceled debt. These exceptions will be addressed in detail later in the paper. (*See Section IV*) Cancellation of a debt may occur if the creditor cannot collect, or gives up on collecting, the amount you are obligated to pay. If a debtor owns property subject to a debt, cancellation of the debt also may occur

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